

# **Reforming insurer profit in compulsory third party (CTP) motor vehicle insurance**

Discussion paper

November 2016



# Contents

Minister's message.....	3
Introduction.....	4
CTP Scheme reform.....	5
Enhanced data collection and use of technology.....	6
Premium setting and the relationship to profit.....	7
Calculating profit.....	8
<b>Legislation and powers of the regulator.....</b>	<b>9</b>
Licence conditions .....	9
Premiums Determination Guidelines.....	9
Market Practice and Business Plan Guidelines.....	9
Investment of funds.....	9
Reports to the Minister .....	9
Regulatory and Enforcement Policy .....	9
<b>Regulatory and administrative actions being taken by SIRA.....</b>	<b>10</b>
Risk Equalisation Mechanism (REM).....	10
Additional activities being undertaken .....	10
<b>Additional mechanisms to reduce or remove insurer super profits.....</b>	<b>11</b>
Increased disclosure on profit .....	11
Profit normalisation .....	11
Caps on expenses.....	11
Abolition of the fully funded test.....	12
Make the premium review process more transparent.....	12
Use of Guidelines in setting assumptions for cost drivers.....	12
<b>Questions for consideration .....</b>	<b>13</b>
<b>How to make a submission.....</b>	<b>14</b>
<b>Next steps.....</b>	<b>14</b>
<b>Appendix.....</b>	<b>15</b>
Profit normalisation technical considerations .....	15

# Minister's message



Over the past year, the NSW Government has undertaken extensive consultation on the proposed redesign of the CTP Green Slip scheme.

In addition to feedback on the new benefits regime, two key themes emerged regarding the role of private insurers in the new CTP scheme.

First, there was a consensus view that insurer super-profits must be reined in.

An effective premium setting and risk rating system is required to prevent excess profit and deliver cheaper premiums for vehicle owners.

Secondly, it was acknowledged that private insurers operate with a profit motive and the regulator must play a role in ensuring they balance this with fairly determining and delivering a claimant's entitlement to benefits.

New independent dispute resolution and advocacy services are required to protect the rights of injured people.

Based on this important feedback, I have asked the State Insurance Regulatory Authority (SIRA) Board to conduct further consultation and make recommendations to the Government.

The Government will ensure there are appropriate legislative safeguards to address the issues of insurer profits, claims handling and dispute resolution.

This discussion paper looks at the issue of insurer profits. A subsequent discussion paper will be released shortly looking at claims handling procedures and independent dispute resolution services.

Central to the success of the new scheme is data collection. Better use and sharing of data, in real-time, will ensure the scheme operates effectively. It will encourage innovation, increase accountability and transparency, and drive greater competition between insurers.

I encourage stakeholders to provide feedback on this discussion paper to assist the NSW Government to deliver a fairer and more sustainable Green Slip scheme.

A handwritten signature in black ink, appearing to read 'Victor Dominello', with a small dot at the end.

Victor Dominello MP  
Minister for Innovation and Better  
Regulation

# Introduction

Over the life of the current Compulsory Third Party (CTP) Scheme there has been a consistent pattern of discrepancy between 'filed' and realised profits of CTP insurers.

The long-term average of realised profits is around 19%, which is more than double what insurers file for when setting their prices. These levels of realised profits are often referred to as 'super-profits'.

In March 2016, the Government released the *Report of the Independent Review of Insurer Profit within the NSW Compulsory Third Party Scheme* by the Independent Review Chair, Trevor Matthews, in conjunction with the Options Paper on the review of the CTP scheme. This was in addition to other measures that had already been adopted by the State Insurance Regulatory Authority (SIRA), including new Premiums Determination Guidelines.

The Matthews report included an examination of premium system design and competition issues as well as opportunities for improving the regulation of the Scheme.

It makes a number of recommendations for CTP scheme enhancements to strengthen the regulatory framework and improve transparency and market competition.

Action has commenced on addressing the regulatory and administrative recommendations of the profit review, and the Government has been considering the recommendations requiring legislative amendment as part of the wider review of the NSW CTP scheme.

The Government has also indicated a number of measures to ensure that insurer super-profits are brought to an end, as part of its legislative reform proposals.

This includes the proposal for a profit normalisation or 'claw back' mechanism for super-profits earned during transition, more powers for the regulator to cap and control prices, and more transparent premium review processes.

Consultation on the details and processes required to implement the Government's preferred reform model was facilitated by Nancy Milne and John Della Bosca earlier this year. Their findings were that there was general support for measures to improve competition and reduce excess profits, though further consultation was required on the detail.

Consultation on these issues will be led by the SIRA Board to consider how they are best implemented, and to canvass other ideas or views, and provide advice to the Government.

The Government would like to hear the views of all stakeholders on the best way to improve premium system design to provide fair but not excessive profit levels.

This paper focuses on reducing super profits, provides options with key considerations and presents targeted questions for discussion.

The NSW Government encourages you to have your say and let us know how we can develop a fair and sustainable CTP system that is effective for motorists and insurers.

A review of claims handling by scheme insurers and dispute resolution services is the subject of a separate discussion paper.

# CTP Scheme reform

The CTP Scheme reform objectives are to:

- increase the proportion of benefits provided to the most seriously injured road users
- reduce the time it takes to resolve a claim
- reduce the opportunities for claims fraud and exaggeration
- reduce the cost of Green Slip premiums.

The Government proposes a hybrid no-fault scheme that will introduce defined benefits for low severity injuries, retain common law for the most seriously injured and for the first time extend protection to at fault road users.

The emphasis will be on the early and quick payment of benefits, returning the injured person to optimal function and maximising their return to work.

The Government intends that the new scheme undergo a statutory review after three years to assess the impact of reforms on insurer profit margins and timeliness of benefits.

For further information, refer to On the road to a better CTP scheme: CTP reform position paper available at [www.greenslipreforms.nsw.gov.au/resources](http://www.greenslipreforms.nsw.gov.au/resources).

# Enhanced data collection and use of technology

The Government's new scheme means that payments to injured people will start soon after their claim is made, unlike the current system where the finalisation of claims can take years and it subsequently takes years before we properly know what is going on in the scheme.

This means that a proactively managed, data-driven scheme is needed, with SIRA being able to respond to trends and provide leadership within the scheme as trends emerge, essentially in real time.

As part of the Government's digital and data strategy, SIRA is embracing technology and investing in a new database that will be rebuilt within SIRA's existing Software as a Service (SAS) platform in the cloud.

The new database will consolidate CTP claims data that SIRA currently collects, introduce new datasets to the platform and enable direct feeds from insurers. SIRA will be building online lodgement systems, and improved methods for purchasing a Green Slip as part of its commitment to digital transactions for customers.

The Government has asked SIRA to join forces with the NSW State Government's Data Analytics Centre, to develop customised analytic tools that will assist in monitoring trends on an ongoing basis. The enhanced data collection capability will enable 'current time' data access and the ability to drill down to greater depths of information enabling SIRA to monitor, track, and analyse claims and insurer activities.

A data driven regulatory approach will allow SIRA to be a more agile and responsive regulator.

This focus on more timely data, coupled with the significantly earlier payment of benefits under the new no-fault scheme, will mean insurers can be held to account for many of their performance indicators within months, rather than years. In particular, it will mean that the emergence of super-profits will be identified earlier, allowing SIRA to respond and require insurers to revise their assumptions to eliminate any super profit — compared to the current system where the

realised profit margins may not be reliably known until years after the premium is written, leaving SIRA with few options.

This will further give SIRA the ability to determine more effective premium pricing and market segmenting based on more accurate risk assessment. It will also make possible the provision of relevant data such as claims lodgement, development and dispute resolution to insurers for improved efficiencies. While SIRA will be collecting data as events happen, it should be noted that the scheme still has a 'long tail' with claimants accessing defined benefits for up to 5 years and some claims having a common law component. This means some issues and trends such as claims finalisation will still take time to become clear.

The Government wants more frequent reporting to SIRA of relevant injury type, claims and CTP policy data, and the development of dashboards and data linkages to improve the responsiveness of SIRA to emerging scheme issues that impact price or claimant outcomes. Digital technologies also provide new opportunities for insurers to function in a more effective and efficient manner in meeting regulatory requirements.

Western Australia has an online crash reporting facility soon after the crash that allows the crash and any injuries to be reported immediately to the Insurance Commission and Western Australia Police so no further reporting is required. As well as using this information for starting the rehabilitation and claim process, it provides Police and road authorities with current information on accident hot spots and trends so that preventative action can be commenced sooner. The Government will be investigating the feasibility and cost benefit of introducing a similar system in NSW.

The Government will include clearer powers for SIRA in the proposed legislative reform to ensure that it gets the data it needs to be a more effective regulator and is able to publish this data to provide greater transparency for injured people and the premium paying motorist.

# Premium setting and the relationship to profit

Compulsory Third Party (CTP) is a form of insurance that every motorist must purchase prior to registering their motor vehicle. The compulsory nature means that premiums must be affordable for all motorists.

NSW CTP Insurance is underwritten<sup>1</sup> in a competitive market by privately owned insurance companies. There are currently six licensed insurers selling CTP in NSW, owned by four insurance companies – NRMA, QBE, Allianz, (Allianz and CIC-Allianz) and Suncorp (AAMI and GIO). The benefit of a privately underwritten scheme is that it promotes competition, leverages private sector efficiencies and avoids taxpayers carrying the risk of underwriting the scheme.

Insurers compete for business in the market and expect to achieve a reasonable level of profit in exchange for the business risk they accept and their capital investment.

Each vehicle owner's premium includes:

- insurers' expected average claims costs
- loadings for insurer expenses and profit margins
- application of premium relativities to determine the relevant premium for each vehicle class and district.
- bonus/malus which is a loading (malus) or discount (bonus) applied to individual policies depending on individual risk characteristics
- Medical Care and Injury Services levy (MCIS levy) which funds, for example, the Lifetime Care and Support Authority for the catastrophically injured
- GST applied to the insurers' base premium but not to the MCIS levy.

---

<sup>1</sup> Note: The Lifetime Care and Support Authority is responsible for the medical and care needs of people catastrophically injured in motor vehicle accidents. This is funded through a levy on all NSW motorists.

SIRA regulates the CTP insurance market through licence conditions but is not responsible for setting the actual CTP premiums/Green Slip prices.

Insurers must provide SIRA with a proposed set of premiums (rate filings) for SIRA to review. Price changes submitted by the insurers can only be rejected by SIRA in limited circumstances including if it is excessive, it will not fund anticipated liabilities, or does not comply with the Premiums Determination Guidelines.

As the majority of funds collected by insurers currently take 3-5 years to be paid out, they have to make assumptions and estimates about future costs at the time of setting a price and selling a policy. This is vastly different to the pricing and selling of most other goods and services where the cost of production and delivery is known at the time of pricing. The difference between this estimate and what eventuates several years later results in either a gain or loss in estimated profit.

Super profits occur when the insurers' estimates of profit in a premium filing in a given year differ substantially in favour of the insurer compared to the actual profits when the claims of that cohort are finalised.

In addition to the assumptions and estimates of future costs being incorrect there are a number of contributing factors relevant to individual insurers that lead to super profit in the scheme, including:

- the level of profit deemed acceptable to the business
- risk selection strategies
- operating practices which may lead to conservative claims pricing estimates
- claims management practices (good and poor), business costs resulting from the use, or lack of, innovation and technology.

# Calculating profit

Profit is measured by SIRA as the residual of premium collected plus investment income earned by insurers after deducting claim payments and insurer expenses.

The actual profit requirements of insurers are based on the levels of capital that insurers need to support an insurance portfolio and the return that the insurers believe they need to earn on the capital having regard to the risks involved in underwriting the portfolio. These requirements generally differ between insurers based on their overall business strategies.

Mr Matthews' report on insurer profit indicates that consultation is required to consider what the appropriate rate of return should be, having regard to the underlying risks and opportunity costs of the capital. That report reflected on profit margins in the more volatile, current system. Recent analysis by Mr Matthews, as chair of the SIRA Board, has proposed that an appropriate profit margin on filed profits in the new scheme would be 8%. Based on the proposed new scheme design, this would see less volatile profits (in a range of 4% to 12%), resulting in a rate of return on capital of around 12%, which is consistent with other schemes in the current low-yield environment (See Appendix). The Government is seeking comment on the updated analysis from Mr Matthews.

The key issue is the implementation of initiatives that will be designed to minimise, to the extent possible, the variance between the filed and realised profits of insurers. The profit review indicated that this was essential before SIRA could realistically prescribe the appropriate rate of return.

Stabilisation of the scheme through the Government's proposed reforms will assist greatly in reducing the gap between filed and realised profits. This paper outlines some other measures that are being implemented or considered to assist in closing this gap.

Importantly, the profit margins published by SIRA are estimates derived from the known expenses compared to the known revenue. This is not the same as the accounting profit that an insurer may realise, for example, to pay tax or dividends, or meet reporting obligations to the Australian Securities & Investments Commission (ASIC) or the Australian Prudential Regulation Authority (APRA). As SIRA is subject to secrecy provisions in the governing legislation, profit margins are reported on an aggregate basis, not for individual insurers. This discussion paper will consider the appropriate ways of reporting on and disclosing profit margins. Views are also sought on how profit should be defined and calculated, particularly what is included or excluded when calculating profit.



# Legislation and powers of the regulator

## Licence conditions

Insurers are licensed under the *Motor Accidents Compensation Act 1999* (the Act). The Act allows for the imposition of licence conditions and for SIRA to develop and issue enforceable Guidelines.

## Premiums Determination Guidelines

SIRA has issued guidelines for the determination of insurance premiums for third-party policies, the *Motor Accidents Premiums Determination Guidelines*. It is a condition of an insurer's licence that it complies with these Guidelines.

The Premiums Determination Guidelines:

- specify the manner in which premiums are to be determined and the factors to be taken into account in determining premiums
- require licensed insurers to specify how they have determined premiums
- specify the nature of the additional information and reports that SIRA may require licensed insurers to furnish with the premiums they file or to justify premiums they have filed
- enable SIRA to request reports on any aspect of their market practices (including with respect to estimated investment earnings, the verification of assumptions, estimated profit, and capital allocation to third-party insurance business).

## Market Practice and Business Plan Guidelines

These Guidelines outline the principles to be used when administering or renewing CTP policies and describe how the insurer's third-party insurance business is to be conducted (including claims handling, management, expenses and systems).

The Act also requires that insurers must prepare and deliver to SIRA a business plan for its third-party insurance business at least every 12 months or when directed by SIRA.

They must conduct their business in accordance with their current business plan.

## Investment of funds

The Act provides that it is a condition of a licence that the insurer, if requested to do so, provide SIRA with details of the way in which its third-party funds (derived from the payment of insurance premiums and from their investment) and other funds are invested.

## Reports to the Minister

SIRA can send reports to the Minister relating to the level of compliance by insurers with any requirements of the Act or licence conditions, guidelines under the Act or complaints made about insurers. A report may identify particular insurers and the Minister may table the report in Parliament or make it public.

## Regulatory and Enforcement Policy

The Regulatory and Enforcement Policy provides a framework for dealing with minor and major non-compliances by CTP insurers. Non-compliance may involve, for example, contravening a licence condition or an issue relating to payment and collection of the MCIS fund levy.

# Regulatory and administrative actions being taken by SIRA

The below actions are being undertaken by SIRA through administrative or regulatory means to reduce the likelihood of CTP insurers making super profits and to encourage competition in the CTP insurance market.

## Risk Equalisation Mechanism (REM)

As the premium framework imposes cross subsidies, within an insurer's individual portfolio, to ensure CTP is affordable for all motorists regardless of their risk level, insurers often try to avoid underwriting certain segments of the market where the premiums are considered inadequate in relation to the risk. Insurers writing a large proportion of lower risk policies such as new cars can realise increased profits from their market share, while insurers writing higher risk policies, such as for young drivers, will often experience reduced profits.

A REM is being introduced for Class 1 & 3c vehicles to better distribute these risks among all insurers<sup>2</sup>. SIRA is proposing to introduce this from May 2017. This mechanism, which will operate in conjunction with the premium relativities published by SIRA, will include age of vehicles, age of owner and certain postcodes where there is a claims hot spot. This will remove the competition between insurers to avoid the high risks and address differences between insurer profits.

With a risk equalisation mechanism (sometimes called risk pooling), premiums are paid into a pool and redistributed to insurers by a clearing house mechanism on a risk basis and adjustments can be performed as frequently as required to ensure no unintended consequences. The REM works in the background and is not visible to consumers.

The advantage of a REM is that it removes the likelihood of an insurer attracting too many high risk customers by spreading the risks across all insurers.

As a result, profits and losses from either end of the risk spectrum are more equally shared across insurers.

## Additional activities being undertaken

### Additional commercial vehicle rating changes

It is proposed to expand the bonus/malus (discount/loading) range for commercial vehicles to increase competition, especially among lower risk vehicles and fleets. Currently, the maximum discount does not reflect the actual risk which results in insurers making excess profit on these policies. It also has the advantage of reducing the level of cross-subsidy in that vehicle class so that businesses that manage their risks well are not subsidising competitors who are higher risk.

### Review premium relativities for the current scheme

A review of premium relativities is being undertaken to ensure that vehicle classes are being charged the correct premium and that changes in claims experience have not resulted in inadvertent cross-subsidies between geographic zones and vehicle classes, leading to super-profits for insurers that are able to acquire more of the better risks.

In particular, it is proposed to introduce a new class for new cars (or require that these be offered at the maximum allowable bonus). This will protect the interests of new car buyers who find it harder to shop around for the best price, and reduce the significant ongoing profits that insurers make by locking in car dealers on long term, exclusive contracts.

### Market Practice & Business Plan Guidelines

The Market Practice and Business Plan Guidelines outline principles to be used when administering or renewing CTP policies and describe how the insurer's third-party insurance business is to be conducted. In light of the changes outlined above, the Guidelines will be updated. Changes will be incorporated to improve the visibility and reporting of profit.

---

<sup>2</sup> Class 1 is a vehicle such as a motor car used for movement of passengers, with 9 or less seats, class 3c is a goods vehicle with a Gross Vehicle Mass of 4.5t or less.

# Additional mechanisms to reduce or remove insurer super profits

While the changes outlined above will go some way to better identifying and subsequently reducing super profits, the Government is considering whether these measures alone are sufficient to address super-profits. As part of consideration of any legislation for reform, the Government seeks feedback on the measures below, and any other ideas, to better regulate premiums and reduce insurer super-profits, which can be considered in any legislation reforming the scheme.

## Increased disclosure on profit

Through Regulation and Guideline changes, the Government has asked SIRA to consider options that would allow for greater disclosure by insurers when setting premiums and the communication of this to both SIRA and vehicle owners.

For example, the Government would like SIRA to consider publishing annual profit by insurer along with other scheme metrics to provide an indication of how individual insurers are performing. If this is to occur, legislation will need to be amended to allow individual profit levels to be disclosed.

A consolidated report on profit levels will also be published by SIRA

## Profit normalisation

The Government is proposing in its legislative reform package to include a profit normalisation, or 'claw back' mechanism to ensure super profits are dealt with or removed, particularly when moving to a new scheme.

There are significant uncertainties when moving to a new scheme (e.g. there may be a lag in the lodgement of claims through unfamiliarity with the scheme) which may lead to profits or losses for insurers different to the profit margins that they filed (estimated). During transition to the new scheme, it is considered prudent to apply a profit normalisation mechanism, which could be maintained as a reserve power for managing any super profits that may still emerge in the future.

Views are also sought on whether that mechanism should be retained beyond a transition period.

Profit normalisation would occur retrospectively based on the difference between what insurers thought would happen when prices were initially set and what actually occurred as measured at some later time. It has been suggested that any profit normalisation should be undertaken on an industry basis, without regard to the financial results of individual insurers. This enables insurers to maintain innovation and incentives to improve management of claims, reduce expenses and file for competitive premiums.

There are a number of technical elements in the development of a profit normalisation mechanism. These are outlined in the Appendix for consideration and feedback.

## Caps on expenses

The Government is proposing to introduce legislated caps on expenses in premiums, including particularly acquisition costs and commissions paid to intermediaries. It should be noted that in a compulsory scheme, an underlying demand is created without the need for insurers to expend significantly in securing new customers.

On the one hand, depending on their design, such caps can act to stifle competition in the market and can create perverse pricing incentives, but on the other hand it can also put downward pressure on premiums. In some jurisdictions, commissions to intermediaries have been abolished entirely. Views are sought on approaches and limits in capping expenses and limiting or removing commissions that can be claimed in premiums.

## **Abolition of the fully funded test**

The current Act requires insurer filings to be fully funded, presumably to help ensure that there are no market failures. This has had the effect of inflating insurer filings so that they are overly conservative – that is, there is very little chance of the insurer making a loss.

This was identified in the Matthews report as contributing to super-profits, while it appears unlikely to prevent the failure of an insurer (which would fail because of their overall portfolio, not specifically CTP). APRA's robust regulation of the insurance industry helps to minimise this risk and so the Government is proposing to abolish the fully funded test in any legislative reform package.

## **Make the premium review process more transparent**

The current premium review process is opaque, in order to protect insurer's commercial data. Yet other regulated markets operate where there is greater public disclosure and scrutiny over many aspects of the price setting process, even in competitive markets with private corporations. In such markets, it is up to the company seeking a price increase to make the case to the satisfaction of the regulator, not that the regulator needs to prove that the proposed price is not acceptable (which is what happens now in CTP). On the other hand, the current system promotes competition, avoids inappropriate regulatory interference in price setting, and allows insurers to be open with the regulator.

The Government proposes that steps should be taken to open the pricing process to greater scrutiny, with more information being published by SIRA after a premium decision is taken. The Government is also considering giving SIRA an approval power over premiums rather than a power of objection, in line with the findings of the Matthews report.

## **Use of Guidelines in setting assumptions for cost drivers**

It is proposed to give SIRA guideline making power to set expectations or limits in premium setting around assumptions for cost drivers such as superimposed inflation (see note below), investment returns and claims frequency. While this would have a minimal impact on premiums for most insurers, it will promote greater transparency.

# Questions for consideration

1. What concerns or risks do you see with the proposed actions to reform the premium system?
2. What are your views on the proposed approach to profit normalisation?
3. Should the definition of appropriate insurer profit levels be set by SIRA, and if so what considerations should be included?
4. Which mechanism(s) do you believe are best to distribute premium super profits back to motorists? Why?
5. If insurers make a loss, should they be compensated in a profit normalisation framework? How?
6. Should a tolerance level (eg x%) above or below the targeted profit be considered? If so, what would be an acceptable tolerance level?
7. What should be done for the insurer who adopts innovation, operates efficiently and makes extra profit as a result of their endeavours?
8. What advantages/disadvantages do you see in annual reporting on individual insurer profit by SIRA?
9. What advantages/disadvantages do you see in increased transparency in the premium setting process, including making SIRA an approval authority?
10. Should there be exclusions, caps, limits or controls on acquisition expenses, including commissions to intermediaries?

# How to make a submission

The SIRA Board will facilitate consultation on behalf of the Government and welcomes comment and feedback from all stakeholders.

The preferred format for a response to this discussion paper is via a written submission.

Written submissions should be emailed to SIRA at [ctp\\_review@sira.nsw.gov.au](mailto:ctp_review@sira.nsw.gov.au) by close of business Friday 25 November 2016.

Written submissions may be published on the SIRA website. If you do not want your submission or any part of it published, you must clearly indicate this at the time of submission, however, the Government reserves the right to publish submissions in the public interest.

## Next steps

The SIRA Board will hold stakeholder discussions around this paper and review submissions to prepare a summary of the feedback received.

The information provided through this consultation process will be submitted to Government and used to

develop the legislative and regulatory options for consideration by Government in the reform of the CTP Scheme.

Submissions, questions or enquiries relating to this discussion paper should be emailed to [ctp\\_review@sira.nsw.gov.au](mailto:ctp_review@sira.nsw.gov.au).

# Appendix

## Profit normalisation technical considerations

### 1. What should be measured?

It is important that existing insurers are able to make sufficient profit to stay in the market, potential new insurers see value in the market and there are still incentives for insurers to innovate and reduce operating costs. It is proposed 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.

### 2. How will profit be measured?

A particular issue is whether insurers will need to file auditable returns (ie actual claims costs and expenses relative to actual revenue), or whether it is sufficient to base the calculations on filings and expected expenses. Another issue is whether insurers will be able to ask for a review of calculations, or what verification process will be used in making the calculations. It is proposed to adopt a requirement for auditable returns, but giving rights for insurers to ask for a review of the regulator's decision.

It is also proposed to apply profit normalisation at an industry level, but it is recognised that this may disadvantage some insurers who did not realise a super-profit.

### 3. When should profits be measured?

SIRA proposes that assessments of total claims costs start to be made progressively once the new scheme benefits start, though it may take up to about 18 months for clear trends to start to appear.

As there will still be common law claims, it is estimated that up to two or three years will be needed before a reasonably accurate assessment can be made of the claims costs for the first year of the new scheme. Also, it is possible that at the three-year point a reasonable estimate could be made for the second year's claims costs. However, a delay in applying profit normalisation may be a point of criticism by stakeholders.

It is proposed to start assessing claims costs immediately the new scheme starts for the purpose of profit normalisation with a review in

the first and second year and an assessment applied at the end of year 3. This approach would provide a balance between the need for timeliness and certainty for insurers versus the need to allow for experience to develop to ensure accuracy. However, it could lead to perverse behaviour to shift costs (either before or after the cut off), and it may mean that claims settled after that (eg some common law claims) would not be picked up under profit normalisation.

It is proposed that the profit normalisation provision could be extended or reactivated by regulation, should profits not stabilise or super-profits re-emerge.

### 4. Is it a two sided test or a one sided test?

A two sided test is one where excess insurer profits and significant insurer losses are both contemplated in the profit normalisation mechanism. A one sided test is where only excess insurer profits are dealt with and insurer losses are absorbed by insurers.

A one-sided test is simpler to design and implement, however it may result in adverse insurer behaviours in terms of financial reporting.

A two-sided test would give insurers a greater incentive to file for 'best estimate' rather than conservative prices. A two-sided test is therefore favoured as it best avoids super profits at the point of sale, rather than a later adjustment.

### 5. What are the parameters of the test?

An important question is what profits/losses should insurers keep/wear, and how much is subject to profit normalisation.

It is considered important that any mechanism retains incentives for better performing insurers to be more efficient and innovative.

SIRA has considered an option in which there is a 'hard cut off' (cap/floor) so that all profits above a certain amount (or losses below a certain amount) are included in profit normalisation.

However, there are concerns that this may create incentives to either make losses, apply poor underwriting and acquisition principles, or not be innovative. There is an alternative in which both gains and losses are recouped on a graduated basis. For example, profits above certain thresholds could be reduced by set percentages in profit margin ranges.

For example, an additional 3% of profit may be acceptable to encourage efficiencies, however if profit exceeds this a 50% normalisation may be applied. The converse may apply to losses.

## 6. How would excess profits or significant losses be managed?

SIRA is of the view that once the level of 'claw back' is determined, it should apply to future premium decreases or increases so that there is a form of catch up in premiums.

SIRA acknowledges, however, that this may make it hard for a new entrant (see next point) and create distortions and complexity in the market place. Another option is for refunds to be made directly to vehicle owners, but this would be difficult to administer and would not deal with losses. Another option is that it is paid to SIRA and 'paid back' to road users in levy reductions but again it would not deal well with losses. Alternatively, the funds could be

directed towards a public purpose such as road safety, however it may then take on the characteristic of a form of taxation on super-profits rather than an adjustment to premiums.

## 7. What are the implications if insurers enter or exit the market?

If profit normalisation is made at an industry level, are there implications if, for example, a highly profitable insurer leaves the market before normalisation can be applied. It is proposed that SIRA should have power to impose a levy on an insurer that notifies its exit.

Special arrangements will also be made when a new entrant who did not share in past profits comes into the market (such as a reserve power to manage the claw back through the levy).

### Disclaimer

This publication contains information that relates to the motor accident third party (CTP) insurance in NSW. It may include details of some of your obligations under the scheme that the State Insurance Regulatory Authority (SIRA) administers. However to ensure you comply with your legal obligations you must refer to the appropriate legislation as currently in force. Up to date legislation can be found at the [NSW Legislation website](#).

This publication does not represent a comprehensive statement of the law as it applies to particular problems or to individuals, or as a substitute for legal advice. You should seek independent legal advice if you need assistance on the application of the law to your situation.

This material may be displayed, printed and reproduced without amendment for personal, in-house or non-commercial use.

ISBN 978-0-7347-4513-2

Website: [www.greenslipreforms.nsw.gov.au](http://www.greenslipreforms.nsw.gov.au)

© State of NSW