Key market trends in general insurance

OVERVIEW

Australian insurers reported improved operational results in 2012 on the back of lower levels of catastrophic climatic activity as the insurance industry recovers from the large claims of recent years.

Insurance brokers remain the linchpin in the general insurance industry, but are seeing their slice of the market wane, as direct insurance becomes increasingly popular with younger decision-makers.

FEATURED INTERVIEWEES

Mike Hooton
Group executive, agency services, Calliden

"Despite the positive response from the industry to the natural disasters, the industry's image is still poor and there needs to be a concerted effort by all parties to change this."

Marc Chiarella
Special counsel for insurance, Colin Biggers & Paisley

"There has been significant expenditure by insurers on technological systems to improve operational efficiencies and ensure the collation of comprehensive, accurate and streamlined management information."

LEARNING OBJECTIVES

After reading this article you should be able to:

- Describe the external factors which impact on the insurance industry and how these have manifested in recent years.
- Outline the internal factors and initiatives launched by the insurance industry in reaction to the external factors and emerging challenges.
- Review the role of insurance brokers in terms of its evolution and future issues.

KNOWLEDGE AREAS AND ACCREDITATION

Knowledge area: General Insurance (30 minutes).

FPA CPD points 0.5 Dimension: Capability (FPA 005931).

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EXTERNAL FACTORS

Like all industries, the insurance sector is affected by external factors which are out of its control. Of key concern is the damage caused by natural disasters and the large claim settlements that are made as a result. This, in turn, has led to escalating premiums and an increased cost to insurance companies seeking to reinsure their risk.

Weather

“The main external factor which has impacted on the industry in the last five years has been the frequency and severity of natural disasters,” Calliden’s group executive for agency services, Mike Hooton said.

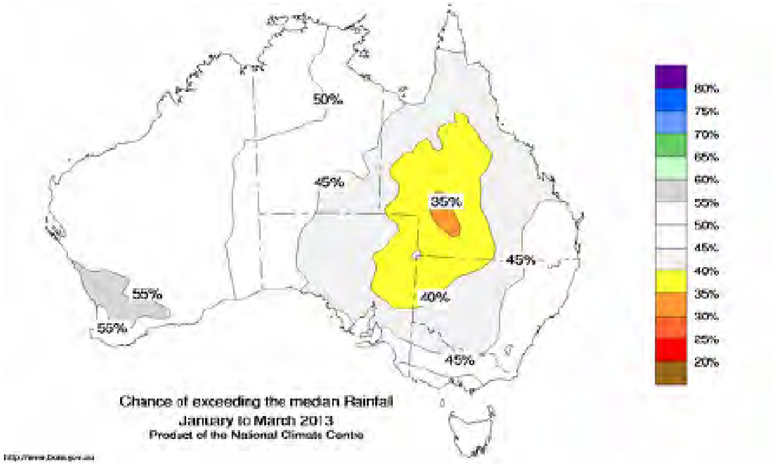
“This has resulted in higher catastrophe reinsurance costs and higher net retentions and less certainty around future individual insurer performance and the industry as a whole.”

Hooton explained that weak investment returns have also impacted insurers’ results and intensified the need for more disciplined underwriting and pricing, including rising premiums to counteract the impact of increased claims. Decreases in the assumed discount rate have also had a bearing on future claims reserves and reported insurer profitability.

The *J.P. Morgan Taylor Fry General Insurance Barometer*, released on 31 January 2013, suggests a shift to more "neutral" climate conditions in 2013 may bring some benefit, on average of $230 million a year, to the general insurance industry.

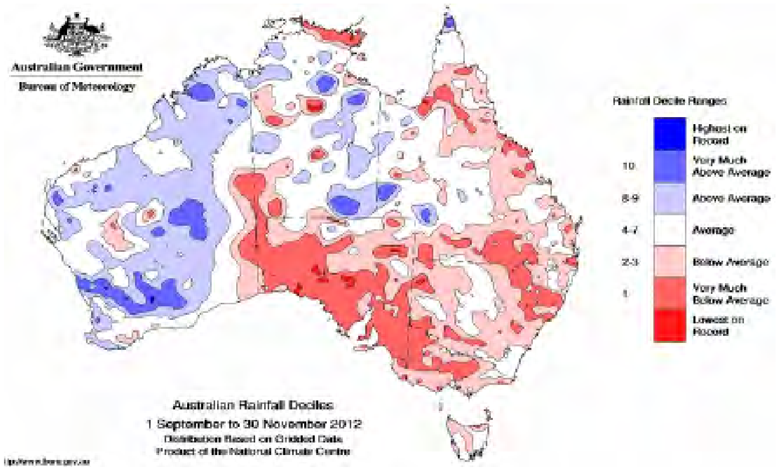
Figures 1 and 2 show the manifestation of these neutral climatic conditions in Australia.

Figure 1: Neutral conditions (Jan–Mar 2013): drier season than prior years



Source: Bureau of Meteorology (via *J.P. Morgan Taylor Fry General Insurance Barometer*)

Figure 2: Australian rainfall November 2012: mostly average or below average



Source: Bureau of Meteorology (via *J.P. Morgan Taylor Fry General Insurance Barometer*)

The Insurance Council of Australia (ICA) said the cost of natural disasters, including cyclones, storms and floods, have had a significant impact on insurance premiums across Australia. Insurance companies have adjusted their pricing to take account of individual risk levels, with sharper increases in areas that have a history of natural disasters or an exposure to future extreme weather events.

"Globally the view of reinsurers is that the risk profile of Australia has changed because of large losses and because of the failure by governments to mitigate against these risks and natural disasters, and this is having an impact on pricing. Low investment returns are also placing pressure on premiums," the ICA's spokesperson reported.

Economy

Colin Biggers & Paisley's special counsel for insurance, Marc Chiarella, said the insurance market has demonstrated "soft symptoms" for the last 10 years.

"Capacity continues to flow into the Australian market despite catastrophic losses, claims against companies and their directors, and economic-related increased claims frequency, such as insolvency, employment and worker's compensation disputes," he said.

"Despite all of this, the 2013 year to date has been good for insurers and reinsurers with regard to catastrophic events."

KPMG's *General Insurance Survey 2012* found that despite the rise in gross written premium from $26.4 billion to $28.6 billion, there was a combined loss ratio across all lines of insurance at 101.8%, meaning the $1.2 billion underwriting surplus of 2011 became a $438 million dollar deficit for 2012.

The survey findings revealed that public liability, underwritten workers compensation and directors and officers liability were the lesser performing classes.

Considering there is potential for Australia's economy to slow in the near future, Chiarella highlighted this could also impact on further on the insurance sector.

"Whilst China's economy has slowed, resources and mining sectors remain pivotal to the Australian economy, and speculators believe that the Chinese economy will correct," he said.

"Australian unemployment remains steady at 5.6% and the dollar remains strong, which will assist in keeping claims inflation under control. Fixed interest investment yields remain weak despite the Reserve Bank's attempted stimulus. Should Australia's economy weaken, it will lead to solvency-related claims activity. The national disability insurance scheme should not create or remove any liability from insurers."

Regulation

Chiarella commented that on the regulatory side, the Insurance Contracts Amendment Bill 2013, which was before the Senate as at May 2013, will impose greater consumer protection and require greater caution and diligence by insurers when writing risk.

"ASIC continues to release regulatory guides that require licensee to maintain broad, and in many circumstances unattainable, insurance cover with the view to ensuring greater consumer protection," he said.

NATURAL DISASTER RECOVERY

The ICA stated that since March 2010, insurance losses in Australia's declared catastrophes have totalled about $8.8 billion. This includes $5.4 billion in 2011. How the insurance industry has bounced back from these claims has been vital in the overall success of the industry.

"The industry has in the main dealt with the natural disasters effectively and recovered well from the unprecedented number and severity losses it has sustained in the period," Hooton said.

"This is reflected in the recent results of the listed insurers and anticipated future profitability of the industry as a whole."

Table 1 lists the cost of natural disasters to the various Australian states and territories over the last three years.

Table 1: Natural disasters in Australia, 2010-2013

Event	Date	Location	Cost
Inundation and storms	27/01/13–30/01/13	Northern NSW	$121m
Inundation and storms	21/01/13–31/01/13	Qld	$939m
Bushfire	13/01/13–19/01/13	Coonabarabran, NSW	$35m
Bushfire	04/01/13–10/01/12	Tas	$89m
Flooding	24/02/12–15/03/12	NSW and Vic	$131m
Flooding	24/01/12–15/02/12	South west Qld	$131m
Christmas Day storms	25/12/2011	Melbourne, Vic	$728m
Margaret River bushfires	22/11/11–24/11/11	Margaret River, WA	$53m
Perth bushfires	05/02/11–07/02/11	Perth and surrounds, WA	$35m
Severe storms	04/02/11–06/02/11	Melbourne and suburbs, Vic	$487m
Cyclone Yasi	02/02/11–07/02/11	Qld	$1.4bn
Flooding	13/01/11–18/01/11	Vic	$126m
Flooding	21/12/10–14/01/11	Qld, Rural Toowoomba, Lockyer Valley	$2.38bn
Perth storm	22/03/2010	Perth, WA	$1bn
Melbourne storm	06/03/10	Melbourne, Vic	$1bn
West Qld flooding	05/03/10	Qld	$46m

Source: ICA

In the wake of the disastrous 2011 — when Queensland in particular was subjected to severe flooding — Chiarella noted there have been limited catastrophe claims throughout 2012 and 2013, but of the 14 most expensive catastrophic events in Australia's history, six occurred between 2009 and 2012.

The $8.8 billion of recent losses for Australia is still dwarfed by the Canterbury earthquakes in New Zealand, said to have cost NZ$30 billion and rising, according to Chiarella.

"Reinsurance costs have increased for insurers in New Zealand, with increased reinstatement premiums and higher retentions for cedents [the insurance company transferring the risk to a reinsurance company]," he said.

"Policyholders in New Zealand have evidently been hit with these costs combined with more restrictive policy terms. There is a more selective approach to underwriting risk with catastrophe exposure."

The "selective approach" to offering cover has not been the case in Australia so much — except perhaps in north Queensland where cyclone cover is hard to obtain.

"The most recent indication of the attitude of the global reinsurance market is evident from the Japanese reinsurance treaty renewal of 1 April 2013. That renewal revealed flat or discounted pricing and oversubscribed treaties due to the increased capital injection of US$35 billion made into the reinsurance market," Chiarella said.

Consider

The positive outcomes to emerge from the devastation of the 2010–2012 natural disasters, according to Chiarella, include:

- recommendations made by inquiries into insurance companies about response times to claims
- unfair contract terms and amendments to legislation, in particular with regard to flood cover under the *Insurance Contracts Act 1984*
- amendments to collection of insurance taxes, such as those proposed under the Fire Service Levy Monitor's draft guidelines in Victoria
- information and analysis relating to the natural disasters that will assist underwriting classes of insurance (e.g. flood modelling in Queensland)
- litigation that will likely provide outcomes to assist in determining how reinsurance treaties ought be interpreted, including aggregation, allocation and general policy terms and conditions.

Despite these positives, Chiarella said there is continued criticism of insurers in Australia, particularly in the wake of rate rises on domestic home and contents throughout the 2012 year.

"Many consumers saw these premium increases as insurers trying to "cash in" using the excuse of natural disasters to increase rates for consumers with risk in areas unaffected by the disasters," he noted.

Chiarella added that there may be further negative press for insurers, as reinsurers push cedents to comply with treaty obligations to recover loss.

▶For example

With regard to the Queensland floods, insurers would have obligations to recover loss under their treaties if it is determined that the flooding of Brisbane was caused by the negligent operation of the Wivenhoe and Somerset dams.

"The past three years have been a watershed for the ICA and wider industry," the ICA said.

"A high incidence of natural disasters, at home and abroad, has placed the ICA and wider industry under the spotlight, with government, consumer groups, media and other stakeholders scrutinising the industry's actions."

However, the ICA claimed in the wake of the disasters, politicians, regulators and consumer advocates now have a much stronger understanding of the industry and its issues and their views are, generally, now more moderate and supportive towards the role of the insurance industry.

INTERNAL FACTORS

The insurance industry itself, both the insurers and regulators, has actioned plenty in recent times. Much of this has been sparked by the natural disasters of recent years, in particular reference to flood insurance and the overall approach to claims and cover.

"Following the disasters of 2010–2011 the industry has undergone some major changes. Most significant, are changes to the *General Insurance Code of Practice*. The Code is the industry's commitment to be fair and honest in the way it deals with its customers and helps to protect the rights of consumers," the ICA said.

General Insurance Code of Practice

Changes to the *General Insurance Code of Practice*, which commenced on 1 July 2012, stem from a series of extreme weather events in Australia and from the desire to provide insured parties with more information when claims are denied.

The changes apply to claims received after that date and contracts of insurance written from that time.

Insurers have four months to decide whether to accept some claims. Crucial changes are listed as follows:

- The Code has a new clause 3.4 which applies particular standards to "specified classes of policies". A "specified class of policy" is any contract of insurance concerning motor vehicles, home buildings, home contents, sickness and accident, consumer credit, or travel.
- Under clause 3.4 of the code, and unless "exceptional circumstances" apply, an insurer must decide whether to accept such a claim within four months.
- For insurers who do not write contracts of insurance that fall within the definition of "specified class of policy", the most significant amendments relate to the disclosure of information to an insured. At the new clause 3.5(b) of the code, where a claim is denied (or partially denied), an insurer must now in addition to providing written reasons for the decision and information about its complaints handling procedures, inform an insured of the right to:
  - ask for copies of information about [the insured] that [it relies] upon in assessing [the insured's] claim; and
  - request a review under 3.5.3 … of any decision [it takes] to decline to release such information…"

"The ICA Board approved changes to the Code to provide clear timeframes for claims handling, including during declared catastrophes, and a greater level of certainty to policyholders on the completion of external expert reports, making these reports available to claimants, and providing claimants with a right to lodge a claim to test the question of policy cover," the ICA clarified.

Quicklink

For more information on the *General Insurance Code of Practice*, visit www.codeofpractice.com.au

Flood definition

In 2012, the industry also acted to clear up consumer confusion after the widespread floods in eastern Australia, with several flood victims believing they had flood cover when they did not. Working with the Federal Government a standard definition of flood was introduced to insurance contracts.

The definition of flood is now as follows:

- *The covering of normally dry land by water that has escaped or been released from the normal confines of:*
  - *any lake, or any river, creek or other natural watercourse, whether or not altered or modified; or*
  - *any reservoir, canal, or dam.*

The ICA said the flood definition has long been a goal of the insurance industry, with the ICA first attempting to introduce such a definition in 2008.

"The definition provides both policyholders and insurers with greater clarity on how a flood is defined. The regulations allow for a two-year transition period, but many insurers have already adopted the definition," the ICA said.

ICA statistics show that more than 80% of household insurance policies that are sold contain some level of flood cover compared with just 3% of policies sold in 2006.

"This shows the industry's willingness to adapt to the challenges presented by extreme weather. The ICA has also established the National Flood Information Database (NFID) and the Flood Exclusion

Zone (FEZ) database. Together these provide some level of flood information to insurers for 10.4 million of Australia's 12.3 million addresses," the ICA elaborated.

"In 2013, the ICA welcomed an announcement by Prime Minister Julia Gillard of $100 million in funding over two years for flood mitigation projects. This is a significant step towards protecting flood-prone communities."

Consider

Hooton highlighted that there are five key internal factors affecting the insurance industry:

1. The withdrawal of insurance capacity in far north Queensland.
2. Affordability of flood cover in certain parts of the country for both domestic and commercial small-to-medium enterprise (SME) customers.
3. The introduction of the Australian Prudential Regulation Authority's new capital standard reform program, bringing with it a suite of new capital and risk management standards requiring insurers to take a more holistic approach to their risk appetite, capital, and overall business operations.
4. The abolition of the Fire Services Levy in Victoria and subsequent monitoring Group set up to ensure insurers pass on the savings to consumers — another instance of increased consumer protection following the Queensland floods in 2010 and the implementation of recommendations following the natural disaster insurance review which included the introduction of a standard flood definition and changes to the *General Insurance Code Of Practice*.
5. Increased competition in the personal lines market, particularly in standard motor insurance and the introduction of an increased number of aggregators, albeit with many brands, but limited number of competing insurers.

Cost cutting

Chiarella advocated that insurers continue to reduce costs by looking at supply and overheads.

"There has been significant expenditure by insurers on technological systems to improve operational efficiencies and ensure the collation of comprehensive, accurate and streamlined management information," he said.

"There is also a drive to reduce transactional cost. Online systems are continually being developed and improved to capture both the policy application — either directly or through intermediaries — and claims processes."

As a result of this ongoing quest to reduce operational costs and attain cost efficiencies, Chiarella explained that there has also been restructuring, including outsourcing of administrative tasks. As a consequence, there continues to be job losses in the industry on a global scale.

"Cost cutting is being offset with increased marketing costs to meet underwriting budgets. It is evident 'panel deals' with major broking cluster groups and large international brokers require insurers to offer significant incentives to these entities to participate on these panels," he said.

BROKER CHANNEL

Brokers remain a vital element in the distribution of insurance, but such is the evolution of the industry that their role has changed and, in some instances, been threatened.

Hooton said professional intermediaries are performing well albeit in an increasingly challenging and dynamic environment. He said the broker channel is likely to move towards a smaller base of brokers who are more profitable.

"Insurer ownership or part ownership of intermediaries will continue as insurers seek to vertically integrate and influence distribution. Direct distribution will become an even greater threat particularly to brokers' micro and small business customers," he elaborated.

Hooton added that to battle the rise in popularity of direct insurance and deliver value in an economic and efficient way, brokers need to reduce transaction costs and utilise electronic trading platforms to transact high-volume low-margin business while still delivering choice to their clients.

Chiarella offered the following predictions regarding the industry.

“Brokers are experiencing pressure due to the soft market conditions,” he said.

“For large cluster groups and large international brokers, a key emerging issue is independence. It is becoming common to appoint panel insurers to underwrite portfolios of product or risk. There are commercial deals with insurers obliging brokers to use the appointed panel insurers.”

Chiarella commented that the agency relationship may become skewed where the broker is in fact holding them out as an agent of the insured, but in reality is acting as an agent of the insurer.

“There have been a number of recent decisions maintaining established duties and obligations of brokers, which are important, given the relevance to 'online insurance transacting'. These decisions re-emphasise the requirement for brokers to make adequate enquiries into the risk, to advise on policy exclusion clauses and to inform of the duty of disclosure,” he said.

Quicklink

For more information on Australia’s insurance brokers and their activities, visit www.niba.com.au

Areas of success

According to the *J.P. Morgan Taylor Fry General Insurance Barometer*, brokers perceived public and product liability as the most profitable class in 2012.

Compulsory third party insurance and fire/industrial special risks insurance were ranked as top classes of profitability, which is more in line with expectations given their combined ratios, were relatively lower compared with the other classes, at 89% and 90%.

Workers’ compensation (Tasmania, Australian Capital Territory and Northern Territory) and domestic motor vehicles were perceived as the least profitable classes of business in 2012.

Brokers are optimistic about industry profitability improvements in three years’ time. Public and product liability is expected to remain in the top spot, followed by householders and fire/ industrial special risks. Workers’ compensation (Tasmania, Australian Capital Territory and Northern Territory) and directors and officers insurance are expected to remain in the least profitable groups as perceived by brokers. These findings are summarised in Table 2.

Table 2: Brokers’ perceptions of class profitability, 2012

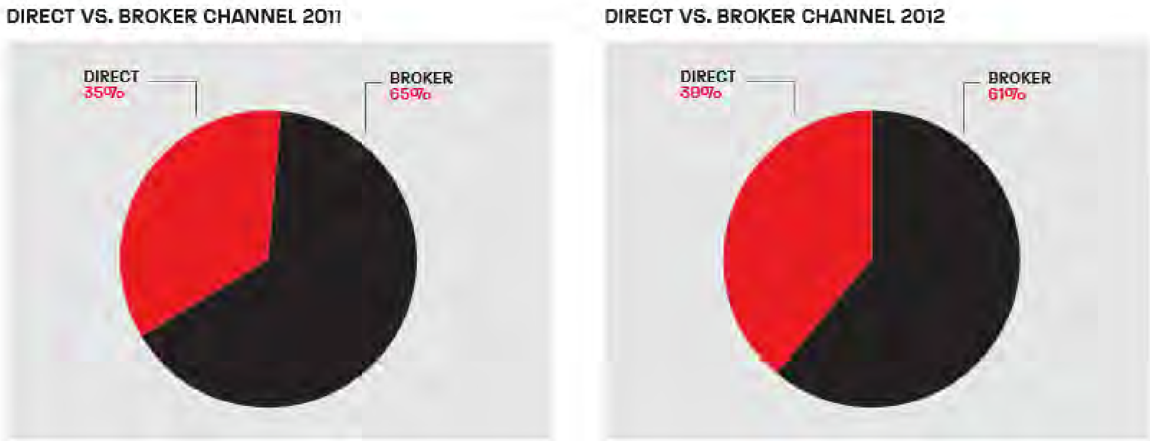
	2012 Combined ratio	2012 Normalised COR	Overall Weighted Ranking	Ranking last year	% Respondents: Very profitable	Moderately profitable	Breakeven	Moderately unprofitable	Very unprofitable
Public & Product Liability	110	107	1	1	38%	63%	0%	0%	0%
CTP (NSW and QLD only)	89	96	2	4	20%	60%	0%	20%	0%
Fire / ISR	90	92	3	9	25%	50%	13%	0%	13%
Householders	83	80	4	10	50%	0%	17%	33%	0%
Commercial Motor Vehicle	99	98	5	5	0%	63%	25%	13%	0%
Professional Indemnity	92	87	5	2	0%	63%	25%	13%	0%
Underwritten Workers' Comp. (WA only)	92	95	7	3	0%	67%	0%	33%	0%
Directors & Officers	102	93	8	7	13%	25%	38%	25%	0%
Domestic Motor Vehicle	95	93	9	8	0%	50%	17%	33%	0%
Underwritten Workers' Comp. (TAS, ACT and NT)	103	109	10	5	0%	25%	0%	75%	0%

Source: *J.P. Morgan Taylor Fry Barometer*, 2012

Brokers wane, but still dominate

Findings from the *Vero SME Insurance Index 2013*, which gathered insights from over 800 Australian business owners to examine their experience and expectations of insurance and insurance brokers, found brokers remain the dominant channel, but a substantial and slowly growing portion of the SME market purchases insurance through the direct channel. This trend is illustrated in Figure 3.

Figure 3: Direct versus broker channel, 2011 and 2012



Source: *Vero SME Insurance Index, 2013*

The Vero Index suggested that generational change is behind the move away from brokers towards dealing with insurers directly.

“This sounds a warning for brokers, as this younger generation starts to take on business decision making. The research shows a continued longer term shift to direct. This however, is happening slowly with only minimal movement over the past year,” the Vero Index reported.

“There is strong evidence of generational change beginning to result in a softening of broker usage among medium-sized businesses as younger business people increasingly take the lead.

“This is likely to be the result of greater familiarity of younger owners with the internet and the strong shift to doing business online.”

FUTURE OUTLOOK

After navigating the rocky waters of Australia’s various natural disasters, the industry is in a position to look towards building a future which still offers plenty of challenges.

Image overhaul

“We collectively need to work on improving the brand ‘insurance’ and its significance to the Australian economy, private individuals, business and communities,” Hooton warned.

“Despite the positive response from the industry to the natural disasters, the industry’s image is still poor and there needs to be a concerted effort by all parties to change this.”

Hooton advocated that both personal and business insurance clients will then be less inclined to begrudge the payment of their insurance premiums, accept a fair premium for their exposures and work with insurers, not against them, if they are unfortunate enough to experience a loss.

“More people will take out insurance and they will insure themselves properly after receiving quality advice from a professional intermediary. There will be a much bigger premium pool than we have today and more of the overall cost will cover the risk premium, as opposed to covering statutory charges,” he said.

“Future natural disasters will be dealt with effectively and enhance the reputation of the industry as a whole, not detract from it. This way we all prosper.”.

Chiarella said the industry must continue to work to improve expertise and excellence, not simply look at ways to streamline process and remove "advisory risk".

“The industry places too much emphasis on writing premium income and not enough on advising consumers on risk and cover,” he said.

"The industry must balance the benefit in cost cutting with quality and delivery of service at the time of application for insurance and at the time of paying claims."

The ICA predicted that the general insurance industry will continue to raise awareness on the importance of insurance protection and to help policyholders find the right policy to match their circumstances.

"On average the industry pays out $102 million in claims every working day, helping thousands of individuals and businesses to recover and get back on their feet. Without insurance, communities would remain paralysed, businesses would remain closed and homes would be unliveable," the ICA added.

IN CONCLUSION

Australia's insurance industry can be satisfied that it has recovered, to a certain extent, from the large payouts caused by the natural disasters of recent years. However, there are still legacy issues to be resolved and the threat of further natural disasters persists. This remains an aspect that the industry must brace itself for in the coming years.

The rise of technology and the use of online transactions has caused the industry to assess how it can deliver insurance in line with these expectations and cut costs to improve profitability at the same time. Getting this balance right will go some way to ensuring the industry's future success.

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