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Nominal Insurer Liability Valuation as at 30 June 2020

Background

Insurance & Care NSW (icare) commissioned Finity Consulting Pty Ltd (Finity) to estimate the insurance liabilities of the NSW Workers Compensation Nominal Insurer (NI) as at 30 June 2020. This document has been prepared by icare and summarises the results of Finity's independent actuarial assessment of the NI insurance liabilities.

The insurance liabilities of the NI include the future claim payments, which continue for the life of the injured worker in some cases, for all claims arising from accidents on or before 30 June 2020 as well as the expenses associated with administering the claims. They also include the expected claim costs that may arise from the exposures written before the valuation date.

The purpose of an insurance liability valuation is to estimate the reserves required for balance sheet reporting. The estimates are reflective of the information available at a specific point in time, the valuation date, and the actuary's expectations across future experience, environmental drivers and economic conditions.

Liability estimates are inherently uncertain and can change as new information becomes available.

The Finity valuation has been prepared with the intention of complying with the Actuaries Institute Professional Standard 302 'Valuations of General Insurance Claims' and producing results that comply with Australian Accounting Standard AASB 1023 'General Insurance Claims'.

Results

As at 30 June 2020 Finity have estimated the discounted net outstanding claims liability of the NI to be $17,636m. This figure includes a 15.6% risk margin over and above the central estimate which has been adopted to provide an estimated 80% probability that the combined liability estimate will prove to be sufficient. The components of the outstanding claims liability as at 30 June 2020 are set out in the following table.

Table 1: Nominal Insurer outstanding claims liability as at 30 June 2020

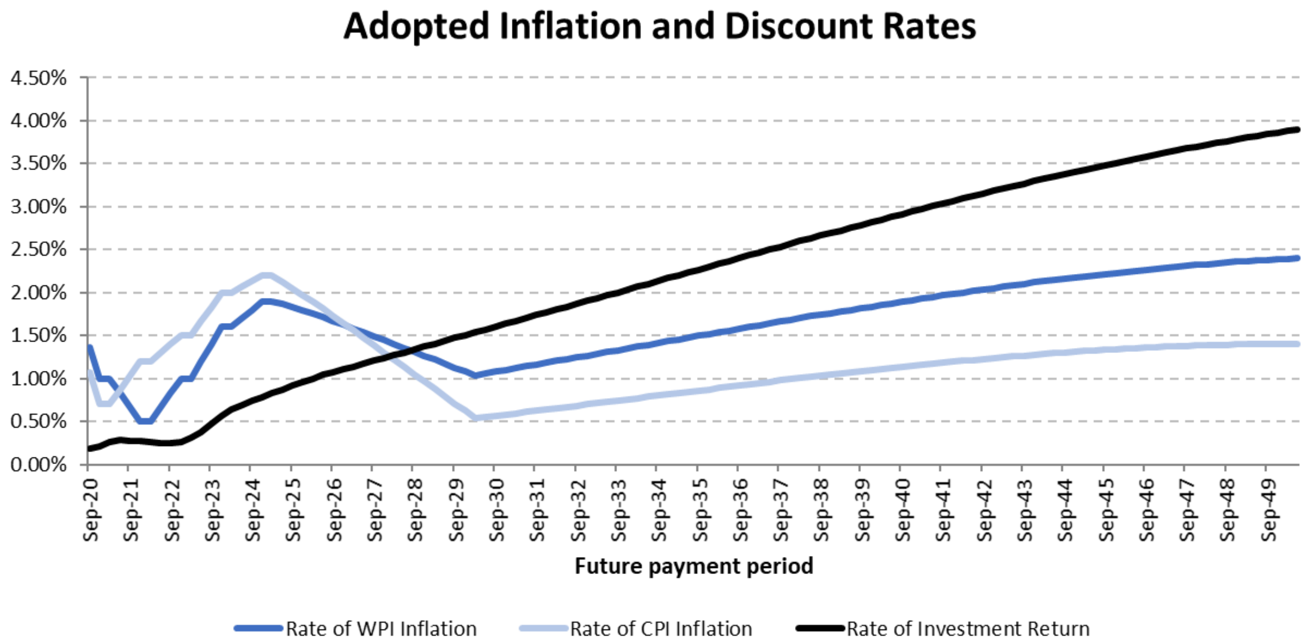
Outstanding claims liability	Undiscounted Liability Estimate ($m's)	Discounted Liability Estimate ($m's)
Weekly compensation	4,668	4,276
Medical benefits	7,352	5,324
Work injury damages	2,739	2,661
Section 66 and 67	802	770
Investigation costs	260	243
Legal costs	202	192
Rehabilitation benefits	207	202
Commutations	135	114
Death	168	160
Other	269	216
Asbestos	198	148
Uninsured employers	177	141
Direct COVID-19	1	1
Gross outstanding claims liability	**17,177**	**14,449**
Tax recoveries	73	70
Other recoveries	185	182
Uninsured employer recoveries	27	21
Net outstanding claims liability (excl. CHE)	**16,892**	**14,176**
Claims handling expenses (CHE)	1,177	1,080
Net outstanding claims liability (incl. CHE)	**18,070**	**15,256**
Risk margin (15.6%)	2,819	2,380
Total outstanding claims liability	**20,888**	**17,636**

The risk margin percentage of 15.6% has increased from 15.1% to allow for the additional uncertainty in future claims costs due to the COVID-19 pandemic.

The discount rates used by Finity in the assessment of the outstanding claims liability were taken from the yields on Commonwealth Government Bonds as at 30 June 2020 for the first 30 projection years. Beyond the 30 year point a fixed discount rate of 4.50% was adopted. Future inflation rates were based on short-term economic forecasts (0 to 5 years), long-term assumptions on the gap between the discount rates and inflation rates (10 years and beyond), and blending between the above approaches for the mid-term (5 to 10 years).

The adopted rates for the June 2020 valuation, along with a comparison to the December 2019 valuation are shown in the following figure.

Figure 1: Economic assumptions as at 30 June 2020



The mean term of the outstanding claims liability was estimated to be 12.2 years on an inflated and undiscounted basis and 8.6 years on an inflated and discounted basis.

Finity estimated the premium liability of the NI to be $808m as at 30 June 2020. This figure includes a risk margin of 16.2% on the unexpired risk component, again with the intention of providing an estimated 80% probability that the unexpired risk liability estimate will prove to be sufficient.

The components of the premium liability as at 30 June 2020 are set out in the following table.

Table 2: Nominal Insurer premium liability as at 30 June 2020

Premium liability	Liability Estimate ($m's)
Total unearned premium reserve	**542**
Unexpired risk reserve	696
Risk margin (16.2%)	113
Total unexpired risk reserve	**808**
Required premium deficiency reserve	267
Premium liability	**808**

No uncertainty margin is included in the pricing basis for the NI which will, in general, lead to a premium deficiency when comparing the unearned premium to the expected future claim costs including a risk margin. Premium under-collection can also adversely impact the premium liabilities.

The premium liability at 30 June 2020 is lower than the comparable figure at 31 December 2019 as a direct result of the non-uniform pattern in which premium is written over the year.

The following table shows the estimated financial position of the NI as at 30 June 2020 where the liabilities are provisioned at the 80% probability of adequacy.

Table 3: Financial Position	($m's)
Investments	17,196
Outstanding claims recoveries	316
Other assets	1,632
Total assets	**19,143**
Gross outstanding claims liability (incl. CHE)	17,952
Unearned premium reserve	542
Unexpired risk reserve	267
Other liabilities	678
Total liabilities	**19,439**
Funding ratio	**98.5%**

The published results for the Nominal Insurer include liabilities expressed at the 80% probability of adequacy. The NI capital management policy has adopted the Target Operating Zone between 115%-135% at a 75% Probability of Adequacy (PoA). This range is based on the estimated APRA prudential capital requirement that would exist for the NI under APRA regulation. It does not include the additional capital an APRA regulated insurer would be required to hold to ensure it did not breach statutory minimums. The Target Operating Zone is broadly converted into 110-130% at an 80% PoA.

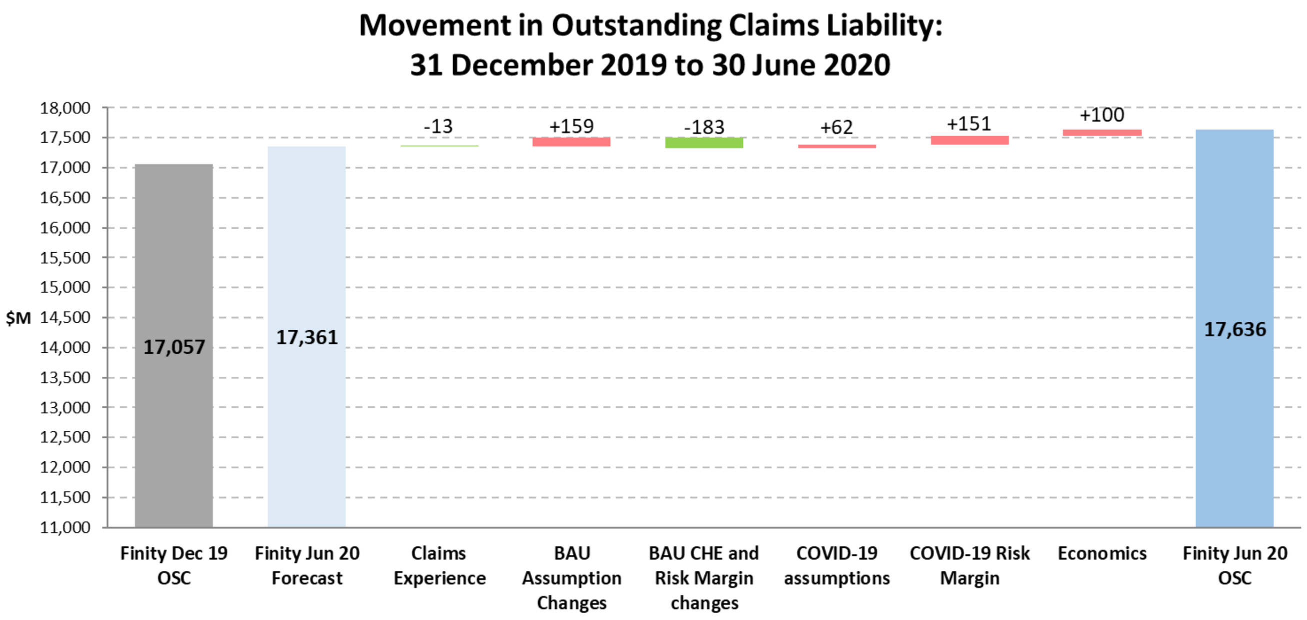
The funding ratio for the NI at 80% probability of adequacy has decreased from 104% as at 31 December 2019 to 98.5% as at 30 June 2020. This is largely driven by the impact of the COVID-19 pandemic on the value of investment assets and the outstanding claims provision. At the 75% probability of adequacy, the funding ratio for the NI would be 101%.

The funding ratio of 101% is outside the target operating range by 14%. The capital management policy requires a management action plan to return the funding ratio to the target range within seven years. icare is actively working on its key financial levers of claim cost savings via return to work improvements and medical cost containment, premium changes and expense savings. Claims experience will continue to be closely monitored so that icare management decisions can appropriately reflect emerging information.

Movement in results

The following figure shows the movement in the total outstanding claims liability between 31 December 2019 and 30 June 2020 split by the key components of the change. The figures are inclusive of risk margins intended to deliver an 80% probability of adequacy.

Figure 2: Change in the outstanding claims liability (incl. risk margin)



Relative to Finity's expectations at 31 December 2019, the outstanding claims liability estimate at 30 June 2020 has increased by approximately $275m, or 1.6%. The key drivers of the change were:

- Actual claims experience over the six months to 31 March 2020, which decreased the liability estimate by $13m mainly due to lower than expected weekly and medical active claims with high Whole Person Impairment (WPI), partially offset by higher than expected numbers of active claims with a low WPI..
- A $159m increase from changes to the pre COVID-19 valuation basis. The main movements were:
  - A $126m increase to allow for higher numbers of psychological injury claims with higher WPI.
  - A $84m increase for catastrophic medical claims largely to allow for expected increases in attendant care rates above inflation due to market pressures including the recent NDIS attendant care rate increases.
  - A $63m decrease due to faster Work Injury Damage (WID) claim lodgements leading to earlier weekly and medical exits for high WPI claims.
  - Other modelling and assumption changes totalling a net increase of $12m.
- A $95m decrease from revised claims handling expense (CHE) assumptions, in response to lower actual claims handling expense and budgeted claims handling expense savings.
- A risk margin review at this valuation has resulted in a lower pre-COVID-19 risk margin and a release of $88m. The reduction in risk margin reflects reduced uncertainty in relation to the financial impacts of the 2012 legislative changes, in particular section 39.
- A $213m increase due to COVID-19 impacts, consisting of:
  - A $119m decrease due to fewer anticipated claims in the June 2020 quarter during the lockdown period.
  - A $42m increase for deferred medical treatments. Whilst this increases the provision, it is not an adverse impact as it relates to the timing of treatment.
  - A $139m increase due to the COVID-19 economic impacts on return to work (RTW).
  - A $151m increase due to an additional 1% loading to the risk margin to allow for the increased uncertainty in return to work prospects for existing claims.
- A $100m increase from revised economic assumptions around inflation and discount rates. These changes are driven by a lower yield curve, only partially offset by lower inflation forecasts at 30 June 2020.

Uncertainties

Any estimate of insurance liabilities will contain elements of uncertainty. In the case of the NI these uncertainties are compounded by past benefit reforms, including but not limited to, the 2012 and 2015 reforms. The key uncertainties identified in the Finity valuation were:

- The COVID-19 pandemic has had unprecedented impact on people and the economy globally, and the financial impacts arising from it on the Nominal Insurer are very uncertain. To date, there have only been a small number of direct COVID-19 claims reported. However, COVID-19 creates uncertainty in overall claim numbers as the level of work done in certain industries will be impacted by potential future lockdowns and the economic downturn. In addition, the economic downturn and higher unemployment is likely to adversely impact claims costs due to poorer return to work prospect for existing and new claims.
- The long-tailed nature of the NI's liabilities mean that it is highly leveraged to risk free discount rates, the actual investment returns achieved and future inflation. Volatility in the current market environment, especially amid the COVID-19 pandemic can lead to continuing instability in both the liability estimates and the funding ratio outcomes.
- The increasing payments for catastrophic medical claims, which is driven by increasing attendant care rates due to pressure from NDIS. The valuation has made some further allowance for increases but there remains uncertainty around the future experience.
- The 2012 reforms made the degree of whole person impairment of an injured worker a key determinant of entitlement to ongoing benefits. It can take a number of years for the degree of whole person impairment to be determined, so there is considerable uncertainty around the ultimate number of claims with a high degree of whole person impairment for the more recent accident years.
- The *Workers Compensation Legislation Amendment Act 2018* changes the way disputes for Work Capacity Decisions and medical assessments of WPI are decided. This may influence the effectiveness of these processes and make future experience difficult to interpret.
- The increasing medical payments, which is driven by procedures such as surgery and inpatient services becoming more expensive and complex for the NI. Although the increase over the past 12-18 months have been moderate relative to the significant increases in the prior years, future inflation in medical payments may be higher or lower than the current valuation assumptions.
- The transition of claims between Scheme Agents and the implementation of the new claims service model from 1 January 2018 has made the claims experience for the more recent accident years more complicated to interpret.
- There is a long-term trend for more eligible claimants pursuing Work Injury Damages (WID). The more recent accident years have very little experience so far, and future levels of WID lodgement are uncertain.
- Residual uncertainty relating to the impact of the Section 39 benefit caps (the limitation of Weekly Compensation benefits to 260 weeks for injured workers with whole person impairment less than 21%). The assessments of whole person impairment through the icare initiated Workers Assistance Program are complete, but there is still uncertainty around the number of claims that will successfully dispute their whole person impairment assessment.

The above list is not exhaustive but does illustrate the uncertainty in the NI portfolio and the liability assessment process. Maintaining a sound funding ratio position is essential to ensure the ongoing ability of the NI to deliver on its commitments to the workers and employers of NSW. That means managing and mitigating the uncertainty in the estimates where possible and holding sufficient funds to protect against potential fluctuations where it is not possible.