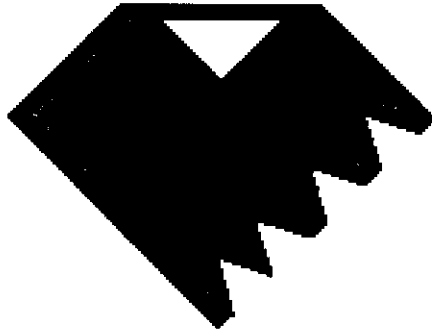


ASSURANCE & ADVISORY
BUSINESS SERVICES



MOTOR ACCIDENTS AUTHORITY

ERNST & YOUNG

FROM THOUGHT TO FINISH.™

Our Motor Accidents Authority team provides comprehensive services to help you manage the risks associated with motor vehicle accidents. We work closely with you to identify potential risks and develop strategies to minimize them. Our services include:

- Risk Assessment
- Policy Review
- Claims Management
- Litigation Support

TABLE OF CONTENTS

Section		Page
1	Introduction and Scope of Review	3
2	Use of Report	4
3	Executive Summary	5
4	MAA's Prudential Responsibilities	7
5	Current State	14
6	MAA Proposed Future State	17
7	Other State Regulatory Authorities	21
8	APRA	23
9	Conclusions	26
10	Recommendations	28

Important Note

This report is intended for the sole use of the Board of Directors, Audit Committee and Executive Management of the Motor Accidents Authority of New South Wales ('MAA'). No other party or parties shall be entitled to place any reliance whatsoever on the contents of this report nor shall it be distributed to third parties without the knowledge and written permission of both MAA and Ernst & Young.

1. Introduction and Scope of Review

Ernst & Young has been engaged by the Motor Accidents Authority (MAA) to perform a review of its prudential responsibilities and practices as outlined in our agreed engagement letter dated 6 July 2001.

In particular, our review is focussed on identifying the MAA's prudential responsibilities and assessing the processes currently established by the authority to discharge these responsibilities. Our review has been broken into a number of phases summarised as follows:

- 1.1 Confirmation of the MAA's prudential responsibilities by reference to:
 - appropriate legislation;
 - discussions with MAA Board members / Executives; and
 - reviewing MAA publications such as recent annual reports.
- 1.2 Reviewing the way in which the MAA discharges these responsibilities, including how it uses information provided by APRA. In addition we will provide feedback on whether we believe MAA does or can 'add value' to the prudential control environment taking into account the role of APRA.
- 1.3 Providing advice in relation to other potential mechanisms to allow the MAA to discharge its prudential responsibilities, including summarising how other Agencies with similar prudential responsibilities are managing the issue.

The following MAA officers were interviewed during our review:

- Richard Grellamn, Chairman, MAA
- David Bowen, General Manager, MAA
- Concetta Rizzo, Manager Insurance Division, MAA
- Steve Clough, Principal Compliance Officer, MAA
- Robert Dawson, Legal Counsell, MAA
- Noel Wong, Principal Financial Analyst, MAA
- Craig Thorburn, General Manager Diversified Institutions, APRA.
- Richard Philip, Manager Diversified Institutions, APRA

We also sought input from the following people during our review:

- Mr Doug Pearce, Chief General Manager Commercial Insurance and Financial Services, NRMA
- Ms Lesley Anderson, Insurance Commissioner, MAIC
- Mr Harry Neesham, Executive Director, WorkCover

Our conclusions and recommendations are set out in sections 9 and 10 of this report.

2. Use of Report

We understand and agree that our report will be used to assist the MAA in discussion with or providing advice to its Board, the Minister, APRA and NSW Treasury and may also be provided as part of any submission by the MAA to the HIH Royal Commission. Our report may not be publicly released in part or in full without our express written consent.

We note that the review does not constitute an audit or review in accordance with Australian Auditing Standards.

3. Executive Summary

This executive summary presents the key conclusions and recommendations arising from our review. A full appreciation of the work performed and the issues addressed can only be obtained from a reading of the full report.

- The Motor Accidents Compensation Act 1999 imposes on the MAA the responsibility for the prudential supervision of the insurers it licenses to underwrite CTP policies in NSW.
- It is our view that the most effective prudential supervision of MAA's licensed insurers would be achieved through a closer working relationship with APRA that encompasses the following:
 - MAA developing a stronger understanding of its licensed insurers and documenting this understanding.
 - MAA being actively involved with APRA in the planning of the prudential supervision.
 - MAA having direct and constant contact with the APRA staff members responsible for each of the MAA's licensed insurers.
 - MAA accompanying APRA on meetings and site inspections.
 - MAA and APRA holding regular meetings on each of MAA's licensed insurers.
 - MAA and APRA sharing information (not just data).
 - MAA forming its own conclusions on each of its licensed insurers and discussing these with APRA.
 - MAA consulting APRA prior to taking any action in respect of termination or suspension of a CTP license.
 - MAA ensuring relevant staff are adequately trained to implement this method of prudential supervision.
- To support this model of prudential supervision the MAA and APRA will need to co-develop a strategy and operational model outlining how they will cooperate acknowledging that the MAA will rely on the work performed by APRA.
- The MAA needs to develop a detailed plan addressing how it will be able to place reliance on APRA including:
 - how information will flow between the entities
 - how the MAA will work with APRA
 - how the MAA will get the necessary comfort it requires
 - how the MAA will make decisions from the information it receives from APRA

- The MAA needs to discuss and agree this detailed plan with APRA.
- The MAA then needs to determine its resourcing requirements based on the strategy operational model and detailed plan.
- To demonstrate that it is fulfilling its responsibilities for prudential supervision the board of the MAA needs to clearly document:
 - when it will rely on APRA
 - how it will rely on APRA
 - why it is reasonable to rely on APRA

The Board also needs to sign off the work plan developed by the MAA regarding prudential supervision including noting the MAA reliance on APRA will work in practice.

- The role of the MAA and the method used by it to discharge its obligations should then be effectively communicated to all key stakeholders including MAA staff, insurers and customers.

4. MAA's Prudential Responsibilities

4.1 Background

The MAA is a statutory corporation that supervises and monitors the NSW Motor Accident Scheme ("Scheme"). The MAA was established on 10 March 1989 by the Motor Accident Act 1988 ("MA Act"). The Scheme was amended significantly by the Motor Accident Compensation Act 1999 ("MAC Act"), which commenced on 5 October 1999. The MAC Act also reconstituted the MAA. The MA Act now only applies to accidents that occurred prior to 5 October 1999.

4.2 Objectives Of MAC Act And MAA

The objectives of the MAC Act are set out in section 5 of the Act. The objectives of the Act are relevant to understanding the context within which the MAA performs its role. The Act's objectives, which are relevant to our review, include:

- promote competition in the setting of premiums for third party policies and to **provide the MAA with a prudential role to ensure against market failure;**
- keep premiums affordable;
- ensure that insurers charge premiums that fully fund their anticipated liability;
- deter fraud in connection with compulsory third party insurance.

The functions of the Motor Accidents Authority are set out in section 206 of the MAC Act. These are summarised in the MAA's 1999/2000 annual report as follows:

- monitoring the operation of the CTP Scheme
- collection and analysis of statistics on the Scheme
- publication and dissemination of information on the Scheme
- provision of funding for the reduction of trauma as a result of motor vehicle accidents
- issue certain guidelines
- advice to the Minister on the efficiency and effectiveness of the Scheme
- provision of support and advice to the Motor Accidents Council, and

- specific functions to support the provision of acute care treatment, rehabilitation, long-term support and other services for persons injured in motor accidents.

4.3 MAA's Vision and Purpose

The MAA's 1999/2000 Annual Report also describes its vision and purpose as follows:

"Our Vision is to have a Compulsory Third Party Scheme that is affordable, fair and accessible.

Our Purpose is to keep Green Slips affordable, lower the level of litigation in resolving claims and improve the timeliness and effectiveness of medical treatment to injured persons through:

- *regulating the CTP Scheme and its participants*
- *providing education and information to stakeholders and service providers*
- *operating medical and claims assessment services; and*
- *continuous improvement in all areas of the Authority's operations."*

Page 8 of the 1999/2000 Annual Report goes on to state that:

"The New Act has provided the MAA with a stronger prudential supervisory role than it has assumed previously and there will be greater emphasis in the coming year on monitoring the Scheme's performance. In addition, the Authority will be examining the compliance of insurers with their obligations under the new Act using performance audit procedures currently being developed. A new compliance unit within the Insurance Division is being established to undertake this work."

It is noted that while a compliance unit has been created it has been focussing primarily on reviewing the effectiveness of the Scheme – in particular, compliance with claims handling and market practice guidelines. It has only assumed a limited prudential role.

4.4 Outline Of Provisions Of The MAC Act

This review is focussed exclusively on the scope of the prudential responsibilities imposed upon the MAA and the manner in which it discharges those responsibilities. The review does not focus on the MAA's broader role under the MAC Act. Therefore, the following summary focuses primarily on Chapter 7.

In this review, we have taken "prudential responsibilities" to be referring to the MAA's role in guarding against the risk of financial failure of the licensed insurer, which includes its role in monitoring capital and liquidity requirements.

Chapter 7 of the MAC Act

Overview of Chapter 7

Chapter 7 deals with the licensing and supervision of insurers who issue third party policies and with the management of insolvent third party insurers.

Part 7. 1 of Chapter 7

This part deals with the licensing of insurers to issue compulsory third party insurance. It:

- prescribes eligibility conditions;
- sets out provisions relating to the contents of licence applications (which includes details of directors, shareholders, re-insurance arrangements, proposed business plan);
- outlines the facts the MAA should take into account in determining an application for a licence;
- sets out rules dealing with the duration of the licence;
- authorises the MAA to impose conditions on a licence;
- permits the review of the MAA's decision by the Administrative Appeals Tribunal;
- sets out provisions relating to the cancellation, assignment and suspension of licences. It is worth noting that the MAA is authorised to cancel a licence for "any reason if thinks fit."; and
- provides for the imposition of a civil penalty of up to \$50,000 for making of a false licence application or a contravention by a licensed insurer of the Act or its licence.

The MAA has previously taken advice from Phillips Fox on the scope of the term "any reason it thinks fit". We agree that with their comments and suggestions are sensible. The MAA's rights to suspend a licence are set out in section 165 and include the right to suspend if the licensee has contravened its licence or the Act, if the insurer is unlikely to meet its liabilities under its CTP policies, a provisional liquidator etc has been appointed, or an inspector has been appointed the Insurance Act. Clearly, this provision demonstrates the need for regular and close contact with APRA.

In October 1999 the MAA issued guidelines on "Applications for NSW CTP Licences". These guidelines describe the licensing process, identify the materials to be lodged with the licence application and sets out possible conditions that may attach to a licence. The MAA has also issued guidelines on the suspension and assignment of licences respectively, although the suspension guidelines only apply in circumstances where there is a transfer and withdrawal of business. There are no general guidelines on suspension powers.

Part 7.2 of Chapter 7

This part deals with the supervision of licensed insurers by the MAA. It authorises the MAA to issue to licensed insurers guidelines with respect to the issue of third party policies and makes it a condition of the licence that the licensed insurer comply with these guidelines. As we understand it, the guidelines that have been issued by the MAA do not have any prudential impact. It should be noted that a standard licence condition requires the licensee to provide the MAA with full details of the existence of or creation of any security, encumbrance or charge over its assets. It appears that this condition is not acted upon by insurers or adequately enforced by the MAA.

More relevantly, this part requires licensed insurers to prepare and provide to the MAA a business plan for its third party business when requested by the MAA. The MAA currently requires a business plan to be submitted at the time of the original application. The part also requires insurers to revise their business plans at least on twelve monthly intervals as the MAA directs or whenever they deviate from the plan. The business plan must be prepared in accordance with any guidelines issued by the MAA from time to time. The business plan is to deal with matters such as claims handling, management, expenses and systems. Although paragraph 13.10 of the Licensing Guidance Notes contains some commentary on business plans, the MAA has issued no general guidelines on the form and content of business plans.

The only regular formal correspondence between the MAA and licensed insurers regarding business plans appears to be the "Certificate of the CEO" provided when insurers submit a rate filing to the MAA. This certificate contains an affirmation by the CEO that the CEO is "satisfied that the company's CTP business plan ensures CTP insurance is available to all proposers in accordance with the terms and conditions of the insurer's licence. MAA Premium Determination Guidelines and MAA Market Practice Guidelines". This is clearly an affirmation on market practice issues rather than a tool for prudential supervision.

Part 7.2 also requires insurers to keep accounting and other records as prescribed by the Regulations.

Lastly, Part 7.2 imposes detailed notification obligations on licensed insurers including the obligation to:

- notify the MAA of the amount of insurance premiums received by it in relation to all third party policies taken to be issued during a relevant period. The MAA is then to determine, having regard to premiums received, the market share of the insurer;
- notify the MAA of actual or proposed reinsurance arrangements, the terms of any ISC(now APRA) approvals under the Insurance Act in relation to the reinsurance
- if requested by the MAA, provide details of the way in which its third party funds and other funds are invested;
- submit returns in the prescribed form on a quarterly basis; and
- notify the MAA within 21 days of certain events occurring (as listed in the "suspension of licence" provision) or of a decrease or proposed decrease in the issued capital of the insurer.

To assist it in performing its functions, the MAA may appoint an appropriately qualified person to audit and inspect the accounting and other records relating to the financial or business position of a licensed insurer.

The MAA may also require an insurer to provide any additional information or documents that the MAA requires relating to the business or the financial position of the insurer. This would include information that is relevant to insurance premiums filed by the insurer and the cost of claims handling and settlement of claims.

The MAA may apply to the Supreme Court to have it make orders to protect the interests of CTP policies issued by a particular licensed insurer or former licensed insurer. The court may make such an order if it is satisfied that the relevant insurer is not able to meet its liabilities or may not be able to do so or has acted in a manner that is prejudicial to the interests of the holder of CTP policies. If the MAA wants to take such a course of action it must notify both APRA and ASIC of its intention to do so. Both of those other regulators have the right to appear in the proceedings.

Section 182 of the Act confers upon the MAA broad powers to enter the premises of the licensed insurer and carry out appropriate inspection, including questioning officers of the insurer.

Part 7.3 of Chapter 7

This part deals with matters relating to insolvent insurers. It includes provisions relating to the tasks of liquidators of insolvent insurers and the role of the nominal defendant as agent and attorney of persons insured under a third party insurance policy issued by an insolvent insurer.

4.5 MAA's Prudential Responsibilities

The MAC Act clearly imposes on the MAA the responsibility for the prudential supervision of the insurers it licences to underwrite CTP policies in NSW. The Act gives the MAA the means to monitor the financial position of insurers by giving it the ability to obtain relevant information, to carry out an inspection of the licensed insurer and to question officers of the insurer. The Act also gives the MAA the power to put conditions on licences and to suspend, cancel or assign licences.

It is our view that it is necessary for the MAA to have these responsibilities and powers if it is to fulfil its primary objective of creating and maintaining a Compulsory Third Party Scheme that is affordable, fair and accessible.

We do not believe that the MAA and the CTP Scheme would be best served by removing this prudential supervision. To effectively manage the Scheme the MAA needs to be able to effectively manage the entry and exit of licensed insurers.

4.6 Advice from Phillips Fox

In December 1996, the MAA took advice from Phillips Fox on the MAA's powers, obligations and role in the event of a licensed insurer's insolvency or anticipated insolvency ("1996 Advice").

In April 1997 the MAA again took advice from Phillips Fox – this time on the question: at what point should the MAA exercise its suspension or winding up rights and which regulator should act first (“1997 Advice”).

Both of these advices pertained to the MA Act, not the MAC Act.

In the 1996 advice Phillips Fox made a number of suggestions as to how the MA Act could be modified to enable it to better guard against insurer insolvency including the introduction of whistle blowing provisions, an obligation on directors to provide a compliance declaration to the regulator, directors liability provisions and an obligation on insurers to notify the MAA of changes in information provided as part of the registration process. The one aspect of the advice that was implemented was the execution of a Memorandum of Understanding between MAA and APRA to facilitate a sharing of information.

The 1997 advice, which looked at the MAA’s obligations to cancel or suspend a licence, concluded that the ISC (now APRA) has a greater prudential role than the MAA and the MAA’s position can best be protected by:

- consistent and diligent examination of the statutory information provided by licensed insurers.
- general monitoring of the industry information; and
- regular consultation and full exchange of relevant information with the ISC or the new prudential regulator of the general insurance industry.

As noted above neither of these advices related to the MAC Act and neither advice was focused on the specific question of what is the scope of the MAA’s prudential obligations and how to discharge them.

5. Current State

It is clear from our review that the main focus of the MAA to date has been to manage and monitor the effectiveness of the Scheme itself. Only limited attention has been given to the prudential supervision of its licensed insurers, the MAA relying almost entirely on APRA (and previously ISC). This is consistent with the 1997 advice of Phillips Fox.

The current state of the MAA's prudential supervision can be summarised under a number of headings.

5.1 Information collected

A condition of the licence that is given to each insurer licensed by the MAA is that the insurer provides the MAA with:

- copies of the forms that the insurer completes and submits to APRA ("APRA forms"). This includes both the unaudited quarterly returns and the annual audited returns.
- copies of any correspondence with APRA

The MAA does not request additional information from licensed insurers other than to clarify the contents of the APRA forms. Nor does the MAA have a formal programme to ensure compliance with this licence condition in regards to the correspondence.

5.2 Analysis of financial information

Currently, the, Principal Financial Analyst, prepares a two page summary of the financial information reviewed and analysed for each licensed insurer. This summary is updated quarterly upon the receipt of new data (APRA quarterly forms). These reports contain general corporate information, market information, financial information (financial information in respect of the previous three years and the current quarter), and details on the insurer's solvency position. The material received from APRA is augmented with general market information. The summaries for each licensed insurer are aggregated in a single report, which also contains some industry data and analysis.

An example document has been provided. The document contains only very basic information and a fairly rudimentary level of analysis. More detailed calculations are performed, both annually and quarterly, based on data in the APRA forms. The Principal Financial Analyst performs these calculations and a history is maintained for each insurer.

A detailed analysis of the trends in the results of the calculations could form a useful basis for further investigation. However as the calculations are based solely on APRA data it would be expected that APRA would also have to the ability to analyse this information.

The current information, without the benefit of additional investigation, provides the MAA with only a limited ability to assess the financial condition of the licensed insurer or to predict an impending insolvency.

5.3 Investigations, inspections and meetings

The MAA does not undertake regular meetings or discussions with licensed insurers on matters pertaining to financial position or solvency.

Nor does the MAA conduct its own onsite investigations of licensed insurers.

5.4 Exercise of other rights under Part 7

While the MAA examines business plans as part of the initial licence application process, it does not call for nor examine business plans on an ongoing basis. The only circumstance in which it would subsequently review a business plan is if there was a major change to the insurer's business. In any event it seems that business plans, when they are submitted, have typically been completed in a rather perfunctory way.

Similarly, although the MAA is empowered to call for information about the way in which its third party funds and other funds are invested it has never done so. While this may be justified because third party assets are not held as a discrete pool and the MAA is not really in a position to investigate the assets of the company as a whole, the MAA has not formally documented this position.

Further, the MAA's review of an insurer's reinsurance arrangements is also quite limited, with the MAA assuming that APRA will undertake all necessary reviews.

Lastly, as noted above, although it has the power to do so, the MAA has not issued guidelines in respect of a number of matters such as the form and content of business plans or suspension or cancellation of licences. Nor has it issued internal guidance notes in respect of the conduct of site inspections.

5.5 Complaints Review

One method commonly employed by regulators to assist them in forming a view on whether there are any potential prudential concerns about an insurer is to monitor complaints in respect of that insurer. For instance, a significant number of complaints that an insurer is late in making payments on claims or has unreasonably refused to admit claims may point to some underlying cash flow or solvency concerns.

The MAA does have an established process for dealing with claims handling complaints against insurers (of which there were 40 in 2001). We have been advised that the MAA has begun to develop a system for analysing complaints to identify systemic problems for particular insurers.

5.6 Relationship with APRA

Currently, the MAA has a cordial relationship with APRA however the relationship is, at present, fairly limited and would not be adding greatly to the MAA's ability to fulfil its responsibilities for prudential supervision.

The MAA and APRA meet every 6 months to discuss issues associated with the MAA's licensed insurers.

It is our assessment that the MAA is wholly reliant on APRA to determine the financial capability of a licensed insurer to remain in business and to continue to underwrite. Again, we note that this practice is consistent with the Phillips Fox 1997 advice.

However

- until recently (viz post Qu. 1 2001) there had been no formal decision by either management or the Board to delegate to APRA
- the rationale for MAA delegating its prudential supervisory role to APRA is not documented and not fully understood by the MAA and APRA
- the relationship between the MAA and APRA is not sufficiently strong to provide the MAA with:
 - sufficient comfort regarding the prudential supervision of their licensed insurers
 - sufficient information regarding their licensed insurers to support the management of the Scheme.

6. MAA Proposed Future State

It is recognised internally within the MAA, that the current state is inadequate to allow the MAA to fulfil its responsibilities for prudential supervision. This belief has been strengthened by the HIH collapse.

An alternative to the current practice of relying on APRA is for the MAA to perform a full function role as a prudential regulator. That is, it could attempt to become self reliant in terms of the prudential regulation of its licensed insurers effectively imposing a state based prudential regime. This could be achieved by either:

- building internal capability; or
- outsourcing to a third party

The alternative of building a fully functioning internal capacity has been examined internally. The Principal Financial Analyst has produced two internal discussion documents that relate to this issue.

- “Prudential Regulation Framework Blueprint”, May – June 2001
- “Risk Based Assessment of Licensed Insurers and Minimising Risks of Insurer Failure”, June 2001

The General Manager of the MAA has reviewed these documents, however we note, they have not been formally accepted and have only the status of internal discussion documents.

Our view of this alternative is summarised as follows;

- Both options involve duplicating to a large extent the role of APRA. If APRA is functioning effectively then this duplication involves an additional cost for the MAA and additional costs for insurers with no real gain.
- The option of building an internal capability has the following additional disadvantages.
 - due to scale issues (ie the MAA only supervises a limited number of insurers – currently 8 active licences and 6 suspended licences) it would be difficult to justify “experts” across the range of risks faced by general insurers

- due to scale issues the ability to benchmark indicator of financial strength and risk management best practices would be severely limited
- it introduces a range of management and human resource issues that would take senior management time to manage (eg is there sufficient career development opportunities to attract and retain the right staff)
- The option of outsourcing to a third party has the following additional considerations:
 - there will be issues associated with providing the third party the same powers and access as is available to APRA and the MAA.
 - with the possible exception of rating agencies there are no third parties with the required experience to operate a regulatory function.
 - it is possible that various components of the regulatory function could be outsourced rather than fully outsourcing the entire role.

Whether the MAA fulfils its responsibility for prudential regulation by relying on APRA, building an internal capability, or outsourcing to a third party the MAA retains the responsibility for dealing with an insurer in financial difficulty. This may include making a decision to suspend or terminate a licence or to transfer assets and liabilities to another insurer. It may also entail managing the MAA's position should an insurer become insolvent (raising funds to cover a deficit, organising appropriate claims management resources etc).

Hence, it is our opinion that the MAA needs to be sure it has sufficient information to support the decisions required. It must also establish the tests or benchmarks it will apply to insurers to ascertain various levels of financial difficulty and the action it will initiate upon breach of each of the tests or benchmarks.

The internal discussion documents noted above include a suggestion to improve the MAA's knowledge gathering and documentation for each licensed insurer. These dossiers on each insurer are given the title of "Insurer Risk Profile".

The aim of the insurer risk profiles is described as follows:

"Insurer Risk Profiles will attempt to identify insurers at risk. If possible, the Profiles would provide advance warnings of potential failure, to allow action to minimise the risk and impact of another licensed insurer solvency"

The information contained in the Insurer Risk Profiles are sourced from either:

- publicly available information; or
- APRA forms (as supplied by APRA or company as a condition of their licence)

In theory the MAA could also obtain its own data from its licensed insurers. This could be gathered from direct requests or from interviews with the Board and senior management.

The Insurer Risk Profiles could provide useful information regarding an insurer and its solvency position however they will not put the MAA in a better position than APRA, the rating agencies or the company's auditors in predicting a pending insolvency.

It is our view that the Insurer Risk Profiles discussed above:

- would put the MAA in a better position to understand its licensed insurers financial position
- would provide a useful tool to keep the Board of the MAA more up to date with the financial position of each of the licensed insurers. This would ensure the Board would have sufficient background information at the time important decisions need to be made.

In addition to these internal discussion documents the General Manger has put forward a paper to the Board of the MAA "Protecting CTP Funds and the role of the MAA as Regulator of CTP Insurers". This paper recommends that the MAC Act be amended to introduce the following components.

1. increase MAA's power to suspend or cancel a CTP licence and arrange for a transfer of business;
2. provide that the MAA may take a charge over the assets of a licensed insurer up to an amount equivalent to the outstanding claims reserves required for CTP claims; and
3. introduce an enhanced monitoring and inspections program.

As regards point (1) it is worth noting that the MAA already has very broad powers of suspension – see paragraph 4.4 above.

Point (2) is outside the scope of this review.

Our views on point (3) are discussed in section 8. As can be seen, we regard enhance monitoring and inspections as an activity that can be performed collaboratively with APRA.

We note that the Paper also states (at paragraph 2.2):

The Board does not believe that the MAA should impose a State based prudential regime. Prudential regulation of insurance companies is the clear responsibility of APRA and the MAA should concentrate on business regulation relating to CTP policies and claims.

As can be seen from our comments in section 4 it is our view that the MAC Act already imposes a significant level of prudential supervisory obligations on the MAA and while APRA is clearly the prime regulator, the MAA still has a real prudential role to fulfil. We discuss at Section 9 how these obligations can be discharged in a manner which minimises duplication and inefficiency.

Consideration of the June 2001 Board paper lead the Board of the MAA to request Ernst & Young to undertake the current review documented in this report.

7. Other State Regulatory Authorities

We have reviewed the legislation associated with the operation of the MAIC in Queensland and WorkCover in Western Australia. We have also conducted short interviews with:

- Ms Lesley Anderson, Insurance Commissioner, MAIC
- Mr Harry Neesham, Executive Director, WorkCover

It has been requested that the content of these discussions remain confidential however the issues arising from those discussions have been dealt with in the substantive body of our report.

Both organisations have prudential responsibilities similar to those of the MAA. The following provides a short description on each authority.

7.1 MAIC Queensland

Division 2 of The Motor Accident Act 1994 provides the description of the general functions of the commission. Section 10(1) outlines the Commission's functions. The first two functions are given as:

10.(1) The commission's functions are to—

- (a) supervise insurers operating under the statutory insurance scheme and issue, suspend or withdraw licenses for insurers operating under the scheme; and
- (b) establish and revise prudential standards with which licensed insurers must comply; and

The requirements for an insurer to obtain a licence to operate in the CTP market in Queensland are set out in a letter provided to insurers upon request. The requirements are more heavily focused towards ensuring companies have sufficient capabilities to provide adequate claims management services to claimants (rather than financial security). Claims management and CTP administration being areas where the MAIC have sole responsibility.

The MAIC rely on APRA with regards to the prudential supervision of its licensed insurers. The prudential standards prescribed by the MAIC are that the insurer must comply with APRA's prudential standards. The MAIC imposes no additional standards. As is the case with the MAA, the MAIC obtain copies of APRA returns and companies are required to provide them with correspondence with APRA.

Again as with the MAA, the MAIC have half yearly meetings with APRA to discuss their licensed insurers, general market conditions and the activities of APRA.

7.2 WorkCover Western Australia

Responsibility for supervision of insurers is given to WorkCover under section 161 of the Workers' Compensation and Rehabilitation Act 1981. In particular section 161(3)(a) seems to be the most relevant to prudential supervision.

The Act sets out licensing requirements. Further, with regard to financial strength and solvency, the Act stipulates that the company must:

- be an incorporated company carrying on business in the State under the Insurance Act 1973 of the Commonwealth (ie licensed by APRA)
- have material and financial resources available to it that the Minister, on the advice of the Commission, considers sufficient to enable it to discharge its obligations for the purposes of this Act

As with the MAA and MAIC, WorkCover require the companies to provide to it:

- all returns provided to APRA
- correspondence with APRA relating to Solvency.

WorkCover do not require companies to provide any other information.

WorkCover do, however, monitor:

- complaints regarding the non payment of claims
- the level of claim payments made (as compared to the "normal" level of claim payments)

to provide an indication as to solvency or financial difficulties (on the basis that a company experiencing problems may start to have problems with cashflow or may start to become very strict on accepting liability and determining quantum).

We believe this is an important area where state authorities can provide additional information to APRA to add to the prudential supervision of its licensed insurers. APRA only receives information of this nature annually and often many weeks after the end of the year. State authorities, on the other hand, receive more regular (monthly or quarterly) and more up to date information than APRA on premiums written and claim payments made.

8. APRA

8.1 Transition from ISC

APRA was established on 1 July 1998 with its inaugural Board meeting taking place on that date. At that time APRA took over the functions of the ISC. By November 1998 staff had been relocated to their current premises however many ISC staff did not make the transition to APRA.

This had a number of consequences:

- APRA lost some of the corporate knowledge existing within the ISC
- APRA lost some expertise and in particular, expertise in general insurance companies
- MAA lost a number of close contacts it had built up within the ISC.

This transition has had an impact on the relationship between the MAA and APRA. It has probably also had a short term impact on APRA's ability to perform its role as prudential regulator for general insurance companies. This may receive some attention at the Royal Commission.

8.2 New Standards for General Insurers

APRA is in the process of introducing a new set of regulations and prudential standards for the general insurance industry. The new standards are fairly wide ranging and deal with:

- liability valuation
- capital requirements
- risk management
- reinsurance arrangements.

This new regime, which is due for implementation on 1 July 2002, will represent a significant improvement in the prudential regulation of general insurers in Australia.

This should provide both APRA and the MAA with a firmer base from which to regulate their licensed insurers.

8.3 Current Dealings with MAA

At present APRA's dealings with the MAA are relatively limited. APRA and MAA have meetings every six months to discuss the MAA's licensed insurers and the general environment for general insurers.

APRA have advised the MAA that it is currently conducting a series of visits to NSW CTP insurers to examine:

- reserving
- pricing
- reinsurance
- capital management

APRA discussed the general programme structure with the MAA and will talk to the MAA regarding the results of their investigations. The MAA are supplying APRA with a number of data sets to assist APRA.

8.4 Interview with APRA

APRA were of the view that they have a reasonable relationship with the MAA. This appears to be a comment that the relationship is friendly and cooperative rather a comment on the effectiveness of the relationship.

To date there has not been a practice of pro-activity on the part of APRA. In other words, if a matter came to APRA's attention that might be of interest to the MAA, APRA would not automatically think to immediately pass that information on to MAA.

APRA believe that their interests and those of the MAA are very much aligned and seem genuinely interested in working more closely and more effectively with the MAA in the future.

Ideas discussed included:

- involving the MAA in the planning of the prudential supervision of MAA's licensed insurers. This would involve planning the issues to be canvassed in and timing of site visits and inspections.
- MAA participating in the meetings which APRA has with the MAA licensed insurers. APRA have stated that these meetings are generally conducted informally on a "non legal" basis (ie not pursuant to statutory rights to inspect) and that if the MAA were to participate in these meetings it would need to do so on the same basis.
- a more direct relationship with APRA staff with responsibility for MAA licensed insurers.

APRA has significant resources working on general insurance companies, much more than had been the case with the ISC. It was estimated that approximately 30-40% of APRA's total resources (approximately 120 people or 60 full time equivalents) are either wholly or partly involved in the general insurance area. Each licensed insurer has allocated to it an APRA staff member who is responsible for that insurer. (Each staff member could be responsible for more than one insurer but would not have responsibility for more than one large insurer). There are also staff members who are specialists in certain areas (eg reinsurance arrangements) and who also have responsibility for a specific insurer.

In addition to these resources APRA has specialist teams (credit risk team, market risk team, operational risk team) that perform reviews across all of the financial institutions regulated by APRA.

Extrapolating from APRA's numbers, it could be expected that if the MAA were to perform a full prudential function itself (using its own resources) it would require 6 company specialists, two technicians and a specialist "visit" team (possible 12 people in total). APRA noted in passing that even if the MAA were to establish a full blown prudential supervision team it would still be difficult for effective supervision due to the limit to which the MAA can benchmark performance and practices and procedures. APRA can benchmark approximately 160 general insurers and then where appropriate, life insurers, banks, superannuation funds etc.

9. Conclusions

The following summarises our conclusions:

- 9.1 Prudential supervision of its licensed insurers is clearly a responsibility of the MAA.
- 9.2 Removing the responsibility for prudential supervision from the MAA may impact its ability to perform its other functions and achieve its aim of creating and maintaining a Compulsory Third Party Scheme that is affordable, fair and accessible.
- 9.3 It would be difficult and expensive for the MAA to put itself in a better position than APRA to perform the prudential supervision of its licensed insurers. It is therefore reasonable that to a large extent the MAA rely on the work performed by APRA.
- 9.4 If the MAA can not be more effective than APRA then there is little to be gained from duplicating APRA's work and imposing additional requirements on licensed insurers.
- 9.5 There is some information collected by the MAA that would be a useful supplement to the information collected by APRA. This information includes frequent and up to date information on premiums underwritten and claim payments. This information could be a useful indicator of liquidity or solvency problems.
- 9.6 The most effective prudential supervision of MAA's licensed insurers would be achieved through a closer working relationship with APRA that would encompass the following:
 - MAA developing a stronger understanding of its licensed insurers and documenting this understanding (eg the enhanced insurer risk profiles, development of a rigorous complaints handling and analysis process). The task of gathering publicly available information about MAA's licensed insurers could be managed internally or outsourced to an external service provider (eg. rating agency). We attach as Appendix A a description of the services provided by some third party service providers.
 - MAA being actively involved with APRA in the planning of the prudential supervision of MAA's licensed insurers.
 - MAA having direct and constant contact with the APRA staff members responsible for each of MAA's licensed insurers.
 - MAA accompanying APRA on meetings and site inspections with MAA's licensed insurers.

- MAA and APRA holding regular meetings on each of MAA's licensed insurers.
- MAA and APRA sharing information (not just data) regarding the MAA's licensed insurers (ie discussing the implications of the data and findings).
- MAA forming its own conclusions on each of its licensed insurers and discussing these with APRA.
- MAA consulting with APRA prior to taking any action in respect of suspension or termination of a CTP licence.
- The MAA ensuring that relevant staff undertake a level of general insurance training appropriate to their specific job function. This point should not be taken to mean we have discovered a lack of knowledge within the MAA. This point recognises that we are recommending a different method of operation for the MAA with regards to prudential supervision and that the staff of the MAA need to be equipped with the necessary knowledge and skills to implement the recommended change.

10. Recommendations

The following summarises our recommendations:

- 10.1 In conjunction with APRA develop a strategy and operational model for how the MAA and APRA will cooperate and how the MAA will rely on the work performed by APRA.
- 10.2 To demonstrate that it is fulfilling its responsibilities for prudential supervision as set out in chapter 7 of the MAC Act, the Board of the MAA needs to clearly document:
- when it will rely on APRA:
 - setting of prudential standards
 - determination of information requirements
 - gathering of collateral data
 - analysis of data
 - carrying out general and specific reviews
 - how it will rely on APRA:
 - APRA will have prime responsibility
 - MAA to be involved in planning to understand APRA's approach and to provide input into issues of concern
 - APRA will collect information and perform analysis and provide regular feedback to MAA
 - APRA will perform site visits, inspections, investigations and reviews. Where appropriate MAA will attend these. If it does not attend, APRA will brief MAA on issues
 - MAA will form own conclusions based on APRA advice and discuss them with APRA
 - MAA will formulate their own actions and discuss with APRA before acting
 - why it is reasonable to rely on APRA:
 - APRA has responsibility for prudential supervision arising from the Insurance Act
 - APRA has significant resources and budget
 - APRA has specialist teams and superior ability to benchmark practices and financial position
 - Changes to Insurance Act and accompanying standards and guidelines should enhance APRA's ability for prudential supervision
 - Duplication of APRA's function is waste of resources and imposes unnecessary obligations on insurers

- Better working relationship with APRA as outlined in detailed plan will keep MAA better informed and better able to plan and make decisions

This should be documented for each supervisory power which the MAA proposes to delegate to APRA. The Board also needs to sign off the work plan developed by the MAA for prudential supervision including how the MAA reliance on APRA will work in practice (see 10.3 below).

10.3 The MAA needs to develop a detailed plan on how the reliance on APRA will work including:

- how information will flow between the entities
 - information not just data
 - regular meetings on each insurer
 - direct contact with APRA staff responsible for each of MAA's licensed insurers
 - MAA information on claims and premiums to be shared with APRA
 - MAA conclusions and actions to be shared with APRA
- how the MAA will work with APRA (as per 8.6 above)
 - expansion of memorandum of understanding
- how the MAA will get the necessary comfort it requires
 - APRA needs to demonstrate that it fully understands each of MAA's licensed insurers
 - Impact of new standards, in particular approach taken by insurers to risk management requirements
- how the MAA will make decisions from the information it receives from APRA.
 - how many stages of warning will MAA adopt, what will indicate each stage, what will be done at each stage
 - what are the early warning signs MAA expect to see in the information obtained by MAA
 - what will MAA do in response to early warning signs
 - how will MAA resolve potential conflict of interest with APRA (eg insurer displays early warning sign, MAA decides to suspend CTP and seek portfolio transfer or security over assets, but APRA is concerned this action will hasten insurers' demise and reduce the possibility of rectification)

- 10.4 The MAA needs to discuss and agree this detailed plan with APRA.
- 10.5 The MAA then needs to determine its resourcing needs based on the strategy, operational model and detailed plan discussed above.
- 10.6 The role of the MAA and the method used by it to discharge its obligations should then be effectively to communicated to all MAA staff and customers.

Attachment A
Information Gathering Services

Information gathering and collation services are operated by a number of organisations including Ernst & Young (through our Centre of Business Knowledge or CBK). This attachment provides examples of the different types of service offerings as well as general indications of the cost of each service.

Service Solution 1: Research & Compilation of Information

The information gathering service will collect, collate and distil the relevant research from a range of sources and organise it into the appropriate categories on a monthly basis, for each company. The research would be provided to MAA in its raw state.

The estimated cost for this service would be between \$200-\$500 per company per month.

Service Solution 2: Monthly News Alert

The information gathering service will provide a monthly news alert, with information taken from press articles for each company. The information will be distilled, summarised and organised in a newsletter format. It may also be organised by company or by category.

The estimated cost for this service would be between \$300-\$600 per company per month.

Service Solution 3: Monthly or Annual Briefing Paper

The information gathering service will collect, collate and distill the relevant research from a range of sources and write a briefing paper on a monthly basis. The briefing paper would be organised into the appropriate categories (as advised) and be segmented by company, or separate reports may be provided.

The estimated cost for this service would be between \$1,000-\$1,500 per company per month.

Service Solution 4: Annual "Company Report" - style report

The information gathering service will provide a detailed report on each company. It will collect, collate and distill information from a range of sources to provide a complete "picture" of the company to the MAA's specifications.

The estimated cost for this service would be between \$5,000-\$10,000 per company per annum.