TAYLOR FRY

RADAR 2020

Our class-by-class insights for insurers

FY2020

Welcome

Welcome to Taylor Fry's RADAR, our take on the most important trends and happenings affecting insurers today, amid the dramatic economic and social change of the past months.

On the following pages, we draw on the latest APRA data, combined with our knowledge and decades of experience inside the industry.

Across three years of results, our analyses break down each line of business to help insurers benchmark their performance, and assess strategies and goals.

We also summarise investments and solvency over the same period to give you an overview of how the market is tracking more broadly.

By highlighting the challenges and opportunities in these particularly testing times, we offer you a clear picture of the industry, where it's headed and your place within it.

Kevin Gomes
Principal
kevin.gomes@taylorfry.com.au

CONTENTS

DOMESTIC MOTOR

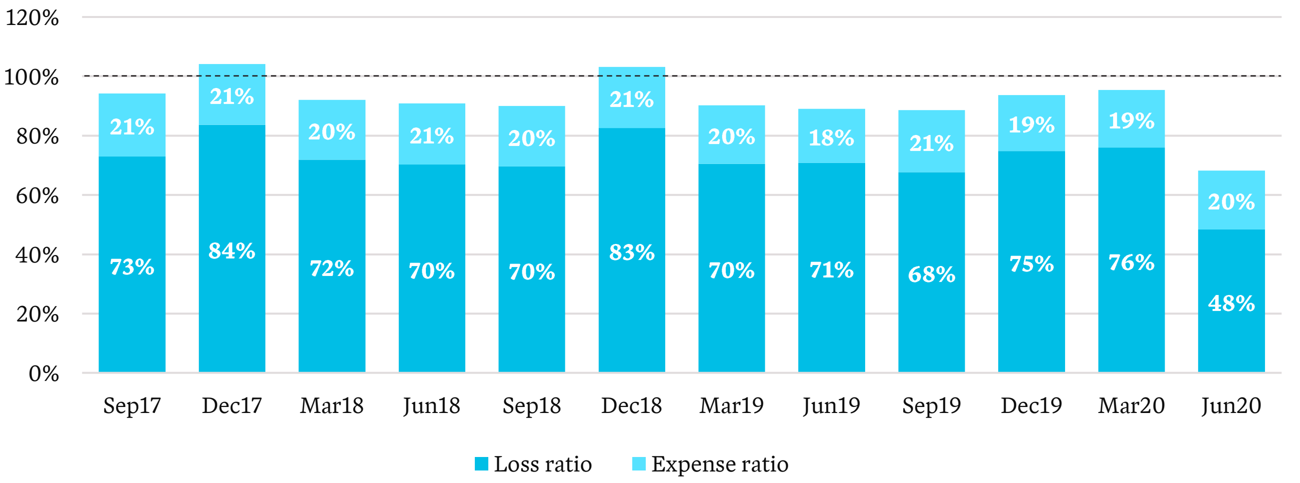
The June 2020 quarter loss ratio of 48% is the lowest on record, driven by a reduction in collision claims. COVID-19-related restrictions have led to a substantial reduction in cars on the road, which has reduced claim frequency and generated a short-term windfall for domestic motor insurers. The longer-term outlook for domestic motor insurance profitability is not so rosy. The main challenges for insurers are expected to be:

- **An increase in claim frequency arising from increased domestic motor vehicle use** – 2020 navigation data released by Apple indicates April motor vehicle usage has halved since January due to social restrictions. In July, vehicle usage increased above pre-pandemic levels for all states except Victoria and Tasmania. With a decline in public transport use and more people driving, claim frequency may exceed pre-pandemic levels.

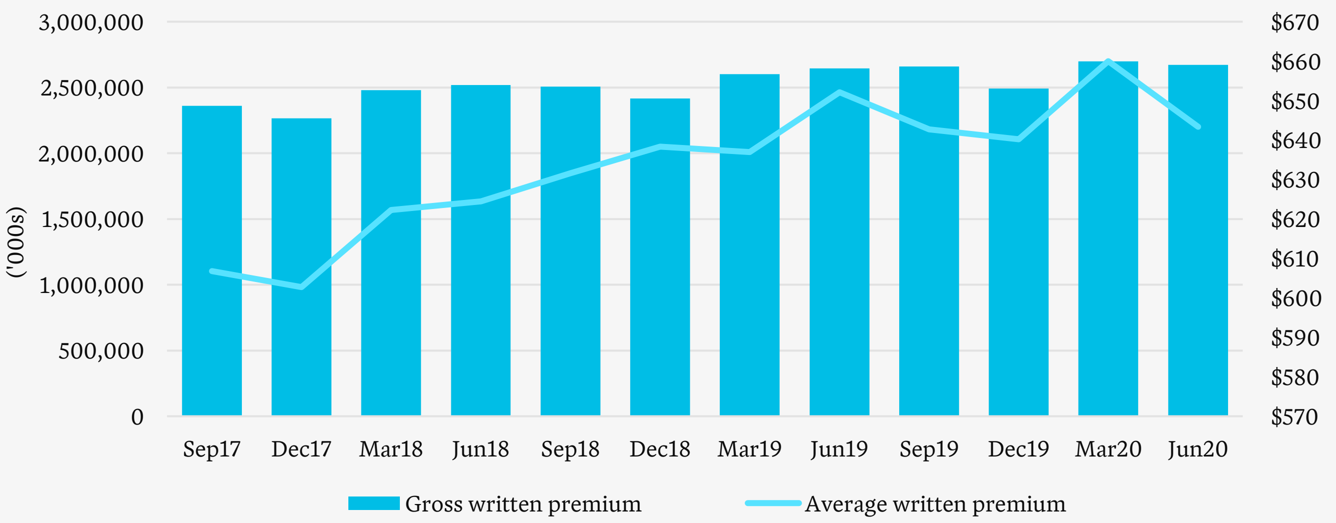
- **A reduction in top-line revenue** – New vehicle sales have declined since 2017, a trend accelerated by the COVID-19-induced recession. Sales this year to August were down 20% against the first eight months of 2019. With a decline in new vehicle sales, top-line revenue growth will come under increasing pressure.

- **Repair cost pressures** – The increasing prevalence of technology in motor vehicles is raising the cost of repairs for insurers. For example, what would have been a simple windscreen repair claim in the past is now complex and expensive – possibly involving sensors, cameras and a head-up display.

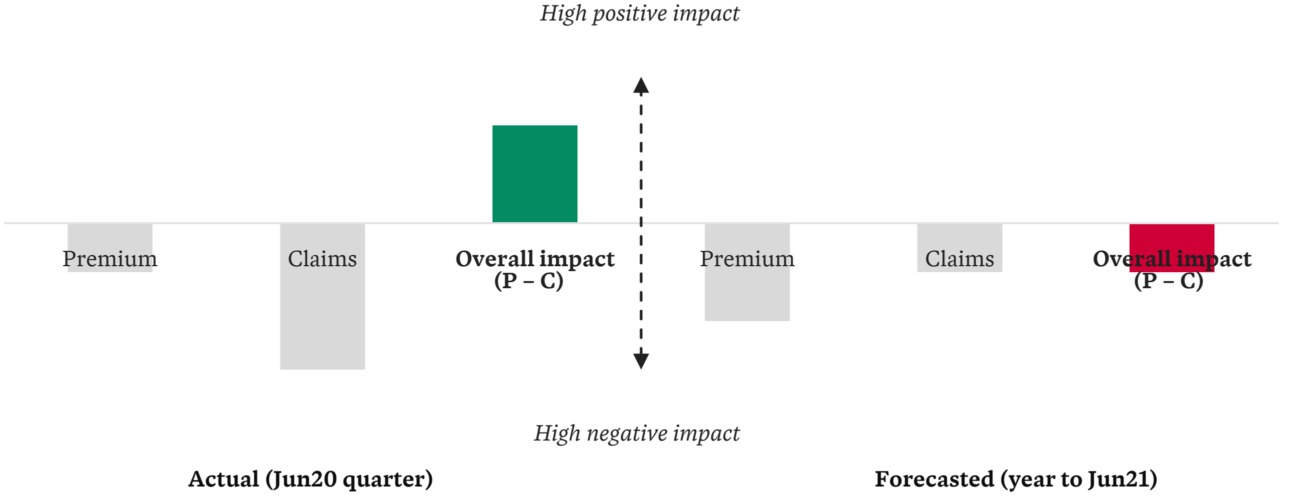
Combined ratio
Reporting quarter



Total premium volume ($)
Reporting quarter



COVID-19 Impact
Actual vs. forecasted



HOUSEHOLDER

Natural perils remain key for this class, highlighting the urgency of longer-term risks, such as climate change, despite the more immediate focus on COVID-19.

This year's US hurricane season (June to November) is predicted to result in a higher-than-usual number of events. These factors, combined with the year's catastrophe experience, are anticipated to put upward pressure on reinsurance renewals.

↘

Several severe weather events resulted in underwriting losses in the December 2019 and March 2020 quarters. In July, a NSW inquiry into how the state plans, prepares for and responds to bushfires made 76 recommendations around hazard reduction, fauna and mental health, which the government said it will adopt. The Royal Commission into National Natural Disaster Arrangements, due to report back in October 2020, outlines a similar agenda on a national scale.

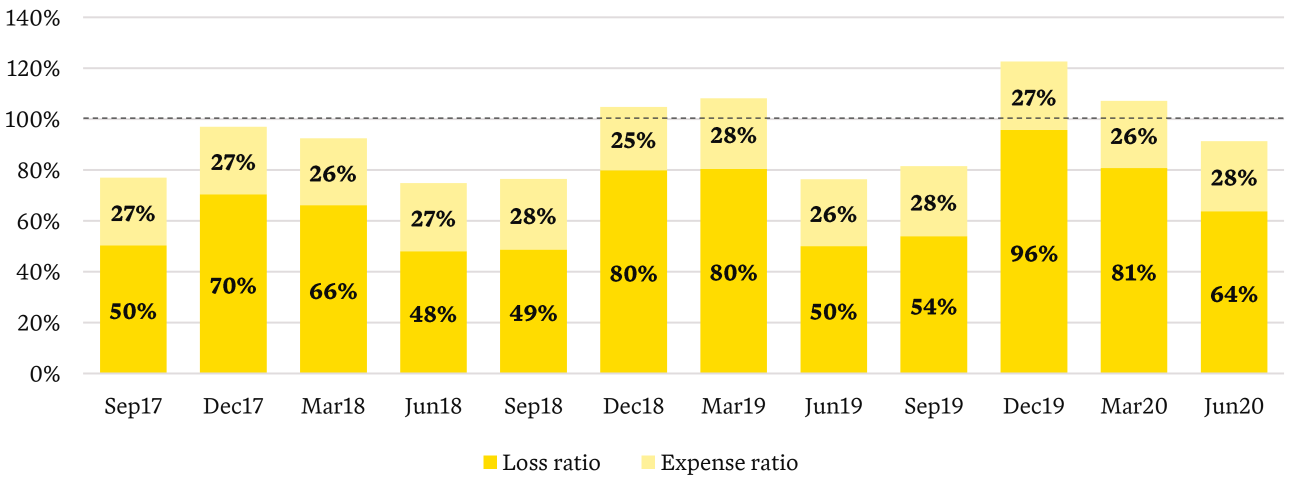
↘

COVID-19 is likely to exacerbate insurance affordability. As the economy moves into recession, insurers will see an increase in customers seeking hardship assistance. The expectation is that total premium volumes will drop, and under-insurance will increase, due to the pandemic and associated economic recession.

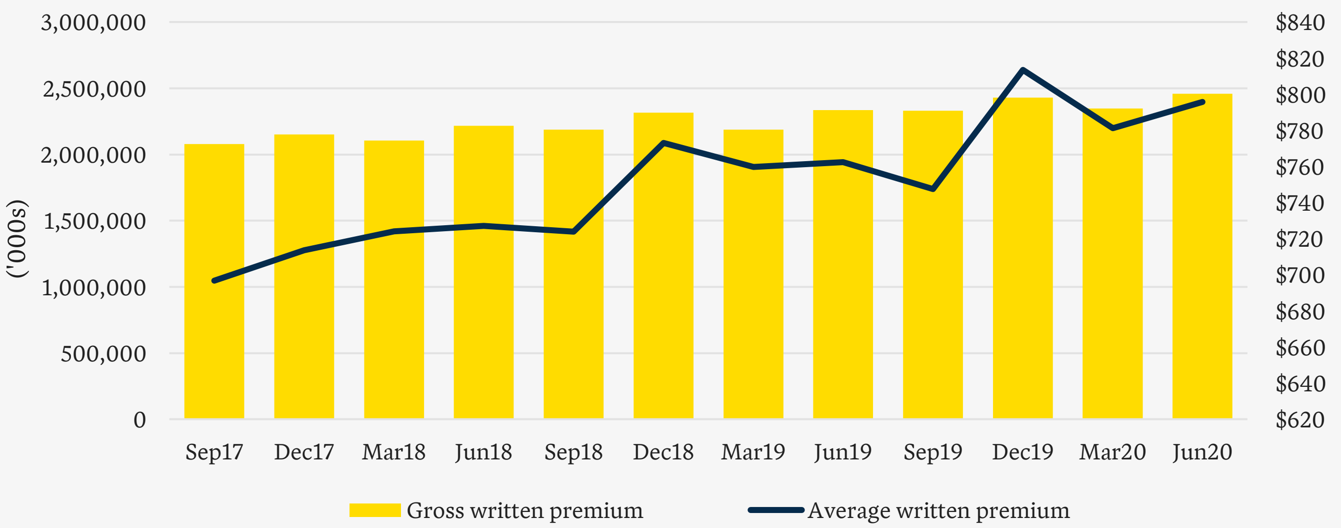
↘

There have been moderate rate increases in premiums over the past year. Initial signs are that reinsurance capacity has reduced, as COVID-19 hits reinsurers with increased losses and reduced asset values. This could put additional pressure on rates in the future.

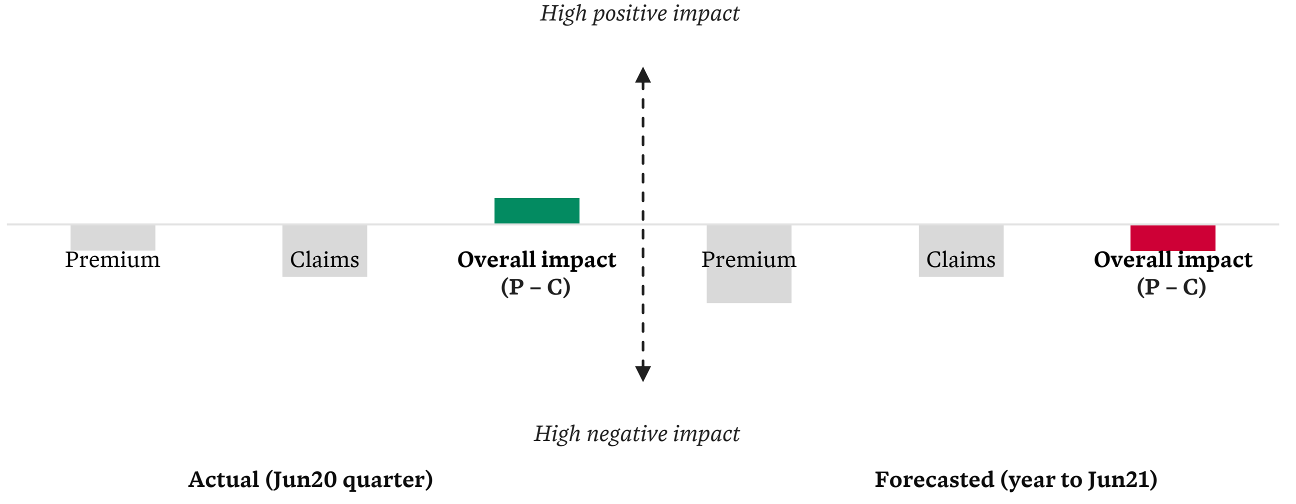
Combined ratio
Reporting quarter



Total premium volume ($)
Reporting quarter



COVID-19 Impact
Actual vs. forecasted



COMPULSORY THIRD PARTY

Combined ratios for all jurisdictions have increased over the past three years and are now above 100%. While reserve releases have reduced reported loss ratios, their effect has lessened over time. In earned premium, only Queensland experienced an increase over the past year – albeit marginally – with all other states experiencing reductions.

Although COVID-19 reduced traffic volumes and claim numbers, the full impact on costs will take longer to realise. This is due to the nuances in CTP claims, such as the time for claimants' injuries to stabilise, and the size and complexity of claims.

↘

Average premium rates in NSW have continued to reduce since the introduction of the new scheme in 2017, reflecting heightened industry competition and the ongoing impacts of scheme reform. We expect reported loss ratios will increase as the previous scheme runs off. The ultimate cost of the new scheme will be largely dependent on claims for damages, which have only recently started being lodged.

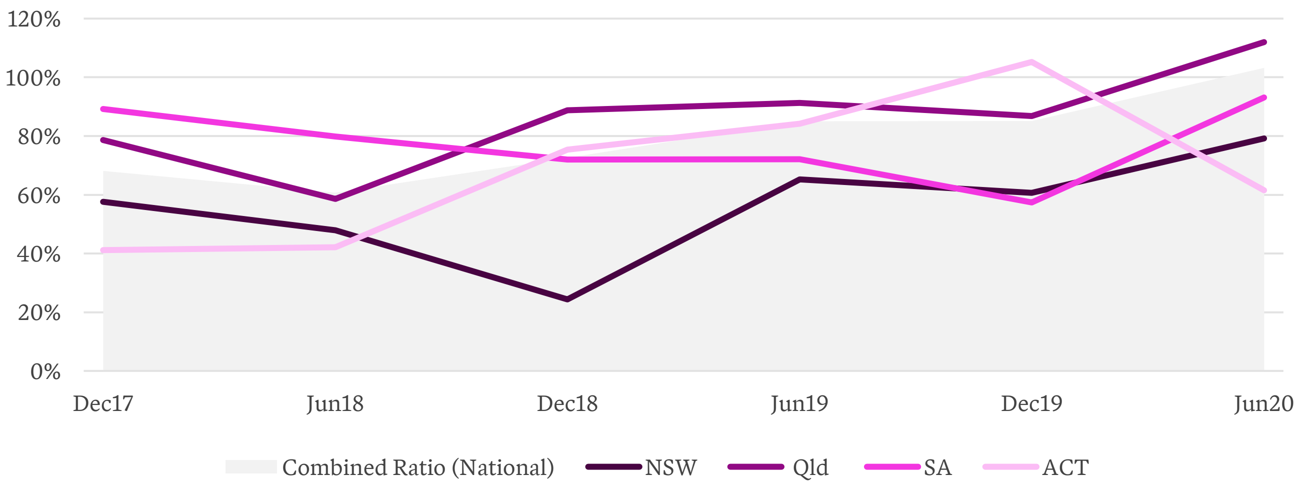
↘

Insurer profits in Qld CTP continue to fall, which we speculate is partly due to differences of opinion between the regulator and insurers on future superimposed inflation. One current issue in the scheme is the increasing prevalence of claims with a secondary psychological injury, and the extent to which this may lead to cost pressures.

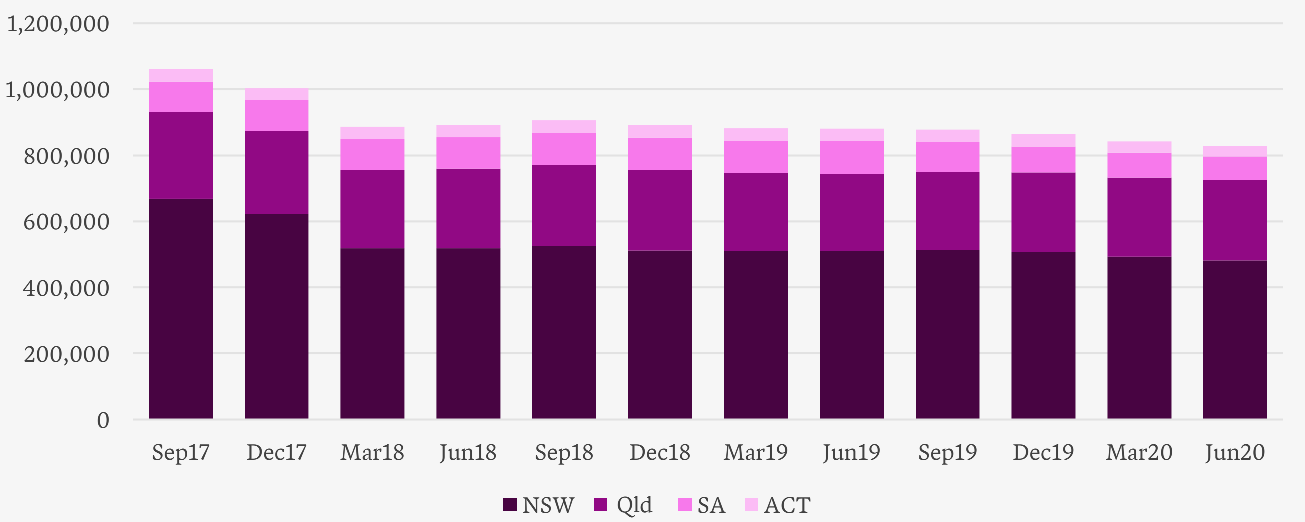
↘

Competition will keep downward pressure on insurer profitability in SA. Insurers here have underwritten annual Class 1 private passenger vehicle policies at $295.40 since competition began on 1 July 2019. This is a significant decrease from $360.50 prior to competition, without fundamental changes in underlying risk.

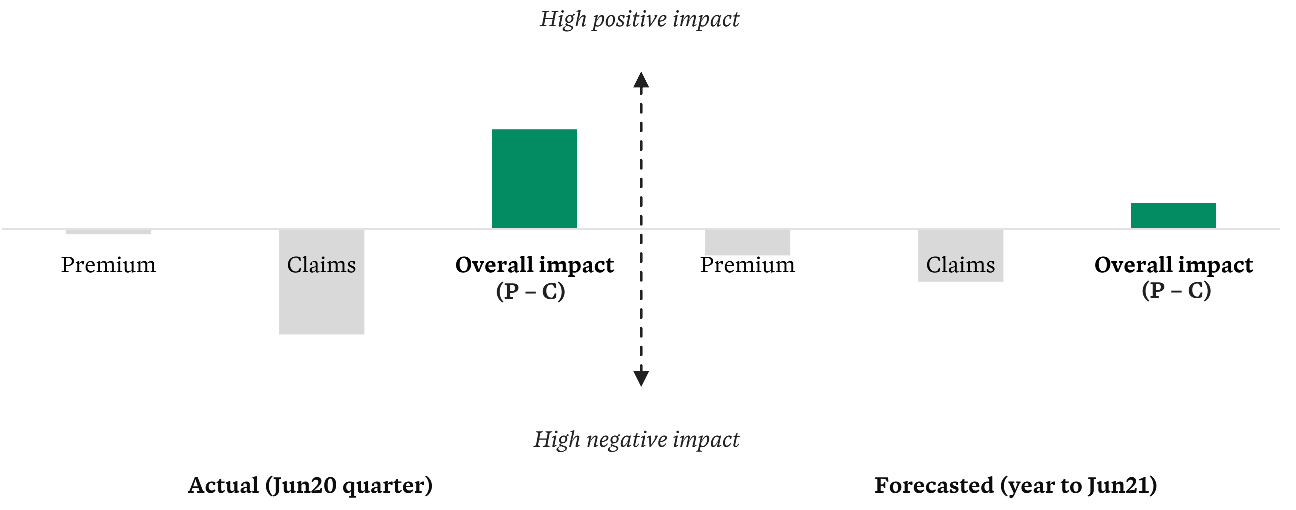
Gross loss ratios
Reporting half year



Gross earned premium
Reporting quarter



COVID-19 Impact
Actual vs. forecasted



WORKERS COMPENSATION

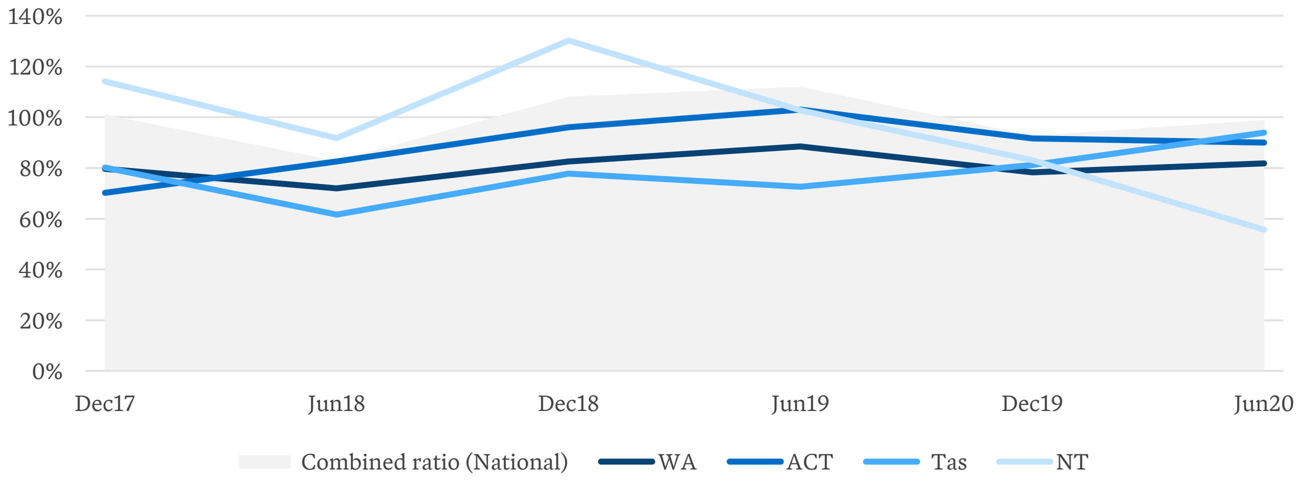
COVID-19 and the associated economic impacts are expected to adversely impact workers compensation schemes across Australia. While the June 2020 APRA data gives us insight into what these impacts are – lower premium volumes and an increase in claims costs – we are yet to see the full impact of COVID-19 in the data. Assuming COVID-19 cases remain at or below current levels, the real challenges for workers compensation schemes resulting from the pandemic will be managing the following:

Indirect claim impacts – Changes to work demands, shifts in working arrangements, and COVID-19-related restrictions are expected to lead to an increase in primary and secondary psychological claims. In addition, return-to-work rates may deteriorate due to difficulties with injured workers finding suitable duties in industries impacted by COVID-19.

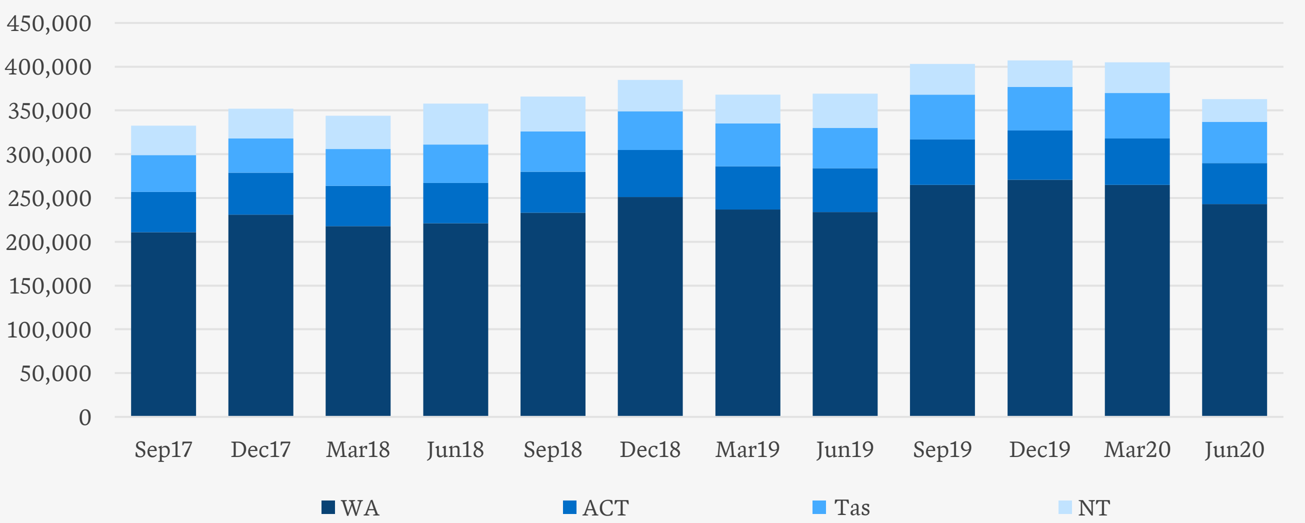
Economic impacts – Lower and more volatile investment returns will place pressure on future premium rates and funding positions. Furthermore, Australia's first recession in almost 30 years means there will be fewer employers paying premiums in future and there will likely be resistance to future premium increases from industry and government.

Operational impacts – The advent of telehealth is the 'silver lining' of COVID-19. It has collapsed geographical boundaries and allowed injured workers to be treated earlier. However, delays elsewhere in the management of claims – for example, in elective surgery – may mute these benefits in the short term.

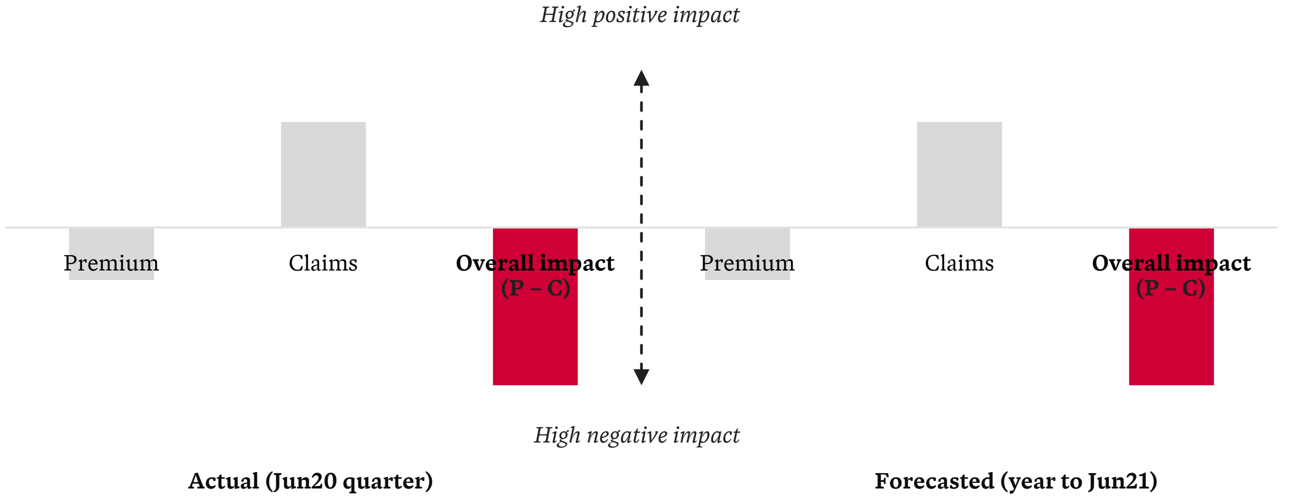
Gross loss ratios
Reporting half year



Gross earned premium
Reporting quarter



COVID-19 Impact
Actual vs. forecasted



COMMERCIAL MOTOR

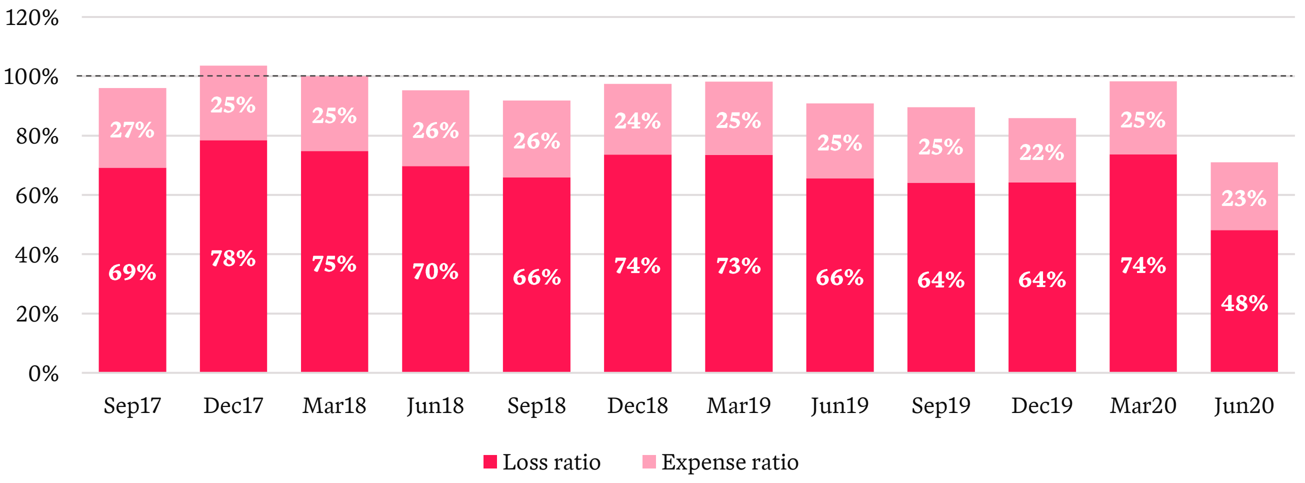
The June 2020 quarter loss ratio of 48% is the lowest on record, driven by a reduction in collision claim frequency – but this favorable experience is expected to be short-lived. Longer term, we expect:

- **A reduction in top-line revenue** – The COVID-19-induced recession will continue to place pressure on a range of industries. To the extent these industries scale back operations or become unviable, there will be a flow-on impact to commercial motor premium volumes.

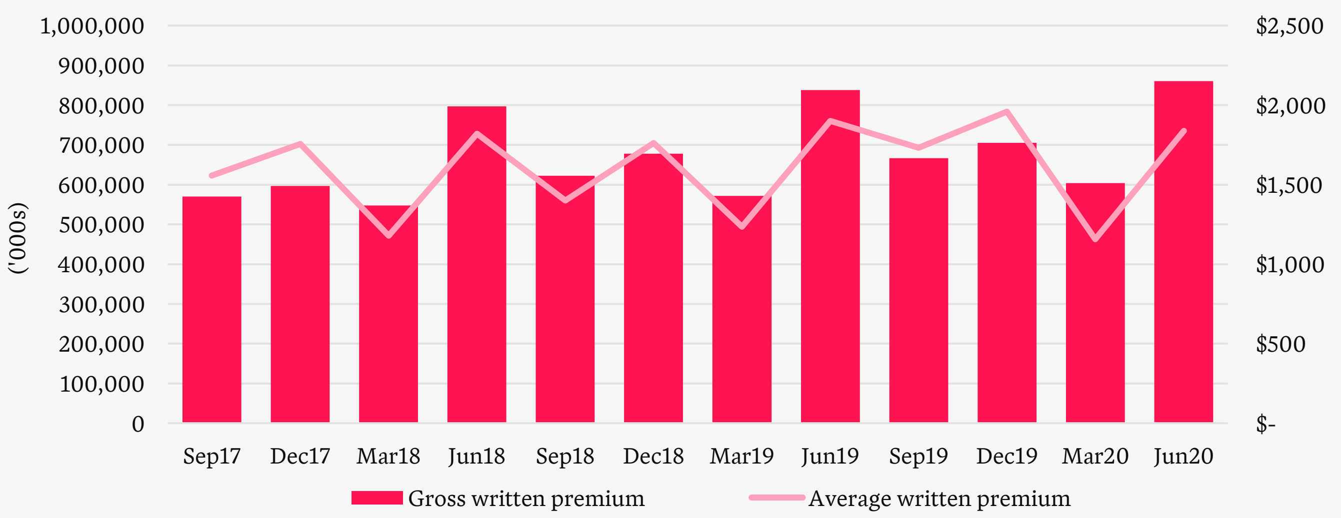
- **Further repair cost pressures** – Similar to domestic motor insurance, the technology in vehicles is placing pressure on average claim sizes.

- **Autonomous vehicles to challenge the determination of liability** – Trials of autonomous vehicles are already underway across Australia. The Transport and Infrastructure Council, a member of the Council of Australian Governments, has agreed to a program of national work in preparation for the deployment of automated vehicles. (The issue also exists for domestic motor.)

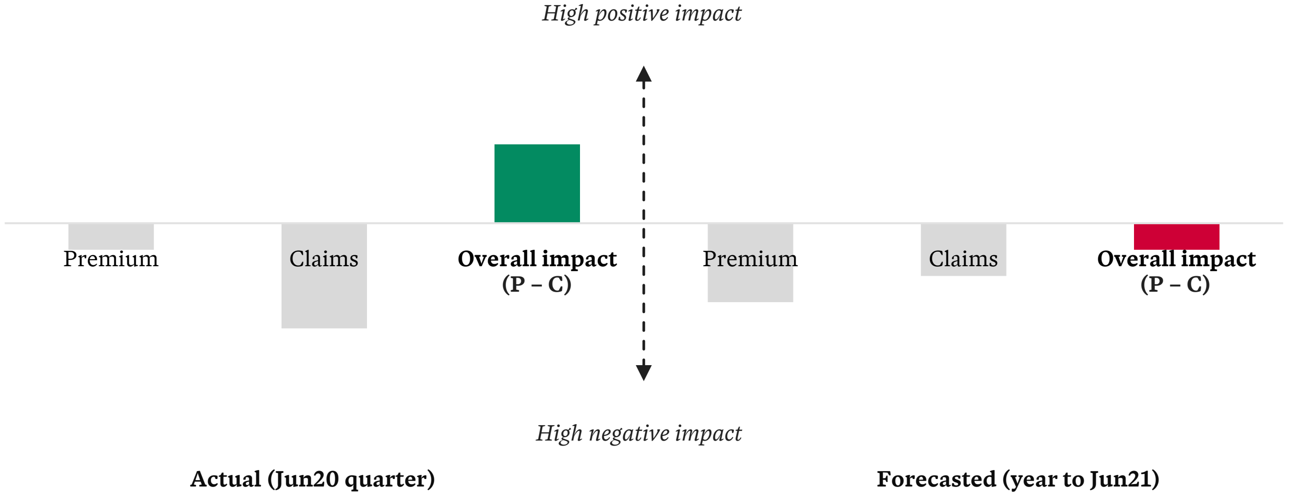
Combined ratio
Reporting quarter



Total premium volume ($)
Reporting quarter



COVID-19 Impact
Actual vs. forecasted



COMMERCIAL PROPERTY

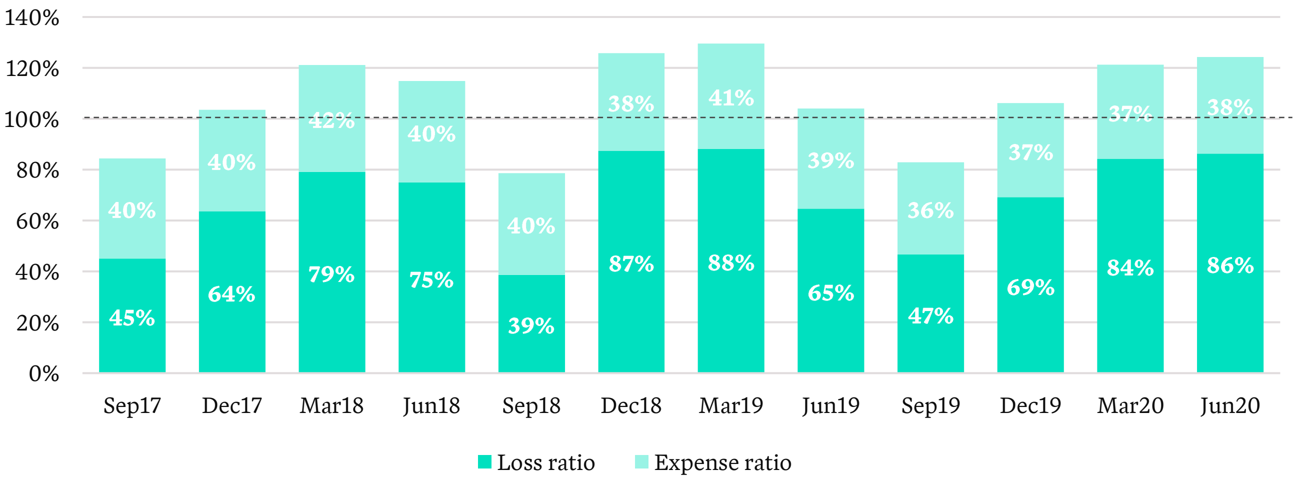
Profit trends remain poor despite the cyclical hardening of rates, with significant catastrophe claims emphasising the ongoing and far-reaching implications of a warming climate. COVID-19 claim concerns centre on pandemic exclusions in business interruption, as Australian insurers digest the implications of the findings from the recent UK court decision on their portfolios.

Cyclical hardening of rates – The insurance cycle turned in 2017, with rates continuing to harden over the past three years. In 2020, profitability remains poor, with combined ratios well above 100% over the first half of the year and consistently above 100% for the past five years.

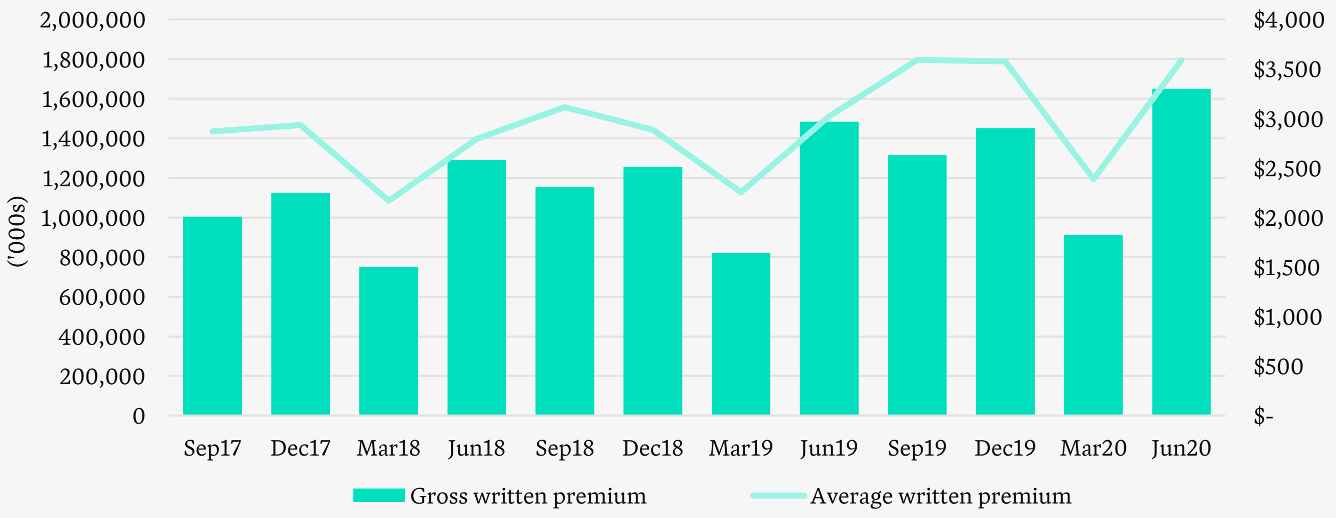
High cost of catastrophes in 4Q19 and 1Q20 – Commercial property losses for the December 2019 quarter and March 2020 quarter were greatly affected by catastrophic events, including summer bushfires ($600m+, Vic, NSW, SA and Qld), January hailstorms ($100m+, ACT, Vic and NSW) and February storms ($100m+, Qld and NSW).

Business interruption claims – Business interruption cover is often written as an add-on. The Insurance Council of Australia and the Australian Financial Complaints Authority have filed a test case, being heard in the NSW Court of Appeal. It aims to determine whether insurers can rely on pandemic exclusions that refer to the *Quarantine Act 1908*, given the legislation was repealed and replaced by the *Biosecurity Act 2015*.

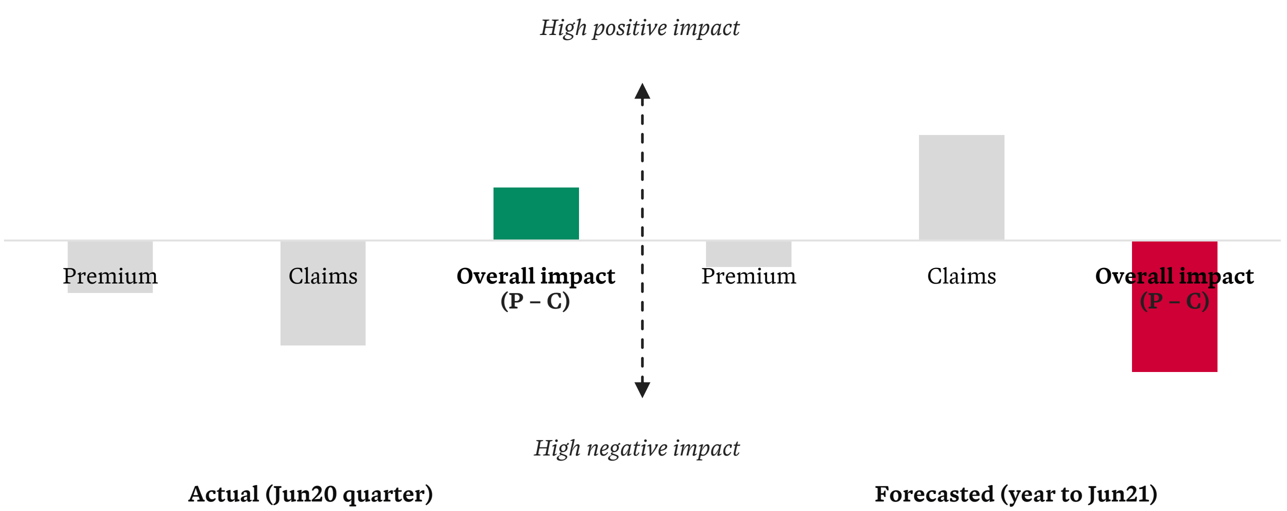
Combined ratio
Reporting quarter



Total premium volume ($)
Reporting quarter



COVID-19 Impact
Actual vs. forecasted



TRAVEL

COVID-19 has greatly affected travel insurance. Many insurers have stopped issuing policies for near-term international travel in response to government restrictions.

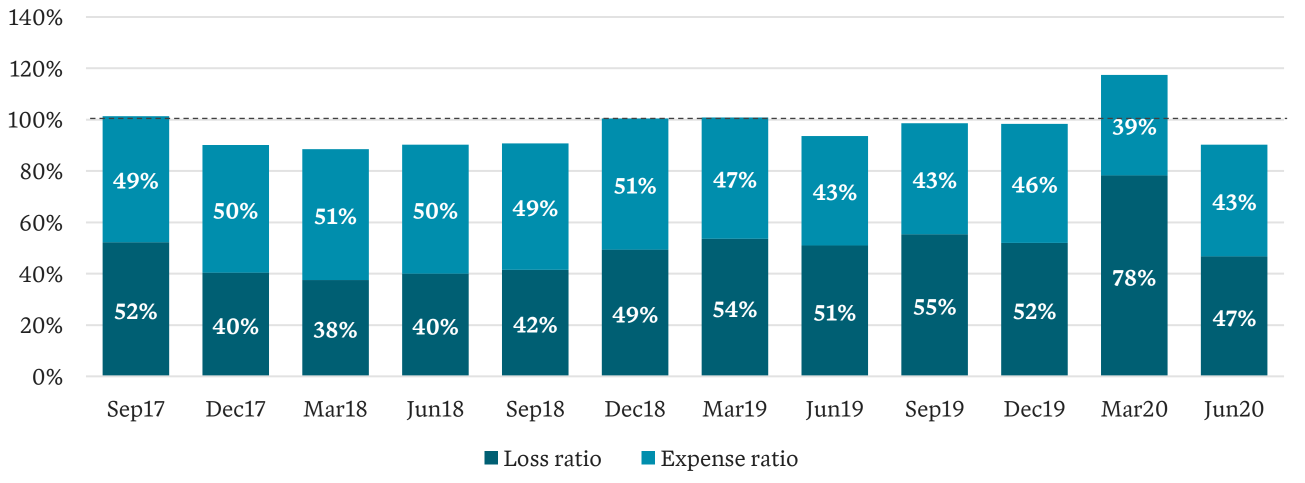
Key for travel insurers is when international border restrictions will lift and what 'normal travel' will look like. Importantly, this will have major implications for staff engagement and morale. Restoring consumer trust is also a priority, as insurers decide how to respond to new requirements arising from the Royal Commission concerning design and distribution obligations, unfair contract terms and duty of disclosure.

Loss ratios were generally stable over the past 12 reporting quarters. The notable spike in March 2020 was mostly due to cancellation claims arising from COVID-19. The declaration of a pandemic by the World Health Organisation in late March 2020 likely activated pandemic exclusion clauses, explaining the drop in loss ratio seen in the June 2020 quarter.

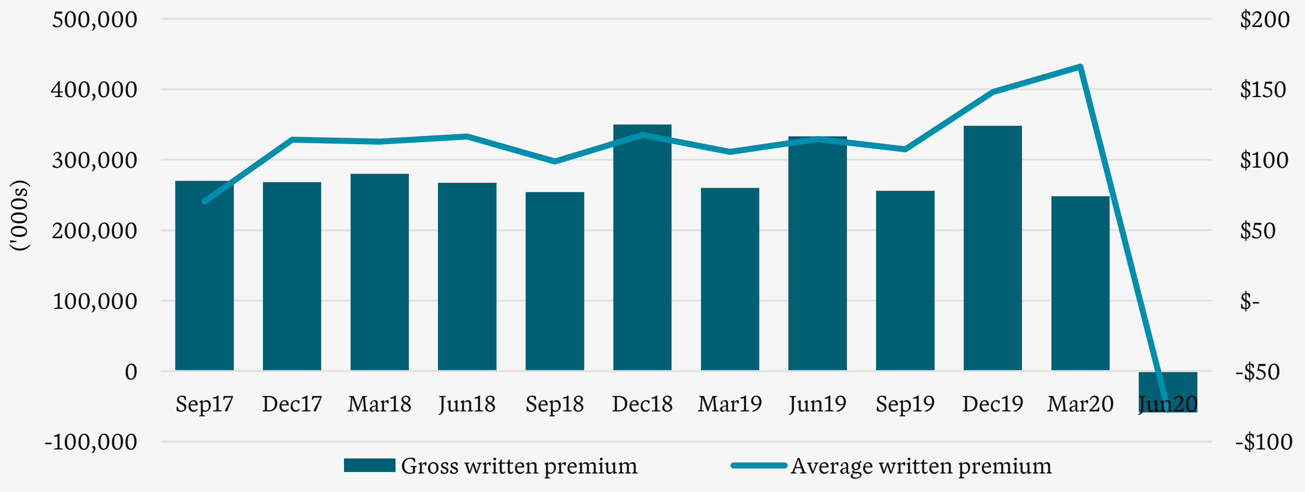
Some travel insurers issued premium refunds in the June 2020 quarter, most likely relating to travellers with previous bookings now unable to leave due to government restrictions.

Unsurprisingly, COVID-19 has caused a sharp increase in travel insurance-related complaints to the Australian Financial Complaints Authority. Balancing financial concerns and customer loyalty is delicate territory for insurers – how they handle claims and refunds will impact community perception of their brand.

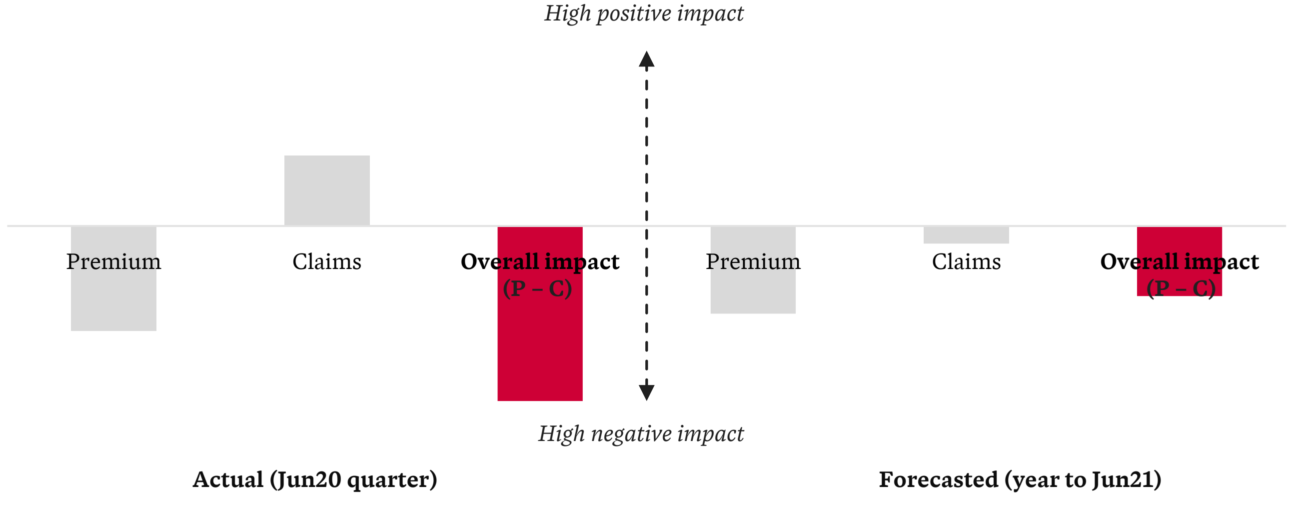
Combined ratio
Reporting quarter



Total premium volume ($)
Reporting quarter



COVID-19 Impact
Actual vs. forecasted



PUBLIC & PRODUCTS LIABILITY

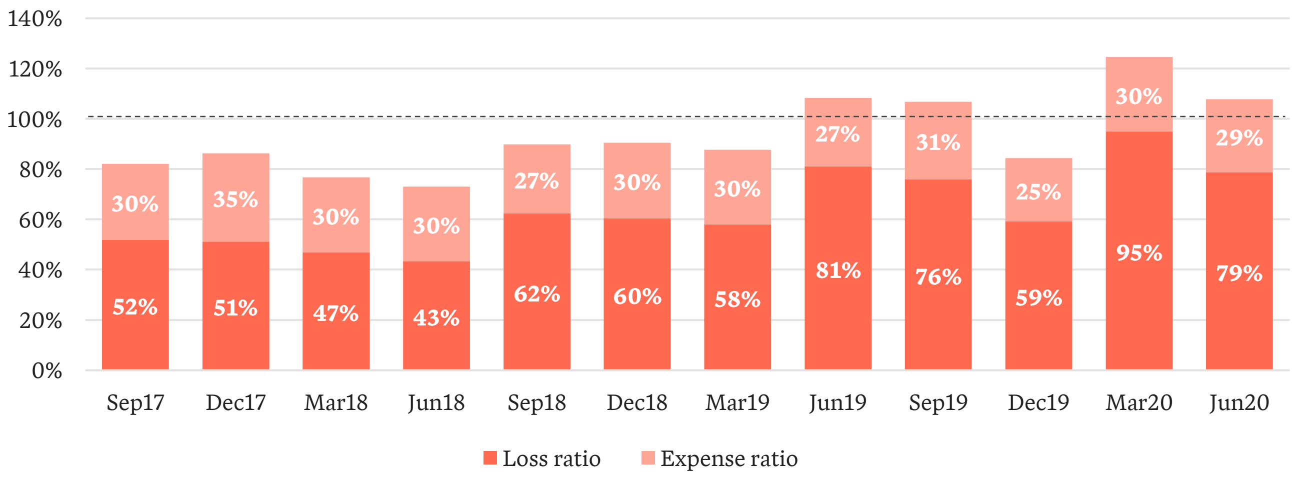
Profit trends remain poor despite the cyclical hardening of rates, impacted by reserve strengthening and risks within the construction sector.

Poor profit trends, driven by reserve strengthening – Despite rate increases, overall profitability has been poor, with combined ratios well above 100% in 4 of the last 5 quarters. The increases in combined ratio can be partly attributed to significant reserve strengthening in FY19 and again in FY20.

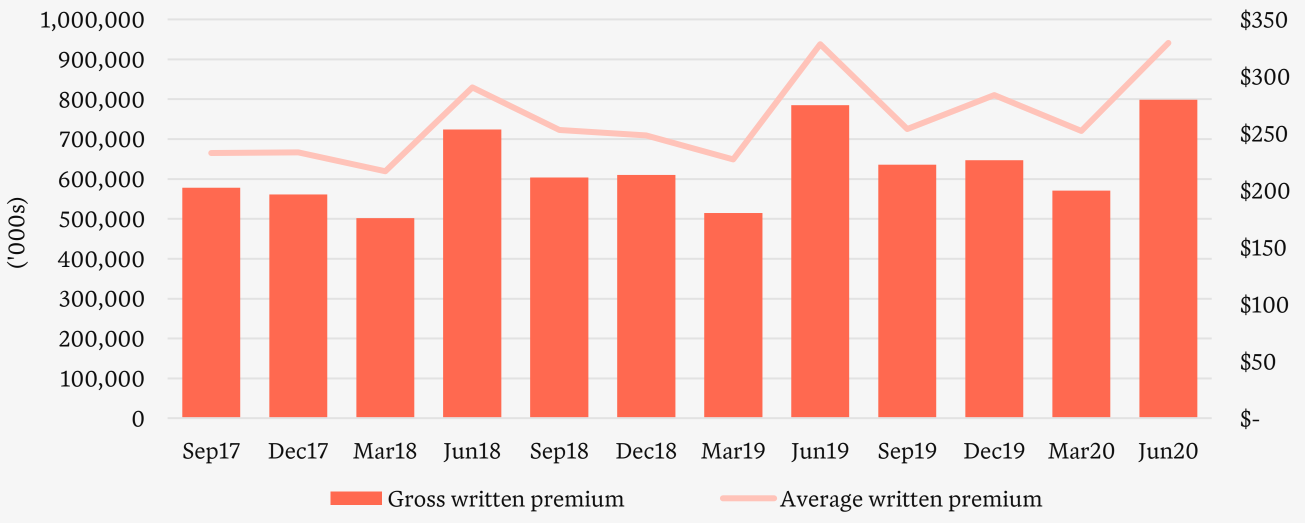
Construction-sector risks – Claims within the construction sector have shown adverse trends. Increasingly, claims have emerged relating to the use of combustible cladding and the design and construction of defective apartments.

COVID-19 impact mixed – A reduction in foot traffic through retail and public spaces during the pandemic will lessen exposure to public liability risk. On the other hand, there will be additional risks arising from controls and procedures put in place to manage infection.

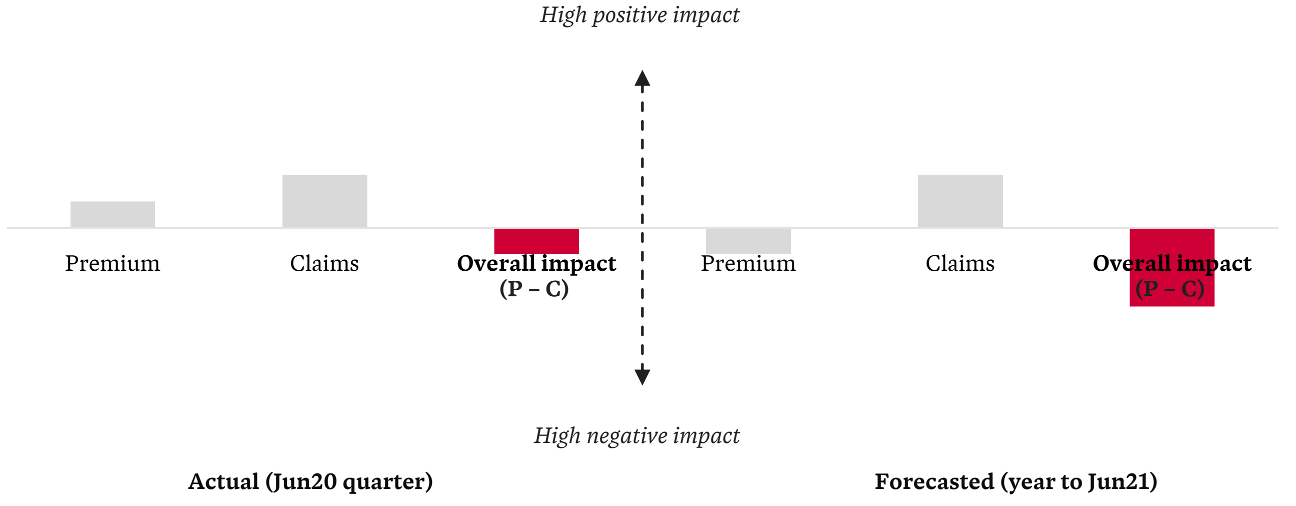
Combined ratio
Reporting quarter



Total premium volume ($)
Reporting quarter



COVID-19 Impact
Actual vs. forecasted



PROFESSIONAL INDEMNITY

Despite rate increases, loss ratios have increased over the past year. These have been impacted by reserve strengthening and class actions affecting directors and officers (D&O) liability cover. Significant risks remain for certain sectors.

↘

Class action risks – Class actions have adversely impacted D&O claims over several years, with potential for the economic downturn under COVID-19 to instigate further claims activity. The growth of class actions may be stemmed by recently announced regulatory changes, which will require litigation funders to hold an Australian financial services licence.

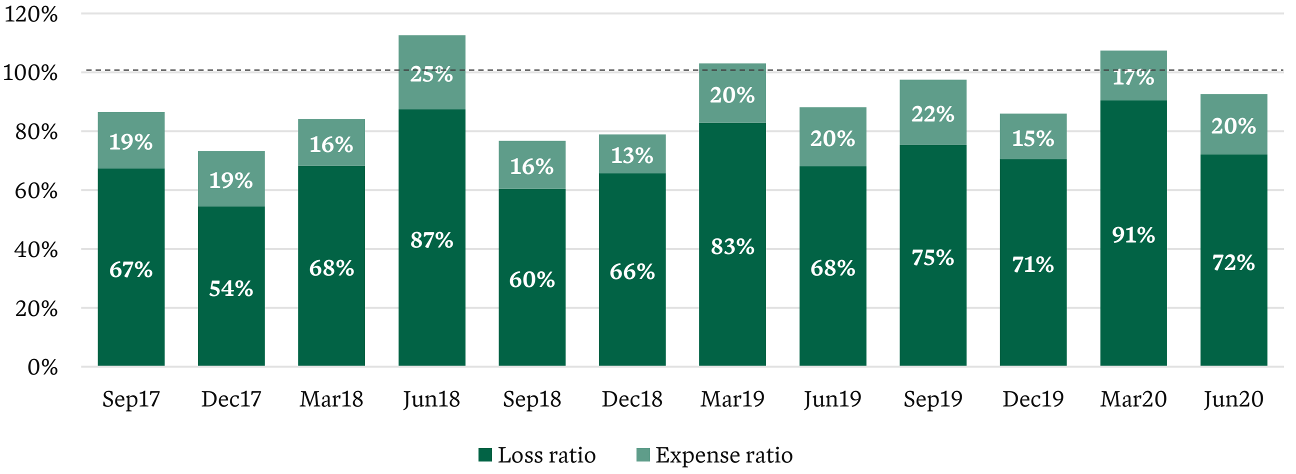
↘

Market conditions deteriorate significantly for some sectors – Price increases and capacity decreases have particularly affected financial advisers, property valuers and building surveyors.

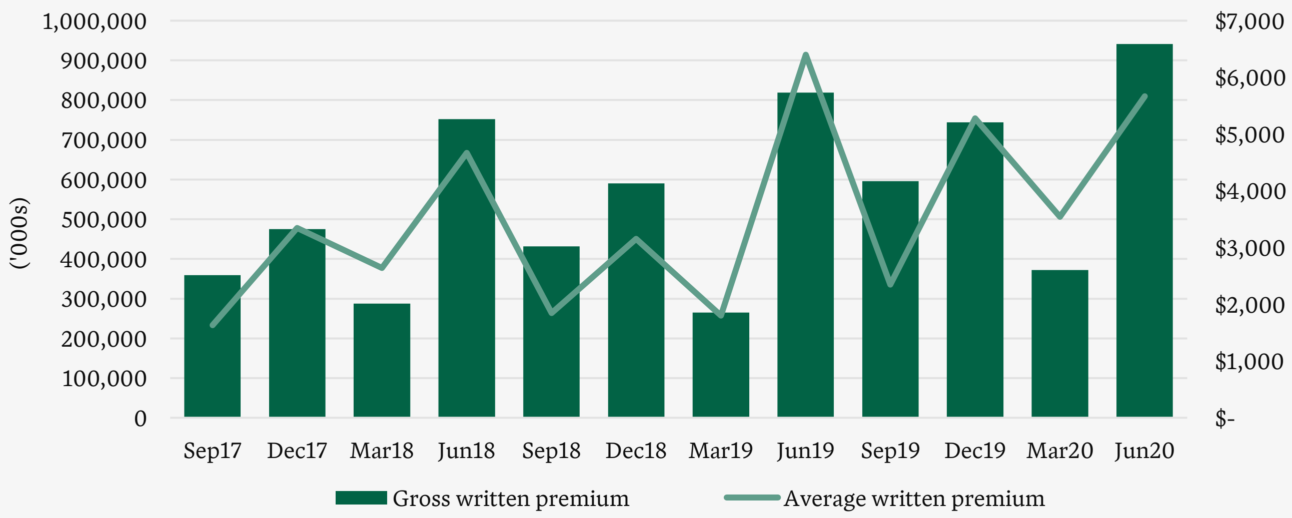
↘

Cyber risk – Elevated cyber risks highlight the need for insurers to fully understand cybersecurity and how to properly price for it, with particular emphasis on 'silent cyber' claims, where an insurer may have to pay claims for losses under a traditional insurance policy not designed for the purpose.

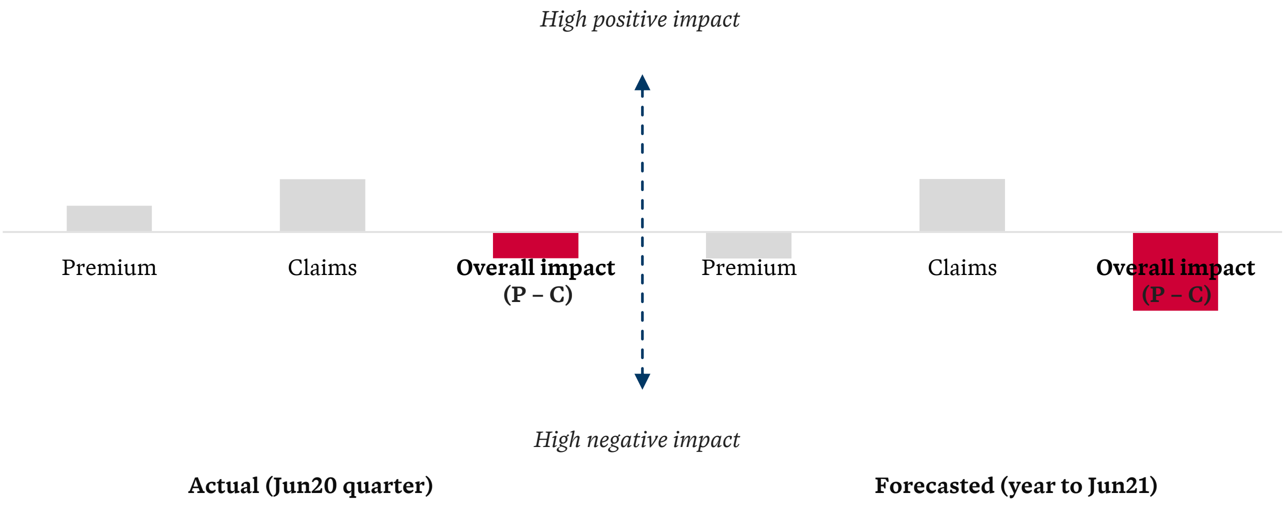
Combined ratio
Reporting quarter



Total premium volume
Reporting quarter



COVID-19 Impact
Actual vs. forecasted

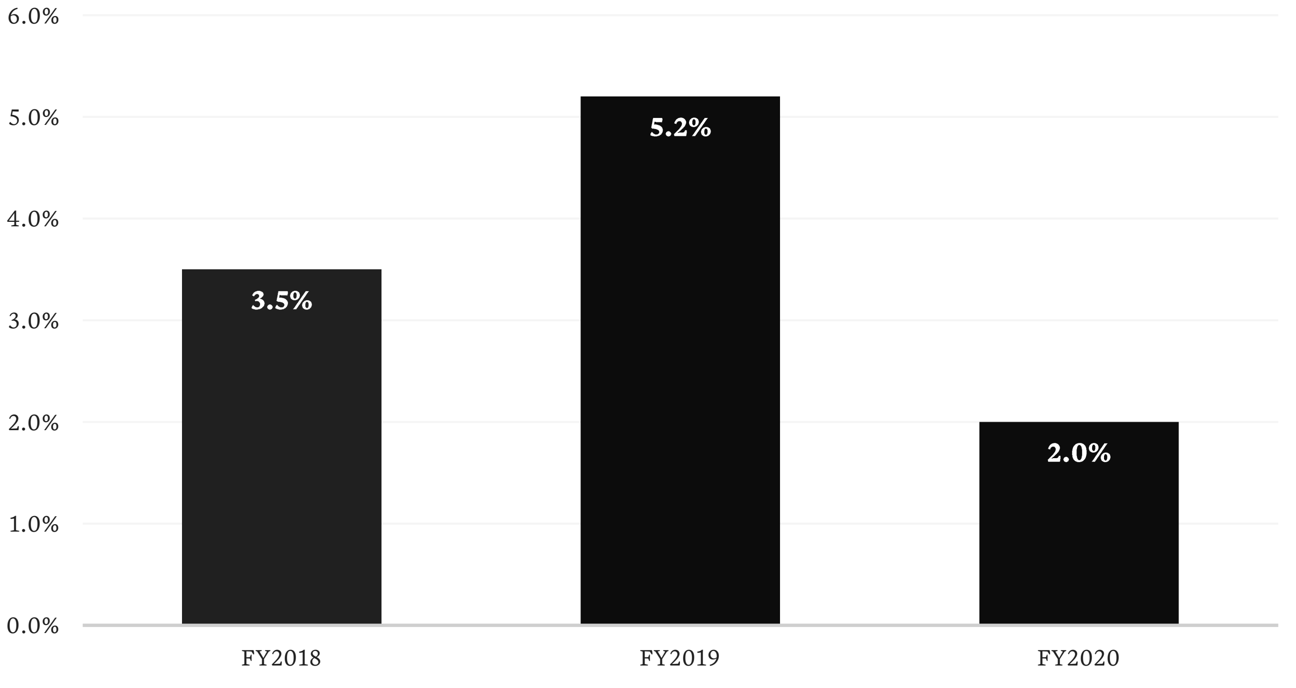


INVESTMENTS

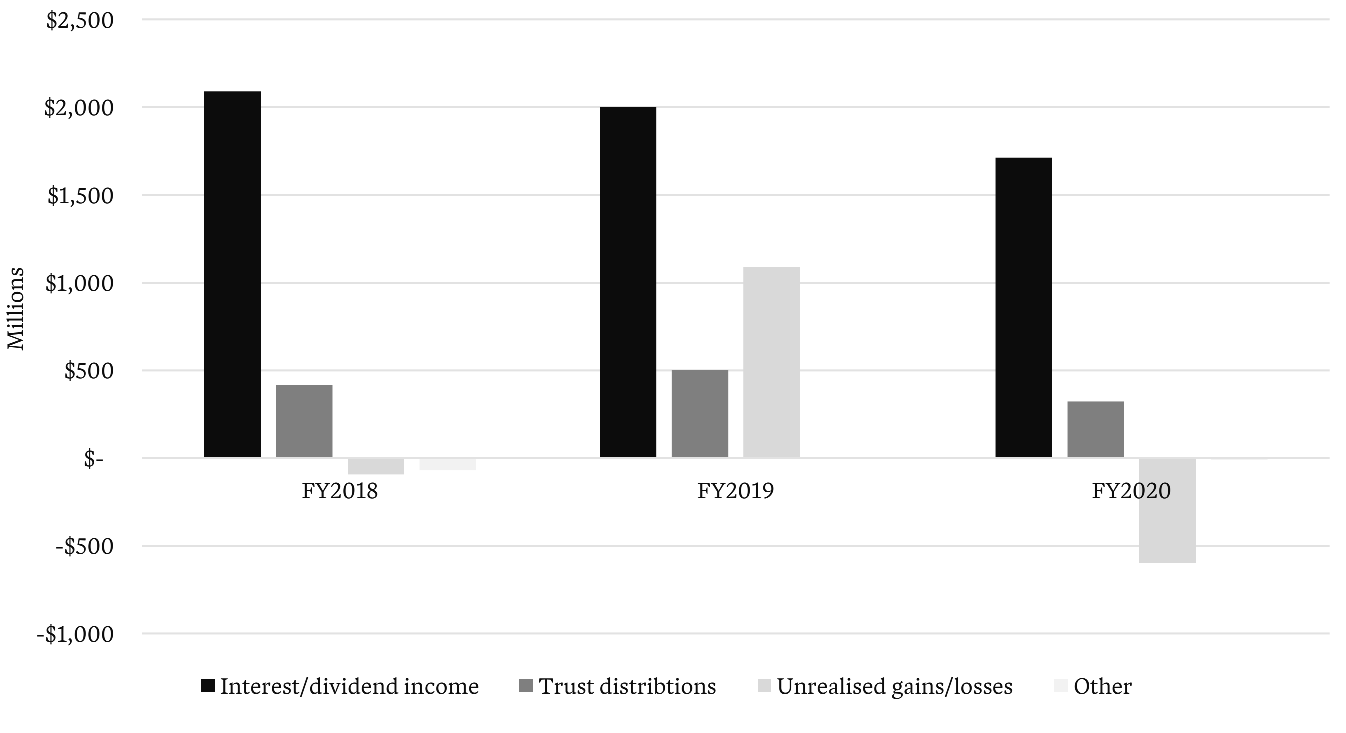
Insurers sustained an average annual investment return of 2.0% during FY2020. This is lower than the returns achieved in the previous two years.

The underperformance relative to previous years was driven by unrealised losses on investment assets incurred over the year, due to the market downturn caused by COVID-19. Insurers may struggle to realise sufficient investment income at an acceptable level of risk due to the combination of a downturn in the equity markets, and increases in the price of high-security fixed-income assets.

Investment returns
Reporting year



Investment income breakdown
Reporting year

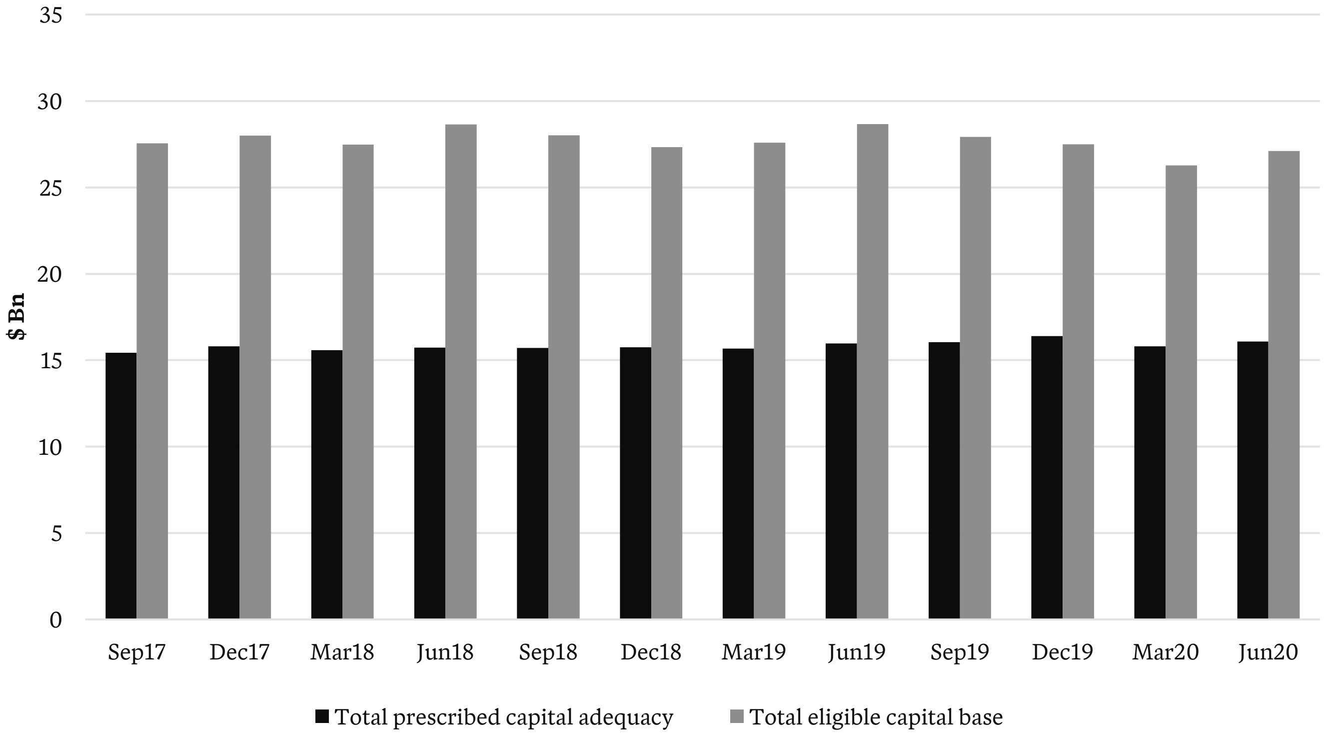


SOLVENCY TRENDS

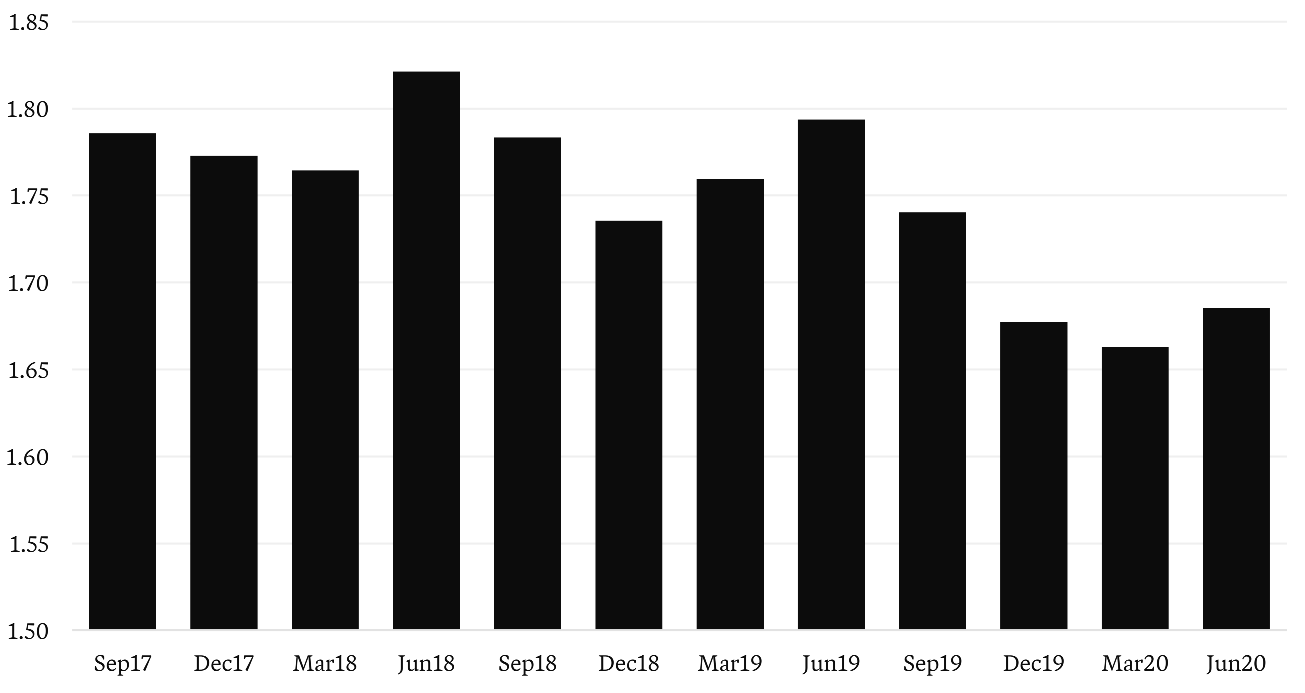
Overall, industry solvency deteriorated after June 2019. As at 30 June 2020, the industry-prescribed capital adequacy (PCA) coverage was 1.69, compared with 1.79 for the same period last year.

The drop in solvency was likely driven by the December 2019 bushfires and January 2020 hailstorms, as well as the downturn in financial markets in the first two 2020 quarters caused by COVID-19. APRA's 2020-2024 corporate plan indicates additional emphasis in the next 12 to 18 months on ensuring financial soundness and resilience of regulated institutions.

Capital base vs Prescribed capital amount
Reporting quarter



Prescribed capital amount coverage ratio
Reporting quarter



taylorfry.com.au

We help business and government leaders see a clear way forward.

Our actuarial and analytics consultants support our clients in making strategic decisions to enhance the financial health of their organisations, and benefit communities, people and society.

We are creative problem solvers – from physicists and engineers to mathematicians and computer scientists. This variety strengthens our advice to meet the needs of our clients and their customers.

Our innovations have led to changes in government policy in Australia and New Zealand, and continue to break new ground, particularly in the social sector. Qantas liked our approaches in analytics so much, it bought a 51% stake in our business in 2015.

Across our offices in Sydney, Melbourne and Wellington, we value our people as individuals, offering a flexible working environment, with limited hierarchy and where everyone shares equally in the rewards.

We are mindful of our effect on the planet and have been carbon neutral since 2006.

Sydney
Level 22
45 Clarence Street
Sydney NSW 2000

Melbourne
Level 27
459 Collins Street
Melbourne VIC 3000

Wellington
Level 3
166 Featherston Street
Wellington 6011