

---

# THE GLOBAL INSURANCE MARKET

clouds on  
the horizon



## FEATURE



**BY JOHN McCABE,**  
Senior Vice President and  
Chief Operating Officer,  
Liberty International  
Underwriters, Asia Pacific

### rollercoaster **economics**

IN THE SECOND ARTICLE IN THIS FEATURE ON ROLLER COASTER ECONOMICS, JOHN McCABE EXAMINES THE GLOBAL INSURANCE MARKET.

The global insurance market has always been cyclical, but the current market is somewhat peculiar. Insurance companies are reporting record financial year profits amid strong credit ratings, yet – at the same time – struggling with reducing premiums year-on-year and increased competition.

pays close attention to ensure it is prepared for whatever eventuates. Or better still, avoid it altogether.

Due to the highly competitive and commoditised nature of the industry, it is not possible for one single industry participant to drive a change in market behaviour. The insurance market will inevitably have to adapt and change if it is going to be sustainable. If, as an industry we fail to prepare, then this cycle will end just as dramatically as previous cycles.

This article considers the layers that make up the picture, some of the catalysts for change and how the evolving market cycle will affect insurers and customers alike.

#### **The view from outside**

Until the market volatility that emerged in mid-August 2007 as a result of the sub-prime credit squeeze, the news about the global economy, financial markets and commodities markets were overwhelmingly positive. Since the beginning of 2008, rumours of a recession in the US, increasing interest rates here at home as we deal with the spectre of inflation, and the worsening financial position of major banks such as Citigroup or Société Générale, have created a sense of uncertainty and even pessimism across the markets in general.

The insurance industry, however, has a cycle all of its own. Current external events may have some impact, but despite some winners and losers, and an increase in natural catastrophe activity, the market appears to be maintaining traction, and most commentators are quietly confident that the fundamentals are sound.

And why wouldn't they be confident? Despite the hiccups, many of the world's economies and regions are continuing to head into record territory of economic growth and prosperity, in spite of the troubles in the US

Focusing on the general insurance industry, companies around the globe and in Australia have reported record financial profits on the back of a relatively benign claims environment and solid investment returns.

After 2001, the global insurance markets hardened and insurers took the opportunity to build their balance sheet strength and take prudent reserve positions. Coupled with the financial markets delivering record high returns, these reserves have flourished.

Observers generally agree that the industry is in a strong position. Analysts are reporting that today's bumper financial results are sustainable at least over the next few years, as companies are still holding surplus reserves.

In Australia, APRA statistics also indicate unprecedented capital strength, and the rating agencies are reporting that insurance companies' credit ratings are stable and financially strong at the moment.

Yet, if we scratch below the surface it is possible to see another trend: recent insurance company financial announcements show that the quality of the reported results may not be as high as portrayed. Insurers are slowly releasing the excess reserves built up on the 2002-2005 underwriting years, to supplement the impact of falling premium rates in the last two years. However, as volatility in the

“If we look very closely, it is possible to see clouds on the horizon. Nobody knows if they're bringing a storm; they may be nothing more than a passing shower.”

At the moment the industry is dealing with this by releasing reserves on prior underwriting years and in some cases buying less reinsurance and increasing the risk profile of their portfolios.

So while the picture is positive on the surface, it is actually more like an Impressionist painting: more complex than it first appears. There are details – flaws even – that aren't immediately apparent, and which differ depending on where you stand.

Indeed, to get a true picture of the current insurance market, it is necessary to see it from the point of view of many stakeholders including the boards and senior management of insurers; intermediaries; shareholders; employees; regulators; commentators and suppliers.

And in fact, if we look very closely, it is possible to see clouds on the horizon. Nobody knows if they're bringing a storm; they may be nothing more than a passing shower. But it's crucial that the insurance industry



world's financial markets continues, and the major indices such as the Dow Jones and S&P/ASX 200 Index continue to decline, the value of these reserves is likely to decrease.

Moreover, if we look at how the insurance market is portrayed by external stakeholders such as media, analysts and rating agencies, one of the underlying themes is a focus on financial year results. However, this is somewhat naïve and puts a short term gloss on what is, by its nature, long term business.

Current pricing is mentioned, but current profits are emphasised, while many observers pay little heed to the fundamental difference between an underwriting year and financial reporting year.

An underwriting year is made up of two parts: premiums, which are allocated to the year a policy is issued or renewed; and claims which are

premiums and new claims, coupled with movements in reserves for old claims, which all happen to occur in the financial year under review.

For investors seeking a financial representation of the current trading year, as typically generated by other industries, the financial year results of an insurer have the potential to falsely represent the facts.

And so we have the current situation where positive financial results are being reported at the same time as the industry hits the downward phase of its cycle after a number of years of reduced pricing.

#### **The view from within: stakeholder perspectives**

The state of the global insurance market looks different from each stakeholder's point of view.

For customers, times are good. It's a 'soft', or buyer's market, with the total costs of insurance reducing. Not just the price of the policy but

Shareholders of insurance companies have also benefited from the positive market and its bumper profits; reaping increased dividend payments, larger capital growth and impressive 'paper profits'.

And as this buoyant stock sector appears increasingly attractive, a flood of new capital has entered the insurance/reinsurance market to seek out the attractive rates of return and capital growth. This is a normal phenomenon, but the market size is mature and finite and then increased capital, with all of its expected new income flow, has the potential downside that it puts further pressure on prices and fuels soft market conditions.

The stellar performance of the insurance market has also comforted regulators. Tightening the rules and increasing the scrutiny of the sector, in the wake of the HIH collapse, has been a positive step for the industry, even if it has added to operating costs.

The Australian Prudential Regulation Authority (APRA) is now happy with the current strength of the industry's balance sheets, but is nonetheless looking for ways to embed that strength.

However, an increasing regulatory burden has also put pressure on revenue for intermediaries, while reduced premiums have had a negative impact on their commissions – making life just a little bit harder for this group at the moment.

Boards and senior management of the insurance companies have several issues on their radar screens. An increasingly regulated environment – from Sarbanes-Oxley in the US, to financial services reform in Australia – has added to the cost and complexity of doing business. Regulation is an important ingredient to stability, but it's crucial that the regulatory burden does not end up weighing down the industry.

#### **Clouds on the horizon**

It is widely accepted that the insurance business is cyclical and that we are now moving into a softer cycle. This in itself presents challenges for the industry.

---

## **“The state of the global insurance market looks different from each stakeholder's point of view.”**

---

also allocated to the year the policy was issued or renewed – even though they may occur or be reported in a different calendar year.

A financial year of course, is an accounting construct covering many underwriting years. It reflects the premiums written and earned in the current year as well as the claims received, but also reflects premium earned on earlier years and increases or reductions of reserves originally recorded in earlier underwriting years.

While the underwriting year results are necessary to see how the decisions of today are going to reflect the results of the future, the insurance industry is only required to report financial year results. Reporting entities show a claims development table as well, but the average investor generally has difficulty interpreting it – if they actually read that far into the annual report. It is a mix of underwriting year

the inclusions within it: greater limits and sums insured, a reduction in deductibles and an expansion of the terms and conditions.

While this is a good time to be a customer, these same customers also want stability – in terms of price, cover and claims handling. Many have bad memories of the last 'hard' market, when newspaper headlines declared “the end of fun” as sports clubs; charities, funfairs and similar enterprises were unable to afford huge premiums as insurance capacity was withdrawn.

In Australia, tort reform helped to alleviate the situation, but there is always the spectre of firstly, the potential for roll back either through a softening of the legislation or through judicial interpretation. Secondly, the market is rapidly adjusting prices downward and there is always the very real concern of undershooting price adequacy.

The softening market increases insurers' risk profiles, as companies seek continued growth in the face of a mature market, new entrants and reduced rates. This can lead to insurers seeking diversification in market segments and geographies without the required expertise.

Another way to grow at least the net line is by buying less reinsurance. While this controls operating ratios and costs to some extent, it also means that when catastrophic events occur, there is greater volatility and less spread of risk to pay those claims.

In fact, the potential impact of catastrophic events is enormous. We know they are inevitable – some would even argue their frequency is increasing – but it should also be remembered that the term doesn't just refer to natural disasters.

While it could be an insurance event, such as a hurricane or flood, it may also be financial: for example the meltdown in the US sub-prime mortgage market, which has spread to the equity and Forex markets like a virus. These markets are still quite fragile and the impact on insurers' or reinsurers' profits can be quite dramatic over a quarterly or annual reporting cycle.

Or a catastrophe may come as a series or combination of insurance and financial events, leaving the insurers' cupboards bare. Recent market volatility demonstrated how bad news multiplies itself, as investors follow a pack mentality.

If a significant insurance event were to spook the markets, reserves could be diminished at the same time as claims spike.

As mentioned earlier, another potential cloud for the industry is the focus on financial year results versus underwriting year results. It is, in fact, something of a sleeper issue for the industry.

In order for underwriters to accurately and rationally price their products, the focus and analysis should be conducted on the underwriting year. At the same time, underwriters need to remain mindful that the adequacy of the premiums charged will not be known for certain for some years to come. This is especially true in liability classes.

I have argued for some time now that consistency is fundamental to the health of the industry, and the key to minimising risk for those insured. To that end it's crucial to resist the lure of price undercutting and less underwriting discipline, in order to ensure long term sustainability.

### Catalysts for change

The single, largest catalyst for change will come when either individual insurers or the broader market have to prepare financial year plans accepting that there will be a loss. This will force a rise in prices to a level that is adequate for the risk being underwritten, ultimately resulting in an underwriting year profit.

This change may be brought about as a result of catastrophic activity that depletes the reserves already run down by rate reductions, by financial market losses impacting the investment results, through a reduction of capital through the withdrawal, or from a collapse of market participants.

While we can all hope none of these come to pass, history tells us one or all of them will – and it's essential to be prepared for when they do.

As an industry, we should be focusing on underwriting year results and their impact on pricing and operating decisions; we should ensure we maintain a strong capital position and meet regulatory requirements while planning for an inevitable turn in the market cycle. We must do this in the face of:

- ❑ continued premium reductions and expansion of coverage
- ❑ new or reinvigorated capacity coming into the marketplace
- ❑ a mature and finite market size; it would be dangerous at best, reckless at worst, to continue to seek premium growth for growth's sake.

After all, isn't that the very essence of insurance: hoping for the best but expecting and being prepared for the worst? **||**



# USE OUR EXPERIENCE TO YOUR ADVANTAGE



Exceptional consultant service standards together with in-depth knowledge of the insurance industry are what candidates and clients have come to expect from Jo Limbourn at The Brooklyn Group.

Specifically within the **General Insurance Division**, Jo Limbourn has extensive experience (11 years in broking and underwriting and 10 years in GI recruitment) and her deeply ingrained ethical standards underpin her well-earned reputation for:

- Excellence in delivering results
- Extensive industry knowledge and networks
- Rapid response without compromising quality
- Exceptional standards of integrity
- Dependable, honest and impartial
- Long-term advice you can always trust

The Brooklyn Group also specialises in:

Banking & Financial Services  
Accounting & Finance  
Construction / Engineering / Resources & Infrastructure  
Executive Search & Selection  
Government  
Human Resources  
Information, Communications & Technology  
Sales & Marketing  
Business Support  
Supply Chain & Procurement  
Legal

Take advantage of our experience today by contacting **Jo Limbourn** on (02) 9240 6666 or you can email [jolimbourn@brooklyngroup.com.au](mailto:jolimbourn@brooklyngroup.com.au)



SYDNEY • MELBOURNE • BRISBANE • PERTH