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Life insurance industry overview

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Life insurance industry overview

This article provides an overview of the life insurance industry (including friendly societies) together with an update of the key prudential risks that face the industry.[1]

1 Unless otherwise stated, the period covered is the 12 months to 30 June 2014.

Introduction

The 12 months of 2013/14 for the life insurance industry could be characterised, on the one hand, as one of stability in terms of industry structure after a long period of years of merger and acquisition activity. It was also a period where the industry successfully bedded down the revised capital framework that commenced 1 January 2013.

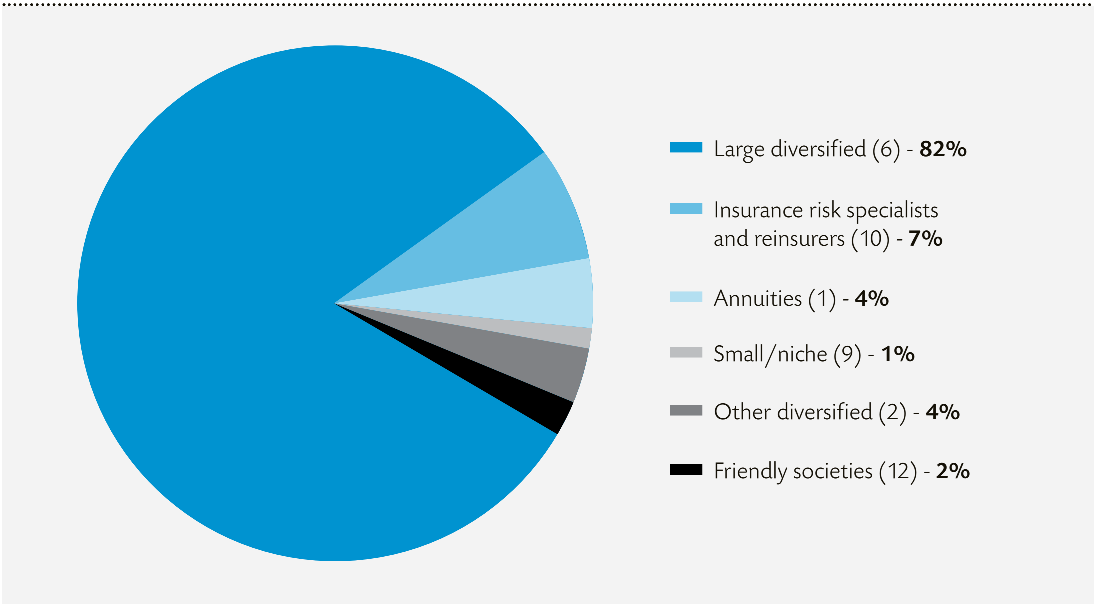
On the other hand, 2013/14 has also been a period of significant instability and uncertainty, where the cost of a slow weakening in business and risk management practices over a number of years finally became evident, crystallising into substantial declines in the performance of risk insurance business.

The industry is nonetheless well capitalised and is financially well placed to work through the current challenges. Life insurers have been making considerable efforts to remediate their pricing and risk management practices for insurance risk business while recognising that much still needs to be done. There are some early signs that profits may be returning to more ‘normal’ levels but it will take a few years yet before it is clear that industry actions have achieved sustainable premiums and profits.

LIFE INSURANCE INDUSTRY OVERVIEW

The integration of life insurance with broader wealth offerings in many institutions meant that the adjustment to regulatory changes such as the Future of Financial Advice (FOFA) and Stronger Super reforms were also key areas of focus during 2013/14 for both the industry and APRA.

Figure 1: Life insurers – Assets by industry sector (at 30 June 2014)



Source: *Life Insurance Institution-level Statistics* publication

Industry structure

As at 30 June 2014, there were 28 registered life insurers, which is unchanged from the previous year.[2] Life insurers are characterised by a heterogeneous mix of business profiles and strategies, comprising six medium to large life insurers (four of which are members of the major banking groups) selling a diversified but similar range of product types, together with a larger number of smaller but diverse life insurers specialising in niche products or markets. Seven reinsurers (all subsidiaries of international groups) provide essential support for the risk insurance market in Australia. An additional 12 friendly societies, accounting for around two per cent of industry assets, complete the mix. See Figure 1.

Measured by gross assets at 30 June 2014, the largest three and five life insurers account for 76 and 85 per cent respectively of industry assets.[3] This level of concentration has been relatively static for a number of years and is not particularly different to that in the general insurance industry.

Many life insurers are, however, strategically centred on regular insurance risk premium revenue and its growth. From this perspective, life insurance business is more evenly distributed across the industry, with the largest three and five life insurers writing 35 and 55 per cent of the industry insurance risk premium respectively over 2013/14.

2 One life insurer and one reinsurer are inactive.

3 AMP and NMLA, being part of the same group, have been combined for the purpose of these measurements.

Financial performance

Life insurer statutory funds held approximately $279 billion of assets at 30 June 2014 ($252 billion at 30 June 2013), a growth of 11 per cent. Repeating the pattern observed in 2012/13, the primary driver of the asset growth over 2013/14 was the continuing strengthening of equity markets.

Stronger equity markets also may have been a key driver of the growth in investment-linked premium inflows (primarily superannuation based) – investment-linked premium revenues were $28.8 billion during 2013/14 compared to $21.7 billion in 2012/13. It is noted though that this remains barely sufficient to cover outflows of $27.8 billion. See Table 1. Likewise, after taking account of insurance claims, insurance risk premium revenue adds little to the aggregate asset base.

Life insurers, as a vehicle for the superannuation investment, continue to lose market share to increasingly popular alternatives such as investment platforms, industry superannuation funds and self-managed superannuation funds (SMSFs). At 30 June 2014, life industry superannuation assets under management now account for 13 per cent of aggregate superannuation industry assets compared to 17 per cent and 40 per cent five years and 20 years ago respectively. This trend shows no signs of abating.

Insurance risk premium growth during 2013/14 was 12 per cent and 19 per cent for individual and group business respectively. Automatic contractual age- and inflation-related premium increases make up a significant and regular part of risk insurance premium growth in any year. For 2013/14, most particularly for group risk insurance, premium growth was nevertheless well above usual levels, reflecting insurers' responses to recent poor disability claims performance.

Table 1: Life insurers – Net premium revenue by product group (12 months ending June)*

	2010 $b	2011 $b	2012 $b	2013 $b	2014 $b
Investment-linked^	22.3	25.4	19.5	21.7	28.8
Other non-investment-linked investment^#	4.8	5.0	7.7	5.7	5.3
Traditional whole life/endowment	0.4	0.3	0.3	0.3	0.3
Total investment business^	**27.5**	**30.8**	**27.4**	**27.7**	**34.3**
Death/disability lump sum	4.3	4.8	5.1	5.7	6.4
Disability income	1.4	1.6	1.7	2.0	2.2
Individual Risk	**5.7**	**6.4**	**6.9**	**7.7**	**8.5**
Death/TPD lump sum	2.3	2.5	2.9	3.0	3.6
Disability income	0.5	0.6	0.7	0.8	0.9
Group risk	**2.9**	**3.0**	**3.6**	**3.8**	**4.6**
Total insurance risk business	**8.5**	**9.4**	**10.5**	**11.5**	**13.1**
Total net premium revenue	**36.0**	**40.2**	**37.9**	**39.2**	**47.4**

Source: APRA Statistics

* Rounding may cause differences in totals.

^ Excludes policy conversions.

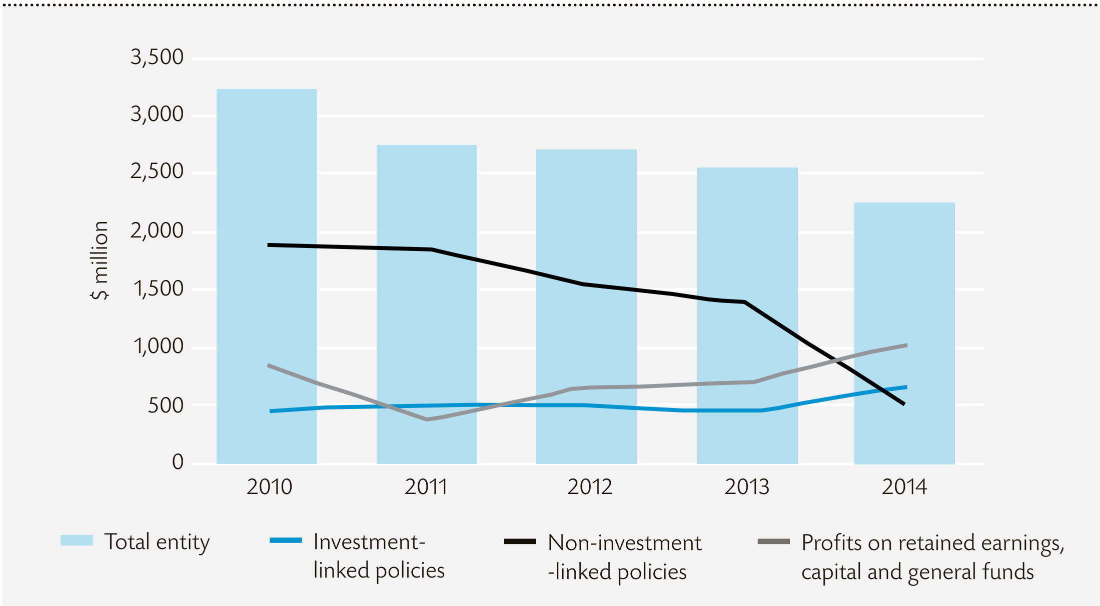
Total and permanent disablement.

Life insurance industry overview

Life insurer aggregate profits have been in steady decline for the last five years. See Figure 2.

The decline in the early part of this period could be attributed, in some part, to highly variable year-on-year investment market returns but, more recently, the progressively deteriorating claims experience of risk insurance business (including associated significant reserve strengthening) has been a prominent and unmistakeable driver (visible in the non-investment linked line).

Figure 2: Life insurers - Net profit by business group[4] (12 months ending June)



Source: *Life Insurance Quarterly Performance* publication

4 Amounts for investment linked and non-investment linked relate to insurance policies only, not total statutory funds.

Table 2: Life insurers – Relative capital performance 2013/14

	Non-investment linked $ b	Investment linked $ b	Ratio June 2013	Ratio June 2014
Total assets	88.0	191.2	0.5	0.5
Net profit	1.4	0.7	2.7	1.9
Prescribed capital amount (PCA)	5.4	0.7	6.4	7.8

Source: *Life Insurance Quarterly Performance* publication

By its nature, non-investment linked business is far more capital intensive than investment-linked business but the revenue, cost and risk drivers of the two forms of business are very different making comparison of capital costs and performance difficult. A return on capital measure is not particularly insightful in these circumstances. One alternative and perhaps more informative approach is to consider the trade-offs between profit and capital. See Table 2.[5]

Non-investment-linked business assets were 0.5 times that of investment-linked business but the business generated 1.9 times the profit in 2013/14, down from 2.7 in 2012/13. However, more relevant was that it required 7.8 times the Prescribed Capital Amount (PCA) to generate that profit, which was up from 6.4 from 2012/13. In other words, non-investment-linked business became even more capital-expensive over 2013/14 relative to investment-linked business due to a combination of the deterioration in claims experience and increases in prudential risk capital requirements as business has grown.

5 A return on capital measure only tells half the story since it hides the relative contributions of these components.

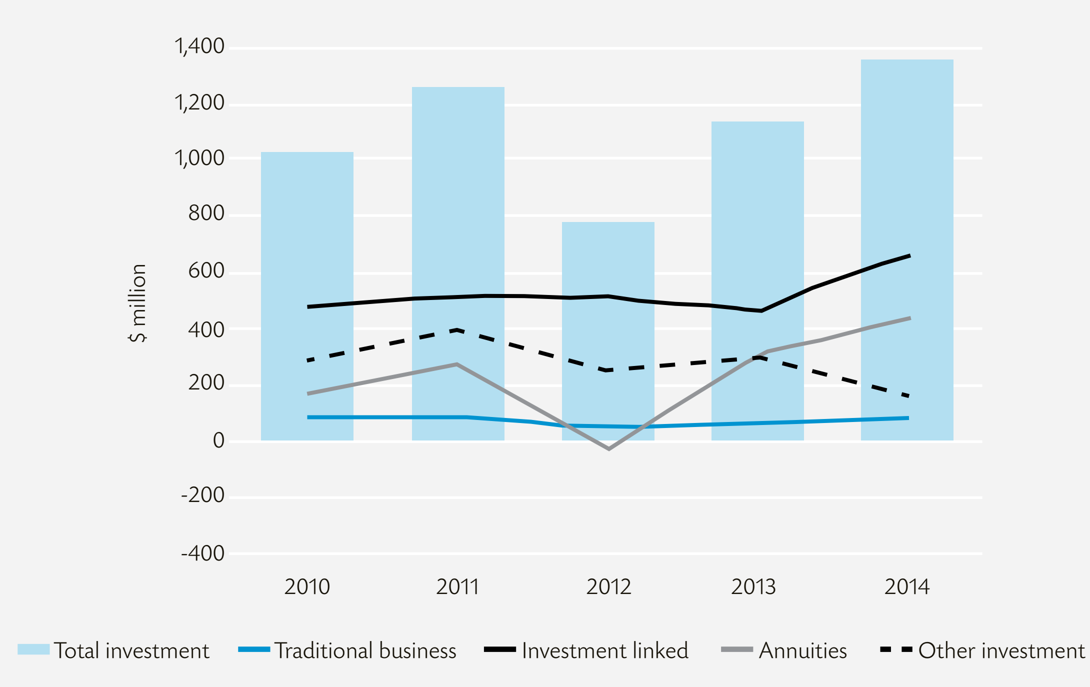
Investment business

Apart from its lower relative capital cost, many life insurers remain attracted to investment-linked business because, historically, it can bring some performance diversification and stability. It contributed 30 per cent of aggregate industry profits in 2013/14 (18 per cent in 2012/13) and therefore played an important role in this period. This is further evident in Figure 3 which shows net profits of investment products (both investment- and non-investment linked) broken into major product groups.

The figure also shows that annuities, while also a material contributor to aggregate profits, generate a significantly more volatile return, being sensitive to movements in interest rates and credit spreads.

The rate of surrender and withdrawals for investment-linked business over recent years has been trending upward. While there are clearly seasonal cycles, the trend appears not have abated during 2013/14.This is partly a function of transfers to the increasingly popular alternative vehicles for superannuation mentioned earlier, including an increasing preference by investors and retirees for SMSFs.

Figure 3: Life insurers – Net profit by major investment product groups (12 months ending 30 June)



Source: *Life Insurance Quarterly Performance* publication

Insurance risk business

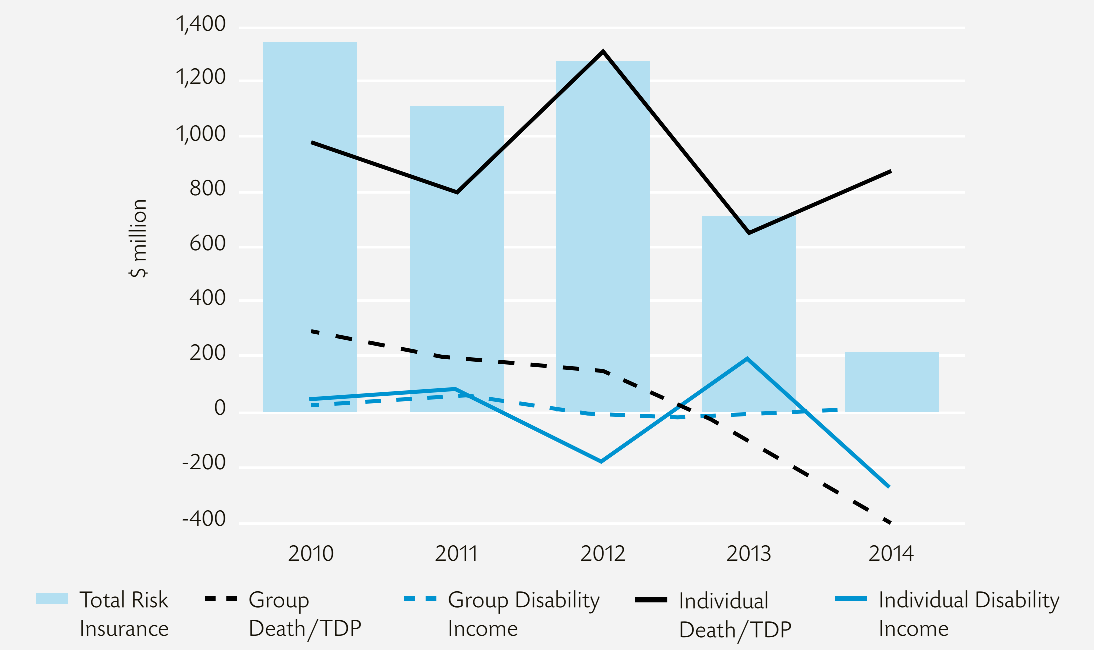
Figure 4 contrasts the profit performance of insurance risk business (both in aggregate and by major product classes) with that of investment business shown in Figure 3 (the axis scales are the same).

Large swings in profits and losses over the five year period are evident as is the further sharp deterioration in 2013/14 for individual disability income and group death/TPD insurance (most particularly for industry superannuation fund schemes). Some part of that deterioration is due to a strengthening of claims reserves in anticipation of ongoing higher claims experience. The most recent quarterly data suggests that industry insurance risk profits might be at the start of a recovery. Should the turnaround be confirmed in due course, it will be important to identify the underlying reasons and where structural problems might still remain, and thereby make an assessment of its long term sustainability.

For example, the impact on profit recovery of the recent steep increases in premium rates for a number of industry superannuation schemes clouds the ability to draw any inference that the underlying deterioration in the claims trend has been arrested. In principle, so long as premium rate settings align with actual claims experience, then the business will be profitable. We expect though that both premium rates and mitigation strategies will take some time to take full effect, and profitability returns to reasonable and sustainable levels.

Over a number of years, lapse rates for individual risk business have risen and are significantly higher than those which prevailed several years ago. There has been no sign of any reversal of this trend during 2013/14. The worsening lapse experience has been attributed to a number of factors including a declining need for risk insurance by ageing ‘baby boomers’, stronger competition in the market, pressure on household budgets leading to some pruning of discretionary expenditure, and the longer-term impact of premium rates that automatically increase each year with age.

Figure 4: Life insurers — Net profit by major insurance risk product groups (12 months ending 30 June)



Source: *Life Insurance Quarterly Performance* publication

It is also possible that consumers are recognising that the life insurance cover they hold may no longer meet their changing needs, and that product 'churn' by financial advisers in light of the attraction of very high up-front commission rates for new business has contributed to lapse rates. Consistent with the Australian and Investment Commission's (ASIC) recently completed review of industry sales practice, APRA has highlighted to insurers the significant reputational risk attached to inadequate oversight of sales practices.

Friendly societies

The net profit of friendly societies declined to $260 million in 2013/14, after a strong result in the previous year of $350 million (and $101 million in the year prior to that).[6] The volatility in friendly society profits is associated with its investment-linked business, which, forming about two thirds of business and broadly tracking Australian share market performance, is the key driver of overall friendly society profits. Non-investment-linked business tends to be supported by more conservatively invested assets and returns for this business tend to be more stable.

6 For friendly societies, 'profit' is not shareholder profit; rather, it is the total profits of the benefit funds and management fund before allocation to policyholders.

Capital

The industry's capital position remained strong in 2013/14. As at 30 June 2014, the aggregate capital base held for life insurers was 1.87 times the PCA, the regulatory minimum capital (before supervisory adjustments). See Table 3.

Since 2013, APRA's revised capital requirements have allowed two general tiers of capital to form the capital base. Some life insurers have taken advantage of this flexibility, with Tier 2 capital representing eight per cent of total life insurer capital at 30 June 2014.

The industry's capital position remained strong in 2013/14.

Table 3: Life insurers - Capital strength (at 30 June 2014)

	Capital Base $m	PCA $m	Surplus over PCA $m	Capital Coverage Ratio
Investment-linked	1,340	690	650	1.94
Non-investment-linked	9,346	5,353	3,993	1.75
Total statutory funds	10,685	6,043	4,643	1.77
General fund	1,418	404	1,014	3.51
Total life insurers	**12,103**	**6,485^**	**5,618**	**1.87**

Source: *Life Insurance Quarterly Performance* publication

^ The total entities PCA is adjusted for the minimum entity PCA of $10 million where applicable.

The make-up of the PCA is generally in alignment with expectations with respect to two general forms business written. For non-investment-linked business, 69 per cent of the PCA is the aggregate of asset and insurance risk charges. The operational risk charge accounts for a further 11 per cent. In contrast, for investment-linked business, the PCA is largely made up of the operational risk charge (67 per cent) with most of the residual being the asset risk charge on surplus assets.[7] While these ratios, at an industry level, align with general expectations of the relative risks for these business classes, they vary significantly by individual insurer reflecting the diversity of business profiles and risk management practices.

While capital ratios vary considerably across individual life insurers, in overall terms, the industry is well capitalised and capable of withstanding significant headwinds. Nevertheless, some forms of life insurance (and friendly society) business remain exposed to sudden shifts in investment market returns, most particularly those with long term investment guarantees. For example, low interest rates across the yield curve have reduced investment income and the outlook for fixed interest markets remains decidedly uncertain. An unexpected but significant change in official cash rate settings, credit spreads or market sentiment would exacerbate asset-liability investment matching, at least in the short term. The resilience of life insurers and friendly societies in times of increased uncertainty and market volatility will always need to be closely monitored by both entities and APRA.

7 Full details are provided in APRA's statistical publication *Quarterly Life Insurance Performance*.

Internal Capital Adequacy Assessment Process (ICAAP)

An important part of the package of revised capital standards for insurers introduced by APRA on 1 January 2013 was the requirement for insurers to have an Internal Capital Adequacy Assessment Process (ICAAP). APRA undertook a detailed review of ICAAP Reports in 2014 including peer comparisons to identify examples of better practice and potential areas for improvement.

While most of the ICAAP Reports reviewed were of a reasonable standard there were some areas where insurers fell short of APRA's expectations with regard to the content and quality of the reports. These areas included the comparison of actual versus planned ICAAP outcomes, description of changes in risk profile, commentary on drivers of future capital needs and the use of stress testing outcomes in decision making processes.

Stress testing

Stress testing is a quantitative 'what if' exercise aimed at assessing vulnerabilities and resilience in the face of 'severe but plausible' shocks. If implemented effectively and with expert judgement, stress testing can be a useful analytical tool to complement other risk management approaches and capital assessment models.

Stress testing is a quantitative 'what if' exercise aimed at assessing vulnerabilities and resilience in the face of 'severe but plausible' shocks.

Stress testing is now a common component of the risk management tool kit of most life insurers and APRA has been placing more emphasis on it during 2013/14. Apart from insurers' own stress testing modelling and scenarios, APRA is developing a standardised stress test for the life insurance industry (now standard practice in the Authorised Deposit-taking Institutions (ADI) industry). Eight life insurers will be participating in the initial test to be undertaken in the middle of 2015. The stress test will focus on 'severe but plausible' scenarios in the areas of investment market and insurance claims risk.

APRA-led stress testing will play a role, complementary to ICAAP stress testing, in informing APRA about entity and industry-wide capital vulnerabilities. It is also one way to ensure that appropriately demanding severity tests are considered by life insurers in their capital planning. While not all insurers will be directly participating in this initial program, APRA will be encouraging to all insurers and friendly societies to consider the standardised stress test in their ICAAPs.

Industry risks

Group risk insurance

In response to the poor claims experience discussed earlier, by the end of 2013 three major reinsurers had ceased quoting for new Total and Permanent Disablement (TPD) business, and quotations for TPD renewal business were generally conditional on minimal changes to contract terms. Given that group risk business is typically a 'bundled' package of TPD and death cover, this effectively meant a significant reduction in reinsurer capacity available to group risk insurers. While there appears to be some interest from additional foreign reinsurers in writing business in Australia, the recent reduction in capacity has posed challenges for group risk insurers seeking competitive reinsurance quotations, resulting in significant premium increases for many group policies.

Factors contributing to this situation include the following developments over recent years:

- record amounts of default cover being made available without underwriting;
- a weakening of underwriting controls for optional levels of cover, and automatic acceptance of incremental increases in cover without the need for medical evidence;
- the growth in complexity of TPD benefit definitions, resulting in some types of claims being admitted that arguably may not have been intended to be covered by the policy wording;
- changing community attitudes to mental health, leading to a higher prevalence of claims for stress-related illness;
- more claims now being subject to the involvement of lawyers on behalf of claimants;
- superannuation fund member awareness of life insurance cover provided through superannuation, leading to a higher propensity to claim; and
- failure to match the greater complexity of the claims environment with development of an adequate pool of experienced claims staff.

Despite a number of warnings from APRA, group risk insurers have been slow to accept that significant price reductions combined with softer underwriting practices and enhancements to benefits would ultimately affect profitability. Nor was the emergence of other underlying headwinds recognised in a sufficiently timely fashion or allowed for in pricing assumptions.

The immediate response of affected life insurers has been to lift premiums sharply to redress losses. Not only has this led to adverse outcomes for superannuation fund members, it does not address the structural problems that caused the situation. APRA supervisors are therefore coordinating closely across the life insurance and superannuation sectors to ensure that life insurers, reinsurers and superannuation fund trustees are working together to identify and resolve the underlying causes of the strains in the group risk insurance market. Throughout, APRA's message to life insurers and reinsurers has been that boards must ensure they understand adequately the risks they incur in group insurance business, and that risk management processes are adequate for the uncertainties in this line of business.

Life insurance industry overview

Many life insurers and reinsurers have subsequently undertaken extensive reviews of their group-risk pricing methodology, product design and claims management. Foreign-owned reinsurers in particular have drawn on their global experience and expertise to seek better insights into the Australian market so as to improve performance.

On 1 July 2013, APRA's new prudential standards for superannuation – in particular, *Prudential Standard SPS 250 Insurance in Superannuation* (SPS250) – came into effect. Two critical new responsibilities of trustees under SPS 250 are:

- for an insurance management framework that reflects the risks associated with making insured benefits available; and
- the need to maintain records of sufficient detail that a prospective insurer can properly assess the insured benefits made available.

APRA supervisors are reviewing the adequacy of trustees' implementation of the new prudential standards. As noted below, the availability of sufficiently detailed, accurate and timely insurance-related data appears to be lacking across the industry and APRA has informed life insurers and superannuation fund trustees of the need for improvement in this area. APRA has issued guidance for superannuation fund trustees and life insurers to assist them in meeting the requirements of SPS 250.

Foreign-owned reinsurers in particular have drawn on their global experience and expertise to seek better insights into the Australian market so as to improve performance.

Other risks

Given the industry trends and issues outlined, it is not surprising that APRA's supervisory intensity has lifted significantly in the past 12 to 18 months. APRA supervisors have closely monitored developments and taken steps to highlight to boards and management the poor business and risk management practices that have contributed to the current situation. Life insurers have also been urged to analyse claims trends so as to identify and respond to the causes of rising adverse claims. APRA strongly supports the use of industry wide claims studies to this end. It is evident to APRA that the quality of data held by life insurers is mixed, and that a lack of sufficiently detailed, accurate and timely data impedes appropriate analysis in many cases.

Apart from challenges with respect to the low interest rate environment and worsening claims experience referred to earlier, life insurers also report continuing difficulties attracting and retaining claims staff, which is putting pressure on remuneration of experienced staff in this field. Most life insurers have commenced projects to address the cost of managing claims and improve their handling. In particular, early intervention in major injury claims is acknowledged widely as a key factor in reducing claims costs and supporting claimants. However, managing such claims effectively requires a specialist expertise that has been in short supply for some time. This suggests the need to better develop and invest in the pool of capable and experienced claims staff, which presents another longer-term challenge for the industry.

General insurance industry overview

This article provides an overview of the general insurance industry together with an overview of recent developments and key prudential risks.

Introduction

The general insurance industry maintained a strong financial position during the year, driven primarily by the profitability of personal lines insurers in the absence of significant natural peril events. In contrast commercial lines insurers continue to face challenges in the current operating environment due to strong competition, excess capacity in the market and low interest rates impacting profitability.

The risk of these pressures leading to inadequate pricing by some commercial lines insurers is currently being examined by APRA, with the objective being to assist supervisors in their engagement with insurers on pricing strategies and processes. Reserving risk is also heightened at present because pressures on insurers' results, through for example lower investment income may prompt some to use reserve releases to aid short term profitability, potentially compromising reserving adequacy.

A thematic review of insurers' governance and risk management practices in catastrophe risk management highlighted a number of concerns. These included the reliance by some insurers on catastrophe model output used in reinsurance purchasing decisions and setting capital targets, without adequate challenge of this output. APRA provided feedback from the review to industry in late 2013 as part of the focus on improving industry practice in this area, and has been engaging with insurers during 2014 on the issues raised.

On the regulatory front, insurers successfully implemented the insurance concentration risk charge (ICRC) for a series of smaller sized loss events as from 1 January 2014. This part of the package of revised capital requirements for general insurers introduced by APRA on 1 January 2013 was deferred for one year to allow insurers time to prepare for the change.

Industry structure

There were 115 licensed general insurers and reinsurers at 30 June 2014, with 18 of these entities in run-off. At that date the 103 licensed insurers accounted for 90 per cent of the industry's $114.4 billion in total assets.

Table 1 shows the steady decline in the number of licensed insurers and reinsurers in the market over the past four years. Further consolidation of insurance licenses took place in 2013/14, with most of this being due to Suncorp's rationalisation of its insurance licenses following a group restructure.

On the regulatory front, insurers successfully implemented the insurance concentration risk charge (ICRC) for a series of smaller sized loss events as from 1 January 2014.

Table 1: Industry structure

	30 June 2011	30 June 2012	30 June 2013	30 June 2014
Number of licensed insurers	115	112	109	103
Number of licensed reinsurers	12	12	12	12
Total licensed insurers/ reinsurers	**127**	**124**	**121**	**115**

Source: *APRA Quarterly General Insurance Performance Statistics* publication

Insurance Australia Group's acquisition of Wesfarmers' insurance business took effect on 30 June 2014, strengthening the market share held by large insurance groups in the personal and commercial lines markets. Despite the increasing concentration in both markets, healthy competition is evident among the large domestic insurance groups, APRA-authorised subsidiaries of foreign insurers and other local insurers.

An important source of competition in personal lines is provided by a number of challenger brands in the market, which continue to gain momentum and are starting to erode some of the established brands' market share. Personal lines on-line 'aggregators' continue to have a small presence in the market.

Financial performance

The industry reported a strong operating result in the year ended 30 June 2014, with a net profit after tax of $4.9 billion driven primarily by insurers' underwriting results. Table 2 outlines industry performance over the past four years.[1]

The industry reported a strong operating result in the year ended 30 June 2014, with a net profit after tax of $4.9 billion driven primarily by insurers' underwriting results.

The growth in gross earned premium in the year ended 30 June 2014 was mainly reported in the personal lines classes of business – householders and domestic motor, with premium growth also reported in the complusory third party (CTP) motor vehicle class of business. The impetus for the premium rate increases in the householders class was the rise in the cost of property reinsurance which followed the severe natural catastrophe claims experience of some property insurers in 2011. Recent data suggests a slowdown in premium growth rates in the householders class, which is consistent with the moderation in property reinsurance rates experienced during the year.[2]

Premium growth in the commercial lines classes of business continues to be subdued due to strong competitive pressures. This is most evident in the commercial property (Fire and ISR) and professional indemnity classes, with little or no growth in earned premium reported during the year.

1 It should be noted that there is a degree of double-counting of data such as gross claims in this table as the figures include data from both insurers and reinsurers.

2 Insurance Council of Australia, GI Industry Trends to June 2014

Table 2: Industry financial performance

$million				
	12 months to			
	30 June 2011	30 June 2012	30 June 2013	30 June 2014
Gross written premium	34,289	37,413	39,891	41,650
Gross earned premium	34,286	36,947	39,937	41,414
Gross incurred claims (current and prior years)	35,968	27,869	24,602	26,251
Reinsurance recoveries revenue (current and prior years)	**15,788**	**5,815**	**4,638**	**4,585**
Net incurred claims (current and prior years) of which:	**17,740**	**19,659**	**17,836**	**19,135**
Current period net claims expense	18,993	19,516	19,308	19,845
Non-recurring items that are part of net claims	-1,254	143	-1,472	-710
Total underwriting expenses	**7,016**	**7,562**	**7,878**	**8,024**
Underwriting result	**1,111**	**569**	**4,157**	**4,092**
Investment income	4,657	5,411	4,091	3,684
Other operating expenses	1,737	1,748	1,883	2,008
Other items	-138	-519	-1,107	-813
Net profit/loss after tax	3,893	3,714	5,257	4,955
Average net assets ($m)	**29,799**	**30,274**	**31,024**	**29,806**
Return on net assets*	**13%**	**12%**	**17%**	**17%**

Source: *Quarterly General Insurance Performance Statistics* publication

* Quarterly figures expressed as annual percentage rates

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Property insurers continue to benefit from relatively benign weather conditions resulting in low claims costs. Claims costs from natural catastrophe events during 2013/14 were well below the twenty year average as shown in Figure 1, with the main events of note being bushfires in New South Wales.

In contrast with the recent strong claims performance in the short-tail property classes of business, the experience in the long tail classes such as CTP motor, professional indemnity and public and product liability has been mixed.

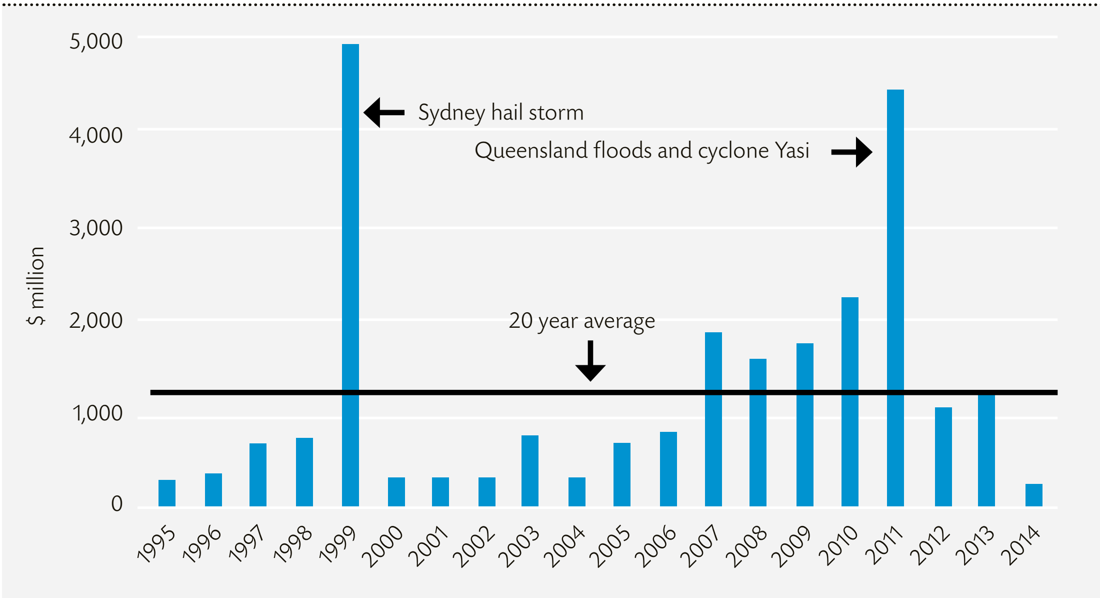
The Motor Accidents Authority of NSW (MAA) has advised that claims frequency and propensity to claim continues to rise in the NSW CTP scheme mainly with minor severity and legally represented claims.[3] In contrast the Queensland CTP scheme has experienced a largely stable claims frequency in recent years.

Claims experience in the professional indemnity class, which includes Directors and Officers (D&O) covers, is sensitive to economic conditions and movements in financial markets. This was illustrated during the global financial crisis with significant claims costs being incurred by insurers and reinsurers in 2008 and 2009, particularly in the financial services sector. Since that time claims frequency in the professional indemnity class has been declining. However an ongoing risk to the claims experience in D&O covers is the increase in litigation funders and class actions evident in the market since the financial crisis.

Industry loss ratios in the public and product liability class continue to be at profitable levels with a relatively stable level of claims inflation, positively impacted by tort law reform, underpinning results in recent years.

3 MAA Annual Report 2013/2014

Figure 1: Gross claims costs from Australian natural catastrophe events



Source: Insurance Council of Australia, Natural Disaster Statistics. Claims costs prior to March 2010 have been indexed to 2011 values.

Reserve releases from prior accident years continue to make an important contribution to insurers' claims performance in some long tail classes of business. However in recent years this contribution at an industry level has been diluted because of the strong claims performance in the property classes of business.

There was a relatively small movement in the interest rates used by insurers to value their long tail claims reserves in the year ended 30 June 2014. This contributed to an increase in claims costs relative to the previous year, because increases in interest rates in 2012/13 had caused reductions in the value of these reserves and resulted in lower long tail claims costs.

Most general insurers match the duration of their assets and liabilities with the aim of minimising the effect on earnings of movements in bond yields/ discount rates. This resulted in insurers' recognising higher realised and unrealised gains on fixed-income investments in 2013/14 when compared to the previous year. Insurers continued to report lower interest income on their fixed income investment portfolios, consistent with the low interest rate environment.

Capital

The industry reported a prescribed capital amount coverage ratio of 190 per cent as at 30 June 2014 (Table 3). Since the natural catastrophe events of early 2011, industry capital levels have trended upwards with healthy industry earnings bolstering retained profits. The industry's capital base is predominantly made up of Common Equity Tier 1 capital (93 per cent), with a small amount of Additional Tier 1 capital (two per cent) and Tier 2 capital (five per cent).

An important change for the industry was the introduction of the ICRC for a series of smaller natural peril events. This came into effect on 1 January 2014 following a 12 month transition period which allowed insurers time to prepare for the change. The introduction of the requirement led to 26 insurers needing to increase their total ICRC, resulting in a $282 million (seven per cent) increase in the industry's total ICRC.

Table 3: Industry capital adequacy

	30 June 2011	30 June 2012	30 June 2013	30 June 2014
Minimum capital requirement ($m)	15,291	15,844		
Prescribed capital amount ($m)			15,631	15,859
which comprises:				
OCL insurance risk charge ($m)			4,079	4,172
PL insurance risk charge ($m)			2,638	2,766
Insurance concentration risk charge ($m)			4,848	5,116
A sset risk charge ($m)			5,444	5,135
Other risk charge items ($m)			-1,428	-1,376
Eligible Capital base ($m)	26,668	28,166	28,442	30,052
Solvency coverage ratio (%)	**175**	**178**		
Prescribed capital amount coverage ratio (%)			**182**	**189**

Source: *APRA Quarterly General Insurance Performance Statistics* publication

The decrease in the industry asset risk charge component of the prescribed capital amount in the year was largely due to a fall in the reinsurance recoverables resulting from the settlement of Christchurch earthquakes property claims though these continue to represent a significant portion of the overall industry reinsurance recoverables. Recoverables attract higher capital risk charges when due from non APRA authorised reinsurers because of the time taken to settle the claims.[4] An exception is if the affected insurers put in place collateral, a guarantee or letter of credit to support the reinsurance recoverables, in which case the risk charges applicable to this support can be used, provided they meet APRA's requirements.

An important part of the package of revised capital standards for insurers introduced by APRA on 1 January 2013 was the requirement for insurers to have an Internal Capital Adequacy Assessment Process (ICAAP). APRA undertook a detailed review of ICAAP Reports in 2014 including peer comparisons to identify examples of better practice and potential areas for improvement.

While most of the ICAAP Reports reviewed were of a reasonable standard there were some areas where insurers fell short of APRA's expectations with regard to the content and quality of the reports. These areas included the comparison of actual versus planned ICAAP outcomes, description of changes in risk profile, commentary on drivers of future capital needs and the use of stress testing outcomes in decision making processes.

Operating environment

Market conditions

Current market expectations are that local interest rates will remain at low levels in the near term. The management of risks arising from a persistently low interest rate environment among a sample of insurers was reviewed by APRA in 2013 with a focus on governance practices, pricing, investment strategies and operational risk.

The review concluded that all of the insurers in the sample have appropriate management and controls in place. Insurers acknowledged in their feedback that continuing competitive pressures were constraining their ability to achieve adequate price increases in some long tail classes to offset the impact of lower investment yields.

4 These risk charges apply to reinsurance contracts incepting on or after 31 December 2008 where the debt is outstanding on or after the second balance date after the event giving rise to the debt.

Insurers indicated they were not looking to significantly change their conservative investment strategies. This feedback is consistent with the investment mix reported at an industry level during 2013 with insurers and reinsurers continuing to largely invest in cash and interest rate investments with highly rated counterparties such as authorised deposit-taking institutions and Australian governments.[5] In the review, insurers indicated some increase in appetite for growth assets and equities in their investment allocations for shareholder funds. The returns on shareholder funds impact the profitability of insurers and so changes in investment risk appetite will continue to be monitored by APRA supervisors.

The review also looked at whether the current environment has influenced insurers' focus on cutting costs, particularly through outsourcing and offshoring activities, as this may increase insurers' operational risk profile. The feedback from insurers was that outsourcing and offshoring decisions have been made to improve operational efficiencies and leverage off group capabilities, rather than as a response to investment market conditions.

APRA supervisors will continue to monitor the effectiveness of insurers' risk management frameworks to ensure they highlight areas where their risk profile is changing in response to the low interest rate environment. These changes should be monitored and expressly considered in insurers' governance and decision making processes.

APRA supervisors will continue to monitor the effectiveness of insurers' risk management frameworks to ensure they highlight areas where their risk profile is changing in response to the low interest rate environment.

5 Highly rated counterparties are defined as being rated APRA Grade 1 or 2 which is the equivalent to an S&P rating of AA- or better. Australian government counterparties are defined as the Commonwealth, State or local government or public sector trading enterprises.

General insurance industry overview

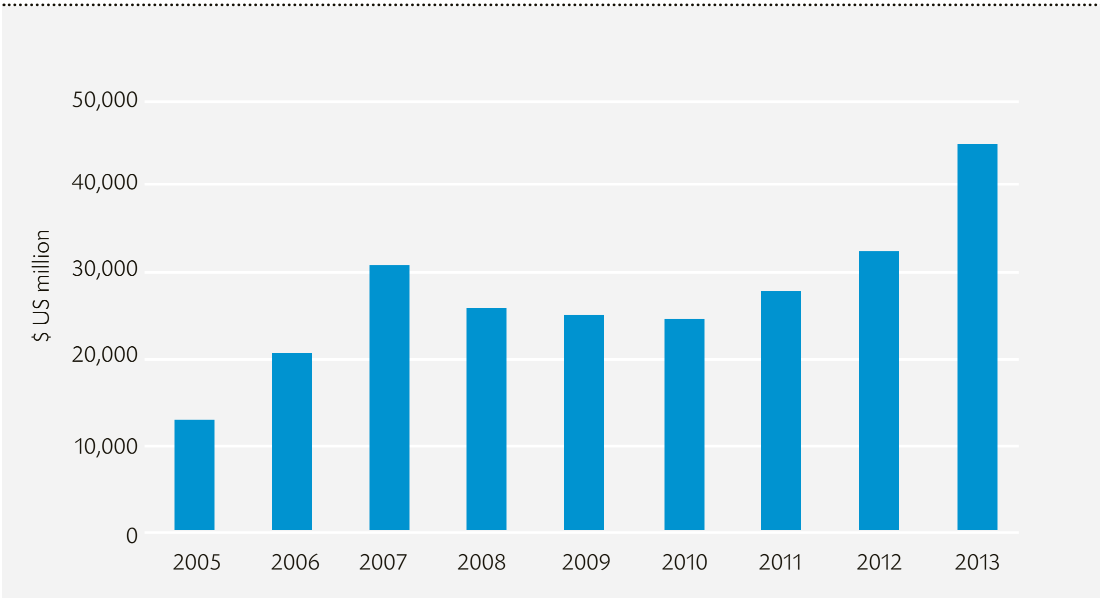
The low interest rate environment is one of the drivers of the recent strong growth of alternative capital in the global property reinsurance market illustrated in Figure 2. Alternative capital refers to the capacity provided to the reinsurance market by investors such as hedge funds and pension funds through insurance-linked products such as catastrophe bonds because of the higher yields on offer and these products' historically low correlation with traditional assets classes.

At present alternative capital is largely concentrated in various offshore property catastrophe reinsurance and retrocession markets such as in the USA.[6] The increased use of alternative capital has led to direct pressure on the pricing and profit margins of traditional reinsurers operating in those markets, while in other peak risk areas such as Australia it has contributed to the excess of traditional property reinsurance available. This excess capacity has been a contributing factor in the fall in reinsurance pricing in the local market.

A review by APRA in 2014 found that there is little appetite at present from APRA authorised insurers for alternative reinsurance products. Insurers surveyed have a preference for traditional reinsurance because it is readily available at favourable terms and conditions. Some also mentioned the value of maintaining the long standing relationships with their traditional reinsurers as well as certainty of traditional arrangements. APRA will continue to monitor developments in this area and, where needed, review alternative reinsurance arrangements entered into by APRA authorised insurers to ensure they adequately address APRA's reinsurance and collateral requirements.

6 To provide some context on the level of alternative reinsurance capital in the reinsurance market, AON Benfield estimates that global reinsurance capital from traditional reinsurers and alternative reinsurance totalled $US540 billion at 31 December 2013.

Figure 2: Alternative capital in the global property reinsurance market



Source: Swiss Re Capital Markets

Insurance affordability

Affordability of natural perils insurance remains an area of reputational and potential political risk for the industry. It has received most attention in north Queensland where the cost of property insurance has increased since the flood and cyclone events of 2011 and some insurers have chosen to withdraw from that market. In instances where the cover for such perils is a compulsory part of insurers' policy offering, home and contents insurance may be unaffordable. Equally where riverine flood cover is available on an opt out basis for properties at high flood risk, the cost of that cover may be unaffordable leading policyholders to opt out of that cover.

In an attempt to increase competition in north Queensland, the Government has announced it will establish a comparison website allowing consumers to compare premiums and product features for home and contents policies offered by insurers. Furthermore the Government has clarified that licensed insurance brokers can sell policies from foreign insurers where they offer a consumers a better price.

Industry risks

The adequacy of the reserves held by general insurers (and reinsurers) to meet their future insurance liabilities is critically important and is an area of regular supervisory review. APRA is of the view that the risk of inadequate reserving is heightened at present because challenges to insurers' profitability in the long tail classes of business may accentuate the risk that insurers use releases from reserves to support short term underwriting profits. These challenges to profitability include falling investment returns in a low interest rate environment and the strong competitive pressures in commercial lines which are restricting pricing increases.

The competitive dynamics in commercial lines have also led APRA to review pricing risk in this market during 2014, with the concern being that inadequate pricing may negatively impact insurers' financial performance and, as a result, their capital position. The review has involved examining data reported by insurers to analyse premium trends and pricing adequacy and in doing so aims to assist APRA supervisors in their ongoing engagement with insurers on their pricing strategies and processes.

An area of ongoing focus by APRA is insurers' governance and risk management processes in their use of catastrophe modelling. A thematic review by APRA highlighted a number of concerns in this area, including the excessive reliance by some insurers on catastrophe model output in reinsurance purchasing decisions and the setting of capital targets, and the absence of formal processes to challenge this output. As part of APRA's drive to encourage better industry practice in this area, a letter was sent to industry in late 2013 setting out the conclusions from the thematic review and highlighting issues APRA expected insurers to address. Supervisors have been engaging with insurers during 2014 on their responses to the issues raised.

Notes

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