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CTP Review
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Response to "Reforming insurer profit in CTP" discussion paper

The Actuaries Institute welcomes the opportunity to submit comments in respect of the State Insurance Regulatory Authority's (SIRA's) November 2016 discussion paper titled "Reforming insurer profit in compulsory third party (CTP) motor vehicle insurance".

Background

A 2013 Government review of the NSW CTP market led to scheme reform recommendations, aiming to:

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

Further, following stakeholder feedback in relation to recent levels of insurer profits within the market, the NSW Government has released a discussion paper outlining a number of reform measures designed to prevent excess profit and deliver cheaper premiums for vehicle owners. The proposed reform measures include:

- profit normalisation across insurers;
- introduction of a risk equalisation mechanism (REM) for class 1 and 3c vehicles, proposed to be introduced from May 2017;
- expansion of the bonus/malus range for commercial vehicles;
- introduction of a new class for new cars;
- increased transparency of the premium review process;
- individual insurer profit reporting;
- abolition of the fully funded test;
- investment in better collection, use and sharing of data;
- increased power for SIRA to cap and control expenses;
- provision of premium approval power to SIRA (rather than the power of objection); and
- provision of guideline making power to SIRA around certain aspects of premium assumption setting such as super-imposed inflation rates and investment returns.

SIRA is seeking feedback on these proposed reform measures.

Actuaries Institute Comments

We fully support the Government's scheme reform objectives and, in particular, recognise the need to ensure premiums remain affordable for motorists.
The following are important considerations which need to be balanced in determining fair and reasonable premiums for the NSW CTP scheme:

- affordability for motorists;
- fairness for motorists;
- transparency and simplicity;
- financial sustainability; and
- attractiveness to insurers.

With these in mind, we outline below our thoughts on the proposed reforms, designed to mitigate against future excess profits.

Impact of increasing regulation

The majority of proposals outlined in the discussion paper involve using an increased level of regulation to reduce profit. In addition, many of the proposals outlined add complexity and cost to the scheme and a balance must be drawn between the cost and added value of each proposal.

Excessive or unnecessary regulation can obstruct an efficient market from functioning and can undermine the public interest. Some key elements of good regulation include:

- proportionality – between the regulatory solution and the problem that it intends to solve; and
- appropriate regulatory tools – considering a range from self-regulation to prescription, where appropriate.

Making the NSW CTP scheme run as efficiently as possible will be critical to containing the cost of future premiums. Therefore, due consideration must be given to the adverse impacts of increasing regulation in the NSW CTP market.

Context for past high levels of profit

In estimating the future costs of long tail business, actuaries give consideration to both observed historic data and the social environment in which the data was developed, together with a forward looking view of how historic trends may or may not continue and how the social context may also change.

In the NSW CTP scheme, recent significant increases in fraud and utilisation for medium size claims is an example of the type of emerging social trend, possibly leading to superimposed inflation (i.e. inflation over and above economic inflation), to which the actuary must give consideration.

The period over which high hindsight insurer profits have been observed in the current scheme has been one of significant change. Technology has had multiple impacts; both decreasing and increasing the financial costs of the scheme. Safer cars, increased safety laws and safer road design have reduced the frequency and often the severity of transport accidents. Offsetting this has been improved, but more costly, medical technology and ambulance services. The scheme has operated through the impacts of 9/11 on world capital markets, the implications of the HIH collapse and the changed societal expectations (including the Ipp reforms), a period of sustained economic growth in Australia and then the GFC with its plunging interest rates.

Whilst the hindsight cost of the scheme has been better than originally assumed, the more recent higher frequencies have highlighted the downside risks when setting premium rates.

Specific comments on key proposed reform measures

- **Profit normalisation**

Changes to the core benefit design of the CTP system increase the uncertainty in pricing and therefore increase the variability and unpredictability of insurer profit.

The Actuaries Institute understands the Government's need to have some level of assurance around profit levels in a newly reformed scheme and supports the introduction of some form of profit normalisation for a limited period. However, permanently having this option available would lead to inefficiencies in the scheme and suboptimal outcomes as well as leaving insurers exposed to subsequent governments utilising it in a manner inconsistent with its intent.

The design of the profit normalisation mechanism needs to be considered in conjunction with the overall benefit design of the scheme.

As identified within the discussion paper, the following aspects need to be carefully considered in determining the viability of a profit normalisation or clawback mechanism. These include:

➢ the treatment of loss making insurers; would they be excluded from the clawback mechanism, or receive a share of the redistributed excess profits of other insurers? Would their treatment under this mechanism depend on the extent to which they contributed to their own losses through, for example, ineffective claims management and, if so, how would that be determined?

➢ the treatment of innovative, efficient insurers; a sustainable CTP scheme relies on insurers being motivated to continue to look for ways to improve performance.

➢ how excess profits might be redistributed to motorists and the impact on price volatility and customer expectations.

The parameters of a profit normalisation mechanism are also important. We note that both a one-sided and two-sided test are presented as options in the discussion paper, with boundaries set relative to the expected profit level. In considering the right level of boundaries to set, it should be noted that once insurers recognise that profits or losses are beyond the boundaries, the incentive to manage claims to reduce costs changes.

On the question of when profits should be measured, the discussion paper suggests that a reasonable estimate of earned profit could be made three years after the commencement of the new scheme. However experience of other personal injury schemes suggests that a much longer time horizon can be needed to accurately estimate profitability, particularly when a common law element remains in the scheme. In addition, statutory benefits can be payable up to five years and beyond in some cases and the full experience of these payments will not be well understood three years after the commencement of the scheme. Under a profit normalisation mechanism, it would be important to allow reassessments of past profit estimates as more experience unfolds.

- **Risk equalisation mechanism**

We agree that a risk equalisation mechanism could (at least temporarily) help to prevent insurers making excess profits by skewing their portfolio to less risky motorists. A similar mechanism has operated within the private health insurance industry since 2007 (and in various other forms prior to that).

It is worth noting that the improving sophistication of data analytics will make it easier over time for insurers to use enhanced data to identify and attract customers who are likely to be more profitable, even after adjusting for such a mechanism. This brings into question whether a risk equalisation mechanism would have more than just a short term impact.

Consideration would also need to be given to the added complexity (and therefore reduced transparency) that such a mechanism adds to premium determinations, particularly if coupled with a profit normalisation calculation.

- **Expansion of the bonus/malus range for commercial vehicles**

The Actuaries Institute supports pricing according to risk, where this does not create social justice issues. Generally, the application of risk pricing to commercial operations encourages greater risk management and hence better outcomes.

The Actuaries Institute therefore supports the proposal to expand the bonus/malus range for commercial vehicles.

- **Introduction of a new class for new cars**

The Actuaries Institute does not have a strong view on this proposal.

- **Abolition of the fully funded test**

It is our view that the existing fully funded test provides an objective measure by which SIRA can determine the appropriateness of filed premiums. We believe that if the underlying experience of an insurer remains stable, premium rates should also remain stable. In an environment without a fully funded test, there is a risk of premium instability, driven by political factors rather than underlying claims experience.

As outlined in the discussion paper, there is also a risk that the fully funded test leads to overly conservative assumptions being made to ensure premiums pass this test.

In the absence of a fully funded test, we would recommend an alternative objective measure be adopted to ensure both stability of premiums and transparency of the premium approval process. Such a test may be related to ensuring a premium is sufficient to cover at a minimum the claims and expense costs of the policy, effectively allowing insurers to complete on profit margins whilst still providing an objective minimum against which any regulatory or approval can be assessed against.

- **Increased transparency of the premium review process, individual insurer profit reporting and investment in better collection, use and sharing of data**

We applaud the Government's commitment to invest in digital technology to both improve efficiency in data collection and better understand unfolding trends through the adoption of customised analytics tools.

However, while the commercial value of privately collected data can spur innovation and economic growth, there is a natural friction between the benefits of innovation and competition and the need to preserve intellectual property and provide reasonable compensation to those that collect and store data.

It should be recognised that CTP insurers in the NSW market collect data for commercial value and will only collect new data where the estimated value exceeds the cost of collecting, storing and analysing the data. That equation would be fundamentally altered if the perceived commercial value to the insurer is eroded by forced sharing.

In our 6 September 2016 submission to The Productivity Commission on this topic, we recommended the development of a framework that assesses the balance between public good and commercial advantage that may flow from sharing private data. SIRA may also wish to consider the development of such a framework.

- **Power to cap and control expenses**

The Actuaries Institute does not have a strong view on this proposal.

- **Premium approval power**

As mentioned above in relation to the proposal to remove the fully funded test, any regulatory power to approve or deny filed premiums should be against an objective test to ensure all stakeholders understand the rules by which the scheme operates.

Whilst the Actuaries Institute does not have a strong view on this proposal, we note that healthy competition should keep insurer profits at a reasonable level.

- **Assumption setting guideline making power**

It is difficult to set individual assumptions in isolation from other assumptions in an actuarial model. For example, in determining an appropriate level of super-imposed inflation, consideration must also be given to the items that have already been allowed for in the "normal" level of inflation assumed. To illustrate this point, if the award rate for attendant care providers increases significantly, it is not obvious whether that increase should be captured in "normal" or "super-imposed" inflation assumptions.

It can also be problematic to set assumptions such as rates of super-imposed inflation and investment returns for the industry as a whole, without due consideration to the underlying factors driving performance of individual insurers. For example, different insurers may utilise different networks of medical providers and may have experienced different past levels of super-imposed inflation, therefore justifying differing assumptions about future super-imposed inflation. Similarly, the asset classes held and investment strategies adopted by individual insurers should form the basis for adopting reasonable future investment return assumptions. Consideration to these points should be given in determining whether it is appropriate to set industry wide assumptions and the extent to which insurers will be mandated to adopt these assumptions.

- **Suitable insurer profit levels**

Suitable levels of profit should only be determined once the benefit design has been agreed and, at a minimum, APRA's required capital levels are understood.

The Actuaries Institute would be pleased to discuss this submission with SIRA. Please contact our CEO David Bell on [redacted] or via email [redacted].

Yours sincerely,

(Signature removed)

Lindsay Smartt
President