Insurance Insights

Reinsurance – villain or hero?

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Summary

The record number of natural catastrophes – from the Queensland floods to the Christchurch earthquakes – has thrown the subject of reinsurance and its contribution to increased insurance costs to customers into stark relief.

As reinsurance intermediary Aon Benfield’s catastrophe modelling arm, Impact Forecasting, noted, insured loss estimates from the Queensland floods (December 2010 and January 2011), Cyclone Yasi, the Perth hailstorm and the New Zealand earthquakes (February and June 2011) totalled $25.6 billion. It is estimated $16 billion will ultimately be recouped from the reinsurance industry.

Just as the industry felt it could put the major claims events behind it Melbourne was battered by storms on Christmas Day, triggering more than $550 million in insurance losses.

Christchurch, still devastated by the previous earthquakes, was rocked by a series of earthquakes just two days before Christmas, exacerbating the damage to the ruined city.

And, Queensland and northern NSW again saw the return of floods this February.

Most local insurers have now completed their 2012 renewal process and have faced increased reinsurance costs, post the catastrophes.

This has become a major topic with commentators citing reinsurance costs as the main reason for the likely increase in premiums, some critics lambasting both insurers and reinsurers for the expected premium hikes.

On the other hand, as Malcolm Steingold, Aon Benfield’s Asia Pacific Chief Executive told an industry conference: “It is clear that the negative impact on consumers and businesses from these recent losses has been lessened because of the role reinsurers played in assuming losses from the region’s insurers.”

Most insurers are reviewing or already increasing premiums. The cost for people to insure their properties or business will inevitably climb.

Underinsurance is one of the key challenges faced by the community as weather-related disasters increase in frequency. Yet, as the Insurance Council of Australia (ICA) points out, the cost of insurance was the main reason many people were uninsured. And Australia has a chronic underinsurance problem, as clearly demonstrated whenever a major catastrophic event hits the community.

So, is reinsurance a villain or hero when it comes to insurers increasing their pricing?

This report examines the role of reinsurance in the insurance industry and the real impact it has on not only the insurer, but, ultimately, the customer.
Background

A simple definition of reinsurance is insurance cover for insurers. That is, insurers are able to buy insurance protection for themselves in case of large or unexpected claims.

The terms and extent of cover of reinsurance varies from insurer to insurer.

Suncorp is one of the largest users of reinsurance in the world and was one of the first major Australian insurers to renew its catastrophe reinsurance program following the succession of natural disasters.

The insurance industry as a whole is reviewing its reinsurance cover in anticipation of major increases being sought by reinsurers.

Reinsurance provides a global balance sheet

The ability of reinsurance to provide Australian insurers with a global balance sheet is crucial to doing business domestically.

In fact, reinsurance lowers the cost of insurance as, by buying reinsurance, insurers are tapping into a global, diversified balance sheet which allows them to purchase capital / capacity for a cheaper price than if they had to provide it themselves.

Therefore, rather than reinsurance being a cost to the insurer, it is an enabler, freeing up capital that insurers would otherwise have to put aside for claims and allowing them to reinvest that capital in their business proposition to their customers.

As Aon Benfield points out: “Reinsurance capital continues to provide financial stability for many insurers through their partnership with reinsurers. Reinsurance capital continues to provide financial stability for many insurers and their shareholders.”

Reinsurance helps meet regulatory obligations

Regulator Australian Prudential Regulation Authority (APRA) requires insurers to buy a minimum amount of catastrophe reinsurance as specified in their prudential standards.

APRA’s requirements for local insurers are more onerous than for overseas insurers companies – one reason why Suncorp has one of the largest programs in the world, Suncorp is certainly the largest Australian general insurer (based on Gross Written Premiums) but is far from being one of the largest insurers in world.

APRA is seen as a leader amongst world insurance regulators so, naturally, some of its requirements are more robust.

APRA is proposing to implement by the beginning of 2013 further changes to insurers’ present capital requirements to cover events, including holding capital against several smaller losses. This will have a significant effect on insurers – and the reinsurance cover they will require. With reinsurance more than likely to cost more in the future, this will impact on the bottom line. However, to be able to meet these proposed requirements without reinsurance would seriously affect insurers’ ability to operate in Australia.

And there’s more. Reinsurance allows insurers to:

- Manage their capital more efficiently
- Better protect themselves and their balance sheet from the effects of large claims
- Maintain solvency
- Reduce large risks / accumulations / exposures
- Finance growth
- Offer larger limits / more cover
- Spread the risk
- Tap into worldwide expertise
- Develop new products

The real costs of insurance

The cost of obtaining insurance cover has increased world-wide over recent years, due to a number of factors and accelerated in recent times with the increase in the number of major events.

Likewise, the world's leading reinsurers have been heavily impacted by the catastrophes. Munich Re, the world's largest reinsurer, said 2011 was the highest ever loss year on record, with about $US265bn ($252.5bn) worth of economic losses occurring in the first half of the year.

(Despite the catastrophe losses, global reinsurance capital, according to AON Benfield, remains strong and competition between reinsurers for business still competitive. More importantly, they have the
capacity to provide reinsurance even if insurers increase their reinsurance needs.)

But, although reinsurance costs are increasing and affecting insurance costs to the consumer, it is not the only factor in the increase in premiums.

The cost of being an insurer and, subsequently, the cost of premiums for customers, is governed by a variety of influences. They include:

**Increased catastrophe claims within net retention**

The increase in catastrophic disasters has had a significant impact on the industry.

The claims from the severe weather catastrophes that hit globally last year – including Australia and the earthquakes in Japan and New Zealand - are estimated at more than USD430 billion, according to AON Benfield. This compares with an average annual economic loss of USD89 billion from 2004 to 2010.

Earthquake losses in 2011 have made the biggest impact compared to prior years where tropical cyclone activity contributed heavily to annual catastrophe loss activity. As AON Benfield notes, even excluding earthquake events, the 2011 losses surpassed the average of recent years.

The claims costs are significant for insurers and, obviously, affect the overall costs to the consumer. Without reinsurance the ultimate costs would probably see insurance too costly for much of the community.

With any major loss (definition, anything over $500m) reinsurers bear 75% - 95% of the total insured loss, thus reducing the cost of claims to insurers and, ultimately, consumers.

**Claims costs – increasing weather claims; claims inflation**

The above effect will be exacerbated if insurers experience more weather-related claims in the near future.

And the Melbourne storms that drew 2011 to a close and the recent floods in Queensland and northern NSW do not auger well for the future.

The Bureau of Metrology’s national outlook to April 2012 shows the following:

- the tropical north of Australia more likely to have wetter season
- western WA more likely to have wetter season
- parts of southeast SA and western NSW more likely to have drier season.

So the threat of floods and bush fires has not gone away.

One effect of widespread damage is known as ‘demand surge’. This is where repair costs spike up as a result of the large amount of work that needs to be carried out by a limited supply of repairers.

As the Insurance Council of Australia (ICA) pointed out in its submission to the National Disaster Insurance Review (NDIR) last year, many communities are becoming more prosperous and densely populated. Consequently, construction and rebuilding costs increase annually, as do the values of the individual assets.

The ICA gave as an example the community of Rhodes in NSW which, like many similar areas, underwent significant urban development during the last 70 years. Models show that an extreme hail event occurring in this location in 1930 would have cost an equivalent of $5 million. Increased development in this area and in the value of the assets to be found in the area meant the same storm occurring in 2007 yields a potential damage bill of $900 million.

Also, although urban development and planning has progressed considerably in recent years as states and councils become more aware of the risk of major weather events, properties and businesses continue to be developed in high risk areas.

The ICA and individual insurers and reinsurers have campaigned extensively to promote community resilience but progress is slow to ‘weather-proof’ communities.

As the ICA commented in its NDIR submission: “As we move forward into a climate presenting more extreme weather events it is critical that we note and where necessary adapt urban planning and development to address the growing risks and the consequential losses to the community.”

Strengthened building codes are an important step in mitigating the impact of extreme weather. Some local building codes are more robust than others and, consequently, some areas better protected.
than others. The limited application of building code improvements to existing homes leaves many exposed to otherwise preventable damage.

**Investment market fluctuations**

The current global economic uncertainty and volatile financial markets are expected to continue throughout this year. The combination of a weak US economy; sovereign debt and bank liquidity issues in Europe and sluggish global growth will also continue to unsettle markets.

The underlying strength of the local economy should once again protect Australia from the full impact of the global issues. Australia’s terms of trade are at a record high and unemployment is relatively low. However, the rise in the Australian dollar and cautious consumers, have dampened economic growth.

While the medium to long term prospects for the local economy are good, current conditions are erratic and uncertain.

The markets have a profound impact on insurers. They rely not only on premiums to derive income, but also heavily on investment income.

The general insurance industry is much less exposed to equity markets than life insurance. However, the general insurance industry has – at present - a larger exposure to credit spreads, given its substantial fixed-interest portfolios.

According to APRA, the local industry bounced back from the disasters, although a $217 million loss for the sector was recorded in the September quarter. However, APRA noted that income from investments helped turn around the underwriting losses, despite the volatility of global markets,

During the 2011 September quarter, insurers managed to increase their investment totals from $63.7 billion in September 2010 to $66.5 billion.

As APRA noted in its industry report: “The strong performance during the (2011) year was attributed to interest-bearing investments that rose from $41.2 billion in 2010 to $44.3 billion in 2011. As with most investors, the small amounts of equity holdings fell from $2.4 billion to $1.6 billion during the year, reflecting volatile global markets.”

**Taxes**

State and Federal taxes and levies have a major impact on the cost of premiums, with insurers finding themselves acting as tax collectors.

Taxes on insurance have escalated considerably in recent years - from $2.1 billion in 2000 to $3.7 billion in 2006. The tax and levies on insurance in NSW is the highest in the world.

Industry estimates show that about a third of the cost of insurance to a small business is in the form of taxes.

So-called ‘sin taxes’ – tobacco, alcohol and gambling - are subject to relatively punitive levels of taxation. In the same manner, general insurance, far from being taxed, or rather subsidised, as a public good, is taxed as a ‘sin’, with only cigarettes being taxed more heavily.

Lobbying by the ICA has been intense but has yet to see governments relax their taxes. Certainly the Victorian government is in the process of waiving the fire levy post the disastrous bushfires to compensate for underinsurance, and the NSW government is reviewing it but progress is slow.

**Insurance cycle**

Just like any market, when supply is short, costs will increase. For insurers, the supply is the supply of capital.

As a result when insurers are suffering in the local market the amount of available capital is reduced leading to the increased pricing.

The local market can also be influenced by global capital availability and even if local insurers are suffering, offshore companies or new entrants will seek to opportunistically gain market share by undercutting rates. This is particularly true for larger corporate risks.

Often, hardening markets are influenced by increasing costs in reinsurance but in the current climate it is insurers who are taking the lead with some of the benefits being passed on to reinsurers.

There are now growing signs that the market is hardening. Both insurers and reinsurers have – and are still - experiencing the effects of the continuous, widespread weather natural catastrophes.

This coupled with the uncertain global economic issues which are unsettling the local stock market, business community and consumers, has been reflected in the genuine signs of market hardening.

Some insurers have taken an early lead to increase prices, while others are poised to do so.
Conclusion

Singling out reinsurance as the main influencer on rising insurance costs is too simplistic.

Without reinsurance the Australian general insurance industry would be in dire straits.

The cost of meeting claims would be impossible without reinsurance. The spate of major disasters has heavily impacted on insurers’ costs. Without the support of reinsurance the increase in costs could be even steeper.

There are other pressures which make reinsurance an integral part of the insurers’ businesses, such as the need to preserve shareholder value and meet regulatory obligations to operate here.

It seems ironic that without reinsurance the cost of insurance would be significantly higher than it is today. Instead of putting aside greater amounts of capital to pay claims, insurers can use that capital to ultimately provide better service to customers.

And there is no doubt if Australia faces further potential major natural events, insurers will again turn to reinsurers to help them – and, more importantly, their customers – ride the storm.