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Nominal Insurer Liability Valuation as at 31 December 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 31 December 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 31 December 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 31 December 2020 Finity have estimated the discounted net outstanding claims liability of the NI to be $17,635m. This figure includes a 11.7% risk margin over and above the central estimate which has been adopted to provide an estimated 75% probability that the combined liability estimate will prove to be sufficient. The components of the outstanding claims liability as at 31 December 2020 are set out in the following table.

Table 1: Nominal Insurer outstanding claims liability as at 31 December 2020

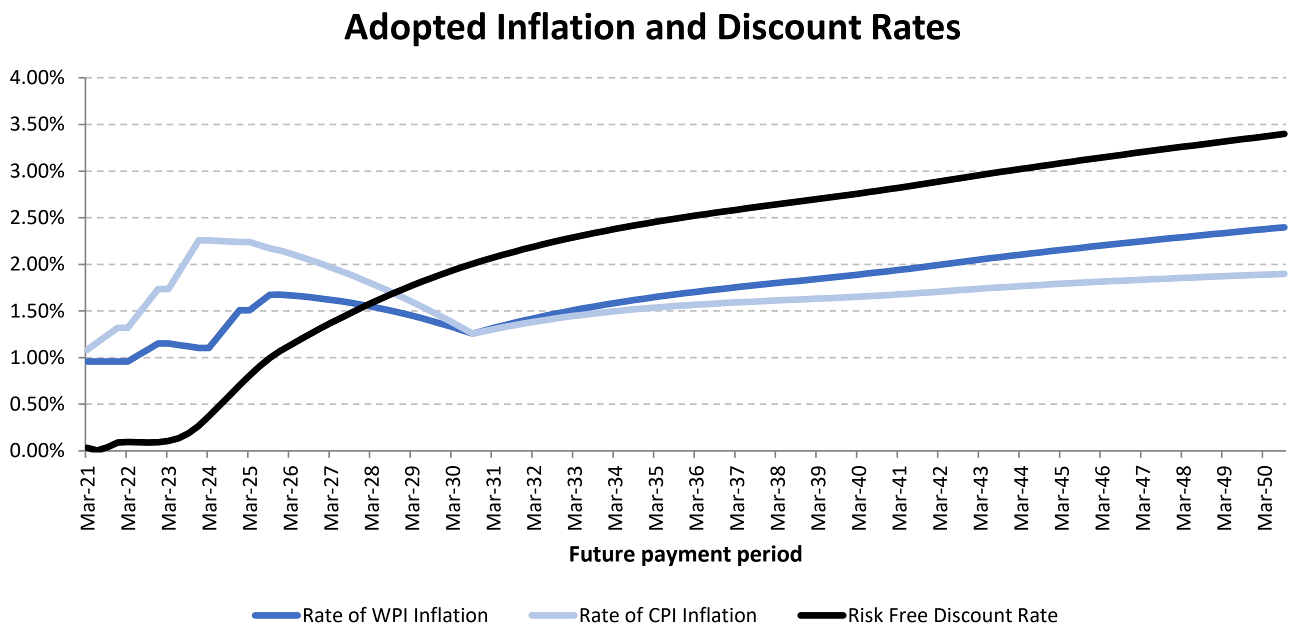
Table 1: Outstanding claims liability	Undiscounted Liability Estimate ($m's)	Discounted Liability Estimate ($m's)
Weekly compensation	5,045	4,648
Medical benefits	7,442	5,392
Work injury damages	2,684	2,611
Section 66 and 67	795	760
Investigation costs	275	260
Legal costs	205	194
Rehabilitation benefits	247	243
Commutations	133	112
Death	165	157
Other	275	223
Asbestos	194	144
Uninsured employers	212	170
Direct COVID-19	1	1
Gross outstanding claims liability	**17,673**	**14,915**
Tax recoveries	75	72
Other recoveries	183	180
Uninsured employer recoveries	35	28
Net outstanding claims liability (excl. CHE)	**17,380**	**14,635**
Claims handling expenses (CHE)	1,247	1,155
Net outstanding claims liability (incl. CHE)	**18,627**	**15,790**
Risk margin (11.7%)	2,177	1,845
Total outstanding claims liability (75% PoA)	**20,804**	**17,635**

The risk margin percentage of 11.7% brings the central estimate to a 75% Probability of Adequacy (PoA). This is a change from the 30 June 2020 valuation which had a risk margin of 15.6% with a Probability of Adequacy of 80%.

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 31 December 2020 as per accounting standard AASB 1023. 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 December 2020 valuation are shown in the following figure.

Figure 1: Economic assumptions as at 31 December 2020



The mean term of the outstanding claims liability was estimated to be 12.1 years on an inflated and undiscounted basis and 8.5 years on an inflated and discounted basis.

Finity estimated the premium liability of the NI to be $2,119m as at 31 December 2020. This figure includes a risk margin of 12.1% on the unexpired risk component, again with the intention of providing an estimated 75% probability that the unexpired risk liability estimate will prove to be sufficient.

The components of the premium liability as at 31 December 2020 are set out in the following table.

Table 2: Nominal Insurer premium liability as at 31 December 2020

Table 2: Premium liability	Liability Estimate ($m's)
Total unearned premium reserve	**1,332**
Unexpired risk reserve	1,890
Risk margin (12.1%)	229
Total unexpired risk reserve	**2,119**
Required premium deficiency reserve	787
Premium liability (75% PoA)	**2,119**

The premium liability includes a risk margin and is discounted using yields from Commonwealth Government Bonds as at 31 December 2020 as per the accounting standard AASB 1023. This is a different basis to the NI pricing basis which includes no margin and allows for investment income that is reflective of the NI's invested assets. This difference in basis means by accounting standards, the NI will always have a premium deficiency reserve.

The premium liability at 31 December 2020 is higher than the comparable figure at 30 June 2020 as a direct result of the seasonality effects of when NI policies are underwritten.

The following table shows the estimated financial position of the NI as at 31 December 2020 where the liabilities are provisioned at the 75% probability of adequacy.

Table 3: Financial Position	($m's)
Investments	17,609
Outstanding claims recoveries (incl. RM on recoveries)	312
Other assets	2,227
Total assets	**20,149**
Gross outstanding claims liability (incl. CHE and RM)	17,948
Unearned premium reserve	1,332
Unexpired risk reserve	787
Other liabilities	465
Total liabilities	**20,531**
Funding ratio	**98%**

The published results for the Nominal Insurer include liabilities expressed at the 75% 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. The McDougall review has made recommendations to review the NI Capital Management Policy and its Target Operating Zone. There is currently a review being carried out as per the McDougall review's recommendation.

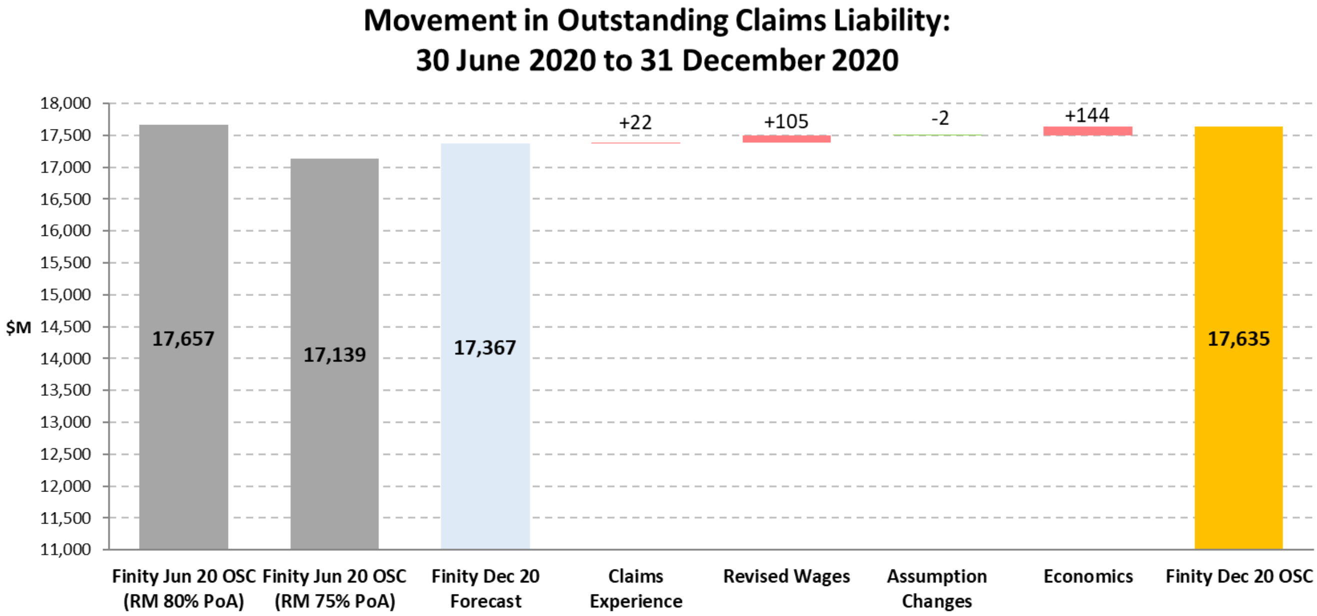
The funding ratio for the NI at 75% probability of adequacy has decreased from 101% as at 30 June 2020 to 98% as at 31 December 2020. This is largely driven by strengthening in outstanding claims liability due to recent claim experience and valuation basis changes described further below.

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 30 June 2020 and 31 December 2020 split by the key components of the change. The figures are inclusive of risk margins intended to deliver an 75% probability of adequacy.

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



Relative to Finity's expectations at 30 June 2020, the outstanding claims liability estimate at 31 December 2020 has increased by approximately $268m, or 1.5%. The key drivers of the change were:

- Actual claims experience over the six months to 30 September 2020 increased the liability estimate by $22m, mainly due to higher than expected weekly and medical active claims with low Whole Person Impairment (WPI), partially offset by lower than expected weekly and medical active claims with high WPI.
- A $105m increase due to higher than expected wages (proxy for employment activity), as COVID lockdown impact on wages was not as significant as initially expected. This would have an offsetting impact from more premium collected.
- A $2m decreases from changes to the valuation basis. The main movements were:
  - A $563m increase to allow for weekly and medical active claims with low WPI staying on benefit for longer durations.
  - A $284m decrease due to the recognition of fewer high WPI claims for accident years 2013-2016.
  - A $165m decrease due to the cohort of claims reaching higher WPI bands being slightly older than expected, which leads to earlier retirement and cessation of weekly benefits.
  - A $27m increase in claims handling expense (CHE) in response to higher number of active claims.
  - A $76m decrease due to a partial release of the additional risk margin held for COVID-19 due to reduced slightly reduced uncertainty of COVID-19 impacts on the scheme's claims.
  - Other modelling and assumption changes totalling a net decrease of $67m.
- A $144m increase from revised economic assumptions around inflation and discount rates. These changes are driven by a lower yield curve at early duration and higher inflation as forecasted at 31 December 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 continues to create uncertainty around claim numbers, the impact on return to work prospects for new and existing claims, as well as inflation and discount rates. There may also be potential future outbreaks which leads to additional compensable direct COVID 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.
- There has been an increase in psychological injury claims (stress claims) over the past few years. These claims have significantly longer durations and higher costs associated. The extent of the growth in psychological claims continues to be uncertain.
- Claim costs have been higher in recent accident years following lower return to work rates. The valuation assumes the recent experience continues into the future but actual return to work rates could be better or worse than currently assumed in the valuation.
- 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 increase in number of weekly claims remaining active at five year duration could also put pressure on the 15% and 21% threshold levels as more claims will reach higher WPI bands and receive longer weekly and medical benefits.
- 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 two years 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.
- 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.
- 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.
- 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.