MOTOR ACCIDENT INSURANCE COMMISSION MAIC

7 September 2004

Study of Financial System Guarantees
c/- Department of the Treasury
Langton Crescent
PARKES ACT 2600

In response to the Commonwealth Government's Discussion Paper on Financial System Guarantees, please find enclosed a submission prepared by the Motor Accident Insurance Commission (MAIC), regulator of the Queensland compulsory third party (CTP) personal injury motor accident insurance scheme.

The submission is made in response to Question 12 of the Discussion Paper which asks about the regulatory implications of a national guarantee scheme. It is limited to the implications a national guarantee scheme might have for Queensland CTP insurance, which as a statutory insurance class underwritten by private sector insurers is heavily exposed to general insurance failure.

The submission also comments on conditions which the Davis Report on Financial System Guarantees suggested might need to be met before a national scheme could apply to statutory insurance classes.

Please note the submission is an MAIC document and does not necessarily represent the views of the Queensland Government. MAIC has no objections to the submission being published on the Study's website, provided it is clearly identified as presenting a MAIC only perspective.

I regret that the submission has been lodged after the formal closing date for submissions but ask that the contents receive due consideration.

Yours sincerely

Ms Lesley Anderson
Insurance Commissioner

Encl.

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MOTOR ACCIDENT INSURANCE COMMISSION
QUEENSLAND

SUBMISSION IN RESPONSE TO
THE COMMONWEALTH GOVERNMENT'S
DISCUSSION PAPER ON
FINANCIAL SYSTEM GUARANTEES

7 SEPTEMBER 2004

MAIC SUBMISSION TO THE COMMONWEALTH GOVERNMENT IN REPSONSE TO THE DISCUSSION PAPER ON FINANCIAL SYSTEM GUARANTEES

Introduction

This submission has been prepared by the Motor Accident Insurance Commission (MAIC), regulator of the Queensland compulsory third party (CTP) personal injury motor accident insurance scheme. It does not necessarily represent the views of the Queensland Government.

The submission is made in response to Question 12 of the Commonwealth Government's Discussion Paper which asks about the regulatory implications of a national guarantee scheme. It is limited to the implications a national guarantee scheme might have for Queensland CTP insurance, which as a statutory insurance class underwritten by private sector insurers is heavily exposed to general insurance failure.

The submission also comments on conditions which the Davis Report on Financial System Guarantees suggested might need to be met before a national scheme could apply to statutory insurance classes.

Statutory CTP insurance in Queensland

Of the two statutory personal injury insurance classes, only compulsory third party (CTP) motor accident insurance is underwritten by private sector insurers in Queensland. Queensland workers compensation is government underwritten, with provisions for self insurance for large employers who meet certain requirements.

The only other States and Territories besides Queensland with privately underwritten CTP insurance are NSW and the ACT. Whilst there are significant similarities across the three schemes, there are some notable jurisdictional differences in terms of how premiums are determined and what benefits are payable.

CTP insurance in Queensland provides indemnity for Queensland registered motor vehicle owners and drivers who are found liable for injury to a third party arising from a motor vehicle accident and provides injured parties with access to monetary compensation for their injuries.

State legislation, the *Motor Accident Insurance Act 1994*, prescribes the policy of CTP insurance. There is no opportunity for the insurer or motor vehicle owner to vary the terms of the cover of the basic CTP product. An insurer cannot refuse to underwrite or decline a policy for a motor vehicle owner. Premiums are based on vehicle description and community rating by class and not on the characteristics of insureds. (Premiums in NSW, on the other hand, are based on individual risk ratings.)

The premium setting process is also prescribed in the legislation. Under Queensland's competitive premium model, insurers determine their premiums for each vehicle class within floor and ceiling bands set by MAIC. The premium bands are set following quarterly actuarial analysis and provide a premium that covers the insurer's risk and allowances for administrative costs and profit.

In Queensland's CTP scheme, injured third parties have essentially unfettered access to the benefits payable at common law. The only limitations applying are to loss of income (capped at 3 times average weekly earnings) and general damages capped at $250,000 and subject to prescribed injury scale values. Among other benefit restrictions, the NSW scheme has a threshold for the payment of general damages.

Currently six insurers are licensed to underwrite CTP in Queensland. They are Suncorp, Allianz, RACQI, AAMI, QBE and NRMA. Five of these insurers – RACQI excepted – also underwrite CTP insurance in NSW, and one insurer, NRMA is the sole underwriter in the ACT.

In aggregate Queensland's six CTP insurers collect around $875 million in Queensland CTP premium per year. Current CTP claims liabilities are estimated to be $2.7 billion. A considerable imbalance exists between the six CTP insurers in terms of Queensland market share, with the range being 55% to 1.5% of Queensland CTP premium.

The regulatory environment

Insurers wishing to participate in the Queensland CTP scheme must first be licensed under the *Insurance Act 1973* and then be licensed with MAIC. Although the State legislation provides for MAIC to establish and revise prudential standards for licensed insurers, it also states MAIC must have proper regard to the prudential standards that apply to the insurance industry under Commonwealth legislation.

In practice this has meant that MAIC has relied on the Australian Prudential Regulation Authority, APRA, and its predecessor, the Insurance and Superannuation Commission, to supervise an insurer's activities, to monitor solvency and if problems arise, to manage the insurer's orderly exit from the market.

Only APRA has the power, under the *Insurance Act 1973*, to prudentially regulate and supervise a general insurer's entire business operations and it has always been considered unworkable to duplicate APRA's functions at a State level. The HIH situation illustrated that any prudential functions MAIC does have are largely ineffectual in the context of an insurance group's operations.

As MAIC's regulatory role is limited to an insurer's Queensland CTP business, its supervisory activities are restricted to monitoring CTP marketing activities, CTP claims management practices, collection of claims data and the like. Significantly, MAIC does not have a legislated role to ensure the CTP premium dollars collected are available when needed to pay CTP claims, or to require CTP insurers to adequately provision for claims. These matters are part of the supervisory framework for the financial status of the entire company (CTP and non-CTP business) which is the responsibility of APRA.

Currently there is no requirement for Queensland CTP insurers to quarantine their CTP funds from other aspects of their business or to restrict the flow of funds from a subsidiary to the group. While there are mutual advantages to having CTP as part of the insurer's larger pool, the downside is that Queensland CTP consumers are exposed to any adverse impacts arising from the insurer's broader operations. For example, it was clearly evident from the HIH Royal Commission that FAI's losses were not in Queensland CTP but in other areas of HIH's operations (eg losses in other business lines, overseas underwriting losses, and inward reinsurance arrangements). Yet Queensland CTP policyholders are bearing the consequences.

The impact an insurer's non-CTP activities can have on a viable CTP scheme is a key concern for MAIC, and although recent enhancements to APRA's regulatory powers and its supervisory capacity provide for a much stronger prudential framework than that in which HIH operated, there is no guarantee another insurer won't fail.

General insurance is now a much more global business than it has been in the past. All Queensland CTP insurers, for example, have international exposures through investment operations and some insurers have international exposure through underwriting.

World events have demonstrated that unexpected, external shocks can have a serious impact on Queensland-licensed CTP insurers operating in the international market. These shocks can lead to insurer failure if the insurer is not in a position to recapitalise. Likewise, the viability of general insurers can be put at risk if there are failures amongst reinsurers.

Domestically, there is also the potential for major natural disasters to impact adversely on the balance sheets of general insurers. With Australia's population concentrated in its major cities on the eastern seaboard, history has already shown the degree of exposure insurers have to cyclones, floods, hailstorms, earthquakes and the like.

Even a strong Australian prudential framework cannot fully protect Australian consumers against risks arising from international events, terrorist attacks and natural disasters.

Current consumer protection arrangements

In the case of third party cover, the impact of general insurer failure is not only on the policyholder but also the injured third party, who does not have a direct relationship with, or any choice in, the insurer providing the cover. Any consumer protection arrangements must therefore cover both the policyholder and third party.

In Queensland if an insurer under a CTP policy becomes insolvent, consumers are protected by legislative provisions which require the Nominal Defendant to become the insurer under the Act.

Under the Nominal Defendant insolvency provisions, indemnity for policyholders continues and the Nominal Defendant becomes liable for the cost of claims against the failed insurer. The Nominal Defendant also has to cover the unexpired portion of policies already issued by the insolvent insurer unless the policies are transferred to some other licensed insurer.

The impact of the current consumer protection arrangements in Queensland can be demonstrated by reference to the collapse of FAI General Insurance, a subsidiary of HIH, and the second largest CTP insurer in Queensland at the time in terms of market share. As a result of FAI's failure, the Nominal Defendant was required to take on the liabilities for outstanding claims from FAI policies expiring prior to 1 January 2001. It was not required to cover the unexpired portion of FAI's policies as Allianz had taken over all in-force policies of FAI from 1 January 2001.

The cost of FAI's Queensland CTP claims liabilities is in excess of $400 million. These costs are being met by reserves in the Nominal Defendant Fund, income from a notional $5 per annum levy imposed on policyholders and funds from Government revenue. The alternative could have been a one-off levy on policyholders of around $140.

Given the impact already being felt as a result of FAI's collapse, the current consumer protection afforded by the Nominal Defendant provisions means failure of another dominant Queensland CTP insurer, or two or more of the smaller insurers in a short period, would have significant consequences for the State's finances. The current level of insurer concentration and market share imbalance in Queensland CTP accentuates the implications.

The implications of a guarantee's design and strength

The introduction of a national guarantee scheme that covered Queensland CTP insurance has the potential to make the Nominal Defendant insolvency provisions redundant and to significantly mitigate the State's present financial exposure to insurer insolvency. The materiality of such implications will be dependent on the degree of consumer protection provided by the national guarantee scheme, and the scheme's strength under the most adverse conditions.

Level of protection

It is noted that the Davis Report has acknowledged that the element of compulsion and circumstances insured presents a case for a guarantee to provide statutory classes with a higher level of protection than other classes of insurance product.[1] However the actual extent of this protection was not defined.

From MAIC's perspective, the national guarantee scheme would need to provide Queensland CTP policyholders and claimants with the current level of protection and entitlements afforded them, even if a dominant insurer failed.

As claimants are currently entitled to full benefits through the Nominal Defendant provision, benefits payable under a guarantee scheme would have to be equivalent. Removal of the Nominal Defendant provision for anything less than the current coverage is likely to bring community pressure to bear on the State Government to address any shortfall.

The guarantee scheme would also need to cover the unexpired portion of policies for a specified period or else policyholders would have to purchase new insurance cover the day after the insurer providing the cover collapsed. In Queensland, the CTP insurance renewal process is complicated as it is presently aligned to vehicle registration. Under current arrangements, if an insurer failed, the Government would possibly decide that motorists could continue to drive with CTP coverage provided by the Queensland Nominal Defendant until the policyholder's next renewal date.

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The Davis Report has suggested the guarantee scheme would offer interim cover for unexpired policies for a specified period after an insurer's collapse in recognition of the fact that alternative insurance may not be immediately available.[2] After the collapse of HIH on 15 March 2001, the HIH Claims Support Scheme, announced on 17 May 2001, gave policyholders to 11 June 2001 to take out replacement policies. Such short interim cover falls short of the current Nominal Defendant provisions for Queensland CTP, though MAIC acknowledges that a specified timeframe might be necessary.

Strength of scheme

In the context of Queensland's CTP scheme where one insurer alone has 55% of the Queensland CTP market, a key concern for MAIC is the magnitude of failure the guarantee could handle. While a pre-funded or post-funded guarantee scheme may be able to provide for a small to medium-sized insurer failure, it could face difficulties under either funding arrangement if a large insurer fails or a number of small insurers fail in a short period of time.

Though such a scenario may be regarded as remote, it is not improbable. The Australian general insurance market is relatively concentrated, with four or five companies commanding well over half the market share. The experience of consumer protection schemes overseas suggests that very few schemes are able to meet their obligations when a major institution fails in a concentrated market, without resorting to significant Government funding.

If a worst-case scenario were to eventuate, MAIC is concerned Governments would be forced to provide loans or grants – or emergency amendments might be made to the extent of cover of the scheme, with statutory classes possibly being forced back onto State Governments. On a micro level, this was the situation that arose in the Northern Territory's workers' compensation scheme following the collapse of HIH. At the outset of any guarantee scheme, it is MAIC's view that an agreement should be reached with the Commonwealth Government to make financial resources available to the scheme if the need for backup support arose.

Furthermore, if a decision is made to establish a national guarantee scheme, MAIC would like the chosen model to be tolerance tested to define the magnitude of failure that could be handled. For example, how would the model have performed in response to the failure of HIH? The ability of a guarantee scheme to minimise any systemic flow-on effects should also be considered, especially in the framework of Australia's relatively small economy. The perceived strength of the model will have implications for stakeholder acceptance of the scheme.

Regulatory implications of a guarantee

It is likely Queensland would consider removing the Nominal Defendant insolvency provision from its legislation if the State Government had sufficient confidence a national guarantee scheme would provide Queensland CTP consumers with the same protection they currently receive, even if a dominant insurer failed. In addition, any references to prudential

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supervision of insurers by MAIC would be removed from the legislation leaving APRA as the sole prudential regulator for all aspects of a general insurer's business.

On the other hand, if the guarantee did not extend to statutory classes, or took a minimalist approach to benefits, and/or seemed unlikely to handle a systemic failure, then Queensland would have to consider other measures to mitigate the State's financial exposure to CTP. In this respect, MAIC has been looking at the options available.

One option MAIC has been exploring in depth is a single line of business structure for Queensland CTP. Under this model, general insurers wishing to participate in the Queensland CTP market would have to establish a separate subsidiary that would carry on no other business than CTP in Queensland. The benefit of this model for Queensland would be that CTP funds would be quarantined in the subsidiary and would not be exposed to the non-CTP risks of the parent. (Exposures via intercompany loans and reinsurance arrangements would need to be minimised through conditions placed on the CTP licence).

Another option available is for the State Government to phase out private sector underwriting and become underwriter for the CTP scheme.

Conditions proposed by the Davis Report

The Davis Report concluded that a guarantee scheme could extend to statutory classes of insurance subject to certain conditions. In particular, the Report suggested that the form of any premium and benefit regulation imposed by the State on private insurers underwriting statutory insurance should be an important consideration in deciding whether or not the guarantee extends to these classes – on the basis that government regulation has the potential to result in non-commercial and imprudent outcomes for private insurers and as such would present a financial risk to the guarantee scheme.

While Queensland CTP has regulations applying to the premium setting process and, to a very limited degree, to benefits payable, MAIC does not consider either to be of a form that should preclude a guarantee scheme from extending to cover this insurance class.

Premium regulation

As mentioned earlier in this submission, the premium setting process requires MAIC to establish premium bands within which insurers may file. MAIC strongly argues that the process used to determine the premium bands does not result in non-commercial or imprudent outcomes for private insurers and therefore would not present a financial risk to the guarantee. The rationale behind the premium bands is that the floor is there to protect the insurance industry from individual insurers who may wish to underprice the product and the ceiling is there to protect motorists from overpricing of the product.

The bands are set quarterly and significant emphasis is placed on actuarial advice on the risk premium components. MAIC also draws on the knowledge and experience of its Advisory Committee and the MAIC executive, and considers submissions from stakeholders including the CTP insurers. The ceiling premium is a set of assumptions that have specified elements of conservatism, such that it is not necessary for insurers to file at the ceiling in order to achieve profitability.

In long tail business it is possible to take widely different views on, for example, superimposed inflation. Further, different views can be held between MAIC and insurers on the profit margin that should be factored into the premium. In setting the ceiling MAIC's role is to reach an analytically based and transparent set of assumptions which do not, for instance, require the motorist to pay for prospective superimposed inflation allowances that cannot be justified on the facts or to pay insurers an excessive profit.

With the premium bands set every quarter, there is a regular opportunity for the consulting actuaries, MAIC and insurers to re-examine the assumptions in light of the most recent claims experience and anecdotal information and make any necessary adjustments in the following quarter.

Benefit regulation

As previously mentioned, the only limitations applying to benefits are to loss of income (capped at 3 times average weekly earnings) and general damages capped at $250,000 and subject to prescribed injury scale values. Some restrictions also apply to the payment of legal fees for minor claims. These limitations apply not only to CTP but to other personal injury insurance lines such as public liability and medical indemnity insurance which is also underwritten by private insurers. All other benefits are subject to common law. The cost of claims and any superimposed inflation in the benefits payable to claimants are risk components included in the actuarial analysis behind the premium setting process.

A financial contribution to the guarantee by the State Government

The Davis Report also suggested that, if State and Territory governments rely on a guarantee scheme to protect them against insolvency losses associated with compulsory insurance classes, there may be a case for them to make an appropriate contribution into any centralised scheme in recognition of the transferred risk. MAIC has chosen not to comment on this particular condition on this occasion.

Conclusion

In summary, MAIC concurs that regulation cannot prevent insurer insolvency and, because insurer failure remains a possibility, the compulsory nature of statutory personal injury insurance lines requires governments to have consumer protection mechanisms in place. Currently Queensland CTP policyholders and claimants are afforded this protection by the State Government, through the Nominal Defendant arrangements.

Transferring consumer protection, and the State's financial risk, to a national guarantee scheme will depend on:

- Consumers continuing to get the same level of protection and benefits as they do now; and
- The perceived strength of the guarantee when faced with failure of a significant magnitude.

MAIC does not consider the form of regulation applying to CTP premium or benefits in Queensland should preclude any guarantee from extending to Queensland CTP. Any State Government contribution to the funding of a guarantee will be a matter for State Government consideration at such time as the detail of a guarantee scheme is known.