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

January 2017

State Insurance Regulatory Authority Board

Contents

Executive Summary

Following the release of the NSW Government's discussion paper *Reforming insurer profit in compulsory third party (CTP) motor vehicle insurance*, the State Insurance Regulatory Authority Board consulted with key stakeholders. This report summarises those consultations and presents recommendations for consideration by the Government.

The subject of profit levels and superprofits is a fertile topic. While insurers deserve to receive a reasonable return on the capital they invest in the business, no one wishes to see insurers benefiting from the system at the expense of vehicle owners and the community. At the same time, it is widely accepted that insurers need to have sufficient freedom and incentive to encourage competition and the innovation and efficiency that can and should arise in a competitive market. Further, the long-tail nature of the CTP scheme makes predicting future claims costs uncertain and encourages insurers to protect against losses by building buffers into their premiums.

Conclusion: it is not easy to move from this general position to something specific about how superprofits might be avoided in future.

With the emergence of past superprofits, and the NSW Government's CTP reform agenda and consultations with stakeholders it is clear that the Government and the community need to see that insurers are held accountable for their performance as insurer participants in the CTP scheme. Their profits need to be limited to within reasonable levels yet, as already noted, they also need to be able to manage the business on their own terms with incentives to innovate, to compete and to build efficiencies.

If insurers have to operate under onerous regulation, innovation and competition may be stifled to the detriment of the scheme, given the inherent uncertainties of future outcomes and future profitability of the scheme.

Hence there is a conundrum over limiting profits on the one hand and encouraging competition and efficiencies on the other.

The key issues

Historically, the problem has not been the profit margins that insurers have used in their rate filings but the profit margins realised in subsequent years.

A filed profit margin of 8% of premiums is accepted as reasonable by insurers and many other stakeholders, notwithstanding that, unsurprisingly, the insurers would prefer a higher margin.

The challenge then is to determine how the emerging realised profits can be contained. Is it to be achieved by SIRA and insurers making some major changes in how they operate, or is it about controlling claims costs differently, or is it about having a mechanism to 'claw back' in some way superprofits if and when they emerge in future? The current scheme uncertainties associated with long-tail benefits and common law lump sum damages make pricing of premiums difficult and assessment of ultimate profit levels uncertain. Benefit reform should deliver some greater stability and predictability of claims costs and therefore ameliorate these issues to some extent but will not resolve them completely as a measure on its own.

The introduction of a Risk Equalisation Mechanism (REM) is aimed at sharing cross subsidies that are needed to assure the affordability of premiums among all insurers instead of, as at present, each insurer having to manage internally its own cross subsidies. It is intended to liberate insurers from the risks of anti-selection and encourage greater competition including the prospect of new entrants. It will also minimise the current practice of some insurers who successfully write a disproportionate number of over-priced policies relative to under-priced policies. In effect they harvest cross subsidies intended for under-priced policies in the form of additional profits. This situation creates a 'dead weight loss' in the form of these extra profits and represents an inefficiency in the system. The REM should generate a more efficient allocation of cross subsidies resulting in a better public policy outcome.

On the operations of insurers and SIRA, some potential exists for insurers to be more accountable for their rate filings. Changes already introduced by SIRA have strengthened this position such as a new principles based approach to Premium Determination Guidelines and a more active supervisory approach by SIRA to premium filings by insurers. Introduction of the REM will remove cross subsidy problems that currently limit competition and generate some 'gaming' of the system by individual insurers to garner extra profits, as explained above. The REM will also allow SIRA to be very clear about customer prices and affordability requirements with transparency about which vehicle owners receive subsidies and which owners fund the subsidies in the system.

The additional reporting and analysis that insurers and SIRA will undertake in operating the REM will assist SIRA to better monitor the rate filings and the emergence of insurer profits.

Profit normalisation is widely accepted by insurers and other stakeholders as a useful mechanism to avoid superprofits during a transition period on the introduction of benefit reforms, given the heightened uncertainty at the outset of the financial effects of the reforms. It is aimed at protecting both the community and insurers through limiting insurer profits and also limiting their losses.

It is debatable, however, whether profit normalisation will be needed after this transition. At this time, that is a matter of speculation. It may be needed, depending on scheme experience, including the performance of insurers and the degree of success that SIRA has in overseeing the scheme where profits do not move outside reasonable bounds.

It is evident from submissions and discussions with stakeholders that profit normalisation is not well understood, nor are the reasons for the past high profits of insurers. During the consultations stakeholders, particularly insurers, were seeking greater understanding about how profit normalisation is intended to work.

Insurers are concerned that they may be held within a straitjacket that would be counter-productive, depending on how profit normalisation is designed. Other stakeholders are concerned to understand whether it will be effective in limiting insurer profits and avoiding future superprofits. Hence its design is critical and there are fears and potential criticisms that may well be overcome by a suitable design.

This report considers stakeholder feedback on the Discussion Paper (summarised in Appendix B) and provides a SIRA Board response to each proposed measure to reform the premium system and deal with insurer profit.

Summary of SIRA Board responses

1. Profit normalisation

(a) Profit Normalisation: structure

The Board considers that, given the inherent uncertainties and volatility of this class of long-tail insurance, profit normalisation:

a) should operate on a transitional basis to respond to the initial uncertainty of the financial effects of the benefit reforms

b) should be maintained in legislation as a reserve power to be available to SIRA after transition; it would then be used if scheme experience warranted it at the time, and

c) should be introduced simultaneously with the introduction of benefit reforms and legislated accordingly.

Noting the current lack of published information and precision around possible techniques for profit normalisation, SIRA will prepare a detailed exposure draft and, subject to testing and feedback with insurers and other stakeholders, proposes to confirm the details during the first quarter of 2017.

This exposure draft will include statements on tolerance levels and other aspects of profit normalisation and will also take account of the need to allow individual insurers who are more innovative or more efficient than their competitors to retain financial benefits from their performances relative to other insurers.

<u>(b) Profit Normalisation: dealing with excess insurer profits or profit shortfalls</u>

Under profit normalisation, if there are excess profits at any time to be reclaimed from insurers or alternatively profit shortfalls to be reimbursed to insurers, SIRA's position is that:

a) the mechanism for doing so should be by adjustment to MCIS[1] levies, and

b) the size of the adjustments and the periods over which they will apply should be at the discretion of SIRA based on considerations of materiality and overall premium stability.

2. Measuring and publishing insurer profitability

For the purpose of publication of insurer profitability and for the operation of profit normalisation, SIRA will adopt a suggestion put forward by insurers and monitor variations in claims ratios or loss ratios (where claims or loss ratios are calculated as claims costs divided by the corresponding premiums). This is a standard metric in common use in the general insurance industry and has the advantage of presenting a simple indicator of performance.

SIRA will examine the ratios of filed claims costs to standardised premiums and variations in realised claims costs relative to filed claims costs. Profit margins themselves will also be published. The loss ratios will be based on accident year analyses (i.e. grouping together all claims occurring in each financial year and comparing them with the corresponding premiums earned in the same period). Average premium levels and profit margins themselves will also be published.

Instead of relying on profit measures alone, this approach has the benefit of focusing attention on the level of claims costs in the scheme relative to premiums, while at the same time yielding insurer and scheme results that will clearly indicate whether superprofits or indeed losses are being made by insurers.

For future publication purposes, SIRA has considered the balance needed between information that is commercially confidential to insurers and SIRA on the one hand and

[1] Medical Care and Injury Services Levy

the desire of the community on the other hand to have more transparency regarding scheme performance. Accordingly SIRA will publish annually:

- industry-wide loss ratios and profit margins
- summaries of the rate filings of insurers derived from the rates available on insurer websites and on SIRA's Green Slip Calculator

This position is being adopted by SIRA to recognise the risks and limitations of publishing all aspects of insurer profits, given the complexity of the scheme and the potential for misunderstanding or misinterpretation of early-stage results, while at the same time recognising the need for the community to have access to the important indicators of scheme performance.

3. Past insurer profitability

SIRA recognises the need for comparability in scheme performance measures between the past and the future. As a result, SIRA will arrange the reworking and publication of past loss ratios and profit margins in the format of the loss ratios and premium disclosures that are to be used in future for the publication of insurer financial results as at Response 2.

4. Insurer profit margins

Historically insurers have commonly included profit margins of 8% or near 8% of premiums in their rate filings. A filed profit margin of 8% of premiums is accepted as reasonable by insurers and many other stakeholders, notwithstanding that, unsurprisingly, the insurers would prefer a higher margin.

SIRA has considered in some depth the question of reasonable profit margins for future rate filing purposes and has also taken account of the opinions and views of insurers and other stakeholders. SIRA will readily accept filed profit margins up to 8% of premiums but would need special justification for a higher level. The revised Premium Determination Guidelines will reflect this position.

5. Insurer acquisition expenses

For the purpose of both rate filings and profit normalisation, SIRA will limit acquisition expenses to an average amount per policy to be specified by SIRA. This means capping the *expense allowance* available to insurers for pricing purposes but leaving it open to them to spend more if they wish, on marketing and sales or other initiatives, in operating their CTP portfolios. In other words, their profits would be measured relative to the expense allowance irrespective of insurers' actual expenditure.

6. Commissions

Commissions are currently limited to 5% of premiums per policy. SIRA is reviewing its policy on commissions and in the meantime is not making any recommendations to Government to change legislation or regulations and therefore they will continue to be limited to 5% of premiums.

It is notable that, in view of the limitation on the acquisition expense allowance at Response 5, the commission arrangements have little bearing on insurer rate filings.

7. SIRA to become an approval authority?

After careful consideration of the potential consequences, the SIRA Board is not intending to seek legislative change to move from rejection powers to approval powers for rate filings.

To give SIRA approval responsibility could be seen to be equivalent to SIRA setting insurer prices or controlling insurer prices directly. As such it would be contrary to the spirit of the 'file and write' system and substantially different from operating a free market environment with regulatory restrictions, as currently occurs.

In the Board's view it is better to continue with the current system where SIRA can influence insurer prices through the rate filing requirements but does not set the prices nor formally approve them. SIRA regards the rejection powers currently available to SIRA and its consequences for insurers when used as sufficient to meet its responsibilities and to meet the objectives of the system.

8. The fully funded test

The fully funded test was originally introduced to protect against insurer failure at a time that precedes the Australian Prudential Regulation Authority (APRA) and its prudential regulation regime which can now be seen as making the fully funded test largely redundant. The fully funded test can act to make insurer filings more conservative than they need to be in a competitive market.

SIRA will recommend that the fully funded test be abolished in 2017 but will nevertheless expect and indeed ensure that insurer rate filings do not envisage losses to the insurer that would jeopardise in any way the stability of the scheme or of an individual insurer.

The Board of SIRA believes that the responses listed above will improve the prospects and future operation of this important CTP scheme.

Further detail concerning the background to measures being considered, key stakeholder feedback and Board responses are contained in the substantive report which follows.

A. Introduction

This report summarises the series of consultations held in November 2016, facilitated by Mr Trevor Matthews, Chair of the State Insurance Regulatory Authority (SIRA) Board; SIRA being the regulator of the NSW Motor Accidents Compulsory Third Party (CTP) scheme. The consultations, which focussed on insurer profits in the CTP scheme, formed part of the process of reform of the scheme in New South Wales.

Previous consultations with stakeholders focussed on the broad range of details and processes required to implement the NSW Government's reform model and resulted in the release of the report *CTP reform consultation observations*[2]. The report included useful feedback on market and premium setting.

During 2016, the Government also released the *Report of the Independent Review of Insurer Profit within the NSW Compulsory Third Party Scheme*[3] (Profit Review).

A key theme which consistently emerged during consultation for the new CTP scheme was that insurer superprofits must be addressed.

While the State Insurance Regulation Authority (SIRA) has commenced action to address the regulatory and administrative recommendations of the Profit Review, the Government has also indicated a number of measures to ensure that insurer superprofits are brought to an end, as part of its legislative reform proposals.

This report summarises the feedback from consultations with the SIRA Board Chair and submissions received by the SIRA Board (listed at Appendix C) in response to specific questions included in the Government discussion paper *Reforming insurer profit in Compulsory Third Party (CTP) motor accident insurance*.

The SIRA Board Chair met or consulted with a range of stakeholders, including each of the insurers involved in the NSW Motor Accidents (CTP) scheme; several professional bodies representing solicitors and barristers; the Motorcycle Council of NSW; the Insurance Council of Australia; and an individual.

A separate, simultaneous consultation addressed in detail the matter of claims management and dispute resolution.

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[2] N Milne and J Della Bosca, CTP Reference Panel, *CTP reform consultation observations*, September 2016

[3] T Matthews, *Report of the Independent Review of Insurer Profit within the NSW Compulsory Third Party Scheme,*15 October 2015

B. Context and background

CTP policy objectives

The Government's policy position is for the CTP scheme to be affordable, sustainable, and efficient.

This reflects the objectives of the *Motor Accidents Compensation Act 1999* and in the relevant scheme performance indicators reported annually by SIRA.

The current scheme reflects compromises between these policy goals. It is designed so that competition not regulation would deliver effective pricing. Promoting competition in the setting of premiums for third-party policies is a legislated objective under section 5 of the Act.

However the regulation of premiums to achieve the policy goal of affordability impacts the level of competition within the scheme.

Ultimately, deciding the right balance between the policy goals of the Scheme is a political judgement by Government.

A privately underwritten CTP scheme

SIRA regulates the CTP insurance that every motorist must purchase prior to registering their vehicle. The NSW CTP scheme is privately underwritten in a competitive market by privately owned insurance companies. There are currently six licensed insurers selling CTP in NSW, owned by four insurance companies – IAG (NRMA brand), QBE, Allianz, (Allianz and CIC-Allianz) and Suncorp (AAMI and GIO).

The Australian Prudential Regulation Authority (APRA) requires private insurers to have sufficient reserves to cover future claims i.e. all liabilities must be fully funded.

The Australian Securities and Investments Commission (ASIC) requires insurance companies operating in Australia to be accountable and transparent in how they operate for the benefit of shareholders and consumers.

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.

The Government proposes maintaining a privately underwritten scheme with a statutory review of the scheme three years after commencement of benefit reforms including a focus on whether superprofits have been eliminated.

Capital, premiums, expenses and profit margins

CTP insurance is capital intensive as serious injury claims can cost in the tens of millions of dollars and take many years to resolve. There is a level of ambiguity in the scheme as:

- Insurers must "write all comers". They cannot select customers.
- It is a long-tail class of business with claims being settled on average 3-5 years after lodgement and often extended past that period. This means that trends do not emerge until a number of years after the policies are written.
- Insurers cannot predict their mix of business accurately. Claims frequency, benefit payouts including superimposed inflation, long-tail liabilities and insurer expenses vary for each cohort year. If the ratio of overfunded to underfunded policyholders is higher than expected, insurers will make higher profits than expected, and vice versa.

Insurer expenses include:

1. The cost of acquiring business e.g. back office costs of accepting and administering policies and premiums, call centre staff and branch staff, corporate overheads for IT systems, management and other functions, and commissions where intermediaries sell insurance (e.g. insurance brokers).
2. The expenses of managing a claim over the life of a claim e.g. claims staff and systems and other overheads.

Being a business, the premium charged must cover claims payments and expenses, and earn a fair profit. But to be competitive, insurance companies must also offer the lowest premium for a given coverage. However NSW regulates what CTP insurance companies can charge through cross-subsidies between high and low risk customers and by reviewing rate filings to ensure that premiums are not excessive. Both business and regulatory objectives must be met.

Typically, insurers have their pricing actuaries determine the technical premium based on underlying claims experience and centrally allocated expenses and capital.

Due to the long-tail nature of the scheme, greater capital than in short tail business must be set aside for future claims. APRA's prudential requirements also require that CTP insurers carry more capital than for other lines of business to ensure that companies do not fail and adversely affect the customer and Australian economy. Consequently CTP insurers require a profit margin to justify the capital and business risk.

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.

There is an argument that being a compulsory scheme with social policy objectives, insurers should accept a lower return on capital than is required for other non-compulsory lines of business.

In the Profit Review's judgment, a reasonable profit margin is a level that corresponds to the returns the providers of capital require (based on forecasts rather than actual results) given the risks in CTP insurance. Importantly, this means that a 'reasonable' profit does not necessarily mean 'affordable' premiums.

A challenge for SIRA is to keep the scheme in balance, providing a responsive regulatory framework which encourages competition yet keeps insurer profit levels at reasonable levels.

C. Consultation findings

1. Profit Normalisation

(a) Profit Normalisation: structure

Background

The Government is proposing, in its legislative reform package, to include a profit normalisation, or clawback, mechanism to ensure superprofits are dealt with or removed, particularly when moving to a new scheme. The aim is to close the gap between filed and ultimate profits during transition to the revised benefits.

As mentioned in the Discussion Paper, there are significant uncertainties in financial outcomes when moving to a new scheme which may lead to profits or losses for insurers different to the profit margins that they file or estimate at the time of filing their premiums with SIRA. During transition to the new scheme it is considered prudent to apply a profit normalisation mechanism. There is also a question as to whether such a mechanism should be maintained as a reserve power for managing any superprofits that may still emerge in the future.

Profit normalisation would occur retrospectively based on the difference between what insurers thought would happen when premium prices were initially set and what actually occurred as measured at some later time.

During consultation it became evident that profit normalisation is not well understood, nor are the reasons for the past high profits of insurers.

Insurers generally view superprofits as something that can emerge as a result of the current scheme structure with its level of uncertainty of the timing and levels of claims costs. Some related factors are the length (long-tail nature) and cost of a claim, the payment of common law damages, the adversarial nature of the scheme and more recently the increase in minor injuries being legally represented.

Other stakeholders consider that the history of long term superprofits is evidence that the regulator has been ineffective in restraining insurer profits.

However, the Profit Review[4] found that:

> *Since insurers are required to "write all comers" in the NSW CTP Scheme, uncertainty around the mix of business, namely, the ratio of overfunded policyholders to underfunded policyholders, affects profit projections. In a Scheme with cross-subsidies aimed at producing affordable premiums for poor risks, some insurers have been more successful at attracting a higher proportion of good risks. It appears that the profits from these overfunded policyholders have been taken as excess profit rather than used to subsidise the poor risks. This practice appears to be contrary to the original intent of the Scheme and its cross-subsidy arrangements.*
>
> *…If claim frequency and claim size are stable, it should be possible to project profit margins with reasonable degrees of reliability. The converse holds if conditions are volatile: small changes in claim frequency and claim size can have significant impacts on realised profits, and projecting profit margins becomes very difficult.*

The scheme was designed with a view that market competition and not regulation would drive effective pricing.

Stakeholder feedback

Insurers are generally accepting of a profit normalisation mechanism during transition to a new scheme. Restricting it to transition, however, is considered important by insurers as, beyond the initial phase of the new scheme, they believe that they can and should be able to carry all the risk and that profit normalisation may drive mediocrity by reducing the incentive for insurers to invest in efficiencies and innovation.

Others, however, including representatives of the legal profession, support profit normalisation being a permanent feature of the scheme and also commencing immediately, regardless of scheme reform.

It is generally accepted that any profit normalisation should be undertaken on an industry basis, without regard to the financial results of individual insurers, so that all insurers are affected equally irrespective of their own individual financial performances.

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[4] T Matthews, *Report of the Independent Review of Insurer Profit within the NSW Compulsory Third Party Scheme*,15 October 2015, p. v

SIRA Board response

There are valid arguments for profit normalisation to operate on a transitional basis to respond to the initial uncertainty of the financial effects of the benefit reforms, given the inherent uncertainties and volatility of this class of long-tail insurance, and to be maintained as a reserve power to be available to SIRA after transition. It would then be used if scheme experience warranted it at the time.

The Board considers that, given the inherent uncertainties and volatility of this class of long-tail insurance, profit normalisation:

a) should operate on a transitional basis to respond to the initial uncertainty of the financial effects of the benefit reforms

b) should be maintained in legislation as a reserve power to be available to SIRA after transition; it would then be used if scheme experience warranted it at the time, and

c) should be introduced simultaneously with the introduction of benefit reforms and legislated accordingly.

Noting the current lack of published information and precision around possible techniques for profit normalisation, SIRA will prepare a detailed exposure draft and, subject to testing and feedback with insurers and other stakeholders, proposes to confirm the details during the first quarter of 2017.

This exposure draft will include statements on tolerance levels and other aspects of profit normalisation and will also take account of the need to allow individual insurers who are more innovative or more efficient than their competitors to retain financial benefits from their performances relative to other insurers.

(b) Profit Normalisation: dealing with excess insurer profit or profit shortfalls

Background

The Discussion Paper outlined three possible methods put forward by SIRA to distribute superprofits once the amounts to be distributed are determined:

- Apply the claw-back to enable future premium deceases (industry profit) or increases (industry loss) so that there is a form of catch up in premiums. This method is preferred by SIRA. However SIRA acknowledges that this may make it difficult for new entrants to the scheme who did not share past profit. It would also create distortions and complexity in the CTP market.

- Provide refunds directly to motorists. This would be difficult to administer and would not deal with any insurer losses.
- Direct funds towards public purposes.

Stakeholder feedback

Insurers provided a range of preferred methods on how to distribute superprofits to NSW motorists but generally agreed that any mechanism to distribute profits back to motorists must balance simplicity of implementation with fairness to individual motorists. Several suggested a "holiday" on the MCIS levy on a state-wide basis for a defined period. One mentioned that funding of road safety initiatives would not be apparent to the premium paying motorist as a premium reduction.

The legal profession submitted that a pool should be created into which superprofits are paid. The pool can be utilised to reduce the MCIS levy and thus reduce premiums for all motorists.

There was widespread acceptance of a two sided test and acceptance that it should limit conservatism in rate filings but there was also some support for a one sided test (meaning clawing back excess profits but insurers bearing any losses) on the grounds that a two-sided test may create complacency among insurers.

SIRA Board response

Under profit normalisation, if there are excess profits at any time to be reclaimed from insurers or alternatively profit shortfalls to be reimbursed to insurers, SIRA's position is that:

a) the mechanism for doing so should be by adjustment to MCIS levies, and

b) the size of the adjustments and the periods over which they will apply should be at the discretion of SIRA based on considerations of materiality and overall premium stability.

2. Measuring and publishing insurer profitability

Stakeholder feedback

There have been suggestions from some observers of past emerging superprofits that there should be greater transparency of insurer rate filings and profit details. The proposition is that, if greater transparency were to replace the opaqueness of insurer rate filings and the limited disclosures each year by insurers and SIRA on insurer profits, the increased transparency would generate greater scrutiny and put a brake on insurer profit levels. In other words, publication of insurer rate filing details and profit details is being sought as a mechanism for insurers and SIRA to be more accountable for their performance and effectiveness in operating the scheme.

Insurers, however, are strongly of the view that such transparency would not be appropriate for a range of commercial reasons. Much of their rate filing information is presented in confidence to SIRA. It is commercially sensitive and not available for disclosure to their competitors and the same applies to details of profit disclosures. Furthermore, the technicalities of portfolio monitoring and profit measurement in CTP as a long-tail class of insurance is far from straightforward and can be readily misunderstood or misinterpreted.

In SIRA's view these insurer concerns carry weight and SIRA does not believe it is appropriate to publish such details. Nevertheless the level of interest in the financial performance of the scheme does warrant publication of some additional disclosures, especially with the impending introduction of benefit reforms and profit normalisation.

Accordingly, SIRA will monitor and publish variations in loss ratios based on the ratios of filed claims costs to standardised premiums and to variations in realised claims costs relative to filed claims costs. The loss ratios will be based on accident year analyses (i.e. grouping together all claims occurring in each financial year and comparing them with the corresponding premiums earned in the same period). Average premium levels and profit margins themselves will also be published.

This approach will demonstrate the levels of expenditure and compensation paid to or on behalf of injured claimants and will compare those levels with the premium revenue collected to meet these costs. It has the benefit of focusing attention on the performance of the scheme as a whole instead of relying on insurer profit measures alone, while at the same time yielding scheme results that will clearly indicate whether superprofits or indeed losses are being made by insurers.

SIRA Board response

For future publication purposes, SIRA has considered the balance needed between information that is commercially confidential to insurers and SIRA on the one hand and the desire of the community on the other hand to have more transparency regarding scheme performance. Accordingly SIRA will publish annually:

- industry-wide loss ratios and profit margins
- summaries of the rate filings of insurers derived from the rates available on insurer websites and on SIRA's Green Slip Calculator.

This position is being adopted by SIRA to recognise the risks and limitations of publishing all aspects of insurer profits, given the complexity of the scheme and the potential for misunderstanding or misinterpretation of early-stage results, while at the same time recognising the need for the community to have access to the important indicators of scheme performance.

3. Past insurer profitability

Background

SIRA and the former Motor Accidents Authority (MAA) have published in annual reports in the past a range of information on scheme performance. They have also prepared additional related information from time to time for the Law and Justice Committee of the Parliament. Additionally some observers have published their own interpretations of some of this information.

Some of this information is confusing for observers, expert and lay alike, as there are different possible measures of claims experience and profit levels such that conflicting views of what has happened or is happening in the scheme can arise.

SIRA Board response

SIRA recognises the need for comparability in scheme performance measures between the past and the future. As a result, SIRA will arrange the reworking and publication of past loss ratios and profit margins in the format of the loss ratios and premium disclosures that are recommended to be used in future for the publication of insurer financial results as at Response 3.

4. Insurer profit margins

Background

The topic of establishing suitable or reasonable insurer profit levels in CTP (and other long-tail classes of insurance) has attracted extensive debate over many years, from regulators, actuaries, economists and others. The debate covers both target profit levels, which are typically used in setting premiums, and realised profit levels, being the profits actually achieved once the claims costs are known.

In recent years, the problem in the NSW CTP scheme has not been the profit margins that insurers have used in their rate filings but the profit margins realised in subsequent years because the realised margins have been consistently higher, and in some years much higher, than the filed margins. This consultation is essentially about how to contain realised profit margins within a reasonable range relative to filed profit margins rather than about the filed profit margins themselves.

Nevertheless the filed margins themselves need to be recognised by both SIRA and the community as a suitable reference point against which to assess whether insurers are earning superprofits.

Stakeholder feedback

Profit margins filed by insurers in the region of 8% of premiums have been common for some years, partly through encouragement by SIRA that this level is reasonable.

Non-insurer stakeholders recognise that insurers need a reasonable profit margin and a level of 8% is widely regarded as fair. Insurers themselves have some differing views and some believe a higher level is appropriate but in the context of this consultation and of the scheme as a whole there is an overall recognition that a level of 8% is reasonable.

Some stakeholders proposed techniques for limiting insurer profits and avoiding superprofits that have the character of SIRA imposing constraints on insurer rate filing assumptions and even of modifying benefits on a regular basis if profits are seen to be excessive. The latter is not practical. The former is already practised by SIRA but the various initiatives arising from this consultation are designed to make such interventions by SIRA more effective in the future.

SIRA Board Response

Historically insurers have commonly included profit margins of 8% or near 8% of premiums in their rate filings. A filed profit margin of 8% of premiums is accepted as reasonable by insurers and many other stakeholders, notwithstanding that, unsurprisingly, the insurers would prefer a higher margin.

SIRA has considered in some depth the question of reasonable profit margins for future rate filing purposes and has also taken account of the opinions and views of insurers and other stakeholders. SIRA will readily accept filed profit margins up to 8% of premiums but would need special justification for a higher level. The revised Premium Determination Guidelines will reflect this position.

5. Insurer acquisition expenses

Background

For the purposes of premium rate filings, acquisition costs are all the costs associated with writing insurance policies and collecting the premiums. They comprise all insurer costs other than the costs of handling claims and generally comprise the costs of sales and distribution by insurers via branches, telephone call centres, internet based sales and intermediaries such as insurance brokers and motor dealers. They also include back office costs of IT systems, management and administration.

For rate filing purposes insurers report their estimated acquisition costs to SIRA and generally include all those costs in their rate filings. The actual costs of individual insurers vary and they depend on a range of factors including in particular economies of scale and internal efficiencies along with the insurer’s sales and distribution strategy.

From SIRA’s perspective there is no meaningful technique for assessing the cost efficiency of any individual insurer and yet it is evident that SIRA cannot allow insurers to file CTP premiums simply on a ‘cost plus’ basis with no particular accountability for their acquisition costs.

A worthwhile response to this problem is to limit the level of expenses that will be allowed for rate filing purposes.

A more complete solution from SIRA’s viewpoint is to allow a standard level of acquisition expenses for all insurers for rate filing purposes. Insurers who can run their business at lower cost would earn some additional profit but, more importantly, insurers who choose to engage in costly marketing and sales endeavours, intermediary incentive programmes and the like would be obliged to do so at their own cost.

Stakeholder feedback

Non-insurer stakeholders strongly support a cap on insurer acquisition expenses in rate filings. They think that the expense assumptions in rate filings contribute to insurer profits and they also believe that CTP premiums contribute to advertising and promotional expenses for sporting ventures and other corporate marketing activities that should not be borne by vehicle owners in a compulsory class of business. They are also concerned that CTP premiums may be inflated in order to fund multi-policy discounts on insurers’ motor and other classes of business.

Insurers are cautious about limits placed on acquisition costs and of any additional regulation on expenses. They are, however, not opposed to limits on the expense allowance they are entitled to use in rate filings provided that any such limits are fair in relation to the actual expenses that insurers are likely to incur in operating a competitive and efficient CTP portfolio.

SIRA Board response

For the purpose of both rate filings and profit normalisation, SIRA will limit acquisition expenses to an average amount per policy to be specified by SIRA. This means capping the expense allowance available to insurers for pricing purposes but leaving it open to them to spend more if they wish, on marketing and sales or other initiatives, in operating their CTP portfolios. In other words, their profits would be measured relative to the expense allowance irrespective of insurers’ actual expenditure.

6. Commissions

Background

Different insurers rely to a different extent on the payment of commissions to insurance brokers, agents and motor dealers in managing their CTP portfolios. Commissions are limited under the legislation to 5% of premium per policy.

Stakeholder feedback

Despite some discussion about deregulating commissions, several insurers indicated that the current 5% limit on commissions is a good regulation that among other things prevents excessive commissions.

Some non-insurer stakeholders believe that commissions should not be paid at all because CTP is a compulsory class of business and others believe that they should continue to be allowed but that in some cases where high premiums are involved that further restrictions below 5% should be introduced.

SIRA Board response

SIRA has no intention of abolishing commissions or of deregulating them so that they might exceed 5% but is currently reviewing its policy. In the meantime commissions will remain unchanged and therefore continue to be limited to 5% of premium on any one policy.

It is notable that, in view of the limitation on the acquisition expense allowance at Response 7, the commission arrangements have little bearing on insurer rate filings.

7. SIRA to become an approval authority?

Background

SIRA has the legislative power to reject an insurer's rate filing but does not have the power to approve a rate filing. Under this 'file and write' system, if an insurer submits a rate filing and SIRA does not reject it within six weeks of its submission, the insurer is free to adopt the rates as nominated in its filing.

The 2015 Profit Review noted that the former Motor Accident Authority's hands appear to have been tied on some past occasions by the legislated time limits it has to work with if it chooses to reject an insurer's rate filing. It therefore recommended reversing the onus so that insurers must prove their case for a premium increase, rather than the current system that requires SIRA to prove its case for a rejection.

Stakeholder feedback

This topic was not explicitly raised by any stakeholders in consultations or in submissions. That suggests that stakeholders do not regard the matter as material to the question of insurer superprofits and nor do they regard it as an important issue for rate filings more generally.

SIRA Board response

After careful consideration of the potential consequences, the SIRA Board is not intending to seek legislative change to move from rejection powers to approval powers for rate filings.

To give SIRA approval responsibility could be seen to be equivalent to SIRA setting insurer prices or controlling insurer prices directly. As such it would be contrary to the spirit of the 'file and write' system and substantially different from operating a free market environment with regulatory restrictions, as currently occurs.

In the Board's view it is better to continue with the current system where SIRA can influence insurer prices through the rate filing requirements but does not set the prices or formally approve them. SIRA regards the rejection powers currently available to SIRA and its consequences for insurers when used as sufficient to meet its responsibilities and to meet the objectives of the system. SIRA regards rejection as a reserve power or a last resort in the case of an insurer who is not cooperative when SIRA believes its rate filing is contrary to the public interest.

8. The fully funded test

Background

An objective under section 5 (1) (f) of the *Motor Accidents Compensation Act 1999* is to ensure that insurers charge premiums that fully fund their anticipated liabilities.

Section 27(8) of the Act states that SIRA can reject premium filings on several grounds, one being that the premium will not fully fund the present and likely future liability of the insurer concerned. SIRA requires certification by an independent actuary that the aggregate premium will fully fund liabilities.

The fully funded test was introduced with the Act to ensure that there are no failures of CTP insurers. One of the effects of the fully funded test, however, is that insurers may file overly conservative premiums in the name of full funding and thereby contribute to superprofits. At the same time the test is unlikely to prevent the failure of an insurer which may fail for reasons other than losses in its CTP portfolio.

The fully funded test was originally introduced to protect against insurer failure at a time that precedes APRA and its prudential regulation regime which can now be seen as making the fully funded test largely redundant. APRA's robust regulation of the insurance market minimises the risk of insurer failure.

Stakeholder feedback

Stakeholder feedback was limited on this issue. The legal profession supports the abolition of the fully funded test if it is considered safe to do so. A few insurers indicated that the fully funded test is not necessary given controls from APRA.

Some insurers are cautious about abolition of the fully funded test as they believe it contributes to scheme stability and provides some constraints on under-pricing by insurers.

SIRA Board response

The fully funded test is essentially redundant as a result of APRA's prudential regulatory regime. Further, it can act to make insurer filings more conservative than they need to be in a competitive market and arguably has been one of the factors contributing to superprofits.

SIRA will therefore abolish the fully funded test in 2017 but will nevertheless expect and indeed ensure that insurer rate filings do not envisage losses to the insurer that would jeopardise in any way the stability of the scheme or of an individual insurer.

Appendix A - Consultation questions

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 superprofits 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 (e.g. 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?

Appendix B – Summary of stakeholder submissions

Responses to targeted questions

Responses to the targeted questions posed in the Discussion Paper *Reforming insurer profit in compulsory third parry (CTP) motor vehicle insurance.*

1. What concerns or risks do you see with the proposed actions to reform the premium system?

CTP insurers raised the following concerns in response to the proposed actions to reform the premium system:

- Controlling profit in a competitive and unpredictable market will be very difficult for SIRA. Determining profit levels can lead to debates between actuaries: it is not a complete science. This would pose a high risk to Government.

- Innovation may be stymied in an environment containing too many rules around profit. Profit is a driver of innovation.

- Defining profit is problematic when many insurers are listed companies. Premium rate filings are provided to SIRA with an estimate of profit. The profit that eventuates several years later and is recorded by SIRA is SIRA assessed profit.

- In aggregate increases in SIRA powers (e.g. approval power over premiums, increased transparency in the premium setting process, capping of profits and expenses and management of risks through a Risk Equalisation Mechanism) create a relatively unattractive market for competition. A duopoly or monopoly may emerge. A finely tuned scheme will affect the rate of return on insurer capital with insurers bearing the risk.

- The introduction of a Risk Equalisation Mechanism (REM), changes to pricing for commercial vehicles, and removal of some of the cross-subsidies which exist in the scheme may provide benefits. However, there is a risk some motorists will see an increase in their premiums as a result of these changes. It is therefore important that SIRA manages the changes in a way which minimises this risk.

- If the actuarial assumptions and projections related to balancing cross subsidies within the REM, and the effects of other mechanisms on the scheme, are incorrect the scheme will be out of sync.

- The introduction of a REM is a significant change to the premium system, with SIRA playing a pivotal role in its operation. Specifically, SIRA will determine the amounts which insurers must pay to (or receive from) other insurers in order to spread risk across the industry. Any misestimating in these REM amounts may create distortions in the market, as all insurers will make decisions based on the same (misestimated) REM amounts. This risk can be managed with regular monitoring and updating of the REM parameters to ensure they are accurate.

The Legal Profession identifies the risk of one or two of the current CTP insurers leaving the market as without superprofits, they will no longer wish to remain. It considers the prospects of attracting additional entrants into the market to be modest stating that greater market concentration leads to less competition.

The Actuaries Institute sees complexity and cost as a risk to the scheme with the mix of mechanisms proposed and question the added value of each proposal. It states that excessive and unnecessary regulation can obstruct an efficient market from functioning and can undermine public interest.

One submitter warned to proceed cautiously, as attempts to smooth profits and distribute the population of high risk vehicles across competing insurers have typically not been successful. Whether an appropriate private sector, competitive market model with a residual market mechanism[5] can be achieved was questioned.

2. What are your views on the proposed approach to profit normalisation?

Insurers generally accepted a profit normalisation mechanism to buffer against the possibility of superprofits in the initial years of the new scheme. They consider the mechanism should only be used when transitioning to the new scheme, and that a sunset clause is critical. Beyond the transitional phase insurers claim that profit normalisation would drive mediocrity and be unattractive for new entrants to the scheme. Once the scheme has matured, it was proposed that it is the responsibility of SIRA to manage or supervise the scheme and make adjustments in response to aberrations.

They favoured any claw back being determined on an industry profit basis.

The legal profession strongly supports profit normalisation as a permanent feature of the scheme. Independent of whether the scheme is extensively reformed or whether the current scheme is maintained, they recommend a scheme of profit normalisation should be introduced immediately.

Another stakeholder who supported the introduction of some form of profit normalisation during the transition to the new scheme warned that permanently having this option available would lead to inefficiencies in the scheme.

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[5] Residual market mechanism: An arrangement, either voluntary or required by law, among participating insurers in which applicants for a certain type of insurance who are unable to secure protection in the open market (hard-to-place risks) may be covered by such participating insurers.

One insurer felt profit normalisation should apply only to profit margins that materially exceed a reasonable range above that filed. It was further suggested that profit normalisation should be based on the difference between actual and filed claims cost, rather than “profit”.

Profit incorporates a range of other factors which will complicate the mechanism without providing any benefit. For example, insurer expenses should be excluded from the calculation since it is difficult to assess expenses for an individual portfolio within an insurance company, given the size and complexity of insurance companies. Similarly, investment income should not be part of the assessment of profit, as insurers adopt varying investment strategies that affect all products, and are not restricted to CTP.

Consider the long-tail

Insurers cautioned that the long-tail on the scheme must be accounted for in the design of any profit normalisation claw back. For example, if superprofits are being identified after three accident years, clawing back industry profits and distributing them in some way to motorists at this point may be premature. There may be a lag in the lodgement of claims through unfamiliarity with the scheme and true superprofits will be clearer once claimant behaviours mature and reflect the long-term level of claims costs.

Without adequate time to mature, an unfavourable situation may arise where motorists receive some form of benefit in one year due to clawing back superprofits from insurers and an increased premium the next to meet a shortfall. The first three accident years of claims may “normalise” or mature at six or seven years.

One insurer also advised that profits for each accident year should be determined for the industry in aggregate no less than two years after the commencement of the new scheme, then annually thereafter until (say) six years after commencement. By this time, the estimate of the ultimate claims cost for the industry for the first accident year should be fairly reliable.

It was strongly argued by an insurer that a scheme with lower levels of superimposed inflation should narrow the difference between filed and realised profits. Taking this into account it considered an on-going profit normalisation mechanism unnecessary.

Due to the ‘long-tail’ class of insurance insurers agreed that any profit normalisation mechanism must be simple.

In developing the Profit Normalisation Mechanism another stakeholder advised to be mindful of the overall benefit design of the new scheme: longer than three years may be needed to assess profitability accurately.

Efficiencies and innovation

Not all submitters addressed this. One insurer argued that the operation of profit normalisation is not required beyond two or three years and that the disadvantages with maintaining it beyond the transition period include reducing incentives for insurers to invest in efficiencies and innovation. It was proposed that this could also result in premium volatility if the scheme experience deteriorates. In such circumstances motorists could face premium increases for higher prospective costs whilst also paying a levy to fund past excess losses.

Accounting for profit normalisation

One insurer stated that accounting for profit normalisation will be challenging.

3. Should the definition of appropriate insurer profit levels be set by SIRA, and if so what considerations should be included?

Superprofits

Insurers generally view superprofits as an artefact of the current scheme structure with its level of uncertainty in terms of the length and cost of a claim, the payment of common law damages, the adversarial nature of the scheme and the increase in minor injuries being legally represented. Insurers assert that the structural reforms in the current scheme will go a long way towards addressing uncertainty and superprofits. Reducing uncertainty and volatility will reduce insurer profit because insurers will require less capital and thus a lower profit margin.

One insurer stated that superprofits relate almost exclusively to external economic factors, unexplained changes in claims frequency and superimposed inflation. Suppressing superimposed inflation and other factors such as the rapid increase in claims frequency since 2008 will address excessive profits.

The legal profession considers it critical to any effort to address excessive insurer profits in the NSW scheme to understand why those excessive profits occur. It considers that experiencing long term superprofits is evidence that the regulator has been ineffective in restraining insurer profits.

Others similarly had the view that the regulator must use its regulatory powers to challenge the assumptions being used by insurers using recent scheme experience. They are also deemed sufficient to suppress superimposed inflation.

One insurer believed that strong competition can also have an important impact on regulating insurer profitability and support first party arrangements which encourage customers to choose who will look after them in the event of being injured.

Appropriate insurer profits levels

One insurer recommended that the assessment of appropriate insurer profit levels needs to be set by an independent body, such as the Independent Pricing and Regulatory Tribunal (IPART). Substantial theoretical work has been done in recent years (by the Actuaries Institute, among others) to determine a technically justifiable and appropriate level of insurer profit in statutory classes. Work such as this would help inform an IPART decision. The assessment of appropriate profit levels would need to be updated regularly (say annually or biannually) as economic conditions change.

Focussing on how much of the premium dollar goes to the claimant (loss ratio on the claim cost) was recommended by a number of insurers as a better gauge of efficiency in the scheme and an alternative to defining appropriate insurer profit.

One insurer mentioned that the scheme does not measure lawyer or medical profit. (NB: These are not organisations licenced to manage premium funds and claims.)

Another insurer was concerned with the proposal to limit the capital and profit levels in a manner inconsistent with obligations to APRA and requested that any such inconsistency be resolved.

Several individual motorists have made submissions stating that competition on CTP premium price is limited and that CTP insurance is becoming unaffordable yet insurers are making “superprofits” for “overseas companies” in a compulsory and protected market. They call for regulated profit margins in a scheme that regulates “pay out claims” plus lower Green Slip prices or a State run scheme offering lower Green Slip prices.

The legal profession advocates an 8% of premium profit margin, excluding the Lifetime Care and Support levy and GST.

A barrister recommended that the CTP insurers should be confined to ‘reasonable’ profit margins: somewhere in the range 8% to 12%. There needs to be a mechanism to obtain a refund from insurers of superprofits. Perhaps insurers could be required to refund say 90% of any excess superprofits after the claims tail is finalised. The 10% buffer provides adequate incentive to innovate.

During discussions the ICA accepted a profit margin of 12% of premiums as acceptable whilst two insurers advised that 8% of profit on premiums as acceptable in the current market.

Another stakeholder mentioned that locking down stakeholder profit is counterproductive.

A further stakeholder advised that suitable levels of profit should only be determined once scheme benefit design has been agreed and, at a minimum, APRA’s required capital levels are understood.

One stakeholder advised that a definition of appropriate profit levels should consider: market interest rates; what is best for the consumer; and scheme performance with the wellbeing of the injured as a key performance indicator.

Generally insurers argued that setting the profit level will erode innovation and increase the premium price. They stated that there is a tension between providing a fair premium to the motorist and maintaining adequate profit margins in a commercial insurance sector that requires a return on capital for shareholders.

4. Which mechanism(s) do you believe are best to distribute premium superprofits back to motorists? Why?

Insurers provided a range of preferred methods on how to distribute superprofits to NSW motorists:

- Road safety e.g. installing speed cameras or average speed cameras.
- A holiday on the MCIS levy on a state-wide basis for a defined period. This would represent a simple transparent method of sharing benefits. Using clawed-back profits for road funding/safety will not be as apparent to the premium paying motorist as a premium reduction. (NB: This would require Government approval.)
- Funding community initiatives e.g. wheelchair sports.

Generally the insurance industry considers that any mechanism to distribute profits back to motorists must balance simplicity of implementation with fairness to individual motorists.

Several insurers advised that returning profits to motorists on a retrospective basis is unviable and supported a State-wide reduction or 'holiday' from the MCIS levy. It was also mentioned by one insurer that this would potentially allow for targeting of levy reductions to segments of the market which generated the excess profits. For example, if vehicles in country regions were over-priced and this resulted in superprofits for insurers, the mechanisms should be designed so that only country regions receive the excess profits. It is noted that any mechanism will involve calculations and implementation several years after motorists have paid their premiums.

A great administrative impost and expense would occur if insurers were required to identify motorists who had paid a premium during the period of superprofits and allocate to them a proportionate amount of the superprofits.

Other insurers preferred utilising the funds from superprofits for public purposes.

The legal profession submitted that a pool should be created into which superprofits are paid. The pool can be utilised to reduce the MCIS levy and thus reduce premiums for all motorists.

Another stakeholder recommended a pool for storing the superprofits which could be used to offset future CTP premiums.

5. If insurers make a loss, should they be compensated in a profit normalisation framework? How?

Various arguments were raised by insurers concerning the benefits of two–sided (clawing back superprofits and losses) and one-sided claw back (i.e. clawing back superprofits but not losses) including:

- Conservatism in premium setting will be exacerbated if the profit normalisation framework requires insurers to ‘pay back’ excess profits but does not allow them to ‘recover’ losses. If insurers made losses SIRA could collect higher levies and return this money to insurers.
- If an insurer cannot make profits they are grossly incompetent and if the band is wide enough someone will make a superprofit.
- A one-sided test is acceptable for two or three years but it should not be a permanent fixture. The two-sided test encourages insurers to be lazy: if claims blow out they still get their money back.
- Prefer a two-sided test but the one-sided test is thought to be advantageous to all as there is a greater incentive to run business efficiently therefore it is only bad management if you make a loss. The insurer focus is on the customer: a different corporate culture than in the 1970’s to 1990’s. ASIC regulation also focuses on the customer. However the two-sided test is inherently fair but politically difficult.
- The consumer gets hit twice if compensating insurer losses.
- If results are poor SIRA should tweak the scheme.

In the legal profession’s view, fairness would seem to dictate that if superprofits are to be captured, then super losses should be underwritten. However, such underwriting should be in the form of credits as against the pool as a set-off against future superprofit or superprofit yet to be paid in respect of previous years.

6. Should a tolerance level (e.g. x%) above or below the targeted profit be considered? If so, what would be an acceptable tolerance level?

ICA believed that SIRA would jeopardise reform in an inherently unpredictable market if it meddled with profits.

One insurer advised that it could not comment until it had seen the proposal in full but that 8% to 12% profit was acceptable and anymore was excessive.

Another insurer stated that below 3% a loss should not be clawed back. The insurer could accept that for 2-3 years.

A further insurer advised that claw-back should be for something unusual and it could accept a tolerance level of +/- 5%.

The legal profession accepts that 8% of premium is a reasonable return but also considers that there should be some incentive for insurers. Its recommendation follows:

a) Take back 25% of superprofits between 10% and 12%;

b) Take back 50% of superprofits between 12% and 14%;

c) Take back 75% of superprofits between 14% and 16%; and

d) Take back 100% of superprofits over 16% (i.e. double the acceptable level).

Also the legal profession accepted that the most pragmatic way to tax superprofits is on an industry-wide basis. To avoid profits being “hidden” for a set period, the clawback needs to run over the lifetime of the claims.

A barrister suggested that insurers could be required to refund say 90% of any excess superprofits after the claims tail is finalised. The 10% buffer provides adequate incentive to innovate.

Another stakeholder warned that, in considering the right boundaries to set, once insurers recognise that profits or losses are beyond the boundaries, the incentive to manage claims to reduce costs changes.

Another stakeholder suggested +/- 2% but always within the limits of prudent management of the superprofits pool.

7. What should be done for the insurer who adopts innovation, operates efficiently and makes extra profit as a result of their endeavours?

One insurer stated that without incentive, the industry will become inefficient which will lead to higher premiums for motorists. One way to reward innovation, while ensuring insurers are not making excess profits through conservative pricing, is to assess profits on an industry wide basis rather than by individual insurer. In the event the industry makes excess profits, each insurer should contribute to the repayment of excess profit (regardless of whether they individually made excess profits, or even losses) based on a measure such as premium, claims cost or portfolio risk profile.

In the event that the cause of the excess profit is restricted to a particular segment of the CTP market, the mechanism must be designed so that the insurers who benefit the most from an excess profit generating issue should be the ones that contribute the most.

Similarly, the motorists who contribute the most to the excess profits should receive the most from the reallocation.

Another insurer advised that the focus was wrong: rate filing and achieved profit are an “appears to” and are less likely to really tell what is going on.

Another insurer advised that insurer management of the expense ratio, and claims ratios encourage innovation. Regulating expenses and profits encourages insurance companies to do nothing and drives mediocrity.

One insurer recommended allowing a profit level across the market and then provide a percentage above this for innovation.

The legal profession considers that, by having a ratchet increase in the degree of super profit being taxed and in taxing the industry as a whole, rather than individual insurers, the innovative are rewarded and the less innovative are not punished.

Generally all stakeholders that commented recommended incentives for efficiency and innovation.

8. What advantages/disadvantages do you see in annual reporting on individual insurer profit by SIRA?

A range of comments were received from insurers:

- There are better metrics for transparency such as complaints and claims handling performance.
- Reporting of any profits once claims have settled will relate to policies which were sold 3-5 years ago, with no relevance to the premiums offered today.
- Publishing individual insurer profits will incorrectly give the impression the insurer with poor claims management practices (and lower profits) is acting in the best interests of the scheme.

- Conversely insurers that achieve higher profit levels can only do so through innovation and efficiencies which will not be captured in a table that simply shows profit by insurer.
- Insurers constantly disclose their financial results to financial regulators such as APRA and also through annual reports and analysts' reports.
- For companies listed on the stock exchange public disclosure of estimated CTP profits could lead to a range of interpretations by analysts with the potential for unintended market impacts for the insurers. Also nobody will file low as it will affect investors.
- Commercial in confidence is an issue.
- How will SIRA define profit? It will be different to the insurer definition of profit.
- The aggregate publication of insurer profit, legal costs and other scheme performance indicators should inform stakeholders.
- SIRA already has multiple indicators to track the health of the scheme, including efficiency measures which clearly show how much premium goes to insurer profits, legal fees and claimants' benefits.
- Report incurred loss ratios only. This is the only semi-meaningful variable. Adequacy of reserves otherwise plays a role. Note also the effect of different operating models on expenses.

Several insurers suggested that a better approach would be to set clear loss-ratio targets (the amount of each premium dollar going to the injured person) for the scheme to achieve. This would place the onus on all stakeholders to ensure costs are contained.

Two other stakeholders supported annual reporting.

The legal profession strongly supports having SIRA as a transparent and effective regulator of premiums. SIRA should be required to approve insurer's premium rates for NSW CTP.

The Actuaries Institute advised that there should be an assessment of the balance between public good and commercial advantage that may flow from sharing private data.

9. What advantages/disadvantages do you see in increased transparency in the premium setting process, including making SIRA an approval authority?

One insurer stated that there is currently a high degree of transparency between insurers and SIRA through the rate filing process. This transparency is possible because insurers can provide commercial-in-confidence information to SIRA when seeking price changes. By making filings publicly available, insurers will need to restrict the information which is included in the filing, which will actually reduce the transparency in the premium setting process.

SIRA currently has legislative power to reject premiums for various reasons, including if they deem the premium to be “excessive”. Therefore, it is unclear whether there would be any benefit in reversing the current process so that SIRA approves, rather than fails to reject, premium filings. There may be an added risk where SIRA simply does not reject or approve the filing and the insurer is left in an uncertain position. In this circumstance, there must be a default position whereby the premiums are automatically approved if SIRA fails to approve within a specified time limit.

A range of other comments were received from insurers:

- One stakeholder requested clarity on the intended outcome. Insurers submit their premiums to SIRA and SIRA has the authority and powers to ensure the appropriate price is set. Further engagement with the community may be required to ensure NSW motorists are confident in this process. Opening up the premium filing process may not be appropriate and could stifle competition and the openness that currently exists between insurers and the regulator.

- A reasonable cap on premiums is acceptable. However regulated pricing is a very difficult game: the regulator will lose. The more intervention the less effective the scheme becomes.

- Extreme care should be taken with increased transparency in the premium setting process. Commercially sensitive information is involved and there are difficulties in interpreting the process. There is the potential use and abuse of the information according to the agendas of others.

- The rate filing transparency in the updated Premium Determination Guidelines are adequate. Rate filings on a public website will create commercial in confidence information concerns.

- There is financial and prudential oversight at the Commonwealth level (APRA and ASIC).

- The principles based regulation has now flipped.

The legal profession strongly supports having SIRA as a transparent and effective regulator of premiums. SIRA should be required to approve insurers’ premium rates for NSW CTP.

A barrister stated that the present system of approving premiums is not robust enough in favour of public scrutiny. The insurers have been allowed to invoke “commercial in confidence" arguments as a reason to avoid any real scrutiny. SIRA's in house reviewers do not appear to have had enough information, expertise, power and resources to test the CTP insurer's data. The higher superprofit levels maintained over decades show the present system has short-changed the public and is a major contributor to Green Slip premiums.

10. Should there be caps, limits or controls on acquisition expenses, including commissions to intermediaries?

One insurer did not support caps on total acquisition costs as it believed a competitive market will drive efficiencies through customer choices. The distribution strategies and cost bases of insurers vary widely.

Another insurer noted a cap (5%) currently exists on commissions to intermediaries and suggests this cap be retained. Another stakeholder stated that costs to acquire business in a statutory scheme are an anathema and questioned the quality of the service for the amount expended by insurers.

Further insurer comment included:

- A five percent (5%) cap on commissions is a good proposition. Not any higher as it stops excesses of greedy people.
- Fleet acquisition costs need to be capped.
- Capping costs will not stop current behaviours: discounts on other products are provided in order to obtain CTP business. Dollar caps are fairer and intermediary costs must not be regulated.
- It affects return on capital and how business is transacted in a full service distribution model.

The legal profession strongly supports a cap on insurer acquisition and operating expenses. It submitted that there should be no allowance within such a cap for general brand promotion advertising. With a statutorily mandated and compulsory CTP product, NSW motorists should not be paying for any part of the branding of Allianz Stadium, the QBE Swans, the NRMA Western Sydney Wanderers FC or the NSW Rugby League GIO Cup etc.

The only allowance that should be incorporated in advertising/marketing expenses is where it informs the public about the product, preferably limited to competition on price.

Also the legal profession supports a ban on the payment of commission or "business support" payments in respect of any CTP insurance policy. Further, business acquisition expense assumptions in premiums filed with SIRA should not be allowed to include any allowance for commission or “business support” payments of any kind.

A barrister supports an allowance of $50 per premium.

The National Insurance Brokers Association submitted that any proposal to regulate acquisition costs, cap expenses and limit or remove commissions should be preceded by a careful analysis of the various distribution channels, the cost of distribution via those channels, and the value and benefit provided by the operators of those channels in terms of convenience and advice to the community. No action should be taken in relation to acquisition and related expenses unless and until proposed reforms are clearly articulated, and a clear cost/benefit analysis has been undertaken in relation to the likely impact of those reforms.

The Motorcycle Council of NSW advocated caps and controls on acquisition costs but also recommended establishment of overall population community risk rating with CTP premiums being collected with vehicle registration fees and policies being distributed across the pool of private insurers. This would provide for minimal acquisition expenses other than any administrative charge required by the Roads and Maritime Services Department.

Additional measures

Responses to the additional measures considered in the Discussion Paper *Reforming insurer profit in compulsory third parry (CTP) motor vehicle insurance* follow.

Risk Equalisation Mechanism (REM)

One comment provided during consultation was that the REM discriminated against smaller insurers and new entrants to the market as segmentation (or niche markets) was the only competitive advantage that they would have against insurers with large market shares that could afford bundling discounts i.e. provide discounts when the customer buys CTP, home and contents insurance as a package. It was suggested that:

1. this practice provided a quasi-discount for CTP insurance.
2. insurers with large market shares could afford a loss lead on CTP insurance and would not be affected significantly by the REM due to their market shares.

Another insurer stated that the REM is needed to maintain affordability across different segments. The objective of the REM is to deal with the mismatches between community requirements on pricing and insurers’ requirements. It is designed to reduce the risk of anti-selection, rather than to eliminate the risk of anti-selection. This should be the objective and the REM should be kept as simple as possible.

Other insurers proposed a simple REM: one without too many calibrations for the range of market risks that exist. The ICA advised that it changes competition in the market: there are winners and losers.

It was mentioned that the REM is modelled on actuarial advice and, if incorrect, the whole scheme could be out of sync.

A further comment was that the introduction of a REM is a significant change to the premium system, with SIRA determining the amounts which insurers must pay to (or receive from) other insurers in order to spread risk across the industry. Any misestimation in these REM amounts may create distortions in the market, as all insurers will make decisions based on the same (misestimated) REM amounts. This risk can be managed with regular monitoring and updating of the REM parameters to ensure they are accurate.

The requirement for a REM for motorbikes in a no-fault scheme was highlighted. Motorbikes are high risk and the premium would be unaffordable for motorbike riders without a REM.

One insurer is concerned that the REM is overwhelmingly in favour of direct distribution over intermediated distribution. The REM creates a distortion in which insurers that predominantly utilise direct marketing and multiple policy discounts will be indemnified for loss-leading with CTP to leverage expanding their market shares of home and motor insurance products. The ramifications of such a distortion may be felt well beyond CTP in NSW and, in particular, it may create the risk of contraction in the home and motor market by insurers without a CTP licence. The concerning consequences of the REM could be mitigated if the REM was modified to indemnify a portion of the premium imbalance, say half, rather than the full amount of any premium imbalance.

The legal profession supports applying a REM to the whole market. However it questions the need for private underwriting. Its preference is for a State-run enterprise. It supports a risk equalisation mechanism to socialise the cost of poorer risk within the scheme (e.g. young drivers) and to introduce better competition on price amongst remaining policies.

One individual stated that assigned risk pools and residual market mechanisms identified during the 1990's had significant design and operational problems.

Commercial vehicle rating changes

One insurer stated that greater flexibility in the commercial segment would be beneficial. Flexibility in this segment would promote innovation and the take-up of technologies such as telematics to reduce risk and premiums.

Another recommendation was that feedback be sought on the proposed changes to the bonus/malus range from representatives of the commercial vehicle owners.

National Insurance Brokers Association of Australia advises that the bonus/malus process inherent in the premium setting framework for CTP insurance in NSW creates a community rating mechanism whereby the premiums for higher risk vehicles are kept at affordable levels by limiting the discounts available to the lower risk, safer vehicles.

It states that SIRA should advise the potential impact these changes will make to the premiums of lower and higher risk vehicles.

It will be important that commercial vehicle owners know and understand the potential impact of these changes. It will also be important that insurance brokers, who invariably arrange the insurance cover for commercial vehicle owners and operators, understand the operation of the proposed bonus/malus arrangements, so they can offer appropriate advice and risk management assistance to their clients (as they do for their property insurance risks).

Fully funded test

One insurer advised that the Fully Funded Test addresses scheme stability but is contrary to competition. Overall it considers that a stable scheme outweighs opening the scheme up to competitive market forces. This is notwithstanding that APRA requires private insurers that participate in CTP insurance to have sufficient reserves to cover all future claims.

It claims that the Fully Funded test is an essential component of the scheme's integrity, and has contributed to a scheme that has been stable since total privatisation in 1991. The Fully Funded test ensures that insurers do not price below the economic cost of the cover which means prices are relatively stable over long periods of time.

Another insurer stated that given controls from APRA a separate Fully Funded Test for the purposes of NSW CTP is not necessary.

The ICA states that the fully funded test requires the premium to cover (i) the expected claims cost; (ii) expenses; (iii) profit margin to deliver an adequate return on capital; (iv) any other matters a prudent insurer should make provision for.

This test has been useful for maintaining scheme stability over many years. In a scheme where historically if one insurer failed, the remaining insurers had to manage the consequences, it is reasonable to have some constraints on the opportunities to under-price. Having the ability to bid the price down to unsustainable levels may not be in the long term interests of the scheme, insurers or the public.

The legal profession supports the abolition of the fully funded test if it is considered safe to do so.

The Actuaries Institute considered that the fully funded test provides an objective measure by which SIRA can determine the appropriateness of filed premiums.

Guidelines to set assumptions

The following limited comment was made on this topic by two insurers and the ICA:

- ICA believes that insurers will accept them knowing that insurers are "disliked".
- The Guidelines from SIRA would help achieve consistency around assumptions.
- Recent changes to the Premium Determination Guidelines require insurers to file a 'central estimate' risk premium. This should make a considerable contribution to limiting superprofits, and should be given time to demonstrate its value.
- Consideration should first be given to the underlying factors driving performance of individual insurers and whether it is appropriate to set industry wide assumptions and the extent to which insurers will be mandated to adopt these assumptions.

Appendix C – Stakeholders

Submissions received:

- Allianz
- Australian Lawyers Alliance
- Barrister Philip W Bates
- Dallas Booth
- IAG
- Insurance Council of Australia
- Institute of Actuaries of Australia
- Motorcycle Council of NSW
- NSW Bar Association
- National Insurance Brokers Association
- Private individuals
- QBE
- Suncorp
- The Law Society of NSW

Appendix D - Excerpt: CTP reform consultation observations, September 2016

In August and September 2016 consultation on the design of the NSW CTP scheme was led by the CTP Reform Reference Panel of Ms Nancy Milne OAM, the Deputy Chair of the SIRA Board, and the Hon. John Della Bosca. The CTP Reform Reference Panel released the report *CTP reform consultation observations*. The following is an excerpt from the report concerning the market and premium setting:

Premium Setting and Vehicle classes

The Government proposes to support more flexible premium setting across all vehicle classes as well as the development of a risk equalisation mechanism to ensure a balance between affordability and risk based pricing that will increase competition among insurers and provide a fair price for all road users.

The insurance industry asserts that there is consistently strong competition in the scheme through ongoing changes to price segmentation, distribution arrangements, and actions to reduce operating costs and avoidance of claims inefficiencies. This is contrary to the findings of the Independent Review of Insurer Profit ("Profit Review"), which found that the current premium system contributes to insurer superprofits because of an inefficient system of cross-subsidisation. The insurance industry contends that increased certainty in claim outcomes will assist in reducing premiums and excessive profits.

A mechanism to address excessive profit taking, spread risk and increase competition

Following detailed consultation between SIRA and the insurance industry, the majority of insurers agree that a permanent risk equalisation or risk pooling mechanism is required. The ICA acknowledged that transitional arrangements may be required to address potential superprofits resulting from the introduction of the new scheme. However some individual insurers indicated their support for a risk equalisation mechanism and supported profit normalisation only in the shorter term while there is pricing uncertainty.

The legal profession supports the cross-subsidy of younger drivers as well as within the Sydney metropolitan area as it redistributes costs between higher and lower income earners. The profession also supports a profit normalisation mechanism, but recognises that profit targets must be practical and realistic.

The ICA also considered that if further cross-subsidisation is seen as detrimental, expanding the elastic gap in pricing using the existing mechanisms in the scheme is a solution to maintaining premium affordability. To overcome complexity the ICA recommended setting a benchmark where no vehicle class will pay more than 10% of what they would have paid prior to the reforms during the transition timeframe. However, these measures run the risk of further entrenching the inefficiencies identified in the Profit Review, and could reduce competition for those higher risks that have their prices capped under such an arrangement.

One insurance company recognised that the premium system directly affects the efficiency and affordability of the scheme. It recommended a phased approach whereby risk pooling of segments of the market could be introduced initially e.g. motorcycles. The introduction of free rating for commercial vehicles would be next and finally the introduction of some form of risk pooling to protect the high-risk motorists. This, it is claimed, will increase competition in the market, drive innovation among insurers, encourage safer driving from motorists, and support any future technological advancement in the motor vehicle market.

A number of options were considered to amend the premium system, though only the following two were considered to be realistic when assessed against the objectives for reform:

<table>
<tr><th>Retain the status quo with small modifications to cap price increases</th><th>Introduce a risk equalisation mechanism</th></tr>
<tr><td>Pros:
This is easy to implement as it will have little impact on current premiums and minimal costs for insurers.</td><td>Pros:
No negative impact on higher risk road users as a result of reform.
Insurers will be receiving the correct premium for risk but have less opportunity to make superprofits.
Ensure certainty for motorists and insurers with clearer cross subsidies.
Encourage new entrants and more competition for all risk levels.</td></tr>
<tr><td>Cons:
Insurers avoiding high risks will be rewarded with superprofits, entrenching anti-competitive behaviour.
It ignores the recommendations of the Report of the Independent Review of Insurer Profit within the NSW Compulsory Third Party Scheme by Trevor Matthews.
Will not encourage new scheme entrants.</td><td>Cons:
Setting up a REM, which will be mandatory for all players, may initially be complex.
Insurers may be concerned that their underwriting strategies are undermined.
System changes will be significant for insurers and SIRA.</td></tr>
</table>

Acquisition expenses including commissions

The Government proposed removing the cap on commissions insurers pay to their intermediaries and allowing for an overall cap on acquisition expenses. Insurers did not support the proposal to remove the cap on commissions as it was felt this would lead to an upward spiral of commissions and distribution costs. There were differing views among insurers on applying an overall cap on acquisition expenses. The legal profession recommended the elimination of non-direct CTP marketing costs such as general branding and sponsorship.

Competition at point of sale

The idea of combining the Green Slip purchase together with registration renewal as one transaction, possibly through Service NSW was discussed. Insurers recommend maintaining the current distribution arrangement where they transact directly with customers for their Green Slip and Service NSW transacts with the customer on the vehicle registration. Maintaining direct contact with customers is an overwhelming preference of the insurance industry. Insurers providing registrations and insurance details to a government website was not supported and would not suit bundling or fleet discounts. Efficiency gains were questioned as many customers purchase their motor insurance at the same time as their CTP insurance and therefore would still be contacting their insurer.

Motorcycles

The two primary motorcycle associations disagree on the principle of a no-fault scheme, primarily because of the risk of significant price increases for motorcycle owners. The motorcycle group which supports a no-fault scheme suggested that an ongoing cross subsidy is required to ensure premiums remain affordable.

The ICA suggested a levy be placed on all motorists to cross subsidise motorcyclists. An alternative suggestion is the establishment of a ‘high risk’ pool which captures motorbikes and other high risk vehicles and individuals which would have capped prices and receive a subsidy from other vehicle owners. Some members of the legal profession expressed concerns about other vehicle owner’s cross-subsidising motorcyclists.

While the Motorcycle Council of NSW are opposed to a no-fault scheme for any motorist, an option discussed among stakeholders was a no-fault scheme with the exclusion of at-fault motorcyclists. This would result in overall lower prices for all vehicle owners including motorcyclists and remove the ongoing issue of an ongoing cross-subsidy. This is the approach in New York State where a no-fault scheme operates but excludes the at-fault rider and their passenger from benefits, but retains a right for them to sue when another motorist is at-fault in causing their injuries.

The CTP Reform Reference Panel comment

- Retaining the status quo in premium setting does not address structural issues regarding lack of competition, potential superprofits and risk avoidance, as identified in the Profit Review.
- A Risk Equalisation Mechanism (REM) is supported by the majority of insurers and appears to offer the following benefits:
    - address the problem of high risk vehicles such as motorcycles;
    - reduce the potential for superprofits by some insurers by targeting or avoiding some risks;
    - create a more level playing field and encourage competition between existing insurers and may encourage new insurers to enter the market; and
    - encourage innovation by insurers to become more efficient with their internal processes.
- The operation of a REM would find a balance to promote competition but off-set the adverse impacts of price control. Price controls should be retained to ensure young drivers do not face excessive premiums, and there should be some transparent system of cross-subsidy embedded in the REM, in addition to the traditional approach of pricing vehicles within a range.
- Profit normalisation presents an effective transitional means of handing superprofits back to vehicle owners but should, to be fair, allow insurers to catch up losses. This would be supported by clear powers for SIRA to drive the new scheme price to the appropriate level. It is noted that the detail still needs to be addressed and that further discussion needs to occur between SIRA and the insurance industry.
- It is considered that an overall cap on acquisition costs, including commissions, should help contain premiums. This may have initial impacts on some insurers depending on their distribution model but this should not be an impediment and may drive some innovation in distribution. It is suggested that a flat dollar fee for commissions be considered, as opposed to the existing percentage, as the work required to procure a policy is the same or similar regardless of the cost of the policy.
- An enabling power included in legislation would permit SIRA to review, at any time, the effects of the reformed third party scheme and convert to a first party scheme if necessary. As previously mentioned, a Code of Conduct for insurers to support the principles underpinning cultural change is suggested. The third party approach could be reviewed initially as part of the formal review which the Government has suggested at the 3-year mark after the new scheme commences.
- Customers could benefit from a single transaction when purchasing their CTP insurance and motor vehicle registration. However, there are a range of views and

other models that can be explored to deliver a simple process for customers. Any arrangement to establish a single transaction should retain existing and alternative purchase channels to promote competition. The impact on potential new entrants needs also to be considered. It is suggested that this initiative be deferred for consideration after implementation of reform, given the many system changes already required.

- Removing motorcycles from the scheme would erode the principle of a no-fault scheme and could encourage other high risk road user groups to seek exemption from the scheme. Other no-fault schemes around Australia include at-fault motorcyclists while successfully cross-subsidising them from the general pool. Some form of ongoing (legislated) cross subsidy should be considered to avoid prices becoming unaffordable and risk an increase in unregistered, uninsured bikes.