

General insurance industry overview

This article provides an update on the financial performance of the general insurance industry in Australia for 2010/11 and on the impact on the industry of the series of catastrophe events in that year. The article also provides an overview of the key risks on APRA's radar relating to the general insurance industry.¹

Financial performance

The financial position of the general insurance industry continues to be sound, despite the adverse impact of the series of natural disasters in Australia and New Zealand in 2010/11. The industry achieved a return on net assets of 13 per cent over 2010/11 (to 30 June) and, although the industry's capital ratio fell over the year, the industry remained well capitalised at 175 per cent of the minimum capital requirement (MCR). The reduction in the capital ratio was largely due to an increase in MCR relating to higher reinsurance recoveries and insurance concentration risk.

Gross written premium increased by three per cent over 2010/11. Changes in underlying premium rates are likely to be one of the primary drivers behind this increase. However, gross written premium is also influenced by other factors such as changes in the number of policies being written and the level and type of cover being taken out. By definition, the 2010/11 earned premium partly reflects premium rate increases implemented in both 2009/10 and 2010/11.

A comparison of the cession ratio and reinsurance recovery ratio for 2010/11 (see Table 1) highlights the importance of reinsurance to the financial stability of the industry over the past year. The impact of the 2010/11 series of catastrophes, discussed below, is also evident in the gross claims incurred figure, which at \$36 billion was significantly higher than earlier years². However, after allowing for reinsurance and other recoveries, net incurred claims halved to \$18 billion, which was only slightly higher than in previous years.

There is some degree of doublecounting of claims costs in Table 1 due to the fact that the industry figures include both direct insurers and reinsurers. Table 2 shows the allocation of the claims costs between direct insurers and reinsurers.

¹ The themes in this article are also discussed in APRA's 2011 Annual Report, which can be found at the following link: www.apra.gov.au/AboutAPRA/Publications/Pages/annual-report-2011.aspx

² Note that claims costs from the New Zealand earthquakes are only included in these figures in cases where the Australian insurer/reinsurer underwrites New Zealand risks. A number of the larger insurers have separately licensed New Zealand entities and, in these cases, the claims costs are not captured in the aggregate level 1 industry figures.

Effective 1 July 2010, the basis used for the financial performance data reported by insurers to APRA changed to largely align with accounting standard AASB 1023 General Insurance Contracts. The data shown in Table 1 for prior years are based on APRA's 'prospective accounting' reporting framework.

As part of the change in accounting basis, APRA now collects the split of the net incurred claims costs into current period and non-recurring. Figures reported for 2010/11 show that non-recurring items (such as reserve releases, impact of discounting and change in risk margins) reduced the net incurred claims cost by \$1.2 billion or seven per cent. This statistic should provide useful information on trends in such items as the historical data set builds over time.

Another change to the accounting basis from 1 July 2010 was the replacement of the estimate of claims costs for future years (the premium liability) with the unearned premium concept. The Liability Adequacy Test (LAT) in the new framework attempts to address the issue of possible under-pricing by requiring insurers to hold additional reserves where the premium liability exceeds the unearned premium (after allowing for the deferred acquisition costs). It should be noted, however, that there are a wide variety of practices adopted by insurers in applying the LAT. For 2010/11, the net impact of the LAT was \$16 million; in comparison, unearned premium was \$21 billion at 30 June 2011.

Investment income for the industry has been reasonably stable at around a seven per cent per annum return on investment assets over the past three years. However, the aggregate 2008/09 result masks the volatility within that period due to movements in the realised and unrealised gains (losses) in response to movements in bond yields.

The new data collection also requires insurers to allocate investment income between insurance liabilities and shareholders' funds where they are already doing so for AASB 1023 purposes. From this allocation the insurance profit (before tax) can be estimated, indicating the profitability of the insurance business. The insurance profit (before tax) for 2010/11 was \$3.5 billion, compared with net earned premium of \$25.9 billion for the year.

Table 1: Summary of industry financial performance

\$m	12 months ended June			
	2008	2009	2010	2011
Gross written premium	31,243	31,823	33,223	34,296
Growth in gross written premium	5%	2%	4%	3%
Net written premium	22,804	24,271	25,449	
Net earned premium				25,858
Reinsurance cession ratio (prospective)	27%	24%	23%	
Reinsurance cession ratio				25%
Gross incurred claims (current and prior years)	22,431	23,699	23,631	35,871
Reinsurance recovery ratio (current and prior years)	33%	24%	23%	47%
Net incurred claims (current and prior years)	13,862	16,644	16,338	17,679
Current period net claims expense				18,917
Non-recurring items that are part of net claims				-1,237
Net incurred claims (future years)	894	1,126	-37	
Net loss ratio (prospective)	65%	73%	64%	
Net loss ratio				68%
Acquisition costs (prospective)	4,157	4,020	4,386	
Acquisition costs (excluding LAT)				2,072
Results of liability adequacy tests				16
Commission expense				3,012
Other underwriting expenses	2,105	2,366	2,201	1,911
Total underwriting expenses	6,262	6,386	6,587	7,011
Underwriting expense ratio (prospective)	27%	26%	26%	
Underwriting expense ratio				27%
Underwriting result	1,784	118	2,563	1,170
Investment income	3,151	4,319	4,853	
Net investment income on assets backing insurance liabilities				2,336
Insurance result				3,505
Investment income on shareholders' funds				2,348
Other operating expenses and other items	-1,915	-1,818	-2,721	-1,916
Net profit / loss after tax	3,022	2,617	4,695	3,936
Net assets (average for the year)	25,898	27,690	29,758	29,240
Return on net assets (annualised)	12%	9%	16%	13%
Capital base	22,727	25,553	27,054	26,740
Minimum Capital Requirement	12,053	13,398	13,910	15,256
Solvency coverage	189%	191%	194%	175%

Source: Performance figures are from the *Quarterly General Insurance Performance Statistics* report and capital figures are from other *Insight* publications.

Table 2: Claims costs split by direct insurers and reinsurers

\$m	12 months ended June			
	2008	2009	2010	2011
Gross incurred claims (current and prior years)	20,594	21,819	21,331	33,478
– direct insurers	21,618	22,540	22,605	30,812
– reinsurers	814	1,158	1,027	5,060
Net incurred claims (current and prior years)	13,862	16,643	16,336	-1,236
– direct insurers	13,385	15,779	15,574	16,666
– reinsurers	477	864	762	1,015

Source: Performance figures are from the *Quarterly General Insurance Performance Statistics* report

Australian and New Zealand catastrophe events

Over 2010/11, the Australian general insurance industry was exposed to a series of catastrophe events including the Brisbane floods, Cyclone Yasi and a series of earthquakes in Christchurch, New Zealand. Claims estimates provided to APRA by Australian direct insurers indicate that gross insured claims (before reinsurance) are around \$4.6 billion from the Australian catastrophe events and \$8.3 billion from the Christchurch earthquakes. A large proportion of these claims is expected to be recoverable from reinsurers and this has dampened the impact of the events on industry profitability. Estimates of claims from the Christchurch earthquakes remain highly uncertain due to difficulties in accessing the city and uncertainties regarding coverage by New Zealand's Earthquake Commission (EQC)³. At the beginning of September 2011, the New Zealand High Court provided private insurers with clarity that the EQC must cover households for every earthquake event rather than treating the earthquakes as one insurable event.

Following the series of catastrophe events some insurers prudently purchased additional reinstatements for their lower layer(s) of catastrophe reinsurance cover and a number of insurers required capital injections from their parent companies. However, the most significant impact on the industry has been more difficult negotiations with reinsurers at 2011 reinsurance renewal dates. Not only have reinsurance prices increased significantly, but reinsurers are now less willing to write the lower layers of catastrophe reinsurance or aggregate reinsurance protection programs. This is not surprising given insurers expect to recover from reinsurers \$3.4 billion for the Australian catastrophe events and around \$7.4 billion for the Christchurch earthquakes.

APRA established a small team of specialist staff to monitor the insurance claims from the 2010/11 catastrophe events and to assess the impact of these claims on individual insurers and on the industry as a whole. The team examined insurers one-by-one and

held meetings with those insurers most impacted. Broader issues identified by the review process were the varying quality of the Reinsurance Arrangement Statements (RASs) provided to APRA and the need for more robust stress-testing. APRA is considering a number of options for addressing these issues.

Some RASs are not of the standard expected by APRA. Specific areas of concern include the omission of critical details such as the number of reinstatement covers, while some of the explanations of reinsurance programs are unclear (with inconsistencies between the narrative descriptions and diagrams).

There is also room for improvement in the stress-testing undertaken by insurers⁴. In particular, many property insurers do not include as part of their regular stress-testing the potential for one or multiple catastrophe events to impact on their capital position, including allowances for increases in reinsurance costs after the stress event and for the possibility of a severe reduction in reinsurance capacity. APRA expects the Boards and management of insurers to consider a range of extreme scenarios in determining their reinsurance arrangements, rather than relying solely on expert advice based on catastrophe models. Furthermore, APRA expects insurers to have a sound understanding of the limitations of any catastrophe models they elect to rely upon and to make decisions on reinsurance cover in this context.

Following the Queensland floods in early 2011, the Commonwealth Government announced the Natural Disaster Insurance Review (NDIR), with a focus on reviewing disaster insurance for losses sustained from floods and other natural catastrophes. The NDIR Panel submitted its report to the Government on 30 September and APRA will consider the Government's responses to the NDIR's recommendations as they emerge.

³ The EQC insures dwellings up to a maximum of NZD100,000 and personal effects up to NZD20,000.

⁴ A lack of scenario analysis and stress-testing was also found to be one of the most common omissions or inadequately addressed areas in an internal APRA review of risk appetite statements in 2010.

Key risks facing the industry

APRA reviewed the key risks facing the general insurance industry in early 2011 and identified the following three areas as requiring particular focus in 2011/12:

- reinsurance placement risk;
- adequacy of pricing processes; and
- concentration of reinsurance counterparty risks across the industry.

Reinsurance placement risk

As discussed above, the recent Australian and New Zealand catastrophe events have resulted in reinsurers increasing premium rates significantly and having less appetite to write the lower layers of catastrophe reinsurance or aggregate reinsurance protection programs. As a result, many property insurers are retaining greater catastrophe risk on their balance sheet. This in turn increases the volatility of their capital position and raises their capital requirements. Insurers have a number of options for responding to this change in circumstances, including:

- raising additional capital;
- increasing their premium rates; and/or
- reducing internal target capital ratios.

A number of the large personal lines insurers have publicly stated that they have been increasing premium rates for property classes in response to the higher reinsurance costs and other factors.

APRA is responding to these developments by undertaking targeted supervisory reviews of insurers with material property exposures. These targeted reviews are focused on:

- the insurer's reinsurance strategy and its alignment with its risk and capital management strategy;
- changes to the insurer's catastrophe reinsurance arrangements and capital triggers after the 2010/11 catastrophe events;
- the robustness of stress-testing for catastrophe events; and
- the insurer's approach to catastrophe models, including any adjustments made to the catastrophe modelling results when determining the reinsurance arrangements.

Adequacy of pricing processes

Assessing the adequacy of an insurer's pricing processes is a core component of APRA's supervisory approach. A number of factors currently heighten the risk for insurers in this area, including:

- the introduction of broker aggregator sites in the small to medium enterprise (SME) market, allowing customers to more readily identify and exploit the insurer's pricing structure;
- higher reinsurance retentions following the 2010/11 catastrophe events; and
- deterioration in the profitability of some classes of business that may have been masked by reserve releases over recent years.

Aggregators (or price comparison platforms) have increased their presence in the Australian insurance market over recent years. Experience in the personal lines market in the United Kingdom has shown that growth in market shares of aggregators has been linked to falling underwriting profits and soft market conditions for insurers. By its very nature, insurance pricing involves an element of uncertainty; hence, the premium for identical risks will vary across insurers depending on the assumptions that underpin their pricing process. Aggregators highlight to consumers the insurer offering the lowest premium for their particular risk characteristics. As a result, insurers tend to only 'win' business in the segments where they are the cheapest and consumers are likely to switch insurers more frequently. It is more difficult for insurers to underwrite a profitable portfolio of risks in this environment. In the commercial lines market, broker groups have recently developed price comparison platforms for products sold to SMEs, although it is too early to assess their impact. In this more competitive environment, it is incumbent on insurers to maintain prudentially sound approaches to underwriting and pricing their business.

As noted earlier, property reinsurance prices have generally risen following the 2010/11 catastrophe events and this, and other factors, have led some direct property insurers to increase their reinsurance retentions. These insurers will have to directly price the additional retained risk. Mispricing the retained risk may change the risk profile of the insurer's portfolio, as the insurer may attract more policyholders in portfolio segments where they undercharge relative to competitors, and viceversa. For those insurers that elect to maintain their retention level and pass on higher reinsurance costs to policyholders, there may be increased risk associated with misallocating those higher costs between policyholders, similarly altering the risk profile of the insurer's portfolio. Such changes in the insurer's risk profile may lead to a poorer underwriting result or to changes in future reinsurance costs as reinsurers respond to the change in the risk profile.

Adjustments to the outstanding claims reserves relating to prior years are a consequence of the reserving process. Since 2005, there has been a series of significant reserve releases, rather than a mix of reserve releases and strengthening. These reserve releases are generally attributed to the effects of legislative reforms made around 2003 and the absence of widespread superimposed inflation in key long-tail classes. The reserve releases have made a significant contribution to industry profitability over recent years and may have masked a deterioration in the profitability of the business underwritten in these years.

In 2010/11, APRA completed its third annual internal review of the adequacy of general insurers' pricing processes. The review aimed to rate insurers' pricing processes, so as to summarise the overall adequacy of these processes and any trends within the industry. It used information from insurers' Financial Condition Reports (FCRs)⁵, as well as reviews of pricing processes conducted by APRA's Insurance Risk team and frontline supervisors' input.

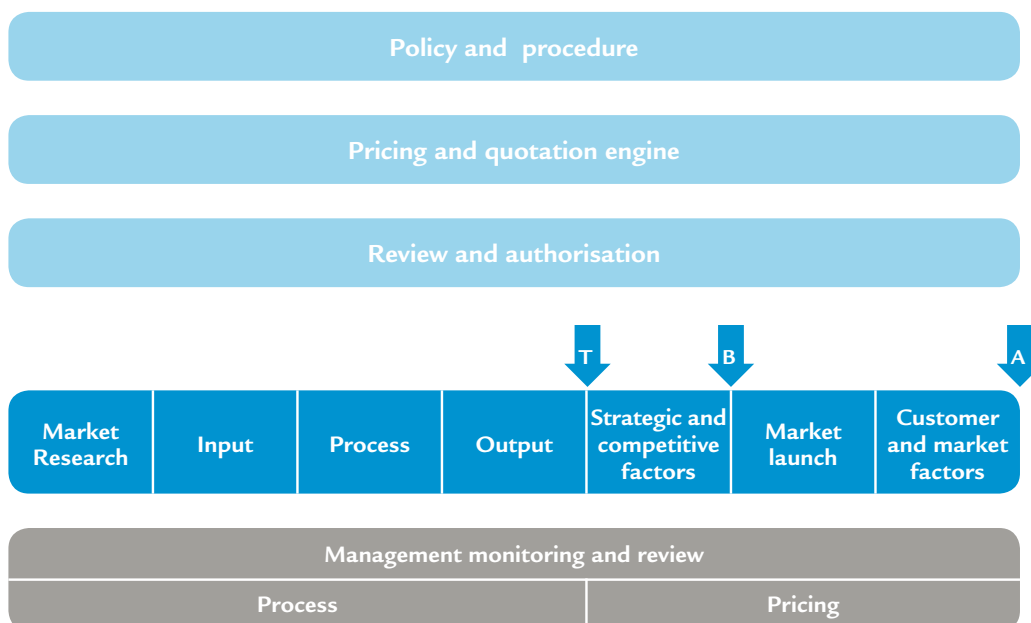
The review of the FCRs considered which elements of the pricing process and control measures (Figure 1) were referred to in the FCR. These measures look at areas of good practice for insurer pricing processes, as well as preventative and detective controls.

The light blue area at the top of Figure 1 shows areas of preventative control. Preventative controls include the existence of a pricing policy and procedure, documentation and control of the rating engine, and adequate review and authorisation. These are designed to ensure that the goals of the pricing process are understood from the outset and an adequate pricing structure that meets those goals can be achieved.

The dark blue area in the middle represents the pricing process itself, with the arrows showing formulation of technical ('T'), book ('B') and actual ('A') prices, respectively. The technical price is the price required to achieve specified goals (e.g. loss ratio, expense ratio, return on capital). The book price considers strategic factors (e.g. growth versus profit) and market factors (e.g. competitor pricing, market position). The actual price is the price actually charged to customers, including discounts and other adjustments to the price at the point of sale.

Finally, the grey section in Figure 1 represents the detective controls. These help monitor the adequacy of pricing and identify areas where prices might be inappropriate. An example of such a control is simple price analysis such as loss ratio analysis. They also include advanced monitoring, involving analysis of quote conversion, comparison of book and actual prices to technical price, and segment analysis of actual versus expected business written to detect inadequate pricing. Audits of the pricing process are another detective control.

Figure 1: Pricing process and control measures



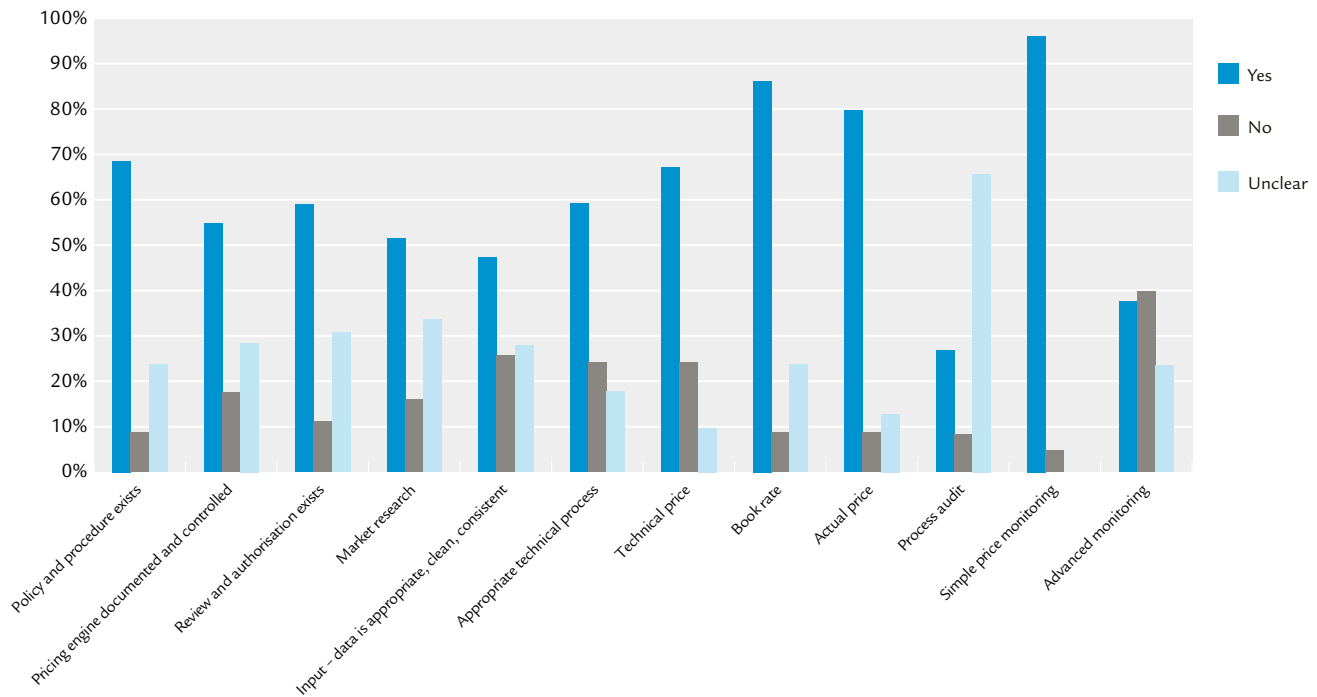
5 For the period 31 December 2009 to 30 September 2010.

Figure 2 shows insurers' reported adoption of the various good practice pricing measures. The green bars represent instances where information from the FCR has identified that an insurer undertakes the particular process, the red bars where the process is not followed, and the grey bars where it is unclear from information in the FCR whether an insurer is undertaking the process.

Figure 2 shows a comparison of insurers by each pricing measure. It reveals that almost all insurers are undertaking simple price monitoring. On the other hand there is very little information given in FCRs about whether pricing process audits are undertaken by insurers. Furthermore, there appears to be room for improvement in the input data that insurers are using to form prices. Figure 2 also shows that there are a large number of insurers that are not performing advanced monitoring or do not include information about it in the FCR.

APRA will continue its focus on insurer pricing processes in 2011/12.

Figure 2: Comparison by pricing measure



Concentration of reinsurance counterparty risks across the industry

The exposure of the general insurance industry to reinsurers is a material source of counterparty risk and that risk is heightened after a series of domestic or global catastrophes. In 2010/11, APRA undertook a special data collection to assist in assessing the degree of industry exposure to particular reinsurers.⁶ There was a strong response with 71 general insurers contributing, accounting for 94 per cent and 95 per cent of the total general insurance industry reinsurance expense and reinsurance recoverable, respectively.

The data collection found that the solvency impact of the downgrade or failure of a major reinsurer was small for the general insurance industry overall, with only a few individual insurers that could be materially impacted should such an event occur. There was a reasonable spread of reinsurer counterparties used across the industry and most insurers did not have material concentrations of exposure to particular reinsurers. The majority of large reinsurer counterparty exposures were found to be within the same insurance group. This analysis was based on the impact from three APRA risk capital charges: reinsurance counterparty risk, insurance risk and asset concentration risk.

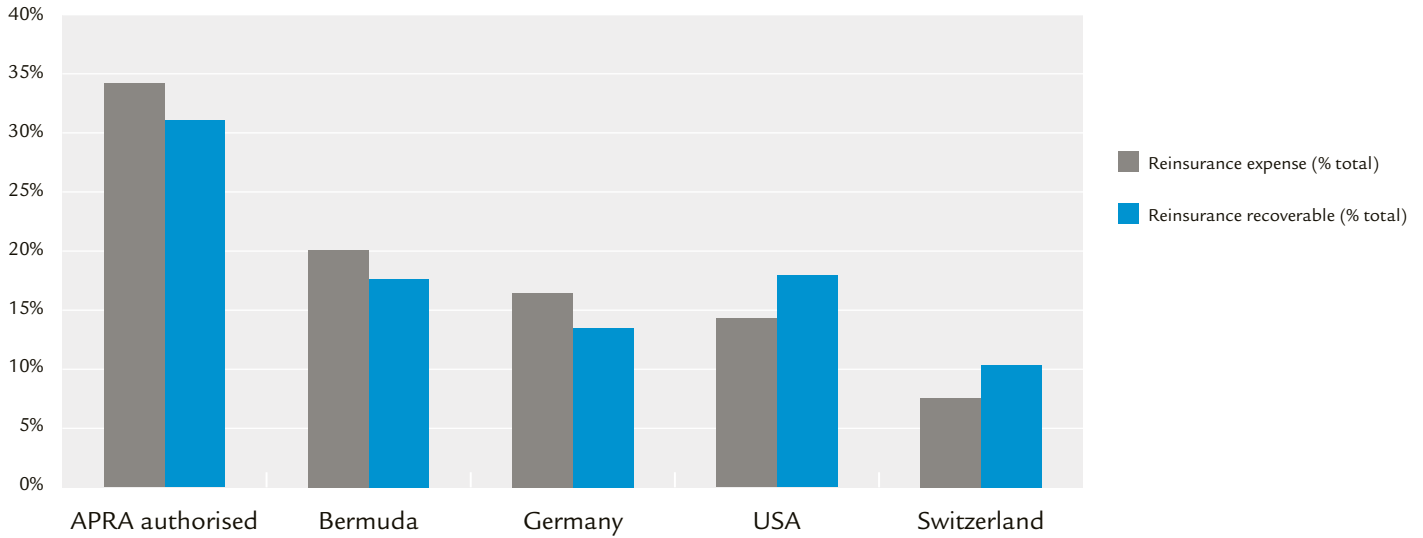
Table 3 highlights that around half of all reinsurance expense and reinsurance recoverables are intra-group. The open market exposures are shared almost equally between APRA authorised and non-APRA authorised reinsurers.

Table 3: Reinsurance expense and recoverables

	Reinsurance expense (%)	Reinsurance recoverable (%)
Intra-group (APRA)	34.0	17.8
Intra-group (non-APRA)	25.4	31.9
Total intra-group	59.4	49.7
Open market (APRA)	22.8	25.8
Open market (non-APRA)	17.8	24.5
Total open market	40.6	50.3

⁶ The data collection covered reinsurance expense for annual periods ending in the 12 months to 30 June 2010, and reinsurance recoverable as at 30 June 2010. Reinsurance expense is the insurance premium ceded (i.e. paid) to reinsurers in exchange for the transfer of some or all of the risk. Reinsurance recoverable represents amounts owed by reinsurers in relation to claims incurred.

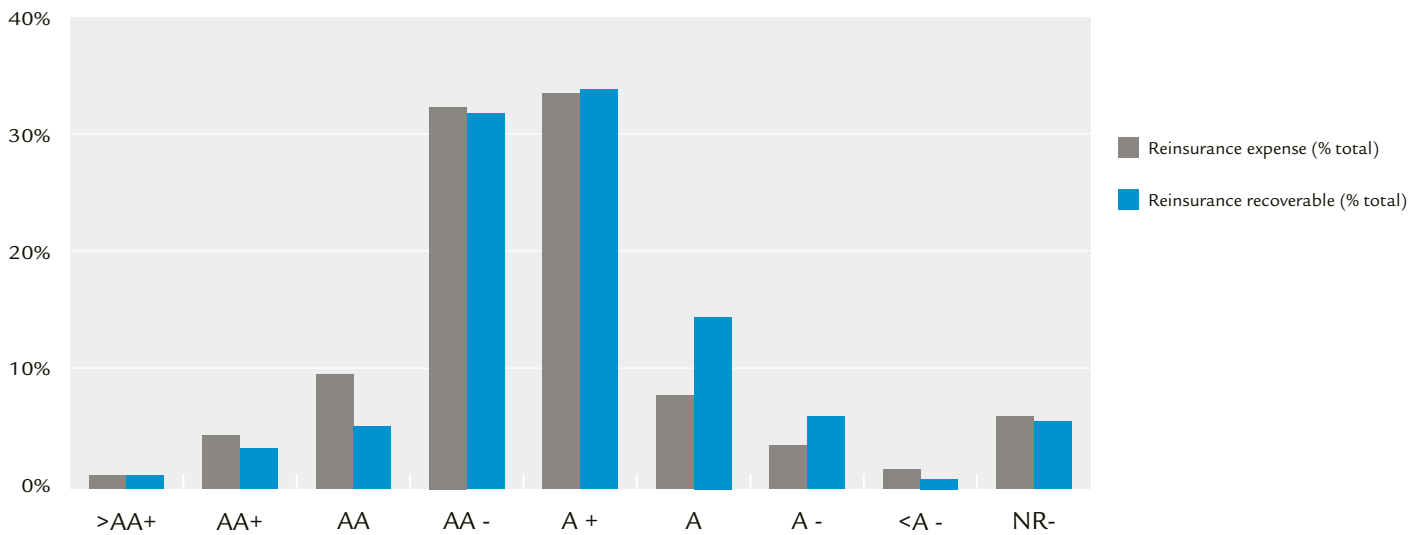
Figure 3: Reinsurer counterparty domiciles



Source: APRA's 2010 reinsurer counterparty data collection:

- data excludes intra-group transactions with APRA-authorized reinsurers to avoid double counting;
- reinsurance recoverable as at 30 June 2010 includes IBNR and expected reinsurance recoveries on Premium Liabilities; and
- reinsurance expense for annual periods ending in the 12 months to 30 June 2010.

Figure 4: Reinsurer counterparty by S&P rating



Source: APRA's 2010 reinsurer counterparty data collection:

- data excludes intra-group transactions with APRA-authorized reinsurers to avoid double counting;
- reinsurance recoverable as at 30 June 2010 includes IBNR and expected reinsurance recoveries on Premium Liabilities; and
- reinsurance expense for annual periods ending in the 12 months to 30 June 2010.

Figure 3 depicts the industry exposure to APRA-authorized reinsurance counterparties, with most of this exposure being to Australian branch reinsurers. It also shows exposures to non-APRA-authorized reinsurance counterparties according to the domicile of the parent entity. Non-APRA-authorized reinsurers account for around two-thirds of total industry reinsurance premiums ceded and amounts recoverable. Of these reinsurers, Bermuda is the largest domicile by total reinsurance expense, followed by Germany, USA and Switzerland. The same domiciles dominate for reinsurance recoverable, with the order changing to become USA, Bermuda, Germany and Switzerland.

The majority of counterparties in the data collection by reinsurance expense and reinsurance recoverable have a financial rating (Standard & Poors) of AA- or A+, equivalent to APRA grade 2 and 3 respectively (Figure 4). Reinsurers with financial ratings below A- made up just 1.4 per cent and 0.1 per cent of total industry reinsurance expense and reinsurance recoverable, respectively. Unrated reinsurers made up 6.0 per cent and 5.3 per cent of total industry reinsurance expense and reinsurance recoverable, respectively.

APRA is currently considering whether there is a need to collect additional data on reinsurance exposures on an ongoing basis.

Conclusion

The general insurance industry remains profitable and well capitalised, notwithstanding the series of catastrophe events in Australia and New Zealand during 2010/11. This is largely due to reinsurance protection in place, a significant proportion of which is provided by APRA-authorized branch reinsurers. However, the industry is now retaining additional catastrophe risk as reinsurers increase premiums and are less willing to underwrite the lower layers of catastrophe programs and aggregate reinsurance covers. Insurers are, at least in part, responding to this situation by increasing direct premium rates to consumers. In the context of its industrywide review of emerging risks, APRA is undertaking targeted supervisory reviews to better understand the impact of the changes in the reinsurance market on insurers.