
The Insurance Business & The Business Of Insurance

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Success in any businesses comes from a deep understanding of one key, perhaps unique characteristic. In the insurance industry that characteristic is risk – how to understand it, manage it and price it.

But all businesses are **united** by *common* drivers. In this paper we discuss the drivers of success in the insurance industry that drive success in *every industry*.

The four key themes we want to look at are:

- ◆ Capital – where it comes from and how to use it well
- ◆ Growth – where to find it – and is it all in Asia?
- ◆ Legislative and competition – especially in relation to the DOFI issue
- ◆ Finally, distribution – and how the internet is changing it for insurers.

Capital – the building block of business

It goes without saying that capital is at the heart of every business and there are some very interesting trends unfolding in the capital front of our business right now. However, the implications are poorly understood.

Looking at the history of the insurance industry, we see that when the financial returns appear good, the supply of available capital expands rapidly and providers of capital seek to gain market share by cutting prices. The crazy part about this dynamic is that for the insurer, price cutting will not increase total demand¹.

The Capital insurers have to enable them to write business has to pay an adequate return. Your return needs to be materially above the cost of capital to be value creating. This is especially so in the volatile world of insurance, where in any normal year the profit has to be well above the bank interest rate to encourage investors to accept the risks.

What has changed in recent years is the sources of capital. Any large single event that in the past would have destroyed surplus capital and hardened the market – like September 11 – will now see that capital vacuum potentially filled by opportunistic institutional capital such as sidecar agreements, Cat bonds, Exchange traded Cat Options and Cat Swaps etc.

This has potential to extend the soft market conditions because this new capital will not need to make up for lost profits/ capital following events like 9/11.

Just to add further softening to our market we have seen expanding competition in Australia in the past year with the arrival of companies like AXIS and WR Berkeley. There are now too many players – and too much capital – competing for the same pot of premium.

¹ “Practical Risk Theory for Actuaries” p342 Daykin, Pentikainen, Pesonen. CRC Press 1994

There is excess capital in the industry at the moment and that is putting pressure on returns. Some in the industry believe that a large cat event like a Hurricane in the Gulf of Mexico would hit the global market by reducing overall capital and as a result lift prices in Australia.

However, this is a narrow view of how capital is allocated in the insurance industry. There will be frequent and predictable storms in the Gulf – Hurricanes Gustav, Hanna and Ike are just the latest incidents and Hurricane Katrina the most well-known. Over 40 have crossed the US coastline in the past 100 years.

For insurers, this hurricane risk is both predictable and expensive. The market is sophisticated enough to know that the global premiums that support random cat events - like an earthquake in Newcastle - cannot go into a pool that supports obvious and frequent losses such as hurricanes in the Gulf of Mexico.

As a result a large hit to capital following a damaging Gulf Hurricane should not affect the capital that supports the insurance market in Australia. Indeed it is vital for success in insurance that your capital sits in diverse pools from a risk perspective.

A 2008 survey of over 1100 CEO's by IBM² showed that 75% plan to aggressively pursue new markets as they adjust to globalization. So what do insurers do? Ideally, they want to take their money where the paddock is greener. So insurers previously focused on Australia start to move offshore. We have seen some companies do this very successfully – like QBE and Liberty International Underwriters. And we have seen others really struggle.

That is because overseas expansion creates a whole new set of issues:

- Moving the money offshore means a new set of transaction costs
- The capital provider/ insurer may not understand the new market and overpay for what they buy. Even worse – they buy the wrong opportunity
- The insurer goes in as a brand new market and charge the wrong prices – through ignorance - for local exposures
- As we have seen recently, there may be a glut of capital around the world, not just in Australia – and so shifting the capital may not improve your position

Chasing growth and increasing risk

Experience tells us insurers often stumble when they have a large pool of capital and think they need to write business to service it. Smart insurers either redeploy the surplus capital or return it to shareholders. We have seen Tokio Marine do that recently, buying back \$450 million dollars worth of its own shares. Unfortunately it takes a rare discipline to do this.

The other difficulty is that insurance executives are not paid to suggest returning capital to shareholders. Incentives are all based around writing business, not returning capital. And companies are reluctant to hand back capital to their shareholders because shareholders might not give it back if it is needed at a later stage. This is particularly so in the middle of a credit crunch.

² “The Enterprise of the Future” IBM Survey, 2008

This combination of soft markets and the drive for growth is sending out a danger signal. We only have to cast an eye over the real estate market in America to see what happens when supposedly conservative financial Institutions start lowering standards and chasing growth. The place where most of that chasing is likely to occur is the great, golden frontier that is Asia.

The Asian insurance market: El Dorado or Shangri-lala land?

We know that the sustained economic growth we are seeing in countries like China, India and Vietnam is extraordinary. Growth on this scale has never been achieved before. That growth shows few sign of slowing. The two charts that follow compare the current size of some big economies with what they are expected to look like in a few decades.

Chart One:		
National GDP: 2007		
Rank	Country	GDP
1	USA	13,843
4	China	3,250
12	India	1,098
13	South Korea	957
14	Australia	908

Source: Goldman Sachs

Chart Two		
National GDP: 2050 (USD \$m)		
2050 Rank	Country	GDP
1	China	78,000
2	USA	38,500
3	India	37,600
7	Indonesia	7,010
13	South Korea	4,080
15	Vietnam	3,600

Source: Goldman Sachs

According to Goldman Sachs, in the next forty odd years:

- China will grow from having an economy one quarter the size of the USA to having an economy twice as big.
- India's GDP in 2050 will be 34 times bigger than it is today

Yet these figures do not make Asia the Promised Land for insurers that it is often held out to be.

Today the world biggest insurance players are landing in Singapore, Chennai and Shanghai, spending up big on office space and expat salaries, buying licences and writing big checks for

statutory capital. In Deloitte's 2006 Global Insurance Executives survey, 40% said that China was going to be very important to their organization by 2010³.

All these companies will say that Asia is a long-term play. But their shareholders and their boards all have short-term expectations that these companies will:

- Service the capital by getting an adequate return on capital
- Grow the premium book dramatically, starting immediately

So now you have a lot of big fish in what is still relatively a small pond. And it is the size of the pond that really matters. Because the reality is that the size of the insurance markets in Asia does not reflect the size of the economy or even the growth in those economies. The following chart proves that point.

Chart three:	
Not so insured, Part 1: Insurance Spend per Person, 2007	
Country	Per Capita Spend – Non Life (USD)
Asia	54
China	25
India	6
Australia	1326
USA	2164

Source: Swiss Re, Sigma World Insurance Reports

This chart shows that people in the US spend 86 times more on general insurance than they do in China. They spend 360 times more than people in India. Just because the East is growing its financial clout does not mean it will adopt Western insurance buying habits. So we need to ask ourselves: "Why is the insurance spend so low?"

We will start by looking at the logic of insurance. To buy insurance in personal lines you must own an asset you want to protect. Today, the Chinese motor vehicle industry builds more cars than Detroit. Yet the US has over 700 cars per 1000 people and Australian 600. China has 12, India has 10. There just is not the same demand for insurance because the assets are not there to insure.

People "get" insurance when they have something they cannot afford to lose. Today the masses in China and India are only just beginning to reach a wealth level that will require insurance. So the opportunity for international insurers to win new business is limited.

The second reason that the insurance opportunity in Asia may be overplayed is cultural. In Asia, it is just not common practice to buy insurance, certainly liability insurance. In Asia the culture is less about an "eye for an eye" and so litigation is, literally, a foreign concept. That lack of litigation means the need to buy legal liability insurance is not perceived to exist. Asia also has more of a "mercantilist" mentality - a belief that if you buy something you get something in return. For many Asian businesspeople a claim-free year is a waste of money.

³"Global Insurance Industry Outlook – Finding the right fit in a changing world". Deloitte 2006

The key point is this. Foreign insurers who think they can carry their capital across to these new markets and make a killing are kidding themselves. The Chinese and the Indians are some of the world's great traders so it is highly unlikely that Westerners will go there and quickly gain the ascendancy.

Asia **is** an important market. But a realistic attitude is crucial to avoid the kind of poor pricing and bad risk management that can turn a growth strategy into a shrinking strategy.

Regulation and competition

Now we turn to the interaction of regulation and competition and specifically the DOFI issue.

After the HIH Royal Commission's final report, the Government commissioned Mr Gary Potts to review whether it is necessary - and possible - for consumers to get the same level of protection from products supplied by discretionary mutual funds (DMFs) and DOFIs as they do from authorised insurers.

Some submissions stated that there was a glaring inconsistency in the regulatory treatment of DOFIs versus Australian regulated insurers, particularly in the areas of prudential supervision and taxes. As a result, local insurers are placed at a competitive disadvantage via significant compliance costs to which DMFs and DOFIs are not subject.

The review recommended that DOFIs be exempt from prudential regulation in Australia if they are domiciled in a country APRA considers to have a comparable prudential regulation. DOFIs not meeting this test would be able to market insurance in Australia as an authorised insurer, through a branch or subsidiary.

Since HIH, APRA has made considerable efforts to strengthen Australia's prudential framework and provide greater protection to policyholders and other stakeholders. However that protection puts authorised insurers at a competitive disadvantage to DOFIs.

The legislation as introduced requires DOFIs operating in general insurance, whether directly or through an agent or a broker, to become authorised and subject to Australia's prudential regime. The Act also provides for a number of exemptions to enable insurance business that cannot be appropriately placed in Australia to be supplied by a DOFI. These exemptions are broad and comprised of three main limbs:

- high-value insured;
- atypical risk; and
- customised.

To support the regulation of DOFIs APRA introduced Refinements to the General Insurance Framework. Some of the controversial refinements were the increased capital requirements for investments in equities and real estate and the increased capital requirements against reinsurance from foreign reinsurers, particularly for long tail business.

The significant changes introduced by APRA contrast strongly with the wide exemptions proposed by Treasury in relation to DOFIs. Existing APRA licensed insurers will require significant additional capital while a large proportion of existing business written by DOFIs will continue without the need for APRA licensing.

This has exacerbated the competitive disadvantage of authorised insurers compared to DOFIs - particularly in large corporate insurance. Like a number of our competitors Liberty is a small part of a large global insurance group and we participate in global reinsurance structures arranged by our head office. It is not cost effective or practical for us to establish arrangements with APRA authorised reinsurers to cover our Australian operations. These changes therefore discourage locally licensed insurers from accessing global reinsurance markets.

In short, the new regulatory framework may drive corporate business away from locally licensed insurers. The likely outcome is that a significant portion of business protected by the existing regulatory regime would be shifted and written offshore under the DOFI exemptions. In this way, Liberty would be able to compete for this business. This is not an optimal outcome, but it would be preferable to losing large corporate accounts to non-APRA authorised DOFIs.

All local industry players will be watching DOFI-related developments in the insurance market and especially at how exemptions are being used. This may give the Treasury the opportunity to revisit the broad exemptions they have put in place. However it is more likely that in the next couple of years a market solution will be found that reduces the business placed in Australia.

Distribution – that’s the name of the game

Now I would like to turn to a fourth and very crucial business driver – distribution. Thanks to the internet, we are about to see a revolution in how insurance is sold.

The key to this is demographic change. The tech-savvy generations X & Y are the next generation of insurance buyers and according to an IBM survey more than half of them use the internet to compare insurance products.

Ten years ago to be told you could use a PC to compare the benefits of a range of policies from a range of providers would have been buyer heaven.

But what looked like ease and convenience a decade ago is a chore now. If you were in the UK today you could go to the TESCO Compare site (Tesco is a large chain of grocery stores). You could log in and review quotations from 33 insurers. Tesco now has 2.7 million insurance customers, yet the Tesco Compare site was only launched in September 2007.

There is no reason the same facility will not be available here, and soon. This aggregator – this insurance supermarket - is not likely to be an insurer. It is likely to be – surprise, surprise - a supermarket.

So what are the issues that an aggregator throws up? In the UK the major insurers who had a brand and market share to protect did not want to sacrifice that by joining Tesco’s insurance platform and competing with dozens of others.

Eventually they *did* join because the supermarket was where the growth was. For the customer, the value proposition is just too attractive – they get wider choice, price competition and online convenience – all packaged by a distributor they trust.

When these insurance aggregators arrive here major players will also resist this innovation. Yet in the end they will capitulate and concentrate on getting the best position in the online aisles.

The aggregators change the way you position your brand. Now you are competing for shelf space just as rival grocery products do in a supermarket. So you really have to understand what that means for your marketing and positioning.

Insurers also have to give up a lot of their power over the distribution model. Sure large supermarkets have an incentive to nurture your business – after all, the more you sell, the more they make. But the provider's control is dramatically weakened.

At the moment this supermarket model applies very much to personal lines and maybe SME cover. A recent survey suggested that brokers now control around 80% of the commercial market but less than a fifth of personal lines. However the power of internet distribution means that intermediaries in commercial business should not be complacent. They need to think about how internet distribution could work in their space – because someone, somewhere is doing it and if you are not ahead of the curve you will end up behind it.

Innovation and insurance

That final cautionary note poses a challenge to the insurance industry in general. By their nature, insurers are conservative. Clients *want* them to be conservative – because the costs of failure are so high. Yet insurance is also an industry facing challenges that require an innovative response. How do insurers innovate in capital management, in distribution and in marketing? How do they do that, yet stick to proven and conservative principles when it comes to risk?

That could be the question that defines our industry over the next five years...