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Taylor Fry

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14 October 2011

Mr. A. Nicholls
Acting General Manager
Motor Accidents Authority of NSW
Level 25
580 George Street
Sydney NSW 2000

Dear Andrew,

Hindsight estimates of insurers' profits referred to in submissions to the Inquiry into the Exercise of the Functions of the Motor Accidents Authority and the Motor Accidents Council – Eleventh Review

1 Introduction

As requested, we are writing concerning the comments on insurers' profits:

- On page 12 of the submission from the Australian Lawyers Alliance ("ALA"), which was received by the Inquiry on 10 August 2011, and
- In paragraphs 36, 37 and 105 to 120 and Annexure A of the submission from the NSW Bar Association ('NSW BA"), which was received by the Inquiry on 18 August 2011.

2 Page 12 of the ALA submission

The submission quotes from advice prepared by Cumpston Sarjeant Consulting Actuaries in February 2010 that "the claims costs contained in the prospective premium filings were significantly higher than were actually experienced. In turn, the lower than expected claims costs provided significantly higher profits to insurers than were allowed for in the prospective filings." That conclusion is clearly valid. However, it is appropriate to bear in mind the context:

- For a long-tail class of insurance business such as NSW CTP, any estimate of ultimate profit for insurers for recent underwriting years is unavoidably subject to a large margin of error, because of the uncertainty inherent in estimates of outstanding claims liabilities.

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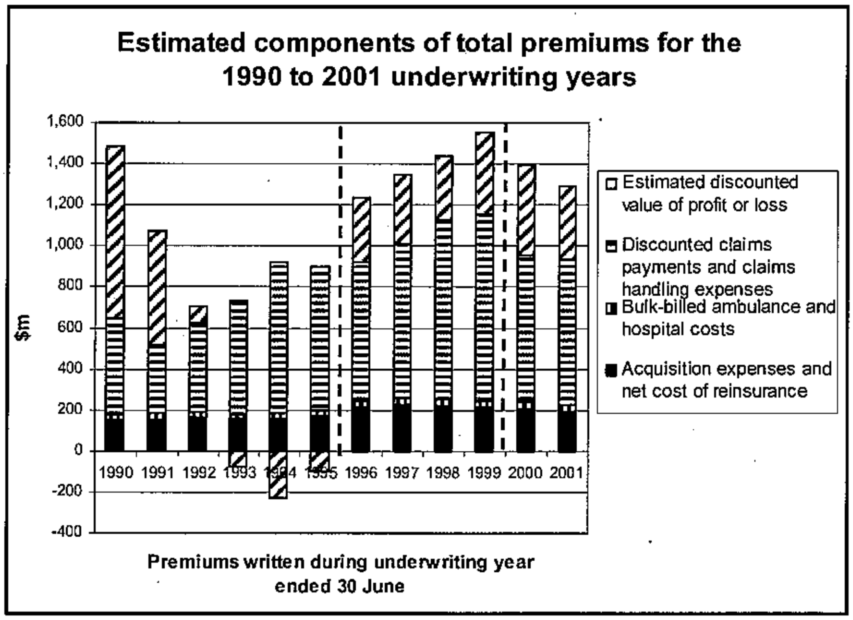
- Estimated profit or loss for insurers. Again, this amount is shown as a discounted present value at the time when each year's premiums were written, and so can be compared with each year's premiums on a like-with-like basis. For the years ended 1993, 1994 and 1995 only, insurers made losses and so this amount is shown as a negative amount below the horizontal axis in Figure 1. For 1993, 1994 and 1995, total premiums paid are still represented by the height of the column above the horizontal axis only.

Figure 1



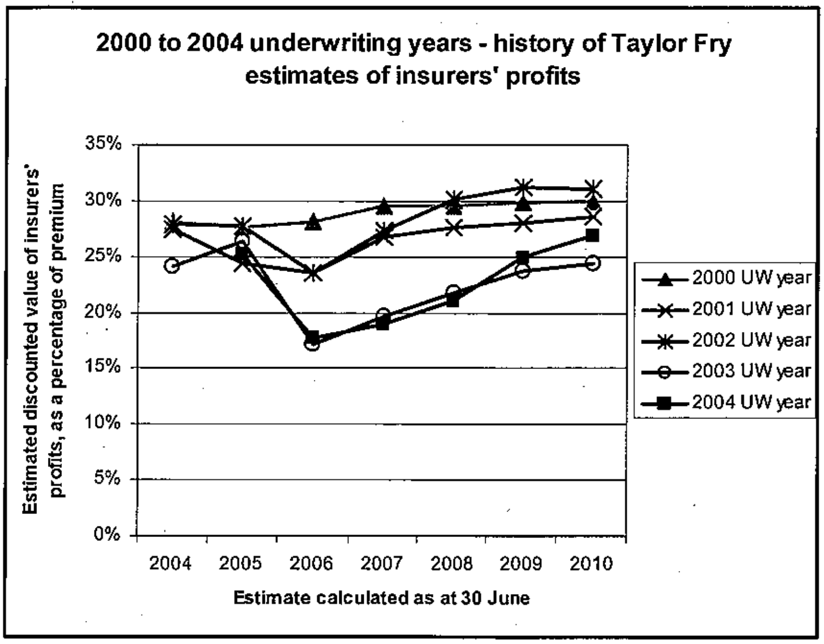
It can be seen that, with the benefit of hindsight:

- Premiums written during the first two years of the Scheme produced extremely high profits for insurers. For those two years:
  - Actual claims costs turned out to be much less than had been projected before the Scheme commenced, and
  - Consequently the fixed premium rates (which were determined by the State Government for those two years only) resulted in extremely high profits for insurers.
- For the 1993 to 1995 underwriting years, a combination of much lower premiums and increasing claim costs resulted in losses for insurers. Those circumstances were not sustainable, and led to legislative amendments in September 1995 which were intended to stabilise claim costs and premiums, primarily by restricting claimants' access to damages for non-economic loss.
- Those legislative amendments, whose effective date is represented approximately by the left-hand vertical dotted line in Figure 1, did result in an initial moderate reduction in claims costs.
- However, between 1996 and 1999 premiums continued to increase and claims costs started to increase again. In 1999 the expectation of the MAA, insurers and their actuarial advisers was that, in the absence of further legislative changes, both premiums and claims costs would continue to increase.

2000 to 2004 underwriting years

For these underwriting years, Taylor Fry's estimates of ultimate profits for insurers calculated as at each 30 June from 2004 to 2010 inclusive are illustrated in Figure 2.

Figure 2



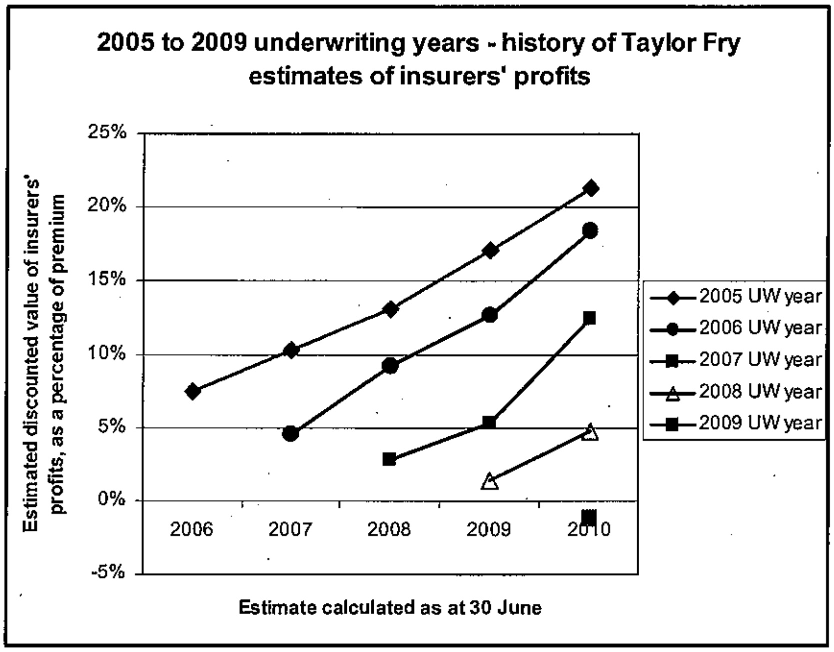
It can be seen that for Taylor Fry's estimates of ultimate profits for insurers:

- Estimates reduced in 2006 and have increased again since then, but
- Overall, estimates calculated as at 30 June 2004 and 2005 are similar to the estimates as at 30 June 2010.

2005 to 2009 underwriting years

Figure 4 shows the history of estimates for each of these underwriting years.

Figure 4



For these underwriting years:

- Estimates published in the MAA's Annual Reports have always been the Taylor Fry estimates without adjustment, and
- For each of the 2005 to 2008 underwriting years, those estimates of insurers' profits were initially less 10% of premiums but have subsequently been increased considerably. Commentary on these increases is provided in section 3.5 of this letter.

Conclusion for the 2000 to 2008 underwriting years

Based on the information described above, in our opinion, the history of estimates of insurers' profits can reasonably be characterised as mixed, in that:

- For the 2000 to 2004 underwriting years:
  - there were fluctuations in Taylor Fry's estimates, but no clear pattern of differences between estimates calculated in 2004 or 2005 and those calculated in 2010 (refer Figure 2), but
  - there was a discontinuity between the nature of the estimates published in the 2005/06 and 2006/07 MAA Annual Reports (refer Figure 3).
- In contrast, for each of the 2005 to 2008 underwriting years, the initial estimate of insurers' profits has subsequently been increased considerably.

Table 2

	Item	Amount
		$m
A	Taylor Fry's discounted present value estimate of outstanding claims liabilities as at 30/06/09	4,464
B.	Deduct claim payments by insurers during the year ended 30/06/10	(1,010)
C.	Add assumed investment income for the year ended 30/06/10 (based on market interest rates on Commonwealth Government bonds on 30/6/09)	135
D.	Changes as at 30/06/10 in Taylor Fry's estimate of remaining outstanding claims liabilities as at30/06/10, due to:	
	(I) More favourable (for insurers) than projected claims experience during the year ended 30/06/10 and resulting re-calculation of Taylor Fry's projection models	**(381)**
	(II) Changes in future interest rates assumed for discounting projected future payments back to a present value	76
E.	Adjusted discounted present value estimate of remaining outstanding claims liabilities as at 30/06/10 (excluding liability for claims in respect of accidents which occurred after 30/06/09) = {A + B + C +D (i) + D (ii)}	3,284

Excluding the effect of changes in future interest rates assumed, the reduction in Taylor Fry's estimates of remaining outstanding claims liabilities (item D (i)) was $381m, which was 8.5% of the estimate of outstanding claims liabilities as at 30 June 2009. While that was a substantial change in estimates of outstanding liabilities, larger changes in actuarial estimates are certainly possible for "long-tail" liabilities for bodily injury insurance claims.

The $381m reduction in estimates of outstanding claims liabilities results in the $309m increase in estimates of the discounted value of insurers' profits shown in the right-hand column in Annexure A to the NSW BA submission. (The main reason why the two amounts are not the same is that the former is a discounted present value as at 30 June 2010 while the latter is the sum of discounted present values back at the time when each underwriting year's premiums were received by insurers.)

We disagree with the description in paragraph 113 of the submission of the 2006 premium collection year as "relatively well developed". For that year the proportion of the discounted value of projected ultimate claim payments attributable to past claim payments:

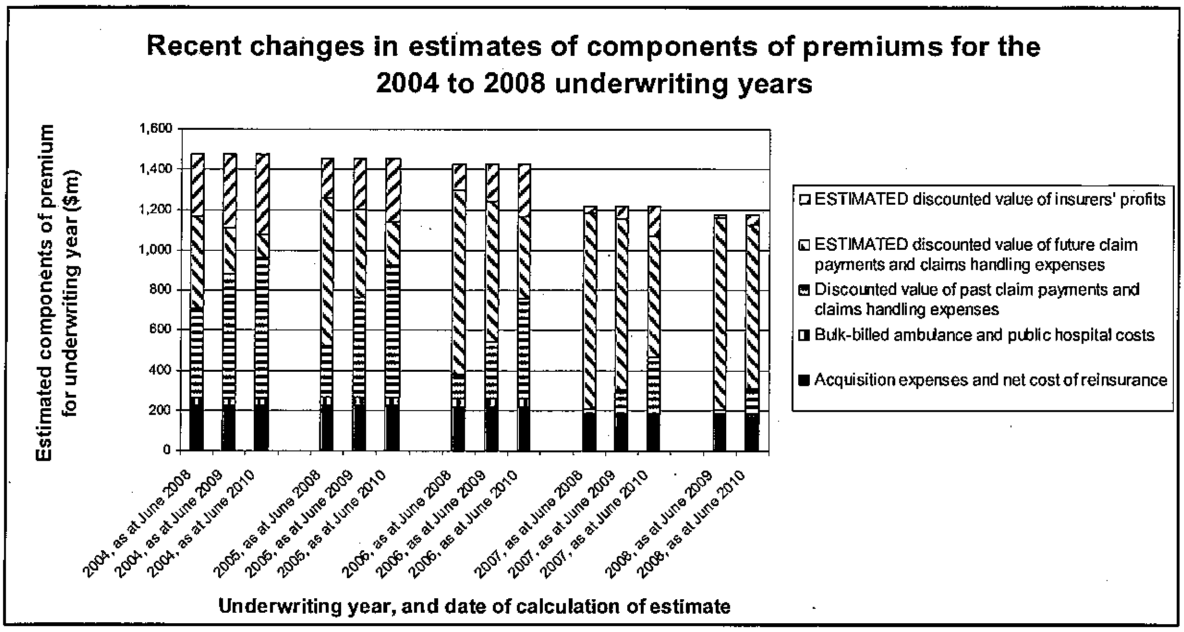
- Was only 29% as at 30 June 2009, and
- Had increased to 55% by 30 June 2010.

Figure 5 illustrates for the 2000 to 2008 underwriting years, based on Taylor Fry's estimates as at 30 June 2009, discounted values of estimated ultimate claim payments and insurers' claims handling expenses, separated into components attributable to:

- Actual past claims payments up to 30 June 2009, and
- Estimated future claims payments after 30 June 2009.

Further, changes in estimates of ultimate claims costs for an underwriting year have a "geared" effect on estimates of insurers' profits. Figure 6 may assist in illustrating this point.

Figure 6



For each underwriting year:

- The total height of the column represents total premiums received by insurers for that year;
- The (discounted value of past claim payments and claims handling expenses) component of the total (shaded in green horizontal stripes) increases progressively as more claim payments are made;
- The (estimated discounted value of future claim payments and claims handling expenses) component of the total (shaded in pink diagonal stripes):
  - reduces progressively as more claim payments are made, but
  - also changes as actuarial estimates of outstanding claims liabilities change based on an analysis of the most recent available claims data, and
- The (estimated discounted value of insurers' profits) component shown at the top of each column is the remaining amount after deducting all of the other components.

The "gearing" effect means that a change in estimates of the discounted value of future claim payments and claims handling expenses results in a **much larger percentage change** in estimates of the discounted value of insurers' profits. Considering the 2006 underwriting year referred to in paragraph 113 of the NSW BA submission:

- As at 30 June 2008:
  - the estimate of the discounted value of future claim payments and claims handling expenses was $917m, and
  - the estimated of the discounted value of insurers' profits was $131m;
- By 30 June 2009:
  - the discounted value of past claim payments and claims handling expenses had increased by $164m;

- Analysis of reasonableness of, and changes since the insurer's previous rate filing, in:
  - allowance made for anticipated investment earnings;
  - estimate of prospective risk premium;
  - projected composition of vehicles insured, and
  - allowance for each of acquisition expenses, net cost of reinsurance, claims handling expenses and profit margin;
- Benchmarking comparisons of insurers' rate filings against each other and against previous rate filings, and
- Detailed advice to the MAA for each insurer's rate filing on:
  - the above items;
  - overall reasonableness of the filing, and
  - a recommendation on whether the MAA should request more information from the insurer, reject the filing or advise the insurer than the MAA does not object to the filing.

(For rate filings which propose a relatively small change in an insurer's current premium rates, a more limited review process is applied.)

Scrutiny of the details of insurer's proposed premium for each class of vehicle is undertaken by the MAA's in-house staff.

If required, we would be happy to clarify and\or provide more information concerning the matters referred to in this letter.

Yours sincerely,

A.M. Gould

Adrian Gould, FIAA