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Private versus Public Underwriting

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Background

The theme for the Xth Accident Compensation Seminar, 2004, is Efficiency in Accident Compensation Schemes. The organisers wish to examine and explore what is efficiency of accident compensation, and how it can be measured. Special emphasis is being given to non-financial objectives of an accident compensation scheme.

This paper will examine a number of aspects of accident compensation schemes in Australia from the perspective of private versus public underwriting. While it is entirely valid to measure and assess non-financial objectives of accident compensation schemes, the paper will concentrate on a range of financial parameters, and the impact they may be having on the overall efficiency of the schemes examined.

This paper will not examine the varying levels of benefits within the accident compensation schemes. Society, through the government and Parliament of the jurisdiction, determines the nature and level of benefits to be provided to people who are killed, injured or sustain a disease at work, on the roads, or in certain other circumstances. The question being examined is the financing of risk and delivery of benefits, rather than the nature of the benefits themselves.

While a variety of Australian accident compensation schemes will be discussed in this paper, special emphasis will be given to recent experience in workers compensation schemes.

Introduction

In Queensland and New South Wales, workers compensation is (largely) underwritten in the public sector. Compulsory third party motor personal injury insurance (CTP) is underwritten by private sector insurers.

In Western Australia and Tasmania, workers compensation is underwritten by a private sector competitive market. CTP is underwritten by public sector agencies.

Each of these States will no doubt argue that they have the most appropriate solution for the particular line of business. Many politicians and bureaucrats within the State Governments and Parliaments of the jurisdictions where the schemes are publicly underwritten will be unaware that there is in fact an alternative model, and that the alternative model exists and operates elsewhere in Australia with success.

Where to start?

It is difficult to know where to start an analysis of private and public underwriting of accident compensation schemes in Australia. Each item of interest will contain its own competing arguments, and the prospect of a very long examination of all issues is troubling for both the writer and, no doubt, for the audience.

One approach might be to compare key indicators between the public and private run schemes in the different States. Such benchmarking studies have been undertaken in the past through the Workplace Relations Ministers' Council. The challenge with these kinds of comparisons is that, while interesting, the vast differences in structure and benefit designs between the states render any direct comparisons difficult.

There is one area where there has been a significant level of agreement between all Australian governments – Commonwealth, States and Territories. Australian Governments have initially agreed, and subsequently re-affirmed, that broad competition-based economic reform is desirable in the interests of ensuring better products and services being delivered more efficiently and effectively for the whole Australian community, ultimately leading to a better standard of living for all.

National Competition Policy[1]

In April 1995 all Australian Governments reached agreement on a National Competition Policy (NCP) for Australia. Three intergovernmental agreements were executed, namely –

- The Competition Principles Agreement;
- The Conduct Code Agreement; and
- The Agreement to Implement the National Competition Policy and Related Reforms.

The agreements outlined the reforms which Governments undertook to put in place under the NCP process.

The agreements reflect recommendations from the Committee of Inquiry into a National Competition Policy for Australia, which later became known as the Hilmer Committee. The Committee made recommendations in six policy areas:

- Extension of the reach of the Trade Practices Act 1974 to unincorporated businesses and State and Territory government businesses;
- Extension of prices surveillance to State and Territory government businesses to deal with those circumstances where all other competition policy reforms had proven inadequate;
- Application of competitive neutrality principles so that government businesses do not enjoy a competitive advantage simply as a result of public sector ownership;

[1] Substantial background material on National Competition Policy and the intergovernmental agreements which underpin NCP is available on the web site of the National Competition Council: www.ncc.gov.au.

- Restructuring of public sector monopoly businesses;
- Reviewing all legislation which restricts competition; and
- Providing for third party access to nationally significant infrastructure.

Under the Implementation Agreement, the Commonwealth Government undertook to make on-going NCP payments to each State and Territory over the period 1997-98 to 2005-06, subject to that State or Territory making satisfactory progress against their NCP and related reform obligations.

In more recent times, National Competition Policy has been challenged by a number of vested interest groups, and in some parts of the country has been unfairly blamed for economic developments which were unrelated to the reform processes set out in the intergovernmental agreements. NCP has become a "dirty word" to some.

Following substantial criticism and political pressure from the community groups and some State Governments, the Council of Australian Governments (COAG) thoroughly reviewed NCP during 2000. Importantly, the ninth meeting of COAG held in Canberra on 3 November 2000 affirmed the importance of NCP in sustaining the competitiveness and flexibility of the Australian economy and contributing to higher standards of living.

While there were some adjustments to the NCP implementation arrangements, there was clear commitment from COAG for the ongoing implementation of NCP, and to safeguard the flow of benefits the program was delivering to Australians as a whole.[2]

Whither NCP?

COAG has agreed to complete its own review of NCP by September 2005. In order to inform this process, the Productivity Commission has been given comprehensive terms of reference to conduct an inquiry into the impacts of NCP to date, and report on future areas "offering opportunities for significant gains to the Australian economy from removing impediments to efficiency and enhancing competition".[3] The Commission has released a Discussion Draft report, and is receiving comment on that draft at the time of this seminar.

The Productivity Commission has found that not all anti-competitive regulation has been properly addressed, and is proposing a more targeted program of legislation reviews be retained beyond the current NCP program. As part of the priorities for the new program it is suggested that there might be value in a second round reviews of compulsory third party and workers compensation insurance.[4]

Competitive Neutrality

A key component of NCP, agreed to by all Governments in 1994, is the adoption of Competitive Neutrality Policy and Principles. According to clause 3 of the Competition Principles Agreement –

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[2] The agreement at COAG is set out in the Communiqué issued following the meeting held on 3 November 2000, available on the NCC web site.
[3] The terms of reference, draft report and other material are all available on the Productivity Commission web site: www.pc.gov.au
[4] Productivity Commission Draft Report, pages 205 - 207.

> "The objective of competitive neutrality policy is the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities: Government businesses should not enjoy any net competitive advantage simply as a result of their public sector ownership."[5]

Under the Competition Principles Agreement, governments are required to adopt a corporatisation model for government business enterprises and apply full taxes or tax equivalent payments, debt guarantee fees and private sector equivalent regulation. **An essential element of the obligations is that government business activities, like their private sector counterparts, set prices that enable them to earn sufficient revenue to cover their costs, including the cost of capital.**[6] (my emphasis)

The 2003 National Competition Council Assessment Report on National Competition Policy outlines the benefits of competitive neutrality as follows:

> "By placing government business activities on a similar competitive footing to that of their actual or potential private competitors, competitive neutrality establishes conditions for increased private sector participation in industries, thus promoting competition with flow-on benefits to consumers. Competitive neutrality also promotes a more dynamic culture within government businesses, partly as a result of the stronger discipline for transparency and accountability. Government businesses cannot rely on the advantages of public ownership, which often encourage complacency and reduce incentives to improve performance. The application of competitive neutrality principles thus contributes to greater efficiency, better services and cost-effective prices for users. In this way, competitive neutrality underpins and complements the performance monitoring regimes that many governments have introduced for their businesses in recent years.
>
> With a competitive neutrality policy in place, governments can better assess the future of their businesses. Full attribution of costs, for example, often leads governments to reassess whether they wish to provide a good or service directly through a government business, allow competitive bidding for the provision of the good or service, or withdraw from the market."[7]

The Competition Principles Agreement does not require governments to implement competitive neutrality principles and policies where the cost of doing so would outweigh any benefits that would be realised from implementation.[8] It would appear from the general thrust of the NCP obligations that the onus is on governments to implement competitive neutrality unless there are strong reasons for not doing so.

From this perspective it can be argued that an assessment of statutory schemes in the context of competitive neutrality can act as a proxy in assessing the benefits of public versus private underwriting. Specifically, if one accepts the premise of the National Competition Policy and

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[5] Competition Principles Agreement, 11 April 1995, clause 3(1), available at: http://www.ncc.gov.au/pdf/PIAg-004.pdf

[6] For further information on competitive neutrality, please refer to: http://www.ncc.gov.au/articleZone.asp?articleZoneID=72

[7] National Competition Council, 2003 NCP Assessment Report, page 2.2, available at: http://www.ncc.gov.au/pdf/AST5Ov-003.pdf

[8] Competition Principles Agreement, 11 April 1995, clause 3(6).

acknowledges the benefits in terms of economic efficiency, then it is a logical extension that a review of statutory schemes against the core elements of competitive neutrality provides an effective basis for assessment of public underwriting schemes.

What does this mean for insurance?

The application of competitive neutrality principles to public sector organisations providing services similar to general insurance (for current purposes, organisations providing workers compensation insurance) would require observation of the following:

- Operational issues such as accurate and transparent reporting based on accepted accounting practices, effective asset management, and cost-based price setting that does not involve inter-generational or inter-departmental cost shifting;
- All relevant taxes and charges and duties, including for New South Wales, provision for the Insurance Protection Tax;
- Adherence to APRA General Insurance Prudential Standards[9], being
  GPS 110 Capital Adequacy for General Insurers
  GPS 120 Assets in Australia for General Insurers
  GPS 210 Liability Valuation for General Insurers
  GPS 220 Risk Management for General Insurers, and
  GPS 230 Reinsurance Arrangements for General Insurers; and
- Maintenance of, and provision of a commercial return on, notional capital.

Queensland

The primary provider of workers compensation in Queensland is WorkCover Queensland. This organisation has a long and honourable history of providing workers compensation services in that State. In addition to the government agency, Q-Comp, the Queensland Workers Compensation Regulatory Authority, licences and supervises 25 workers compensation self-insurers, each employing more than 2,000 workers.[10]

WorkCover Queensland has achieved a relatively sound financial position, despite being in a deficit funding position in 1995-1996. According to their Annual Reports[11], the net asset position of the organisation as at 30 June each year has been

Year	1998	1999	2000	2001	2002	2003	2004
Net Assets ($M)	42.7	300	519	600	466.4	444.6	636

The net assets constitute 26.7% of total assets as at 30 June 2004. Measured another way, total assets comprise 136% of total liabilities as at that date.

[9] Full details of the APRA General Insurance Prudential Standards and Guidance Notes are available at: http://www.apra.gov.au/General/General-Insurance-Prudential-Standards-and-Guidance-Notes.cfm
[10] Information relating to Q-Comp is available at: http://www.qcomp.com.au/home_page/htm/index.htm
[11] Information relating to WorkCover Queensland is taken from Annual Reports available at: http://www.workcover.qld.gov.au/public/htm/main.htm#about

The 2004 Annual Report also indicates that WorkCover benchmarks itself with the minimum capital requirements set by APRA, and that the financial position as at 30 June 2004 provides for a capital adequacy multiple in excess of APRA's requirements. It is pleasing to note that in recognition of uncertainties surrounding the calculation of provisions for outstanding claims, allowance is made for a prudential margin of 15% over the actuary's central estimate, giving a probability of sufficiency of between 80% and 85%.

Part of the financial recovery up to June 2000 was a result of careful management and investment of assets. In keeping with the public sector ownership of the organisation, part of the recovery also came from a significant investment of Queensland Government revenue into the organisation. Hence, the financial risks of the organisation are ultimately being carried by Queensland citizens and taxpayers, and this has amounted to the diversion of funds from Government programs to fund the recovery of WorkCover. There was little discussion or debate, at the time, as to whether this was an appropriate use of public monies.

While the WorkCover accounts reflect provision for the payment of income tax equivalents, there is no indication of a notional return on equity being provided to the Queensland Government. In these circumstances, Queensland taxpayers are not receiving a dividend on the $636 million currently supporting the organisation's financial position. The opportunity cost of providing these funds is not being met.

New South Wales

At the time of preparation of this paper, the 2004 Annual Report for the WorkCover Authority of New South Wales was not available. Information is provided on the financial position up to 30 June 2003, and is taken from Annual Reports.[12]

It is well known that in New South Wales, the Government and the WorkCover Authority take the view that because the WorkCover Authority does not "control" the WorkCover Scheme Statutory Funds within the meaning of Australian Accounting Standard AAS24 (Consolidated Financial Reports), the Scheme Statutory Funds are not consolidated within the financial statements of the Authority itself, but are reported separately in the Annual Report.[13]

This would tend to imply that the Scheme Statutory Funds are not owned by the Government or the Authority. It is an open question as to who owns the Funds, and is therefore responsible to account for their financial position and performance.

The financial position of the Statutory Funds in recent years has been problematic. The net asset position, reported in recent Annual Reports, has been as follows:

Year	1997	1998	1999	2000	2001	2002	2003
Net Assets ($M)	-788.8	-1674	-1636	-1638	-2756	-2801	-2982

[12] Information on WorkCover NSW is available at: http://www.workcover.nsw.gov.au/Publications/General/AnnualReports/annualreport_200203.htm
[13] For further information, see WorkCover Authority of NSW Annual Report for 2002-2003, Financial Statements, Note 26 – WorkCover Scheme Statutory Funds.

As at 30 June 2003, total assets comprised 65.5% of total liabilities. The Funds do not meet APRA prudential standards. The Statutory Funds are not being operated on a competitively neutral basis. So what?

Since the Government claims it does not own the funds, it is not offering or supplying taxpayers funds to support any financial recovery of the Funds. NSW taxpayers are not being required to support the deficit.

This leaves only one source of funds to meet the cost of claims from recent years that are still to be paid. It is quite clear that NSW employers will have to meet the deficit, probably over a number of years.

On the one hand, it is entirely appropriate that employers pay appropriate premiums, and fund the cost of workplace injury and death over time. The difficulty with the current arrangement is that the generation of deficits from whatever cause requires future generations of employers to meet the cost of claims that were incurred in the past. There is an inter-generational subsidy operating in New South Wales, which must add to the overall cost of employment in the years ahead regardless of the future operation of the workers compensation scheme.

In other words, new employers, and existing safe employers, will have to pay higher premiums than might otherwise have been necessary, in order to contribute to the reduction of the deficit. This result is completely contrary to sound economic and financial principles, and must operate as a significant distortion to the cost of employment in the State.

Victoria

The Victorian WorkCover Authority (VWA) is the principal workers compensation provider in that State. There were a further 38 major employers operating as self-insurers as at 30 June 2004.

The following information is taken from VWA Annual Reports up to and including 30 June 2004.[14] The 2004 Annual Report only became available as this paper was being finalised.

The overall operation of the Victorian workers compensation scheme has also been troublesome in recent times. The financial position of the VWA as at 30 June each year has been as follows:

Year	2000	2001	2002	2003	2004
Net Assets ($M)	-423	-682.9	-781	-1096	125.4

As at 30 June 2004, total assets comprised 101.7% of total liabilities. VWA would not have met APRA prudential standards.

On 26 October 2004 the VWA announced that the scheme had achieved full funding for the first time in two decades, following a full year profit of $1.2 billion. Significantly, investment revenue

[14] VWA Annual Reports are available at:
http://www.workcover.vic.gov.au/dir090/vwa/home.nsf/pages/Annual+Report

improved from -$50million in 2003 to a contribution of $815million in 2004. In addition, VWA had an underwriting profit in 2004 of $491million.

As with New South Wales, a range of factors lead to a significant deficit by June 2003. The deficit appears to have been funded by strong investment and underwriting results in 2003/04. Premiums may have been lower if the deficit from previous years had not needed to be funded.

The 2003 VWA Annual Report includes the following comment -

> "Key drivers impacting the valuation of claim liabilities are equity market prices and the claims discount rate, external factors over which management has no material control but which have the capacity to significantly impact the Scheme's reported annual results."

I will return to this issue later in the paper.

VWA does not meet the full range of competitive neutrality obligations. Companies with the capacity to apply for and achieve self-insurance status have an alternative to VWA cover. However, the majority of small and medium size businesses in Victoria would not have any choice of workers compensation provider.

South Australia

The primary provider of workers compensation insurance in South Australia is the WorkCover Corporation.[15] According to the Corporation's 2004 Annual Report, more than 60 per cent of South Australian workers are employed by organisations covered by the Corporation.[16]

In addition to cover provided by the Corporation, there were 69 private exempt employers in South Australia as at 30 June 2004. All State Government agencies are also exempt employers, and are not covered by the Corporation.

The recent financial performance of the Corporation has been dramatic, with a major deficit developing in a relatively short period of time. The net asset position of the Corporation has been as follows:

Year	2001	2002	2003	2004
Net Assets ($M)	-55.5	-192.4	-591	-572

On 30 June 2004 the Corporation held assets which funded 60.4% of the Corporation's liabilities. This was an improvement from the June 2003 position, when assets funded only 55% of the Corporation's liabilities. The Corporation does not meet APRA prudential standards.

A new Board of Directors for the Corporation was appointed in August 2003, and a new Chief Executive Officer was appointed in March 2004.

[15] Information regarding the WorkCover Corporation is taken from its Annual Reports, available at www.workcover.sa.gov.au.
[16] WorkCover Corporation 2004 Annual Report, page 15.

Private Sector Insurers

Workers compensation is privately underwritten in competitive markets operating in Western Australia, Tasmania, Northern Territory and Australian Capital Territory. Each of these jurisdictions also include a number of licensed or authorised self-insurers, and public sector workers compensation is also largely self-insured.

Private sector insurers are required to comply with APRA prudential standards, including for their workers compensation business. In addition, the companies are licensed by State or Territory regulatory bodies, and must meet local legislative and regulatory obligations in addition to national obligations under the *Insurance Act 1973* and APRA's prudential standards.

APRA recently published information regarding the solvency of general insurers as at December 2003. At that date, active direct insurers had a minimum capital requirement of $7.1 billion, and held a capital base of $15.4 billion. This meant that the direct general insurers (including those underwriting workers compensation) met their capital obligations by a factor of 2.2.[17]

The Role of Capital

It is well accepted that workers compensation, and other long tail classes of liability insurance, can experience volatile conditions over time, sometimes because of actions of the insurer, and sometimes because of events beyond their control.

For this reason, prudential regulations have been developed in Australia which have the overall aim of ensuring valid claims will be paid when payment is required to be made. In order to cope with the unexpected variability of claims costs in long tail classes of insurance, the prudential regulations involve –

- Conservative assessment of provisions for outstanding claims, with a probability of sufficiency of at least 75%; and
- Obligations to carry additional capital for a wide range of operational and financial risks.

The role of capital was recently explained in APRA *Insight*, 2nd Quarter 2004, as follows:[18]

> "…the regulatory capital requirement is risk-based so that insurers are required to hold an amount of capital commensurate with their individual risk profile. This entails the summation of three capital charges: the insurance risk charge, the investment charge and a concentration (or Maximum Event Retention) charge. For example, insurers writing liability and reinsurance lines, which tend to involve higher risk, need to hold more capital to meet the greater uncertainty they face than insurers writing residential property insurance."

As noted above, private sector insurers meet their minimum capital obligations by a factor of 2.2 times. Of the public sector workers compensation insurers, only Queensland WorkCover meets

[17] APRA Insight, 2nd Quarter 2004, Table C^.1, page 73, available at www.apra.gov.au.
[18] APRA Insight, 2nd Quarter 2004, page 67.

APRA minimum capital requirements, but it does not state the extent to which this minimum capital requirement is exceeded.

The role of capital, therefore, is to ensure, as far as is reasonably practicable, that funds will be available when claims are due to be paid, having regard to the time frame over which payments will be made (in the case of workers compensation, well in excess of 10 years after the premium was collected) and the potential variation in claims costs, and the historical role of superimposed inflation, over that period of time.

Investment of Funds

Insurers generally segment their funds into –

- Policyholders funds – funds required to meet the cost of known and yet to be reported claims, and to fund claims management costs; and
- Shareholders funds – funds held by the insurer in addition to policyholders funds, to meet prudential obligations and to ensure the insurer's obligations to its policyholders will be met as and when they fall due.

This segmentation is generally undertaken for the formulation of investment strategies. Policyholder funds are invested conservatively, as it is highly desirable the funds required for the payment of claims are not subjected to high levels of investment risk. To the extent to which policyholder funds are held in riskier assets, APRA prudential standards will require the insurer to provide additional capital to cover that investment risk in order to meet its regulatory minimum capital requirement.

Shareholder funds are not directly required for the payment of claims, and can be invested in less conservative assets. The investment strategy will be developed by the insurer's Board of Directors having regard to the level of returns they wish to generate and the level of investment risk they wish to take with shareholders funds.

The five largest general insurers operating in the Australian market[19] raise their capital from the stock markets – four locally, one in Europe. Each of these companies is active in the privately underwritten workers compensation markets.

Suppliers of capital (shareholders) do so expecting an appropriate return for the use of that capital. If the return being provided is not regarded as reasonable or acceptable, the capital will be withdrawn and provided elsewhere. This would then challenge the company's capacity to continue in business.

Capital, therefore, plays a vital part in general insurance, but carries with it a cost – the need to provide a fair and appropriate return to suppliers of capital. Of course, company managers seek to maximise the return on capital for the benefit of their shareholders. They do so in the context of a strong (some say world leading) prudential regulatory regime, which requires careful assessment and management of all business risks, and a competitive market, which provides alternative sources of supply to policyholders.

[19] IAG, Suncorp, Promina, QBE, Allianz

Reference has previously been made to comments by VWA regarding “external factors over which management has no material control”. Prudential management of insurance requires careful management of premiums, claims, investments and operations. APRA prudential standards require risk-based capital in respect of these and other areas of operations. Private insurers are fully accountable for the management of all aspects of business operations including external factors which may have an impact on that business.

Private versus Public

Since the introduction of the enhanced prudential regulatory regime on 1 July 2002, the general insurance industry in Australia has been strongly capitalised, stable and secure. Competitive markets are operating in the privately underwritten workers compensation jurisdictions, insurers are also pricing the risk they insure appropriately and are making conservative provisions for outstanding claims.

Where statutory amendments have introduced overall savings in claims costs, premiums have fallen to reflect the lower cost base. This indicates the theoretical benefits flowing from a competitive market set out by the Productivity Commission and the National Competition Council, and contained in the Competition Principles Agreement, are present in the privately underwritten workers compensation schemes operating in Australia.

Most importantly, employers and injured workers can have confidence that claims will be paid as and when they fall due.

It is acknowledged that the benefits of the competitive market also carry a cost, being the return which must be provided to the owners of the capital that underpins the privately underwritten insurance framework.

More importantly, the privately underwritten jurisdictions are now showing a considerable degree of stability and consistency, following a number of years of turmoil in the second half of the 1990’s. Until very recent reforms were introduced in Western Australia and Tasmania, the workers compensation schemes in those States were showing stable claims trends, as a result of reforms introduced in 1999 and 2000, and insurers were delivering the benefits of overall lower claims costs to the economies of each State through lower premiums.

In the publicly underwritten jurisdictions, there are examples of negative net asset positions, inter-generational cost shifting, diversion of funds, and questionable accountability. Of the four State schemes examined only one would current meet APRA prudential standards for capital adequacy and in this case it was, in part, a function of diverted funds from other government programs.

While in some cases there is at least recognition of the need to pay taxes, none of the schemes provided an adequate return on the equity investments. As a result the opportunity costs of providing funds to schemes is not being met or even considered.

Public sector provision of workers compensation insurance where premiums are not necessarily risk based can lead to significant economic and market distortions, including:

- Adverse section since price controls will mean that only “bad” risks have an incentive to seek insurance through government providers;

- Moral hazard and underpricing that results from price caps and floors, which neither provide incentives for poor performers to improve their workers compensation outcomes, nor rewards for those with exemplary records;

- Cross subsidies where again price controls lead to poor risks being subsidised by good risks, a practice that distorts and retards the economic incentives that would exist in private markets;

- Under-reserving that results from non-market and non-cost based pricing and ultimate leads to the need for diversion of capital, not to mention issues around assessing the opportunity costs of capital; and

- Cost shifting as when schemes run into financial difficulties, those costs are generally born by general taxpayers through diversion of capital, other programs such as public health through restrictions on benefits, or by future policyholders so that past losses become a burden for new businesses and employers.

Private underwriting on the other hand promotes a dynamic and competitive environment where there is:

- Effective premium setting based on true costs and risks rather than political factors;

- Strong prudential monitoring that prohibits under-reserving; and

- Timely and rigorous accountability, which insures that there is no cost shifting and effective losses are realised and deducted from shareholder or owner value. This accountability provides meaningful incentive for sound pricing and management of the insurance business.

In the end it is clear that from an efficiency and equity standpoint, private underwriting is the preferred method for the provision of all classes of insurance. While it may be argued that, particularly in compulsory classes of insurance, there is a political interest in public sector underwriting, the very real costs of economic distortions outweigh any perceived benefits from a lower cost of capital.