

**The General Insurance Market in New Zealand -
Changes that have taken place during 2001/2002**

Janet Lockett

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Introduction and Summary

The general insurance market has been continually evolving ever since it began. The New Zealand market started from overseas roots, but has developed several distinctive features of its own. It is subject to many influences from outside the industry, including local and global factors.

The President of the Insurance Council of New Zealand, described the year 2001 as *“one of the most traumatic in the history of international insurance and will define much of the insurance thinking and planning for decades to come. Inevitably this will impact on the industry in New Zealand”*.¹ This comment probably reflected the views of most commentators on insurance markets around the world. There have been insured disasters before, but the events of September 2001 indicated a clear step up in potential global risk. The losses triggered many changes that have affected insurance markets around the world - some changes are more direct than others and some will be more long lasting than others. These changes have taken or are taking place against the background of the more general developments affecting each local insurance market.

It is instructive to investigate the changes that have taken place in the New Zealand general insurance market during this very challenging recent period. I hope that my findings will be of interest to actuaries and others involved in, or thinking about, general insurance matters.

In this paper, I provide a broad description of the general insurance market scene over the past few years, including aspects of management thinking and planning within insurance companies, and indicating the nature of the prime drivers of the changes. I have drawn on published material from New Zealand and from overseas sources for background information. However, to present the players view of the market situation, my main sources of information have been New Zealand insurance company underwriters and managers, as well as brokers and other key people associated with this business. I wish to thank those people who assisted me by giving their time for discussions.

I chose to speak to people with different backgrounds and experience with various different types and sizes of general insurance portfolios in the New Zealand market. Since some aspects of our discussions could have related to commercially sensitive matters, it was agreed that all company specific information would be treated as confidential. Hence, I am unable in general to attribute particular remarks to individuals, and certainly not to companies. Whilst acknowledging the input and assistance from others, I point out that the views expressed are my own, as are any errors in facts or interpretations.

This paper deals with topics under the following general headings:

- The nature of the New Zealand general insurance market.
- The insurance cycle, and the state of the markets prior to 11 September 2001.
- The effects on global insurance and reinsurance markets of September 11, and hence on New Zealand insurers, disaster management and terrorism exclusion clauses.

¹ President's report in Insurance Council Review 2002

- Other factors (locally and globally) that affect New Zealand general insurers.
- Comments on insurance industry management strategies and focus.
- A summary of the effects on New Zealand policyholders of recent market developments.
- Views on the whether or not the changes noted will last and on the future of the New Zealand general insurance market.

Throughout the paper, while focusing on New Zealand, comparisons are made with other general insurance markets, particularly those in Australia and Britain, over recent years.

The nature of the NZ general insurance market

Some very brief comments are given here to provide background, particularly for any overseas readers.

Since much of this paper relates to global events, it is useful to start with some global comparisons. The New Zealand general insurance market is comparatively small. The latest published figures for Insurance Council members show total Gross Written Premiums (for all classes of business) of about \$1.9 billion for the 2000 year and just over \$2 billion for the 2001 year.² The Insurance Council represents over 95% of the market. The following figures (in NZ\$ billions) give an international comparison.³

Country	Period	Estimated GWP
U S A	Financial year to 31 March 2000	800
Japan	Fiscal year 1999	180
U K	Financial year to 31 March 2000	120
Australia	Financial years ending in 1999	27

Most New Zealand insurers are listed companies, although there are a very small number of mutuals. Although there are a number of New Zealand owned companies, most are a local subsidiary of an international group with a head office overseas, generally in the UK, Australia or the USA. Most of the major reinsurers have a presence in New Zealand, sometimes through a branch office.

Virtually all the managers of companies that are New Zealand subsidiaries state that they have considerable autonomy regarding the local operations. However, most commented that reporting requirements to the parent have increased in recent years and their strategic plans are subject to approval from head office.

The New Zealand general insurance market is one of the least regulated in the developed world. Currently, non-life insurers must comply with the Companies Act 1955, the Insurance Companies Deposits Act of 1953 and the Insurance Companies Rating and Inspections Act of 1994. However, the Ministry of Economic Development is reviewing the Insurance Companies Deposits Act and the Insurance Companies Rating and Inspections Act. It is

² Industry statistics in Insurance Council Review 2002

³ Tillinghast-Towers Perrin, Insurance Pocket Book 2001 (GWP amounts converted to NZ\$ rounded)

expected that amended legislation will be introduced so that deposits will be no longer be required, but all non-life insurers will have to seek and disclose annual ratings from approved ratings agencies.⁴

Those insurers registered to transact employers' accident insurance, during the privatised year (from 1 July 1999) were/are subject to the Accident Insurance Act 1998. Other relevant legislation includes that relating to human rights and consumer protection matters.

It may be noted that, despite having no legislation setting specific solvency standards, most of the major New Zealand insurance companies have historically operated with relatively high solvency margins (above 40%, and some markedly higher at times). This is particularly interesting in view of the nature of the business written in New Zealand.

The Insurance Council has a self-regulatory framework that requires all member companies to maintain a solvency ratio (that is the ratio of free reserves/shareholder funds to net written premium) of at least 20%.

The existence of the Accident Compensation Commission (ACC) and the Earthquake Commission (EQC) make the New Zealand general insurance market significantly different from other markets. The ACC provides medical treatment, rehabilitation and income replacement for the victims of accidents on a no-fault 24-hour basis. In virtually all cases there is no right to sue for damages. This means that there is no requirement for bodily injury elements of cover under private market general insurance policies, and hence a much reduced claims tail for motor and liability classes.

The EQC covers insured dwellings up to \$100,000 plus GST, and covers personal property up to \$20,000 plus GST, in the event of natural disasters. The private insurance market offers cover above these levels on household policies, and also cover for non-residential property. The potential insured cost of a major Wellington earthquake is arguable, but one ballpark estimate is about NZ\$20 billion. This includes up to \$5 billion for EQC losses, about \$8 billion for other property damage and presumably about \$7 billion for associated business interruption and other losses. The ACC would incur significant costs in relation to injuries. This cost is certainly significant in global terms and requires considerable reinsurance capacity.

The insurance cycle, and the state of the markets prior to 11 September 2001

For a long time, insurance theory has indicated that there is an insurance market cycle with a period of between 5 and 10 years, most commonly taken as being about 7 years. However, this has not been in evidence over the last decade. The last peak was around 1992, and was perhaps rather lower than might have previously been expected. Having descended following the expected pattern in the early/mid 1990s, it might have been anticipated that the market would have reached the next trough and started to recover by 1996, but this did not happen. The market stayed at the bottom of the trough into 2000. New Zealand was not

⁴ Liane Dalziel, speech on 23 August 2002

alone in this situation. Many of the insurance markets worldwide were in similar positions, and parts of the global reinsurance market were also considered 'soft'.

In the late 1990s, the New Zealand market was dominated by the privatisation of employers' accident insurance. Eventually only seven companies were registered to write this business from 1 July 1999. Then the new Labour Government returned the business to the ACC by 30 June 2000.

Although the market remained very competitive into 2000, other factors were having an influence. The low New Zealand dollar was increasing replacement costs and in many lines of business an increased frequency of claims was also recorded. Also, after some boom years, investment returns were beginning to fall. There was some merger and acquisition activity. The premium rates of personal and commercial lines insurance were starting to move upwards. This progress continued during early 2001. However, as will be discussed later, New Zealand was rather behind overseas insurance markets in underwriting attitudes and moves to tighten policy terms and conditions.

In the international insurance arena during 2000 and early 2001, slow moves out of the trough were taking effect. Premium rates were being increased. Most insurers were expecting firming of rates for reinsurance treaty renewals. Other influences were at work, including discussions on new international accounting rules for insurers and reinsurers, and regarding risk based capital requirements for insurers in various territories. In Britain, insurers had been hit by severe flood losses and were imposing premium increases. That market was also affected by the failure of the Independent. In Australia, the failure of HIH had occurred and its ramifications were being felt throughout the industry, its regulators and by the general public.

Even in mid-2001, the insurance industry worldwide was starting to refocus:

from	market share and premium income,
back to	adequate return on capital,
and	underwriting quality business at the right price.

Then the terrible events of September 11 occurred. They had a major effect on the world insurance (and stock) markets. Although remote geographically from New Zealand, it is clear that these events acted as a catalyst for significant changes to be made here.

The effects on global insurance and reinsurance markets of September 11

Many insurers suffered severely from multiple claims under many different lines of business resulting from the September 11 event. In many cases, a New Zealand insurer was part of a worldwide group which was affected directly. However the New Zealand market has been affected in the main by the fallout from that event. This has come particularly through the reinsurance market. Companies about to enter negotiation for reinsurance cover from 1 January 2002 found that it had become much more complex. Also, there was the introduction of blanket exclusion of terrorism cover from all reinsurance treaties.

The capacity of the global reinsurance market needs to be put into perspective. Estimates of the insured losses from the World Trade Centre and associated events are in the range US \$30 to \$60 billion dollars.⁵ Most of these losses fell on commercial lines insurers, particularly in the property classes, but also business interruption, liability and workers compensation lines, as well as life classes.⁶ It has been estimated that by the end of 2001 the global reinsurance market had capital available of roughly US\$125 billion, a reduction of between 20% and 30% on mid-year figures.⁷ There are indications that new capital of about US\$25 billion has been put into the reinsurance market, primarily in Bermuda, during the last year.⁸ However there are reportedly still some reinsurers considering withdrawal.

Although the reinsurance markets can cope with individual large losses, there are cycles associated with the available levels of capacity. The previous largest insured loss event had been Hurricane Andrew in 1992, which cost US\$19.6 billion, mostly in personal lines with some commercial losses. This was associated with the last peak in worldwide insurance cycles. The previous largest man-made insured loss was the Piper Alpha oil-rig, in 1988, that cost US\$2.9 billion.⁹ However, it may also be noted that one estimate of the eventual total cost of asbestos related claims worldwide will be around US\$200 billion.¹⁰

The reinsurance market has suffered considerable property lines losses over the last decade, particularly in the most recent five year period. Reinsurers have modelled possible future East coast weather events at around US\$50 billion.¹¹ They, and others, also use modelling to assess potential losses from other disaster scenarios, man-made as well as natural. However it seems clear that the September 11 event was beyond the scope of the existing disaster models.

In addition, during 2002 the reinsurance, and insurance, markets have been hit by the considerable declines in global stock markets. There are also potentially large claims in connection with Enron, Arthur Andersen et cetera. It has been reported that at least one American insurer expects losses associated with the Enron collapse to be over US\$50 million.¹² Overall, the combination of problems has led to the reinsurance capital available globally being somewhat lower than in the late 1990s, at a time when the financial strength of many players in the market is reduced.

Financial strength and capacity are important factors for reinsurers, as well as for insurers. They require retrocession to protect their own accounts in relation to the larger risks and aggregations of risks that they have undertaken. As available capacity has reduced, the cost of these retrocessions has also increased.

⁵ Peta Miller, Insurance Day, 11 June 2002

⁶ Swiss Re, Focus Report 2/2002

⁷ Selina Man, The Independent, 12 June 2002

⁸ Benfield Group, WTC Update, April 2002

⁹ Tables on major losses 1970-2001 in Swiss Re - Sigma 1/2002

¹⁰ Tillinghast-Towers Perrin study quoted in Outlandish Claims, The Economist, 25 May 2002

¹¹ Munich Re - The Reinsurance of Natural Catastrophe Risks, 1/2002

¹² Diana Marks in Boardroom, August 2002

The reinsurers are focusing on the same goals as the insurance industry:

- return on equity and
- long term profitable relationships.

Reinsurers want to build relationships with profitable insurers through treaties consisting of good quality business. Because of the distance of the reinsurer from the underlying risks covered, there can be nasty surprises for reinsurers following a disaster, particularly involving aggregations of multiple losses. Hence there are moves away from broad based covers, to specific risk/named perils covers. Insurers providing good quality data on the risks covered by a treaty can expect to be favoured. The factors affecting reinsurance rates include:

- the amount of risk information available,
- the classes of business,
- the level of cover required, and
- the geographical areas involved and potential aggregations.

These factors are assessed in relation to the previous commitments of the reinsurer, and the extent of associated business being offered.

Reinsurance of New Zealand general insurers

The circumstances of the various New Zealand companies in regard to placing their reinsurances vary quite considerably, particularly between the smaller companies and those that are part of a large overseas group. Variations include cover being sought for New Zealand business alone, New Zealand together with Australia, or as part of a Pacific region including Australia as well, up to inclusion in a worldwide group. Cover may be by class of business or for whole accounts.

It is usually accepted that reinsurance is a long term relationship between the insurer and the lead reinsurance companies. New Zealand insurers have said that they have strict rules regarding the financial strength of reinsurers eligible for involvement in their treaties. Some have reported that they have had to replace minor reinsurers on their treaties for that reason. Some small reinsurers have asked to be taken off certain treaties as well. Some insurers have had three-year contracts with their reinsurers for some classes of business. In some cases, these were replaced by one-year covers when they came up for renewal this year.

The retention held by the New Zealand company depends on its financial situation. Smaller, local companies usually have considerable reinsurance protection. Multinational groups ensure that their New Zealand company has appropriate protection, perhaps using an internal funding or captive arrangement for lower levels with global treaties at higher levels. All use a variety of combinations of per risk or per account, proportional and/or excess of loss covers, with per account or whole portfolio catastrophe excess of loss protection. There are also a few stop loss treaties for specialist areas of business.

Clearly the negotiation of renewals at 1 January were made extremely complicated by the effects of September 11. Some people were taking part in negotiations at that time. For some types of treaty, significant increases in cost had been expected anyway. For a time there were fears that there could be increases of up to 100% for some treaties. In the end, probably due to the new reinsurance capital that entered the market, the actual results were not as bad as that.

Many New Zealand companies had treaties running until 1 July 2002 and hoped that the market would have settled back before then. However, there do not seem to have been any consistent patterns that emerged in regard to terms for treaty renewals as at 1 April or 1 July rather than the start of the year. Capacity remains relatively tight as a result of lower asset values, despite the entry of new capital, and this is subject to high return on equity targets. Following the return to underwriting basics, the rates for most treaties seem to be dependent on the perceived quality of the direct business being placed. However, some insurers have found a few odd features in the market for some types of treaty. Areas where high minimum costs are being applied, which make them expensive for smaller New Zealand companies, were mentioned.

The levels of premium and the size of increases for recent renewals or placements vary by class of business. Property classes have been subject to the largest increases, particularly for catastrophe excess of loss. However, classes involving liability risks are also affected.

For obvious reasons, the managers that I spoke to were reluctant to discuss details of their reinsurance negotiations. Therefore, I have limited information in this area. An indication of the order of magnitude of premium increases for property catastrophe excess of loss treaties appears to be 20-50%. However, there were wide variations indicated relating to the layers involved. In combination with these increases, some reinsurers have required the retentions held by direct writers to be increased. (In some cases, the direct insurers had not increased their retention for a number of years and the reinsurer regarded the level as being unrealistic for the nature of the business being placed and the status of the insurer. However, there had also been some cases where the direct insurer had made a tactical decision to have a lower retention than necessary because of favourable reinsurance prices, and of course such options were no longer available.) For other treaties involving significant amounts of capacity, particularly liability risk, it appears that even larger premium increases have been required.

At a more basic level, proportional treaties have been more difficult to place and the exchange commission has been significantly reduced, despite higher original premium rates being charged, so that they have become more expensive. In addition, facultative cover for individual risks is also now difficult to obtain and expensive, although there is still an active facultative market. Excess of loss cover was described as affected by 'cripplingly high' minimum premiums. This has affected the acceptance limits for large local risks.

In the past reinsurers have increased the amount of detail that they require in order to underwrite treaties following large loss events. This appears to have been the case again. Some New Zealand insurers indicated that they felt they had always provided a good standard of data in recent years, whereas others commented that they were being required to obtain and provide more detail to their reinsurers this year. The first group suggested that they had obtained better terms for their renewals than might otherwise have been the case. This may well be a valid view, and comments from a reinsurance broker tend to support it.

Although New Zealand is a small market, and so has a small premium base, it does offer reinsurers well defined risks and diversification, globally and by type of exposure. However, as already discussed, it has a significant catastrophe risk in global terms in a well insured marketplace.

Disaster management

An important feature of an insurer is its own risk management. Most underwriters pay considerable attention to the aggregation of exposures and the expected frequency and severity of major losses. Scientific research into such matters as earthquakes and weather is continually developing. Many insurers, brokers and reinsurers, and some actuaries, have their own models in regard to losses that could be suffered in a major event.

In considering retentions and levels of cover required by New Zealand insurers, attention seems to be focused on the potential losses arising from a major earthquake centred near Wellington. Researchers at the Institute of Geological and Nuclear Sciences (IGNS) and others have developed models that consider risk factors and damage levels for various types of building in microzones within the Wellington region.

A number of insurers report that they apply microzoned limits to acceptances for earthquake risks, but other insurers indicated that they do not yet see the need to consider this level of detail. However, all insurers apply limits to acceptances (based on probable maximum losses) within the Wellington area. The strictness of the application of the limits possibly varies between companies.

Because of the EQC, private insurance market losses from an earthquake affecting an urban area are likely to be most costly in the commercial classes. However insurers with large domestic lines of business must also consider the possibility of significant weather losses in various parts of the country. One major insurer said they modelled past weather events using current exposures to estimate potential weather losses. Most others reported using the Queenstown floods as their benchmark loss.

Most insurers commented that the World Trade Centre disaster had reinforced their appreciation of the need to assess potential aggregation of losses arising from all types of policies. Some insurers seem to have more highly developed views as to 'worst case scenarios' than others. These include having plans for coping with a serious loss event that has also severely affected their own head office, computer systems and key staff. Most companies have some emergency plan for operating after a disaster. There were several

references to the Auckland power crisis in this context. However, no-one indicated particularly novel scenarios as being considered for future loss assessments.

Terrorism exclusion clauses

The central question is whether or not terrorism can be regarded as an insurable risk. After September 11, virtually all reinsurers introduced a blanket exclusion of terrorism from their treaties and arrangements. I understand that there are a number of wordings for this clause. One standard version is the following.

"An act, including but not limited to the use of force violence and/or threat thereof, of any person or group(s) of persons, whether acting alone or on behalf of or in connection with any organisation(s) or government(s), which from its nature or context is done for, or in connection with political, religious, ideological, ethical or similar reasons, including the intention to influence any government and/or to put the public, or any section of the public in fear."

Clearly it is the intention that any losses resulting from any type of terrorist attack should not have coverage. Insurers have problems in that many other actions, not generally regarded as 'terrorism' fall within this wording and so any damage resulting would not be covered by reinsurance. In New Zealand, any damages related to gang activities, Maori, anti-GE or any other protests, or actions by police in response to such activities, which would previously have been covered under material damage or liability policies, are excluded by the wording of the various exclusion clauses.

During 2002 many reinsurers agreed to reinstate the previous terms of coverage for personal lines business, but in general the terrorism exclusion continues to apply to commercial risks. This leaves the direct insurers with the choice of introducing the terrorism exclusion clause for all their commercial policies or accepting risks that cannot be reinsured.

One insurer commented that business interruption risks for commercial clients could be considerable and in certain circumstances would not now be covered by their reinsurance. It is particularly difficult to estimate the nature and extent of these risks.

Throughout the world insurers have been negotiating with governments about how terrorism risks can be met in future. It is understood that some European pools, including ones with government backing in France and Germany, have been set up to provide terrorism protection for insured property risks.¹³ The Association of British Insurers has been negotiating with the UK Government to get the coverage provide by Pool Re extended. Pool Re was set up in 1993 to give protection for material damage resulting from IRA terrorism activities. The big problem appears to be a need to extend the cover to include third party liability and employers liability.¹⁴

¹³ Liz Booth, Insurance Day, 4 June 2002

¹⁴ Jon Guy, Insurance Day, 4 June 2002

I understand that there have been discussions with the New Zealand Government concerning the possibility of setting up a terrorism pool here with Government participation. It is interesting to remember that until 1993, there was cover for war risks available for domestic and commercial property from the EQC, which was then called the Earthquake & War Damage Commission. As always the problems seem to be trying to assess the cost of the cover, how the risks can be fairly allocated and determining who will bear the cost in the long run.¹⁵

It may be noted that some cover can be obtained for terrorism risk in various markets. Nuclear, biological and chemical attacks are generally excluded. Other exclusions from ordinary policy coverage include cyber risks.

Other factors that affect NZ general insurers

Accounting standards

In New Zealand, the Financial Reporting Standard No. 35 (FRS 35) dealing with financial reporting of insurance activities came into effect for general purpose financial reports covering periods beginning on or after 1 July 1999. In passing, I note that there is some recognition of actuarial input to general insurance management in the reference made in paragraph 5.25 to "*reports from independent experts such as actuaries*" in regard to the estimation of outstanding claims liability.

In drawing up this standard, the Institute of Chartered Accountants drew on various overseas standards and reviews of overseas accounting professionals. However it may be noted that some further amendment to insurance reporting standards may be required in a few years time. For several years, the Steering Committee on Insurance Accounting of the International Accounting Standards Board (IASB) has been considering the possibility of introducing global insurance specific accounting standards. These are expected to be based on fair value measures. However, the question that must be resolved is whether a new standard would follow a US rules based approach, or the UK 'true and fair' principles approach.

The accounting standards require investments to be valued using net market values as at reporting date with any changes being recognised in the financial accounts as revenues or expenses in the reporting period in which the changes occur. This can create severe difficulties for companies reporting during a period when stock markets are volatile and asset values may have fallen considerably at the balance date. This applies particularly in territories with tight solvency requirements.

Legislation

As noted earlier, the Ministry of Economic Development has been reviewing the Insurance Companies Deposits Act and the Insurance Companies Rating and Inspections Act.

¹⁵ Catherine Beard, The Independent, 12 June 2002

The Society's General Insurance Committee made a submission to the Ministry on behalf of the Society. The Committee noted that the deposits required under that Act do not provide much in the way of protection to policyholders and indicated that a specific solvency standard for general insurers would be more appropriate. Proposals that all general insurers will be required to file audited accounts prepared on FRS35 basis and that ratings should be of financial strength rather than claims paying ability were supported.

The Minister of Commerce has said that it is intended that insurers will no longer have to lodge deposits under the Deposits Act and those already held by the Public trustee will be refunded. She also said that amendments will be introduced to require all non-life insurers, without exception, to seek and disclose annual ratings from approved ratings agencies. All insurers will be required to file annual financial statements complying with current financial reporting standards.¹⁶

Solvency standards

As previously indicated, the only solvency standard currently applicable to general insurers in New Zealand is the self-imposed 20% rule for Insurance Council members, as there are no legislative solvency standards applied. This contrasts with the situation in most other developed insurance markets. In the UK and Europe, risk based solvency regulations have been introduced.

The Australian Prudential Regulation Authority (APRA) has introduced new requirements under Prudential Standard GPS 210 as from 1 July 2002. These involve assessments of outstanding claims liabilities, including IBNRs, and premium liabilities, all on both net and gross of reinsurance bases in order that the effect of reinsurance can be correctly assessed and suitable provision made for possible failure of reinsurers. Actuarial calculations of a central estimate and a suitable risk margin relating to the inherent uncertainty in each of the central estimates, such that liabilities are expected to be secure at a 75% level of sufficiency are required. An extra assessment relating to the nature and matching of assets with liabilities is also necessary.

Although New Zealand does not have solvency regulations, most New Zealand general insurers have overseas parents who are subject to regulation. These subsidiaries have to produce accounts in formats consistent with the regulations applying to the parent company, and many now have to give attention to the requirements of overseas reserving standards. Several New Zealand insurers commented on the extra information that they now have to provide to their parent company to meet the requirements of the parent's regulatory authority.

However, it must be noted that failure of insurance companies cannot be eliminated by the existence of legislation and regulations relating to their operation. There have been many examples of insurers that have failed for a variety of reasons in markets subject to regulation.

¹⁶ Liane Dalziel, speech on 23 August 2002

Solvency regulations based on detailed calculations can result in relatively higher margin requirements for small portfolios of business. This can create problems for small insurance companies that cover assorted risks including those with potentially long tails or of other unusual nature, even where there is suitable reinsurance. Hence, there could be difficulties if such regulations were applied to some of the smaller New Zealand general insurers. Many of these must be regarded as very small in global terms, and some have solvency margins much lower than the generous levels previously noted for the leading New Zealand companies. It has been reported that a number of smaller Australian general insurance companies left the scene prior to 1 July 2002.

Overseas company activities

Overseas owned New Zealand companies can be subject to knock-on effects from severe events, such as September 11, on their parent or associated companies. Also of course, there can be decisions made by the parent companies that have significant effect. There have been a number of mergers and acquisitions in recent years. However, these have not usually had marked effect on the local policyholders or the rest of the New Zealand market.

The HIH collapse has created major problems in Australia, particularly for people requiring liability cover. HIH had secured a high market share in liability classes at low premium rates. The failure of this company left a hole in the market in an area that many insurers are wary of entering. Therefore Australians seeking liability insurance of any sort have had difficulty finding a replacement insurer and have faced significant premium increases. The effects of September 11, and the introduction of GPS 210, served to exaggerate the problems. HIH also had a New Zealand operation that closed. However, it does not seem to have been subject to financial problems. Most of the business was bought by QBE, and it appears that adequate funds are available for the remaining FAI claims being run off. Fortunately, the liability market here, although affected by the closure has not been disrupted to the same extent as that in Australia - probably because the existence of the ACC legislation makes the cover required from liability insurance very different from that in Australia (and elsewhere).

Management focus

Almost all insurers are listed companies, and so one objective of management is to maintain the share price. This usually translates into a need to obtain adequate and reasonably stable profitability. The results of a multinational group are affected by adverse experience in any part of its operations and so the New Zealand operations must perform consistently. It may be noted that the insurance sector has been out of favour in most investment markets for some time, due to poor returns and issues related to the new solvency standards.

During the later 1990s, it was possible for insurers to focus on premium growth and offset underwriting losses against investment profits. This had created the very competitive and extended 'soft' markets seen in that period. However, the combination of increasing costs, lower investment income and falling stock markets has meant that this is no longer possible. Once again it is realised that it is important to achieve an adequate level of underwriting profit

from each class of business. As noted earlier, insurers around the world are returning to basics and focusing on :

- getting adequate return on capital, and
- underwriting quality business at the right price.

This objective requires:

- underwriting based on understanding the details of each risk,
- strict application of suitable underwriting standards,
- regular, detailed management reporting on all aspects of the business,
- investment controls and
- appropriate risk management, including reinsurance protection for the company.

Effects on New Zealand policyholders of recent market developments

Commercial property

The class of business subject to most significant change has been commercial property.

With increased priority placed on the need to obtain full information about every risk being underwritten, it is now virtually impossible to obtain policies with blanket or open ended covers. Policyholders, or their brokers, are required to provide full details of the underwriting features of all properties to be covered - construction, occupation, protection and exposure. Cover is based on detailed schedules including limits on the value of contents at each site. Details are required for customer/supplier extensions and other associated covers, such as machinery breakdown, are subject to more stringent assessment than in recent years. One underwriter remarked that at last he was getting sufficient information for the premiums to match the actual sums at risk.

There appear to be significant variations in the level of premium increases imposed according to the type and location of the risk. The increases are driven largely by capacity. Smaller policies outside the major target aggregation zones have probably had increases over 2001/2 of 20-25%. However, as previously noted, all insurers have limits on the total amount of risk they will accept within aggregation zones for catastrophe losses. Underwriters are now expected to ensure that each risk provides its appropriate contribution to the cost of reinsurance. Even some good risks in target zones have had premium increases approaching 100%. Any policy with undesirable features, especially in a 'high risk' area such as Wellington city, are extremely difficult to place and may be charged very high premiums. Increases of the order of 300% or more have been reported, particularly where capacity issues are involved.¹⁷

¹⁷ Tom Cardy, The Evening Post, 23 April 2002

During the soft market underwriting attitudes have been relaxed and many large policyholders were not sharing their risks to suitable levels. Underwriters are now putting pressure on policyholders to accept reasonable levels of deductible, appropriate to both the size of the risk and the financial status of the client. The imposition of these higher level deductibles puts pressure on the policyholders to improve their own risk management. As insurers focus on return on capital and quality of business, it is clear that commercial clients must improve the quality of their risks or face even bigger premiums.

A further feature in the present market is an apparent reduction in the capacity available from leading underwriters. This has led to more covers for large commercial risks being placed using co-insurance by several insurers rather than through a lead underwriter backed by reinsurance. This may be the effect of the increased cost of arranging suitable reinsurance combined with the direct insurers revised underwriting limits within aggregation zones. As far as policyholders are concerned, placement of the cover has become more complex. When several co-insurers are required, the options of obtaining alternative competitive premium quotes are reduced.

Another factor of note is that overseas markets have also increased their rates very significantly. One underwriter indicated that local insurers were now being asked for quotes on some large risks that have previously been placed overseas.

Business interruption risks are affected by similar premium increases and capacity issues to those for material damage, but there are also other potential problems for both policyholders and insurers. Following the recent premium increases, some insurers have expressed doubts whether policyholders are purchasing sufficient cover to meet their actual needs. Insurers have difficulty assessing the nature and severity of possible loss situations, and the extent to which business interruption losses could aggregate throughout the country following a single large event.

It has been suggested that the significant increases in commercial property rates that have been imposed for large corporate risks (and to a lesser extent for smaller risks) has led to some insureds saying that they cannot afford increases in other classes of insurance, and to some clients deciding to self-insure or consider alternative risk transfer (ART) arrangements.

Liability

Many New Zealand insurers have indicated that they do not actively pursue this type of business and provide it merely as an accommodation, where necessary, to their preferred policyholders. Within New Zealand, it is a relatively small market consisting of a range of somewhat disparate covers. Until last year, it was regarded as very competitive and it is now appreciated that the insurers had been undercharging for the risks. I have been told that this was the largely the influence of HIH seeking high market share, with their rates being met by other insurers in this field. Unfortunately, liability claims tend to be low frequency/high severity and subject long settlement patterns, which delays the emergence of the actual risk costs and makes them difficult to assess and monitor.

Internationally liability insurers and reinsurers are tightening coverage and reducing capacity. Fortunately New Zealand has not seen the complications and difficulties that have arisen in the Australian market by the withdrawal of insurers from liability classes. Although the ACC makes many types of liability coverage less risky in New Zealand than elsewhere, there are other classes, such as directors' and officers' (D&O) and professional indemnity that are fairly standard. Perhaps, with the developments as regards accounting and auditing overseas, we may expect further difficulties to affect these classes of business here as well.

There is now much less competition as several insurers have recently withdrawn from the New Zealand liability market. It may be difficult for some clients to find a suitable D&O or professional indemnity insurer, particularly at a price that they regard as reasonable. There are expected to be extra information requirements by underwriters, increased excesses and reduced limits as well as tighter policy conditions and higher premiums. However, it was suggested to me that the rates for many risks would not rise above levels applicable about eight years ago, before competition brought the big reductions. Some queries have been raised as to whether policyholders buy appropriate levels of protection or merely what they believe they can afford.

Motor

The existence of ACC also distinguishes the New Zealand motor insurance market from similar markets in overseas countries. There is general agreement that the motor insurance market has been very 'soft' for a number of years.

Premium rates were already being adjusted during 2001, largely in relation to increases in the frequency and cost of claims. In some areas, the frequency of stolen vehicles has significantly increased. Also, the cost of spare parts is continually increasing, influenced by various economic factors affecting manufacturers and suppliers, and including the value of the New Zealand dollar.

Private motor rates have generally increased by 5% to 10% since early 2001, and further increases of similar order are likely over the next year or so. The commercial motor rating scene is less clear. Much of the business is experience rated. One insurer suggested that they would like to be able to review their rates for this business. Generally, increases are difficult to impose at present, except where there has been poor recent experience.

Domestic house and contents

As with the other classes of business this line had been subject to 'soft' premiums, but some premium increases in the range 3% to 5% were starting to come through early last year. The cost of claims has been rising. The sums insured are usually low enough that the individual risks are not directly affected by the major upheavals affecting the commercial market. However most insurers do need to consider aggregations in target areas subject to earthquake, storm or flood.

Policyholders appear to be receptive to premium increases at this time because of the publicity that has been given to the increases resulting from September 11 and the reinsurance market problems that have affected the other classes of business. Suggestions of possible premium increases of about 10% over the next year or two have been made. As usual, the insurers are monitoring their experience carefully for such factors as increased frequency of burglaries and potential fraudulent claims that can be expected during an economic downturn.

The future of the NZ general insurance market

There is general agreement that 2001 and 2002 have been difficult years for insurers and reinsurers. However, barring another extreme loss in the near future creating further disruption, things are expected to settle over a fairly short future period.

In the New Zealand market, as well as in overseas markets, increased premiums and careful underwriting will improve return on capital. Once stock markets stabilise, investment allocations and returns can be reassessed. It is anticipated that shareholders will require levels of return on equity rather higher than has been achieved in recent years.

Unfortunately most New Zealand insurers do not expect a situation in which they can focus on getting adequate return on capital and underwrite quality business at the right price to last for more than three years. Some indicated that they expect competitive elements to start affecting parts of the market before the end of 2003.

In markets subject to risk based solvency rules, the investment mix of insurers may be different from that of the past to limit the need for extra margins related to asset risk in addition to those required in relation to the underwriting risks. Also, it has been suggested that the mix of business offered by many insurers may alter, as higher risk/ long tail classes have become even more unattractive due to higher associated margins. These factors do not directly affect New Zealand insurers, but may influence the philosophy of their parent companies.

The capacity of the reinsurance market has expanded fairly rapidly over the last year. There are high return on equity targets set for much of the new capital. This factor has influenced the rate increases imposed for most types of reinsurance, despite the recovery in capacity available. However, some sources indicate that there is already evidence of over-capacity in some areas. We expect that the reinsurers will continue to require more detailed information on the risks that they are asked to cover. The new excesses and cover limits, together with the new treaty conditions introduced this year, are expected to continue - at least until competition bites and the next trough in the reinsurance cycle is reached. Opinions as to how soon this might occur vary widely. Some suggest that the reinsurance market will have turned by the end of 2003.

We might have expected that insurers would always have wanted to have full details of all risks that they cover, and so could be expected to continue enforcing the new information requirements from commercial clients. However, some insurers are pessimistic, and believe that large clients and their brokers will exert pressure to relax such requirements, once the market becomes competitive. They also expect that in time other underwriting standards will start to slip.

It has already been noted that many New Zealand insurers have been indirectly affected by the introduction of new solvency regulations overseas. It is expected that parent companies will require their subsidiary companies to provide accounting information in a consistent format in accordance with the regulatory requirements in future. It is likely that there will be an increase in actuarial involvement in assessing central estimate reserves and the risk margins required to achieve the desired levels of reserve adequacy.

All insurers monitor the experience of each class of business. To improve returns, more detailed investigations may be necessary. Insurers want to be able to identify the most profitable sectors within each class, so that sales and renewal efforts can be suitably targeted. The theoretical risk cost per unit covered allowing for the various combinations of rating factors can be assessed using standard actuarial methods. Then the profitability of various blocks of business can be compared, after adjustment for expenses and margins. However, to consider the overall profitability of competitive market rates, consideration must extend to capital management and asset/liability relationships. Sophisticated modelling techniques, such as dynamic financial analysis, can also assist in assessment of the most effective use of capital and reinsurance.

There are differing opinions as to whether or not the role of alternative risk transfer (ART) arrangements will increase over the next few years. Catastrophe bonds were invented in 1994, but still represent less than 1% of the reinsurance market.¹⁸ There are doubts that the market for them will grow significantly in the near future. It is unlikely that there will be any noticeable effect on business in New Zealand.

ART can also be utilised by large commercial entities. There are various captive insurance and pool arrangements in existence already. If the premium rates for commercial risks remain at high levels for a sustained period, more large companies may consider the viability of such alternatives. It is unlikely that many New Zealand companies standing alone would find ART appropriate, but multinational groups could set up worldwide arrangements and include their New Zealand subsidiaries.

If large policyholders in New Zealand maintain their insurance protection, they will wish to ensure that the most cost-effective cover is obtained. The insurance companies will have to be prepared to negotiate the levels of self-insurance appropriate to each entity as well as premiums for the coverage to be provided. This will enable extra encouragement to be given to the policyholders to improve their own risk management practices.

¹⁸ The Economist, 9 March 2002

There seems to be general agreement that there will be a reduction in the number of insurance companies operating in New Zealand over the next few years. This may tend to be mostly through the closure of small insurers, although some further merger and acquisition activity can also be expected.

In conclusion, I anticipate that the future for general insurers will be ever more demanding for general insurers than the past. However, the use of better analysis should mean that the industry is in a good position to satisfy the needs of the market.

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