Private insurance in the work account

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The government is considering introducing private insurance as an option within the ACC Work Account. The ACC itself would remain a part of the market for the provision of workplace accident insurance cover, and would be the default insurer.

This falls well short of the ACC “Stocktake” Steering Group recommendations. They recommended private insurance of workplace injuries, non-work injuries to employed people, and for motor vehicle accidents, but with no role for the ACC as a competitor in the market. ACC would be confined to managing residual claims for accidents that occurred before private insurance cover took effect.

The matter of the market scope involved in the options needs to be clarified at the outset.

ACC is big business in the insurance market. Depending on whether residual levies for earlier accidents are in or out of the comparison, ACC levies are equivalent to 72% or 92% of the other major lines of private insurance sold in New Zealand. Residual claims are an important part of any future scenario for private insurance of accident insurance, and I will come back to that.

In summary, private insurance premiums¹ now collect (per annum):

<table>
<thead>
<tr>
<th>Insurance Type</th>
<th>Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial, Marine and Earthquake</td>
<td>$ 770 m</td>
</tr>
<tr>
<td>Health, Disability and Income Replacement</td>
<td>$1,100 m</td>
</tr>
<tr>
<td>Motor vehicles</td>
<td>$1,250 m</td>
</tr>
<tr>
<td>Domestic</td>
<td>$ 790 m</td>
</tr>
<tr>
<td>Liability and Professional indemnity</td>
<td>$ 280 m</td>
</tr>
<tr>
<td>Other general insurance</td>
<td>$ 320 m</td>
</tr>
</tbody>
</table>

**Total** $4,510 m

By way of comparison, within ACC, the levies in the various accounts are:

<table>
<thead>
<tr>
<th>Account</th>
<th>Levy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Work Account</td>
<td>$ 540 m</td>
</tr>
<tr>
<td>Earners’ Account (including small residual levy of $18 m)</td>
<td>$1,112 m</td>
</tr>
<tr>
<td>Motor Vehicle Account (excl. residual levy)</td>
<td>$ 346 m</td>
</tr>
<tr>
<td>Motor Vehicle residual levy</td>
<td>$ 393 m</td>
</tr>
<tr>
<td>Non-earners Account</td>
<td>$ 982 m</td>
</tr>
<tr>
<td>Treatment Injury Account</td>
<td>$ 315 m</td>
</tr>
</tbody>
</table>

¹ 2009. The insurance market is in a state of flux after the Christchurch earthquakes. Equally, ACC levies may be jumping around as the Corporation consults on substantial reductions for some future levies. All figures from the Stocktake Report, p39.
Residual Claims (for work injuries) $ 496 mill

Total (excluding residual levies) $3,276 mill

Total (including residual levies) $4,183 mill

The residual levy matter needs to be addressed in any assessment of the introduction of private insurance. It is a big part of the total ACC cash requirement – a little over a quarter. The “easy” solution is to see this as a legacy matter. It can be represented as being the cost of claims that emerged when ACC was not fully funded, and hence to be covered through some generic funding source: a levy on all insurers, a discriminating levy on sub-insurers (work, motor vehicles), or through direct government subsidy.

The trouble is it is not a linear, declining liability. It is a volatile liability. The residual liability can be seen as the difference between the future costs of past accidents minus the assets that ACC holds to cover them. But both assets and liabilities can move substantially from year to year.

In the case of assets, that was very evident during the global financial crisis, when asset values collapsed and bounced back. In effect, all future finance market risk has to be allocated to some defined party, or it will simply fall back on the injured person: when the funds run out!

With liabilities, the current cost of meeting entitlements to compensation and rehabilitation for past accidents requires the application of a discount rate. Simplifying for purposes of explanation, the assets that ACC holds will earn interest up until the future cost is met in 2, 3 or 10 years time. Hence the assets needed to cover that future cost can be smaller than the actual $ needed at the future date. If interest rates fall, the current level of that future liability will rise and if they rise, the liability will fall. Because interest rates are volatile, the liabilities that have to be covered rise and fall.

Looking at ACC as a part of the insurance market therefore has to regard residual claims cost as part of the ongoing revenue requirement.

There are some interesting ironies in the scale of ACC levies compared to the existing private insurance market.

- The roughly $1 billion of Work Account plus residual claims would more than double the current “Commercial” insurance book.
- The Earners’ Account would similarly double the amount that insurers currently cover through health, disability and income replacement insurance.
- Motor Vehicle insurers would get a 60 percent revenue boost if they also covered motor vehicle accidents.
If treatment injuries had to be insured against in like manner to Professional indemnity insurance (like in the USA), again that part of the market would more than double.

Hence there is a “prize” that market participants could well seek to capture. The current proposal out for consultation does, however, fall well short of the Steering Group’s target market.

- It takes the Earners’ and Motor Vehicle accounts off the table, and
- Leaves ACC as a player in the market, and crucially as the default insurer (crucial because there is a vast literature in the area of Behavioural Economics that concludes that inertia means that the default position in a market tends to dominate it).

We need to know now if this pared back private insurance option will work. If it does, will it provide ammunition for advocates of more expansive insurance cover? If it fails, will it provide ammunition for advocates to suggest that the proposal was too timid and that a more aggressive option is required (such as by taking ACC out of the market)? Was it designed to achieve either result with either intended end game?

I can’t answer this last question: that is for conspiracy theorists to speculate on. What I can say is that the current proposal cannot work.

For any market to work, we need participants in it:

(a) to know the rules of the game that they are going to have to play by (regulatory certainty in the jargon) and
(b) to have some pricing margin within which to construct competitive price and quality product offerings.

The longer the forward commitment of contractual obligations is, the more important the certainty of the regulatory environment becomes. With compensation for loss of earnings arising from injury, that forward commitment can be very long indeed: several decades in fact.

The greater the front end sunk cost of establishing a position in the market is, the greater the pricing margin needs to be in order to attract entrants to it.

I would argue that with private insurance in the work account:

(a) there is a huge level of regulatory uncertainty, which cannot be entirely clarified prior to – and indeed during – the operation of a competitive market; and
(b) there is virtually no pricing margin that competitors can work with.

With due deference to Donald Rumsfeld, potential competitors have to consider known unknowns and unknown unknowns.
Known unknowns are

When, if and to what degree residual claims shortfalls will emerge, and how the costs of meeting them will be shared between insurers.

How gradual process injuries will be paid for, especially if the original accident was with another employer or if the employer was with another insurer when it occurred.

The basis on which the costs of public health and emergency transport services will be allocated across insurers.

The nature of the special prudential regulatory regime that will apply to the insurance of personal injury.

The cost of the administration and regulatory regimes and how they will be recovered.

If, when and to what extent insurers will need to contribute to meeting the claims against failed insurers.

Unknown unknowns

Almost by definition this list cannot exist, but even government officials note (in the Regulatory Impact Statement that accompanied the Cabinet Paper that “it is possible that there are potential impacts or risks that have not been identified or adequately considered”.

Two possible unknowns are:

(a) whether there will be capacity and appetite within the global reinsurance market to reinsure risks of catastrophic events; and
(b) what sort of risk margin will need to be built into premiums to satisfy investors that there is adequate protection for their capital.

Pricing margins

Pricing margins exist:

- **below** the levy rate that ACC charges employers; and
- **above** the relative returns required to pay taxes due and earn an acceptable return on capital invested.

On any reasonable assessment, this pricing margin is negative.
Levy rate

At present, employers who have good accident prevention and rehabilitation systems in place can – provided they meet some audit requirements – opt in to the Accredited Employer Programme, which allows them to self insure for up to four years of cover.

In theory, they should be able to match what a private insurer can offer by way of price through AEP, so there is no margin for a private insurer to undercut. Despite that, participation in the AEP has been declining by about six percent a year for the last four years, which on the surface suggests that ACC levies are close to what is achievable in a competitive market.

Since April 2011, ACC has introduced compulsory experience rating of premiums, which can qualify employers for discounts of up to 50 percent of standard industry levies. Experience rating should mimic private competitive premiums if both prices (ACC and private insurers’) are efficient. It is hard to see a private competitor beating the industry average by more than 50 percent, for non AEP participants, and make a return on any investment in this market.

ACC is consulting on reducing levies by another 22 percent on average in the 2012/2013 levy year. Any perceived pricing margin is about to get a haircut!

Minimum return required

As a Crown Agent ACC does not need to pay taxes or return a dividend to the Crown. On the other hand it is customised insurer, and cannot bundle work accident insurance with other insurance products like fire, loss of profits and such like to offer a package to potential clients.

Government officials estimate that the tax and dividend needs of private insurers to equate to around 20 – 25 percent of premium charged.

The advantages of being able to offer bundled products would need to be greater than 20 percent to offset the pricing advantage of a Crown Agent. That is simply not plausible.

A harmless experiment?

So why not just give it a try?

Regardless of whether there is any ex ante case that a competitive market can offer positive benefits, it could be argued that it is an insurer’s choice on whether to enter a market or not. If they choose not to – for all the lack of profitable opportunity described earlier – no harm is done: the ACC is there as a default insurer.

The risk here is that while this is what the government is consulting on, it is not what the Stocktake recommended! The Stocktake wants the ACC out of the market.
If there is no statutory default insurer, the market will clear at a profitable level of price and quality. The risk is that the clearing price might well be – and probably will be – higher than the status quo, but a much bigger risk is that the market will trade profitably by eroding the entitlements of the injured worker – regardless of what the law may say.

This is because at the end of the day, if entitlements cannot be met out of premiums, there will simply be no money to meet them, and it is not viable to envisage private individuals suing insurers who have long since exited the industry for the costs of injuries received decades ago!

Here we come back to the fundamental nature of what is being insured. The private insurer is not insuring the employer against meeting the cost of workplace accidents. The law has already absolved the employer from legal liability for those costs per medium of the no-fault nature of ACC. The law then stands in the shoes of the injured claimant by requiring the employer to pay levies to ACC (or self insure through AEP) to meet statutorily defined – and limited – obligations. (Contrast this with the Hot Coffee movie example).

If the employer can pass the obligation to meet claims on to a private insurer, receiving statutory entitlements becomes a complex process involving claimant, insurer, regulator and central claims handling manager. As time goes on, enforcement becomes more and more tenuous: who was the employer at the time, who was the insurer at the time, has the insurer exited the industry or merged with another, how have the costs of unmet claims been reallocated among remaining insurers and so on. The employer is out of it. The claimant is trapped in a web of contractual and regulatory enforcement authorities.

The advice the government received.

The government’s advisors cautioned it (inter alia), that with private insurance:

- “there is a high degree of uncertainty regarding the magnitude of both the costs and benefits (and in some cases even the sign – whether they will have a net positive or negative impact...” and

- “better pricing signals to employers can be achieved through experience rating and self-insurance arrangements”.

Perhaps ominously, Treasury advised the government that “the minimum mandated cover requirement – which is necessary to protect the rights of claimants and the liability of the Crown – means that we may not be able to capture all the benefits of a truly competitive insurance market”. Turning that advice around, it is not too hard to conclude that if “we” (identity not established) want to capture all the benefits of a truly competitive insurance market (not specified) then minimum mandated cover requirements need to be reduced. And that in turn means weaker protections of the rights of claimants and the liability of the Crown!

So why
If all of the analysis and advice points to private insurance being a second best solution to improving the efficiency of workplace accident protection, why is this proposal still getting active consideration?

I would offer three speculative explanations:

- The government’s election manifesto said it would look at this option, and it is simply doing that. If it doesn’t stack up, it won’t go anywhere. No conspiracy!

- If the current proposal doesn’t deliver positive results, structural changes to make private insurance might be needed. These could include reducing the entitlement of injured workers, converting ACC into a SoE so that it would have to earn a return on capital and pay tax and dividends, and/or taking ACC out of the market. If this is the scenario, “set up to fail” looks possible, but it is not really credible. The changes needed to make the market work would raise levies, so it seems the cure is worse than the disease.

- If insurance in the work account can’t work, the alternative would be to go the whole way with the Stocktake: throw the Earners and Motor Vehicle accounts into the pot and take ACC out of the market. This is the “prize” of a “set up to fail” scenario. There is no detail of how such a market would work (and in particular it seems impossible to deliver private insurance of non-work injuries through a competitive insurance market when compensation is comprehensive and no-fault) but if the market is always best, that is a mere detail!

My preference is always for process failure over conspiracy to explain bizarre policy pathways, but maybe I am naive.