EVOLUTION OF THE COMMERCIAL LINES MARKET

THE GROWTH AND PROFIT CHALLENGE

With the commercial lines market in Australia having undergone substantial change in recent years, Susie Amos examines the current situation, discussing challenges for market participants and implications for the future.
The last 10 years has seen an evolution of the commercial lines market. The proliferation of market participants and the influx of capital into Australia have changed the face of the market. Capacity is plentiful and competition is fierce, which has led to challenges in achieving growth and profit.

While the overall picture for the general insurance industry is a positive one, the positive story mostly comes from the personal lines side. The commercial lines market provides challenges for insurers who are looking to find growth and who want to remain profitable.

This article examines changes in the Australian commercial lines insurance market in recent years – the changing face of distribution, influx of new capital, and an increase in the prevalence of underwriting agencies.

**MARKET PARTICIPANTS**

The commercial lines market in Australia has been flooded with capital in recent years. Capacity is currently plentiful and, in the absence of a market shock, is unlikely to diminish any time soon.

A succession of overseas insurers, and particularly Lloyd’s, is directly engaging in the Australian insurance market. Some offshore insurers have opted for agency arrangements, while a smaller proportion has committed to the more costly and time-consuming process of establishing their own local licences, often as a branch.

Local commercial brokers and insurers have also seen the benefit in the underwriting agency structure, resulting in acquisition activity by these players. Brokers and insurers, through ownership of agencies, gain the benefit of securing distribution, as well as trying to capture profit at two stages of the distribution chain.

**Growth in new markets**

After the GFC, local providers limited capacity in some areas of financial lines, particularly for non-standard or poorly performing risks. Similarly, the spate of natural catastrophes in 2010 and 2011 led to some hardening of rates in areas prone to natural perils. These changes provided a natural opportunity for offshore players to enter the Australian market.

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The market structure has evolved into a complex integration of intermediaries and capital providers.

The following sections discuss the characteristics of the underwriting agencies, Lloyd’s and offshore insurers (also known as unauthorised foreign insurers, or UFIs) and how they have changed over time.

**Underwriting agencies**

Underwriting agencies perform underwriting, distribution and (sometimes) claims functions on behalf of risk carriers. Historically, one of the main drivers of business growth for agencies has been their ability to provide quick access to specialist insurance knowledge and their greater willingness to assess unusual risks.

Key agency characteristics can be summarised as follows:

- specialist knowledge, with relationships and access to markets for specialist products or services
- assessment of unusual risks
- entrepreneurial and opportunistic – can easily dive in and out of a market segment
- focus on customer (i.e. mainly brokers) service.

**Growth in agencies**

Underwriting agencies have been a feature of the Australian commercial insurance landscape since the 1950s. They grew rapidly in the 1970s and 1980s through hard-to-place business, such as trucks, fishing boats, exotic cars and bloodstock, and again when some overseas insurers discontinued their Australian operations in the 1990s.

In 1998, when the Australian government implemented major regulatory change, the Underwriting Agencies Council (UAC) was formed by the six major underwriting agencies.

We estimate that the total number of underwriting agencies has increased from around 70 in 2007 to almost 120 in 2014. Some views in the market suggest that the current number may actually be closer to 140.

UAC currently represents the interests of 90% of our estimated 120 underwriting agencies operating in Australia. UAC estimates that its members collectively write $3.5 billion of commercial lines premium.

Figure 2 shows the growth in the number of underwriting agencies between 2007 and 2014; it also breaks the numbers down by source of capital.

The proportion of overseas underwriters (which includes international insurers and Lloyd’s in Figure 2) increased between 2007 and 2014. In 2007, about half of the underwriting agencies were writing business purely for Australian insurers, and this has reduced to one-third in 2014. In 2014, around half of the premium sourced through agencies is written by Lloyd’s.
Underwriting agency ownership
Underwriting agencies have historically been set up by individuals with expertise in a market or product segment. As a result, around 50 per cent of agencies are owned or partly owned by individuals. In recent years, brokers and local insurers have bought into the agency market, both for different reasons:

- Brokers – to increase their profit potential, as they earn a commission from the underwriter in addition to the normal broker’s commission. The ownership of the agency enables the broker to differentiate its business as a specialist, as well as secure its distribution channel.
- Insurers – are able to access a specialist market and can increase market share and expertise quickly and cheaply.

Lloyd’s
Lloyd’s syndicates in Australia are allowed to write business through either:

- an underwriting agency based in Australia, known as a “coverholder” in the London market (this is the most common arrangement)
- the syndicate’s Australian service company (if they have one)
- from London via a Lloyd’s broker.

Australia has been a growth area for Lloyd’s in the last five years, with written premium almost doubling. Lloyd’s premium peaked in 2012, reaching US$2 billion (although some of this is reinsurance). According to APRA intermediated statistics, Lloyd’s represents 10 per cent of intermediated business. The most significant class for Lloyd’s in Australia is casualty, which includes public liability, professional indemnity and directors’ and officers’ insurance.

Lloyd’s players, despite being UK insurers, are able to operate like APRA-authorised insurers. This is due to the level of security and the high standards to which they are required to adhere (the Lloyd’s Minimum Standards), as well as holding a Lloyd’s Australian Trust Fund (which is currently $2.5 billion). This means that Lloyd’s entities can easily enter the market – either directly onshore, through brokers or via agency arrangements. The easiest and most cost-effective is through establishing arrangements with the underwriting agencies.

Given the high level of competition and the ongoing soft market, we would expect Lloyd’s premiums to stabilise over the short-term.

UFIs
UFIs are insurance companies incorporated overseas and not APRA-authorised. As such, UFIs do not need to comply with the Australian regulatory standards. They are subject to the laws and regulations of the country where they are licensed and their local regulators need to give approval for them to operate in Australia.

UFIs typically provide cover for:

- atypical risks
- high-value insureds
- other risks that cannot be placed readily in Australia.

APRA’s intermediated statistics show $1.4 billion of premium written through UFIs in 2013, which equates to five per cent of the total Australian general insurance premium pool. We believe captives form a significant portfolio of the UFI premium pool, as they are able to provide more affordable insurance.

Direct insurance
As more of the world’s business moves online, there is a growing trend for insurers to write commercial insurance for small enterprises directly via the internet. Underwriters have targeted the SME segment with “standard” commercial packages on automated distribution platforms. Covers include property, product liability, professional indemnity and commercial motor.

The characteristics driving this trend are:

- The insurance needs of many small business types are largely homogeneous.
- Small businesses are often price sensitive and the direct insurance model can offer lower premiums.

There is a natural limit to the complexity of business that can be written directly. More complex risks are expected to continue to require intermediaries to ensure their needs are appropriately met.
Brokers

The insurance broking industry has continued its trend of consolidation. The competitive environment has made it difficult for the smaller broking firms to retain the infrastructure, such as technology, systems and talented human resources that are essential to maintain competitive advantage and meet regulatory and operational commitments.

In addition to consolidation, brokers have expanded their operations to underwriting agencies ownership. Steadfast, A J Gallagher and Austbrokers have all been extremely active in this space. This structure seeks to increase their profit potential and provides underwriting security and stability to their business.

Contestable platforms have been a key development for the industry in an effort to drive efficiency and add value. They appear to have been “accepted” by insurers as the new generation of quoting systems. Brokers’ contestable platforms appear to have replaced the facilities seen in the past.

CHALLENGES IN COMMERCIAL LINES

The proliferation of market participants and the influx of capital into Australia has created challenges, which are not expected to diminish anytime soon, for the commercial lines market.

Soft market

The muted growth in total commercial lines premiums, compared with personal lines, demonstrates the impact of the soft market (see Figure 3).

Commercial lines premiums have grown only 25 per cent since 2005, with most of the growth in the last three years relating to property insurance and mainly driven by reinsurance costs, which have now abated. At the same time, there has been an 80 per cent increase for personal lines.

Profitability and rate adequacy

While the commercial lines market has reported good profits in its accounts in the last couple of years, we believe the premium rates are deficient, particularly for parts of commercial property and financial lines. The absence of catastrophes in recent years has masked the impact of the softening market.

This can be seen in Figure 4, which shows historical loss ratios for commercial lines classes on a financial year basis (as shown in accounts) as well as our estimates on an accident year basis (which we consider to be the underlying experience). The financial year performance can mask the underlying trends in claims experience.

The year ending June 2014 appears profitable at around a loss ratio of 60 per cent, assuming insurers are targeting around a 60 per cent loss ratio. However, we highlight this result is for years where there have been no major catastrophes. Across all classes we estimate that premium rates are deficient.

Since 2007, there has been limited opportunity for commercial insurers to recoup weather losses and losses experienced during the GFC. This is due to the increase in capacity in the market keeping a lid on rate increases. Catastrophes play a big factor in insurers achieving profitability and significant volatility can arise depending on the catastrophe experience in a year.

The market appears to be all too aware of the underlying pressures on profitability. However, the soft market has made rate increases difficult to achieve. Insurers are obviously trying to find the profitable segments and avoid the poor performing ones, but until a consistent and disciplined approach is taken across the market, no hardening can be expected.

Notes

1 Based on discussions with market participants.
3 UAC CM.
4 UAC member survey results 2010.
7 Lloyd’s Intermediated General Insurance Statistics, December 2013 (issued 5 March 2014), Table 1.
8 APRA Intermediated General Insurance Statistics, December 2013 (issued 5 March 2014), Table 1.
9 SPV rating of the Lloyd’s market, January 2014.
10 APRA Intermediated General Insurance Statistics, December 2013 (issued 5 March 2014), Table 1.
11 Ibid.