

The Australian and New Zealand Insurance Industry: who will survive?

Recent surveys and risk analysis indicate that in terms of their stage of risk management programs, human capital management programs and sustainable profitability, much of the insurance industry requires considerable and urgent changes to their business practices.



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THE 2003 MCKINSEY STUDY¹ looked at the key drivers for success in the general insurance industry in the United States. The study found:

- underwriting performance drove wealth creation;
- results were remarkably stable over time;
- 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.

A survey of Australian and New Zealand insurers was sponsored by Gen Re in late 2006 to ascertain the key drivers for success in these markets. There were 50 respondents, with estimated annualised premium income in excess of \$13 billion, which is approximately 50 per cent of the industry.

The Australian and New Zealand survey looked at the following criteria as measures of the ability of individual insurers to survive:

- sustainable profitability;
- adequate risk management and human capital management practices; and
- identification and reaction to threats to the industry.

Sustainable profitability

Figure 1 indicates the return on shareholders equity² over the past seven years for the insurance industry in Australia.

The industry has seen the relatively poor returns of 1999 and 2000 replaced with several years of high returns. However, the general insurance industry has recently

exhibited greater volatility of returns relative to banks and the overall market (as indicated by the ASX 200 index). This would normally be expected to be compensated by higher average returns, which are not evident (see Figure 2).

To understand the industry results, and to appreciate what changes might be occurring, it is necessary to understand the sources of profit. The major sources of profits are underwriting and investments and their contribution to profits are shown in Figure 3.

It would seem that historically the investment returns could be relied upon to dampen, if not eliminate poor underwriting results. In recent years this is not the case, largely due to the decline in interest rates and the increasing allocation of insurers to fixed-interest type investments.

Generally, insurers have underperformed the banks and the listed equity market over the past six years by significant amounts. However, insurers have not shown a corresponding reduction in their volatility of returns.

Are all insurers the same?

No, there are significant differences between insurers' profitability. While the ratio of profit to shareholder equity is of interest as a measure of the efficient use of capital, and facilitates inter-sector comparisons, in the general insurance industry this ratio can be distorted by parent/subsidiary arrangements, specifically guarantees and reinsurance arrangements. The profit margin in the underwriting account is more indicative of the soundness of an insurer's profitability, and this is generally summarised by the 'combined ratio'.³ Figure 4 shows the distribution of the combined ratios across the industry over the past 10 years.

The results indicate that almost 70 per cent of insurers in the survey had combined ratios of less than 100 per cent on average, i.e. they had some profit margin in their premiums. But almost 30 per cent of insurers had no margins at all; it is difficult to perceive why shareholders would support a business that over 10 years demonstrated it could not obtain a profit margin in its business.

To determine if 'size' is a factor affecting profitability, Figure 5 compares the combined ratio with premium income.⁴

These results suggest that the larger insurers as a group can generally achieve profit margins in their premiums, but that the smaller insurers show widely different results with some being profitable and some not. This does suggest, however, that it is not necessary to be a large player in the market to achieve profit margins. Further, small insurers can earn higher profit ratios than larger insurers.

FIGURE 1. RETURN ON SHAREHOLDER EQUITY, AUSTRALIAN GENERAL INSURANCE INDUSTRY

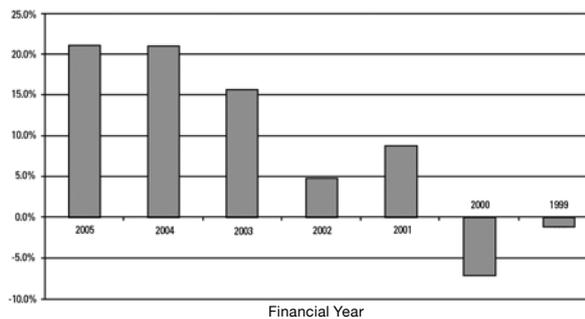


FIGURE 2. RETURN COMPARISONS GENERAL INSURANCE INDUSTRY vs BANKS AND ASX200

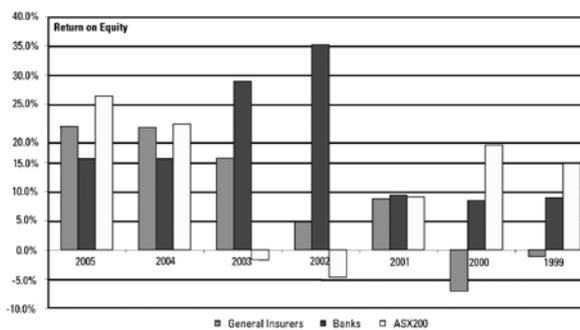


FIGURE 3. SOURCES OF AUSTRALIAN GENERAL INSURER PROFITS 1999-2005

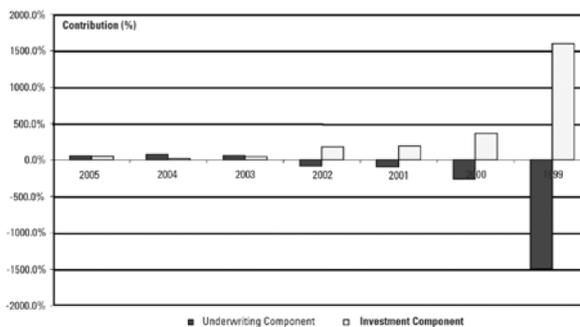
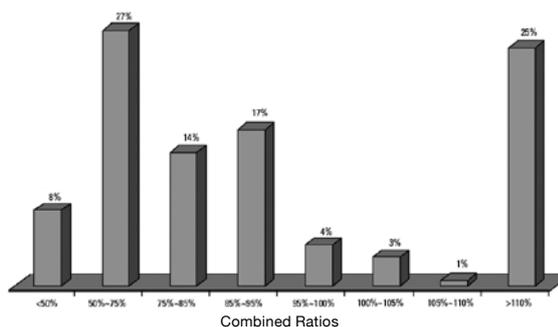


FIGURE 4. DISTRIBUTION OF COMBINED RATIOS 1996-2006



It would seem from this analysis that the insurance industry has a long way to go with bringing itself up to a reasonable standard for risk management and particularly human capital management procedures. Small insurers, in particular, need to devote significant resources to develop these techniques.

Management practices

Risk management practices

Respondents were asked to indicate if they carried out the following risk management practices:

- the use of financial ratios to determine the 'success' of the business;
- the existence of a Board-endorsed risk management statement;
- employment of specialised risk management personnel;
- regular risk monitoring and reporting to the Board;
- internal allocation of capital to lines of business;
- monitoring of returns and volatility of returns by lines of business; and
- tracking of competitiveness of products by multi-features.

Figure 6 indicates the distribution of risk management scores.

This analysis indicates that only 9 per cent of respondents had in place 90 per cent or more of what should be regarded as reasonably basic good risk management practices.

A comparison of risk rankings for large and small insurers reveals that generally the major insurers are more advanced in their risk management process (see Figure 7).

Human capital management

Respondents were asked to indicate if they carried out:

- identification of key personnel and consequent risks;
- internal training programs; and
- identification and management of people with senior management potential.

Figure 8 indicates the distribution of human capital management scores.

The results indicate that 35 per cent of respondents had in place 90 per cent or more of what should be regarded

FIGURE 5. COMPARISON OF COMBINED RATIO AND SIZE 1996-2006 ELIMINATING EXTREME RATIOS

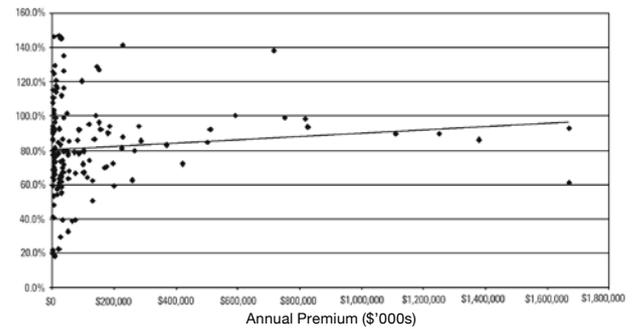


FIGURE 6. DISTRIBUTION OF RISK MANAGEMENT RANKINGS

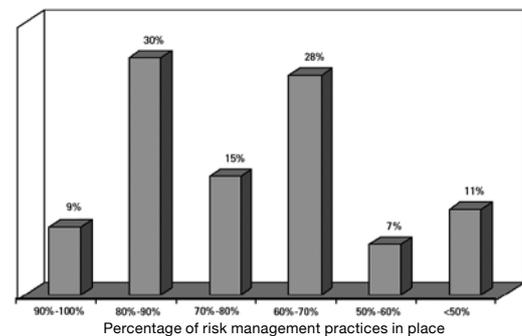


FIGURE 7. RELATIVE DISTRIBUTION OF RISK RANKING FOR BIG AND SMALL INSURERS

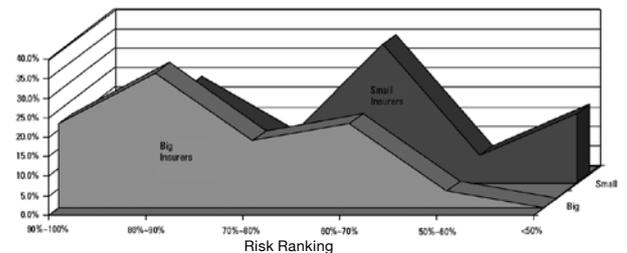
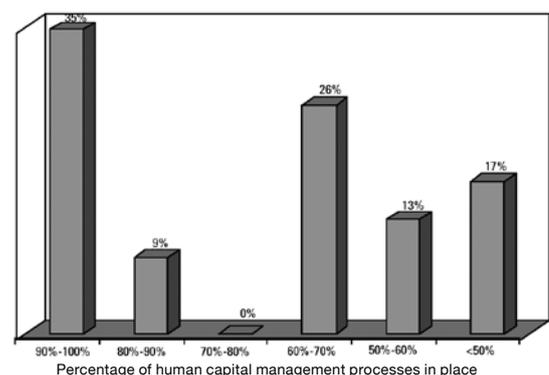


FIGURE 8. DISTRIBUTION OF HUMAN CAPITAL MANAGEMENT RANKINGS



as basic good human capital management practices, but an alarming 65 per cent of respondents did not.

Again, the large insurers are more advanced in their human capital management systems as indicated in Figure 9.

It would seem from this analysis that the insurance industry has a long way to go with bringing itself up to a reasonable standard for risk management and particularly human capital management procedures. Small insurers, in particular, need to devote significant resources to develop these techniques.

Industry threats

Insurers were asked as to the threats they saw for the industry as a whole, and then for themselves and to rank on a scale of 0 to 5 with a '5' ranking indicating a significant threat and a '0' ranking indicating an insignificant threat. The results are shown in Figure 10.

There is a broad consistency between perceived industry threats and their own threats, with catastrophic events, increased regulation and increased competition scoring the highest rankings.

Survival prediction

The perceived major indicators of the ability of insurers to survive are the stage of development of risk management, human capital management practices and sustainable profitability.

While the following is necessarily then subjective as to categorisation, it indicates the extent to which insurers are achieving acceptable standards, given that the evolution is already underway (see Figure 11).

The survey indicates that 36 per cent of the industry could be considered as being in a satisfactory condition, and 55 per cent of the industry should be considered as needing considerable and urgent changes to business practices. These results take into account: the stage of risk management programs (as measured by positive responses to the survey questions); human capital management programs (as measured by positive responses to the survey questions); and sustainable profitability (as measured by the combined ratio over the past 10 years).

Improving performance

While statistical analysis helps to summarise complex data sets, statistics fail to bring out the underlying causes of the results.

Based on the interviews conducted, and subsequent industry group discussions organised by Gen Re in Sydney & Auckland, there was a consistent story of an industry about to face what was perceived as significant external threats from regulation and workforce quality.

The reality, however, may be quite different. My view is that the threat is actually internal, not external, and this information emerged not from the statistics but from the interviews with senior managers of the institutions.

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FIGURE 9. DISTRIBUTION OF HUMAN CAPITAL MANAGEMENT RANKINGS FOR BIG AND SMALL INSURERS

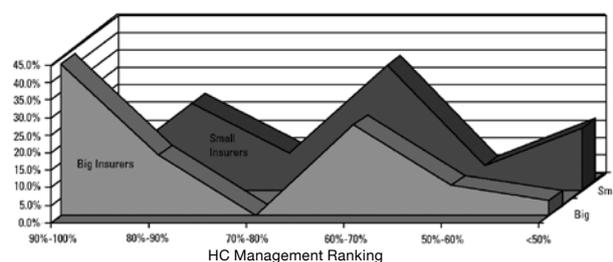


FIGURE 10. RELATIVE RANKINGS OF PERCEIVED THREATS TO OWN BUSINESS vs INDUSTRY

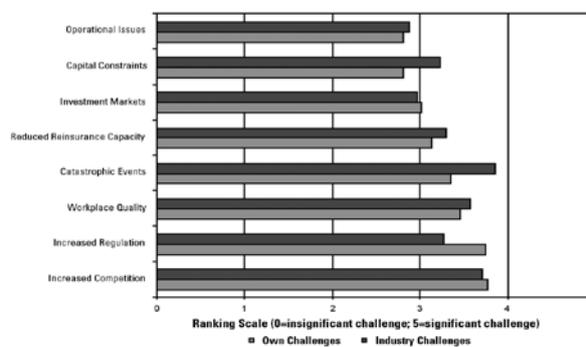
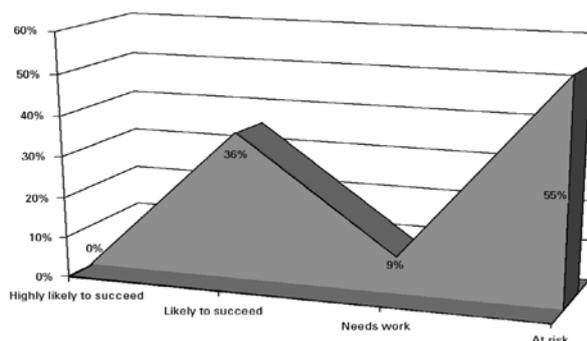


FIGURE 11. RANKING OF COMPANIES OVERALL POSITION



The major reason the industry has a workforce quality issue is that historically it has not encouraged high-quality new entrants to join the industry. This, in turn, has led to what we now call operational issues and a lack of experienced management conversant with current financial and human capital management thinking, particularly related to risk management.

The consequence of this is that as risk-based regulation evolves:

- (i) insurers will be threatened not only by lack of knowledge of the techniques but also, and more importantly, how to use risk-based management procedures to better manage stakeholder expectations; and
- (ii) there will be increased competition from those better able to grasp the issues and manage stakeholder expectations.

At the base of the threats to insurers then is a culture that has not been conducive to encouraging the introduction of improvements in financial management through recruitment and retention of staff capable of introducing and utilising these concepts.

It is clear that insurers need to go through the same cultural change that the banks have been through in recent years, namely:

- (i) changes to Board structures so as to ensure there are Boards that can appreciate the issues involved in effective management of a financial institution and can effect management changes to ensure the day-to-day management is moving to best practice; and
- (ii) re-engineering of management structures to focus on the management of acceptable risks relative to available capital and required probability of survival.

This will require significant changes to human capital management, systems support, management quality, and patience while results are achieved.

Conclusion

This analysis suggests that, on balance, and in the absence of major and immediate change, a significant number of insurers are unlikely to be able to meet the real challenges of the current evolution of the insurance industry to meet stakeholders' required results.

Notes

1. McKinsey & Company 2004, *The Journey Revisited*.
2. APRA data.
3. The combined ratio is (claims+ expenses)/premium income.
4. This chart eliminates some combined ratio results that were regarded as extreme and the result of special circumstances.