

Compliance and Performance Review of the Nominal Insurer

State Insurance Regulatory Authority

December 2019

Part 3: Expense Review

Table of contents

1.	Executive Summary	1
2.	Introduction and scope.....	5
3.	Data	6
4.	Summary of premium and expense ratios	7
5.	Operating expenses	10
6.	Expense allocation process.....	12
7.	Reliances and Limitations.....	13
Appendix A	Terms of Reference.....	14

1. Executive Summary

In February 2019, SIRA commenced an integrated compliance audit and performance review of the NSW workers compensation Nominal Insurer (NI or the NI scheme), which is managed by icare (icare workers insurance). EY has been engaged by SIRA to support the independent review being conducted by Ms Janet Dore.

The terms of reference (included in full as Appendix A) for the review include:

- An audit of compliance with relevant guidelines including the Market Practice and Premium Guidelines (MPPGs), and
- A performance review in relation to claims management, return to work outcomes and other objectives under the legislation

The scope of EY's services for this expense review are contained in a letter to Mr Darren Parker dated 16 May 2019. In summary our scope was to assess:

- The nature of the NI's expenses
- The reasons for increases in the NI's expenses, which are understood to be impacted by the icare transformation program
- How the service fee payable to icare is determined
- The quantum of expenses that are direct expenses to the NI (such as payments to EML for claims management) and indirect expenses (such as overheads)

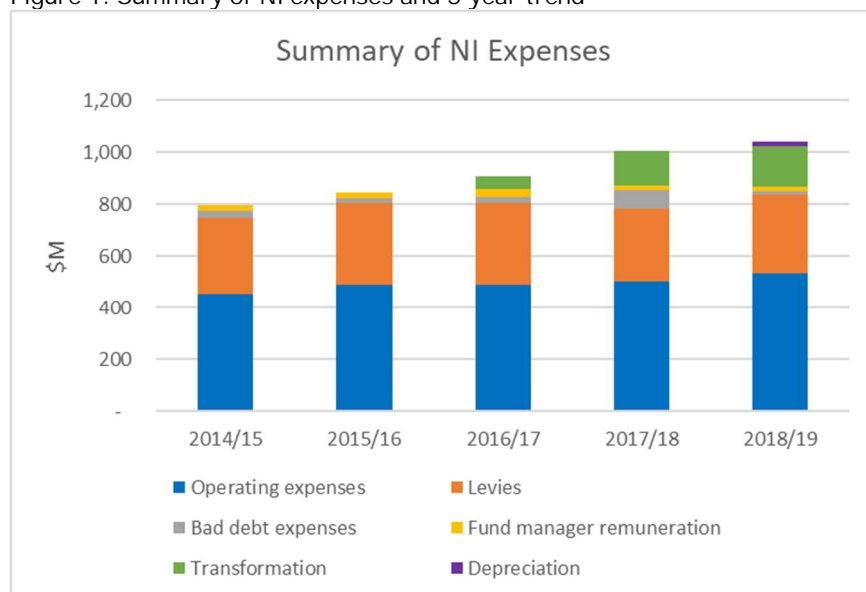
SIRA had raised concerns regarding the increase in the NI's expenses over the last three years as shown in icare's annual reports. SIRA wanted to better understand the drivers of this increase.

This report contains the findings from the review into the expenses of the NI scheme.

1.1 Key Findings

The key findings regarding total expenses, operational expenses and expense ratios are highlighted in the figures and tables below.

Figure 1: Summary of NI expenses and 5 year trend¹



¹ All expenses shown are from the audited accounts of icare with the exception of 2014/15 which is sourced from the audited accounts of WorkCover

Table 1: Key findings – expense trends

Aspect reviewed	Findings
NI's expenses and trends over the last 5 years	<ul style="list-style-type: none"> In the financial year 2018/19 the total expenses of the NI amounted to \$1,041m This included levies of \$302m and transformation expenses of \$159m Overall, the NI's expenses have increased at an average rate of 5.5% per annum since 2014/15 Excluding transformation expenses and levies, the rate of increase has been 2.8% per annum Over this period the net earned premium of the NI (excluding levies) has grown at a rate of approximately 4.8% per annum and this impact is shown in the expense ratio in figure 3

Figure 2: Summary of the operating expenses

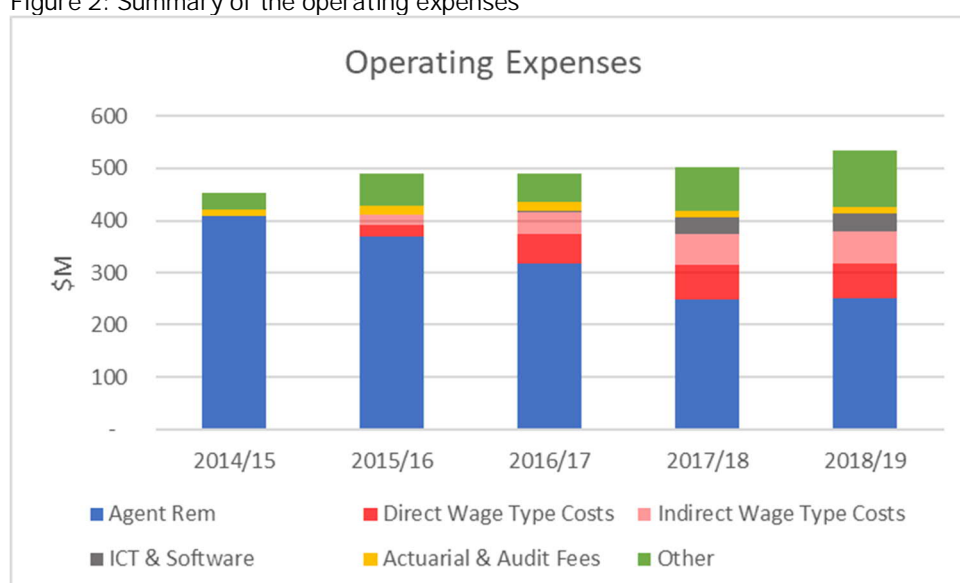


Table 2: Key findings – operating expenses

Aspect reviewed	Findings
Operating expenses and scheme agent remuneration	<ul style="list-style-type: none"> Operating expenses consist primarily of scheme agent remuneration, icare salary costs, ICT and software costs and other miscellaneous expenses The operating expenses have increased from \$452m in 2014/15 to \$533m in 2018/19 an annualized rate of increase of 3.3% Scheme agent remuneration has reduced from approximately \$410m in 2014/15 to \$251m in 2018/19 The reduction in scheme agent remuneration has been largely offset by icare salary and ICT costs allocated to the NI. We do note that the 2014/15 year is not directly comparable to icare as some employee costs were shared between WorkCover and the WorkCover Authority (effectively the regulator) ICT and software costs related to the (Nominal Insurer Single Platform) NISP will be a recurring cost to icare (prior to the NISP, these costs were borne by the scheme agents and passed onto WorkCover through the scheme agent remuneration) A full definition of the expense categories within the operating expenses is contained in section 5 of this report

Figure 3: Expense ratios

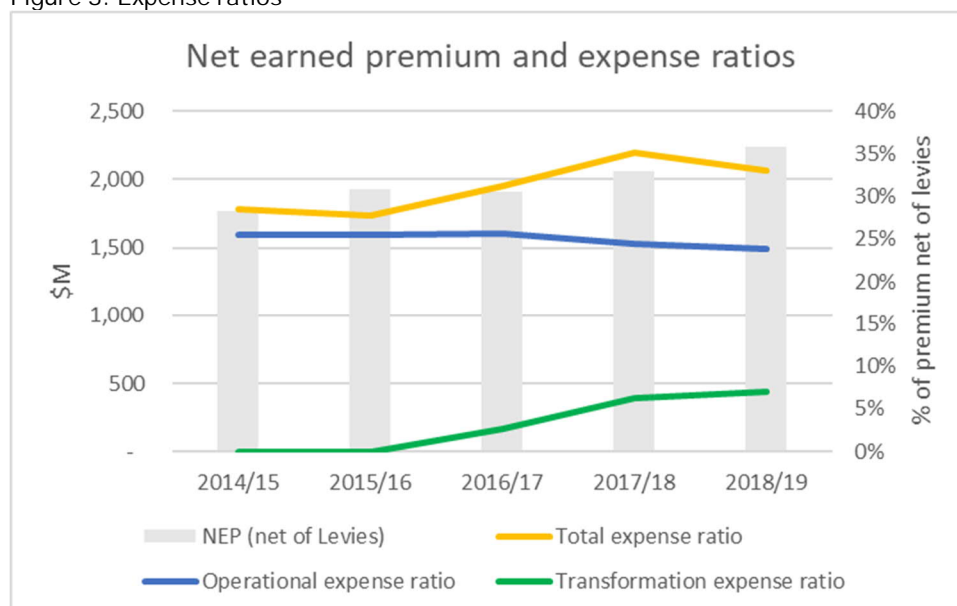


Table 3: Key findings – Expense ratios

Aspect reviewed	Findings
Expense ratios	<ul style="list-style-type: none"> The denominator used to define the expense ratio is the net earned premium excluding all levies The total expense ratio includes all expenses (except levies). This ratio has increased from approximately 29% to 33%. However, this includes transformation expenses which icare consider to be predominantly one-off. Ongoing transformation costs are budgeted to be \$58m in 2019/20 reducing to \$23m thereafter (for continual improvement initiatives) The “spike” in the 2017/18 total expense ratio was caused by the write-off of bad debts going back a number of years The transformation expense ratio (green line) shows the impact of these transformation expenses on the expense ratio The operational expense ratio includes the ongoing controllable costs of icare. The operating expense ratio has trended downwards from 26% in 2015 to 24% in 2019 The net earned premium has increased on average by 4.8%pa over the period. This increase is a combination of wage growth, portfolio growth and premium rate increases

Table 4: Expense allocation process

Aspect reviewed	Findings
Expense allocation process	<ul style="list-style-type: none"> icare incur expenses in supporting the various schemes under its management icare have outlined an expense allocation process that is used to allocate expenses to the schemes that they manage. This process is summarised in section 6 The allocation consists of costs that are directly attributable to the schemes (such as scheme agent remuneration) and costs that are indirectly attributable to the schemes (such as some salary costs and ICT costs) In the 2018/19 year, 67% of the service fee was directly attributable to the NI while 33% was indirectly attributable The cost allocation process and the drivers used for the allocation have not been reviewed for this report

1.2 Reliances and Limitations

Our Report may be relied upon by SIRA for the purpose of the agreed scope only pursuant to the terms of our Contract Agreement SIRA//6358/2016 between EY and SIRA commencing on 20 April 2017. We disclaim all responsibility to any other party for all costs, loss, damage and liability that any third party may suffer or incur arising from or relating to or in any way connected with the contents of our Report, the provision of our Report to the other party or the reliance upon our Report by the other party. We are providing specific advice only for this engagement and for no other purpose and we disclaim any responsibility for the use of our advice for a different purpose or in a different context.

The conduct of this Review has been dependent on the provision of information, including documentation and consultations with relevant stakeholders. The data received and relied upon for this review is outlined in section 3. In undertaking this review, reliance has been placed upon information supplied in the consultations and documentation, and has been used without independent verification.

Judgements based on the data, methods and assumptions contained in the report should be made only after studying the report in its entirety, as conclusions reached by a review of a section or sections on an isolated basis may be incorrect.

Refer to section 7 for complete Reliances and Limitations.

2. Introduction and scope

In February 2019, SIRA commenced an integrated compliance audit and performance review of the NSW workers compensation Nominal Insurer (the NI or the scheme), which is managed by icare (icare workers insurance). EY has been engaged by SIRA to support the independent review being conducted by Ms Janet Dore.

The review will be undertaken for SIRA by an independent expert, Ms Janet Dore, and supported by EY and authorized officers of SIRA. The Terms of Reference for the review are to consult with stakeholders and undertake analysis of data to provide findings in relation to the NI's compliance and performance, in particular to:

- Assess NI compliance with the MPPGs and identify any unintended consequences, risks and priorities for improvement in SIRA regulation of the premiums of the NI
- Identify the benefits and risks to the performance of the NSW workers compensation system arising from icare's implementation changes to the NI operating model and supporting digital platforms
- Assess the NI's performance in relation to return to work outcomes, claims management (including guidance, support and services for workers, employers and health service providers), customer experience and data quality and reporting.

The Independent Reviewer, Ms Dore, and EY will present on their independent findings to the SIRA Chief Executive and Board. The Independent Reviewer may also provide advice to SIRA on any other significant matters, emergent risks or opportunities detected during the review.

The terms and conditions covering this engagement are as set out in Contract Agreement SIRA//6358/2016 between EY and SIRA commencing on 20 April 2017. The scope of EY's services for this expense review are contained in a letter to Mr Darren Parker dated 16 May 2019. In summary our scope was to assess:

- The nature of the NI's expenses
- The reasons for increases in the NI's expenses, which are understood to be impacted by the icare transformation program
- How the service fee payable to icare is determined
- The quantum of expenses that are direct expenses to the NI (such as payments to EML for claims management) and indirect expenses (such as overheads)
- SIRA had raised concerns regarding the increase in the NI's expenses over the last three years as shown in icare's annual reports. SIRA wanted to better understand the drivers of this increase.

Any assessment of allocation of expenses was not in scope of this review. As such EY has not reviewed the allocation of expenses from icare to the Nominal Insurer nor has EY reviewed the allocation of expenses to transformation expenses or operational expenses.

We'd like to acknowledge the input of the icare CFO in assisting our understanding of the NI expense basis.

This report contains our findings from the review into the expenses of the NI scheme.

3. Data

The following data sources have been used to collate the expense information presented in this analysis:

- WorkCover annual report 2014/15
- icare annual report 2015/16 (containing the accounts for 2 months of WorkCover and 10 months of icare)
- icare annual report 2016/17
- icare annual report 2017/18
- icare audited financial statements 2018/19

The information from the accounts has been supplemented by more detailed expenses information supplied by icare including meetings with the icare CFO.

Over the time series illustrated in this report, the presentation of the accounts of the Nominal Insurer have changed a number of times. To present the expenses, as far as practical, on a “like for like” basis, some adjustments have been made to the prior period expenses. The most material of these include:

- Deduct interest expense of \$110m from the 2014/15 WorkCover expenses
- Deduct interest expense of \$105m from the 2015/16 icare expenses

icare explained that this line item in the expenses related to one half of the interest rate swap trades within the investment fund. These figures were more than offset by interest income on the corresponding years. The interest income figures include interest received on the bond portfolio and the corresponding side of the interest rate swap. With the change in the custodian the accounting for interest rate swap trades within the investment fund moved from a gross to net basis resulting in the interest expense no longer reflected in the accounts.

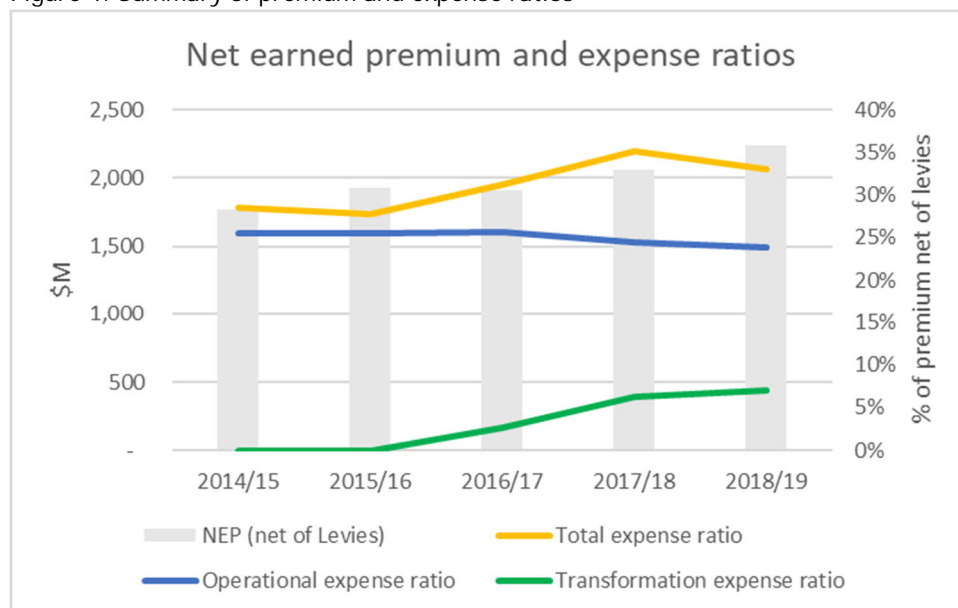
We note that the 2014/15 year is not directly comparable to subsequent years since icare was established. This is because prior to icare’s establishment, some employee costs were shared between WorkCover and the WorkCover Authority. Some of this cost would have been included under the levies rather than as operational expense.

4. Summary of premium and expense ratios

Figure 4 shows the earned premium of the nominal insurer (net of all levies) and the expense ratio. The expense ratio is expressed as a percentage of the net earned premium. The three lines shown represent:

- Yellow line - all expenses except for levies
- Blue line - operational expenses (as defined in section 5)
- Green line - Transformation expenses (considered by icare to be a predominantly one-off investment and are budgeted to decrease substantially in 2019/20 and beyond)

Figure 4: Summary of premium and expense ratios



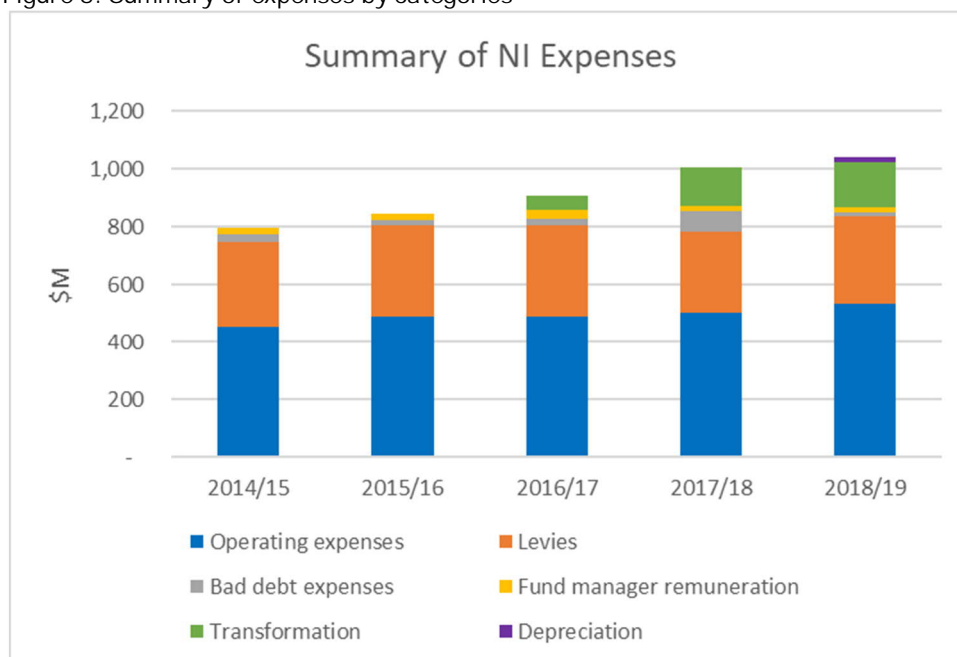
The total expense ratio has increased from approximately 29% to 33%. The spike in the expense ratio in 2017/18 was due to a clean up of bad debts going back a number of years.

The operational expense ratio has trended downwards from 26% to 24%. The transformation expenses have contributed 6% and 7% respectively to the total expense ratio in 2017/18 and 2018/19.

The net earned premium has increased on average by 4.8% pa over the period. This increase is a combination of wage growth, portfolio growth and premium rate increases

The various categories of expenses are shown more clearly in figure 5 (including levies for completeness)

Figure 5: Summary of expenses by categories



The various expense categories include:

- Levies - this is primarily the levy paid to SIRA (for the funding of SIRA, SafeWork NSW, WCC and WIRO) but also includes the mine safety levy and the dust disease levy
- Operational expenses include the service fee charged by icare to the Nominal Insurer and fees for contractors directly employed by the NI. The service fee includes a number of other items and is expanded upon in section 5
- Bad debt expenses including bad debts written off and impairment of trade receivables (basically premiums)
- Fund management expenses
- Transformation costs include primarily contracting staff and also some ICT costs

Figure 6 shows more clearly the trend in each of these expense categories over the last 5 years

Figure 6: Trend by expense category

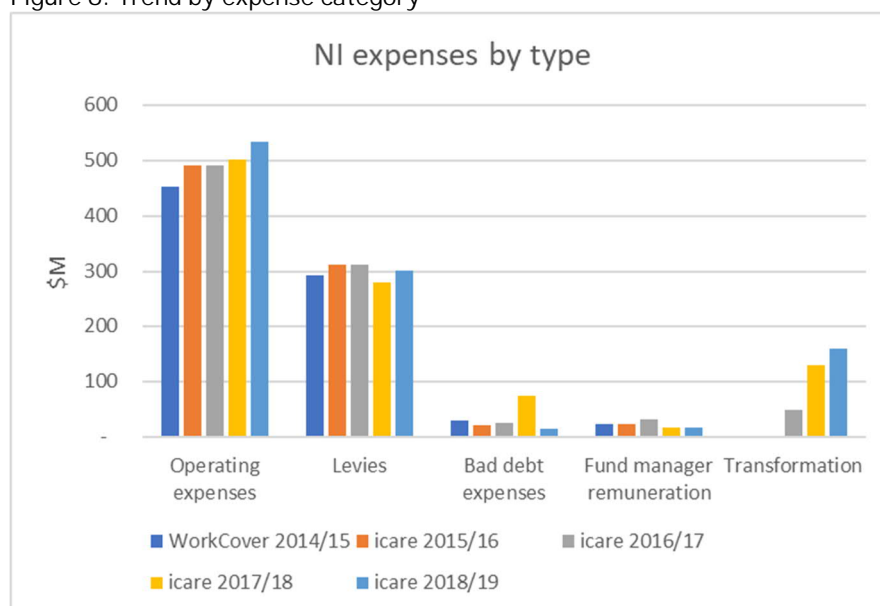


Figure 6 highlights:

- A steady increase in operational expenses since 2015 amounting to an annualised increase of 3.3% pa
- Levies relatively constant
- A spike in bad debt expenses in 2017/18
- Fund manager remuneration relatively constant
- Transformation expenses have increase over the last three years. The icare CFO informed us that the NISP costs are now complete and the budgeted transformation expenses for 2019/2020 will reduce to \$58m and \$23m thereafter (budgeted for continual improvement initiatives).

5. Operating expenses

icare has been able to supply sufficient detail to the review to enable an understanding of the different components of the operational expenses.

The following expense categories are included within operational expenses:

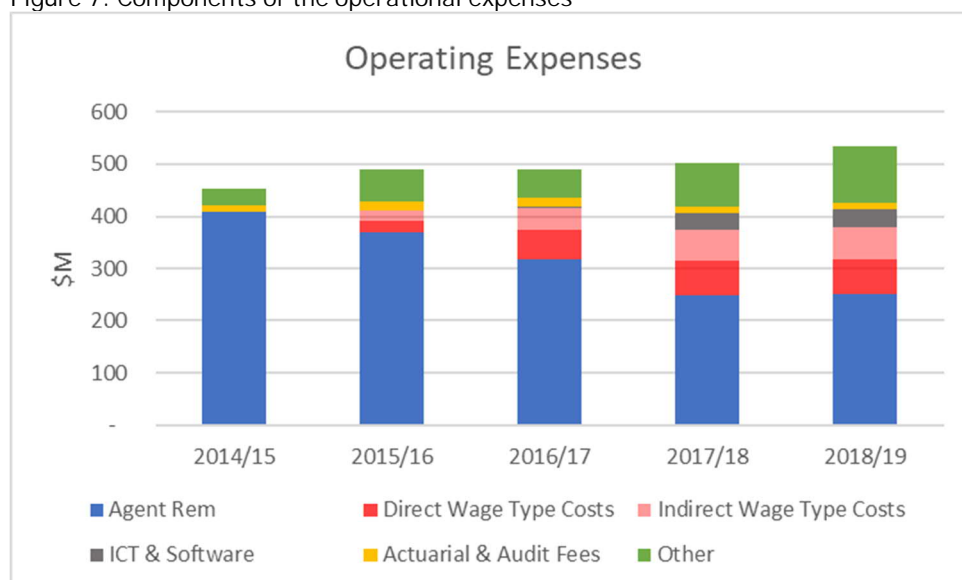
- The icare service fee which is the fee icare charges the Nominal Insurer for the services it provides. The main components of the icare service fee include:
 - Scheme agent remuneration
 - Direct wages (for staff working directly for the NI)
 - Indirect wages (for staff who have a proportion of their salary allocated to the NI)
 - Actuarial and audit fees
 - ICT service fees and licenses
 - Other including Service NSW fees, legal costs, grants, etc
- Costs incurred directly by the NI including:
 - Contractor costs
 - Debt collection fees
 - Other operating expenses

For presentation purposes we have grouped these costs as:

- Scheme agent remuneration
- Direct wage costs
- Indirect wage costs
- ICT and software costs
- Actuarial and audit fees
- Other

Figure 7 summarises the operational expenses over the 5 years to 30 June 2019.

Figure 7: Components of the operational expenses



The different components of the operational expenses and the trends seen within them can be summarised as follows:

- Scheme agent remuneration has reduced significantly under the new scheme agent model that icare introduced. In 2014/15, scheme agent remuneration amounted to \$410m and represented the majority of WorkCover's expenses. In 2018/19, scheme agent remuneration has reduced to \$250m and represents approximately half of the total operational expenses
- The reduction in scheme agent remuneration has been largely offset by the salary and ICT costs of icare (the red, light red and grey bars in figure 7). Direct wages represent staff that are employed by icare and work solely for the NI. Indirect wages represent staff that are employed by icare and a proportion of their wages are allocated to the NI.
- ICT and software costs relate to the costs of the software solutions and managed services that icare have put in place that form the NISP. In 2018/19 these costs amounted to \$35m (2017/18 was \$32m)
- External actuarial and audit fees are relatively small and have fluctuated between \$11m and \$21m
- The "other" category contains a range of different expenses including:
 - Service NSW fees
 - Depreciation amounts associated with the NISP
 - Grants
 - Costs associated with managing icare's contingent workforce

6. Expense allocation process

icare provide enabling services to each of the funds that they manage. icare expenditure is the operational cost of administering all the schemes and includes the provision of staff, claims handling, facilities, scheme agent's remuneration, general expenses and governance services. icare have provided a high level summary of the expense allocation process they use to allocate expenses to their various schemes.

Figure 8 summarises the allocation process. It was outside the scope of this review to form an opinion of the allocation process or the subsequently allocated costs.

Figure 8: Current methodology to allocate icare's enabling services costs to schemes

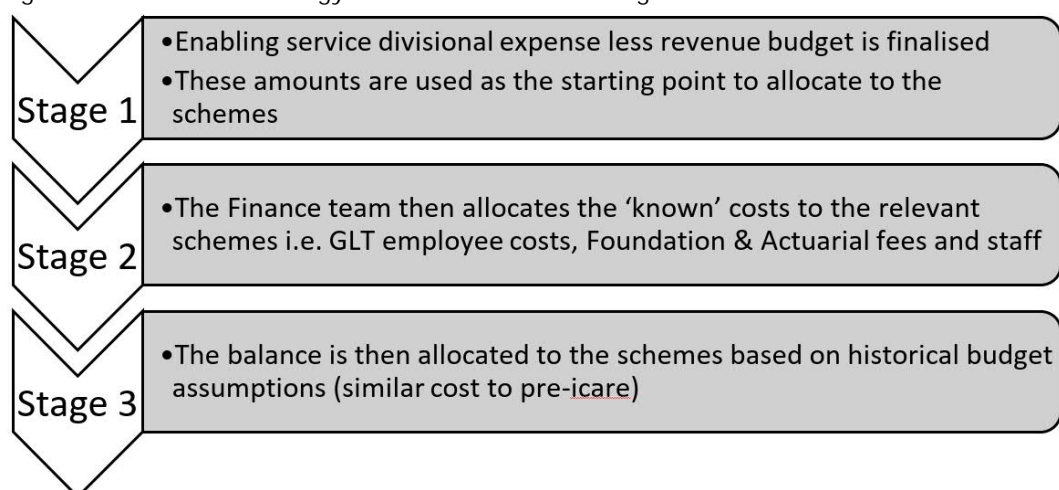


Table 4 illustrates the breakdown of the 2018/19 NI service fee. It shows the icare wage costs, 35% of which are directly allocated to the NI, 65% are an indirect allocation. The scheme agent remuneration is directly allocated to the NI. Of the remaining costs, 81% are indirectly allocated to the NI.

Figure 4: The 2018/19 allocation of service fee (\$000)

	2018/19		
	Direct	Indirect	Total
Employee Related			
Direct Salary	24,490	45,449	69,939
Salary Related	3,407	6,533	9,940
Total	27,897	51,982	79,879
		65%	
Operating Expenses			
Agent Rem	251,179		251,179
Actuarial Fees		7,258	7,258
Contractors	1,574	9,725	11,299
Advertising	280	1,566	1,846
ICT Managed Service		15,416	15,416
Software Licenses	147	19,303	19,450
Service NSW	6,162	4,851	11,013
Grants		6,330	6,330
Other	14,854	33,585	48,439
Total	274,196	98,034	372,230
		81%	
Total	302,093	150,016	452,109

7. Reliances and Limitations

In our professional capacity and EY operating policy requirements we are required to state the reliances and limitations of our report.

The scope of EY's services for this review is contained in a letter to Mr Darren Parker dated 16 May 2019. The letter sets out the terms of the engagement of Ernst & Young (EY, we) by the State Insurance Regulatory Authority (SIRA) to provide the services specified in the Scope section of that letter. The terms and conditions covering this engagement are as set out in Contract Agreement SIRA//6358/2016 between EY and SIRA commencing on 20 April 2017.

Our Report may be relied upon by SIRA for the purpose of the agreed scope only pursuant to the terms of our Contract Agreement SIRA//6358/2016 between EY and SIRA commencing on 20 April 2017. We disclaim all responsibility to any other party for all costs, loss, damage and liability that any third party may suffer or incur arising from or relating to or in any way connected with the contents of our Report, the provision of our Report to the other party or the reliance upon our Report by the other party. We are providing specific advice only for this engagement and for no other purpose and we disclaim any responsibility for the use of our advice for a different purpose or in a different context.

EY has acted in accordance with the instructions of SIRA in conducting its work and preparing the Report and, in doing so, has prepared the Report for the benefit of SIRA, and has considered only the interests of SIRA. The Report does not seek to address the specific circumstances of any other party, and EY makes no representations as to the appropriateness, accuracy or completeness of the Report for any other party's purposes. EY is under no obligation to provide any other party with any additional information or to update any of the information contained in the Report.

The conduct of this Review has been dependent on the provision of information, including documentation and consultations with relevant stakeholders. The data received and relied upon for this review is outlined in section 3. In undertaking this review, reliance has been placed upon information supplied in the consultations and documentation, and has been used without independent verification.

Judgements based on the data, methods and assumptions contained in the Report should be made only after studying the report in its entirety, as conclusions reached by a review of a section or sections on an isolated basis may be incorrect.

Appendix A Terms of Reference

The complete terms of reference can be found at:

<https://www.sira.nsw.gov.au/fraud-and-regulation/review-of-the-nominal-insurer/terms-of-reference-for-the-review-of-the-nominal-insurer>

In summary, the terms of reference state:

Over 2018, SIRA has closely monitored and considered analysis of aspects of the compliance and performance of the NI scheme, including trends in liability valuations and costs, premium setting, operational reforms and risk management, return to work rates, data quality, customer complaints and concerns raised by business representatives, unions and other stakeholders.

In February 2019, SIRA will commence an integrated compliance audit and performance review including:

- an audit of compliance with relevant guidelines including the Market Practice and Premiums Guidelines (MPPGs) and
- a performance review in relation to claims management, return to work outcomes and other objectives and requirements under the legislation.

In establishing this Review, SIRA is exercising its authority and undertaking responsibilities under the State Insurance and Care Governance Act 2015, the Workplace Injury Management and Workers Compensation Act 1998 and the Workers Compensation Act 1987.

The Review is established, in particular, under the following legislative provisions:

- Sections 23 and 24 of the State Insurance and Care Governance Act 2015
- Sections 22 and 23 of the Workplace Injury Management and Workers Compensation Act 1998

This Independent Compliance and Performance Review is imperative given the materiality of the NI performance on the overall performance of the workers compensation system and SIRA's responsibilities as regulator of that system.

The review will be undertaken for SIRA by an independent expert, Ms Janet Dore and supported by independent actuaries Ernst and Young (EY) and authorised officers of SIRA.

Consistent with the objectives, functions, responsibilities and powers of SIRA under the State Insurance and Care Governance Act 2015, the WIM Act and the 1987 Act, the Terms of Reference for the review are to consult with stakeholders and undertake analysis of data to provide findings in relation to the NI's compliance and performance, in particular to:

- assess NI compliance with the MPPGs and identify any unintended consequences, risks and priorities for improvement in SIRA regulation of the premiums of the NI
- identify the benefits and risks to the performance of the NSW workers compensation system arising from icare's implementation changes to the NI operating model and supporting digital platforms
- assess the NI's performance in relation to return to work outcomes, claims management (including guidance, support and services for workers, employers and health service providers), customer experience and data quality and reporting.

The Independent Reviewer, Ms Dore, and EY will present on their independent findings to the SIRA Chief Executive and Board. The Independent Reviewer may also provide advice to SIRA on any other significant matters, emergent risks or opportunities detected during the review.

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2019 Ernst & Young, Australia
All Rights Reserved.

Liability limited by a scheme approved under Professional Standards Legislation.

In line with EY's commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

Ernst & Young is a registered trademark.

Our report may be relied upon by SIRA for the purpose of the agreed scope only pursuant to the terms of our Contract Agreement SIRA//6358/2016 between EY and SIRA commencing on 20 April 2017. We disclaim all responsibility to any other party for any loss or liability that the other party may suffer or incur arising from or relating to or in any way connected with the contents of our report, the provision of our report to the other party or the reliance upon our report by the other party.

ey.com