

29 July 2013

Steering Committee  
Department of Finance and Services  
2-24 Rawson Place  
Sydney NSW 2000

## Proposed changes to NSW Compulsory Third Party (“CTP”) Insurance – Peer Review of Actuarial Costings and Related Advice provided by Ernst and Young (“EY”)

### 1 Purpose and scope

1.1 Taylor Fry Consulting Actuaries (“TFCA”) has been engaged by the Department of Finance and Services (“DFS”) to peer review two reports prepared by EY for the Motor Accidents Authority of NSW (“MAA”), titled:

- “Estimated cost per policy of the proposed NSW Green Slip Scheme” dated 29 July 2013, and
- “Premium system transition for the proposed NSW Green Slip Scheme” dated 29 July 2013.

In this letter these documents are referred to as the “EY Costing Report” and the “EY Premium System Report” respectively.

1.2 In particular, DFS has asked for a peer review of whether the analytical approaches used for the EY Costing Report and the resulting estimates of future average NSW CTP costs are reasonable, given the inherent uncertainties.

1.3 This letter should only be considered together with the EY Costing Report and the EY Premium System Report, and not in isolation.

### 2 Peer review process

2.1 Our peer review process consisted of:

- Discussions and email correspondence with staff of EY and DFS, and discussions with MAA staff;

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- Reviewing materials supplied by EY which are relevant to the EY Costing Report and the EY Premium System Report. The materials supplied included various EY draft reports, presentations, detailed file notes and spreadsheets which describe the analytical approach, data and assumptions used by EY and resulting estimates of future average costs;
- Asking EY questions which arose from our review, and
- Reviewing draft versions of the EY Costing Report and the EY Premium System Report, and making suggestions regarding possible modifications to those draft versions.

2.2 EY cooperated fully with our peer review, and many of the modifications which we suggested to draft versions of the EY Costing Report and the EY Premium System Report have been incorporated in the final versions of those reports.

### 3 Materiality and uncertainty

3.1 During our peer review, we have concentrated on raising matters which might be material. We have considered a matter to be potentially material if, in our opinion, it might result in an informed reader of the EY Costing Report and EY Premium System Report reaching a conclusion which differs substantively from our own opinion regarding the same issue.

3.2 Determination of whether a matter is material requires the exercise of professional judgement. In the context of this peer review, it should be noted that:

- Many parts of the selection of modelling approaches, analysis, assumptions and resulting estimates of future average costs described in the EY Costing Report involved actuarial judgement. As such, there is scope for a range of legitimately differing opinions concerning these matters;
- Estimates of future average costs are inherently and unavoidably uncertain, especially for estimates of costs for which allowance for anticipated effects of proposed substantive legislative changes is needed. Reasons for the existence of such uncertainty are described in the EY Costing Report, particularly in sections 3, 5 and 6 of that report, and
- There are some parts of the analysis for which our approach and resulting estimates of future average costs might not be identical to EY's. However, in our opinion, such differences would not lead to substantively different conclusions.

### 4 Conclusions concerning the EY Costing Report

4.1 EY's estimates of average premiums for the underwriting year commencing 1 April 2014 if the current NSW CTP scheme was to remain unchanged are based on CTP insurers' premium rates effective from February 2013, adjusted for anticipated changes during the period until April 2014. We regard that approach, and the resulting estimates of average premiums for the 2014 underwriting year, as reasonable.

4.2 EY's estimates of average costs for the 2014 underwriting year if the Motor Accident Injuries Amendment Bill 2013 ("the Bill") were to be enacted in its original form are based on analysis of a combination of:

- Traffic casualties data for NSW and Victoria;
- Claims data for the existing NSW CTP scheme;
- Claims data and actuarial estimates of prospective claims and other costs for the Victorian CTP scheme, which is managed by the Transport Accidents Commission, and
- Information on NSW CTP insurers' expenses and target profit margins contained in insurers' premium rate filings effective from February 2013.

4.3 Claims data and actuarial estimates for the Victorian CTP scheme have been used by EY in estimating costs of statutory benefits for loss of earnings or earning capacity, treatment, care and permanent impairment under the proposed changes to the NSW CTP scheme. We regard this approach as appropriate given that:

- There are similarities between these statutory benefits proposed for NSW and corresponding statutory benefits which are provided in Victoria;
- For the EY Costing Report, several adjustments have been made by EY to attempt to allow for differences between the statutory benefits which are provided in Victoria, and related management arrangements, and those proposed for NSW, and
- In EY's opinion, with which we agree, there is no other source of available claims data which could be used as the basis for more reliable estimates of costs of the statutory benefits proposed for NSW.

4.4 Claims data for the existing NSW CTP scheme has been used by EY in estimating costs of modified common law damages claims, and associated legal, investigation and other costs, under the proposed changes to the NSW CTP scheme. Again, we regard this approach as appropriate for these components of anticipated claims costs.

4.5 Subject to the proviso described in paragraphs 4.6 and 4.7 below, we regard as reasonable EY's estimates of an average cost for Class 1 vehicles for the 2014 underwriting year (including MCIS levy but excluding GST) set out in Table 3 of the EY Costing Report of:

- \$571 for the current NSW CTP scheme, and
- \$474 for the proposed NSW CTP scheme.

4.6 The proviso is that, for the proposed scheme, we have reservations about whether the estimated \$13 reduction in average per policy insurer expenses from \$67 to \$54 (refer Table 3 in the EY Costing Report) will be achievable. Achieving that estimated reduction in average expenses will depend in part on development and effective enforcement by the MAA of new Premiums Determination Guidelines. We understand that those guidelines have not been drafted yet.

4.7 In particular, those total allowances for insurer expenses shown in Table 3 in the EY Costing Report include allowance for insurers' claims handling expenses of:

- \$20 per policy for the current NSW Scheme, and
- \$21 per policy for the proposed NSW Scheme.

We think that a larger increase in average claims handling expenses than this estimate is likely for the proposed scheme, given the proposed extension of compensation to almost all at-fault claimants and the proposed requirement for periodic payments of statutory benefits. EY advised that it had been envisaged that EY's estimate of claims handling expenses for the proposed scheme would be tested in consultations between the MAA and insurers regarding insurers' planned operational structures and costs under the proposed scheme. That part of the envisaged consultation process has not been undertaken yet.

4.8 However, it should be borne in mind that, even if one were to assume a smaller reduction in total average insurer expenses to, say, about \$60 per policy (instead of \$54 per policy) for the proposed scheme, the estimate of average cost for the 2014 underwriting year would remain substantially less for the proposed scheme than for the current scheme:

- \$571 for the current scheme, and
- \$480 for the proposed scheme (estimate of \$474 from Table 3 in the EY Costing Report increased by \$6).

4.9 The descriptions of sources of risk and uncertainty, and reliance and limitations, in the EY Costing Report are very important, and should be regarded as an integral part of EY's advice to the MAA. In particular, we agree with EY's advice that the extent of uncertainty inherent in estimates of future average costs is substantially greater for the proposed NSW CTP scheme than for the current scheme. It is to be expected that the extent of uncertainty about future costs would be greater for a proposed new scheme than for an existing scheme, and Section 5.2.2 of the EY Costing Report describes several reasons why this is the case for the proposed scheme.

## 5 EY Premium System Report

5.1 The EY Premium System Report provides a brief description of several of the measures which would affect the method of determination and level of future premiums under the proposed scheme.

5.2 We regard the description in the EY Premium System Report as sound. However, it should be borne in mind that:

- Some of those proposed measures, in particular risk equalisation and sharing of claims costs, would be complex to operate, and
- Successful implementation of these proposed measures would require (inter alia) extensive consultations between the MAA, its actuarial advisers, NSW CTP insurers and other interested parties. This is noted in Section 10.3 of the EY Premium System Report.

5.3 Because of the uncertainty inherent in estimates of claims costs under the proposed scheme, with the benefit of hindsight actual claims costs may turn out to differ considerably from the estimates described in the EY Costing Report. This comment should not be interpreted as a criticism of that report. Rather, it serves to demonstrate the relevance of the proposed "Profit normalisation" transitional pricing mechanism described in Section 4 of the EY Premium System Report. Provided that proposed

mechanism is implemented effectively, for premiums for NSW CTP policies to be issued by insurers during the period until three years after commencement of the proposed scheme, the mechanism should act to prevent either substantial excess aggregate profits for insurers or unreasonable aggregate losses for insurers.

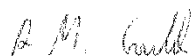
## 6 Distribution and use of this letter

6.1 This letter, or any part thereof, may not be published in any document, statement or communication with third parties without prior written approval by TFCA of the form and context in which it will appear.

6.2 Further TFCA requires that, if this letter is distributed to third parties:

- It must be distributed in its entirety, and
- It must be distributed in conjunction with both the EY Costing Report and the EY Premium System Report in their entirety.

Yours sincerely



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Fellow of the Actuaries Institute