

25 March 2002

Reverend the Hon F J Nile MLC ED LTh  
Chairman, General Purpose Standing Committee No 1  
Legislative Council, Parliament House, Macquarie Street  
SYDNEY NSW 2000

Dear Reverend Nile

**REVIEW AND MONITORING OF THE NSW WORKERS' COMPENSATION  
SCHEME – THIRD REPORT**

We have pleasure in submitting our third report of the Legislative Council's General Purpose Standing Committee No 1 Review and Monitoring of the NSW Workers' Compensation Scheme for inclusion in the Committee's third report.

In the report we set out our observations on the applicability to the WorkCover Scheme of the amendments to the Insurance Act by the Australian Prudential Regulatory Authority (APRA), options for further reform of the WorkCover Scheme and some more observations on Tillinghast costing of the 2001 Scheme reforms.

Yours sincerely



**Peter McCarthy, FIAA**  
**Director, General Insurance**

**GENERAL PURPOSE STANDING COMMITTEE No. 1**

**NSW WORKERS'  
COMPENSTATION REVIEW**

**THIRD REPORT**

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NSW WORKERS’ COMPENSATION REVIEW**

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A Summary of APRA’s Prudential Standards

## 1. INTRODUCTION

- 1.1 Ernst & Young ABC (“EYABC”) has been engaged to provide actuarial and accounting advice to the General Purpose Standing Committee No. 1 of the NSW Legislative Council in respect of the Committee’s Review and Monitoring of the NSW Workers’ Compensation Scheme. This is EYABC’s third report to the Committee.
- 1.2 In this report reference to the “Scheme” refers to the NSW WorkCover Managed Fund Scheme unless otherwise stated. Thus it excludes self-insurers, Treasury Managed Fund and other Funds regulated by the WorkCover Authority of NSW (“WorkCover”).
- 1.3 We have divided our observations and comments into:
- Applicability of Australian Prudential Regulatory Authority (APRA) new prudential regime of the general insurance industry from 1 July 2002
  - Options for further reform of the WorkCover Scheme
  - Some more observations on Tillinghast costing of the 2001 Scheme reforms
- 1.4 Our comments are based on information presented at the third set of hearings held on 14 February and 6 and 7 March 2002 and information discussed at NSW Workers’ Compensation Scheme Forum “The Way Forward on Scheme Ownership and Design” on 15 March 2002. We refer you to our Second Report that outlined the reports relied on for our two previous reports.
- 1.5 We refer you to Section 4 on Reliances and Limitations. **In section three please note the options for Scheme reform are not meant to be exhaustive and there are many other possible options that observers may suggest. We have made no assessment of the feasibility or otherwise of the options mentioned in this report.**
- 1.6 For this report we have relied on APRA’s March 2002 Prudential Standards and Guidance Notes that all General Insurers in Australia must comply with to the extent described in the 2001 amendments to the Insurance Act.

## 2. AUSTRALIN PRUDENTIAL REGULATORY AUTHORITY (APRA) NEW PRUDENTIAL REGIME OF THE GENERAL INSURANCE INDUSTRY

### Background

- 2.1 During 2001 the Federal Government amended the Insurance Act 1973 to reform the prudential regulation of the General Insurance Industry in Australia. The amendments included giving power to APRA to implement Prudential Standards and Guidance Notes that all insurers must comply with to the extent noted in the Act or the standards. The amendments apply a significantly more extensive and higher standard of prudential supervision than the old standards. For example the minimum level of capital required for the industry is about 50% higher than the old standard. APRA's prudential reforms to the Insurance do not legally apply to the WorkCover Scheme.
- 2.2 These changes are effective from 1 July 2002. The main amendments are described in the Appendix and summarised below:
- a. Appointment of an Approved Actuary unless exempt by APRA. Each Approved Actuary is approved by APRA. Only insurers with less than \$20m in insurance liabilities (ie outstanding claims and premium liabilities) and no significant long tail business can apply for an exemption.
  - b. Compulsory annual reviews by the Approved Actuary of the level of insurance liabilities being outstanding claims liabilities and premium liabilities.
  - c. The Approved Actuary and Auditor have a whistle blowing role. They are required to report matters to APRA and the legislation protects them in the role from prosecution.
  - d. Changes in how the minimum capital requirements of insurers are calculated. This change moves the calculation to a more risk based approach. In the past the minimum capital requirement was a percentage of outstanding claims liabilities or net written premium whichever was higher. The new requirements include outstanding claims, premium liabilities, assets and investments and concentration risks. APRA's new minimum capital produces industry minimum capital of about 50% higher than the old standard.
  - e. Insurance liabilities must include a risk margin at the 75% sufficiency level above the central estimates of liabilities. Insurance liabilities are estimates and consequently are uncertain. A 75% sufficiency level means liabilities have a 75% chance of being adequate and a 25% chance being inadequate.
  - f. A fit and proper person test applicable to each insurer's Board of Directors and Senior Management.

- g. Each year an insurer is to supply a detailed business plan to APRA including 3 year financial projections of profit and loss account, balance sheet and cash flow.
- h. Each insurer is to submit a Risk Management Strategy annually to APRA. The matters to be addressed are included in APRA's Risk Management Prudential Standard and Guidance Notes on Operation Risks, Credit Quality, Balance Sheet and Market Risk, Risk Management Systems and Governance.
- i. Each year an insurer is to submit to APRA a Reinsurance Management Strategy. The matters to be addressed are included in APRA's Prudential Standard on Reinsurance Arrangements and the Guidance note on Reinsurance Management Strategy.

### **Applicability of APRA Changes to the WorkCover Scheme**

- 2.3 The General Purpose Standing Committee No. 1 wished to assess the extent to which the WorkCover Scheme should comply with the APRA reforms outlined above from 1 July 2002. The remainder of this section discusses the issues and approaches that can be considered in making that assessment.
- 2.4 The Insurance Act does not apply to state based workers compensation and CTP schemes such as the NSW WorkCover Scheme since the federal Government does not have jurisdiction over state based schemes. That is, there is not legal reason why WorkCover needs to comply with the Insurance Act requirements.
- 2.5 Some specialised insurers are licensed under both WorkCover and Insurance Act legislation. Specialised insurers licensed under both sets of legislation are catholic Church Insurance, Guild Insurance, StateCover and North. These insurers write other classes of insurance other than workers compensation.
- 2.6 WorkCover licenses the Joint Coal Board and the Thoroughbred Racing Board as specialised insurers but they are not licensed under the Federal Insurance Act. The Joint Coal Board is like a group scheme insuring coal industry workers from many different employers but it does not have to comply with the greater prudential requirements of similar insurers licensed under the Insurance Act.
- 2.7 Self-insurers are single employer based and consequently have different prudential requirements as the risks for them not being able to meet their employee workers compensation entitlements depend on their wider business activities and not insurance risks as is the case for specialised insurers and insurers licensed under the Insurance Act.
- 2.8 We consider below the differing rationales why WorkCover should either comply or not with the Insurance Act requirements and the extent to which they currently comply.

- 2.9 Both APRA and WorkCovers' prudential requirements that apply to agents/insurers, self-insurers and specialised insurers are designed to protect policyholders and claimants and a degree of consistency between them is desirable.
- 2.10 We note on occasions in this section that some specialised insurers are licensed under the Insurance Act and some are not. We suggest there is no rationale for these specialised insurers not being licensed under the Insurance Act. This creates an uneven playing field with the specialised insurers licensed under the Insurance Act being subject to a higher standard of prudential regulation especially from 1 July 2002, than the specialised insurers not licensed under the Insurance Act. Consequently it may be inferred that the employee workers compensation entitlements insured by the unlicensed specialised insurers are subject to an inferior level of prudential supervision.

### **Appointment of Actuaries and Their Role**

- 2.11 The WorkCover Authority currently complies with requirements (a) and (b) in paragraph 2.2 above regarding the Approved Actuary appointment and an annual actuarial review. WorkCover appoints an actuary to the WorkCover Managed Fund. It also requires each self-insurer including the Treasury Managed Fund and all specialised insurers, to have an actuary review their outstanding claims liabilities each year.
- 2.12 WorkCover's Board appoints an actuary to WorkCover. Consideration could be given to some part of Treasury formally approving the actuary to WorkCover but we are unsure if any value would be gained from this process.
- 2.13 Currently there is no formal process by which WorkCover approves the actuaries appointed to self-insurers and specialised insurers as there is with APRA. APRA has set out desired criteria the actuary needs to comply with to be approved by APRA. The criteria includes an actuary having at least 5 years experience in general insurance, being a resident in Australia, being a Fellow of The Institute of Actuaries of Australia or another relevant professional body and satisfying the fit and proper criteria. APRA has the power to approve actuaries outside the criteria. Insurers cannot remove a current actuary or appoint another actuary unless they gain approval from APRA.
- 2.14 WorkCover could consider applying similar criteria and process to the appointment of actuaries to the Managed Fund, self-insurers and specialised insurers. APRA's process is a form of accreditation for actuaries. We are aware that at least one Australian workers compensation regulator (Queensland) has a form of accreditation for actuaries before an actuary can undertake work for a self-insurer. If WorkCover were to follow this route, then to avoid duplication, we suggest they rely on APRA for the appointment of Approved Actuaries to Specialised Insurers licensed under the Insurance Act.

### **75% Sufficiency Level for Outstanding Claims Reserves (Risk Margins)**

- 2.15 We consider each of specialised insurers, self-insurers (excluding Treasury Managed Fund), Treasury Managed Fund and the WorkCover Managed Fund below. Insurance liabilities are estimates and consequently are uncertain. A 75% sufficiency level means liabilities have a 75% chance of being adequate and a 25% chance being inadequate.
- 2.16 *Specialised insurers* licensed under the Insurance Act will need to comply with APRA's 75% sufficiency level on reserving for outstanding claims. WorkCover currently requires each specialised insurer whether licensed under the Insurance Act or not, to purchase a bank guarantee equal to a figure 30% above the 50% sufficiency level of their outstanding claims reserve. For specialised insurers licensed under the Insurance Act there is a duplication of regulation and for these insurers WorkCover may wish to dispense with the bank guarantee requirements and instead rely more on APRA's requirements.
- 2.17 For Specialised Insurers not licensed under the Insurance Act continuation of the bank guarantee is appropriate especially as these insurers do not have to comply with any of APRA's prudential requirements. WorkCover may wish to formally review the adequacy of the 30% requirement given APRA's more stringent requirements.
- 2.18 *Self-insurers (excluding Treasury Managed Fund)* are required to purchase a bank guarantee as for specialised insurers. In the failure of Pasminco, a licensed self-insurer, the bank guarantee did protect claimant's workers compensations entitlements. With the benefit of the failure of Pasminco and the introduction of APRA's higher standard of prudential requirements, WorkCover's Board may wish to assess the adequacy of the 30% margin.
- 2.19 WorkCover could also consider replacing the 30% rule and using a 75% or higher level of sufficiency of outstanding claims reserves as the basis of purchasing the bank guarantee. This would tailor the margin above the central estimate to the size and circumstances of the self-insurer. We do not believe there is a compelling argument for adopting this approach. The 30% rule is more objective and is our preference.
- 2.20 We do not know if WorkCover asks its actuary to review the actuarial reports of each self-insurer and report the results to WorkCover. As part of its prudential supervision of self-insurers, WorkCover should have the actuarial reports of each self-insurer reviewed by an actuary it appoints at least once every three years and have the actuary report to it on the adequacy of the actuarial advice. There is a compelling argument for this given the substantial under reserving within the general insurance industry over the last few years even though actuaries reviewed most of the outstanding claims reserves of insurers. WorkCover may also wish to consider asking its actuary, Tillinghast to review the overall adequacy of central estimates for self-insurers as a prudent check on their adequacy. This would be assessed on a group basis not by individual self-insurer.

- 2.21 *The Treasury Managed Fund* collects premiums from the State Government revenue base. Consequently there is a strong argument that it is adequate for the Fund to only reserve at 50% sufficiency level since any under reserving can be paid from future State Government revenue.
- 2.22 *The WorkCover Managed Fund* reserving levels involve a number of issues as discussed below.
- 2.23 At the 14 February hearing the NSW Auditor General implied that WorkCover needed to have a good reason not to comply with setting outstanding claims and premium liabilities at the 75% sufficiency level if it was normal practice of the general insurance industry.
- 2.24 Practice in Australia by regulatory authorities in workers compensation and CTP varies with some authorities including risk margins above the 50% sufficiency level. WorkCover's own practice has varied over time in some years they have included risk margins above the 50% sufficiency level but usually only reserve at a 50% sufficiency level. Examples of Australian regulators that include prudential margins in the outstanding claims include:
- The Transport Accident Commission in Victoria's accounting policy is to include a risk margin in its outstanding claims liabilities at a sufficiency level of 80% to 85%. The Transport Accident Commission also maintains a capital level of 15% to 25% of claims liabilities
  - The Board of the Queensland WorkCover scheme's policy is to include a risk margin in its outstanding claims liabilities at a sufficiency level of 80% to 85%. Under the WorkCover Queensland Act 1996 the scheme is taken to be fully-funded if WorkCover is able to meet its liabilities for statutory compensation and common law payments from its fund and it maintains minimum solvency or capital adequacy standards under the Insurance Act
  - The Board of the Insurance Commission of Western Australia's accounting policy for CTP is to include a risk margin in its outstanding claims liabilities at a sufficiency level of 80% to 85%
- 2.25 The issues to be considered in deciding the level at which the WorkCover Managed Fund should be set reserves are complex. Some of the issues to be dealt with include:
- i. If workers compensation under the Managed Fund is not considered to be insurance then one can argue that reserves should be set at the 50% sufficiency level. That is, workers compensation is a form of social security and premiums are really a tax.
  - ii. If NSW workers compensation under WorkCover is viewed as insurance then prudent management using APRA's reform suggests insurance liabilities should be set at the 75% sufficiency level for the Managed Fund.

- iii. The Government considers that the WorkCover Managed Fund assets and liabilities are held in trust for employers. We note the NSW Auditor General does not agree with this view. Under this scenario the Fund would not have access to the tax and other revenue of the State Government. It may then be argued that the Fund should reserve at a 75% sufficiency level.
- iv. The NSW Auditor General believes the WorkCover Managed Fund should be consolidated in the State Government's financial statements including its balance sheet. Currently it is not treated in this manner. If it was to be included on the Government's balance sheet then the Fund may have access to State taxes to finance the deficit. In this situation it could be argued outstanding claims reserves should be set at a 50% sufficiency level.
- v. Even if the WorkCover Managed Fund was included on the State Government's balance sheet it may not legally have access to State Government taxes to finance the deficit. In this situation it may be argued that the outstanding claims reserves should be set at a 75% sufficiency level.

2.26 We suggest the Board of WorkCover Board may wish to consider their policy on risk margins above the 50% sufficiency level and the detailed rationale for their adopted view for the WorkCover Managed Fund including their approach on accounting for the Fund. WorkCover's Board could consider commissioning a report on the issue and quantifying the financial impact from reserving at a 75% sufficiency level, and on the financial status of the WorkCover Managed Fund Scheme and premium rates.

2.27 If WorkCover were to include risk margins at a 75% sufficiency level for the Managed Fund it would result in a significantly higher Scheme deficit. Premium rates would need to increase to finance the additional level of reserving each year and also to fund the increased deficit. Scheme stakeholders may view such a step as undesirable placing an unnecessary burden on employers. However, as illustrated in paragraph 2.24 there are certainly other Australian regulators that believe it prudent to include risk margins in their outstanding claims liabilities.

### **Minimum Capital Requirements**

2.28 The issues for self-insurers, specialised insurers, the Treasury Managed Fund and the WorkCover Managed Fund for the minimum capital requirements are similar to the reserving for outstanding claims liabilities outlined above. Again we look at each group separately.

2.29 The intention of APRA's minimum capital requirement and risk margins is to help protect policyholder's interest.

2.30 Our comments above in respect of risk margins for *specialised insurers* apply to the minimum capital requirements for those insurers licensed under the Insurance

Act. The bank guarantee creates a problem for these insurers under APRA's new rules since the insurers' assets backing the guarantee do not count towards APRA's minimum solvency. Consequently these insurers need to hold double the level of capital. That is, there is double counting of prudential requirements. This could be viewed as an undesirable situation. WorkCover may wish to rely on APRA's prudential requirements and dispense with the bank guarantee requirements for these insurers.

- 2.31 For *self-insurers (excluding Treasury Managed Fund)* and specialised insurers not licensed under the Insurance Act the 30% buffer in the bank guarantee can be reviewed as partly a risk margin and partly a form of capital to protect employee workers compensation entitlements. In total APRA's risk margin and minimum capital standards suggest the 30% buffer for these insurers may be at an inferior level. Consequently, WorkCovers' Board may wish to review the adequacy of the 30% buffer in light of APRA's new more stringent requirements for insurers licensed under the Insurance Act.
- 2.32 The same issues apply to the *Treasury Managed Fund* in respect of minimum capital requirements as in the case of outstanding claims reserving levels as outlined above. Consequently, there seems to be no reason why the Fund needs to comply with APRA's minimum capital requirements.
- 2.33 The same issues on risk margins above apply to whether the *WorkCover Managed Fund* should comply with APRA's minimum capital requirements. That is, if one argues the Fund should set outstanding claims reserves at a 75% sufficiency level then the Fund may also need to meet APRA's minimum capital requirements.
- 2.34 As illustrated in paragraph 2.24 there are at least two other Australian regulators that believe it is prudent to maintain capital consistent with APRA's previous minimum capital levels with one even written into the state's legislation. We do not know if these two states will maintain higher levels of capital required under the APRA's new minimum capital requirements. APRA's new minimum capital requirements for workers compensation are substantially higher than the 50% average for the industry and may be as high at double times the old standard.
- 2.35 Premium rates would need to increase significantly if WorkCover were to comply with APRA's minimum capital requirement to finance the capital required. The level of capital required may be many billions of dollars. Many stakeholders may view this result as placing too large a financial burden on employers.

### **Remaining Prudential Requirements**

- 2.36 We assume WorkCover and the Government already has a process through normal public sector employment processes that, implicitly or explicitly, applies fit and proper test to WorkCovers' Board of Directors and senior management. WorkCover may wish to consider applying such a test to the relevant managers of each agent/insurers, self-insurer and specialised insurer.

- 2.37 A prudent organisation would see the benefits of APRA's requirements for business plans, financial projections and a risk management strategy. In our view APRA's requirements in these areas are such that the Government or WorkCover if they follow a prudent level of management, should consider introducing not only to itself but also to each managed agent/insurer, self-insurer and specialised insurer. It is essential that APRA's requirements should be tailored to the circumstances of workers compensation in NSW before being introduced.
- 2.38 In respect of reinsurance WorkCover may wish to consider obtaining a reinsurance strategy from each self-insurer and specialist insurer.
- 2.39 WorkCover does not currently purchase reinsurance protection for the WorkCover Managed Fund but does require each self-insurer and Specialised Insurer to purchase certain reinsurance protection. We are aware that the Treasury Managed Fund purchases reinsurance protection. We are aware that other workers compensation and CTP monopoly funds in Australia and overseas do purchase reinsurance protection for catastrophes (eg terrorism, earthquake). Examples include South Australian workers compensation and CTP schemes, Transport Accident Commission in Victoria and the Northern Territory CTP scheme. We are not aware if WorkCover has considered purchasing such reinsurance cover and if not the WorkCover Board may wish formally to review whether it should purchase such protection for the WorkCover Managed Fund, and if so at what level and how much protection is appropriate.
- 2.40 We suggest WorkCover rely on APRA for the above matters in respect of specialised insurers licensed under the Insurance Act to avoid duplication of regulation for these insurers.
- 2.41 WorkCover should not rely on APRA by default but it should actively engage with APRA regarding the prudential regulation of specialised insurers. Reliance should be documented and agreed with APRA along the following lines:
- When WorkCover will rely on APRA
  - How WorkCover will rely on APRA
  - Why it is reasonable for WorkCover to rely on APRA
  - Detailed plan of co-operation with APRA that both bodies agree.

### 3. OPTIONS FOR FURTHER REFORM OF THE WORKCOVER SCHEME

#### Background

3.1 During the last two years the NSW Government has passed through Parliament substantial reforms to the Workers' Compensation system in the areas of:

- Benefit design
- Benefit delivery
- Dispute resolution
- Legal provider remuneration
- Injury management

3.2 WorkCover has also commenced a number of initiatives to improve the Scheme (eg injury management pilots, changes to agent/insurer remuneration).

3.3 The Government has excluded the possibility of private underwriting. This should be viewed as a long-term decision as it has a major bearing on other major decisions (e.g. a decision on IT systems for the Scheme). The lack of a clear direction on private underwriting may have had an adverse impact on the Scheme decision making and operations since 1998.

3.4 The above changes will take three and probably more likely five years to work through the system to establish the extent of the financial impact on the Scheme's financial situation. The changes have been extensively reviewed and debated by many parties. There are philosophical differences between many stakeholders and these are difficult to resolve. Accordingly it may not be constructive to now consider the merits or otherwise of the changes.

3.5 Instead it is better to focus attention on other areas of the Scheme that have not been addressed by the Government reforms.

3.6 The General Purpose Standing Committee's Forum on workers compensation held on 15 March 2002 raised possible areas of further Scheme reform in addition to those already addressed by the Government and WorkCover.

3.7 We set out in the rest of the section areas of possible Scheme reform and discuss some options in each area.

3.8 **Please note the options set out below are not meant to be exhaustive and there are many other possible options that observers may suggest. We have made no assessment of the feasibility or otherwise of the options mentioned in this report.**

3.9 The areas we consider are

- a. Scheme ownership and accountability
- b. Early reporting of claims
- c. Premium system and employer incentives
- d. Incentives for claimants to return to work
- e. Management of the Scheme's tail
- f. Scheme management, regulation and governance

3.10 Participants at the Forum believed the complexity of existing legislation is worthy of reform. This can be addressed by rewriting the legislation. It would seem unlikely to be a priority by the Government which has just been through a process of extensive amendments to legislation in a scheme with serious financial issues that needed addressing. However, the Government may wish to consider simplifying the legislation at some future time.

3.11 Before considering reform options we briefly review Information Technology which is an important enabler for some possible reforms.

### **Information Technology (IT)**

3.12 Adequate IT systems are a key enabler for some possible options of Scheme reform. Many observers believe that the current state of IT within the Scheme is a significant barrier to entry for new agents/insurers and a significant impediment to improving the management of the Scheme by WorkCover, agents/insurers and other stakeholders. Observers to the Scheme and the Committee note that access to Scheme data is awkward and limited. Improving the premium system, claims management, Scheme management and other incentives depend partly on IT initiatives.

3.13 A good IT system with appropriate and quick access to data is essential for WorkCover for the following reasons:

- In monitoring its performance
- Enabling stakeholders (WorkCover, agents / insurer, doctors, etc) to target poorly performing areas or parts of Scheme.
- Essential for WorkCover to set strategies and look at policy matters to improve Scheme performance.
- Enabling WorkCover flexibility to introduce new initiatives.

3.14 IT investment by agents or insurers is expensive and it is acknowledged that agents have not been remunerated sufficiently to invest in new IT systems to improve the Scheme's performance. WorkCovers' new remuneration does go somewhat towards addressing this matter.

- 3.15 The South Australian and Victorian workers compensation systems both use insurers as agents but have one central computer system that all agents use. In NSW every insurer has a different IT system and each provides WorkCover with data on a monthly basis as input to WorkCover's IT system.
- 3.16 WorkCover could consider adopting the South Australian and Victorian approach to IT. Both approaches have advantages and disadvantages that need to be evaluated.
- 3.17 Other data and IT matters WorkCover should consider include:
- Improving data quality. A central computer system may assist
  - Create one data warehouse for the Scheme's data to improve access to data for stakeholders and improve monitoring of Scheme performance
  - Use of the internet
  - Expanding the list of data items collected
  - Expanding the sources of data included on WorkCovers' data base and data warehouse (eg from lawyers, injury management consultants)
- 3.18 It is essential for WorkCover to have a long term IT plan for the Scheme and to do so requires a long term robust strategy for the whole Scheme. There is a huge amount of work and cost to the Scheme pursuing all these matters and they will take many years to address. For this reason WorkCovers' Board needs to prioritise work on IT.

### **Scheme Ownership and Accountability**

- 3.19 Many Scheme stakeholders believe there is a lack of clarity around Scheme ownership and believe the lack of financial accountability for the Scheme is a key issue. These issues were drivers for many recommendations in the Grellman report in 1997. Five years on the same issues remain unresolved. Any lack of ownership and financial accountability will have an adverse impact on decision making and the ability to effectively manage the Scheme's financial situation.
- 3.20 These issues are difficult to address in the absence of private underwriting which the Government has excluded from possible consideration.
- 3.21 The NSW Auditor General's view of including WorkCovers' Managed Fund balance sheet on the NSW Government balance sheet does not in his view solve the issues of Scheme ownership and accountability. We agree with this view.
- 3.22 The Government has clear responsibility for Scheme design including benefit design and delivery. It also sets the premium rate and the design of the premium system and consequently is seen by many stakeholders to be accountable for the Scheme's financial status. This creates political difficulties for any Government

especially as workers compensation is a politically sensitive issue at the best of times.

- 3.23 An option the Government may wish to consider can be modelled on the Federal Government's approach to setting interest rates by the Reserve Bank. In that model the Reserve Bank has responsibility for setting interest rates independently of the Government. That is the Government can not over rule or force the Reserve Bank to set interest rates at a certain level.
- 3.24 The interest rate model could be applied to the setting of premium rates for the WorkCover Managed Fund as follows:
- Set up an independent body to set premium rates and possibly the rating structure and system.
  - The body would set rates each year without recourse to the Government.
  - Public hearings could be part of the process.
  - The independent body could have boundaries set including:
    - requirement to be provided with actuarial advice
    - Scheme deficits/surpluses to be taken into account in setting rates (eg fund deficits over no more than 5 to 10 years)
    - premiums rates to be fully funded
    - setting stable premium rates (ie limit increases/decreases in a year)
  - Accountability for the Scheme financial status.
  - Other aspects as deemed appropriate.
- 3.25 One option for the independent body is the Independent Pricing and Regulatory Tribunal.
- 3.26 The model would partially address the accountability issue. However, Governments may find it difficult to accept the model.

### **Early Reporting of Claims**

- 3.27 Many commentators believe earlier reporting of claims to insurers will provide substantial benefits to injured workers and consequently improve the financial status of the Scheme. There are significant barriers to the early reporting of claims including the operation of the health system in Australia, limited incentives on employers to report claims and process matters. There are many possible initiatives that would be employed to speed up the reporting of claims.
- 3.28 The Forum heard that the early experience of provisional liability is encouraging as is the claims advisory service. Other options for improving the early reporting of claims include:

- Providing financial incentives to employers for early reporting of claims. This could be done through lower premiums or other ways
- Provide financial incentives to Doctors to report claims earlier to insurers
- Provide Doctors access via computer to WorkCover to report claims earlier
- Better educate employers to report claims earlier
- Set up a Scheme based call centre – so that employers, workers and Doctors can report claims earlier. This could be set up by WorkCover or by agents/insurers, self-insurers and specialised insurers.

### **Premium System and Employer Incentives**

- 3.29 WorkCover issued a green paper on possible changes to the premium system in September 2001. Many commentators believe there is significant leakage from the premium system and a lack of fairness between employers. Employers have found legitimate ways to exploit the premium system. The leakages in the premium system distort employer financial incentives and actively work against Scheme objectives.
- 3.30 Limited financial incentives arise from the premium system for smaller employers to mitigate against the occurrence of claims and to improved the management of claims.
- 3.31 The current premium system has largely remained unchanged since 1987. The biggest change made was the introduction of the ANZSIC classification system in 2001 to reduce cross subsidies in the system. WorkCover also introduced the premium discount scheme in 2001 to provide more incentives for smaller to medium sized employers to reduce the incidence of claims.
- 3.32 The options proposed in WorkCovers' green paper are briefly summarised below:
- Option 1 A proposal to remove the uncertainty regarding contractors/deemed workers by defining all individual contractors as deemed workers unless they employ labour or have a workers compensation insurance policy.
  - Option 2 A proposal to remove the uncertainty regarding contractors/deemed workers by defining all individual contractors as deemed workers but allowing them to opt out if they satisfy strict criteria, including having appropriate insurance.
  - Option 3 A proposal to remove the uncertainty regarding contractors/deemed workers by defining individual contractors who meet the ATO 80% test as 'deemed workers'.

- Option 4 A proposal to remove the uncertainty regarding contractors/deemed workers by amending the legislation to require sole traders and partnerships to obtain workers compensation insurance.
- Option 5 A proposal to address non-insurance or the under-declaration of wages by sub-contractors by making principal contractors responsible for ensuring that their sub-contractors are properly insured under the correct tariff classification and that the sub-contractor has declared the correct wages.
- Option 6 A proposal to address non-insurance / under-declaration by the introduction of a requirement that the employer's full legal name and workers compensation insurer be shown on the worker's pay slip and that the employer notify the worker in writing if the employer changes.
- Option 7 A proposal to address premium avoidance through company splitting by the introduction of grouping provisions to enable premiums to be assessed at a group level (ie all related employers to be considered together for assessing premiums).
- Option 8 A proposal to reduce premium avoidance by expanding the related corporations provisions to non-corporate trusts, partnerships and other business arrangements.
- Option 9 A proposal to address premium avoidance by company splitting by amending the application of the 'two times' rule so that it does not apply to related corporations.
- Option 10 A proposal to address the under-declaration of wages by the introduction of a requirement that employers provide their workers compensation insurer with a monthly list of the names of all the employer's workers.
- Option 11 A proposal to address premium avoidance by requiring employers to provide full and complete information to insurers for the correct allocation of industry classification and the calculation of premium, and to enable insurers to retrospectively amend incorrect allocations and recover underpaid premium.

3.33 We understand that WorkCover have received submissions and are currently evaluating them.

3.34 Other possible options include:

- A thorough review of the premium formula especially for small to medium sized employers. In 2001 the Victorian workers compensation scheme initiated a thorough review system of its premiums system and we expect to see the results of the review rolled out later this year and into future years.

- Amending the premium formula to deal with employers who consistently have significantly poor or better claims experience relative to their industry average
- Require WorkCover or an independent agency to set the ANZSIC code for each employer to stop incorrect coding and premium leakage from the systems

### **Incentives for Claimants to Return to Work**

3.35 Incentives for claimants to return to work arise from:

- Benefit design
- Levels of compensation
- Benefit delivery
- Injury management

3.36 These are the areas that the Government have made substantial reform to during the last year.

3.37 Some participants at the Forum believes it is much more difficult for smaller employers to find alternative duties for injured workers. There are less financial incentives for smaller employers through the premium system to find alternative duties for injured workers. Providing more return to work incentives will reduce the size of the tail. Most schemes in Australia and overseas have found it extremely difficult to provide incentives to smaller employees using scheme wide initiatives. WorkCover introduced the premium discount scheme aimed at providing small to medium sized employers with incentives to reduce the incidence of accident. It is too early to assess its success. Some schemes have tried to introduce premium incentives using claims experience. These attempts have not been successful since small employers will on average only have one claim every 10 to 15 years providing little incentive for small employers to reduce incidence and cost of claims. Most small employers are not in existence for 10 to 15 years and will never have a workers compensation claim.

3.38 Other options available to increase the return to work revolve around making suitable duties available to injured workers. These options include:

- Group schemes for small employers for suitable duties. These could be arranged by industry or by geographic area.
- Industry based group schemes for large and small industries.
- Utilising employment agencies to find suitable duties.

- Educating employers especially small ones about the benefits of finding suitable duties for injured workers.
- 3.39 There are examples in overseas schemes (e.g. Ohio in America) where group of employers in similar industries or geographic areas band together to help each other provide suitable duties to injured workers.
- 3.40 The details of all these options would need careful consideration and some may not end up being practical or feasible in NSW.

### **Management of the Scheme Tail**

- 3.41 WorkCover defines the tail as long-term claims that have been open for more than two years. Long term claims make up most of the Scheme's outstanding claims liability represent nearly 75% of the Scheme's claims liabilities. Commutations were introduced as a way of managing the tail but now have a much more limited role. Insurer's remuneration is partly based on their performance in managing tail claims.
- 3.42 Many stakeholders believe there needs to be a clear tail management strategy and pro active management of the tail by WorkCover and agents/insurers. A robust and clear strategy, and proactive management has the potential to substantially improve the financial status of the Scheme.
- 3.43 Options that could be considered in managing the Scheme's tail include:
- A special project to tackle recoveries that agents/insurers, self-insurers and specialised insurers have not identified or pursued even back to 1987.
  - Reintroduction of limited commutations with a clear strategy set by WorkCover on their use. WorkCover Board would have the power to change the strategy and limit or expand access to commutations so that effectiveness could be properly managed.
  - Set up a specialist organisation(s) separate to current agents / insurers to manage claims that are over 3 years old and not included in an employer's premium calculation.
  - Amend the premium system so that claims in excess of 3 years impact employer's premiums. For example extend the period to 5 years. This will give employers more incentive to return these claimants to work.
  - Set up return to work initiatives by geographic area or at an industry level using suitable duties. See the discussion above on incentives for claimants to return to work.

## Scheme Management and Regulation

3.44 This covers a broad range of matters that are not independent of the areas discussed above and include Governance issues. The matters covered include:

- How the functions performed by agents/insurers should be delivered and the types of organisations that are capable of delivering them. Agents/Insurer's functions are:
  - Claims and injury management
  - Investment management
  - Policy administration (issue of policies and premium collection)

Options that could be considered include:

- Have different organisations manage some or all of the above functions. For example specialist investment managers including or excluding current agents/insurers could have the mandate for the investment management. Similar examples could apply to the other functions.
- It may be possible to split up claims management into short term and long term claims each going to different agents. This would be easier if there was one central computer system.
- How WorkCover should manage agents/insurers and what contractual arrangement should exist between WorkCover and the agents/insurers.

There is general agreement amongst Scheme stakeholders that WorkCover does not manage agents/insurers. That is it appears that no one is managing the Scheme or insurers.

There is no contractual agreement between WorkCover and agents/insurers. Each agent/insurer is licensed and subject to WorkCover's licensing criteria. Licensing criteria is normally focused on high-level requirements and compliance with legislation and do not necessarily consider detailed performance by an agent/insurer. Licensing is an all or nothing approach with disciplinary options in between the agent/insurer being licensed or not. Licensing is probably best viewed as a left over from when insurers were involved in underwriting the workers compensation risk.

Contractual agreements are normal when agency arrangements are in place. A contractual agreement between WorkCover provides greater flexibility for it to require detailed performance from agents/insurers and may be a better option to improve the operation of agents/insurers and consequently the scheme performance.

South Australia and more recently Victoria have abandoned the common remuneration of Managed Fund agents/insurers and instead went through a detailed tender process. Our understanding is each agent set out in the tender how they wished to be remunerated. There were contractual agreements between WorkCover in South Australia and Victoria.

- Should the functions of WorkCover be separated? The functions include:
  - Scheme regulation, providing Government policy advice and monitoring and management of the Scheme
  - OH&S
  - Insurance including claims management, premium system, licensing of agents/insurers, self-insurers and specialised insurers and injury management. This could exclude or include monitoring and management of agents/insurers

The options include having separate Government bodies manage each or a few of the above functions. Other states in Australia have different models with a few such as Queensland workers compensation and South Australian CTP separating the regulatory functions from management of the scheme.

- Making the setting of premium rates more transparent and independent of Government influence. The discussion on Scheme ownership and accountability above considered this matter.
- Governance matters other than setting premium rates include:
  - Power of the WorkCover Board. Currently the Board effectively has no policy responsibility and a limited role in setting premiums. The structure of the Board could be reviewed to either just include employer and employee representations or make it a more commercial Board.
- The Role of the Advisory Council is currently purely advisory. It is large and options for the future include:
  - Disbanding it and replacing it with various Stakeholder consultative groups
  - Reduce its size to just employer and employee representatives (ie no service provider member)
  - Expand its powers to be more of a policy making body but that may conflict with WorkCovers' role.

#### 4. TILLINGHAST COSTINGS OF SCHEME REFORM

4.1 The Committee third set of hearings considered evidence from Tillinghast and WorkCover regarding the costings by Tillinghast of various Schemes reforms passed by parliament during 2001.

4.2 Our two main conclusions from the hearings are:

- The Minister and WorkCover were happy with Tillinghast's performance in costing the Scheme reforms during 2001
- The Committee should adopt Tillinghast's 'low savings' or 'moderate position' costings since these are the scenarios Tillinghast will be adopting for the scheme valuations until emerging claims experience suggests otherwise. Tillinghast have used these two descriptions in different written communication to WorkCover but they are broadly the same scenario. The final costings from Tillinghast under this scenario produce estimated annual savings of \$400m and a retrospective impact on the deficit at 31 December 2001 of \$809m.

## 5. RELIANCES AND LIMITATIONS

- 5.1 In undertaking this investigation, we have relied upon information supplied by the General Purpose Standing Committee No. 1, WorkCover and APRA. In general, reliance was placed on but not limited to the information provided. We have used the information without independent verification. However, it was reviewed where possible for reasonableness and consistency.
- 5.2 While we have endeavoured to allow for perceived incomplete information, the conclusions from our review may not be identical with those we would have reached using more complete information.
- 5.3 We have performed the work assigned and have prepared this report in conformity with its intended utilisation by persons technically familiar with the areas addressed and for the stated purposes only. Judgements as to the data, methods and assumptions contained in the report should be made only after studying the report in its entirety, as conclusions reached by a review of a section or sections on an isolated basis may be incorrect. Members of Ernst & Young ABC staff are available to explain or amplify any matter presented herein.
- 5.4 Distribution or disclosure of the report, or the opinion and conclusion contained therein, to other parties apart from the General Purpose Standing Committee No. 1, is expressly prohibited without Ernst & Young ABC's prior consent, and is subject to Ernst & Young ABC providing a copy of the report in its entirety to each party and each party agreeing to be bound by the conditions which Ernst & Young ABC may impose. Distribution of this report is subject to the confidentiality agreement between Ernst & Young ABC and the General Purpose Standing Committee No. 1.
- 5.5 This report has been prepared at the request of the General Purpose Standing Committee No.1 of the NSW Legislative Council in accordance with the terms of engagement agreed between it and Ernst & Young. The report is not to be used by any other person/party for any purpose nor should any other person/party seek to rely on the opinions, advises or information contained in this report. Ernst & Young ABC disclaims all liability to any person/party in respect or in consequence of anything done or omitted to be done by any person/party in reliance, whether whole or partial, upon any information contained in this report. Any person/party other than the General Purpose Standing Committee No.1 of the NSW Legislative Council who chooses to rely in any way on the contents of this report does so at their own risk.

## APPENDIX

### A SUMMARY OF APRA'S PRUDENTIAL STANDARDS

#### The Minimum Capital Requirement (MCR) may be determined by:

- An internal model;
- The prescribed method;
- A combination of the two; or
- A higher APRA requirement.

#### The prescribed method

MCR is the sum of;

- Insurance risk;
- Investment risk and;
- Concentration risk

#### Valuation of insurance liabilities

- An insurer must appoint an approved actuary if insurance liabilities exceed \$20m or the insurance liabilities for long tail classes are material relative to the total insurance liabilities;
- Unearned premium provisions and deferred acquisition costs asset are replaced by an actuarially certified premium liability provision by class including an allowance for claims handling and policy administration expenses;
- Both claims and premium liabilities must include a risk margin to give a 75% probability of sufficiency; and
- Claims and premium liabilities must be discounted at the risk free rate of return.

#### The Governance Standards

The standards require:

- All key people (as defined) to be “fit and proper”.
- Board Declarations covering
  - Compliance with the Act
  - Reinsurance Management Strategy
- Local company Board and Audit Committees to be majority non executive directors.

- Risk management strategy

### **The Risk Management Standard**

The Risk Management Standard takes a systems-based approach. Each insurer can establish the risk framework that best caters for its processes, information systems and culture.

The Standards also raise a number of new concepts including:

- fit and proper person;
- identification of tolerance for risk;
- tripartite meetings;
- stress testing and scenario analysis;
- assessments of brokers procedures and systems;
- audits of ceding companies; and
- ‘whistle blowing’ responsibilities.

The ‘fit and proper’ test is the most wide reaching, covering directors, senior management, auditors and valuation actuaries. Used wisely, it is one of the most powerful tools for a regulator, however, it is also one of the most challenging to find the right balance.

### **The new reporting requirements**

The reporting requirements to APRA will be more extensive and will include:

- annual statement regarding directors;
- annual board declaration;
- quarterly reporting (unaudited);
- annual audited accounts (increased scope);
- annual report from valuation actuary;
- business plan;
- risk management strategy (as updated);
- non-routine reporting by auditor; and

- non-routine reporting by a valuation actuary.

On an ongoing basis, the key requirements will be the board declaration and the valuation report for the actuary.

### **What risks needs to be covered?**

The Standard requires 'effective risk management' and does not limit the requirements to particular areas. However, it does go on to state that at a minimum the categories to be addressed are:

- balance sheet and market risk;
- credit risk; and
- operational risk.

For most companies balance sheet and market risk is likely to be the most complex. This category covers the insurance specific issues of underwriting, claims, product design and pricing as well as liquidity and derivatives.

Some of the requirements that must be documented in the Risk Management Statement include:

- details of global risk management and global reporting for overseas groups and branches;
- statement of willingness and capacity to accept risk;
- criteria for use of policy exclusions and reinsurance;
- assessment of brokers' procedures (underwriting and claims);
- audits of ceding companies (underwriting and claims);
- how emerging experience is to be reflected in price adjustments;
- how product pricing responds to competitive pressures;
- the level of mismatch between asset and liability cashflows; and
- risk tolerance for derivatives.