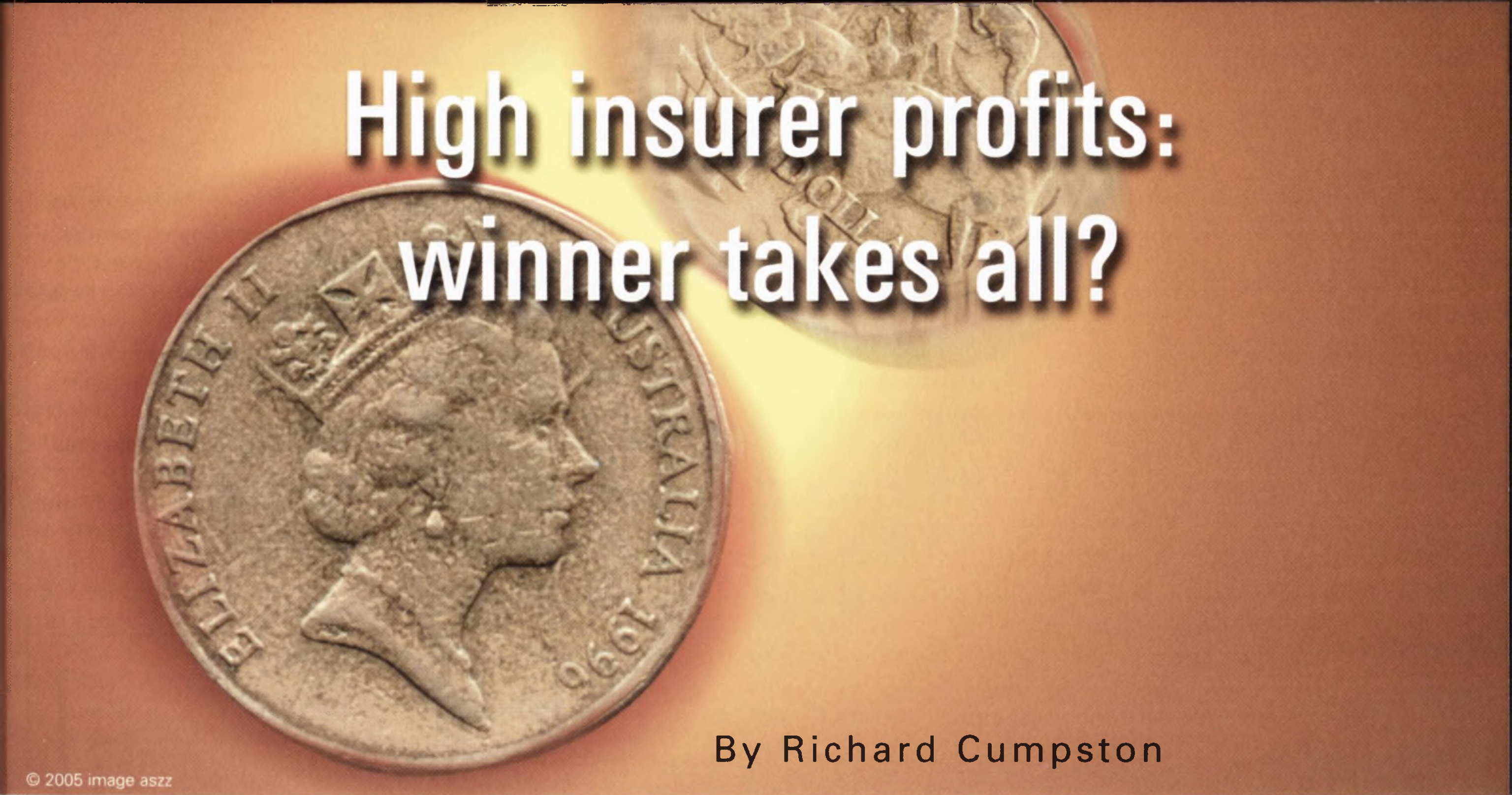
High insurer profits: winner takes all?



By Richard Cumpston

Following a severe shortfall of insurance capital in 2001, substantial changes were made to the common law entitlements of injured persons in most states.

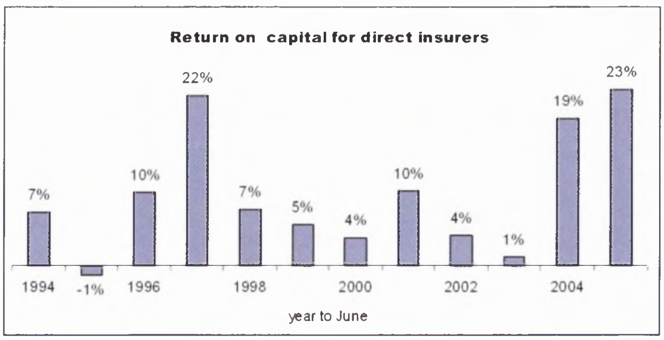
Australian insurers now argue that after-tax returns on capital of about 12% to 15% are reasonable. By contrast, in the 11 years to June 2004, Australian direct insurers obtained after-tax returns on capital averaging about 8%.

The limited data currently available suggest that:

- Australian insurers had returns on capital of about 23% in the six months to 31 December 2004;
- compulsory third-party insurers had returns on capital of about 19% in 2003-04;
- public liability insurers had returns on capital of about 19% in 2003-04; and
- at 30 June 2004, medical indemnity insurers had capital of 166% of the minimum capital requirement, and were projecting an increase to 206% by 30 June 2005.

These profits appear high enough to allow better benefits to injured persons, particularly those most harshly affected by recent legislative changes.

WHAT IS A REASONABLE PROFIT?



The bar chart shows the estimated after-tax return on capital of Australian direct insurers. The last bar is for the six months to December 2004. Market value changes in investments, and profits from non-insurance business, are included. The average after-tax profit for the 11 years to June 2004 was about 6% of net premiums, and the average after-tax return on capital about 8%. The after-tax return for the six months to December 2004 was a high 23%.

The low return on capital in 2002-03 was partly due to the risk margins made necessary from 1 July 2002 by changes to the *Insurance Act* 1972. Insurer provisions for premium liabilities and outstanding claims now have to include risk margins chosen so as to give at least a 75% probability of adequacy. Before 1 July 2002, most insurers included prudential margins on their outstanding claims provisions, but generally below the risk margins now held. >>

There is lively debate about reasonable profits for insurers. The NSW Motor Accidents Authority has initiated some of this debate, as compulsory third-party (CTP) insurers in NSW are required to file analyses of their proposed premiums, including profit margins. The MAA report for 2003-04 said (on page 101):

> 'The indicative range resulting from Taylor Fry's calculations is a profit of 4.5-6% of gross premium for the representative insurer…
>
> 'Over the last five years, profit margins (in premium filings) have ranged from 7.5% to 10% for individual insurers … The MAA considers this range of profit margins to be reasonable although the MAA has ongoing discussions with the CTP insurers who believe that the level of profit derived from the Taylor Fry methodology is not adequate.'

On 20 July 2004 the Institute of Actuaries of Australia and the Insurance Australia Group held a one-day seminar on 'The Economic Theory of Profit Margins'. In a presentation, Tim Andrews argued that insurance premiums need to support returns on capital which are in line with the general expectations of mainstream investment markets.

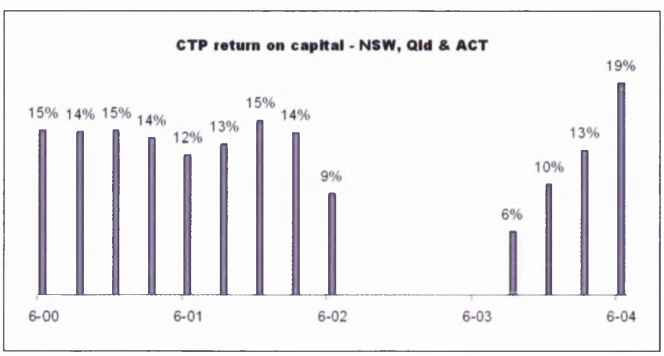
Andrews noted that Australian-listed insurers had recently been achieving returns on capital of about 12%, and had stated target returns of 12% to 15%.

I understand these returns on capital include investment earnings on capital, and are after taxes on profits. Target returns of 12% to 15% are above the 8% average achieved in the 11 years to June 2004. For comparison, Australian banks apparently average 16% return on capital, with the big four averaging 20%.

Based on an example provided by Andrews, target returns of 12-15% may correspond to premium profit margins of 10-13%, where premium profit margins are estimated ignoring tax and capital, and assuming all investments are risk-free.

ACTUAL RETURNS ON CAPITAL

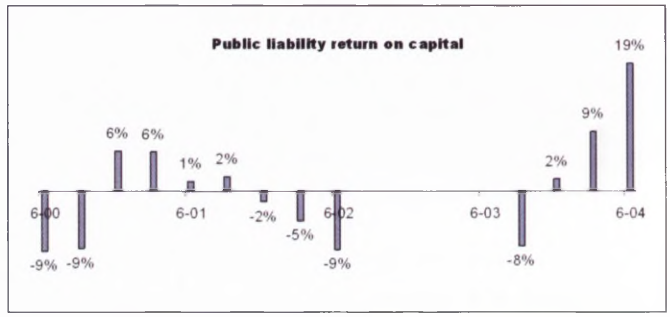
CTP



The chart shows estimated returns on capital for private CTP insurers in NSW, Queensland and the ACT, the only states allowing private insurance. The estimated returns have been derived from APRA's quarterly *Insight* general insurance statistics, which were not published for the quarters ending September 2002 to June 2003. The *Insight* statistics are not intended to provide full details, and the estimated returns thus rest on a number of approximations. The returns shown are for the year ending in June, September, December and March.

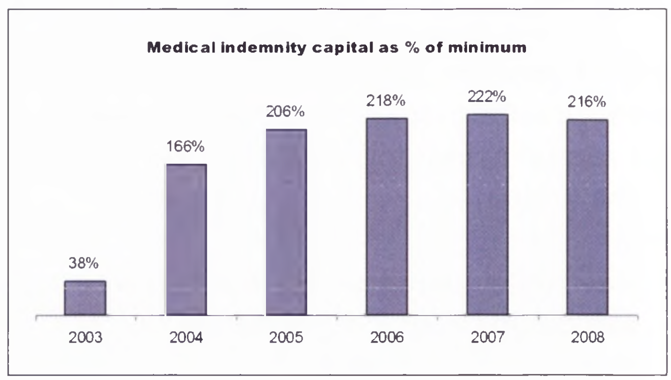
CTP and travel insurance data are grouped together in *Insight* from September 2003 onwards, and the CTP figures shown here were estimated by assuming that travel insurance formed unchanged percentages of net premiums and net claims from June 2002 onwards. As travel insurance is a much smaller class of insurance than CTP, the estimates for CTP insurance should be reasonably reliable.

Public liability



The bar chart shows estimated returns on capital for public liability insurers in Australia, derived from APRA's *Insight*. As with CTP, many uncertainties exist in these estimates.

Medical indemnity



The above percentages are estimates from chart 3 of 'Review of Competitive Neutrality in the Medical Indemnity Insurance Industry', a March 2005 report by Graham Rogers. They are ratios, as at 30 June each year, of insurer net assets to APRA's minimum capital requirements. The figures for 2003 and 2004 are actual, and those for 2005 onwards are projections. Rogers notes (page 9) that these projections are above the 150% that APRA has designated as an appropriate minimum for the medical indemnity industry.

APRA DISCONTINUED STATISTICS

APRA used to publish premiums and claims for each class of business in each state every six months, but has not done so since June 2002. Such data would be particularly valuable now, as it would help to assess the effectiveness of legislative changes made in each state. I understand that the data will be published for the year to June 2005, and then may be published for the years to June 2003 and June 2004.

APRA once published annual analyses by accident year and state, showing claim numbers and costs for CTP and employers' liability, and for Australia for public liability. It now receives such data for Australia for each class of insurance, but not by state. Such analyses for public liability would be particularly helpful now, as they would help identify temporary claim increases associated with impending legislation, and asbestos claims emerging from past cover.

APRA also published statistics for CTP and travel insurance, but now marks the data for these classes as 'na' in its quarterly *Insight* statistics. CTP is one of the largest and most profitable classes of insurance, and it is hard to see why statistics should not be published for it.

APRA – POSSIBLE ADDITIONAL STATISTICS

The HIH Royal Commission recommended that all the statistical returns supplied regularly by insurers to APRA should be publicly available. APRA has rejected this recommendation, at least for the solvency details of each insurer, and for the business of some specialised insurers. APRA instead intends to publish summaries, but this may be slow and uninformative.

Since 1 July 2002, insurers have been required to add risk margins to their provisions for outstanding claims and future claims, to give a probability of about 75% that these provisions will prove adequate. Regular publication of these risk margins for each class of insurance would help to show whether increases in claims incurred were due to increases in claims or increases in risk margins.

APRA's quarterly *Insight* statistics, and its new *Quarterly General Insurance Performance Statistics*, would be more valuable if they showed revenues, expenditures, assets and liabilities for each class separately.

WIDER CONSULTATION BY APRA

At present, APRA consults extensively with the insurance industry when drafting prudential regulations and guidance notes, and when designing statistical inputs and outputs.

Unlike submissions to the Productivity Commission, submissions made to APRA are kept confidential, severely limiting informed public discussion.

Many types of insurance statistics are of value to legislators, and to bodies such as the Law Council of Australia seeking to make submissions about legislation.

- APRA should consult with representative organisations, as well as with the insurance industry, about its data collections and publications.
- APRA should also make available on its website any submission it receives about its data collections and publications.

HOW THE LAW COUNCIL CAN HELP

The Council's central role makes it well placed to:

- talk with the Insurance Council of Australia about APRA policies and publications (ICA is keen for APRA to resume detailed publications);
- talk with the Institute of Actuaries of Australia about APRA publications and reasonable profit margins;
- talk with APRA about their publications, and possible amendments to the *Insurance Act;*
- draft amendments to the *Insurance Act*, requiring APRA to consult with the public as well as insurers, to make all submissions publicly available, and to take into account the public interest as well as their regulatory duties;
- decide what statistics are needed to assist legislative reform;
- discuss statistical reform proposals with the appropriate minister; and
- seek multi-party support for any legislative changes needed.

On 19 July 2005 President of the Council, John North, wrote to the Minister for Revenue and Assistant Treasurer, raising some of these issues.

HOW THE LAWYERS ALLIANCE CAN HELP

The Australian Lawyers Alliance should take part in any discussions with Commonwealth authorities, helping the Law Council where it can. But the Alliance can do much to make changes to personal state injury legislation better informed by:

- ensuring that actuarial reports to state accident compensation schemes are routinely available to the public (rare at present);
- ensuring that research done by one scheme is available to help legislators in other states (rare at present); and
- making other states aware of problems with new legislation (devices to reduce benefits tend to be quickly copied). ■

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This article is based on a presentation at the Personal Injury and Compensation Forum held by the Law Council of Australia in Sydney on 3 June 2005.