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Australian and New Zealand insurers: issues for success

A survey of Australian and New Zealand insurers has identified a new focus on capital management within the industry. Insurers are recognising the need to better manage their risks, they are relying less on investment returns as a component of profits, and are using reserves instead of investment returns to manage profits.

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THE SURVEY, conducted in July 2008 both by personal interview and an internet-based process, updates an earlier survey completed in 2006.[1] The survey covered almost the entire industry as measured by premium income, but has excluded some small specialist insurers. Both the 2006 and 2008 surveys were supported by Gen Re, whose assistance is acknowledged.

A McKinsey study,[2] based on a 2004 survey of US insurers, identified five key issues affecting the performance of these businesses. The study found that:

- Underwriting performance drove wealth creation;
- Results were remarkably stable over time;
- The best underwriting companies stay the course;
- Risk needs to be managed at four levels; and
- Major changes would be required by companies wanting to improve their relative position.

The 2006 Australian and New Zealand study found similar issues to the McKinsey study, and identified the major issues for the industry as being:

- Sustainable profitability;
- Adequate risk management and human capital management practices; and
- Identification and reaction to threats to the industry.

The 2008 survey has identified that in addition to the three major issues identified in 2006, there is a new issue that now needs to be added: capital management.

Survey respondent profile

There were 52 respondents to the latest survey, with annualised premiums approximating the industry total indicated by APRA. The survey covered both large and small insurers as indicated by the distribution of premium income (see Figure 1).

Rankings

Risk management

Risk management is critical to achieving acceptable results for stakeholders on a sustainable basis. The following survey results were elicited when respondents were asked whether they carried out what should be regarded as reasonably basic risk management practices:

- 50% of respondents believed risk management was highly integrated into the management process;
- 90% said that it was regularly measured;
- 97% said that risk management was a regular board report;
- 94% said regular risk reviews were conducted;
- 91% said that reporting procedures were documented; and
- 80% said credit assessments were conducted on outsourced service providers.

Given that the purpose of the industry is the management of insurance risks, the management processes to ensure risks are controlled to acceptable levels is a critical issue for success. The previous survey (2006) found that the overall industry had to improve its risk management practices to improve the chances of survival for individual companies. Comparing the results of this survey with the 2006 survey, it appears a significant proportion of companies have upgraded their risk management strategy in the past two to three years.

Human capital management

In a business such as general insurance, there are factors that affect the performance of the business that can be categorised as internal, i.e. management can create and manage them, and external, i.e. the events are outside the control of management. The critical determinant of performance and success is the ability of management to optimise these interacting internal and external drivers to achieve the best possible return or profitability. Failure to retain adequate resources in both quantity and quality could be a major issue for an insurer's chance of success.

The following responses were provided when respondents were asked to indicate if they carried out what should be regarded as reasonably basic human capital management practices:

- 93% of respondents confirmed that formal in-house or external training programs were taking place;
- 72% confirmed that graduate/management/leadership development training was taking place;
- 90% said critical positions within the company had planned replacements; and
- 70% of senior management said retention plans for high performers were in place.

Sustainable profitability

This is the ability of a company to deliver consistent results over a period of time. Clearly, profitability is a major desired outcome, and would be regarded as the major single indicator of success of management.

Based on Figure 2, if a combined ratio of 100% or less is taken as a reflection of the overall management skill, then only about 40% of the industry on average managed to achieve this objective over the three years: 1999, 2001 and 2007. This is a particularly concerning result as it means insurers are relying on investment returns to remain in business, yet there is a clear trend to reduced investment returns relative to historical results. However, it is possible that the industry could achieve sustained profitability in future years through increased premiums.

The combined ratios are shown in Figure 2 for the three years for which this data is available from APRA.

Capital Management

Insurers' financial results tend to be more complex to understand than industrial companies due to the need to estimate reserves each year to pay for future claims arising from the current year's risks. Where reserves are over or underestimated, the changes are reflected in subsequent years' accounts, which can distort financial year results. To appreciate the extent of changes in reserves for the industry, Figure 3 shows the changes in reserves (over the past three years) of several large insurers who account for around 60% of the total market profits.

FIGURE 1: **Distribution of respondents's gross premiums**

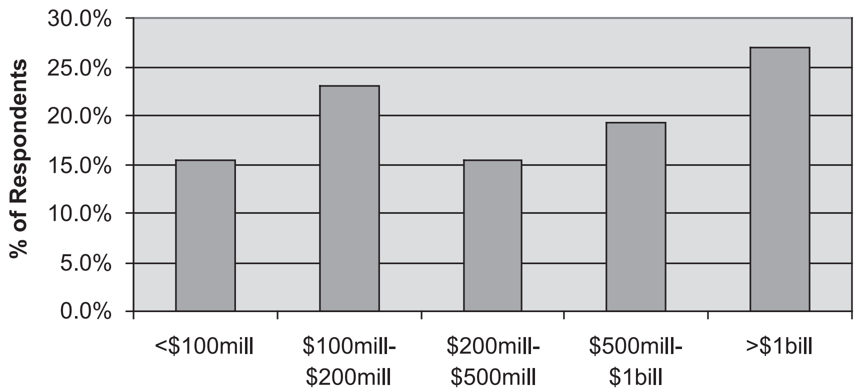


Figure 3 indicates that insurers have been substantially reducing reserves since 2005. Without the reduction in reserves in 2007, the overall profitability would have been close to zero, and the apparent continuing profitability of the industry in 2007 is an illusion. It is possible, however, that the prior reserves were too conservative and that the current release of reserves is aligning the reserves with results. The ratio of reserves to claims provides an indicator of whether the industry is reducing security or just aligning reserves with results. This indicates whether the amount of capital is being kept consistent with claims experience, as there should be a basic relationship between these two factors. Figure 4 is based on APRA data and indicates the ratio of reserves to claims paid net of reinsurance recoveries.

Figure 4 indicates that the industry has significantly reduced its capital security and, whereas until 2007 the industry broadly held reserves of around 100% of net claims paid each year, this was almost halved in 2007.

To see what happened to the released reserves, Figure 5 examines the ratio of shareholder equity at the end of the 2007 financial year to shareholder equity at the beginning of the year.

While some insurers have increased their shareholder equity, this was mainly due to mergers and capital raisings. Figure 5 indicates that most insurers did not change their shareholder equity materially, indicating that the reduction in reserves was used to pay dividends.

It could be argued that the industry had been holding levels of reserves that were too high and that insurers were now releasing to shareholders profits that had been locked up in prior years. While it has not yet been determined whether current levels of reserves are appropriate, clearly the industry has started to consider capital management, which it had not done previously. This increase in attention to capital management may well be a reaction to the profitability issues outlined earlier, but the industry needs to recognise that, in doing so, it has introduced other risks into the business. These risks include the need to manage the availability of capital better than has occurred previously and the need to avoid any implicit assumption that capital will be there when needed. If capital is not available when needed, there could be increased failures among insurers.

FIGURE 2: Distribution of combined ratios 1999, 2001 and 2007

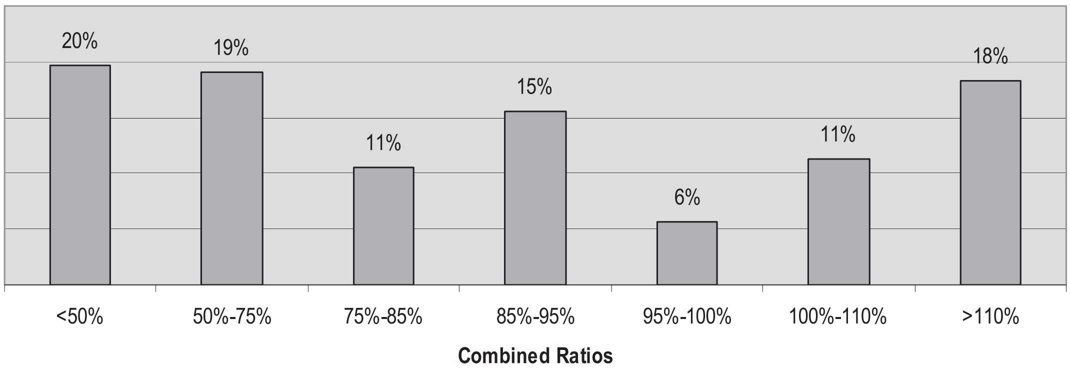


FIGURE 3: Changes in reserves for prior years

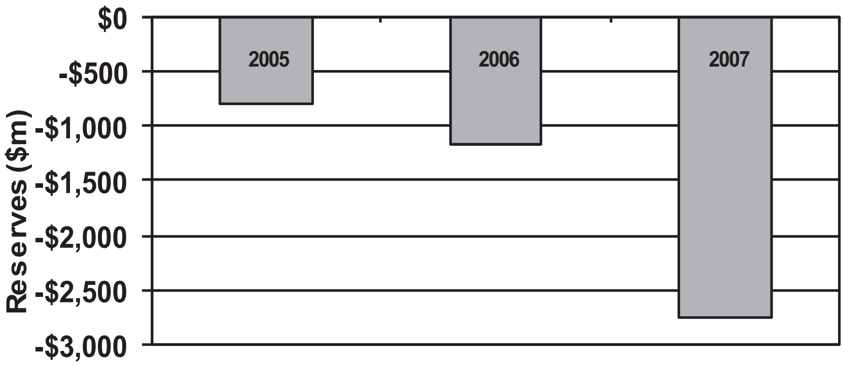


FIGURE 4: **Ratios of reserves to net claims**

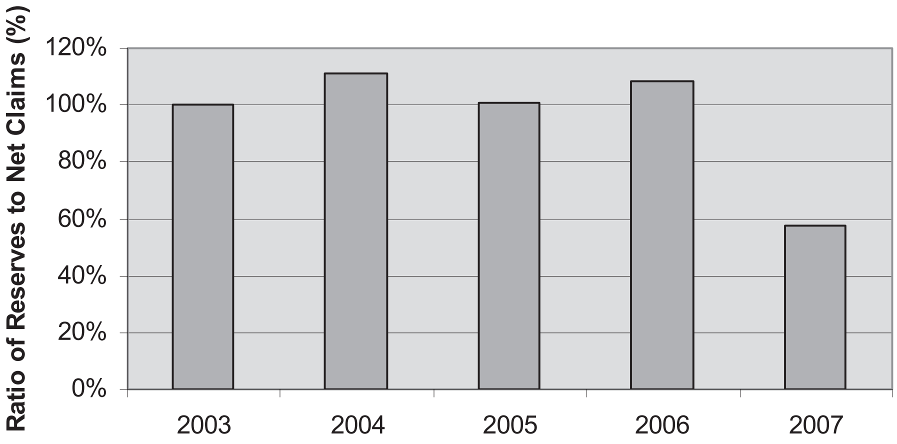
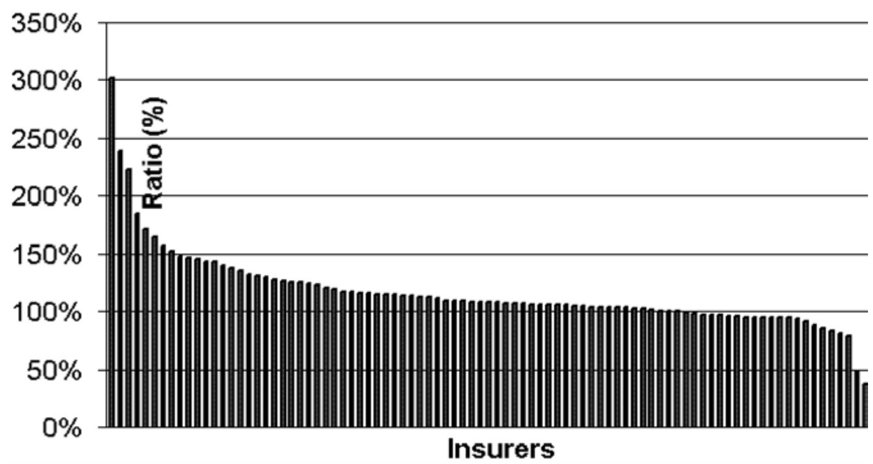


FIGURE 5: **Ratio of end to beginning shareholder equity**



Conclusion

In summary, it would appear that significant changes are occurring. Insurers have moved into a new phase where capital management is receiving significant attention and, as a consequence, insurers are:

- relying less on investment returns as a component of profits than previously;
- using reserves instead of investment returns to manage profits; and
- recognising their need to better manage their risks.

Notes

1 JASSA – the Finsia Journal of Applied Finance, issue 3, 2007.
2 McKinsey & Company 2004, *The Journey Revisited*.