



INSURANCE

## State of the Insurance Industry

**Brian Greig**  
Chairman – Insurance Practice, KPMG

AILA National Conference  
Hilton Hotel, Sydney  
Friday 3 November 2006

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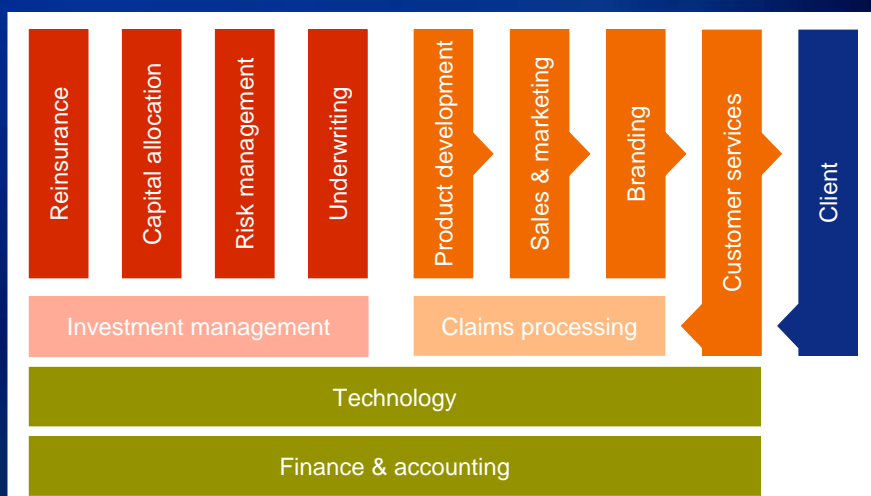
## Agenda

- **Part 1 – Globalising the Risk Business  
(KPMG/EIU Global Survey, July 2006)**
- **Part 2 – General Insurance Industry  
(KPMG Australia Survey, September 2006)**

## Agenda

- Part 1 – Globalising the Risk Business (KPMG/EIU Global Survey, July 2006)
  - Pace of change accelerating
  - M & A activity and global restructuring
  - Who will come out on top?
  - Will the biggest insurers get bigger?

## Insurance company value chain



## Business model focus areas

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- Customer relationships
- Technology
- Risk, capital management/capital allocation
- Core insurance processes
- Asset management
- Outsourcing

## Agenda

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- Part 2 - General Insurance Industry  
(KPMG Australia Survey, September 2006)
  - Results
  - Cycle
  - Customers
  - Outlook

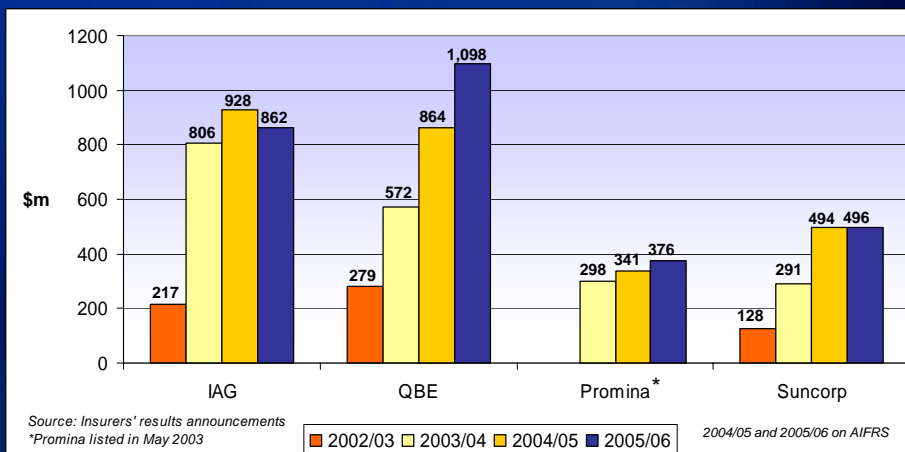
## Results

	2006 \$m	2005 \$m
Gross written premium	26,080	25,205
Net earned premium	23,107	22,140
Underwriting profit	2,171	1,722
Investment income	3,171	3,223
Net profit after tax	3,556	3,448

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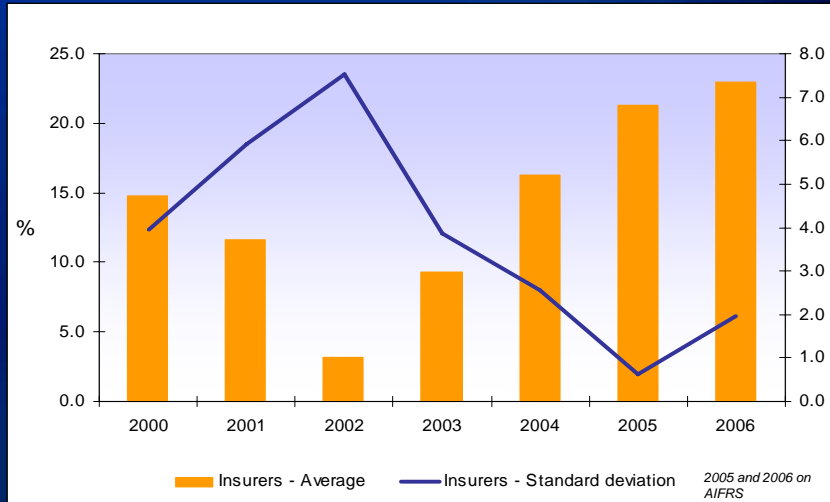
## Listed insurers' NPAT 2003 - 2006



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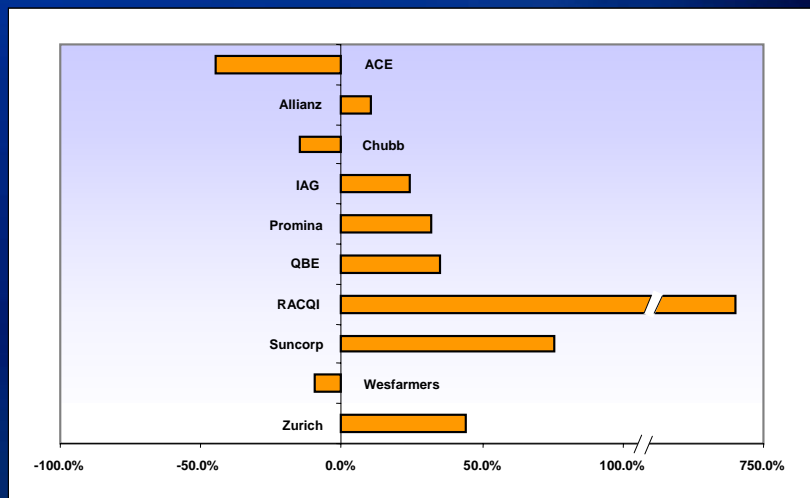
## Return on Equity



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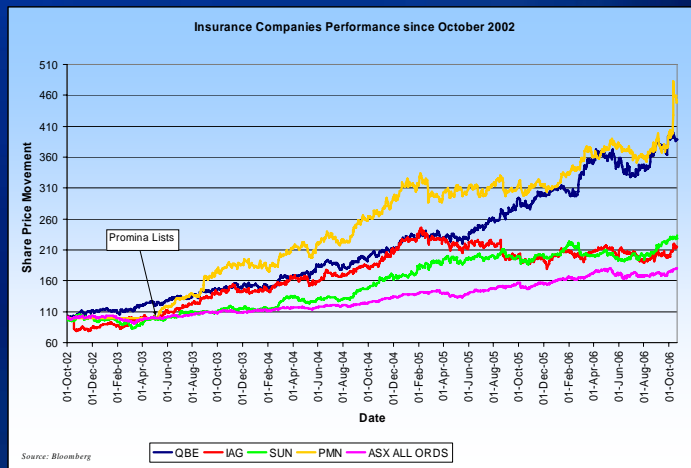
## Insurers' underwriting surplus growth (YoY)



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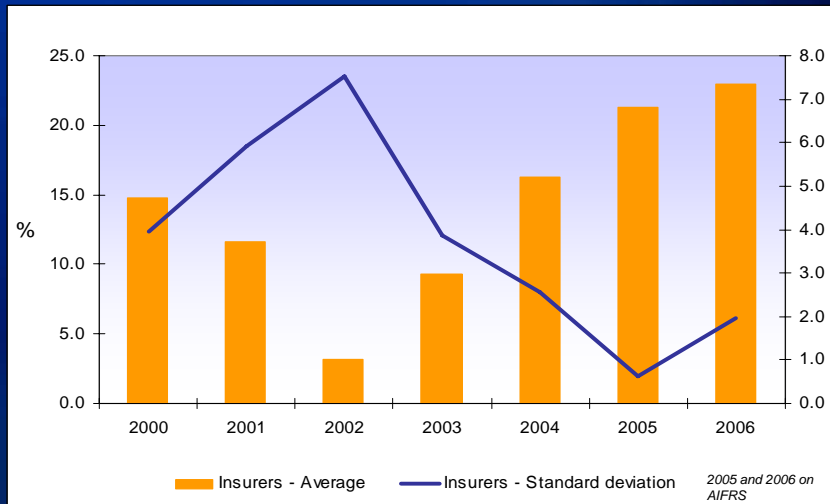
## Share prices



## Agenda

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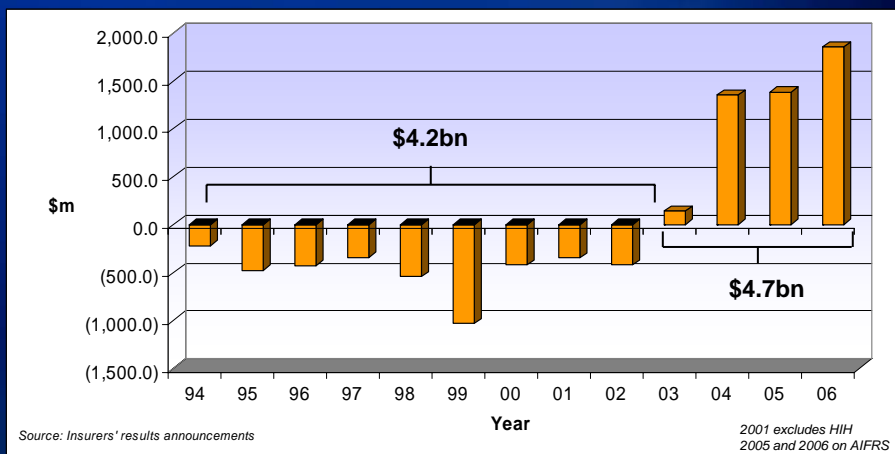
## Return on Equity



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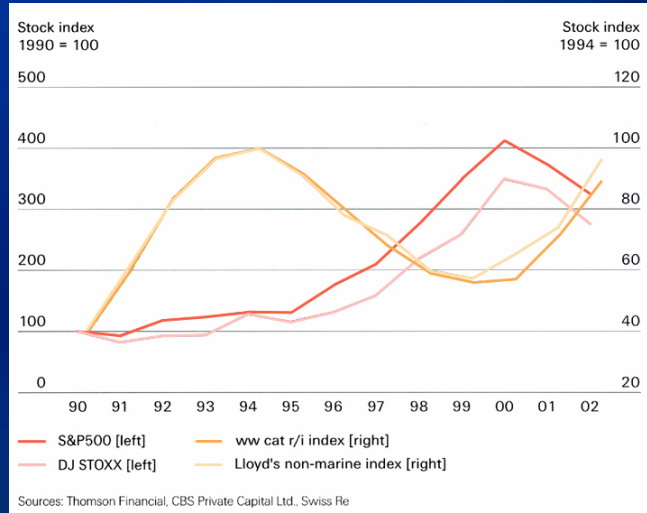
## Underwriting results of top five insurers



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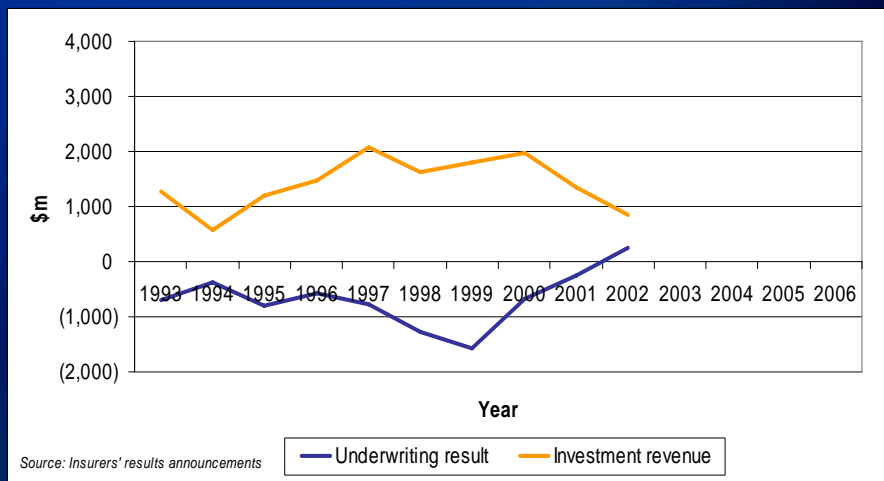
## Stock markets vs. premium rates



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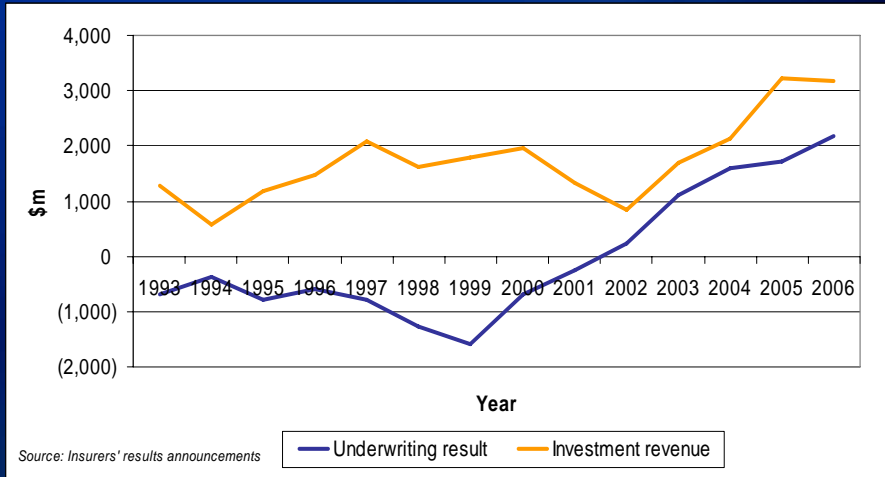
## Underwriting results and investment revenue



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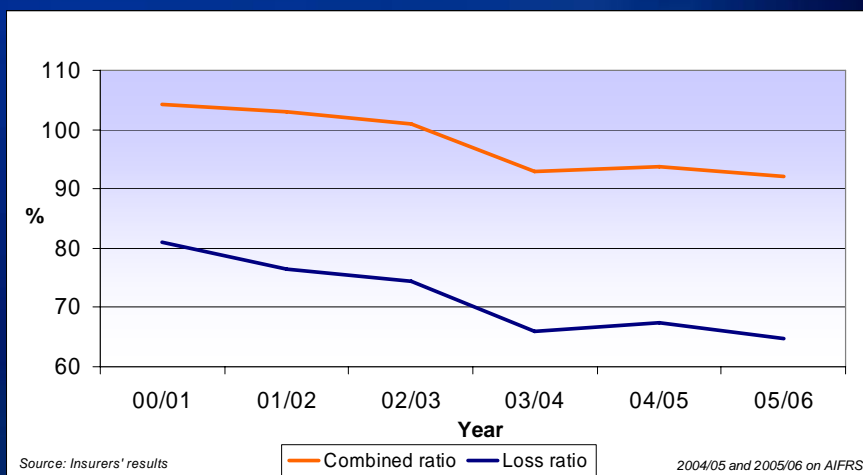
## Underwriting results and investment revenue



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## Industry KPIs of top five insurers



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## Factors underpinning share performance

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- Growth
- Underwriting profitability
- Size

## Insurance industry's biggest challenge

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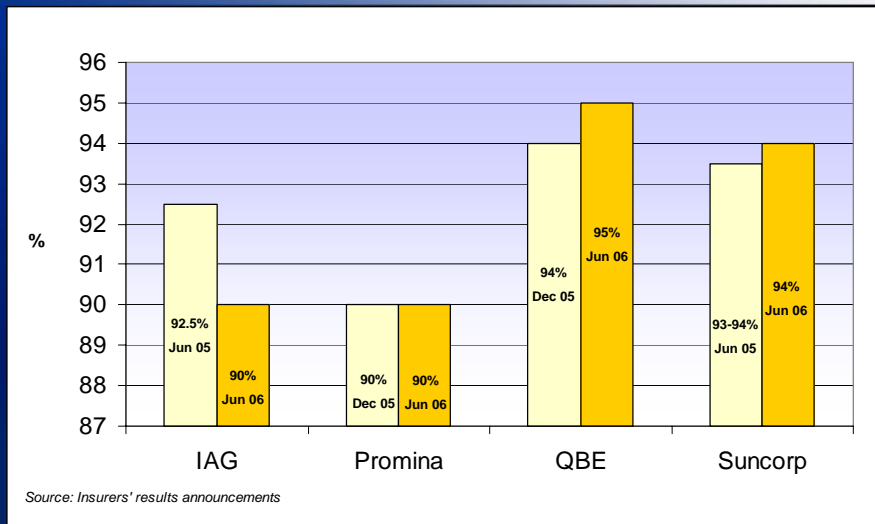
**Profitable top line growth**  
in a  
**congested, competitive domestic market**

## What we may see...

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- **Mergers and acquisitions**
- **Alternative product differentiation**
- **Marketing campaigns**
- **More intense customer focus**

## Probability of adequacy of listed insurers' provisions



## Customer position

	Price competition	Industry solvency
Historic (pre 2001)	✓ ✓	?
Hardened market (2002 – 2005)	?	✓
Softening market (2005 onwards)	✓	✓

## Customers' perspective

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- Solvent industry
- Strong(er) competition
- Product differentiation
- More intense customer focus

## Agenda

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- Part 2 - General Insurance Industry  
(KPMG Australia Survey, September 2006)
  - = Results
  - = Cycle
  - = Customers
  - = Outlook

## Outlook

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- Prolonged softened cycle
- High solvency levels
- Profitable growth challenges
- Further M&A
- Increased advertising
- Greater customer focus

## Questions



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## Globalising the risk business InFinsia Journal, August/September 2006

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### **M & A and branding is high on the list of priorities for insurers worldwide.**

The pace of change for insurers and re-insurers worldwide is rapidly accelerating due to ongoing globalisation and consolidation. In a recent global report commissioned by KPMG and conducted by the Economist Intelligence Unit, half the respondents indicated that the pace of consolidation is set to accelerate and 45 per cent said their firm will take part in a merger or acquisition over the next three years.

In recent years, Australian insurers both nationally and overseas, have engaged in a high level of acquisitions activity. For example, in the last 13 months to end-July 2006, IAG has acquired, or agreed to acquire with regulatory approval, interests in insurance underwriters based in Thailand, Malaysia, Singapore and China. Promina has completed or announced eight bolt-on acquisitions since listing in May 2003 and has indicated its intention to spend \$100 million on acquisitions in the future. QBE has also reported adding \$2.8 billion of gross premium income to the group through acquisitions in the four years to 2005.

While KPMG's report, *Globalising the Risk Business: Servicing and competing in the global insurance industry*, is based on a global survey of 148 senior insurance executives, its results are equally relevant to the Australian insurance sector.

The insurers believe it is the firms that get closest to their customers that are likely to come out on top, and that the biggest firms within the industry could get bigger still.

This shouldn't come as any great surprise to Australia's largest insurers which, following significant merger and acquisition activity some years ago, have been quietly building strength and customer service, improving their underwriting standards, enjoying healthy share prices and now, with significant surplus capital available, are ready to look for further expansion opportunities both in Australia and further afield.

Insurers should identify and build on their strengths, and consider exiting from those areas of the value chain where they are weak.

The research points to several areas that insurance companies should focus on as they work to streamline and globalise their business operations:



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## Customer focus

The single most important lever of competitive advantage is quality of service, according to 70 per cent of executives in the survey. These sentiments have also been raised by several of Australia's insurers. Promina, for example, has made a number of statements about new business sales being led by activities that segment, understand and provide superior experiences to advisers and their customers. Other insurers such as Suncorp's GIO have launched new service charters for customer service commitments.

The theme of customer focus is reflected elsewhere, with insurers working hard to create powerful global brands on the one hand and to deliver products that are tailored to the needs of specific customer groups on the other. Interestingly in Australia, Promina has successfully followed its 'house of brands' strategy (e.g. AAMI, APIA, Vero, Asteron) which it claims enables it to specialise and focus on specific market segments thereby achieving the same end result.

## The role of technology

The need to improve customer responsiveness while reducing costs may also require many insurers to update their IT systems. In many insurance companies, data is locked within different silos around the business, making it difficult to achieve a single view of the customer. Even now, only one-fifth of companies in the survey have plans to move to a global IT platform. In Australia, as in the rest of the world, progress in this area has been hampered by the cost of replacing legacy systems that aren't well integrated, however, the insurer that bites the bullet and makes the first move and invests here is likely to reap substantial rewards through improved customer service and reduced costs in the longer term.

## Risk and reward

Profitability depends not just on making money from underwriting, but on controlling risk in an increasingly complex market. No fewer than 76 per cent of those questioned in this survey said that improved knowledge of the group's overall exposure was the single most important factor in managing risk. Another expected trend, according to several executives interviewed for this report, is for underwriting and the allocation of capital to be tied together more closely in the future.

## Outsourcing

Only a small minority (less than 8 per cent) of executives said they would outsource over the next three years. The high importance that executives place on quality of customer service and maintaining strong control over key processes may explain the reluctance to hand areas like claims processing over to third parties. Insurers are more comfortable with the idea of internal shared service centres, particularly for back-office functions; approximately one-fifth of executives said they will rely on shared service centres to handle IT and finance within the next three years. In Australia, there will be selective sourcing, rather than large scale outsourcing. Plus, an insurer must consult with APRA prior to entering into any offshoring arrangements, which makes the decision to do so more considered.

## Global restructuring

Insurance markets in the United States and continental Europe are still highly fragmented, providing abundant opportunities for further restructuring. As noted, half of the executives surveyed expect consolidation in the global insurance industry to accelerate. At the same time, insurance companies are exiting from non-core business: for example, around three-quarters of survey respondents indicated their company had either left a national market during the past three years by selling its operations there or by closing down an office. The Australian insurance sector has seen some of this activity in the past few years but most consolidation has already happened.



## Managing a global business

How should insurers and re-insurers manage their increasingly complex, global operations?

The answer depends on which part of the business you have in mind. In the survey, companies indicate that management of the brand is expected to be increasingly centralised on a worldwide basis. By contrast, sales and marketing may need greater autonomy at a local level in order to respond to specific market needs

In the past, insurance companies have been relatively sheltered from the competitive forces that have reshaped business models in other areas of financial services. But that is changing. Scale, simplicity and customer focus will be extremely important for future success, but achieving those goals may require more than minor modifications to the business model. In the end, restructuring at the industry level may need to be matched by deep-rooted changes to the way individual insurance companies go about their business. In Australia, where only one major insurer, QBE, is truly global, this applies more to how Australian insurers should manage their various brands, and new brands that will come with M&A activity. Promina successfully manages a 'house of brands', where several strong brands make up its business.

We expect to see an investment in brand, sales and marketing but it is unlikely that Australian companies, with a strong suite of brands would move to a single brand without compelling evidence that customer and shareholder value would be enhanced.

## Risk and Capital Management

More than half the executives in the survey believe that underwriting should be tied more closely to levels of exposure. This means turning away business that is unprofitable and fails to fit an insurer's risk profile or desired mix of business.

In Australia, general insurers have, in recent years, enjoyed the benefits of disciplined underwriting, legislative reform, strong investment markets, and a continued focus on cost control. The insurance industry is now in a position where it can choose to maintain the current positive cycle by remaining disciplined in its underwriting, or succumb to the historic temptations of 'growth above quality' and trigger the onset of a soft cycle.

The experience in the recent 30 June renewal season would indicate that some insurers have continued to soften their prices to achieve growth in commercial lines although personal lines appear to have been less affected.

As published in *InFinsia*, Journal of Finsia – Financial Services Institute of Australasia, August/September 2006, Volume 120 Number 4

The *Globalizing the Risk Business: surviving and competing in the global insurance industry* survey can be found at <http://www.kpmg.com.au/Default.aspx?TabID=209&KPMGArticleItemID=2064>



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# KPMG General Insurance Industry Survey September 2006 (Extract)

## Executive Summary

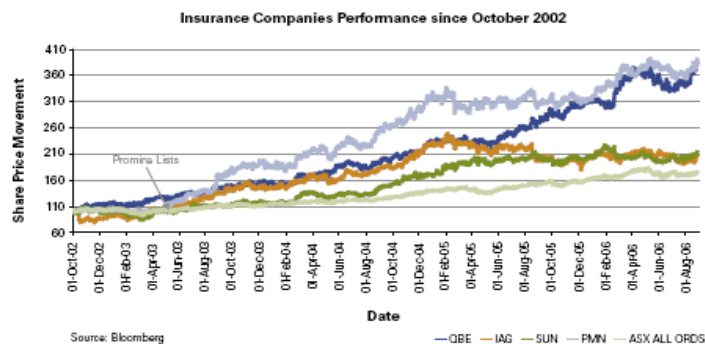
### Results announced

The 2005/06 reporting season announced new record results for the Australian insurance industry. The results were achieved despite increased competition and lower investment returns. Overall, Gross Written Premium increased by 3.5 percent to \$26,080 million, whilst underwriting profit improved by 26.1 percent to \$2,171 million. The investment market's performance contributed \$3,171 million to the result, down by \$52 million (1.6 percent) from last year. Operating profit after tax improved by 3.1 percent to \$3,556 million – a record result.

Not all insurance companies surveyed, however, shared the same trends as the overall results. Some companies suffered reduced underwriting results, whereas half of the insurers surveyed achieved lower profit after tax than last year. In general terms, the larger insurance companies appeared more successful in increasing profits after tax.

The insurance industry's results translate into a Return on Assets (ROA) of 4.6 percent (2004/05: 4.9 percent), and a Return on Equity (ROE) of 22.9 percent, surpassing last year's record average ROE of 22.8 percent. Not surprisingly, the volatility of financial performance deteriorated marginally to a standard deviation of 2.0 compared to 0.6 for 2005 and 2.6 for 2004. This was to be expected given the increased competition, particularly in some classes of business, and the disproportionately detrimental effect it had on companies that were more exposed to these classes of business.

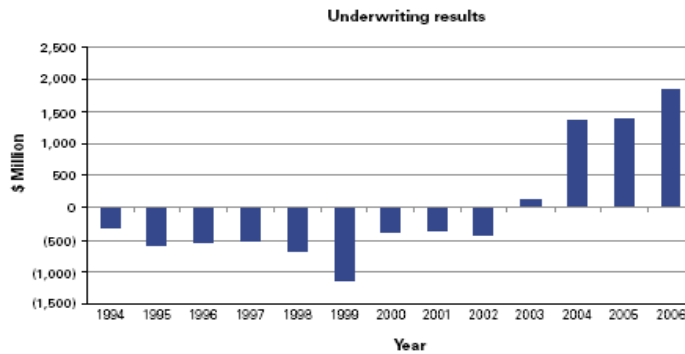
Share prices too reflected mixed performances: some insurers continued to produce very strong performances, whilst others displayed the first downward trend in three years (year on year). That said, as an industry the share price performances continued to outperform the ASX All Ordinaries Index, albeit by more diversified individual performances as the following graphic and table bear out:



<sup>1</sup> The survey includes insurers with net earned premium greater than \$180 million in the current year.

	30 Jun 2003 \$	30 Jun 2004 \$	30 Jun 2005 \$	30 Jun 2006 \$	Growth 2003-04 %	Growth 2003-05 %	Growth 2003-06 %
IAG	3.40	5.00	6.01	5.35	47.1	76.8	57.4
Promina	2.36	4.00	4.71	5.62	69.5	99.6	138.1
QBE	9.32	12.80	16.03	20.5	37.3	72.0	120.0
Suncorp	11.60	14.20	20.11	19.35	22.4	73.4	66.8

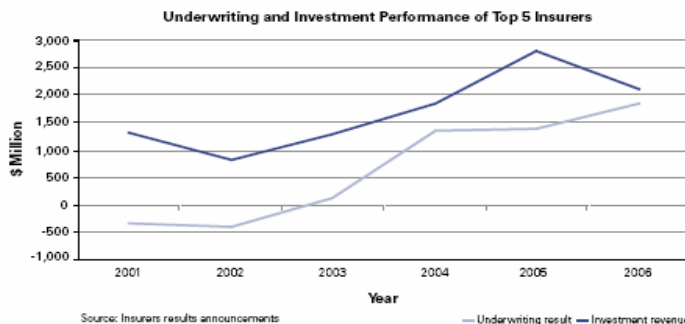
The greater diversity of underwriting and share performance results for the current year reflect the substantially increased competition, particularly in commercial classes, which caused a softening of the insurance cycle – the first in recent years. This softened cycle must, however, be contrasted to historic soft cycles: the industry has to date not exhibited the deep cycle behaviour observed prior to the collapse of HIH in 2001. Alternatively stated: to date, and as a whole, the industry has remained more disciplined and rational in its pricing. The following chart illustrates this clearly:



Source: KPMG General Insurance Industry Surveys

The early indicators of the 2005/06 reporting season are therefore that the industry is operating and reacting quite differently to competitive pressures. This is encouraging, and appears to signal (at least at this stage) that future behaviour may, at industry level, be different from that observed historically.

The difference in behaviour is particularly noticeable when underwriting performance is compared to investment income: prior to 2002/03 the industry took advantage of favourable investment markets and tolerated irrational pricing to the point that it led to negative underwriting results. In contrast, overall underwriting performance for the current period remained positive, despite increased competition and ongoing positive investment performance.



Source: Insurers results announcements

— Underwriting result — Investment revenue

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Overall, the industry remains very well capitalised with high levels of claims provisioning sufficiency. All listed insurers disclosed claims provisioning adequacy levels of 90 percent or higher, making the Australian insurance industry one of the most solvent and well provisioned markets in the world.

### Issues facing the industry

Australian insurers continue to experience pressure on top line growth in an increasingly congested domestic market. Contemporaneously, insurers are expected to sustain, and indeed improve, underwriting performance and margins. The interaction of these expectations denies insurers the historic opportunity of pursuing one objective at the expense of the other, e.g. the industry can no longer achieve top line growth by sacrificing underwriting margins (as it did historically). Increased disclosures and understanding of the market, shareholder interest, regulatory monitoring and more sophisticated market analyses have changed the landscape to the point where this response is no longer acceptable. Of course, this means that insurers have to find alternative solutions to achieve top line, profitable growth.

The achievement of sustained, profitable top line growth represents one of the biggest challenges to the industry at this time. Insurers are exploring, with varying degrees of success, how the objective can be achieved through alternative means, including:

- local and overseas mergers and acquisitions;
- alternative product differentiation;
- more aggressive marketing campaigns; and
- differentiating customer service and experience.

A second challenge, and opportunity for profitable growth to the industry, relates to the high levels of underinsurance. Both manifestations of underinsurance, that is insufficient insurance protection or the complete absence of insurance protection, remain largely unaddressed. Furthermore, the recent increases in fuel prices and interest rates continue to exert more pressure on consumers' cash flow, which has the potential of exacerbating the current levels of underinsurance.

The third challenge, and one that the industry has already taken some steps in addressing, is market reputation and customer interaction. The insurance industry has made good reputational progress with its adoption of the Code of Conduct. The challenge now is to execute on the Code of Conduct, and to do so in a financial services environment of heightened customer expectation and attention.

### Outlook

The current levels of competition, particularly in the commercial classes of business, show no signs of respite and are expected to continue into the following year. Similarly, competition is expected to increase in personal lines of business, albeit not to the same extent as in commercial business. The softened cycle is therefore expected to continue, but is expected to be much 'shallower' than the deep cycles observed prior to the HIH collapse.

The industry remains well capitalised with strong cash flows. At the same time it remains under pressure to achieve profitable top line growth, which may lead to increased merger and acquisition activity, more aggressive marketing, alternative products, and greater focus on differentiation through customer service. In this sense customers may be positioned to experience the best the industry has to offer:



- highly sufficient solvency levels; yet
- strong competition between insurers; characterised by
- greater product differentiation; and
- more intense customer focus, including service delivery.

They said, it is also a time of warning to consumers not to be complacent about their insurance cover. Whilst Australia has been fortunate to have escaped the catastrophic natural events observed elsewhere (with the exception of Cyclone Larry), it is no time to be impervious to insurance protection. Against an environment of increasing pressure on family budgets, brought about by the higher fuel prices and interest rates, every effort must be made by consumers to ensure they have adequate insurance protection. This is particularly important for home owners in view of increasing building (and therefore, replacement) costs.

Lastly, and with few exceptions, the larger insurance companies are facing defining stages of their evolution as they have grown to the sizes they are today, but will have to find alternative avenues for pursuing growth in an increasingly concentrated domestic market. This will require a more lateral exploration of alternative growth strategies than what historically have been required in the industry.

The complete version of the KPMG General Insurance Industry Survey 2006 can be found at <http://www.kpmg.com.au/Default.aspx?TabID=209&KPMGArticleItemID=969>



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