SIRA review of the Nominal Insurer liability valuation as at December 2018

September 2019

NSW GOVERNMENT

Contents

1. Executive summary

The State Insurance Regulatory Authority (SIRA) reviews the six-monthly actuarial reports on the Nominal Insurer liability valuation and publishes reports on the SIRA assessment of key valuation risks. SIRA has reviewed the Finity Report on the actuarial valuation of the insurance liabilities for the NSW Workers Compensation Nominal Insurer as at 31 December 2018.

The valuation reflects an assessment of outstanding insurance liabilities at a specific point in time, based on all information then available. It should be noted, however, that valuing insurance liabilities is a difficult and complex exercise, particularly for long-tail insurance schemes like workers compensation; and estimates are based on a range of assumptions and therefore inherently uncertain. Caution is warranted when interpreting valuation results; and regard should be had to medium- and long-term trends, as well as valuation-to-valuation fluctuations in assets and liabilities.

The funding ratio for the Nominal Insurer reported in the December 2018 valuation was 110.8% based on a probability of sufficiency (PoS) of 75%. This is a decline in funding ratio from 118.0% at December 2017. The reduction in this valuation is driven by an increase in outstanding claims liabilities, under-collection of premiums, and lower than expected investment returns, among other factors detailed in this review.

The funding ratio remains below the target funding ratio of 115-135% of assets over expected liabilities set by the icare Board in November 2018.

This report considers the main drivers of the decrease in funding ratio from December 2017 to December 2018 and areas of uncertainty in the valuation, including:

- The persistent trend of above-inflation medical cost increases;
- The distribution of whole person impairment levels;
- The proportion of eligible injured workers who elect to pursue Work Injury Damages; and
- Changes to the economic outlook and the associated impact on investment returns.

The report also notes that key anticipated benefits of the new icare claims model have yet to be realised, which will likely impact claims experience modelling over future valuation periods.

SIRA has identified data and performance issues relating to the Nominal Insurer's (NI) delivery of return to work outcomes. SIRA has convened a Joint Claims Assurance Committee to actively monitor the NI's return to work performance improvements.

2. The Review

2.1 Context

SIRA has reviewed the report on the actuarial valuation of insurance liabilities for the NSW Workers Compensation Nominal Insurer managed by icare as at 31 December 2018.

The impact of the 2012 and 2015 legislative amendments have become clearer in recent valuations, particularly the impact to the section 39 cessation of weekly payments, introduced in 2012. While there remains some uncertainty about the number of section 66 and Work Injury Damages lodgements, that uncertainty is reducing.

icare has continued its significant transformation strategy, which includes development of a single IT platform for workers compensation matters, implementation of a new claims triage model, and transition to fewer scheme agents with one predominant scheme agent (EML). These transformation initiatives are impacting employer and worker experience.

SIRA has identified NI data and return to work performance issues. In response, SIRA has established a Joint Claims Assurance Committee with the NI to actively monitor return to work improvements.

2.2 Valuation of insurance liabilities

The purpose of the six-monthly valuation of insurance liabilities is to determine an appropriate financial provision for future claim payments. The valuation articulates the amount of assets that need to be set aside today, earning interest, to pay all future costs associated with claims expected to accrue as at the date of the valuation.

The ultimate number and cost of claims that accrue as at the date of the valuation will not be known for many years. This is one of the primary uncertainties associated with valuing insurance liabilities. Some claims may be lodged late, and the average duration of claims is not certain. Some injured workers continue to receive weekly benefits to retirement age and some may receive medical benefits for life.

Valuations are by their nature complex, and a wide range of assumptions are made in their preparation. The current valuation is prepared on the basis of a 75% probability of sufficiency (PoS). That is, there is a 75% likelihood that the level of assets will be adequate to meet future claims. It should be recognised that because the valuation seeks to estimate assets required over a very long time period, there is a high degree of uncertainty; and there are likely to be variations from one valuation to the next. This review seeks to explain some of these variations.

Insurance liabilities are first estimated as an 'unbiased' central estimate, which has an equal chance of being either too high or too low, in hindsight. This reflects a 50% PoS. In estimating an appropriate provision for insurance liabilities, the following elements are adopted that implicitly introduce a degree of conservatism:

- **Discount rate:** Under Australian Accounting standards (AASB 1023), claims liabilities must be discounted using a risk-free rate, such as the long-term

Commonwealth bond yield rate. This implies that assets set aside to meet liabilities generate income at the risk-free rate (irrespective of whether assets are invested in classes expected to generate a higher return).

- Risk margin: The Australian Prudential Regulatory Authority (APRA) requires insurers to apply a risk margin to increase the PoS to at least 75%. This is a statistical measure of the level of confidence that the funds put aside to pay claims will be sufficient to cover the claims costs when they need to be paid. Some insurers adopt a more stringent PoS standard, such as 80%, 85% or even 95%.

The valuation actuary estimates the risk margin that needs to be added to the central estimate of insurance liabilities to increase the PoS to the level specified by the insurer.

SIRA requires icare to report the funding ratio at 75% PoS. This is discussed further below.

2.3 Capital and funding ratio

Australian general insurers regulated by APRA are required to hold a minimum level of capital. This is referred to as the Prudential Capital Requirement (PCR). The principal purpose of the PCR is to protect policyholders and claimants from insurer insolvency, which, if it occurred, would leave these parties financially disadvantaged.

The capital level prescribed by APRA is risk based, in that the amount of capital required is commensurate with the individual characteristics of an insurer's exposure and the risk characteristics of its assets and liabilities, as well its level of insurance operational risk and concentration risk. The resulting capital requirement aims to ensure that there are sufficient assets to survive a 1 in 200-year failure event.

Reflecting a low risk tolerance (appetite) for default in any one year (even at a 1 in 200-year level) and the desire to maintain a high grading from rating agencies, Australian general insurers typically hold a substantially larger capital buffer than the minimum specified under the APRA PCR methodology. Private general insurers regulated by APRA typically maintain buffer capital in the order of 65% in excess of insurance liabilities (equivalent to a funding ratio of 165%), and many general insurers set their insurance liability provisions using a PoS higher than the minimum of 75% required by APRA. It is a decision for each insurer's board to determine an adequate level and quality of capital that reflects the scale, nature, complexity and risk profile of the insurer.

In November 2018 icare published a capital management policy for the Nominal Insurer following endorsement by the icare Board. This policy defines for the Nominal Insurer risk tolerance, capital targets, and action plan and review requirements.

The capital management policy states that:

- an appropriate target capital ratio is 123% (previously 127%)
- an appropriate minimum capital requirement is 100%
- the target operating zone is 115-135% (previously 120-140%)
- the funding ratio reporting and monitoring for the capital management policy will be based on 75% PoS.

Nominal Insurer funding ratio at 75% PoS (Jun 2016-Dec 2018)

Report	Funding ratio
Jun 2016	127%
Dec 2016	115%
Jun 2017	119%
Dec 2017	118%
Jun 2018	118.5%
Dec 2018	110.8%

The Capital Management Policy states that if the funding ratio falls below the target operating zone, icare management will formulate an action plan, with the aim of returning the funding ratio to the target zone within five years. At December 2018, the level of assets is $18.7 billion. A funding ratio of 110.8% implies assets of $1.8 billion in excess of liabilities.

The current funding ratio is below 115% and therefore outside the updated target operating zone set out in the capital management policy for the Nominal Insurer.

Based on the projection provided in the most recent premium filing, icare expects the funding ratio to recover to the minimum mandated range of 115% in June 2022.

2.4 Results

Valuation of insurance liabilities as at 31 December 2018

Component of valuation	December 2017 valuation of insurance liability ($ billion)	December 2018 valuation of insurance liability ($ billion)
Net central estimate of outstanding claims liability (OCL)	12.335	13.056
OCL risk margin for 75% PoS (11.5% of net central estimate)	1.419	1.501
Net central estimate of premium liability (PL)	1.224	1.340
PL risk margin for 75% PoS (10.5% of net central estimate)	0.129	0.141
Total	15.107	16.038

2.5 Key experience drivers, risks and uncertainties

The key change in the Nominal Insurer financial position is an increase in the total value of insurance liabilities from $15.107 billion at December 2017 to $16.038 billion at December 2018. Assets have largely remained unchanged in this period. However, actual collected premium has continued to be below breakeven premium.

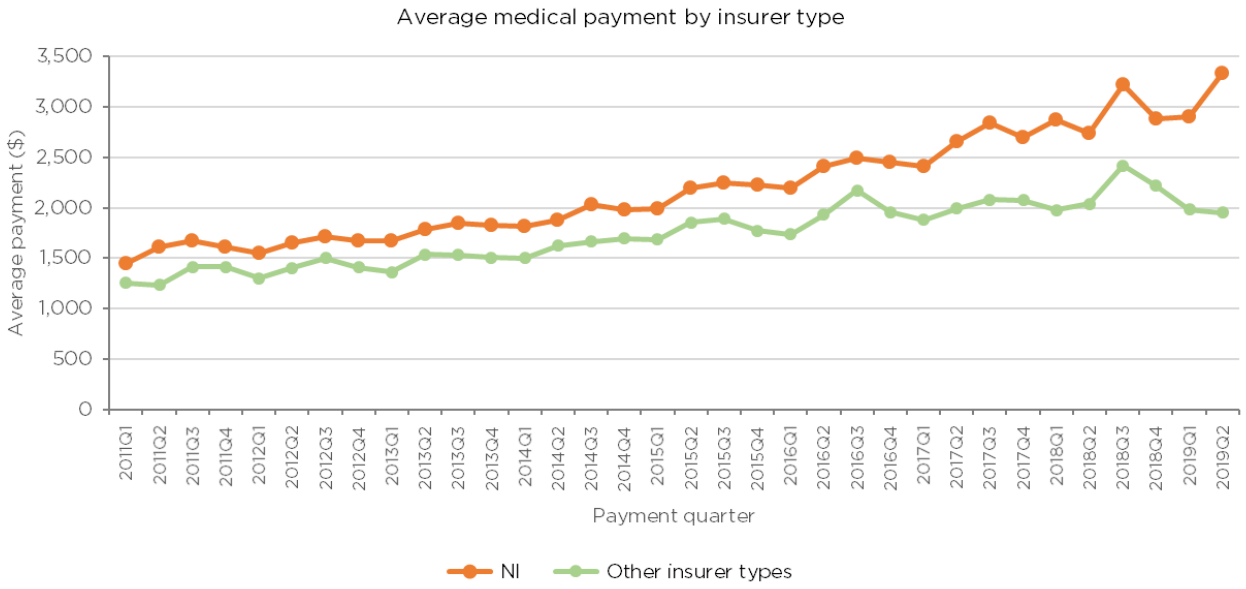
Drivers and risk associated with the increase in liabilities are set out below.

Increases in medical costs

The December 2018 valuation continues to show significant upward trends in the Nominal Insurer's medical costs, both in terms of the total volume of medical services and the average cost of services. Additionally, the number, type and complexity of medical services appears to be increasing on a per-claim basis, leading to higher overall medical expenses.

The level of medical inflation is significantly higher than normal average weekly earnings inflation and higher than forecast in previous valuation reports. The December 2018 valuation includes an assumption that medical costs inflation will continue at the same above-average rate for the medium term, which increases the expected future medical costs for existing claims. This is a source of risk and uncertainty.

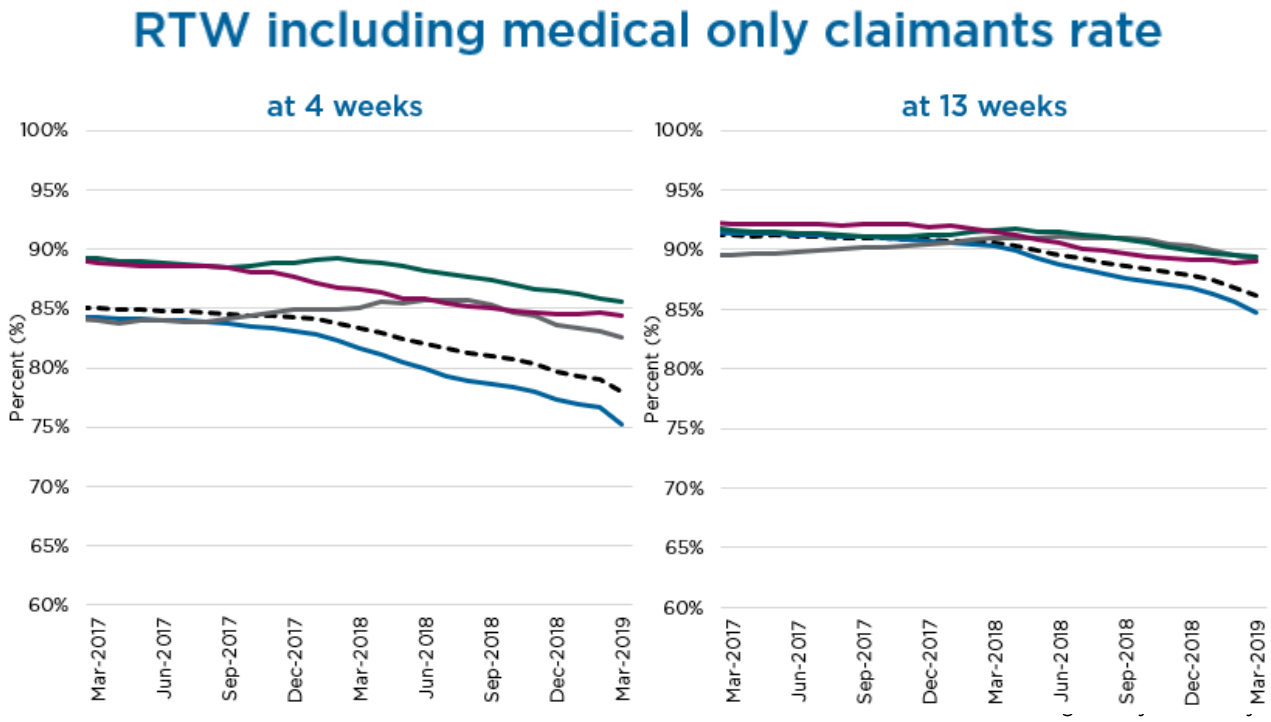
SIRA has identified that the average medical payment per claim incurred by the NI, is significantly higher than the average medical claims cost for other insurer participants.



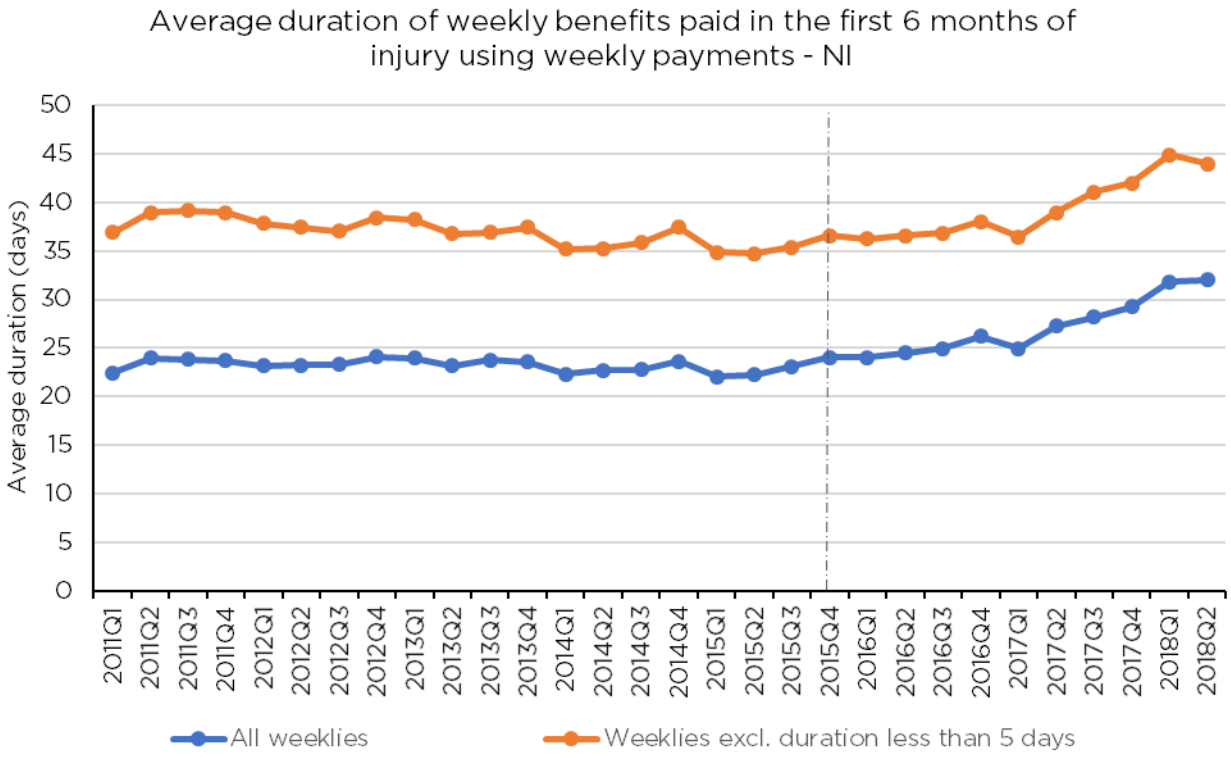
Deteriorating early return-to-work performance

icare implemented a new claims service model on 1 January 2018. Under the new model claims are triaged into streams with different claims management approaches. In addition to the new claim triage approach, icare made changes to scheme agent arrangements from 1 January 2018, with a single scheme agent now managing the majority of the new claims in the Nominal Insurer portfolio. This transition has been a significant operational undertaking for the Nominal Insurer and return-to-work benefits are yet to be realised.

The return to work (RTW) outcomes, is a key metric that was considered as part of the Compliance and Performance Review of the Nominal Insurer. An observed deterioration in the NI's RTW performance, was one of the factors that led to SIRA initiating the Review. As illustrated in the below graph, the deterioration coincides with the introduction of the new claims model. There was a further deterioration following the launch of the Nominal Insurer Single Platform (NISP) system (February 2019). The findings of the Review are scheduled to be published in late 2019.



As illustrated in the below table, the average duration of weekly benefits paid to injured workers in the first 6 months of a claim has trended upwards since early 2017.



The RTW measure has a direct correlation to both weekly payments and medical expenses. These two cost components represent the greatest financial burden to the scheme. Hence a deteriorating RTW rate has a direct and real impact on the performance and continued viability of the workers compensations scheme.

Proportion of eligible workers accessing work injury damages

A growing proportion of claimants with claims from older accident years have reached the work injury damages (WID) threshold of 15% whole person impairment. However, it is unclear what proportion of these claimants will pursue a WID claim, and it is therefore unclear what proportion will remain in the system over the longer term. Also, the nature of this benefit type means it is subject to volatility and may escalate rapidly. The short and long-term cost impact of changes to WID experience can be significant and is therefore a key risk for the Nominal Insurer.

Impact of Section 39 maximum benefits period

The impacts of the section 39 maximum benefits period, which limits weekly compensation to 260 weeks for workers with whole person impairment (WPI) less than 21%, is still emerging for the Nominal Insurer portfolio.

SIRA understands that the assessment of WPI through the icare-initiated Workers Assistance Program is complete; however, there remains some uncertainty about the number of injured workers who will successfully dispute their WPI assessment. There are also some workers who have not yet reached maximum medical improvement from their injury and have therefore not yet had their whole person impairment assessed; and other workers' WPI may change over time, which can impact the worker's ongoing entitlement to weekly payments.

Eligibility for lump-sum compensation for permanent impairment

Workers whose injury results in permanent whole person impairment (WPI) greater than 10 percent, or 15 per cent in the case of primary psychological injury, is entitled to receive lump-sum compensation for the impairment, with the amount of compensation increasing as the degree of impairment increases. The proportion of workers whose injury has (or will) result in permanent impairment, and the degree of permanent impairment these workers will suffer, is uncertain, making it difficult to estimate the value of permanent impairment compensation liabilities.

3. Summary and conclusions

The Finity report on its valuation of the Nominal Insurer's liabilities as at December 2018 indicates a funding ratio of 110.8% at the 75% PoS. This is below the target operating zone of 115-135%. A number of identified risks could lead to further decline in the financial position.

SIRA continues to closely monitor risks and costs associated with the icare transformation strategy. These risks are included in the scope of the current SIRA Compliance and Performance Review of the Nominal Insurer.

Nominal Insurer investment earnings are impacted by broader economic and local investment market conditions.

Medical costs for the Nominal Insurer have increased at a rate that is higher than forecast. SIRA is undertaking a thorough review of medical service utilisation and costs in both the workers compensation and CTP systems to inform regulator action.

The icare Board is accountable for the performance of the Nominal Insurer.

SIRA has also introduced closer regulatory oversight of the Nominal Insurer premium, prudential and claims management performance. These matters are all included in the scope of the current SIRA Compliance and Performance Review of the Nominal Insurer.

Based on this valuation, the financial position of the Scheme has declined and, in line with the relevant icare Capital Management Policy, icare is required to implement an action plan to bring the funding ratio within the target operating zone within five years.

The valuation provides for future savings to be realised as a result of the new claim model implemented by icare. This presumption forms part of the plan to bring the funding ratio within the target operating range. However, observed trends suggest that the new claims model has yet to realise its benefits. SIRA is undertaking a Compliance and Performance Review of the NI. The terms of reference for the Review include consideration of the impacts and benefits of the new claims model. The findings from this Review are due to be published in late 2019.

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