SYNOPSIS

PREMIUM SYSTEM DESIGN – BALANCING STAKEHOLDER NEEDS

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Key words: underwriting, pricing mechanisms, premium, premium system, competition, profitability, scheme design, reform

Purpose of your paper: To discuss the design and operation of two <u>unique</u> features of the newly implemented premium system mechanisms in the NSW CTP market:

- Risk Equalisation Mechanism – aimed at improving competition between insurers whilst maintaining premium affordability for vehicle owners (by dealing with major cross subsidies in the scheme by ensuring insurers receive the full risk price for the risks they underwrite in a privately underwritten market)
- Profit Normalisation – aimed at curbing excessive profitability (or loss) by insurers whilst retaining private market incentives to innovate and compete

We aim to stimulate debate on ways premium systems can be improved in a price regulated, privately underwritten insurance market, such that the conflicting goals of premium affordability and market competition can be achieved. This discussion will be of interest to stakeholders of other regulated but privately underwritten markets.

Synopsis: The very high profitability of the NSW CTP scheme has been under the spotlight in recent years, following the average profit margin estimated to have been achieved by insurers in the scheme since 2000 of about 20% which 2.5 times the average filed profit margin by insurers during that period. It has become a very controversial issue with independent reviews being undertaken and high profits being heavily criticised by Parliamentary committees, lawyers and the media and is one reason why NSW premiums have been higher than they otherwise need to be. .

Against this backdrop of high past profitability and rising premiums, the NSW CTP scheme has been driven to innovate of the premium system for the scheme.

Scheme regulators have traditionally looked to market competition to help put appropriate downward pressure on prices and also as incentive for insurers to increase efficiency and invest in innovation. However, the imperative to keep premiums affordable for a compulsory insurance product means that the regulated pricing (creating cross subsidisation in costs) may work against market competition.

To overcome this, the NSW CTP scheme has designed and implemented two unique premium system mechanisms:

- Risk Equalisation Mechanism (REM – aimed at improving competition between insurers whilst maintaining premium affordability for vehicle owners (by dealing with major cross subsidies in the scheme by ensuring insurers receive the full risk price for the risks they underwrite in a privately underwritten market)
- Profit Normalisation – aimed at curbing excessive profitability (or loss) by insurers whilst retaining private market incentives to innovate and compete

In our presentation, we will discuss:

- Why such mechanisms were needed
- The key objectives of each mechanism and principles behind the design
- Their features, benefits and potential weaknesses
- How they will operate in practice
- Learnings to date

In respect of REM, we will cover:

- The drivers for introducing the mechanism including the extent of the cross subsidisation inherent in the (previous) premium system despite NSW CTP already permitting insurers to risk rate more than any other CTP jurisdiction, and how it impacted on insurers' pricing and distribution strategies
- The overall objectives and key principles adhered to in designing the mechanism (e.g. that it should not impact on the competitive advantage of individual insurers)
- How risk equalisation works in other sectors of insurance, and how it is different to the REM design used in NSW CTP
- The benefits of the mechanism, and from the perspective of the insurers, the issues raised during the design process
- The operationalization of the mechanism with the need for a clearinghouse and regular collection of policy data from insurers
- Observations of changes in market and competitive practices, where available

In respect of profit normalisation, our presentation will cover:

- The history of profitability in NSW CTP and some of the drivers of the high levels of profitability
- The need for such a mechanism, particularly in light of the benefit reforms to be implemented
- The overall objectives and key principles considered in designing the mechanism (e.g. that it should not impact on the relative competitive advantage of individual insurers) as well as consequential design issues (e.g. should insurers making a loss be forced to make a bigger loss?)
- How it is implemented in other overseas jurisdictions
- The pros and cons of design options considered (e.g. does the design effectively guarantee insurers a profit?)
- Challenges in design and operation (e.g. how do we define and measure "profit", and in a way that minimises potential for gaming by insurers?)

We will also discuss how insurers will behave in the new market with both these new mechanisms and also what risks they present to the scheme.

We aim to stimulate debate on ways premium systems can be improved in a price regulated, privately underwritten insurance market, such that the conflicting goals of premium affordability and market competition can be achieved.