

# ROLLER COASTER ECONOMICS

The year ahead –  
the industry's most  
important issues



## FEATURE



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### rollercoaster **economics**

IN THIS CURRENT ROLLERCOASTER ECONOMY, WHAT CAN THE INSURANCE INDUSTRY EXPECT IN 2008? A RECENT SURVEY IDENTIFIED THE TOP CHALLENGES THE INDUSTRY FACES AND IN THIS ARTICLE ELAINE COLLINS, DELOITTE GENERAL INSURANCE ACTUARIAL PARTNER, REVIEWS THESE ISSUES IN A YEAR WHICH WILL REPORTEDLY ALSO CONTINUE TO ENGENDER INTENSE COMPETITION.

In the 15th annual 2007 JP Morgan Deloitte General Insurance Industry Survey published at the end of 2007 respondents nominated and ranked six issues as the most important factors expected to impact their businesses in 2008.

The two top-ranked and equally important issues were the lack of skilled staff and the highly competitive environment – both ranked top by eighty per cent of respondents. Next ranking was compliance costs (73 per cent), followed by climate change (53 per cent) and following equally: pressure on tort reform to be unwound and lack of product innovation (27 per cent each). It should be noted that the JP Morgan Deloitte General Insurance Industry Survey accounts

for more than 75 per cent of the general insurance market in Australia including direct underwriters, reinsurers and brokers. This article reviews each of the top four issues: skills shortage, competition, climate change and compliance costs.

#### **Skills shortage**

A number of underwriters noted that a tight labour market has made it increasingly difficult to attract and retain skilled employees. With unemployment in the Australian economy at a 33-year low, it is expected that the skills shortage will remain a primary concern for the industry.

In this critical people area, obviously if there's a big hole in one of your key technical skill areas, it should be filled. Now. But generally, that's not the way to build a long-term talent management strategy.

Skills get the job done. But it's talent that really drives the value of the organisation. And how you manage and deploy that talent will most likely determine how much value your people can create for the business. *(See next page – The market for talented insurance professionals is red hot.)*

## THE MARKET FOR TALENTED

### INSURANCE PROFESSIONALS IS RED HOT.

Talent can be picky when it comes to the type of organisation they want to join. For most candidates though, it's usually not just about the money. Mostly it is about expanding networks, getting different experiences and growing as professionals. And primarily we have found that 'talent' wants responsibility. To have an impact.

So to retain your talent, you should make sure they have real opportunities to learn new skills, and to demonstrate their competencies by taking on greater responsibilities. If top talent is not presented with the opportunity to grow, it will probably seek opportunities, somewhere else.

One option is to implement formal rotational and training programs. Another is to look for someone with acceptable technical skills and extraordinary potential. Qualities like curiosity, intelligence, social skills, drive and understanding the business. Someone who can drill down to details and see the big picture. Someone who can deal with ambiguity. Who's looking for more than a narrow slot in a specialised niche. Someone who wants to spread out and grow with the company.

You might then be surprised at how easy it can be to find and retain high performers.

“Commercial rates are expected to fall by around three per cent in 2008, but to turn in 2009 with rates expected to increase by one per cent.”



## Competition

The high level of competition that is causing premium reductions continues to be an issue. This is demonstrated in each of the commercial lines of the insurance industry as premium rates remain under downward pressure. A number of underwriters indicated in the JP Morgan Deloitte General Insurance Survey that pricing is reaching unsustainable levels with price led competition now appearing in the traditionally more stable personal lines.

Underwriters also noted that the industry would benefit from longer term pricing rather than short-term, growth-driven pricing.

Expectations over the next two years by the industry are for competition to continue to squeeze premium rates and, as a consequence, increase combined ratios in the commercial classes. (As we know, this measure of incurred claims plus expenses divided by premiums is used to measure profitability.)

The increased combined ratio is expected to continue to constrain future top-line revenue growth and put pressure on margins.

### Profitability remains sound

The JP Morgan Deloitte General Insurance Industry Survey highlighted that despite the increase in the combined ratio from 91 per cent to 94 per cent in 2007 and average premium rate reductions in commercial classes of eight per cent on top of a similar fall the previous year, profitability continues to remain sound, but it is the future that is less certain as this price competition starts to "bite".

### Outlook

The industry expects to see rates in commercial classes fall on average by three per cent in 2008. With individual business lines, commercial property (fire and ISR) also expected to fall by three per cent. Liability, workers' compensation, professional indemnity and D&O are expected to fall by 6-7 per cent.

The primary issues in 2008 will continue to be pricing pressure as insurers seek to maintain or grow market share.

### When to walk away

It is difficult to assess when to walk away from business, even when comparing market price to underlying technical price. The insurers likely to be hardest hit in the coming year are those that specialise in the business lines experiencing the heaviest rate pressure and are not able to maintain the required pricing discipline to walk away from unprofitable business.

Commercial rates are expected to fall by around three per cent in 2008, but to turn in 2009 with rates expected to increase by one per cent.

Nevertheless, profitability in the long tail classes is still attractive, supported by prior year reserve releases as the benefits of tort reform and lower than expected incurred claims emerge.

For professional lines the annual surveys show that PI and D&O rates have been declining over the past three years and are expected to continue to soften until 2009.

Rates for PI are under pressure owing to attractive levels of profitability after tort reform was introduced and the benign PI and D&O claims environment. Rate pressure exists across the corporate, middle and SME markets in PI. D&O lines have also experienced an increase in competition leading to rate reductions.

### Broking

Several brokers indicated a need to continue to justify why they are seeing the kinds of rate reductions that they told their clients a few years previously were no longer possible to achieve.

Only a few underwriters raised concerns over the pricing power of cluster groups. With nothing specific mentioned in the industry about cluster groups or their impact on smaller brokers.

**Loss ratio better than expected in 2007**

Industry participants nevertheless indicated that the loss ratio for the industry during 2007 was better than expected and in line with what was anticipated in the previous year's survey projections.

The lower than anticipated claims in the industry helped keep profitability levels sound, in spite the fact that premium rates in the commercial lines continued to fall.

However the question that is concerning the market is whether claims will increase as a result of climate change. It was one of the top six issues for the industry in the year ahead.

**Climate change**

A number of survey respondents noted the increase in the frequency and severity of weather related events. Approximately \$1,500 billion of Australia's wealth is locked up in homes, commercial buildings, ports and other physical assets, equivalent to nine times the current national budget or twice Australia's gross domestic product.

The insurance industry currently underwrites the risk to the bulk of these assets from weather events, but climate change is threatening its ability to do so as effectively in the future.

With more than eighty per cent of Australia's population concentrated in towns and cities along the coastal fringes of the east, south-east and south-west, floods are Australia's most common and most costly natural disaster. Over the past three decades, the cost of all flooding in Australia has ranged between \$2.5 billion and \$4 billion per decade.

The industry noted that the availability of accurate data is a roadblock in accurately pricing flood cover in particular. And a number of underwriters called on the government to set up a pool to cover future flood losses and top up potential flood claims costs.

The general insurance industry is investigating the collective

development of a national flood mapping tool. This tool would be employed by all insurers to test the risk applicable to an insured's property and enable the insurer to offer flood cover if the risk was within its calibrated limits.

The responsibility for implementing ways to minimise flood risk remains with government, insurance regulators, insurers and property owners.

Balancing the public interest with that of the shareholders will be the challenge.

**INSURING THE RISK OF FLOOD**

Although a flood can be assigned to a single event type on many occasions, a combination of flood types and other natural hazards such as hurricanes, hailstorms and earthquakes may occur. In these circumstances, problems with insurance cover can arise if some of the event types are covered, but others are not.

There are a number of factors the insurer must consider before calculating an appropriate premium for flood risk. For example, when providing flood insurance for property, insurers must consider:

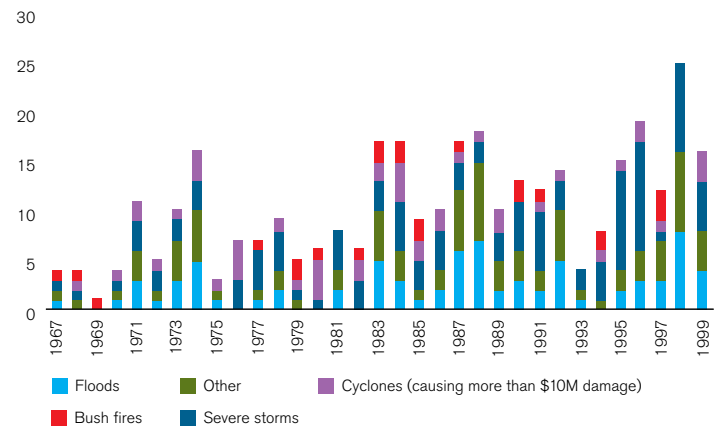
- location
- height of the land
- previous flooding in the area including frequency and severity of floods
- construction and design of the building.

As flood risk is expected to become an escalating dilemma, the insurance industry will need to manage flood risk at an accelerated rate.

As a result, insurance premiums will increase, as the volume and frequency of claims increase.

This trend of increasing premiums unfortunately will not encourage individuals, industry and commerce to insure against such events.

**Figure 1: Number of natural disasters in Australia**



Source: JP Morgan Deloitte 2007 General Insurance Industry Survey

“The IAG Sustainability Report 2005 summarised the issues around flood insurance in Australia as follows: The lack of affordable and consistent flood insurance is one of the biggest issues facing Australian communities. It is a challenge that we have begun tackling but it is one that is fraught with complexity. Although the issue poses a significant reputation risk to insurers, we believe it is a whole-of-society issue affecting local communities, governments and insurers. In the past, flood insurance has not been provided for one simple reason – insurers have not been able to determine the flood risk to individual homes. Understanding this risk is essential to be able to set a premium.”

### Compliance costs

Respondents noted compliance costs from increased regulation was the third most important issue facing the industry and is a considerable financial burden with some commenting that the industry had become overregulated.

“To make the largest impact on both the bottom and top lines, underwriting improvement is the key area of focus.”

As the cost of providing greater transparency around the operation and governance of the business to regulators, shareholders and other stakeholders continues to mount, with the need for more and frequent reporting, some industry players complained that these costs were mainly due to increased regulation.

Others however realise the necessity and eventual value of tightening the process. To this end it was possible to glean an insight into those areas where insurers expect to obtain operating efficiency gains while at the same time having to make the process as transparent, safe and efficient as possible for the customer and of course the regulator.

To do this, the industry has to invest significantly. This investment is primarily in the tools and technology required to support growth plans.

At the same time it is essential to reduce costs.

We believe that one of the key factors to doing this and improving the combined ratio is to, as far as possible, assign the appropriate price to each risk. The following comments outline some of the ways to achieve this across the various insurance lines.

### Personal Lines

For Personal Lines, the priority is to understand risk at a more granular level and translate this into product pricing where cross subsidisation of risk is minimised. It is also about using new technologies and tools such as Geographic Information Systems to educate customers into reducing their exposure during natural events by providing them with the information they need and thereby reducing their claims frequency for the insurer.

### Commercial Lines

For Commercial Lines, the priority is to increase the percentage of straight through transactions (also known as “straight through processing”) and to enhance the experience of customers, intermediaries and alliance partners. A large proportion of small commercial insurance contracts still require a high degree of human intervention during the underwriting process. Tools and technologies do exist to support the commercial underwriter.

The leading underwriters of tomorrow must focus on the necessary capabilities to create and capture value to achieve profitable growth and reduce costs.

### Changes in business and IT

The industry as a whole places a lot of emphasis on improving their core insurance areas, including

claims, underwriting and policy administration. The struggle has been to enable the business to be more responsive and more effective – e.g. reduce claims leakage and introduce better risk selection in underwriting – and contain costs.

To make the largest impact on both the bottom and top lines, underwriting improvement is the key area of focus.

While there have been a few large underwriting transformations, it is not the norm. Mostly the initiatives are to provide underwriters with better information access, both internal and external; information analysis; information presentation; and seamless handoff of information work throughout the underwriting process.

The objective is to provide the right information to the right underwriting staff, at the right time.

In the IT area, the key to achieving this has been information linkages to the distribution channels and data sources (claims, underwriting etc). The goal has been to enable as much straight through processing as possible.

If human intervention is required, as in most commercial lines – such as specialty lines or reinsurance – then as much automation of the functionality in the workflow as possible is best. Also introducing

**TABLE 2**  
PROFITABLE GROWTH, DRIVING DOWN COSTS

Profitable Growth	Driving Down Costs
CLIENT CENTRIC <input type="checkbox"/> Segmentation <input type="checkbox"/> Customer lifetime value <input type="checkbox"/> Customer retention <input type="checkbox"/> Cross or Up-selling	Business process transformation
Multi-channel integration	Back office consolidation and standardisation
Rapidly introducing new products or changes to existing products	Componentisation of business and technology
Reduce underwriting leakage	Shared service models

Source: Deloitte

systems to better support underwriting infrastructure such as customer files, product catalogues and workflow is gaining attention as they require better co-ordination of underwriting across branches/lines – as well as offering a complete customer/account view.

### **Underwriting excellence – hot topics**

In short, to help insurance underwriters be more responsive, flexible, resilient and cost effective, they need the capability to obtain more information and analyse holistically. They also need a “single client view” across the lines of business and geographies.

Purpose built underwriting tools – customised to the unique strategy, business directions and operational environment of the underwriter – will inevitably enhance account penetration. They should also boost the ability of an underwriter to gain market share in both soft and hard markets.

To achieve the best possible underwriting decisions though, it is important that insurers provide the required information in easily understandable formats to their underwriting staff. And for management, the capability to monitor the process and performance down to a granular level is key.

Added to that, underwriting, actuarial and marketing support staff members also need to enhance their understanding of the risk classes and customer insights. Together these tools will aid an improved underwriting philosophy, pricing and segments, resulting in better information to develop products and meet the needs of the customer while helping the company to achieve its profitability objectives.

Some of the tools and capabilities that address the challenges outlined above include: Geographic Information Systems in Underwriting; Console for Underwriters and Straight through Processing.

### **The JP Morgan/Deloitte 2007 General Insurance Survey outlook at a glance**

#### **1. Industry profitability has deteriorated but remains attractive**

– The industry's overall combined ratio has increased from 91 per cent in 2006 to 94 per cent in 2007. However, combined ratios in the commercial classes remain attractive and as a result will continue to drive competition.

#### **2. Premium rate in the commercial classes remain under pressure**

– Premium rates in the commercial lines fell by an average of eight per cent in 2007 on top of the nine per cent reduction in 2006. Levels of competition continue to drive rate reductions but the industry must not let premium rates fall to unprofitable levels.

#### **3. Personal lines rate movements tracking in line with inflation**

– In personal lines, rates increased in all classes except CTP. However, rate increases were in line with claims inflation so on an inflation adjusted basis, rates are down slightly in 2007 on the previous year. CTP rates in NSW were impacted by the introduction of the Lifetime Care and Support Scheme.

#### **4. Market sees the cycle turning in two years**

– The market is expecting the commercial cycle to turn in 2009.

#### **5. Reserve releases are supporting current results**

– Premium rates in the commercial lines have continued to fall, but with no deterioration in profitability commensurate with the level of rate reductions.

#### **6. In the Commercial classes reported profitability is strong, but accident year profitability is weaker**

– The gap between accident year and financial year profitability continues to widen. Even if premium rates turn in two years' time, the gap between accident year and financial year profitability could take considerably longer to close.

#### **7. The profitability of the domestic motor and home markets looks stable, but for CTP less stable**

– In CTP the gap between financial year and accident year profitability remains significant. **II**

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“In short, to help insurance underwriters be more responsive, flexible, resilient and cost effective, they need the capability to obtain more information and analyse holistically.”

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