Evolution of the Commercial Lines Market – The growth and profit challenge

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.

This market provides challenges for insurers who are looking to find growth, and who want to remain profitable.

We examine recent changes in the market, the impact of the new players, and then consider the implications for the future of commercial lines in Australia.

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, are directly engaging in the Australian insurance market. Some offshore insurers have opted for agency arrangements, while a smaller proportion have committed to the more costly and time consuming process of establishing their own local licences.

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 capturing profit at two stages of the distribution chain.
Market Participants

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

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.

Opportunities for product innovation and new coverages in the Australian market have also interested offshore players. Cyber insurance, management liability, accident and health, and strata insurance products have been launched in recent years, mainly via agencies backed by Lloyd’s capital.

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 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 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. The UAC became the lobbying voice for the agencies and since this time the UAC has expanded its role to become a promoter, a regulator, a developer and placement facilitator. More recently they have focused on the training and development of the knowledge and skills of their members.

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

The number of underwriting agencies has grown dramatically over the last 10 years.

The 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.

The UAC currently represents the interests of 90 of the 120 underwriting agencies operating in Australia. UAC estimates that its members collectively write $3 billion of commercial lines premium.

The proportion of overseas underwriters (which includes international insurers and Lloyd’s in the chart) 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% of agencies are owned or partly owned by individuals.

In recent years, brokers and local insurers have bought into the agency market, for different reasons:

- **Brokers** – 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, to 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), or
- Directly from London.

Australia has been a growth area for Lloyd’s in the last five years, with written premium almost doubling.

Lloyd’s Gross Signed Premiums in Australia (US$ m)

<table>
<thead>
<tr>
<th>Year</th>
<th>Property &amp; Casualty</th>
<th>Lloyd’s Premiums: By Class</th>
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<tbody>
<tr>
<td>2009</td>
<td>126.8</td>
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<td>2010</td>
<td>540.1</td>
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<td>2011</td>
<td>1,039.3</td>
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<td>2012</td>
<td>2,034.7</td>
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<td>2013</td>
<td>3,043.2</td>
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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% of intermediated business. The most significant class for Lloyd’s in Australia is casualty which includes public liability, professional indemnity and Directors and Officers.

Lloyd’s players, despite being UK insurers, are categorised in Australia as APRA-authorised insurers; this is due to Lloyd’s level of security and the high standards to which they are required to adhere (the Lloyd’s Minimum Standards), as well as for historical reasons. This means that Lloyd’s entities have increased their presence in Australia, mainly through agency arrangements.
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 5% of the total Australian general insurance premium pool and 7% of intermediated business. We believe UFIs have grown in the property classes, particularly where the local market has withdrawn from insuring high risk catastrophe exposures.

**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 market 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 small business 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 will always be expected to use intermediaries to ensure their needs are appropriately met.
Challenges in Commercial Lines

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

Soft Market

The muted growth in total commercial lines premiums, compared with Personal Lines, demonstrates the impact of the soft market.

### Premium Growth Personal Lines vs Commercial Lines ($billion)

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<tbody>
<tr>
<td>Personal = Motor + Home + CTP</td>
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<td>6</td>
<td>7</td>
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<tr>
<td>Commercial = Fire + Motor + Liability + PIDO + W/C</td>
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Source: APRA

Commercial lines premiums have grown only 25% 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% increase for Personal Lines.

Profitability and Rate Adequacy

While the commercial lines market has reported good profits in their 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 the chart below 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 soft market has continued for commercial lines whereas Personal Lines has hardened.

Commercial lines insurers are currently making good profits…but only due to the absence of catastrophes.
The current years appear profitable at around a loss ratio of 60%, assuming insurers are targeting around a 60% 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 aware of the underlying pressures on the profitability, however, the soft market has made rate increases difficult to achieve. Many players have taken steps to identify and underwrite the more profitable segments of the market and to limit exposure to the unprofitable segments.

Implications for the Future

Finally, we ask, what does the future look like for the commercial lines market?

Our thoughts are:

- **The soft market is here for a while.** Until poor profitability hits capital providers’ bottom lines in a significant way, we do not expect significant withdrawal of capacity or hardening of the market.

- **Underwriting agencies are here to stay as a valuable player.** Where in the past their prominence has risen and fallen with the market cycle, we expect agencies to remain a significant ongoing part of the market.

- **Growth opportunities will be limited.** This is a function of insurance market saturation, as well as limited overall economic growth.
- **Rationalisation of the ownership of agencies will continue.** Ownership of underwriting agencies is likely to rationalise to generate growth, and unlock distribution and expense efficiencies.

- **Increase in sophistication of the market.** As profitability pressures bite, we expect market players to continue to give more focus to identifying profitable pockets of business, increasing the sophistication of the commercial lines market. Indeed, we have already seen insurers, underwriting agencies and Lloyd’s analysing historical information in more detail, implementing more sophisticated pricing models and using additional sources of information to make underwriting decisions.