20 May 2013

Mr Glenn Bounds
Assistant Director – Price and Service
Office of the Tasmanian Economic Regulator
GPO Box 770
Hobart 7001

Dear Sir,

Submission to the Investigation into the Motor Accidents Insurance Board's Pricing Policies

This submission addresses the general question of the appropriate basis for setting premiums, and in particular the question of how premiums should interact with scheme solvency. It also addresses the question of premium stability.

1 The Draft Report

The Draft Report into the Pricing Policies of the MAIB released by the Office of the Tasmanian Economic Regulator in April 2013 ("the Draft Report") stated that:

"Pricing may be described as a blunt instrument to assist in maintaining solvency levels[1]".

We agree with that conclusion.

The Draft Report also stated that:

"the Regulator considers that its recommended maximum premiums need not be impacted by the MAIB's financial position if its current and expected future solvency ratio is above zero per cent[1]"

We consider this to be incorrect and inconsistent with the previous statement.

The Draft Report proposes that the premium pricing order should be re-opened only if material changes occur. It defines material change as solvency falling below zero per cent.

[1] Investigation into the Pricing Policies of the MAIB – Draft Report, Office of the Tasmanian Economic Regulator, April 2013, page x

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2 Actuarial Views on Premium Setting

2.1 Accident Compensation history

The history of accident compensation schemes in Australia is littered with examples of schemes which have unintentionally allowed their solvency levels (also referred to as funding ratios) to decline to a stage where they have experienced unpleasant and unforeseen consequences.

In some cases, premiums were set below the cost of claims plus expenses (break-even premium) during a period of apparently strong solvency. This led to reduced solvency, but it proved difficult to achieve a smooth transition to the target solvency position or to increase premiums once solvency reached its target level. In some cases there was a massive over-shooting and solvency declined to a stage where benefits needed to be reduced, or specific funding levies were added to premiums to return the scheme's solvency position to its target. Several of those schemes took many years to regain their target solvency level, and some have still not done so.

In all cases, the ramifications were politically significant and the rectification of the unsatisfactory solvency position was very difficult. It is definitely not a situation that Tasmanian motorists or the MAIB would want to be placed in.

2.2 Use of Surpluses to Subsidise Premiums

There is an obvious question of how a surplus in any insurance operation should be used, and whether it should ever be used to subsidise premiums.

In some situations, the use of surplus to subsidise premiums is sensible and actuaries have no concerns about it. The requirements for successfully doing it are that:

1. the subsidy needs to be gradually tapered off, so that the necessary premium increase (once the surplus has been used) is small (i.e. avoid overshooting); and
2. there are no impediments to subsequent premium increases.

In the case of accident compensation schemes, the first requirement is not met because surpluses are volatile (due to fluctuations in assets and liabilities) so that it is often not possible to reduce the subsidy gradually. This has been the experience of several accident compensation schemes in Australia.

The second requirement is not met because the premium payers generally do not understand when premiums have been subsidized and do not recognize the need for premium increases – this in turn leads to political interference in the premium process, which has also been observed during the history of accident compensation in Australia.

2.3 Equity

The final observation regarding the use of surplus is that past generations of motorists, together with strong investment results, have produced the current strong financial position of the MAIB. If the NIIS is implemented or the hospital bed-day costs increase during the pricing period, they are expected to cause a significant increase in break-even premiums. They would not however, meet the Draft Report's criteria for re-opening the premiums order. In that case, premiums would be below break-even levels and premiums would need to be subsidised by using surplus.

The Draft Report's recommendation would effectively lead to future generations being subsidised by past generations, which is not equitable. Equity indicates that future generations of motorists should aim to maintain the scheme's solvency position.

2.4 Consequences for Premium Setting

The consequences of the above considerations are that for accident compensation schemes in Australia, premiums should normally be set equal to the cost of claims plus expenses, together with an appropriate profit margin. For the reasons above, the solvency of the scheme should not be the main consideration for premium setting. Historical precedents indicate that it is dangerous to reduce premiums below this level without very careful consideration of the consequences. This is expected to occur if the NIIS is implemented or the hospital bed-day costs increase during the pricing period, but the premiums order is not re-opened. The Draft Report's recommendation does not contain any analysis of the consequences of allowing premiums to remain below break-even until solvency reaches zero per cent.

In summary, we consider that the primary focus of premium setting should be the break-even premium plus profit margin, not the scheme's solvency.

2.5 Conclusion

For these reasons, we do not consider that the Draft report's recommendation (that maximum premiums need not be impacted by the MAIB's financial position if its current and expected future solvency ratio is above zero per cent) is appropriate for an accident compensation scheme in a strong solvency position, as the MAIB scheme currently is.

Instead, we consider that the premium should be maintained at a level that covers the break-even premium plus profit margin, with some variations to meet the secondary objective of premium stability, which we consider in the following Section.

3 Premium Stability

The Draft Report does not contain any discussion of the trade-off between the proposed reduction followed by future increases and the premium stability that the MAIB has achieved over the last ten years. Motorists in Tasmania have received real reductions in premiums over the past decade, as MAIB premiums have increased by 29% less than AWOTE[2]. They have also experienced stable premiums over that period, with premiums increasing only three times during that ten year period.

Experience of other accident compensation schemes has been that premium stability is valued by premium payers, and the proposals in the Draft Report will introduce relative premium instability, without analysis of the costs and benefits of doing so.

[2] Investigation into the Pricing Policies of the MAIB – Draft Report, Office of the Tasmanian Economic Regulator, April 2013, Table 5.3

4 Disclosure

As indicated in the Draft Report, we are actuarial advisors to the MAIB. We provide advice on liabilities, solvency, premiums and financial management of the scheme.

We would be pleased to provide further detail if required by the Office of the Tasmanian Economic Regulator.

Yours sincerely,

Martin H Fry

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