

# Focus NZ:

*Prospects on the horizon...*

## ***Competition in the Work Account and Getting the most out of your Financial Condition Report***

It's been a very sad year for New Zealand. And a very busy one as well. Apart from having to deal with the trauma and additional work resulting from the devastating Canterbury earthquakes, New Zealand insurers have also had to wrap their heads around the new prudential regime and start thinking about what to do when, and if, the ACC Accounts are opened up to competition.

In this *Focus NZ* special edition of the Taylor Fry newsletter we take a close look at these changes in the world of New Zealand insurance.

We draw your attention to the Financial Condition Report (FCR): a key aspect of the new insurer prudential regime.

FCRs are about to become a mandatory part of the New Zealand insurance year. More than just a compliance exercise, FCRs can be a valuable management tool. We take you through what you can learn from your FCR and how you can really make them work for your business.

And, of course, the Accident Compensation Corporation (ACC) accounts. The NZ Government has just wrapped up its period of public consultation and is now deciding if and how to open up the Work Account to competition. With the proposed date looming — it's just over a year away now — we hone in on the ACC Accounts from an insurer's perspective. Is it a viable option? And how can you really make it pay?

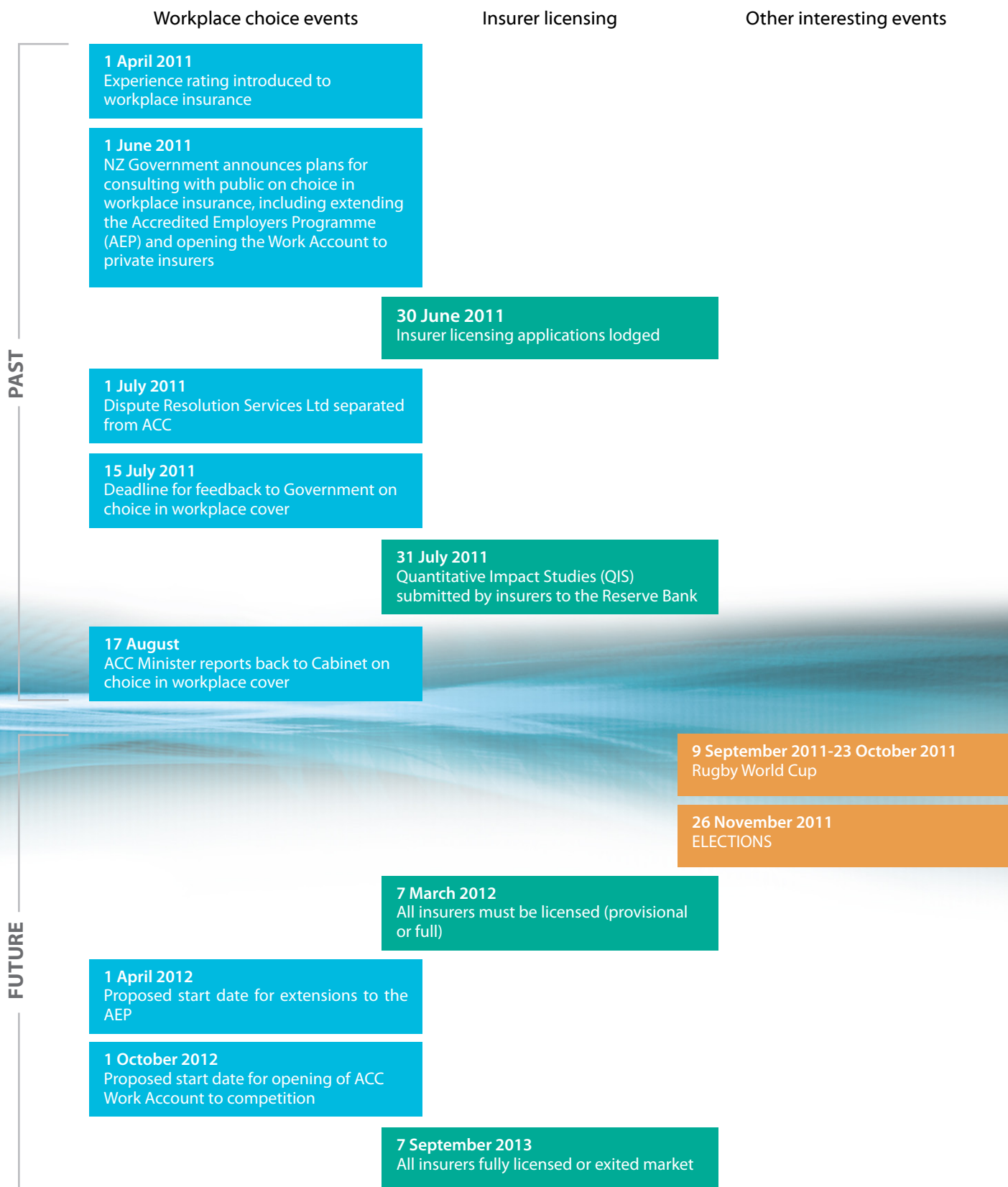
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# What's up in New Zealand insurance: a snapshot

The diagram below offers a snapshot of the significant dates for New Zealand insurers. And, unable to help ourselves, we've put in the World Cup as well..... (for those of you interested in some mathematically derived World Cup tips, check out our TF World Cup newsletter: <http://www.taylorfry.com.au/newsletters/RugbyWorldCupFinal.pdf>).



# The Financial Condition Report (FCR) – compliance or management tool?

The new prudential regime in NZ is now well underway, with many insurers having recently lodged their applications for provisional licences, in preparation for obtaining their full licence by September 2013. And of course, those who didn't apply for the provisional licence will be busily preparing to obtain a full licence by March 2012. In other words, full steam ahead for everyone!

One of the key changes that comes with the new licensing arrangement is the introduction of mandatory annual financial condition reports (FCRs). But, don't worry, the FCR isn't just more paperwork for insurers; in fact, if you approach it in the right way, the FCR has the potential to be a valuable addition to your management toolbox.

In the following, we turn the Taylor Fry spotlight on FCRs: what are they, when are they due, what can you learn from them, and how can you make sure they really work for you?

## ■ *What is an FCR?*

An FCR is an annual compliance report for all general insurers. The FCR works like a snapshot of your current financial condition, and provides the basis for an objective assessment of the key financial risks and issues affecting your business.

Basically, any facet of an insurer's operations that may impact on the financial condition (and this may include anything from reinsurance arrangements, to underwriting, IT and so forth) can be included and assessed in the FCR.

So, FCRs are about to become a normal part of insurance life in NZ. The FCRs you'll be submitting will have to do the following:

- Identify, describe and quantify material risks that pose a threat to your ability to meet the solvency standard.
- Assess capital charges and your solvency position, including a three-year forward projection.
- Comment on any differences in outstanding claims provisions to those determined under NZ IFRS 4, with a 75% sufficiency margin.
- Comment on the basis for outstanding claims and unexpired risk, and whether an additional risk charge is appropriate.

You can find further details of the required content of the FCR in the Draft Non-Life Solvency Standard Consultation Version May 2011 issued by the Reserve Bank:  
<http://www.rbnz.govt.nz/finstab/insurance/4482245.pdf>

FCRs have to be prepared by your appointed actuary (AA). The New Zealand Society of Actuaries is also in the process of drafting a new professional standard that covers the issues to consider and the components required in the FCR.

The power of the FCR is that, by drawing all facets of your business together, it allows you to understand what you are doing right, and to identify and begin to address what you are not.



## ■ **When do I have to lodge my FCR?**

### *For the first time?*

As may be seen from the timeline on page 3, we are now in the middle stages of implementation of the new regulatory regime in New Zealand.

The regime will be fully up and running by September 2013, when all insurers will have to have a licence or exit the market. According to the Reserve Bank, all insurers will have to lodge their first FCR within five months of their balance date in 2012.

### *When it's business as usual?*

Once the new regime is up and running, the FCR will become an annual requirement. Your appointed actuary will have to prepare and submit your FCR to the Reserve Bank, along with your annual solvency return, within five months and twenty days of the financial year end.

So, as you'll see from our comments below, this means you'll have an annual opportunity to comprehensively review your financial condition and tighten up your business performance.

## ■ **What can I learn from my FCR?**

The thrust of an FCR is to summarise your financial position. This entails not just a review of your current capital position, but an examination of your recent history and your future outlook. When looking at your recent history, the FCR typically examines profitability, underwriting, investment and capital. And by examining your past business plans and comparing these with your actual outcomes, your appointed actuary is able to comment on your track record.

FCRs have been a feature of the general insurance prudential regime in Australia for over five years. We've found that many insurers have come to recognise that FCRs are much more than just another compliance task. In fact, in our experience, many Boards and management have come to welcome the FCR. This is because it coherently and consistently draws together all financial aspects of their operations in one report and gives their AA a perfect opportunity to provide insights into their business.

Below we outline some of the key ways in which your FCR can help you gain a greater understanding of your business.

### *Know your threats and opportunities*

Your AA will be able to make informed comments about the threats and opportunities you are facing, and your capacity to capitalise on the opportunities and withstand the threats. Key financial risks to your operations are conveniently set out and reviewed in one document.

### *Learn from the past*

The comparison of your previous business plans with your actual experience often highlights recurring factors that were not apparent when the plans were made. Actuarial review can often identify those factors and measure their financial impact on your future projections. For instance, in the actuarial valuation of your claims liabilities, your AA can identify what aspects of experience (numbers of claims, gross costs per claim or recoveries) caused claims costs to differ from projections, and so factor the impact of these differences into future financial projections.

### *Review your pricing process*

Another very useful output from an FCR is a review of your pricing process. This review incorporates all of the factors of claims cost identified above, including the outlook for claim frequency and claim size. It also includes a review of other elements of the pricing process such as expenses, investment returns and past profitability.

### *Bring everything into line*

Perhaps the greatest benefit that we have observed from FCRs is the assurance that all aspects of an insurer's operations are being managed in a consistent way: that business plans are consistent with historical performance; that premiums reflect the trends observed in the reviews of claims costs; that reinsurance strategy is consistent with projected net claims costs; and, that capital management is consistent with all other aspects.

And, of course, and perhaps even more importantly, when all aspects of an insurer's operations are not being managed in a consistent way, the FCR process enables identification of the inconsistencies. This has been of great assistance in remedying them.

## **How can I make the most of my FCR?**

In our experience — and we've undertaken a fair few FCRs over the years now, as appointed actuary to over 20 general insurers in Australia, and submitted our first FCR for an insurer in New Zealand — there are a number of actions you and your appointed actuary can take to ensure that your FCRs go well beyond compliance and deliver real value.

Here are our key pointers.

### *View it positively*

It's understandable for management to be apprehensive of the FCR. An FCR, being an independent and objective review, has the potential to be critical of aspects of your operations. Furthermore, the FCR often has a high degree of visibility, being read by the Board, auditors and regulators.

However, the FCR can be a vital component in your toolkit: as mentioned, your AA can use his or her experience to identify your strengths and weaknesses, and, on the basis of this, make recommendations that form important input to decision-making by Board and management.

If you're honest and open, and actively ask questions about what you are or are not doing well, you'll get a lot more from the FCR process. The early identification of weaknesses, and being able to put in train actions to address them, can ultimately only be a good thing. And by knowing what you're doing well, you'll be able to keep these aspects of your financial operations functioning optimally.

By the second or third FCR, insurers with this attitude have often strengthened their strengths and turned their weaknesses into strengths.

### *Be proactive*

We've found that insurers who ensure that a range of executives are engaged with the appointed actuary right from the get go tend to get a lot more out of the FCR. Meeting with your actuary at the outset to discuss what you would like from the process, and making sure that he or she is aware of areas that you would like to receive specific attention, makes a big difference. For instance, you might be particularly interested in the communication channel, and quality of information flow, between your underwriting and claims teams. Once you've alerted your AA, he or she can ensure that special attention is paid to this aspect of your operations during the FCR process.

The FCR can cover a lot of ground and providing some targeted areas for attention makes sure that the process goes beyond pure compliance and gives you real management value.

### *Engage your board and management*

Where the insurer's Board is genuinely interested in the FCR and management activities, and management have a similar attitude to understanding and addressing the issues raised by the FCR, valuable outcomes can be achieved. Get your actuary to present clearly his or her findings to Board and management, and actively involve yourself in how you can best act on the recommendations.

### *Involve your actuary in business operations from the word go*

In general, if you leave your engagement with the FCR process until the last moment, when your accounts and year-end processes are largely done, you'll lose much of the opportunity to benefit. Undertaken in this way, the preparation of the FCR becomes a rushed activity of reviewing documentation rather than a considered review of business operations. By including the FCR as an integral aspect of your year-end processes you'll make sure that you get real value from it.

## ■ *Where to from here?*

Given the potential to learn from your FCR, you could consider doing a trial run of the FCR process before it becomes mandatory. A trial would ensure that your systems are well set up in preparation, and that you are able to gain the most from your FCRs.

If you would like to discuss any aspect of FCRs or the prudential regime in New Zealand, feel free to get in touch.



# Open for business?

## What you need to know about the ACC Accounts

The New Zealand Government has undergone a period of consultation with the public on choice in workplace cover, with the Minister for the ACC, Hon Dr Nick Smith, reporting back to Cabinet in August this year. The proposed start date for the opening of the ACC Work Account to competition is just over a year away, on 1 October 2012.

In this section of the *Focus NZ* Taylor Fry newsletter we talk you through the key issues that you need to consider before deciding if and how to make the most of this opportunity.

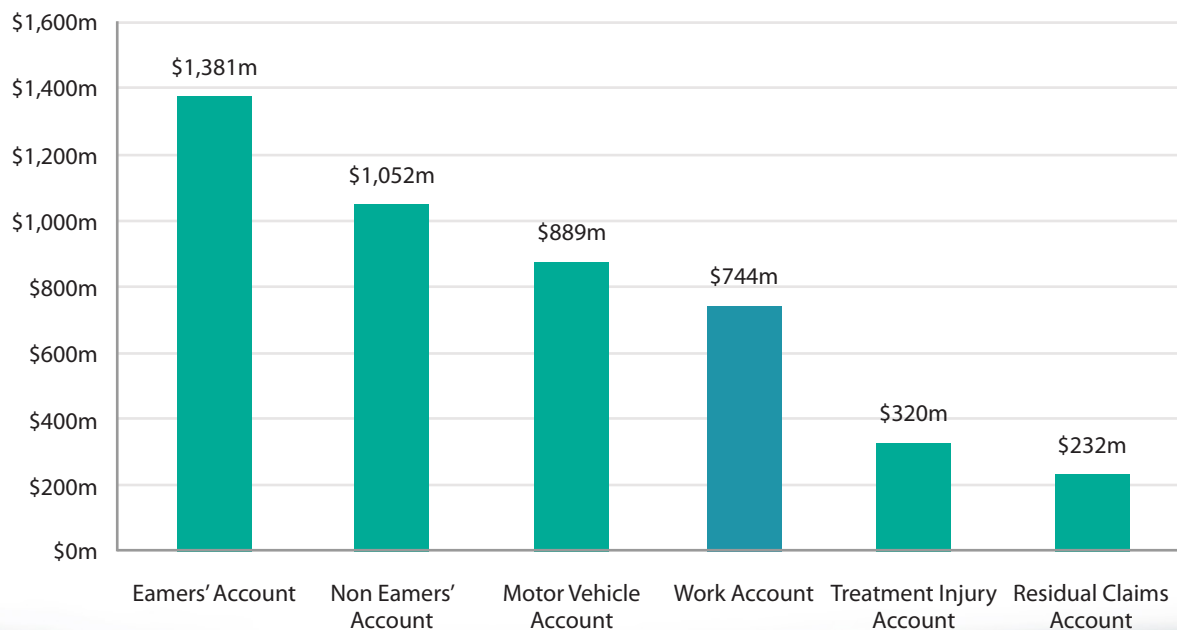
Of course, before you get too excited, we'll have to wait for the NZ elections... depending on the outcomes of this, and any election promises made in the interim, anything could happen in terms of the proposed reform. Many of us will recall the privatisation of the ACC Work Account back in 1999 that was rolled back after a year. So in addition to the issues we explore below, you'll need to make a call on the likelihood of the reform proceeding and the likely longevity of the private market before committing to the fixed costs involved in establishing a market presence.

### ■ *The ACC: what's on offer?*

At first glance, the opening up of such a significant market is an appetising prospect for insurers. In the financial year 2009/10, the ACC collected NZ\$744 million in levies on the Work Account. This represents around half of the entire privately underwritten workers' compensation market in Australia. And there are signs that the other levy paying accounts might also be similarly opened later on down the track. There are also proposals to open the high cost claims and stop loss covers required by employers participating in the Accredited Employers Programme (AEP)<sup>1</sup> to private insurers.

The chart below shows the levies received by ACC on the various accounts over 2009/10.

*All up - levies of NZ \$4.6billion*



1. The AEP is a risk-sharing arrangement, where employers take responsibility for the direct costs of injuries and managing claims for a set period, in return for a lower levy.

Adding all of this to the mix, there looks to be some pretty exciting prospects indeed...

## ■ *Is the ACC good business for my business?*

While at first glance taking on the ACC Work Account certainly represents an exciting opportunity, there are two key issues that you'll need to consider before tackling this market. Is this the market for you? And if it is, then how can you make sure that you make the most of it?

In what follows we outline the key questions that insurers who are considering entering the market need to ask about the ACC Accounts. Even if you're an insurer with experience in similar markets (for instance if you have Australian operations or 'parents' who have participated in the reasonably mature markets for workers' compensation and CTP across many of the Australian states), there are issues unique to the proposed New Zealand scheme which will be essential to consider.

### *Know your data*

Access to good historical claims data will be invaluable in helping you to decide whether or not to enter the market, and if so, how to enter, set initial prices and develop products. Thankfully the New Zealand Government has promised to give insurers access to the relevant data in relation to the Work Account. This data will cover historical claims and their costs, with only the identifying details of the individuals involved removed. So with luck you'll have access to comprehensive de-identified records, such as exposure and claims transaction files, with exposure files including information specific to each risk underwritten over past years.

To make the most of this information you'll need sufficient time for processing, and the subsequent development of pricing strategies. We believe that this would require the database to be made available at least six months before the commencement of underwriting, i.e. by 1 April 2012 at the very latest.

### *Know your potential market*

Clearly, the prospect of entering the market would be more attractive if other accounts were also opened to private insurers. Unfortunately, at this point we remain somewhat in the dark – while the possibility of other markets being opened up has been signalled, at this stage there are no definite proposals on the table.

### *Know your long-tailed classes*

As a private sector insurer in New Zealand, you'll be confronted with the prospect of underwriting long-tailed lines of business with little-to-no prior local experience. When compared to the mostly short-tail classes written to date in New Zealand, the long-tailed nature of the liabilities for accident compensation involves significant delays between setting premiums, claim reporting and claim settlement. In such a context, effective claims management becomes even more vital to ensure cost containment.

### *Know your potential market share*

The annual Work Account levies may be over NZ\$0.7 billion, but the attractiveness of entry to the market depends on how much market share the private sector, and the particular insurer, is able to attract and retain. To this end, it's worth bearing in mind the following points.

Firstly, your potential market share will be impacted by the presence of ACC as a competitor, and the arguably preferential terms on which it competes i.e. no tax, no requirement for a return on capital, or indeed even a requirement to hold any capital. That said, the Government's proposals do attempt to mitigate this, and include measures for greater transparency to the market of ACC's management of the Work Account. These include having a funding policy that has similar approaches to private insurers in terms of matters such as funding horizons, risk margins and discount rates.

Secondly, your pool of potential corporate clientele may be significantly reduced by proposed reforms to extend the Accredited Employers Programme to more employers – these reforms include reductions to compliance costs, providing a greater range of time periods that the employer can manage the claim before passing onto ACC, and enabling lower levels of reinsurance for individual high cost claims and stop loss. These changes have a proposed start date of 1 April 2012 and may make partial or complete self-insurance a more attractive option for the corporates. What's more, your ability to target the more profitable segments for corporates who do remain in the scheme will be compromised by the reduction in cross-subsidies offered by experience rating (introduced in April this year).

### *Know what you can charge*

When it comes to pricing strategies, you'll need to look at what, if any, remaining restrictions there'll be on the price that can be charged. Since premiums are calculated in terms of risk cost, expenses and profit allowance, it'll be important for you to have a sound grasp of the probable expenses related to each line. Although expense data will also be available from the scheme, this is unlikely to be helpful to private sector insurers, since underwriting only fractions of the total scheme would cause overheads to differ from the ACC's.

When setting your premiums, we suggest you take into account the experiences of other national insurance industries with experience in these lines of business. But when drawing comparisons, be sure to compare like-with-like and take account of relevant differences. For instance, many Australian state schemes deliver a substantial proportion of income compensation in the form of lump sums, whereas ACC claims are generally of longer duration, and so claims management is typically more labour-intensive and costly. Some Australian schemes do provide long-term income compensation and are therefore more useful to broadly compare with the ACC scheme.

### *Know your capital needs and your profit potential*

The underwriting of any bodily injury lines of business will change the capital scene considerably for New Zealand insurers. These lines of business are capital-heavy, and underwriting them will cause a substantial increase in the required capitalisation of insurers. This factor will in turn interact with the Minimum Capital Requirements under the insurance prudential regime, which will be fully effective from 7 September 2013.

### *Know your regulatory requirements*

All insurers in this market will need to be registered under the Insurance (Prudential Supervision) Act 2010, and will be subject to prudential regulation that reflects the particular features of work-related personal injury insurance. These features are compulsory continuous cover, stipulated statutory minimums, and the long-tail of claims that must be fully funded and paid out.

## Where to from here?

After reviewing the feedback from the recent consultations with the public, the Government will make decisions on how to proceed. Hopefully, there will be greater clarification on the above issues which will enable you to better plan what actions to take. It is expected that there will be further opportunity to comment on any proposed changes to regulation or legislation then.

Watch this space. We'll make sure we keep you posted.

*The Taylor Fry Team*

## About Taylor Fry

Taylor Fry is an Australian-based actuarial and analytics consultancy with strong New Zealand connections. We specialise in providing actuarial, financial modelling, statistical and related policy advice to business and government.

We currently hold over 20 Appointed Actuary roles with insurers across a broad spectrum of size and specialty.

We're also a major specialist provider to both Australian and New Zealand Government accident compensation schemes, departments and agencies at all levels.

Our involvement in both markets has given us a broad yet deep understanding of the Australian and New Zealand accident compensation market.

If you've got any questions regarding the information in this newsletter, or our services in general...

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