REVIEW OF QUEENSLAND'S COMPULSORY THIRD PARTY INSURANCE SCHEME'S UNDERWRITING MODEL

Purpose of the Review

On 25 March 2010, the Treasurer announced the Motor Accident Insurance Commission (MAIC) would conduct a review of the scheme to analyse alternative underwriting models with the objective of achieving greater efficiencies in the delivery of CTP insurance by ensuring administration and delivery costs are as low as possible. The review was to be limited to analysis of the way in which the CTP scheme is underwritten with consideration of claimant benefits outside the scope of the review.

Consultation and Process of the Review

Following the Treasurer's announcement, MAIC met with representatives from the Insurance Council of Australia and the scheme's licensed insurers on 26 March 2010. Insurers were invited to attend individual meetings with the Commission as well as provide submissions to the review by 16 April 2010. Given the disproportionate and increasing costs associated with acquisition, insurers were asked to consider ways of reducing those delivery costs.

Written submissions were received from each of the underwriting insurers, the RACQ club, the Motor Trades Association of Queensland (MTAQ) and the Queensland Taxi Council. An industry submission was also received from the Insurance Council of Australia. MAIC met individually with insurers on numerous occasions and the outcome of these discussions, together with analysis of the written submissions received have been taken into account by MAIC in recommending the preferred option to Government.

Concurrent with the work of MAIC, the appointed consultants Synergies Economic Consulting conducted a Regulatory Assessment Statement (RAS) incorporating a cost benefit analysis of each option and consideration of National Competition Policy principles. While the findings of the RAS have been taken into consideration, it is not proposed to publicly release the RAS as to do so would prejudice the competitive commercial activities of the private sector insurers.

The Department of Transport and Main Roads was also consulted in relation to the development of measures to encourage ease of consumer choice of CTP insurer either at renewal or at the point of purchase of a new vehicle.

Outcome of the Review

The current underwriting model which was introduced with the aim of encouraging competition among insurers, has failed to generate the level of competition between insurers that was expected. Motor vehicle owners are not getting the full benefit of price competition which should result from private sector involvement.

The outcome of the review has identified savings for motor vehicle owners that could be as much as $20 per motor vehicle by removing the payment of commissions and other inducements to intermediaries. Removing commissions and untying motor dealer and insurer arrangements along with developing initiatives that promote consumers making an active choice when arranging CTP insurance for a new vehicle should provide an environment that enhances price competition on CTP insurance.

It is important to note that the premium savings are based on reductions in current delivery costs but the primary factor which impacts premium price is claims costs. CTP premiums can fluctuate from quarter to quarter depending on the size of damages awards, the number of claims in the scheme and changing economic factors. Even if efficiencies can be achieved in terms of delivery costs, if the frequency and cost of claims increase, so too will premiums.

In addition to these savings, it is recommended that the $4 HIH surcharge be removed from the Nominal Defendant levy from 1 October 2010, providing a further saving to motor vehicle owners of $4 per Class 1 vehicle. A regulation is required to effect this change. This surcharge was introduced in October 2001 to assist the Nominal Defendant in its legislative role of meeting the claim costs of any licensed insurer which becomes insolvent. With the HIH specific liabilities having reduced to $46 million, and given the current reserves of the Nominal Defendant, the outstanding claims liabilities can now be met through the Nominal Defendant Fund without the need for this surcharge.

MAIC will continue to keep the scheme under review to ensure a level of price competition emerges and will report back to Government 12 months post implementation on the efficacy of these changes.

Background

The Queensland CTP scheme has been underwritten by the private insurance sector since 1936 and covers liability for personal injury arising out of motor vehicle accidents. The scheme is compulsory so that persons injured in motor vehicle accidents through another person's fault can access compensation and owners or drivers who are at fault have unlimited insurance protection against liability. CTP is a condition of motor vehicle registration with the insurance premium a component of the motor vehicle owner's registration payment.

Currently, there are six insurers licensed to underwrite CTP in Queensland. They are, in order of market share, Suncorp, Allianz, RACQI, NRMA, QBE and AAMI. The Suncorp group own the licenses for both Suncorp and AAMI and through a joint venture arrangement also hold a 50% interest in RACQI's business. In aggregate, Queensland's CTP insurers collect around $1 billion in premiums per year. Reflecting the long tail nature ofthe scheme, there are around 13,500 open claims with outstanding claims liabilities associated with those claims estimated to be around $2.4 billion. Approximately 6,500 claims are brought against the scheme per year.

Given that it has been ten years since the last major review of the CTP scheme, it was appropriate to assess whether the original objectives of scheme amendments introduced in 2000 have been fulfilled and whether further changes should be considered in light of current circumstances. Reviewing the scheme at this time also addressed the scheduled review of the *Motor Accident Insurance Act 1994* in relation to National Competition Policy principles.

While the amendments of 2000 encompassed many changes to the scheme, three key initiatives were introduced with the aim of encouraging competition with flow on pricing benefits to motor vehicle owners. These three key elements were the introduction of a Vehicle Class Filing Model for determining premiums, the setting of a benchmark for measuring the affordability of premiums known as the 'Affordability Index' and improvements in scheme efficiency, that is, the proportion of the premium applied to meet benefits for injured parties. Another measure aimed at improving the competitiveness of the scheme included removal of caps on agent commissions.

Under the current Vehicle Class Filing Model, insurers file their premiums each quarter for each vehicle class within a floor and ceiling premium range set by MAIC. MAIC determines the premium range having first obtained independent actuarial advice and having considered submissions from stakeholders and the input of an Advisory Committee. The premium ceiling incorporates a margin above the central estimate which allows individual insurers the flexibility to be competitive without premiums being excessive and also allows the insurers to take a more pessimistic outlook having regard to covering the uncertainties of 'long tail' liability insurances. The floor ensures premiums are sufficient to meet the cost of claims and associated costs so that the scheme remains viable and fully funded.

The underlying elements factored into premiums are claim frequency, cost of claims and economic assumptions (wage inflation and the discount rate). In addition to the base premium, allowances are made for the insurers to administer and acquire CTP business, claims handling costs to manage the claims, reinsurance costs and a profit margin. The policy and acquisition component includes costs associated with advertising, marketing and commissions paid to intermediaries such as motor vehicle dealers. MAIC annually reviews these allowances. Scheme levies and an internal administration fee for collection and distribution of the premiums also forms part of the overall cost of CTP insurance.

In determining the floor and ceiling, MAIC derives a theoretical premium and, as it is insurer capital at risk, MAIC has to adopt a reasonably conservative approach in the calculation of each of the underlying elements. In MAIC's view, and a position supported by the independent actuary, insurers do not need to file their premiums at or near the ceiling in order to compete on price while still making a reasonable profit from the business.

Prior to 2000, premiums were set annually by regulation and could not be varied by the insurer. The Vehicle Class Filing Model was seen as a move away from CTP premiums being determined by the Government of the day to a system whereby Government involvement was minimised. By offering insurers the opportunity to set premiums within a floor and ceiling limit, it was expected to encourage competition among insurers for market share which would generate benefits for the motoring public in the form of cheaper premiums. There have been some indirect benefits to motor vehicle owners in the form of complementary add-on insurance products and multi-policy discounts on other insurance products but the anticipated environment of sustained competition in CTP premium price has not materialised.

In the first 18 months following the introduction of the Vehicle Class Filing Model in 2000 some competition emerged and premiums differed by up to $14 (for Class 1 vehicles –cars and station wagons). One insurer competed reasonably aggressively from July 2004 to July 2008, which at one stage resulted in a $17 difference in premium for Class 1 vehicles. However, there has been very little price differentiation between insurers with the exception of one quarter in January2007 where there was a $21.20 difference in premium. In the past two years, the most variation in premium price among insurers has been $10.20. For the last three consecutive quarters, all six insurers have filed at the ceiling for Class 1 policies. While motor vehicle owners have the option of changing insurers, there is little incentive to do so. Despite some price variation in Class 1, there has been little competition in the other 23 classes.

Insurers continue to promulgate a pessimistic outlook on the future claims environment despite a number of reforms that have been implemented to contain claims costs (such as the *Civil Liability Act 2003*). Insurers maintain that the long-tail nature of insurance (where it may take several years - sometimes more than a decade -for all claims for an accident year to be made and settled) makes determining appropriate premium levels problematic, particularly if there are uncertainties surrounding legislative reforms which may have an effect on future claims experience and claimant behaviour. Other arguments advanced for pricing at the upper limit are related to an appropriate insurer profit allowance in the premium setting process, barriers to entry in the new motor dealer market distribution stream and insurers simply not wanting to grow market share. The latter is to some degree a consequence of the Australian Prudential Regulation Authority's (APRA) stringent, but appropriate, capital requirements applicable to long tail liability classes of insurance.

In addition, a number of factors have altered the market over the last ten years resulting in a period of rationalisation and consolidation, including the collapse of the HIH Insurance Group in March 2001 which at the time of its insolvency, held approximately 16% share (net of transferred business to Allianz) of the Queensland CTP market. World events and the global economic downturn have also had an impact. Combined, these factors, along with new prudential requirements, have put capital pressures on insurers with consequential effects on the market.

MAIC has considered specialist input in assessing the impact of alternative underwriting options for Queensland's CTP scheme. These include:

- A high-level financial analysis of the potential impact on key stakeholders of alternative underwriting models by Queensland Treasury Corporation (QTC's report);
- A Regulatory Assessment Statement (RAS) incorporating a cost benefit analysis of the various options by Synergies Economic Consulting.

It is not proposed to publicly release these reports as to do so would prejudice the competitive commercial activities of the private sector insurers.

While the Queensland CTP scheme is relatively stable, there are some short-comings in the current scheme with the result that Queensland motor vehicle owners are bearing additional costs. Analysis of alternative underwriting options and existing policy and acquisition costs (including insurer allowances) indicates that premium savings for motor vehicle owners could be achieved by modifying the current underwriting model and removing the payment of commissions. This would have the effect of reducing delivery costs but most importantly, it removes a significant barrier for those insurers wishing to increase their market share or for new entrants to the scheme.

Matters for Consideration

All insurers support retention of private sector underwriting and are of the view that the current scheme is performing well in terms of stability and affordability and premiums are lower in comparison to other jurisdictions. Insurers argue that while there has been little variation in premium prices over the last two years, there is healthy competition within the scheme as evidenced by the increasing market share of smaller insurers and the provision of customer benefits such as multi-policy discounts and five of the six insurers offering limited add-on driver protection policies.

Although premiums remain $196 below the affordability index, this is largely the result of tort law reform initiatives which have had a positive impact on claims experience rather than any active price competition between insurers. Benefits to injured claimants have been reduced over the years and the proportion of premium applied to meet benefits for injured parties (scheme efficiency) has reduced rather than increased. In the ensuing years since the 1999 scheme review, scheme efficiency has declined from 67% to 59%, largely due to the higher delivery costs of the current model.

What is a reasonable return on equity (ROE) for a long-tail insurance product like CTP insurance is an area of contention. Insurer consensus is that the profit allowance factored in by MAIC when setting the premium bands is inadequate and should reflect a greater return commensurate with other product lines. Insurers submit that a ROE of at least 15% is required to satisfy Board and shareholder expectations whereas the profit allowance provided by MAIC equates to a ROE of around 12%. Insurers submit that this is the major reason premiums are filed at the ceiling as the margin allowed for competition in the premium band ceiling is actually required to deliver on their ROE target.

Under the current scheme, insurers with significant market share have strong links with motor vehicle dealers who are seen as key to maintaining market share and a flow of perceived better insurance risks (new vehicles). These motor dealers receive commissions on any new business generated for the insurer as well as trailing commissions for each year the CTP policy remains with the insurer. Commissions are generally in the range of 3 to 7% of the insurer premium for both new vehicle business and trailing commissions. In addition, there exists financial subsidies and benefits on other insurance products from the insurer. There is a paucity of evidence on the total remuneration motor dealers receive from the CTP premium. It is not possible to identify further additional CTP premium funds that are being channelled to motor dealers through other business related expenses. Insurer submissions support the figure of around $15 to $20 per Class 1 policy.

There is strong competition for the new motor dealer business which is seen as offering the best risk for an insurer. It has been reported that insurers seeking to build their market share have attempted to win this business by offering higher commission levels as well as paying substantial fees to buy out the residual trailing commissions. In addition to the high cost of commissions, insurers which have struggled to break in to this tightly held market argue that there is no active process in place requiring new motor vehicle owners to nominate their CTP insurance provider, leaving it to the dealer to select an insurer on their behalf. These tied arrangements are causing significant barriers for new entrants to the scheme or those insurers wanting to build market share.

Prior to the 2000 amendments, intermediary commissions were capped at up to 2% for new business and 1% for transferred business at renewals. Trailing commissions were not a feature. On the back of the 1999 review, commission restrictions were removed with the intention of facilitating greater competition by allowing insurers to gain and hold market share.

In an attempt to reduce costs and negate the influence of motor dealers in nominating a CTP insurer at the point of sale, there is support for the banning of commissions and other incentives to motor dealers. Some insurers submit however, that the cost of commissions is only a part of motor vehicle dealer remuneration and have advocated a blanket prohibition on commissions and other inducements which, on the insurers input, together with other acquisition efficiencies, will deliver savings in the order of $20.

The removal of commissions may be viewed as government interference in the retail and distribution of an insurance product rather than allowing the competitive market to operate freely noting that distribution of insurance products through intermediaries is a usual insurer business practice. However, it is questionable whether commissions should be allowed on a compulsory insurance product, particularly where the cost is ultimately borne by motor vehicle owners. Only Queensland and New South Wales (with private sector underwriting of CTP insurance) allow for the payment of commissions.

It is important to note that the premium savings are based on reductions in current delivery costs but the primary factor which impacts premium price is claims costs. CTP premiums can fluctuate from quarter to quarter depending on the size of damages awards, the number of claims in the scheme and changing economic factors. Even if efficiencies can be achieved in terms of delivery costs, if the frequency and cost of claims increase, so too will premiums.

HIH Surcharge

In addition to the savings outlined above, a further reduction in the CTP insurance premium can be achieved by removing the HIH surcharge from the Nominal Defendant levy. At the time of HIH's collapse, the CTP claim liabilities of HIH amounted to approximately $440 million. These liabilities fell back to the Queensland Government through the Nominal Defendant which has a legislative role to meet the claim costs of any insolvent licensed insurer. A $5 HIH surcharge per annum per vehicle was introduced in October 2001 to assist the Nominal Defendant in meeting these claim costs. The surcharge is to be reduced to $4 from 1 July 2010 noting the current outstanding claims are now in the order of $46 million. The liabilities are now at a level that can be met through the Nominal Defendant Fund, and it is recommended that the HIH surcharge be removed from the Nominal Defendant levy altogether, thereby providing motor vehicle owners with a further saving of $4 per Class 1 vehicle.

Options

A range of alternatives have been considered to achieve greater efficiencies in the delivery of CTP insurance. In evaluating the merits of each option, the overall objective is to ensure Queensland continues to have a stable and affordable CTP scheme where injured persons receive adequate compensation and at a premium price which is reasonable for motor vehicle owners.

While some changes could be made to the CTP scheme such as increasing the ceiling premium which potentially could encourage greater competition between insurers in terms of premium pricing, there is a significant risk of premiums increasing rather than decreasing and for this reason is not considered a viable option.

In assessing alternative underwriting models, and in accordance with the fundamentals espoused in the 1999 review, there will be no separation of the CTP renewal and motor vehicle registration process. Community rating by class of vehicle is also considered appropriate to be retained as it helps to spread the cost of CTP across the motor vehicle owning public. Linking CTP and registration combats the level of uninsured vehicles on the road and is much more convenient for motor vehicle owners. Any move to separate the process (as is the case in New South Wales' 'File and Write' model) is likely to come with much higher delivery costs and be more cumbersome for vehicle owners.

Based on the above considerations, there are five principal underwriting options for the future delivery of Queensland's CTP scheme. These options are:

Option 1 – Maintain Status Quo

This option retains the current Vehicle Class Filing Model and private sector underwriting, accepting that although the current premium setting process has failed to deliver a more competitive premium environment, premiums levels are reasonable and well below the affordability index, the breach of which would automatically trigger a scheme review. To do nothing however, would be inconsistent with the policy objective of improving efficiency in the delivery of CTP insurance.

Option 2– Retain Vehicle Class Filing Model with modifications (Preferred Option)

This option retains the current Vehicle Class Filing Model recognising the benefits of continued private sector underwriting, however reduces the delivery costs in the scheme by removing the payment of commissions and inducements. This option could conceivably deliver premium savings for Class 1 vehicles (cars and station wagons) of $20 per year and potentially improve scheme efficiency by increasing the proportion of premium applied to meet benefits for claimants from 59% to around 63%.

Most insurers support the removal of commissions and suggest that price competition may follow as the new car distribution channel would be more readily available. While the removal of commissions may impact on motor dealer's revenue stream, public opinion is likely to be that the savings to motor vehicle owners would far outweigh any negative impact on dealer revenue.

Motor dealers may seek remuneration for the administration work required to register a motor vehicle (which includes the selection of a CTP insurer), but it would be more appropriate that this fee be paid by the owner at the time of purchase as a component of the dealer delivery charges rather than subsidised by all Queensland motor vehicle owners.

If this option is adopted and legislated, it is recommended that complementary provisions be included that any costs associated with customer inducements (for example, multi-policy discounts) are not a charge on the CTP scheme.

The benefit of this option is that it retains private sector underwriting rather than transferring the financial risk to government.

Option 3 – Regulated Premium

This option would see a return to the underwriting model in place prior to the 2000 amendments. It includes a higher insurer allowance for profit but falls short of the insurer's expectation on ROE. While this option retains private sector underwriting and claims management, premiums would be set at least annually by regulation following recommendations by MAIC and cannot be varied by an insurer.

While this model would deliver premium savings for Class 1 vehicles (cars and station wagons) at a level similar to that indicated in the preferred option, it extinguishes all opportunity for price competition. As the premium payable would be set by government, the community may also view CTP insurance as a tax rather than a private sector insurance product.

Option 4 – Risk Pool

The introduction of a Risk Pool concept would be a fundamental shift from the current framework and is strongly opposed by insurers. Under this model the Government would assume the role of underwriter and all CTP premiums would be collected, pooled and reinsured in the private sector akin to the scheme underpinning the Building Services Authority insurance arrangement. Insurers and reinsurers wishing to participate in the pool would submit for a percentage of the pool on a policy year basis and receive profits and losses commensurate with their percentage share. There would be no individual policy allocation to insurers. Government would manage the CTP policy administration work currently undertaken by the private insurers and outsource management of claims to agents.

While this concept seeks to retain the involvement of private insurers and has lower acquisition costs, insurers have expressed little appetite to participate in such an arrangement and see it as a greater risk requiring a higher ROE thereby reducing potential savings. This model also negatively impacts on the customer relationship value generated from underwriting CTP.

Option 5 – Government Underwriting

This option would see the scheme totally underwritten by the Government (other than for reinsurance) through MAIC with no private insurer involvement in the underwriting process. Except for NSW and the ACT, all CTP schemes across Australia are government underwritten. Under this option, the claims would be outsourced to claims agents.

Allowing for a dividend to government, this option would have a significant benefit to motor vehicle owners, potentially achieving a much higher premium saving. It also offers the lowest delivery costs. One of the biggest advantages of government underwriting is any surplus achieved is retained to offset future premium cost. Similarly, the downside risk is that shortfalls need to be met by future policyholders. Due to the nature of insurance, there will be good years and bad years. Prudent pricing processes and good reserving practices ensure appropriate levels of solvency.

While this model delivers the greatest savings to motor vehicle owners, it transfers financial risk to Government and could well be viewed by the community as a tax rather than an insurance premium.

Another consideration is the impact on staff of underwriting insurers, although some staff would still need to be retained by the insurers to manage the run-off of existing claims over a 3-5 year period. There would also be corresponding staff movement to the appointed claims agents.

Recommended Option

Based on the impact assessment (including cost benefit analysis), the preferred option is to retain the current Vehicle Class Filing Model but remove the payment of commissions and other financial inducements (*Option 2*). This option achieves a reduction in scheme delivery costs in accordance with the objectives of the review, whilst still retaining private insurer involvement in the underwriting and claims management process, a key element of the scheme supported by stakeholders. It also represents an effective and proportional response to the issues identified and is an incremental rather than wholesale change.

Changes to the CTP scheme ordinarily should be prospective and coincide with quarterly premium cycles. The first available opportunity would be the quarter commencing 1 October 2010. Legislation giving effect to the Government's preferred option would need to specify a 1 October 2010 commencement.