The Australian & New Zealand Insurance Industry: Who Will Survive?

The 2003 McKinsey study\(^1\) looked at the key drivers for success in the general insurance industry in the US. 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
- 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 annualized premium income in excess of $13 billion, which is approximately 50% 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
- Identification and reaction to threats to the industry

**Sustainable Profitability**

The following chart indicates the return on shareholders equity\(^2\) over the last 7 years for the insurance industry in Australia:

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\(^1\) The Journey, Revisited, McKinsey & Company, 2004
\(^2\) APRA data
The industry has seen the relative poor returns of 1999 & 2000 replaced with several years of high returns, but relative to banks and the overall market (as indicated by the ASX 200 index), the general insurance industry has over recent times exhibited greater volatility of returns, which would normally be expected to be compensated by higher average returns, which are not evident.

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 the profits are underwriting and investments and their contribution to profits has been:
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 last 6 years by significant amounts; however the insurers have not shown a corresponding reduction in volatility of returns.

Are all Insurers the Same?

No, there are significant differences between insurer’s profitability. Whilst 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 summarized by the “combined ratio”\(^3\). The following chart considers the distribution of the combined ratios across the industry over the last 10 years:

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\(^3\) The combined ratio is (claims + expenses)/premium income
The results indicate that almost 70% of insurers in the survey had combined ratios less than 100% on average, i.e., they had some profit margin in their premiums. But almost 30% of insurers had on average 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, the following chart compares the Combined Ratio with premium income:\(^4\):

\(^4\) This chart eliminates some Combined Ratio results that were regarded as extreme and the result of special circumstances
This result suggests that the bigger 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 bigger insurers.

Management Practices

Risk Management Practices

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

(a) the use of financial ratios to determine “success” of the business;
(b) the existence of a Board endorsed risk management statement
(c) employment of specialized risk management personnel
(d) regular risk monitoring and reporting to the Board
(e) internal allocation of capital to lines of business
(f) monitoring of returns and volatility of returns by lines of business
(g) tracking of competitiveness of products by multi features

The following chart indicates the distribution of risk management scores:

![Distribution of Risk Management Rankings](image)

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

A comparison of risk rankings for big and small insurers reveals that generally the big insurers are more advanced in their risk management process:
**Human Capital Management**

Respondents were asked to indicate if they carried out:

(a) identification of key personnel and consequent risks  
(b) internal training programs  
© identification of and management of people with senior management potential

The following chart indicates the distribution of human capital management scores:
The results indicate that 35% of respondents had in place 90% or more of what should be regarded as basic good human capital management practices, but an alarming 65% of respondents did not.

Again, big insurers are more advanced in their human capital management systems:

![Distribution of Human Capital Management Rankings for Big and Small Insurers](image)

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 were:
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.

Whilst the following is necessarily then subjective as to categorization, it indicates the extent to which insurers are achieving acceptable standards, given that the evolution is already underway:
Taking 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 last 10 years), the survey indicates that 36% of the industry could be considered as being in a satisfactory condition, and 55% of the industry should be considered as needing considerable and urgent changes to business practices.

**Improving Performance**

Whilst 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 organized 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.

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, which in turn has lead 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:

1. 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;
2. There will be increased competition from those better able to grasp the issues and manage stakeholder expectations better.

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

It is clear that insurers need to go through the same culture change that the banks have been through over the last few years namely:

1. 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.
(i) 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 whilst results are achieved.

**Conclusion**

In balance, and in the absence of major and immediate change, a significant number of insurers are on this analysis unlikely to be able to meet the real challenges of the evolution of the insurance industry to meet stakeholder required results.