Global Financial Crisis and self insurance

The Global Financial Crisis (GFC) has resulted in a global economic slowdown although there is significant uncertainty about the duration and the severity of the downturn. Recent volatility in financial markets has had - or will have - a significant impact on the financial results of most self insurers for the reasons outlined below.

<table>
<thead>
<tr>
<th>Discount rates</th>
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<tbody>
<tr>
<td>With risk free yields dropping from around 6% to as low as 3% in the last 9 months and long term claims inflation expected to remain at around 3 to 4% per annum - possibly a 1 in 20 or 30 year occurrence - companies with long tail claim liabilities will have taken a hit to profits from the recent reduction in the discount rate.</td>
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</tbody>
</table>

Why is this so?

- A self insurer’s outstanding claim liabilities at a particular date is equal to the sum of all future claim payments (on past claims) discounted to allow for future investment income which will be earned between now and the date when the claim is expected to be paid
- Accounting and actuarial professional standards specify that the rate used to discount (or reduce) the outstanding claim liabilities must be a risk-free rate based on the returns available on Commonwealth Securities
- Hence a lower discount rate means less discounting of future claim payments and hence a higher outstanding claim liabilities (all other things being equal). |
### Mind the Gap

With discount rates at historical lows it is worth noting that there is an expectation that discount rates (or more specifically the “gap” between inflation and discount rates) will increase (widen) at future balance dates so that some of the “accounting hit” in 2008/09 will reverse.

### Cost of claims

Immediate financial impacts aside, possible impacts of the GFC on the future claims cost of self insurers include:

- A deterioration in Return to Work (RTW) outcomes as injured workers are less likely to return to work if there is a prospect of retrenchment and the ageing workforce means fewer prospects of redeployment

- An increase in claim frequency if job redundancies occur or through an increase in fraudulent claims

  Increased inflationary pressure on personal injury claims.

### Impact on Workers’ Compensation Schemes and Insurers

As well as impacting self insurers the GFC has had a significant impact on Schemes with many recently announcing deficits; mainly due to discount rate impacts and investment losses. Their reaction to this could be to increase premiums and/or to reduce costs. Self insurer levies or exit fees could also come under pressure (although noting that WorkCover NSW have indicated that they have no plans for introducing exit fees). These potential impacts should be considered in making any comparisons between insurance and self insurance.

Insurers in the underwritten states have also been impacted by the issues raised above with many indicating that they intend to increase workers’ compensation premiums in 2009. More broadly we would expect other lines of insurance (such as public liability and professional indemnity) to also come under premium pressure. Hence it may be a good time to review insurance programs including deductibles and limits.
Impact on Workers’ Compensation Schemes and Insurers

The drastic slide in equity markets has made a nasty dent in asset values for those holding equities. For those companies with significant equity holdings who have already taken a capital hit the question is now whether to stick to the investment strategy or to move forward with a more defensive strategy. Balance sheet strength and ability to absorb further downside risk will be key factors going forward.

Equity investments have always been, and remain, suited only to those with the ability to take a longer term view and with sufficient solvency to withstand short term asset value fluctuations. With the GFC uppermost in mind many will now be re-assessing how well equities sit as an asset class in their investment portfolio. The potential for over-reaction is high with a global ‘flight to safety’.

For the organisations that are listed on the stock exchange, the equity market fall not only impacts their investments but also their own share price.

Mind the Gap

So far Australia has avoided the full brunt of the GFC. The consensus is for worse times ahead but with huge uncertainty about the length and depth of the economic downturn. Given the potential impacts described above it is important for self insurers to explore what the future ramifications of the GFC may be for their own organisations. Areas to consider include:

- **Discount rates:** understand the impact on claims liabilities and build this into budgets and management’s expectations. It is possible to mitigate this impact by investing in assets that “match” the duration and risk profile of the liabilities. However, any policy change now will also neutralise the ability to profit from future interest rate rises.

- **Cost of claims:** OH&S strategy and injury prevention become even more important to reduce the level of claims. Also management of claims, particularly early intervention and a plan for redeployment are vital. We believe now is not the time to reduce staffing in these operational areas.

- **Insurance:** understand that although there may be increases in your own self insurance costs through lower discount rates and, possibly through deteriorating claims experience, Schemes and insurers are also facing similar issues which are impacting their performance. For employers who do not self insure, consideration of self insurance as a way of reducing the costs of business remains an option.

- **Equity markets:** review investment strategy in light of current conditions.
Assessing the financial viability of self insurance

Recently Finity gave a presentation to the 2009 National Self insurance Summit on measuring the success of self insuring workers’ compensation liabilities. The presentation provides an actuarial perspective into assessing the success (or otherwise) of the decision to self insure using Star City, a real self insurance success story, as a case study. The key findings of the paper are summarised in the following table.


<table>
<thead>
<tr>
<th>Measure</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compare <strong>pre-self insurance</strong> experience vs <strong>self insurance</strong></td>
<td>Good early indicator of success</td>
<td>Becomes less relevant over time.</td>
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<tr>
<td></td>
<td></td>
<td>‘Honeymoon Impact’</td>
</tr>
<tr>
<td>How does <strong>self insurance</strong> compare to <strong>insurance</strong></td>
<td>Measure of ‘true’ cost of self insurance / savings at point in time.</td>
<td>Difficult to calculate: premiums, development of claims, IBNR</td>
</tr>
<tr>
<td></td>
<td>Common question from management.</td>
<td></td>
</tr>
<tr>
<td>Compare own experience to <strong>benchmarks</strong></td>
<td>Measure of performance relative to peers / competitors</td>
<td>Access to reliable / relevant benchmarks</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Comparing across industries / states is difficult</td>
</tr>
<tr>
<td><strong>Ongoing Monitoring</strong> of claims experience</td>
<td>Understand key drivers of claim costs</td>
<td>Needs to be regular</td>
</tr>
<tr>
<td></td>
<td>Current - early indicator of deterioration</td>
<td>Accident period vs accounting period monitoring</td>
</tr>
<tr>
<td></td>
<td>Avoid surprises</td>
<td></td>
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<tr>
<td></td>
<td>Allows corrective action</td>
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<tr>
<td></td>
<td>Management reporting</td>
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Comcare Review

The moratorium on new applications from private sector employers seeking to join the Comcare scheme remains in place and there is still no indication of a likely release date of the Comcare review. Our previous newsletter considered the impact of one possible set of changes to the Comcare scheme as a result of the review.

In preparation for the lifting of the moratorium employers may want to consider:

1. A high level review of eligibility under a range of potential criteria - for example, the current criteria (i.e. with no change to “competition test” and financial / prudential requirements) or some new criteria (e.g. removal of competition test but with tougher financial scrutiny and requirement that there must be some sort of national presence)

2. Performing a high level comparison of current workers’ compensation costs with estimated costs under Comcare (claims and expenses)

3. Reviewing whether they meet current standards for OH&S claims management, benefit delivery, prevention and rehabilitation.

Market Updates

New South Wales

NSW Fund loses $2.3 billion

WorkCover NSW has recently announced (April 2009) that the workers’ compensation fund has fallen from a surplus of $625 million at June 2008 to a $1.8 billion deficit at December 2008; a fall of $2.3 billion in just 6 months. The fall is largely due to poor investment returns as a consequence of the GFC and the discount rate impact on outstanding claim liabilities.

The impact on the latest Insurance Premium Order is uncertain although the NSW Finance Minister, Joe Tripodi, has indicated that WorkCover NSW will not be increasing premiums.

Burner Premiums

WorkCover NSW has issued its April 2009 guidelines outlining the details of its “burning cost” premium model for large employers. Under this methodology an employers’ premium is equal to their claims cost for the period - with large claims capped at either $350,000 or $500,000 per claim, at the discretion of the employer - plus a loading for development of claim costs plus expenses. Hence the premium is not related to the size of the employer (unless minimum or maximum premiums are payable) or their relativity to their own industries’ experience.

The burning cost methodology will provide large employees with an alternative to self insurance within the NSW scheme. Note, however, that it is only for employers with a tariff premium greater than $0.5 million and, initially, will be limited to a small number of organisations. In addition WorkCover will have complete discretion as to who is eligible to participate. Employers will be invited to participate in the new premium model from July 2009.
It is our experience from costing this arrangement for a number of employers, that the benefit, or otherwise, of a burning cost premium will vary significantly from employer to employer.


**Legal Panel for NSW Scheme**

WorkCover NSW plans to implement legal panels during 2009 for the scheme’s agents in line with the 2003 McKinsey Report recommendations. Self and specialised insurers will be able to participate on a voluntary basis. NSW Self Insurers Association chair, Denise Fishlock, has said that the Association does not support the appointment of legal panels, pointing out that the majority of self insurers are happy with the existing service level agreements with legal providers of their own choice and would not look favourably upon a panel put in place for them.

**Death Benefits Increased**

The Workers’ Compensation Legislation Amendment Bill 2008, which increased the lump sum death benefit from $343,000 to $425,000, was passed through the Lower House in December 2008.

Other benefit changes announced in November 2007 are still pending and given the current deficit are unlikely to be adopted in the near future.

http://www.finity.com.au/newsletters.php?id=4#NLbc announced in November 2007 are still pending and given the current deficit are unlikely to be adopted in the near future.

**Victoria**

**Vic WorkSafe now in deficit**

WorkSafe’s funding ratio has reduced to 94% at December 2008 down from 136% at June 2008 following net losses of $1.4 billion due to the investment downturn.

**Accident Comp Act Review**

The final findings of the Accident Comp Act 1985 review headed by Peter Hanks, QC were released in September 2008. The report recommended sweeping changes including benefit changes, provisional liability and changes to the contribution formula for self insurers.

The Victoria Government’s stakeholder consultation report by Peter Rose has found several concerns with the Hanks report including strong criticism from key industry bodies. However, the significant reduction in the funding ratio (as mentioned above) means it is likely that the government will defer release of its response until it assesses the full impact of the current funding position.
Queensland

No major changes - Scheme continues to be reasonably stable.

South Australia

$1.3bn Scheme Blowout; Levy unchanged

The SA workers compensation scheme’s unfunded liability has grown to $1.3 billion in half-year results to 31 December 2008 (up from $984 million at 30 June 2008). This implies a funding ratio of 52%. In the half year to 31 December economic factors (predominately changes in interest rates and inflation assumptions) had negatively impacted on the scheme’s liabilities by $188 million. At the same time the government announced its intention to maintain the average levy for 2009/10 at 3%.

Legislation Changes

The final tranche of changes to the Workers Rehabilitation and Compensation Act came into effect on 1 April 2009. The key changes to the scheme include:

- Earlier step-downs for weekly benefits
- A Work Capacity Review to determine entitlement to ongoing income maintenance compensation beyond 130 weeks
- Changes to non-economic loss payments intended to provide additional compensation to more seriously injured workers
- Changes to the dispute resolution framework (including the introduction of Medical Panels) and
- A system of provisional liability to enable early commencement of rehabilitation.

The provisional liability changes have been particularly contentious amongst self insurers. Provisional liability requires payments within seven calendar days of an injury being reported, unless mandatory information was not given at the time the injury was reported or a “reasonable excuse” applied. It is designed to ensure that payments to injured workers are not unnecessarily delayed and hence help return claimants to work early. However, self insurers are concerned that it will increase the level of fraudulent claims and that aspects of the legislation are inconsistent.

The state government has announced it intends to review the new scheme changes after six months.

Discontinuance Fees

The SA Government introduced new discontinuance (or exit) fee regulations during March 2009 setting out the formula to calculate the fee for employers that leave the scheme because of stopping operations in SA, transferring operations interstate or overseas, becoming self insured or moving to Comcare self insurance.

SA WorkCover and Linfox continue to be in dispute over a $3 million exit fee charged as a result of Linfox’s move to Comcare in 2006. SA WorkCover say that the fee is to cover Linfox’s share of the Scheme deficit whilst Linfox argue that the fee is punitive and that the calculation of the fee is incorrect.
**Western Australia**  
**Workers’ Compensation Review**

WorkCover WA has announced a review of Western Australia’s workers’ compensation legislation. The review has a number of aims including:

- Reducing the complexity of the Act
- Addressing concerns arising out of the 2005 Act changes
- Reviewing entitlements for workers over 65.

**Premium rates up 10%**

WorkCover WA has recently (April 2009) announced that the average premium rate charged to employers for 2009/10 will be 1.738% of total wages (up by 10% from the 2008/09 rate of 1.582%). The increase is primarily due to lower real rates of return but also takes into account future wage growth and claim costs. Premium rate increases vary by premium rate classification as set out on WorkCover WA’s website. [http://www.workcover.wa.gov.au/Publications+And+Forms/Rates+fees+and+payments/Premium+Rates.htm](http://www.workcover.wa.gov.au/Publications+And+Forms/Rates+fees+and+payments/Premium+Rates.htm)

**Tasmania**  
**Clayton Review**

The Clayton review is still being considered with no changes announced. The review was completed last year and recommended a number of key changes to the Tasmanian Workers’ Compensation legislation including:

- Extension of weekly benefits to normal retirement age (currently 9 years), depending on degree of whole person impairment (WPI)
- Increase in weekly benefits to dependent children
- Increase in maximum impairment lump sum benefit to $250,000 (currently $208,000)
- Increase in maximum lump sum death benefit to $250,000
- Introduction of narrative test for Common Law (CL) - likely to increase the number of CL claims as currently only available for 30%+ WPI

Four packages of preferred recommendations were costed by the Board in July 2008 and have been put to the Minister. The packages essentially consist of combinations of including / excluding the CL changes and the increase in lump sum impairment benefits.

**ACT & NT**

No significant developments that we are aware of.
About Finity

Finity is the largest independent general insurance actuarial and consulting firm in Australia, with around 80 staff in Sydney and Melbourne. Finity has a dedicated practice to provide actuarial and management consulting to private health insurance companies. Our core areas of expertise include:

1. Strategy: Finity assists insurers with a range of strategic issues. Recent assignments have included assisting health insurance companies to review their capital management plan in response to recent financial events.
2. Appointed actuary role: Our consultants have experience in preparing liability valuations and Financial Condition Reports, and can provide the necessary opinions on pricing and product design. Our reputation is built on providing advice that is clearly communicated and of outstanding technical quality.
3. Demutualisation, merger and acquisition: Finity has been actively involved in recent industry consolidation, engaged by insurers on both the buy and sell sides in recent transactions.

We also have expertise to assist health insurers in other areas, including:

1. Actuarial Outsourcing: Finity is able to assist whether you are looking for help with a single project or require a complete outsourcing solution.
2. Peer Review: We are happy to provide management and the board with a second opinion on any matter. We can provide a concise opinion on the work, drawing out key issues and making broad market comparisons.

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We are grateful to everyone who has responded with comments about the previous issue - as ever, we appreciate your feedback. Any suggestions for topics that you would like to see addressed in greater depth in future newsletters are welcome. mark.hurst@finity.com.au