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22 November, 2002

Mr David Bowen
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Motor Accidents Authority of New South Wales
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580 George Street
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Dear David,

Estimates of Rates of Return on Capital for NSW CTP Insurance Business

1. Estimates of return on capital from different sources

Recent estimates of return on capital for insurers for CTP business are summarised in Table 1.

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Table 1

Year ended 30 June	Underwriting year basis estimates for NSW CTP calculated for the MAA[a]	Financial reporting year basis estimates for ACCC reports for all CTP business combined[b]
	% p.a.	%
1990	44	Na
1991	72	Na
1992	15	Na
1993	7	24
1994	5	14
1995	7	(30)
1996	19	(24)
1997	17	2
1998	12	12
1999	14	28
2000	14	21
2001	Na	30
December 2001	Na	46[c]

Notes: (a) "Full analysis" approach estimates net of tax from Table 2.1 in our report to the MAA dated 17 October 2001.

(b) Gross of tax estimates underlying Figure 4.5 in report "Australian Competition and Consumer Commission Insurance Industry Market Pricing Review" dated March 2002.

(c) From Figure 2.11 in ACCC report "Second insurance industry market pricing review" dated September 2002. Based on insurers' year-end returns to APRA for year-ends during calendar year 2001. Gross of tax.

For this letter I have not undertaken detailed calculations regarding causes of the differences between the estimates shown in Table 1. However, four important general causes of the differences can be identified and are discussed in Sections 2 to 5 below.

2. Gross of tax v net of tax estimates

The underwriting year basis estimates calculated for the MAA were of net of tax return on capital.

By contrast, the financial reporting year basis estimates for each class of business in the ACCC reports were on a gross of tax basis.

3. Underwriting year v financial reporting year bases and their implications

3.1 Differences between underwriting year and financial reporting year bases

The estimates which we calculated for the MAA during 2001 were on an **underwriting year** basis, which is appropriate for assessing the estimated profitability for insurers of premiums written during each year. (As discussed, we are currently updating these estimates based on information on claims and expenses to 30 June 2002.)

By contrast, the estimates calculated for the ACCC reports were on a **financial reporting year basis**, because that is the form in which the information published by APRA is available. Profits or losses reported by an insurer for its financial reporting year consist essentially of:

[estimated profit or loss from premium earned during the most recent accident year

plus

profit or loss arising from restatement of provision for outstanding claims for all prior accident years].

(This is a deliberate over-simplification, in that other factors also affect insurers' reported profits or losses materially.)

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By comparison with the underwriting year basis of assessment, the financial reporting year basis tends to have the following effects:

(a) Apparent emergence of high or low reported returns in financial reporting years **after** the underwriting years which actually generated those high or low returns. Thus:
- The extremely profitable (fixed premiums) 1990 and 1991 underwriting years for NSW CTP resulted in high reported returns for the 1993 financial reporting year.
- Poor returns for the 1993, 1994 and 1995 underwriting years were (to a large extent) the cause of the negative reported returns for the 1995 and 1996 financial reporting years.
- Relatively high estimated returns for the 1996 to 2000 underwriting years resulted in high reported returns for the 1999, 2000 and 2001 (particularly) financial reporting years. Section 2.3.3 of the ACCC's September 2002 report includes the statement "Insurers indicated that part of the profit in 2001 is due to the release of excess reserves held in respect of accidents relating to the early and mid-1990s."

(b) **To accentuate reported changes in profitability** for insurers of the class of business. To illustrate why this tends to occur, consider deterioration in claims experience which is not recognised as such immediately. Say, two years after the deterioration started when the deterioration has been fully recognised, a large loss reported on a financial reporting year basis is likely to result from a combination of **both**:
- the estimated loss from the latest accident year due to recent premiums having been written at unprofitable rates, **and**
- additional reported losses from having to increase outstanding claims provisions for prior accident years to allow for the previously unrecognised deterioration in claims experience.

Hence the large negative returns on capital for 1995 and 1996 on the financial reporting year basis.

3.2 Outlook for financial reporting year returns for the near future

The outlook for **financial reporting year** returns for each class of business was included in the "Market overview" section in the summary at the start of the ACCC's September 2002 report. For CTP, the outlook was shown as "Very High". For returns measured on a financial reporting year basis, it does seem likely that high returns will be reported for CTP for, say, the 2002 and 2003 financial reporting years. For NSW CTP business:

- It now appears likely that ultimate claims costs for at least the two accident years since the commencement of the New Act on 5 October 1999 will turn out to be less than was estimated when corresponding premiums had to be determined.

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- Resulting profits for insurers greater than was originally anticipated would only have been reflected partly in financial reporting years to the end of 2001.
- The remainder of these profits are likely to emerge during the 2002 and later financial reporting years.

Hence the outlook for high returns for **financial reporting years for the near future**.

However, debating whether these financial reporting year gross of tax returns on capital for the near future might fall into the ranges defined by the ACCC as

- "high" – between 20% and 50%, or
- "very high" – over 50%

would be somewhat speculative given the uncertainties involved and the limited information which is available publicly.

It should also be borne in mind that, because of the differences between underwriting year and financial reporting year bases, the high recent returns on the latter basis do not necessarily imply a high level of profitability of NSW CTP premiums being written by insurers under their current premium rate filings which took effect from 1 October 2002.

The comments in this Section 3.2 are based on our assessment of NSW CTP business. For this letter, we have not attempted to consider how different prospects for Queensland and ACT CTP business might affect the outlook for financial reporting year returns for all three jurisdictions combined (refer Section 5 below).

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4. Capital allocation used for calculations and related issues

4.1 Bases for calculations in the ACCC's reports

Section 2.2 "Market update" of the ACCC's September 2002 report includes both:

- Estimates of insurers' net of tax return on **actual equity** for all classes of insurance business combined, on a financial reporting year basis. For the 2001 financial reporting year:
  - the calculated net of tax return on equity excluding the HIH Group was 5.5% (refer Section 2.2.5), but
  - if the HIH Group had been included in the 2001 APRA statistics, the return on equity would have been –30%, instead of 5.5% (refer Section 2.2.1).

- Estimates, again on a financial reporting year basis, of gross of tax return on capital for each class of business. For deriving these estimates, the capital allocated to each class by insurers was assumed to be the **minimum capital** required by APRA under its new requirements. (This is explained in Section 2.3 and Appendix F.6 of the ACCC's report.)

The "Summary" section at the start of the ACCC's September 2002 report includes the estimates of gross of tax return on (APRA minimum) capital for each class of business, but not the estimates of net of tax return on (actual total) equity. My (wholly personal) opinion is that it would have been preferable to include both estimates in the "Summary" section.

4.2 Different bases for determining amount of capital

Making generalisations which ignore differences between insurers, various bases for determining total capital can be arranged in **increasing** order of total capital as follows:

(a) former (pre 1 July 2002) ISC and APRA minimum capital requirements;
(b) new APRA stated minimum capital required ("MCR");
(c) effective new APRA MCR of 120% of (b), as we understand that APRA has advised insurers that it expects maintenance of capital of at least 120% of the MCR as representing a satisfactory capital management approach, and
(d) actual capital held by the majority of insurers.

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The estimates of gross of tax return on capital for each class of business in the ACCC's reports were calculated on basis (b).

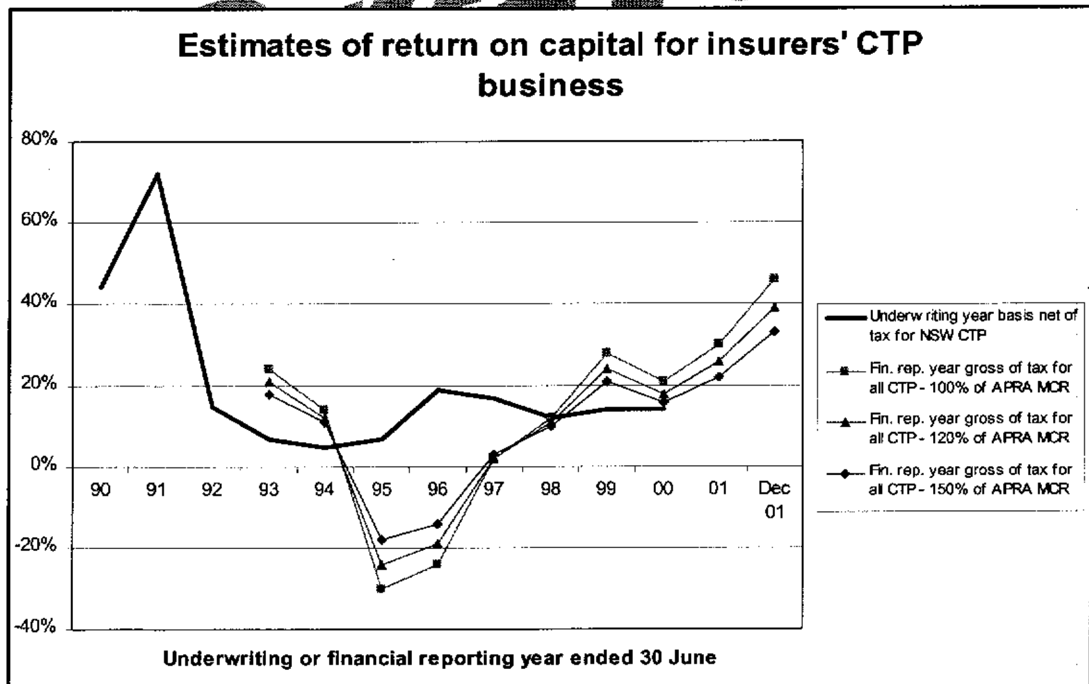
Table 2 and the following graph show the estimates in Table 1 and the effect on the financial reporting year basis estimates in the ACCC reports of adjustment to base them on:

- 120% of the new APRA MCR, ie basis (c) above, and
- 150% of the new APRA MCR. This is simply an illustrative level of capital moderately more than basis (c) above. It is not intended to be representative of any particular CTP insurer.

Table 2

Year ended 30 June	Underwriting year basis net of tax estimates for NSW CTP calculated for the MAA[(a)]	Financial reporting year basis gross of tax estimates for all CTP business combined, based on capital of:		
		100% of new APRA MCR[(a)]	120% of new APRA MCR	150% of new APRA MCR
	% p.a.	%	%	%
1990	44	Na	Na	Na
1991	72	Na	Na	Na
1992	15	Na	Na	Na
1993	7	24	21	18
1994	5	14	12	11
1995	7	(30)	(24)	(18)
1996	19	(24)	(19)	(14)
1997	17	2	2	3
1998	12	12	11	10
1999	14	28	24	21
2000	14	21	18	16
2001	Na	30	26	22
December 2001	Na	46	[illegible]9	33

Note: (a) From Table 1.



All other things being equal, assuming a greater allocation of capital tends to moderate both high and low values for estimated return on capital. Essentially, a greater allocation of capital "dilutes" the effect on return of the profits or losses generated by writing the insurance business, because the overall return depends more on the investment return on the capital and correspondingly less on the profits or losses generated by writing the insurance business. Thus:

- For the financial reporting year basis estimates, increasing the amount of capital assumed for the calculations from 100% to 150% of the APRA MCR **moderates** both the high and low values for estimated return.
- Ignoring the exceptional returns for the 1990 and 1991 (fixed premiums) underwriting years, the underwriting year basis estimates calculated for the MAA exhibit a much smaller range of returns than all of the financial reporting year basis estimates. The estimates calculated for the MAA were based on capital assumed to be allocated to CTP of approximately 3 times the new APRA MCR. The capital allocation used for the estimates for the MAA:
  - was based on allocating insurers' overall **actual** total capital, and
  - used a relatively sophisticated approach for allocating capital between classes, the general effect of which was to allocate more capital to the larger long-tail classes, such as NSW CTP, than most other capital allocation methods.

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5. Business to which estimates relate

The estimates calculated for the MAA were for NSW CTP business only while those in the ACCC reports were for NSW, ACT and Queensland CTP business combined.

As agreed, for this letter we have not attempted to undertake further analysis of the extent to which this difference might affect the comparisons.

Please contact me if you want to discuss these issues further and/or have any queries.

Yours sincerely,

Adrian Gould

cc Concetta Rizzo, Motor Accidents Authority
Clive Amery, Taylor Fry
Greg Taylor, Taylor Fry