Taylor Fry
Analytics & Actuarial Consulting
Radar 2017
Insights for
insurance leaders

Taylor Fry is pleased to present our third annual edition of *Radar: Insights for insurance leaders*. We produce Radar to give our insurance partners insights into the issues that will feature prominently in the coming year. This year, for the first time, we offer our opinion on the New Zealand insurance landscape (coinciding with the opening of our Wellington office in 2016).

The outlook on the whole is more positive for Australian and New Zealand insurers than in recent years. This should ease some pressure for insurers, creating space to assess the impact of changes in the broader economic landscape and regulatory environment, as well as disruptive technological advances.

Ongoing competitive pressures have insurers looking for accessible insights that can help them maintain their edge. In Radar we draw on our continued market research and unique perspective as an independent consultancy to provide insurance leaders with insights to help them tackle the challenges that lie ahead.

What's inside?

Readers looking for a quick summary of facts and insights should turn to *What's on the radar for 2017 and beyond?* (pp. 4-5).

In *2016 in review* (pp. 6-11) we look back at the trends that emerged in FY 2016, and in *Key issues for 2017 and beyond* (pp. 12-19) we consider some of the strategic issues that should be on all insurers' radars going forward. In the final section, *Review of classes of business* (pp. 20-27), we dive deeper into recent past experience and outlook for individual lines of business.

Have a question? Our insurance team would welcome the opportunity to discuss any aspect of *Radar* with you.

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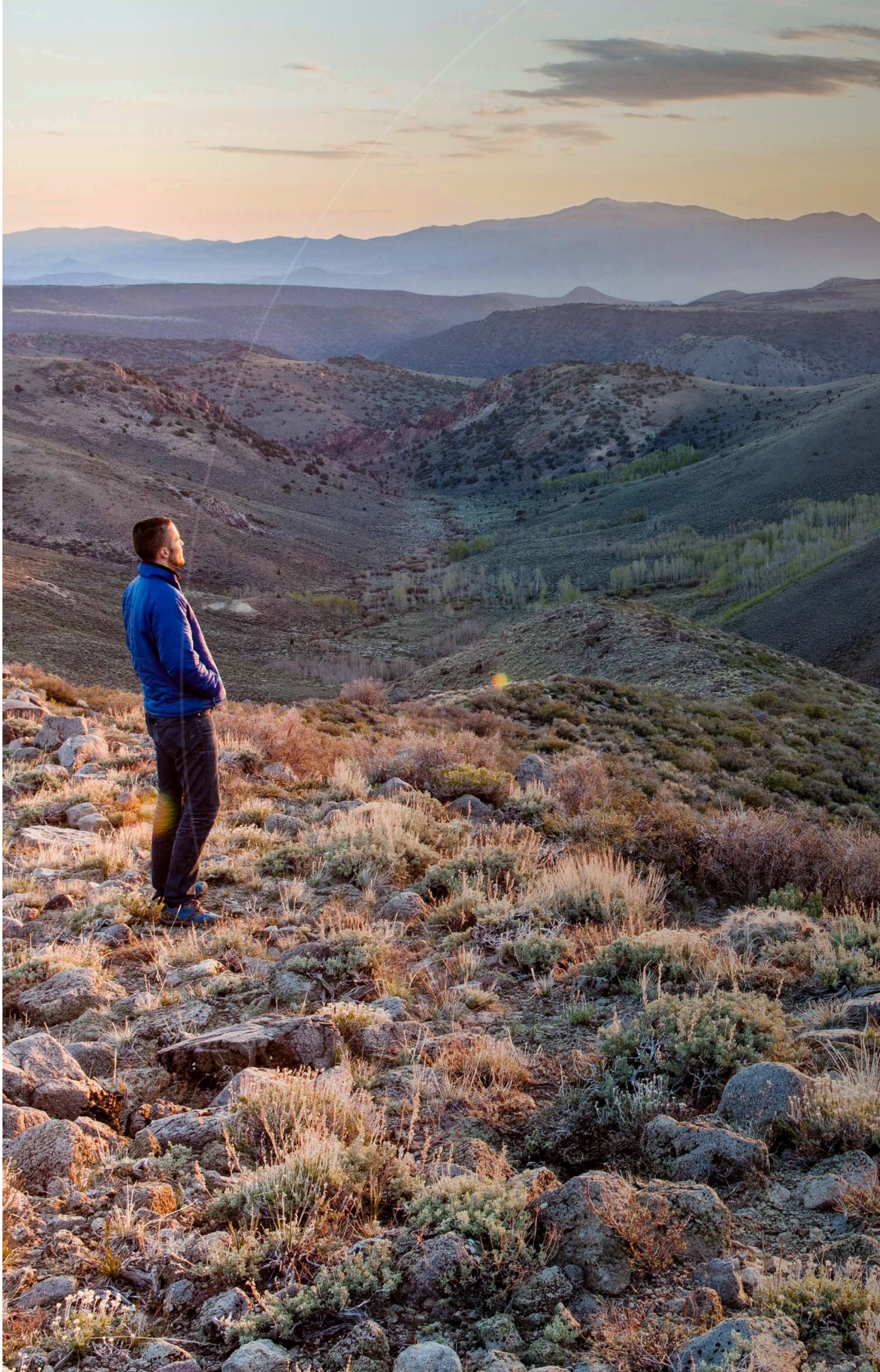

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What's on the radar for 2017 and beyond?

Conditions began to improve for the insurance industry in the 2016 financial year, and it looks like 2017 may be a year of increasing profitability. Claims pressures remain, and the entire market remains highly competitive.

Regulation update – insurers urged to prepare and protect / p12

Regulatory concerns continue to be an area of focus for insurers. In the face of the economic and political changes entailed in Australia's move towards a low-carbon economy, those in financial industries are being urged to turn their attention towards the transition risks associated with climate change.

The protection of consumer rights is also topical, following the concerning findings of ASIC's 2016 review into the selling of general insurance add-ons by car dealers. With regulators strengthening their involvement in industry practices, insurers will need to ensure they have adequate measures in place to protect their customers' needs.

With (cyber) risk comes opportunities / p13

Insurers have rated cyber risk as one of the key opportunities for growth in the Australian market. We anticipate some major developments this year, including a likely influx of capital into the development of cyber products and capabilities, and an increase in insured losses.

Pricing cyber risk effectively will remain a key challenge given the lack of insured-loss data, and insurers will continue to rely on competitor and international pricing as their first point of reference.

Big data, big responsibilities – the latest on privacy guidelines / p14

Big data presents a double-edged sword for insurers. It opens up opportunities to gain greater insight into customers and improve service offerings, but it also brings new challenges associated with managing personalised information responsibly.

Best practice guidelines encourage organisations to embed privacy in their culture, systems, and risk management processes – that is, design privacy into the fabric of projects rather than bolting it on afterwards.

Fighting fire with fire – sophisticated fraud schemes call for a sophisticated response / p15

The increased incidence and magnitude of fraud today presents a significant cost to the insurance industry – estimated to be more than $2 billion per year in Australia alone.

Globally, top insurers are reviewing their risk-management programs in response to the proliferation of fraud, and many are finding that established fraud detection strategies and existing infrastructure are falling short in the face of increasingly sophisticated fraud schemes.

With fast-moving advancements in the field unlikely to abate any time soon, insurers will do well to look for agile fraud solutions that can adapt to emerging types of fraudulent activity and support timely and effective action.

Survival of the fittest – innovation spells adaptation for insurers / p16

Peer-to-peer insurance is globally on the rise, with the promise of a 'fairer' insurance system at the heart of its appeal. Now more than ever, insurers will need to consider what they offer their customers in terms of product, price and process transparency.

When considering the automotive industry, insurers should be looking to keep on top of changes affecting ridesharing platforms across Australia. Driverless car technology continues to develop at a rapid pace.

Many insurers believe that blockchain technology has the potential to add real value to their businesses – particularly through its potential to automate key processes and help detect fraud. Insurers will need to partner with a range of stakeholders to make the most of this exciting new technology.

2016 in review

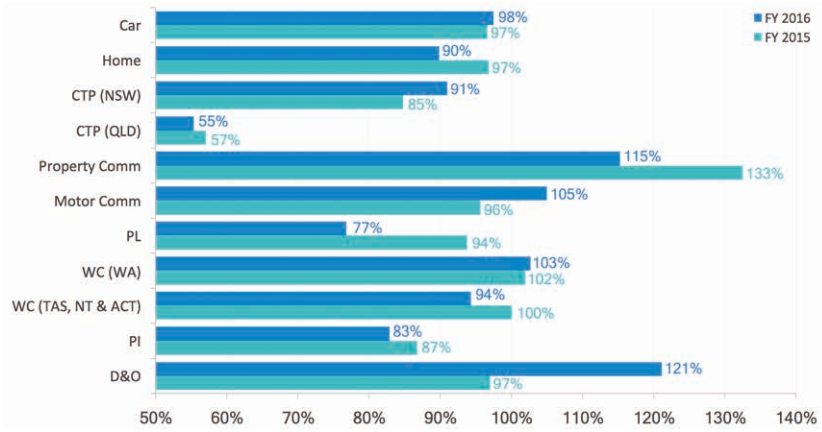
Detecting change: the Radar in action

Every year Taylor Fry jointly publishes the *General Insurance Barometer* with JP Morgan. This survey of insurers and brokers has been undertaken for 24 years – making it the longest running and most comprehensive survey of its kind. Canvassing the vast majority of the Australian insurance market, it provides unique insights into the challenges and opportunities facing the industry, as told by the industry itself.

Radar draws on the Barometer to provide insurers with a snapshot of the Australian insurance industry over FY 2016, with further research and market insights provided by the Taylor Fry team around key issues that should be on all insurers' radars in 2017.

Industry profitability improved, although commercial lines are still suffering

The industry experienced a slight overall improvement in profitability (measured by combined ratios) in FY 2016. Personal lines remained at a similar level of overall profitability as in FY 2015, and commercial lines achieved an overall modest improvement. Industry results from the first half of FY 2017 indicate that commercial lines are continuing to improve, while key personal lines remain flat.



Combined operating ratios. Source: Barometer, APRA

The improvement in profitability over FY 2016 was primarily due to benign catastrophe experience and significant reserve releases for some long tail classes. Survey respondents reported overall combined ratios of 92%, with returns on regulatory capital of 12% for FY 2016 – slightly up from 11% returns in FY 2015.

For personal insurance lines, the combined ratio decreased marginally to 90% in FY 2016 from 91% in FY 2015, with the favourable impact of eased weather events on the Home class being partially offset by poor claims experience for NSW CTP.

Abbreviation / Description

APRA / Australian Prudential Regulatory Authority

Barometer / 2016 JP Morgan Taylor Fry General Insurance Barometer

Car / Domestic motor insurance

CTP / Compulsory third party motor insurance

D&O / Directors and officers insurance

FY / Financial year ending 30 June

Home / Householders insurance

Motor Comm / Commercial motor insurance

PI / Professional indemnity insurance

PIDO / Professional indemnity and directors and officers insurance

PL / Public and products liability insurance

Property Comm / Commercial property insurance including fire and industrial special risks

RBA / Reserve Bank of Australia

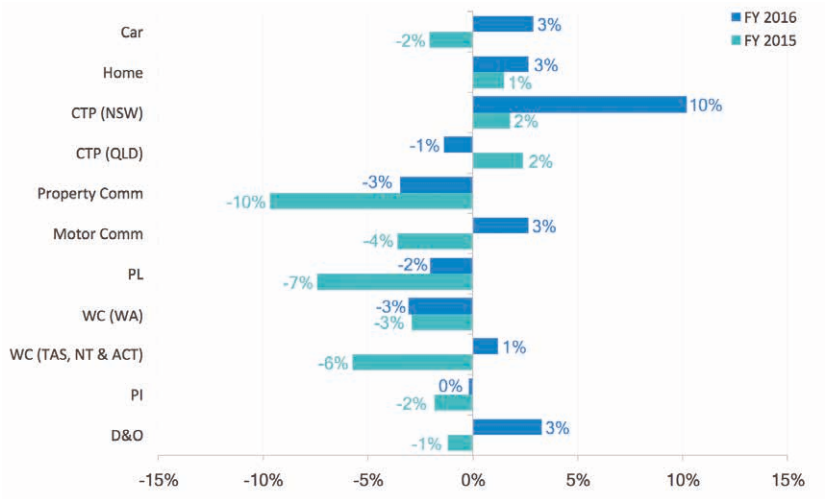
WC / Workers' compensation insurance in privately underwritten states and territories

For commercial insurance lines, the combined ratio decreased from 106% in FY 2015 to 101%. This was driven by significant improvements in Commercial Property and reserve releases in the CTP and Liability classes, and dampened by a deterioration in Commercial Motor and D&O. The first half of FY 2017 has seen further improvements in profitability for commercial lines, with Property combined ratios dropping close to the 100% mark and long-tail classes benefiting from significant reserve releases. All commercial lines experienced lower combined ratios in the first half of FY 2017 compared to FY 2016, excluding PL. PL remained stable despite an 8% reserve release. We note that half a year's worth of results should be treated with caution, as they may not capture inherent seasonality in some lines.

Premium rates are showing some signs of growth in both personal and commercial lines.

Premium rates appear to be turning for commercial lines, with slow growth in key personal lines

After multiple years of downwards pressure on premium rates – particularly for commercial lines – premium rates have begun to show some signs of increasing in FY 2016, with an outlook for further growth.



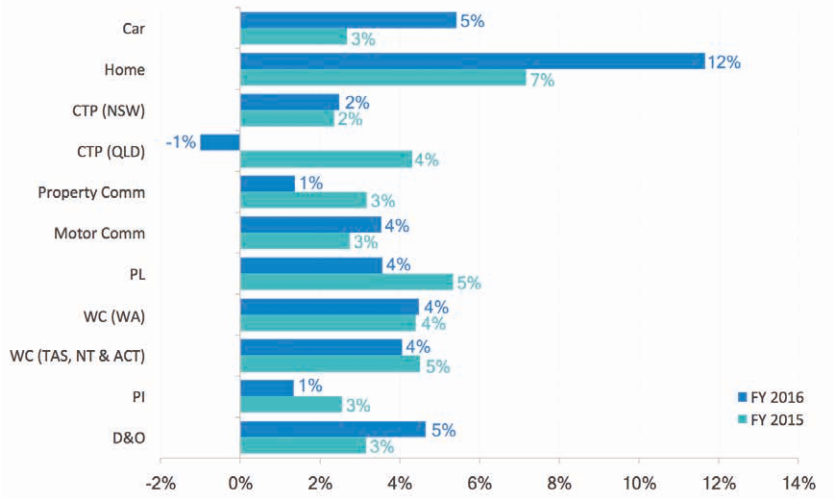
Premium rate changes. Source: Barometer

Participants in the Barometer reported that for personal lines, premium rate increases reached 3% in FY 2016 – slightly lower than overall claims inflation – after a flat year in FY 2015. NSW CTP experienced a large increase of 10% over FY 2016, which pushed personal lines upwards – although not by enough to cover its own deterioration in claims experience. Motor and Home premium rates increased by nominal amounts, similarly insufficient to cover their respective claims increases. Looking forward, personal lines premiums are expected to continue their FY 2016 trends into FY 2017, with the CTP classes, however, being strongly influenced by regulatory change.

Commercial lines premium rates reduced by 1% in FY 2016, signalling a nod towards positive levels from the back-to-back 6% declines in the prior two years. Commercial Property dialled back on the premium reductions, lowering premiums by only 3% compared to the 10% reduction in FY 2015, while Commercial Motor and D&O were the first commercial lines to experience clear increases since FY 2014. The industry is expecting a continued turnaround in commercial premium rates, albeit at a slow pace, with modest increases expected across the board.

Claims inflation continued at 2015 levels and frequency increases built momentum

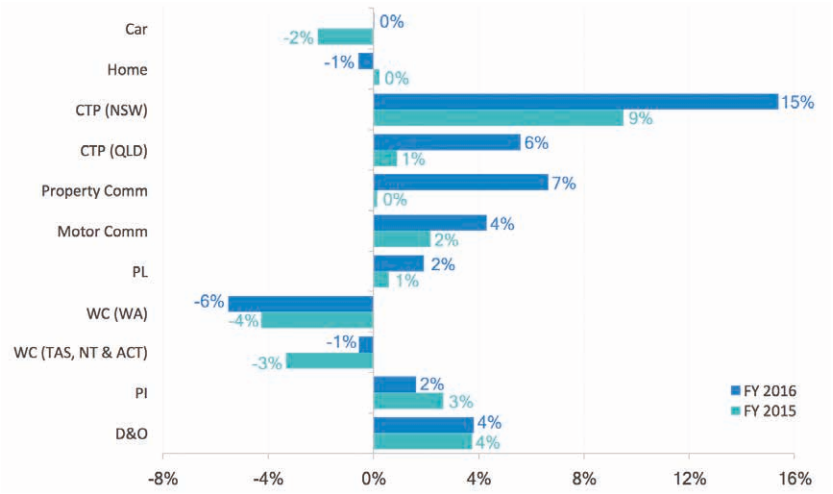
In FY 2016, claims inflation continued to strain profitability and increases in claim frequency intensified.



Claims inflation. Source: Barometer

For commercial lines, average claims inflation was slightly more favourable than 2015 levels, but still positive at 3%, while personal lines further deteriorated from 5% inflation in FY 2015 to 7% in FY 2016. Home experienced a blowout in working (non-large) claim sizes – partially due to increased labour costs in a high-demand environment for construction – resulting in average claims inflation of 12%. Motor similarly experienced a deterioration in claim sizes, although to a lesser extent than Home. QLD CTP experienced the only reduction in claim size. Going forward, the industry expects further claim size inflation at slightly lower levels than those observed in FY 2016, although QLD CTP is expecting decreases with the introduction of the National Injury Insurance Scheme.

Claims inflation continues to remain a challenge for the industry – particularly for personal lines.

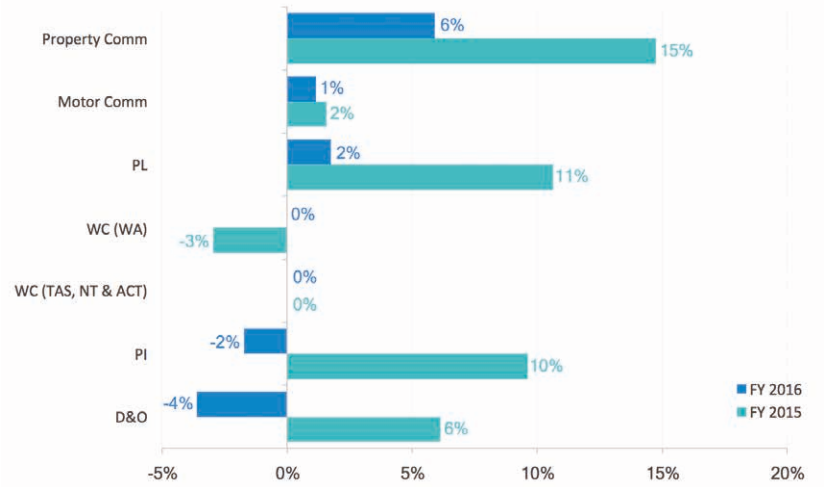


Changes in claims frequency. Source: Barometer

Frequency trends were mixed across classes, averaging 3% both for personal and commercial lines. CTP NSW stands out this year, experiencing further deterioration due to increased legal representation for relatively minor claims – part of the focus of a current overhaul in the regulation. Commercial property had a jump in claim frequency which contributed to another unprofitable year for the class. The outlook for FY 2017 is for claim frequency to generally halt, with some increases expected for the long-tail classes.

Top concerns for the insurance industry

Insurers identified competition and low premium rates due to excess capacity as the equal highest ranking concerns, highlighting the pressure being felt throughout the industry over the last three years. The growth in capacity for commercial lines is beginning to pull back, especially for commercial property, although this may catalyse the flow of capacity into long-tail classes rather than short-tail classes.



Change in capacity. Source: Barometer

Alongside competition and low premium rates, regulatory change and compliance are key concerns.

This year, regulatory changes and compliance featured as the other highest ranking concerns, reflecting the uncertain environment around CTP in NSW and QLD, and the potential for regulatory changes to hinder profitability. Technology remained prominent on insurers' radars again, with similar themes emerging as those discussed last year – cyber risk, blockchain innovations, autonomous cars, and other technological changes are forcing their way into Board-level discussions and company strategies. Ignoring the changing technological landscape could be detrimental for an insurer over the coming few years.

Outlook

Continued modest premium rate increases for the key personal lines and a long-awaited turn to premium rate growth across the commercial lines are expected to propel the industry into a year of improved profitability, and industry results for the first half of FY 2017 support this outlook. The outlook for personal lines is for lower overall claims inflation than FY 2016, while commercial lines may have to grapple with ongoing claims pressures, limiting the potential extent of the improvements to their profitability. The CTP classes (QLD and NSW), however, are in for a turbulent year of regulatory change with a particularly uncertain outlook.

Spotlight on New Zealand

Overall results for New Zealand insurers were solid in 2016. Benign weather has meant natural disaster experience (excluding the Kaikoura earthquake) over the year has been lower than normal. This has been offset by increasing claims cost pressures and the soft commercial market, which has slowed premium growth for personal lines.

The November 2016 Kaikoura earthquake has affected results, with losses already approaching NZ$1B. The majority of these costs will fall onto reinsurers, which may result in increased reinsurance costs going forward. If this materialises, there will be pressure on insurance affordability, particularly in regions with higher risk to seismic events.

New Zealand's two largest insurers, IAG and Suncorp, have both had significant restructures in 2016 and will continue to focus on controlling expenses as they look to maintain margins.

Continued modest premium rate increases for the key personal lines and a long-awaited turn to premium rate growth across the commercial lines are expected to propel the industry into a year of improved profitability.

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Key issues for 2017 and beyond

Regulatory changes

Regulatory concerns continue to be an area of focus for insurers, reflected at this year's Insurance Council of Australia (ICA) Annual Forum where some key themes emerged.

Climate change risk disclosure and mitigation was flagged as high up on APRA's regulatory agenda for 2017 and beyond. Pointing to the ramifications of Australia's ratification of the Paris Climate Agreement, APRA Executive Board Member Geoff Summerhayes urged those in financial industries to explicitly consider and manage the 'transition risks' associated with climate change – namely, risks stemming from the changes to policy, law, markets, technology and pricing that will form part of Australia's transition to a low-carbon economy. This is an important message for insurers who, to date, have focused primarily on the more direct physical risks associated with climate change.

Another issue raised at the Forum related to the fairness of insurance product design and sales processes – such concerns prompted ASIC to undertake a review of products sold through car dealers in 2016. ASIC Chairman Greg Medcraft highlighted key findings from this review:

- An unacceptably low overall claims ratio of 9% across the products reviewed, suggesting poor value for consumers
- Car dealers receiving excessive commissions – as high as 79%
- A sales environment that inhibits good decision-making through a conflict of interest and pressure sales.

To further tighten the regulatory reins, ASIC is considering the following:

- The introduction of a deferred sales model
- Increased training standards for complex add-on general insurance products
- Holding insurers to account to deliver products that are designed with consumers' genuine needs in mind
- Enforcing action against individual insurers who have breached the law
- Public reporting on individual insurer outcomes and key value measures for consumers.

Mr Medcraft also flagged the likelihood of a follow up to ASIC's 2015 review of insurer no-claim discount schemes to assess whether insurers are complying with their obligations to provide consumers with accurate information.

With regulators strengthening their involvement in industry practices, insurers must have clear protocols in place to ensure products are designed with customers' needs at the forefront, and clear standards which distributors are held to meet.

Key strategic questions for insurance leaders

- Has your business given due consideration to the risks associated with Australia's transition to a low carbon economy?
- Have you developed robust strategies for managing climate change risks under a range of scenarios and are you comfortable that residual risks have been adequately disclosed to stakeholders?
- Are you comfortable that your products offer reasonable value and are designed with consumers' genuine needs in mind?
- Do you provide appropriate training for your sales force and promote a sales environment that encourages good-decision making?

Cyber risk in Australia

With media outlets reporting cyber attacks almost daily, it's not surprising that insurers have rated cyber risk as one of the key opportunities for growth and development in the Australian market. In recent years annual growth in GWP has been around 30% per annum, with Australian insurers estimated to have written $20M in 2015, and US insurers over $20B.

One of the key factors driving growth in the US market is the existence of mandatory data breach notification laws. Things are moving quickly in Australia, with the Notifiable Data Breaches Bill expected to be enacted in 2017, formalising the requirements for companies suffering data breaches likely to cause serious harm.

Around 20 Australian insurers are currently offering cyber policies – though policy wording, coverage and underwriting processes are not yet standard, and there are significant variations in premium.

We expect to see major developments in the Australian insurance landscape this year, including:

- A likely influx of capital into the development of cyber products and capabilities
- The evolution of the product through greater data availability, which will influence pricing, policy wording and coverage
- An increase in insured losses due to higher notification frequency, publicity, forensic assessment costs, regulation costs, and increased likelihood of class action.

Pricing cyber risk effectively will remain a key challenge given the lack of substantial insured-loss data – insurers will continue to rely on competitor and international pricing as their first point of reference. Some insurers may offer significant reductions in prices in the fight to gain market share. However, early signs indicate that renewal pricing has been flat, suggesting that Australian players are approaching the current opportunity cautiously.

At the moment, large businesses make up the majority of policy holders, resulting in 70% of cyber claims costs being split roughly equally between investigation costs and business interruption costs, with legal/notification costs making up most of the remainder. As smaller businesses look to cover themselves, insurers must grapple with the need to ensure profitability when investigation costs are likely to make up an even greater proportion of the claims profile. One solution might be the development of an 'all-perils' insurance product, essentially adding cyber-related perils to a package of commercial insurance products.

Key strategic questions for insurance leaders

- Does cyber insurance naturally fit into the suite of commercial lines that you currently offer, and would your policyholders benefit from cyber cover?
- Would you offer cyber insurance as a standalone product, or consider offering it in conjunction with other covers as a more comprehensive business solution?
- Does your cyber pricing accurately reflect the risks underlying each policy?
- Do you have the capacity to offer integrated incidence response teams and third party support for crisis mitigation, IT forensics and legal?

Big data and privacy

Big data presents a double-edged sword for insurers. It opens up opportunities to gain greater insight into customers, improve service offerings, and strengthen relationships with customers; but it also brings new challenges associated with managing personalised information responsibly, and avoiding privacy breaches.

Industry and government are pushing to create best practice guidelines to ensure that enterprises engaging in big data activities use data appropriately, and minimise potential negative social impacts.

In 2016, the Office of the Australian Information Commissioner developed a draft *Guide to big data and the Australian Privacy Principles*. Importantly, the draft guide encourages organisations to embed privacy in their culture, systems, and risk management processes – that is, design privacy into the fabric of projects, rather than bolting it on afterwards.

The draft guideline also lists some key risks and mitigation tips associated with big data. We list our top recommendations below.

Do	Don't
✓ undertake a thorough risk assessment to consider the likelihood of re-identification.	✗ treat de-identification lightly – when not done properly it can lead to re-identification of personal information.
✓ think carefully about your privacy impact assessment when putting together a business case for big data activities.	✗ be tempted to use all data for unspecified reasons – it will expose you to privacy compliance risks.
✓ check third party data thoroughly, especially as it can come through a variety of sources.	✗ forget to carefully inspect third party data – there's a higher risk that it may not be accurate, complete and up-to-date.
✓ create easy to read, user-friendly privacy notices.	✗ think your customers will read privacy notices thoroughly.
✓ undertake information security risk assessments so you can take reasonable steps to protect personal information.	✗ leave 'honey pots' of valuable and sensitive personal information exposed – they are often targets for hacking.

We know big data activities will continue to change, as will the associated privacy implications. Savvy insurers will be doing all they can to collect relevant data that allows them to positively interact with their target customers. Furthermore, if privacy is embedded into their culture and systems, they will be better prepared to respond to the evolving privacy landscape.

Key strategic questions for insurance leaders

- Do your leadership and governance arrangements create a culture of privacy that values personal information?
- Are you continuously monitoring and addressing new security risks and threats to data held?
- Have you taken reasonable steps to protect the personal information you hold?
- Do you have in place a rigorous process to ensure that the data you hold is accurate, up-to-date and complete?

Fraud

Insurance is second only to banking as the main target of fraud. Fraud is difficult to detect, and in the past insurers may have accepted some fraud loss as a cost of doing business. However fraud is currently estimated to cost the Australian insurance industry more than $2B per year, and so represents a significant industry expense. Unsurprisingly, fraud has a visible impact on profitability and flow-on costs for policyholders. Indeed the spiralling cost and increased insurer premiums resulting from fraudulent claims is driving reform, including to the NSW CTP Scheme – which is currently under review.

The insurance industry's anti-fraud efforts have recently come under the spotlight. ASIC has announced plans to review industry practices in response to policyholders' and consumer groups' concerns of harassment in regards to insurers' current investigative practices. Amongst other things, this highlights the importance of proper protocol and accuracy when it comes to fraud detection.

Concurrently, many insurers are finding their existing fraud detection strategies and infrastructure falling short in the face of increasingly sophisticated fraud schemes. In response, leading insurers are reviewing their risk-management programs and looking to the latest technological developments in fraud detection.

Big data analytics is emerging as one of the most important tools in the fight against fraud. New technology harnesses data previously held in siloes – using advanced analytical techniques to identify areas of high-risk. Savvy insurers are looking to rapidly upgrade their fraud management practices, and integrate them into business as usual. Many are seeking external expertise to bridge their capability gaps to keep up with advancements in the field.

All insurers should look for fraud solutions that can adapt to emerging risks and enable appropriate and timely action. Best practice fraud management takes a holistic view, combining internal and external resources to address the entire risk lifecycle – including assessment, prevention, detection and investigation.

Adopting best practice defensive tools and techniques can have major financial advantages for insurers and their customers. Moreover, a comprehensive approach to risk management has other flow-on benefits – such as providing further insight into customer behaviour, deeper understanding of business processes, and cost reductions to help drive a competitive advantage.

Key strategic questions for insurance leaders

- Does your executive team view fraud as a significant risk, or simply a cost of doing business?
- Are your current systems and procedures adequate to combat emerging fraud trends?

Innovation and disruption

Technology and innovation continue to dramatically impact the insurance industry, with disruption being felt by insurers on multiple levels of business operation:

- The sharing economy is giving rise to previously unimagined forms of risk as it continues to blur the division between public and private, and change the way we do business.
- Insurers are becoming increasingly focused on better understanding the market and their customers through leveraging multiple data sources. In doing so, a more comprehensive picture of the individual is formed, offering nuanced insights into customer behaviour and preferences.
- There is a growing emphasis on customer-centric service provision, with insurers investing in, and partnering with, tech firms in a bid to offer more appealing user-experiences.

Three specific issues that insurers will need to pay particular attention to in 2017 and beyond are peer-to-peer insurance, changes in the automotive industry and blockchain technology.

Peer-to-peer insurance

The phenomenon of peer-to-peer (P2P) insurance – where policy owners with the same insurance type form small groups and pool their money to share risk – is surfacing around the globe. German P2P insurer Friendsurance established its Australian operations in 2016, and is set to launch its first product in 2017.

Typically, insurers have a reduced role to play in the P2P model – insuring the experience of pools if claims costs reach a given threshold, but losing the direct relationship with the customer since this is facilitated through the P2P platform.

It's early days, but the promise of a portion of premium being returned to customers as a reward for good claims experience is likely to appeal to some consumers. This financial incentive, in combination with the increased accountability entailed by a peer-to-peer arrangement, is also likely to serve as a strong deterrent against fraudulent or exaggerated claims.

The advent of P2P insurance serves as a timely reminder for insurers to carefully consider what they offer their customers in terms of product, price and process transparency.

Key strategic questions for insurance leaders

- How well do you know your customer and their changing needs and expectations?
- Do you have access to tech experts who can translate the jargon into industry relevant insights?
- Are you keeping up to date with blockchain technology developments to ensure you can reap the rewards once the technology is more mature?

Automotive changes

For direct insurers, domestic motor and compulsory third party insurance accounts for almost 40% of industry GWP. As such, insurers have every incentive to keep up to date with disruptive technologies changing the way people choose to use their cars.

In the near term, insurers should be looking to keep on top of changes affecting ridesharing platforms across Australia. Looking forward, driverless car technology continues to develop at a rapid pace, with Uber launching a driverless car service in Pittsburgh in September 2016 (albeit with in-car technicians). Uber is not alone – other tech giants including Google, Apple, and Tesla are racing to deliver improved technology to enable driverless cars to better negotiate traffic, pedestrians, and obstacles.

Regulatory changes are also afoot, with California paving the way – the State has proposed regulations that could come into effect later this year to allow autonomous vehicles to drive on public roads. With technological and regulatory advancements progressing at such a rapid rate, insurers should prepare for the largest shake-up of the automotive industry since the introduction of the production line.

Blockchain technology

Blockchain technology is predicted by many to be the next big digital disruptor across numerous industries. The technology, at its essence, is a distributed ledger that maintains a continuously growing list of ordered records, called 'blocks'. Its disruptive power comes from removing the middleman, because a central intermediary is no longer needed for verification.

So far, the technology has mainly been used in the banking arena. However, many of its value-adding features are also applicable to insurers – opportunities include cost reduction by the automation of key processes, and enhanced fraud detection capabilities.

While the concept is still relatively immature, a number of insurers and reinsurers have already agreed to co-operate in a pilot project to develop a business use case for intra-group retrocessions. Many others have a keen interest in applying blockchain technology to their business.

Going forward, to make the most from emerging blockchain technologies, insurers must be willing to collaborate with a range of stakeholders, particularly in order to work through the challenges associated with blockchain's 'open source' nature. It is likely that insurers will need to look to partnerships to help them in this journey.

Spotlight on New Zealand

In 2017, the New Zealand insurance landscape is set to be dominated by the following issues:

- The likely sale of Tower Insurance – Suncorp and Halifax both have offers on the table. Regardless of who is the successful purchaser, the sale should provide additional capital to Tower, which should bolster competitive pressures in the direct insurance market.
- The potential increased costs of reinsurance renewals – primarily due to the Kaikoura earthquake. This may signal a turn in the soft market for commercial property insurance.
- Emerging claims cost pressures – caused by factors including methamphetamine contamination claims and increasing motor claim costs. These may result in premium increases, particularly in personal lines. In addition, the recent floods in the upper North Island show that any part of the country can be affected by weather-related events. An increase in the frequency of heavy rainfall events, which is expected under global warming, may see more insurers starting to focus on exposures to flood perils.

The combination of increased competition and increasing costs from both reinsurance and claims may result in insurers looking to improve their performance through underwriting risk selection.

It's also worth noting that there are regulatory changes on the near-term horizon:

- The Fire Service Levy changes (which are yet to be finalised) are due to be implemented from 1 July 2017. This will result in increases in customers' premiums, but won't impact insurers' top lines.
- The Earthquake Commission Bill may be released in 2017, following the 2015 consultation paper. However, with the New Zealand general election in late September this year, the Bill is likely to be deferred until 2018.

The combination of increased competition and increasing costs from both reinsurance and claims may result in New Zealand insurers looking to improve their performance through underwriting risk selection.

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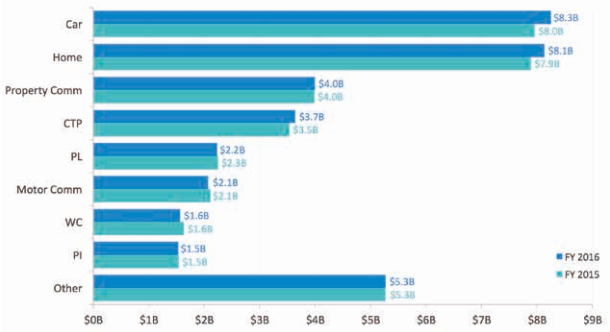
Review of classes of business

Focus on the Australian insurance markets



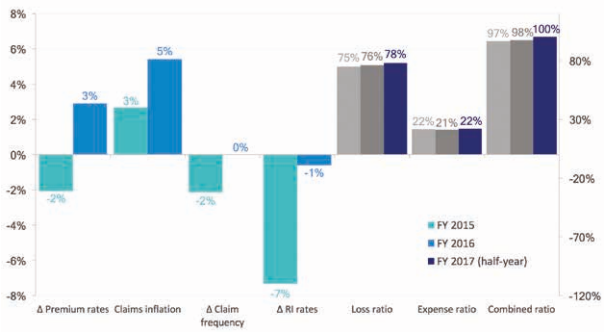
Gross premium income. Source: APRA

In this section we review the eight major classes of business, using statistics from the Barometer, supplemented by APRA data for the first half of FY 2017.

The proportional mix of gross premium income by class has effectively remained static since last year, while the total gross premium has increased by 1.5%. Car and Home each make up 22% of the gross premium income in Australia, and CTP adds an additional 10%, to give personal lines a combined 54% share of the market.

Of the commercial lines, Property is the largest at 11% of the market, while PL and Motor each have 6%, and WC and PIDO each have 4%. The remaining classes, including reinsurance, account for 14% of the market.

Car: competition and rising repair costs driving profit concerns



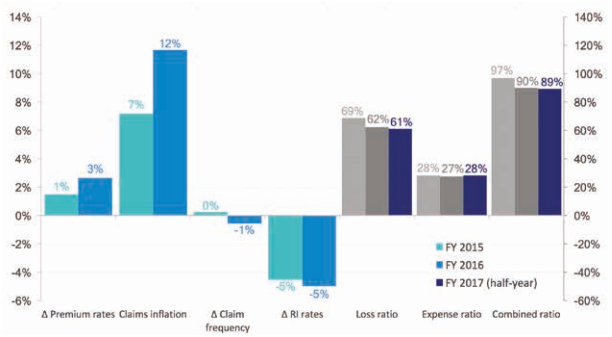
Car insurance. Source: Barometer

Following the catastrophic events of FY 2015, reinsurance rates unexpectedly fell by 1% in FY 2016 due to flat reinsurance capacity, helping insurers to maintain profitability.

Despite the relatively flat combined ratio from FY 2015 to FY 2016, underlying profitability slightly deteriorated, with the normalised combined ratio (adjusted for the more benign catastrophe experience in FY 2016) increasing from 94% in FY 2015 to 99% in FY 2016. This follows a 3% rate rise in FY 2016 that failed to keep up with claims inflation. Industry results from the first half of FY 2017 indicate that there has been a further deterioration in profitability, with the combined ratio for FY 2017 (half year) rising to 100%.

Notwithstanding profit concerns, competition remains strong, with challenger brands continuing to put pressure on established insurers. While the introduction of semi-autonomous vehicles is expected to lead to reductions in claim frequency, insurers don't view this as an immediate prospect. On the other hand, repair costs are already rising as the repair industry adapts to meet technological advances.

Home: profits reduced during FY 2016, but a stable outlook for FY 2017



Home Insurance. Source: Barometer, APRA

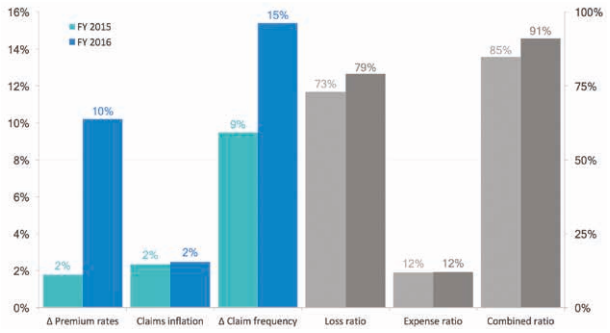
Continuing on from the low increases in premium rates over FY 2015, Home rates increased by forecast inflation (of 3%) in FY 2016. The modest premium rate growth is heavily influenced by competition from both existing and challenger brands. Claims inflation for FY 2016 was particularly unfavourable at 12% – driven by large increases in working (non-large) claim sizes, partially attributable to increased labour cost in a high-demand environment for construction. However, reinsurance rates continued to decline in FY 2016, contributing to improvements in total profitability.

Although the combined ratio improved from 97% in FY 2015 to 90% in FY 2016, the underlying profitability deteriorated with the normalised combined ratio (adjusted for the more benign catastrophe experience in FY 2016) increasing from 87% in FY 2015 to 92% in FY 2016.

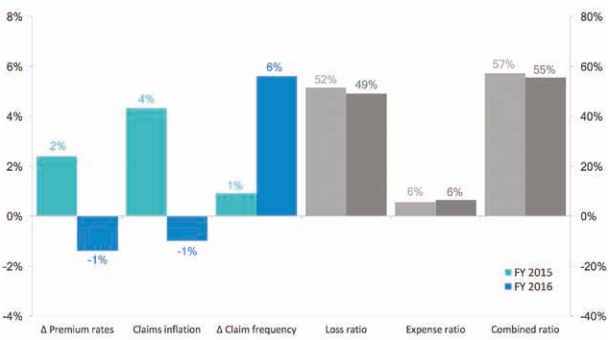
Small premium increases have been forecast for FY 2017, but are expected to remain below the level of claims inflation – putting pressure on insurers' short term profitability. Despite these pressures, the combined ratio is forecast to remain relatively flat at 89% in FY 2017.

Rising catastrophe costs caused by extreme weather and natural disaster events continues to be a major issue for insurers, leading to increased concerns around additional peril covers, insurance affordability and under-insurance – particularly in high risk natural catastrophe zones.

CTP: reserve releases continue to support profitability, though there are questions regarding sustainability



CTP NSW. Source: Barometer



CTP Queensland. Source: Barometer

In New South Wales, the experience has been mixed. As was the case in FY 2014 and FY 2015, profitability based on combined ratios has been strong (reported combined ratios of around 91%). However, this is driven by abnormal reserve releases on prior year reserves. Superimposed inflation has generally emerged at a level below that which was allowed for in premium rates and this has, over time, contributed to excess insurer profitability.

More recent accident years, however, have been under considerable pressure from an increased claim frequency – particularly for legally represented claims with minor injuries, concentrated in particular regions of South West Sydney. The emergence of fraudulent and exaggerated claims has been an area of particular concern. Insurer premium rates have risen, on average, by more than 10% over the last year. The environment of low investment returns has also served to keep premiums elevated.

In the Queensland scheme, insurer profitability has been significantly greater than expected, also bolstered by abnormal releases from prior year insurer reserves. As in NSW, superimposed inflation has been well-contained in the Scheme, resulting in greater than expected profitability from premium rates that included an allowance for superimposed inflation at a higher level.

The Motor Accident Insurance Commission has undertaken a Scheme review in late 2016, but at the time of writing the recommendations were not yet public. In response to this review and continued benign superimposed inflation, industry participants are expecting a reduction in premium rates over the next year, and a consequential increase in combined ratio of around 15%.

Also noteworthy is the recent introduction of Queensland's National Injury Insurance Scheme (NIISQ), which will reduce claim costs falling to the Queensland CTP scheme. The NIISQ provides for the care and support needs of people catastrophically injured in Queensland motor vehicle accidents, regardless of fault.

The ACT CTP scheme has continued to see a changing mix of insurer participation. Prior to 2013, NRMA Insurance (under the Insurance Australia Group) was the sole provider of CTP. Since this time, three Suncorp entities (AAMI, GIO and APIA) have entered the market and have continued to rapidly build market share. On a combined basis, these entities now represent around 40% of the market – almost double their market share one year earlier.

The CTP scheme in South Australia has undergone significant change, privatising in 2016. Following a tender process, four insurers were approved to provide CTP cover (AAMI, Allianz Australia, QBE and SGIC) and were allocated market share. From 1 July 2016 to 30 June 2019, these insurers are required to provide the same CTP product at the same fixed regulated rate. This means there is currently no incentive to switch insurers. After mid-2019, however, insurers will be permitted to undertake their own pricing, and market movements can be expected.

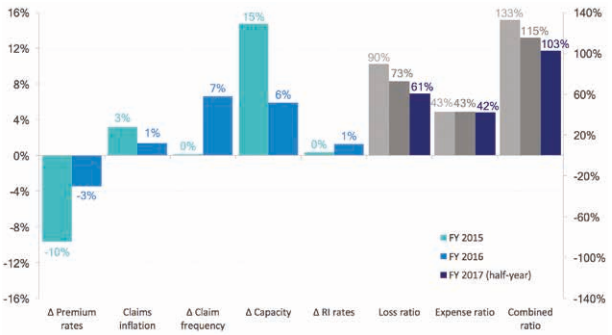
Watching brief

The NSW Government is proposing a number of extensive reforms to the CTP scheme, on both the benefit side and for the operation of the premium system itself. Proposed changes to benefits are targeted at:

- Increasing scheme efficiency – namely, the proportion of premium used to pay claims
- Reducing average premium rates
- Providing support to injured people earlier
- Reducing opportunities for fraudulent and exaggerated claims.

Excess insurer profitability is also an area of focus. This is being addressed through changes to the premium system, which include the introduction of mandatory discounts for new vehicles. A Risk Equalisation Mechanism (REM) is also planned (initially for only motor cars and small goods vehicles) which aims to reduce the extent of cross-subsidy in the market, encourage new capital into the market and generally increase competition. This is not intended to change the overall profitability of the market at an aggregate level, but will impact the profitability of individual insurers, depending on their portfolio composition.

Commercial Property: excess capacity drives reduction in rates, but rises expected during FY 2017



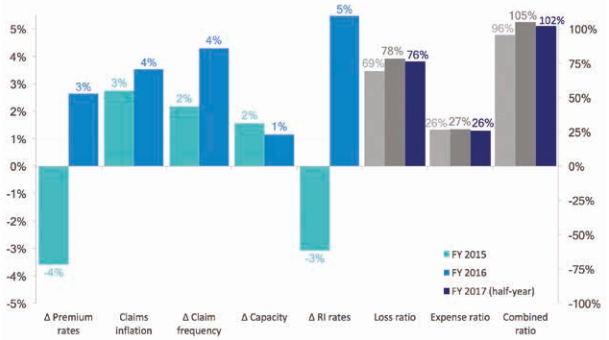
Commercial Property. Source: Barometer, APRA

Strong competition and an oversupply of capital drove a continued reduction in premium rates in FY 2016, marking the fourth straight year of premium declines. Rates reduced by 3% in FY 2016, following decreases of 10% in FY 2015 and 12% in FY 2014. Consistent with prior years, rate reductions were deepest for large corporate risks – reflecting the significant excess capacity at the corporate end of the market. Almost all underwriters perceive premium rate pressure in this class as posing one of the greatest risks to profits. There is recognition that significant capacity entering the market has led to price-driven competition, resulting in pricing below break-even levels. The industry has noted that the profitability of this class is not sustainable at current levels, and expects rate increases to start coming through from FY 2017.

Claims experience continues to be poor, with adverse event claims on commercial covers (in contrast to the favourable event experience in Home) contributing 13 percentage points to the FY 2016 loss ratio, compared to 23 percentage points in FY 2015. While poor, the FY 2016 loss ratio was an improvement on FY 2015, decreasing from 90% to 73% and resulting in the combined ratio dropping from 133% to 115%.

Profitability is expected to improve in FY 2017, with premiums expected to begin to rise and event activity anticipated to return to normal levels. However, the outlook on this class of business remains weak in the near-term.

Commercial Motor: rising repair costs a key issue, with a weak outlook



Commercial Motor. Source: Barometer, APRA

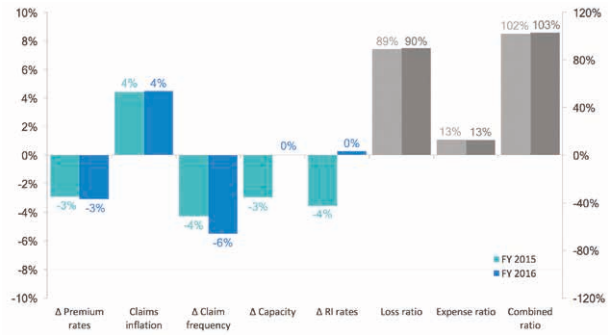
While premium rates rose by 3% in FY 2016 (following a premium decrease of 4% in FY 2015), the increase was insufficient to cover increased claim costs and higher reinsurance rates. Repair costs have replaced competition and its resulting effect on premium rates as the main issue of concern in this class of business. The industry expects premium rates to continue to increase in FY 2017.

Profitability for the class has deteriorated in FY 2016 with a combined ratio of 105%, attributable to increases in claim frequency, claims inflation and expenses. The expectation is for profitability in this class of business to remain poor in FY 2017 and FY 2018. Early indications from APRA disclosures support this view, with loss ratios in the first half of FY 2017 at 76% and combined ratios at 102% – levels similar to those seen in FY 2016.

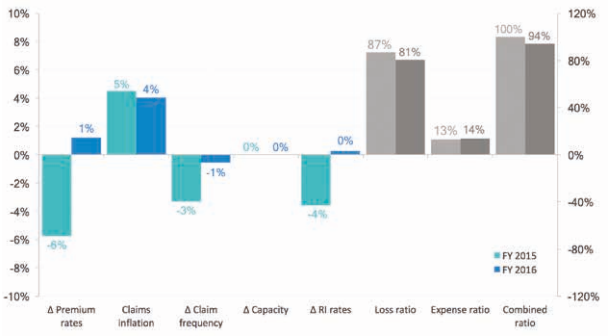
Watching brief

iSelect has recently entered into Motor, through its partnership with Zurich and its acceptance as a member of Insurance Brokers Network Australia. Whether this is the first sign of comparator websites gaining traction in this area remains unclear at this stage.

Workers' Compensation: slowing economy shrinks premium pool and increases competition



Workers' Compensation Western Australia.
Source: Barometer



Workers' Compensation Tasmania, NT and ACT.
Source: Barometer

Experience in Western Australia during FY 2016 was very similar to FY 2015, with premiums reducing by 3% for both years. For Tasmania, the Northern Territory and the ACT combined, overall premiums increased by 1% – consistent with the forecast last year. Claims inflation remains above broader wage and price increases, but premiums are not showing signs of similar increases due to ongoing reductions in claim frequency. Current expectations for Western Australia are for premium levels to remain flat over 2017. For Tasmania, the Northern Territory and the ACT combined an increase of 2% is forecast for premium rates in 2017.

Profitability in Western Australia in FY 2016 was slightly worse than in FY 2015, with the loss ratio increasing by 1%. Despite premium rate changes being predicted to be below the rate of claim inflation, industry forecasts are for a slightly improved profit outlook in FY 2017. Notably for the scheme, in January 2017 the presumptive coverage that applied to current firefighters in the Department of Fire and Emergency Services was expanded to include former firefighters from the Department, and firefighters from other Western Australian State organisations.

In Tasmania, the Northern Territory and the ACT, profitability improved, primarily due to an increase in premium rates. However the outlook for FY 2017 is for deteriorating profitability.

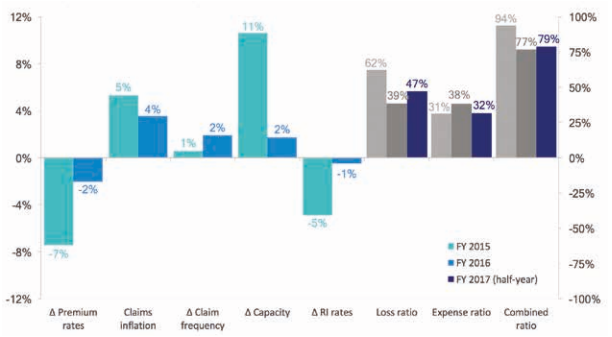
The impact of a slow economy has been a significant issue for insurers, with wage contraction – particularly in the mining sector – effectively shrinking the premium pool and increasing competition in the insurance market. Recent increases to commodity prices may change this picture going into FY 2018. Outside of Western Australia premium rate change continues to be constrained for large clients, but rates have started to increase for SME clients.

Watching brief

The Western Australian Law Reform Commission recently published its report relating to provisional damages and gratuitous care reforms. At this stage, no reforms have been enacted but the Commission has recommended:

- Provisional damages must be available where a new injury occurs and the risk of the new injury was included as part of the original damages action. This change would apply to all injuries, but is expected to mostly affect asbestos-related diseases. A deterioration of the original injury is not included within the proposed reforms.
- Where an injured person provided gratuitous domestic services to family members prior to their injury, and they can no longer provide these services, this must be factored into the damages awarded.

Public and Products Liability: a profit from reserve releases during FY 2016, but continued high competition a major concern



Public and Product Liability. Source: Barometer, APRA

Premium rates continued to decline in FY 2016, driven by strong competition and excess capacity. Rates are forecast to increase slightly in FY 2017 as capacity stabilises.

Over the year, claims inflation of 4% was reported, while claim frequency increased by 2% – with further increases expected in FY 2017.

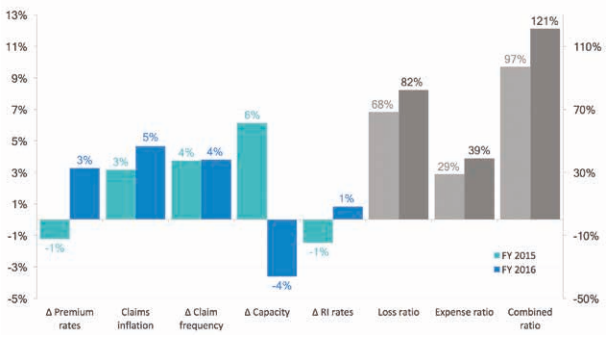
The reduction in the combined ratio from 94% in FY 2015 to 77% in FY 2016 was primarily driven by reserve releases, reflecting a more optimistic outlook on prior year reserves. After adjusting for reserve releases – which were partly offset by decreases in real interest rates – the FY 2016 normalised combined ratio was 109%. Further reserve releases are expected in FY 2017, with experience in the first six months of the financial year supporting this projection.

Reinsurance rates reduced by a further 1% in FY 2016. The expectation is for rates to remain flat over FY 2017.

Strong competition and excess capacity remain the major concerns for this class of business. Insurers are now competing via enhanced policy options, which may flow through to higher claim inflation. Latent sexual abuse claims also represent an area of emerging risk.

Professional Indemnity and Directors and Officers: PI becoming more profitable, while outlook for D&O remains bleak

Professional indemnity. Source: Barometer, APRA



Directors and Officers. Source: Barometer

PI premium rates held steady over FY 2016, while D&O rates increased by 3% – the largest increases being for the SME segment. Capacity reduced across both markets, setting the foundation for rate increases over FY 2017.

PI profitability improved over the year, driven by a reduction in the loss ratio from 59% to 49%. The FY 2017 combined ratio is projected to remain flat as modest premium rate increases are matched by claims cost increases. Experience over the first half of the 2017 financial year has been more favourable than anticipated on both the claims and expense sides.

D&O profitability reduced further over FY 2016 with a combined ratio of 121%. Both the loss ratio and expense ratio deteriorated over the year. The outlook for FY 2017 is similarly bleak, with further anticipated claim and frequency increases resulting in a projected combined ratio of over 110%.

Competition and pricing remain major concerns for brokers and underwriters of both PI and D&O business. Class actions and litigation funding are also key concerns, alongside economic uncertainty and broadening cover.

With a turn in the cycle, the time is ripe for insurers to embrace the opportunities afforded by rapid technological change.

—
Taylor Fry

About Taylor Fry

Who we are

Taylor Fry is a leading consultancy firm providing actuarial, data analytics, statistical and related policy advice to business and government. We develop innovative and fit-for-purpose solutions for our clients' analytical and actuarial needs.

Taylor Fry has operated since 1999, and Qantas Loyalty now owns a 51% stake in the firm. Our Principals each have over 20 years' experience in a range of corporate and consulting roles. Our team of professionals are based in our Sydney, Melbourne and Wellington offices.

We pride ourselves on building strong relationships with our clients by seeking to understand their business goals and processes, providing customised solutions that deliver real value. Our people are leaders in their field – recruited for their expertise, integrity, and enthusiasm.

Taylor Fry is proudly carbon neutral.

Further information about Taylor Fry can be found at our website.

www.taylorfry.com.au.

Our insurance practice

We provide the full range of general insurance actuarial services to business and government. Our consultants have a wealth of experience acting as Appointed Actuaries and Principal Advisers for:

- Insurers and reinsurers of all sizes – from small specialist monoline insurers to large multi-brand conglomerates
- Accident compensation schemes, including state and federal workers' compensation and compulsory third party schemes
- Courts of Law, where we act as Expert Witnesses on all aspects of insurance and accident compensation.

Our services include:

- Reliable, integrated and practical insurance liability valuation processes — ranging from the provision of independent advice for small and self-insurers, to working in collaboration with large insurers to design and implement in-house valuation processes
- Customised capital models that allow our clients to determine optimum capital management strategies fit for today's complex environment
- Financial condition reports that provide genuine insight into our clients' operations, and provide recommendations to reduce significant risks to their ongoing viability
- Budgeting and monitoring tools that allow our clients to stay one step ahead as they identify and address underlying performance issues as they arise
- Data visualisation tools that provide clear insight into business performance
- Specialist fraud analytics services intended to detect fraud, error, waste and abuse, enhance risk and compliance programs, and strengthen internal controls
- Technical pricing and optimisation for insurers looking to understand customer behaviour and maximise the value of their portfolio
- A range of courses and workshops aimed to assist clients in the management and direction of their business.

In 2016, Taylor Fry proudly opened the doors to its Wellington office – building on many years of partnership with New Zealand clients.

—
Taylor Fry

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