

tendered by Ms Carmel
for review of the MAA Donnelly
11/6/2010
[Signature]



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10 June 2010

Ms C Donnelly
General Manager
Motor Accidents Authority of NSW
Level 25
580 George Street
Sydney, NSW 2000

Dear Carmel,

Hindsight estimates of insurers' profits referred to in submissions to the Standing Committee on Law and Justice from the Australian Lawyers Alliance ("ALA") and the NSW Bar Association ("NSW BA")

Introduction

As requested, I am writing concerning the comments on insurers' profits in:

- paragraphs 6 to 8 of the ALA submission dated 21 April 2010, and
- section 2 of the NSW BA submission dated 23 April 2010.

Paragraphs 6 to 8 of the ALA submission

I have not seen the updated Cumpston Sarjeant report prepared in February 2010, and so I cannot comment reliably on it.

Paragraph 7 in the submission refers to "... very conservative allowances made for potential future payments." It is not clear to me whether that refers to estimates in the Cumpston Sarjeant report or to the Taylor Fry estimates used in calculating estimates of insurers' profits published in the MAA's annual reports. If the latter, I would disagree with the "very conservative" description. The Taylor Fry estimates:

- were intended to have no bias towards either under- or over-estimation of ultimate costs of claims, and hence insurers' profits, but
- are inherently highly uncertain for recent underwriting years.

The statement in paragraph 8 “Moreover, these calculations ignore the fact that the insurers have the benefit of investing (presumably profitably) the premiums whilst they wait to see if there are claims” is **incorrect**. In the Taylor Fry estimates:

- investment returns are allowed for by discounting claim payments and insurers’ claims handling expenses from the time of payment by insurers back to a discounted present value at the time when the corresponding premiums were received by insurers, and
- this approach produces estimates of insurers’ profits which allow for investment returns and which can validly be expressed as a percentage of corresponding premiums on a like-with-like basis, ie both in values at the time when premiums were received by insurers.

Without having seen the updated Cumpston Sarjeant report prepared in February 2010, I cannot comment on whether the same (or a similar) approach was adopted for that report. However, I would expect that to be the case.

NSW BA submission

Tabulation of past estimates of insurers’ profits

Annexure A referred to in the submission is a tabulation of past estimates of insurers’ profits published in MAA annual reports from 2003/04 to 2008/09 inclusive, but I only have the submission excluding annexures.

Therefore I have compiled the tabulation shown in Table 1 and Figure 1 below of estimates published in the MAA annual reports from 2003/04 to 2008/09 inclusive. However, there is the following important complication:

- Taylor Fry prepared estimates as at each 30 June from 2004 to 2009 inclusive, based on our **central estimates** of outstanding claims liabilities as at each date, ie estimates intended to have no bias towards either under- or over-statement;
- however, for the 2003/04, 2004/05 and 2005/06 annual reports, the MAA decided to publish estimates of insurers’ profits calculated **with a 15% margin added to the Taylor Fry central estimates of outstanding claims liabilities**. Consequently, even if the Taylor Fry estimates of outstanding claims liabilities had turned out to be accurate, those published estimates of insurers’ profits could have been expected to increase subsequently as outstanding claims liabilities became actual claim payments and the 15% margin added to the former was released;
- for the 2006/07, 2007/08 and 2008/09 annual reports, the MAA published estimates **based on the Taylor Fry central estimates**.

Figure 1 shows the estimates published in the MAA annual reports, while Figure 2 shows the Taylor Fry central estimates. The dotted vertical line in each graph marks the boundary between:

- to the left, estimates as at 30 June 2004, 2005 and 2006 for which the published estimates were not the Taylor Fry central estimates, and
- to the right, estimates as at 30 June 2007 and subsequently, for which the published estimates were the Taylor Fry central estimates.

Table 1

Underwriting year ended 30 September	Estimate of discounted value of insurers' profits, as a percentage of premiums, calculated as at 30 June:														
	2004:			2005:			2006:			2007 ^(a)			2008 ^(a)		2009 ^(a)
	TF central estimate	MAA annual report	%	TF central estimate	MAA annual report	%	TF central estimate	MAA annual report	%	TF central estimate	MAA annual report	%	TF central estimate	MAA annual report	%
2000	28	24	24	28	25	28	28	26	30	26	26	30	30	30	30
2001	27	21	21	24	20	24	24	21	27	21	21	28	28	28	28
2002	28	21	21	28	21	28	24	18	27	18	18	30	30	31	31
2003	24	16	16	26	19	26	17	10	20	10	10	22	22	24	24
2004	Na	Na	Na	25	Na	25	18	9	19	9	9	21	21	25	25
2005	Na	Na	Na	Na	Na	Na	7	Na	10	Na	Na	13	13	17	17
2006	Na	Na	Na	Na	Na	Na	Na	Na	5	Na	Na	9	9	13	13
2007	Na	Na	Na	Na	Na	Na	Na	Na	Na	Na	Na	3	3	5	5
2008	Na	Na	Na	Na	Na	Na	Na	Na	Na	Na	Na	Na	Na	1	1

Note: (a) The estimates published in the MAA annual reports for 2006/07, 2007/08 and 2008/09 were the same as the Taylor Fry central estimates as at 30 June 2007, 2008 and 2009 respectively.

Figure 1

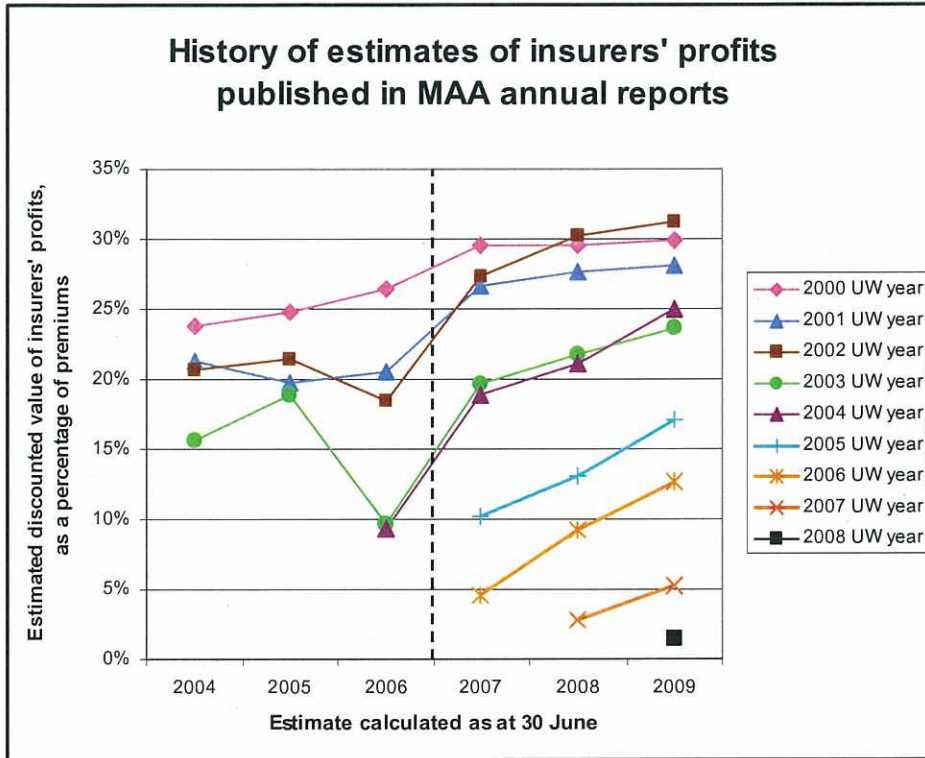
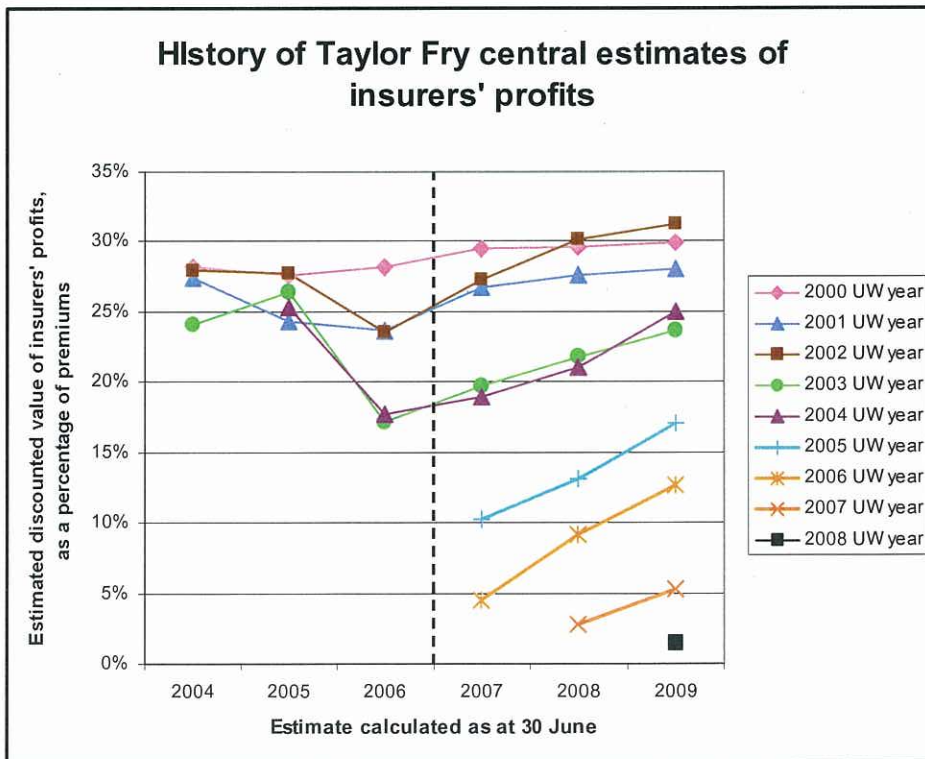


Figure 2



It can be seen that:

- Based on the Taylor Fry **central estimates** shown in Figure 2:
 - for each of the 2000 to 2004 underwriting years, there is **little difference** between the estimate as at 30 June 2004 (or 30 June 2005 for the 2004 underwriting year) and as at 30 June 2009, although there were noticeable variations at intervening dates, but
 - for each for the 2005 to 2007 underwriting years, our estimates of insurers' profits have **increased progressively** between the initial estimate shown (10%, 5% and 3% of premiums respectively) to our estimate as at 30 June 2009 (17%, 13% and 5% of premiums respectively). Those changes in our estimates have occurred because in recent years aggregate claims costs have turned out to be less than we projected previously. Consequently, our estimates of ultimate claims costs have been reduced and our estimates of insurers' ultimate profits increased.
- However, for the estimates published in the MAA's annual reports shown in Figure 1, for each underwriting year **the initial estimate published was considerably less than the estimate published in the 2009 annual report**. This occurred because:
 - for each of the 2000 to 2004 underwriting years, the initial estimate published was calculated with the 15% margin added to the Taylor Fry estimates of outstanding liabilities. Estimates of insurers' profits calculated on that basis could be expected to increase progressively;
 - there was a particularly sharp increase in published estimates of insurers' profits between the 2006 and 2007 annual reports. That was due mainly to the 2006 report estimates being calculated with the 15% margin added to the Taylor Fry estimates of outstanding liabilities but the 2007 report estimates not allowing for any margin. Essentially, there was a discontinuity between the approach used in calculating the estimates shown in the 2006 and 2007 annual reports, and
 - for each of the 2005 to 2007 underwriting years, all published estimates have been based on the Taylor Fry central estimates and have increased progressively for the reason explained above.

Inferences drawn by the NSW BA from the tabulation

Comments on the following sentences in the submission, which I have referred to as quotes A, B and C, may be helpful.

- A "Having regard to the foregoing, the Standing Committee is entitled to take the estimate presented in the 2008/09 annual report for the 2008 premium collection year of 1% profit with a grain of salt."
- B "The experience of eight years of previous projections leads inexorably to the conclusion that within three to four years the insurer profit for 2008 will be above the 8% return which the MAA regards as 'reasonable'."
- C "The starting point for any reasonable discussion on profits is to stop accepting that the first year of projections as to likely insurer profits is likely to be accurate. History shows that it is not."

Statements A and C are valid. For a long-tail class of insurance business such as NSW CTP, for which ultimate claims costs are inherently uncertain, any estimate of ultimate insurer profit calculated soon after the end of an underwriting year is highly uncertain and may turn out to

differ considerably from the ultimate outcome. Because of the inherent and unavoidable uncertainty, the only ways to ensure that one does not publish estimates which subsequently turn out to differ materially from the ultimate outcome would be:

- either to publish estimates which show a wide range of possible ultimate outcomes for recent underwriting years (instead of single point estimates), or
- not to publish any estimates until several years after the end of the underwriting year concerned, which could reasonably be regarded as unhelpful or obstructive.

Regarding statement B:

- It is understandable that reviewing the history of estimates published in past MAA annual reports (as illustrated in Figure 1) would lead to that conclusion.
- However, that is partly an unfortunate consequence of the estimates published in the 2003/04 to 2005/06 annual reports being calculated with the 15% margin added to the Taylor Fry estimates of outstanding claims liabilities.
- If that distortion is removed, past experience is much less clear cut, in that:
 - for each of the 2000 to 2004 underwriting years, there is little difference between the estimates of insurers' profits as at 30 June 2004 (or 30 June 2005 for the 2004 underwriting year) and as at 30 June 2009, but
 - for each of the 2005 to 2007 underwriting years, there have been marked increases between the initial (unavoidably highly uncertain) estimate of insurers' profits and the estimate as at 30 June 2009.

It is also worth bearing in mind that the estimation and communication difficulties inherent in reporting on insurers' profits were acknowledged back in 2001, when the approach to such reporting was being considered. I have attached Part C of a Status Report as at 18 June 2001 which was prepared by Taylor Fry for the MAA. The comments in paragraphs C.26 to C.28, particularly C.27, largely remain relevant.

Specific questions on insurer profits

Although I have not attempted to suggest specific responses to questions 2.1 to 2.5 in the NSW BA submission, I hope the information in this letter will assist the MAA in answering those questions.

Please contact me if you have any queries and/or require anything further.

Yours sincerely,



Adrian Gould

cc Andrew Nicholls
David Baxter

Appendix 1 - Part C of Status Report as at 18 June 2001

C. Proposed approach to reporting on profitability of past NSW CTP business written by insurers

Nature of analysis

C.1 It is proposed that there will be two types of analysis:

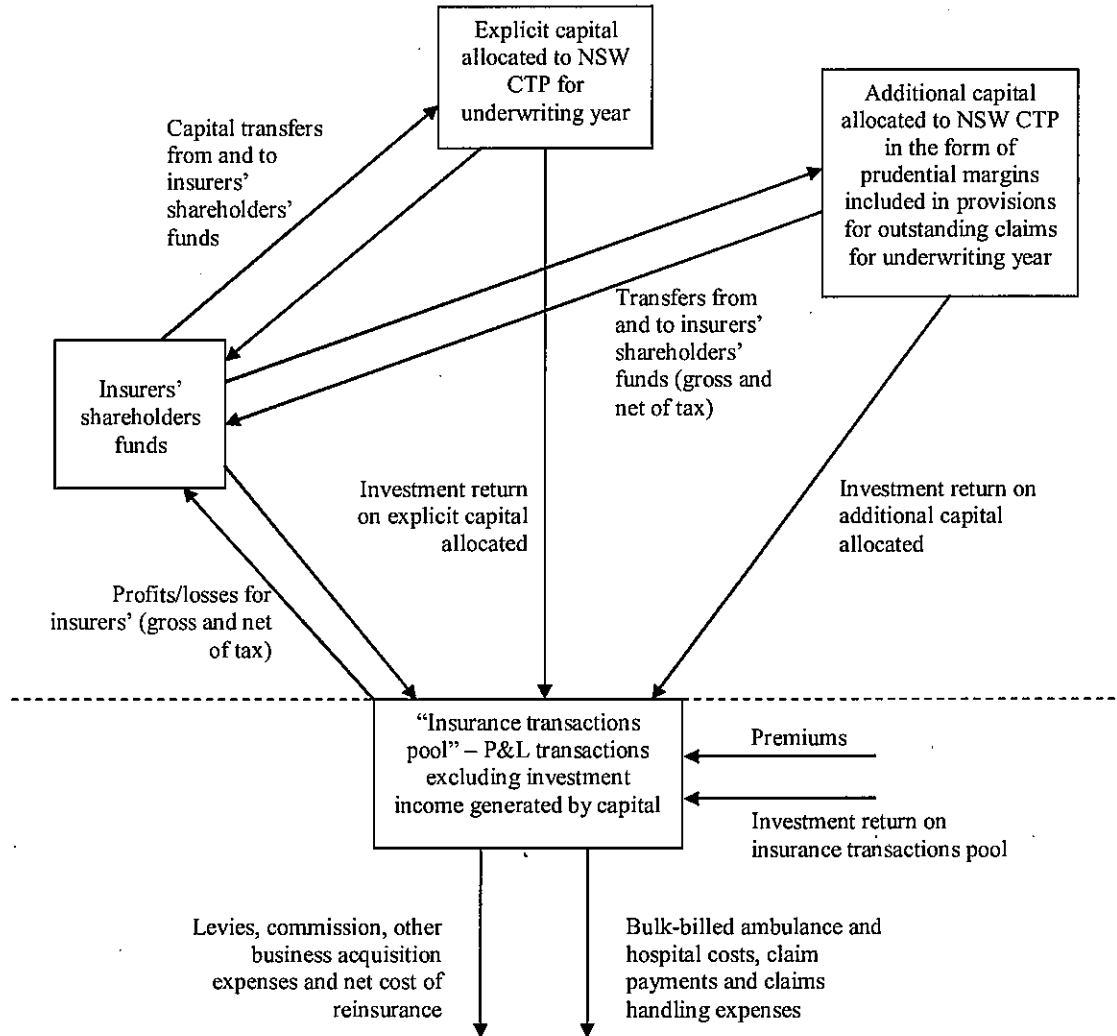
- “Full analysis” approach which will estimate insurers’ return on capital (“ROC”) for NSW CTP business. This approach will be similar to that used by Ernst & Young in preparing Appendix One to their November 1998 report prepared for the MAA’s Board “Review of the NSW Motor Accidents Scheme”. For insurance policies written during each year, it will involve modelling:
 - transfers from and to shareholders’ funds, ie initial allocation of capital, profits/losses (both gross and net of tax) and changes in the amount of capital allocated as the outstanding claims liability for that underwriting year’s policies runs off;
 - premiums received;
 - levies, commission, other business acquisition expenses and net cost of reinsurance;
 - claim payments and associated claims handling expenses;
 - establishment of and subsequent changes in outstanding claims provisions, and
 - the internal rate of return (“IRR”) for that underwriting year produced by the movements to and from shareholders’ funds (both gross and net of tax).
- “Simple pie chart” approach which involves estimating how much of gross premiums (net of GST) for insurance policies written during each year are attributable to:
 - claim payments – discounted value thereof at the average time when premiums are received;
 - levies, commission, insurers’ other business acquisition expenses and net cost of reinsurance (all generally not discounted because assumed to be incurred at the time when premiums are received);
 - discounted value of claims handling expenses, and
 - discounted value of insurers’ profit margin.

This approach will facilitate explanation to an audience which is not expert in insurance matters. It will also be consistent with the MAA’s presentation of the prospective efficiency measure for the Scheme based on the weighted average of insurers’ premium filings (refer Figures 5 and 6 in the MAA’s “Report on the First Year of the New Scheme” dated November 2000).

(While this simplified approach does not itself involve estimating insurers’ ROC, in presenting results it could be noted that the estimated profit margin of x% of gross premiums was equivalent to a ROC of y% p.a. estimated using the full analysis approach.)

C.2 The following diagram helps illustrate what the two types of analysis involve for insurance policies written during each year.

Figure 1



The full analysis approach involves modelling of all the components illustrated. The insurers' IRR on capital for policies written during a year would then be estimated based on the transfers from and to shareholders' funds and the profits/losses.

The simple pie chart approach would essentially:

- Exclude from the analysis all items above the dotted line in Figure 1.
- Express the "outflows" from the "insurance transactions pool" box as estimated proportions of the premiums "inflow" to that box. The results would be presented on a discounted basis, thus also removing the "investment return on insurance transactions pool" item from presentation of results under this approach.

C.3 Insurers' representatives queried whether the full analysis approach was necessary or appropriate, given that:

- public presentation and discussion would probably be focused mainly on the results of the simple pie chart approach analysis, and
- many of the complexities and more subjective elements of the analysis are only required for the full analysis approach, and not for the simple pie chart approach.

The MAA's view is that both approaches are necessary. As insurers' prospective target profit margins are generally determined based on a target ROC, it is appropriate that ROC arising from policies written during past periods be estimated for comparison with previous target ROC. To estimate ROC arising from policies written during past periods, a full analysis approach is necessary.

Underwriting year basis for analysis

C.4 Both approaches would analyse all (ie actual past and projected future) cash flows associated with policies written during each year considered in isolation. This basis of analysis is consistent with the MAA's proposed approach to reviewing the reasonableness of prospective target profit margins included in premium filings.

(After discussions with insurers' representatives, it was agreed that analyses will be undertaken on an "underwriting year" basis, estimating profitability according to the year during which NSW CTP policies were written. This will differ from the basis adopted by Ernst & Young for their November 1998 report. That report was prepared on an "accident year" basis which estimated profitability according to the year during which policies were in force.)

Capital allocation

C.5 The full analysis approach involves estimating the appropriate amount of capital for the licensed NSW CTP insurers in three steps:

- firstly the appropriate total capital for all lines of business combined;
- then the proportion of the total which is allocated to NSW CTP (for all underwriting years combined), and
- then the allocation to each underwriting year for NSW CTP.

C.6 The first two steps in this process raise essentially the same issues as are described in Section B.2 of this status report. It is intended that:

- The conclusions reached from the proposed analyses described in Sections B.3 and B.4 of this status report regarding appropriate capital allocations will be used for the full analysis approach estimates of ROC for past business.
- As the analyses described in Sections B.3 and B.4 will produce an estimated range of reasonable capital allocations for NSW CTP business, the full analysis approach will produce a corresponding range of estimates of insurers' ROC for past business.

Premiums

C.7 The amount of premiums (net of GST) will be obtained from insurers' premium returns to the MAA.

C.8 It is recognized that amounts of premiums in these returns are subject to some timing distortions, eg some premiums relating to policies issued near the end of a quarter may be included in the premium returns for the next quarter. However, it is not proposed to adjust premium returns on this account unless a major distortion(s) which would affect materially estimates of profitability becomes apparent.

Levies, commission and other expenses

C.9 For Ernst & Young's November 1998 report:

- The amount of insurers' expenses attributed to CTP obtained from APRA returns was compared with expected amounts calculated using the allowances included in insurers' premium filings. Considerable differences between these amounts were noted. For periods for which comparison was possible, for all insurers' combined the total amounts of expenses obtained from APRA returns were more than the expected amounts calculated from allowances in premium filings.
- The analyses used the amounts obtained from APRA returns. (For insurers which underwrite CTP business in more than one jurisdiction, Ernst & Young apportioned total expenses for CTP between jurisdictions in proportion to gross earned premium.)

C.10 It is proposed that a similar approach will be adopted for future analyses of profitability of past business written by insurers. (It will be necessary to adjust amounts obtained from APRA returns (inter alia) from an accident year basis to an underwriting year basis.)

C.11 The main reasons for basing future analyses on amounts obtained from APRA returns, rather than on amounts calculated using expense allowances in insurers' premium filings, are:

- Insurers' annual APRA returns are audited, while expense allowances in premium filings are not. However, it is recognized that:
 - When preparing and auditing APRA returns related to expenses, the focus is typically on ensuring that the amount of an insurers' total expenses for all classes of business is correct, rather than on the accuracy of the allocation of total expenses between classes of insurance business.
 - Consequently the allocation between classes may be unreliable for some insurers.
- Analyses of estimated profitability of past business are intended to try to measure actual outcomes. Use of amounts obtained from APRA returns is consistent with this objective because APRA returns record insurers' actual expenses. By contrast, past premium filings contained prospective estimates of expenses.

C.12 It is acknowledged that the proposal to base future analyses on amounts of expenses obtained from APRA returns is contrary to the recommendation from insurers' representatives. Their recommendation was to base analyses on allowances for expenses in insurers' past premium filings because of:

- the approximate way in which total expenses are typically allocated between classes of insurance business for the purpose of APRA returns, and
- some insurers' premium filings incorporating more detailed analysis of insurers' expenses attributable to NSW CTP business.

C.13 At the present time, the MAA does not intend to introduce a general requirement that insurers' expenses allocated to NSW CTP business be audited for the purpose of premium filings or reporting on profitability for past periods.

However, the MAA will require a satisfactory explanation from an individual insurer(s) for which there appear to be significant differences between that insurer's expense levels and other insurers and/or between information obtained from different sources for that insurer.

Net cost of reinsurance

- C.14 It is proposed that the net cost of reinsurance to direct insurers would be based on allowances in premium filings, subject to review to confirm that these allowances appear reasonable. (The same approach was adopted for Ernst & Young's report.)

Outstanding claims liabilities and provisions

- C.15 Current and future estimates of outstanding claims liabilities for each underwriting year will be based on actuarial advice commissioned by the MAA. The advice will include both estimates of the liabilities and sensitivity analyses quantifying the effect on the estimates of changes in some of the actuarial assumptions.
- C.16 For the full analysis approach, it will be necessary to adopt assumptions about what prudential margins are included in outstanding claims provisions for all insurers combined. Prudential margins will be in the "additional capital" box in Figure 1. A separate box is required for prudential margins because they can be regarded as additional capital supporting the business but their tax treatment differs from that of explicit capital.
- C.17 Practice regarding what prudential margins are included in provisions for outstanding claims has varied considerably between insurers. It is proposed that the full analysis approach will:
- be based on an approximate market weighted average percentage prudential margin adopted for NSW CTP business by insurers, but
 - also investigate the effect on estimates of insurers' ROC of alternative assumptions regarding prudential margins.
- C.18 For this analysis, outstanding claims provisions will be calculated using the Australian accounting approach of a discounted estimate of the outstanding liability plus a prudential margin. While it is acknowledged that several NSW CTP insurers are subsidiaries of overseas parent companies which may determine outstanding claims provisions and profits on different bases, it is not considered appropriate to allow for such differences in the analysis of industry profitability.
- C.19 It should be noted that prudential margins will be recognised in the full analysis approach but not in the simple pie chart approach. For the latter approach a best estimate – excluding margins but acknowledging uncertainties – of the discounted value of claim payments as a proportion of each underwriting year's gross premiums will be needed.

Investment returns

- C.20 The full analysis approach would allow for investment returns earned on explicit and additional capital allocated and on provisions.
- C.21 It is proposed that investment returns will be estimated using index returns for specified asset classes, ie not based on a weighted average of the actual investment returns achieved by the individual insurers, for several reasons:
- Unusually good/bad investment returns for an insurer resulting from a particular investment decision(s) taken by that insurer should not have a material effect on the assessment of profitability of the insurance industry.
 - Impracticality of apportioning by line of business each insurer's actual total assets and hence actual investment returns.
 - Ease of calculation.

C.22 For long-tail insurers, a very broad generalisation which is often made is that it may be appropriate to invest:

- assets backing technical provisions (unearned premium and outstanding claims provisions including prudential margins) mainly in fixed-interest securities and cash, and
- assets corresponding to shareholders' funds mainly in growth assets such as equities and property.

It is acknowledged that investment allocations, and the extent to which they are constrained by statutory solvency requirements, differ considerably between insurers.

C.23 Based on the very generalised investment policy described in paragraph C.22, it is proposed:

- For the full analysis approach, to estimate investment returns based on:
 - a fixed interest index (or indices) for provisions and additional capital in the form of prudential margins, and
 - an equity index (indices) for explicit capital

(refer Figure 1).

- For the simple pie chart approach, to discount using a medium-term market fixed-interest yield available at the middle of the underwriting year concerned. (For the simple pie chart approach, one will only be discounting claim payments and associated claims handling expenses. Therefore investment returns on explicit and additional capital allocated will not directly enter into the calculation.)

Tax

C.24 The full analysis approach will allow for tax payable on profits (or tax credits arising on losses) for each underwriting year at the time when those profits/losses arose or were projected to arise in future. Profits/losses will be projected based on Australian tax practice (as established prior to the *Mercantile Mutual v ATO* decision), with outstanding claims provisions calculated on a discounted basis including a prudential margin but no provision for claims handling expenses.

C.25 Implicit in this approach are:

- A decision not to allow for possible differences between insurers in tax status, eg different taxation bases for overseas parent companies of some NSW CTP insurers, different capacity to use imputation credits, carried forward tax losses, etc.
- Simplifying assumptions that:
 - capital gains/losses on investments would be taxed at the same time as other profits/losses (which is equivalent to assuming that capital gains/losses would all be realised at the end of each year), and
 - taxable profits would not be offset by carried forward losses, and that tax losses would be offset immediately against taxable profits from other classes of business. It is recognised that this will not always be the case in practice.

Communication of results of analyses

C.26 It is recognised that:

- Analyses of profitability of past business written by insurers are not straightforward.
- Effective communication in an appropriate context of the results of such analyses will be important.

C.27 Two issues which it will be particularly important to communicate effectively are:

- The large margin of error which is unavoidably inherent in any assessment of profitability for recent underwriting years, because of the uncertainty inherent in estimates of outstanding claims liabilities. This issue is exacerbated at present because the substantive nature of the New Act amendments in 1999 increases the degree of uncertainty.

Estimates of profits/losses for recent underwriting years naturally tend to be of more interest than those for older underwriting years, but are subject to greater uncertainty.

- Inherent uncertainties mean that it is quite possible for estimates in rate filings of prospective profitability to be prepared based on assumptions which appear sound and reasonable at the time, but for actual profits or losses to turn out (with the benefit of hindsight) to differ substantially from the prospective estimates.

When a retrospective assessment of profitability which shows large estimated profits/losses for an underwriting year(s) is presented to an audience which is not expert in insurance matters, it may be difficult for the audience to accept that this outcome does **not** necessarily mean either:

- that the very different earlier prospective estimates of profitability were unreasonable at the time when they were made, or
- that a similar outcome should be expected for subsequent underwriting years.

C.28 To address these issues, it is proposed that:

- Results of both the full analysis and simple pie chart approach analyses should incorporate sensitivity analyses which quantify the effects on the estimates of profitability and insurers' ROC of variations in:
 - the amount of capital allocated to NSW CTP business;
 - expenses attributable to NSW CTP business;
 - estimates of outstanding claims liabilities;
 - prudential margins included in outstanding claims provisions, and
 - future investment returns earned on insurers' assets.
- For each underwriting year, a history will be compiled which shows:
 - the initial estimate of profitability implied by the weighted average of insurers' premium filings;
 - successive estimates of the ultimate cost of claims and of profitability contained in the MAA's annual reports on estimated profitability of insurers' NSW CTP business.

The extent of changes over time in estimates of profitability for each underwriting year can be expected to illustrate the uncertainty inherent in such estimates for NSW CTP business.