

**The General Insurance Market in New Zealand -
Developments since 2002**

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1. Introduction

1.1 Background

Four years ago, at the Society conference in Rotorua, I presented a paper in which I discussed the state of the New Zealand general insurance market in 2002, with some comments on the insurance cycle, and the effects of September 11. In this paper, I look at developments since then and how the future looks now in comparison to the possible courses for the future suggested by market participants in 2002.

Last time, I noted that the general insurance market had been evolving continuously since it began to meet challenges that have arisen from inside and from outside the industry, including reacting to the effects of local and global factors. In 2002, a major topic was the impact of the events of September 2001, with the President of the Insurance Council of New Zealand (ICNZ) quoted as saying that those events would “...define much of the insurance thinking and planning for decades to come”.¹ Nowadays, more prominence is given to problems related to global warming and/or changing weather patterns. The ICNZ holds an annual general insurance financial management seminar, and this year the title was ‘A Gathering Storm – issues confronting insurers’. Chris Ryan, Chief Executive of the ICNZ, said a few months ago that “*It’s the insurer’s job to calculate risk and the feeling is that after this winter the risks are much higher. We’re getting climate change – or at least more volatile weather and we haven’t faced up to the risks of where we live.*”² Bad weather certainly creates problems for many insurers, particularly in New Zealand, although it may be noted that, despite the damage done by Hurricane Katrina, American ‘*company executives are more concerned about terrorism than about weather-related risks*’.³

However, these major topics of discussion form only a part of the overall picture that represents the current state of the market. More general and on-going issues continue to have very significant effect on management focus and strategies. Analysis shows that there have been a number of important underlying changes affecting the New Zealand general insurance market in recent years.

1.2 Sources and acknowledgements

As last time, I have tried to provide here an overview of the market over the past few years, including aspects of management thinking and planning within insurance companies, indicating the nature of the prime drivers of recent changes and where the industry is heading. I have drawn on published material from New Zealand and from overseas sources for background information. To present a broad view of the market situation, I have had discussions with New Zealand insurance company underwriters and managers, as well as brokers and other key people associated with this business, and I wish to thank those people who assisted me in that way. I have also been allowed to refer to some of the industry data collected by the Insurance Council of New Zealand, and I wish to thank the Chief Executive of the ICNZ for giving me permission to do this.

¹ President’s report in Insurance Council Review 2002

² Chris Ryan as quoted by Matt Philp in the Dominion Post 26 August 2006

³ Survey by the Economist Intelligence Unit, reported in The Economist 14 October 2006

Since some aspects of discussions and of the data available relate to commercially sensitive matters, all company specific information has been treated as confidential.

Whilst acknowledging the input and assistance from others, including my colleague Neil Christie, I point out that the views expressed are my own, as are any errors in facts or interpretations. Indeed, at some points I have tried to put forward some more provocative opinions to stir up debate of some important topics.

2. The NZ general insurance market - where it was in 2002?

2.1 Insurers' objectives

Most of the large general insurers in the NZ market are listed companies, although there are some notable participants of other types, including mutuals. It is reasonable to assume that, regardless of constitution, one major objective of all insurance managements is to obtain adequate and reasonably stable profitability. This is considered to be particularly important where there is a need to maintain the share price of a listed company, but it is also essential in the long term to the continued operation and development of all insurers. Objectives may be expressed in various ways, including setting targets for different divisions or managers within entities in terms of growth of premium income, underwriting profit, after tax profit or return on capital.

2.2 Market focus in 2002

It was expected that once stock markets stabilised after the 9/11 shock, investment allocations would be reassessed. It was anticipated that shareholders would require levels of return on equity rather higher than had been achieved by insurers in prior years. In 2002 it was noted that increasing costs, lower investment income and falling stock markets had increased the importance of achieving an adequate level of underwriting profit from each class of business. To this end, insurance management and the underwriters reported strong support for a return to basics:

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

Unhappily, even the most optimistic New Zealand underwriters did not expect an environment in which they could 'focus on the basics' to last for more than two or three years.

2.3 Other factors

Some New Zealand insurance managers commented in 2002 that the expected course of development of international accounting standards and associated requirements for greater disclosure would tend to place further emphasis on following conservative management principles. Also, it was noted that the Ministry of Economic Development was reviewing the regulation of insurers and that this could lead to minimum solvency and other requirements that would affect management attitudes.

3. Where was the market expected to go from 2002?

3.1 General comments

The importance of earning underwriting profit in order to achieve an adequate return on capital had been emphasised by the lower investment income obtained and the falling stock markets in the period 2001/2002. (New Zealand general insurers are rather atypical, as the relatively short term nature of the business here has meant that volumes of equity holding are generally small. However, extra pressure was placed on overseas insurers and reinsurers by the changed investment environment combined with risk based solvency rules to which they were subject, causing them to review their investment portfolios.)

3.2 Commercial lines

By late 2002, the consensus view seemed to be that the New Zealand commercial insurance market had moved out of a period of strong competition and underwriters of commercial risks expected to be able to make reasonable profits over the next year or two. This was to some extent based on the knock-on effects from factors relating to international markets enabling the underwriters to insist on being given extensive information about each risk and then impose significant premium increases levels and/or tighter conditions. Also, in many cases where it was felt that large policyholders were not sharing their risks as they should, suitable and higher deductibles/excesses appropriate to each risk had been negotiated. Indeed, some large or unusual risks had been difficult to place, and it was suggested that some policyholders were cutting back on the amount of cover purchased, saying they could not afford it because of the increased cost. The situation was not as clear for experience rated business, such as commercial motor, but some small improvements were expected nevertheless.

3.3 Personal lines

The situation for personal lines business was not quite as optimistic. By 2002, this business had experienced several years of a 'soft' market. Premium rates were increasing, but the level of increments tended to be small and varied between products and insurers. However, some problem areas had been identified, in particular increasing frequencies for some types of claims and the potential for increasing costs associated with NZ dollar movements.

3.4 Other matters

It was noted in 2002 that most insurers had had to reassess their reinsurance options in order to match their needs at a reasonable cost. Aggregations of exposure in target areas subject to earthquake, storm or flood were being closely monitored. There was general agreement that, barring another extreme loss in the near future creating further disruption, global insurance markets would settle down over a fairly short period.

A final comment in my previous paper was to the effect that there seemed to be general agreement that there would be a reduction in the number of insurance companies operating in New Zealand within a few years. It was expected that this would be mostly through the closure of small insurers, although there could be some merger and acquisition activity as well.

4. Effects of global insurance and reinsurance markets on NZ insurers.

4.1 General comments

Global markets affect New Zealand insurers in various ways. Most obviously, local insurers look to global reinsurers to give them protection against unusually large losses. This allows local coverage of large or unusual risks and of risks in vulnerable locations, which would otherwise be difficult to place without affordable support.

It may be noted that the larger local risks look not only at the local market for their insurance needs, but are also able and willing to arrange cover off shore, if it is available on more advantageous terms. As well, some large risks or groups of associated risks may withdraw from the direct insurance market and operate a captive insurer or pool, if suitable reinsurance support is available at good terms.

4.2 Reinsurance capital and market capacity

In 2002, the flow-on effects of 9/11 and revised solvency requirements initially created a period in which the capacity of the global reinsurance market was limited. This led to tightening of terms and conditions, and hence markets around the world 'hardened'. As expected, a considerable volume of new capital then entered the reinsurance market, subject to requiring relatively high return on equity targets. Due to the effect of tightened solvency regulation on asset allocations, when stock market values rose there was not as much effect on the asset values and capacity of the larger reinsurers as might have been the case previously. Even so, the pressures on capacity eased and 'softened' that market for a while.

However, in recent years there has been a series of large weather events causing significant losses in many parts of the world. Most notably the 2005 hurricane season in US included Hurricane Katrina, which is estimated to have cost at least US \$45 billion, and Hurricanes Rita and Wilma, with estimated insurance cost of about \$10 billion each.⁴ In Australasia, Cyclone Larry hit North Queensland in March this year causing about A\$250 million in insurance claims. It destroyed most of Queensland's avocado crop as well as 80% of Australia's banana crop.⁵

The global reinsurance market for property insurance is currently relatively 'hard'. Tougher capital requirements from regulators and rating agencies have affected catastrophe reinsurers and led to premium increases, particularly in America this year. More capital entered the market after 9/11, but it has been estimated that despite the outflows of capital last year '*only \$20 billion to \$30 billion of new money flowed in*'⁶. This situation, and the possibilities for high returns, has contributed to a growth in alternative funding arrangements including catastrophe bonds and the recent entry of new reinsurers owned by hedge funds.

⁴ Risk and Insurance Review, Willis Q2 2006

⁵ National Geographic News, 21 March 2006

⁶ Barney Schauble, of Nephila Capital quoted in Balmy in Bermuda, The Economist, 14 October 2006

4.3 New Zealand factors

The New Zealand general insurance market offers reinsurers some diversification of risk, globally and by type of exposure, but the market is small and so has a small premium base. Also, it is recognised that there is significant catastrophe risk and there is concern expressed at times in some quarters about the concentration of risks in earthquake prone areas. As well, there have been some severe weather events here in recent years, some of which have involved significant reinsurance claims. These include the Manawatu floods in February 2004 that cost insurers a total of about \$115 million, and the Bay of Plenty floods in May 2005 that cost over \$25 million.⁷ Climate change is regarded by many as likely to be the cause of much greater frequency of severe weather events causing larger insurance losses in future years.

Other classes of business, such as liability, have also suffered large claims in some areas, creating fears that similar or related claims could become widespread and so lead to reviews of cover available globally. In particular, there have been a number of high profile professional indemnity cases, as well as ongoing 'asbestos claim' problems overseas. In New Zealand, the arguments over responsibility for 'leaky homes' are still being worked through, leading to some uncertainty for insurers.

4.4 Recent reinsurance terms

For obvious commercial reasons, managers are reluctant to discuss details of their reinsurance negotiations, and therefore I have limited information in this area. Most New Zealand general insurance managers have reviewed their reinsurance requirements in recent years. 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.

Underwriters have re-assessed the expected frequency and severity of major losses, their exposure to aggregation of risks and the rates in the market for various types of reinsurance cover and combinations of retentions and limits. There were a number of changes made at the 2002 reinsurance renewals. Since then, it seems likely that most insurers have kept their retentions at those levels, or perhaps slightly increased them.

As noted above, the property reinsurance market is currently relatively 'hard'. For treaties involving significant amounts of capacity, the rates were very high in 2002 following 9/11, and then slowly reduced somewhat. The rates have now hardened again and it seems unlikely that the levels enjoyed prior to 9/11 will be seen for some time. As one would expect, the rates for most treaties are dependent on the perceived quality of the business being placed. Those insurers who can demonstrate good market practices and provide accurate and detailed information on the risks to be covered can usually negotiate more favourable terms. However, some insurers have found the market remains expensive for some types of treaty, for example facultative cover for individual risks or for high level excess of loss cover,. The exchange commission on proportional treaties remains at a relatively low level (compared to that which used to be available), despite higher original premium rates being charged, so that such treaties have become more expensive.

⁷ ICNZ website, Current Issues, Cost of Weather claims, September 2005

5. Other factors that affect NZ general insurers

5.1 Accounting standards

For several years, the Steering Committee on Insurance Accounting of the International Accounting Standards Board (IASB) has been considering the possibility of introducing global accounting standards. This has now progressed and Phase 1 changes have been introduced.

Many more changes that will affect general insurers have been deferred to Phase 2, in part because Americans and Europeans currently deal with some issues in different ways and there is difficulty getting agreement on a standard approach in those matters. It is anticipated that the discussion document for Phase 2 will be circulated at the end of March 2007. The date of application of the associated new accounting standards is unlikely to be before 2009.

The Australians are hopeful that the measures required under new IFRS standards will follow the approaches that have been (or are being) developed by APRA and the Institute of Actuaries of Australia. If so, liabilities will be given as central estimate values, with allowance for discounting and appropriate risk margins. Already companies are required to provide considerable information in notes to their financial statements and it must be expected that Phase 2 will require even more detail to be shown.

5.2 NZ dollar exchange rates and interest rates

The NZ dollar was very low (at times below US 40 cents) in 2000 and 2001, but it then strengthened steadily (supported by relatively high NZ interest rates and against a weakening US dollar) and it was over US 70 cents for a short time during 2005.⁸ Although the NZ dollar fell back towards US 60 cents and below A 80 cents early this year, it has risen again since then as NZ interest rates here have stayed relatively high. The higher NZ dollar creates problems in some areas, but does tend to hold the cost of some insurance claims down. To this extent, the rise in the dollar as well as in interest rates in recent years may have helped improve some results for insurers.

There is a significant time lag after a change in the exchange rate before it is reflected in the cost of claims. If the exchange rate should drop during the next year, even those replacement items and spare parts for repairs that are imported can, for a period, be sourced from stocks or second hand supplies at better prices than will eventually apply.

5.3 Legislation

The Ministry of Economic Development (MED) is carrying out an extensive review of all insurance legislation. It is clear that the present regulation, comprising the Insurance Companies Deposits Act and the Insurance Companies Rating and Inspections Act, will be replaced by more stringent requirements.

⁸ Key graphs –exchange rate, Reserve Bank, October 2006

The MED has released a discussion document *Review of Financial Products and Providers: Insurance* dated September 2006. The Society's General Insurance Committee, along with the other practice committees of the Society, is reviewing that document. It is expected that the Society will make a detailed submission to the Ministry. It is not my intention to discuss in any depth here the proposals and options presented in. However, the matters it raises will have significant effects on aspects of the New Zealand insurance market.

Some of the more important of the proposals and options in the discussion document that will affect general insurers are:

- an insurer must register as a financial services provider of insurance,
- to obtain a licence, an insurer must have a physical presence in New Zealand and provide products in New Zealand,
- the introduction of an enhanced solvency regime,
- a requirement that insurers prepare a financial condition report with attestation by the directors that this has been done,
- possible requirement for accounting separation rules for life, general and health insurance, with segregation of funds and perhaps other conditions being imposed,
- possible mandatory requirement for a rating, although the value of ratings is debated and alternatives include voluntary rating or exemptions for some (generally small, niche) insurers,
- possible introduction of director attestation regarding risk management strategy, and
- mandatory annual audited financial reporting (in accordance with the Financial Reporting Act) by all insurers, with unaudited half-yearly reports.

In contrast to the situation in most other developed insurance markets, New Zealand does not have statutory solvency regulations. 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%. However, most New Zealand general insurers have overseas parents subject to regulation. The 'Enhanced solvency requirement' proposals in the discussion document appear to reflect recent developments overseas towards risk based solvency regimes. The discussion document states that '*As the calculations used to assess the solvency position and determine the necessary levels of reserving are highly technical, actuarial input and independent review in this area are essential.*'⁹ There is an expectation that the Society will provide significant input to the development of an appropriate solvency regime and standards to support it.

Not unnaturally, New Zealand insurers are concerned that new regulations will greatly increase the burden of compliance placed on them. Also, several companies already have to compile a significant volume of information for an overseas parent company in order that it can meet the requirements of the parent's regulatory authority. If new legislation requires data to be filed in a somewhat different format, this will be time consuming and expensive.

⁹ Paragraph 164, *Review of Financial Products and Providers: Insurance*, MED, September 2006

5.4 Problems for small insurers

It has been argued that the cost of obtaining a rating is high for many of the small New Zealand insurers, many of which operate in niche markets. The discussion document includes the option of allowing some exemptions from a mandatory requirement for rating. However, it is not clear how this system would operate in practice. Also, it may be noted that risk based solvency regulations can result in relatively higher margin requirements for small portfolios of business. This could create problems for small insurance companies that cover assorted risks including long tail or other unusual business, even where there is suitable reinsurance. Many of these insurers must be regarded as very small in global terms, and some have solvency margins lower than the levels held by most New Zealand insurers. The new proposals could lead to the closure of small insurers, as happened prior to the new APRA regulations coming into force in Australia.

5.5 Comments on effectiveness of regulation

Finally, 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, including numerous companies that have failed in USA and UK. In Australia, HIH failed despite being subject to APRA supervision, prompting changes to APRA regulations. It could be said that strict regulation:

- is unnecessary for large well-run companies that use good management practices to ensure their own futures anyway,
- can be helpful to guide smaller companies and those with less experience of insurance management, particularly when the business environment creates difficult trading conditions,
- may not be enough to save the inexperienced who do not recognise their problems, particularly if there is not sufficient experienced analysis of returns made to the regulator and an ability to ensure appropriate and timely action should potential problems be identified, and
- will almost certainly not be enough to eliminate the possibility that clever individuals bent on fraud could appear to satisfy the regulatory requirements for a sufficient period to create significant problems when the true situation is discovered (however that may occur).

6. The NZ general insurance market since 2002

6.1 Size of the market

The latest published figures¹⁰ for ICNZ members show total Gross Written Premiums (GWP) and Gross Incurred Claims (for all classes of business) for the years ended 30 September as below:

Year	Gross Written Premiums \$m	Gross Incurred Claims \$m
2002	2,323	1,340
2003	2,689	1,392
2004	2,873	1,612
2005	2,992	1,639

This table gives an idea of the size (comparatively small in global terms) of the New Zealand general insurance market. However, it should be noted that not all general insurers operating in New Zealand belong to the ICNZ, although in premium terms over 90% of the market is represented. Unfortunately the September figures were not yet available when I was writing this. Strict comparisons between years can be misleading as from time to time insurers have left or joined the ICNZ. In addition, reporting of claims on an incurred basis can be misleading, due to practices regarding claims provisions.

The table indicates written premium growth was almost 16% in the year to September 2003 but has been only 7% and 4% in the next two years. This implies that there has been little actual market growth after allowing for premium rate changes and growth of sums insured related to inflationary increases.

Making comparisons with the published accounts of leading companies is complicated by the different financial year ends and various financial structures as well as mergers and acquisitions. However, not unexpectedly, it appears that the industry pattern only broadly reflects the experience of individual companies. The results for individual companies differ for a number of reasons, including the areas of the market in which they operate, changes in their mix of business and perhaps changes in product conditions or changes to reinsurance arrangements affecting their gross acceptances, as well as effects relating to acquisitions or associated companies.

6.2 Industry results by class of business

The ICNZ collects data from its member insurers on a quarterly basis. For obvious reasons of confidentiality in a highly competitive business, results and trends are discussed here in terms of industry, and no details or comments relate to any individual company.

Although quarterly returns to the ICNZ include amounts and numbers of claims by class of business, comparisons between quarters can be difficult. The only measure of exposure is earned premiums. This means that frequency of claim can be distorted by change in volume of business, mix of cover within a class, or by changes in premium rates.

¹⁰ The Annual Insurance Industry Review 2005-06, www.icnz.org.nz

Claim amounts are incurred claim figures and so may be distorted by timing of claim notification, and over or under estimation or adjustments prior to final settlement. Also, there have been some changes in claims recording practices by some insurers that may have caused distortions in the figures. Some further problems arise in relation to reinsurance, particularly aggregate reinsurance arrangements.

When trying to assess levels of underwriting results, it is necessary to consider the levels of exposure, premiums received and the frequency and cost of claims incurred by class of business. However, the other components in the profit calculation are expenses. In published data and even in many management accounts, there are large amounts of expenses incurred by an insurer that are not allocated to specific blocks of business. In order to assess profitability, overhead costs must be taken into account and adequately covered, and expense analyses may be used to assess a reasonable allocation of most costs. It is well known that some categories of business can be more expensive to operate than others. Expenses in the range of 20% to 30% of written premiums for personal lines and 30% to 40% for commercial lines may be expected, although there can be considerable variation between products and between insurers. Appropriate levels of expenses must be born in mind when assessing what level of loss ratio is a suitable target level for each class of business in the following discussions of claims experience.

6.3 Commercial Material damage

As noted earlier, in 2000/2001 the Material damage market was very competitive, underwriting attitudes had been relaxed and in many cases brokers had been able to negotiate placement of risks with somewhat limited background details or updating of information. Gross incurred loss ratios for each quarter were generally in the range 55% to 65%. The environment changed at the end of 2001. During 2002, underwriters were able to apply high standards and review their risk portfolios. Policyholders, or their brokers, had to provide full details of the underwriting features of all properties to be covered and more information regarding any customer/supplier extensions and other associated covers. Premium increases were driven to a large extent by capacity, as underwriters sought to ensure that each risk provided its appropriate contribution to the increased cost of reinsurance. Overall premium increases of the order of 25% were applied, although increases of over 100% were not unusual for some types of risks in some places.

As a result of these premium increases, the industry gross incurred loss ratio (GLR) dropped steadily from over 60% in the June 2002 quarter to below 40% for the September 2003 quarter. Later results have been more volatile, with a high of 67% in March 2004 (associated with the Manawatu floods) and an apparent low in December 2005 (almost certainly distorted by some revision of estimates). In the June 2006 quarter the GLR rose above 60%, perhaps the first indication of the effect of greater competition for business.

Changes in industry net loss ratios (NLR) have been less marked. The industry average for the proportion of premiums ceded has varied slightly over the period since 2002, but is now about 40%. The increased costs of reinsurance at renewals in 2002 may have contributed to a jump in the industry NLR, which had been at about 65% through 2001, to above 80% for the first three quarters of 2002. It dropped back to an underlying level of around 60% for most of 2003, 2004 and 2005, but with the 'Manawatu' hiccup in the first half of 2004.

After being comparatively low for the December 2005 and March 2006 quarters, the NLR rose above 80% in the June 2006 quarter, a level not usually seen except when there have been major loss events or in a 'soft' market.

It was noted in 2002 that there had been an apparent reduction in the capacity available from underwriters leading to large commercial risks being placed using co-insurance by several insurers rather than through a single underwriter backed by reinsurance. This might have caused a small increase in claim numbers reported, but not to any significant extent. Also noted were increases in the deductibles under many policies particularly for larger insureds, and this is likely to have led to some reduction in claim numbers. Examination of the figures indicates that numbers of claims were actually comparatively low through 2003, 2004 (except for the March quarter) and 2005, but that claim numbers have now risen back to levels seen in earlier years.

Average gross claim size shows a volatile pattern with an underlying increasing trend. The situation is confused by changing levels of deductibles. It is difficult to gauge the effects of these on average claim sizes without a detailed analysis. The average net claim size also shows fluctuations. Overall, there may have been an increase in both gross and net average claims of about 25% over the last few years.

I have been told that large clients and brokers expect to be able to negotiate significantly improved terms for renewals at present, particularly if they can show recent good experience. Another factor of note is that overseas markets have not yet 'softened' to the extent seen locally. Some years ago many of the larger local risks were placed offshore, but much of this business returned when the overseas markets hardened. The current environment is helping to retain these risks in the local market.

6.4 Business interruption

Similar premium and capacity issues to those affecting Material damage affect Business interruption risks. In 2002 it was suggested that premium increases had led to some policyholders purchasing insufficient cover to meet their actual needs. It is difficult to tell from the claim figures if this was the case. The premiums written in 2003 showed a big increase over 2002, but there was a significant reduction the following year that has been maintained since then.

In general, the experience of Business interruption may be expected to follow that of Material damage, but the results are extremely volatile (as expected for a class with relatively few claims, often of high amounts) and underlying patterns are difficult to discern. There have been several peaks in the industry figures for claims experience in recent years, although these appear to be affected by amounts and timing of adjustments to provisions and reinsurance recoveries.

6.5 Liability

This is a relatively small market consisting of a range of somewhat disparate covers. Liability claims tend to be low frequency/high severity and subject to long settlement patterns, which delay the emergence of the actual risk costs and makes them difficult to assess and monitor. This feature also means that policy wordings and reinsurance are very important. Almost all policies are on a 'claims made' basis rather than the 'occurrence' basis.

The Accident Compensation Commission (ACC) makes many types of liability coverage less risky for insurers in New Zealand than in other countries. Other classes, such as Directors' and Officers' (D&O) and Professional indemnity, are similar to those elsewhere.

Few New Zealand insurers actively pursue this category of business. In 2002 there was little competition between those insurers and the market was 'hard'. Most underwriters considered that they were applying good principles in writing the business.

The loss ratios for many of the types of liability business are very low, although there is no knowing whether New Zealand behaviour and attitudes could change in future causing a sudden rise in claims experience for classes such as, for example, Directors' and Officers' or Medical Malpractice. Professional Indemnity has had some poor experience. The 'leaky homes' problem continues to cause concern, as there is a backlog in assessment of damages and allocation of responsibility, and as more claims are still being made by homeowners. There have also been other difficult claims for insurers that have caused claim spikes in their own figures and affected the overall industry liability experience.

Most insurers have reviewed the coverage provided under each type of liability policy and the underwriters have become more aware of potential problem areas of risk. However, it is difficult to predict the sources of the next generation of problem claims - otherwise risk management could be applied to reduce or eliminate them!

Competition for liability business has increased during 2006. In 2002, it was suggested that the rates for many risks would not rise above levels applicable in the last 'hard' market of the mid 1990s, before competition brought about reductions in premiums. It seems that this has come true as, despite the comments made above about some sectors of this business, some clients can now negotiate significantly lower premiums and/or higher levels of cover than they could obtain previously.

6.6 Commercial Motor

The existence of ACC also distinguishes the New Zealand motor insurance market from such markets in overseas countries. There was an impression that the commercial motor insurance market might be starting to harden in 2002, although the extent to which this could lead to increased premiums was limited by the use of experience rating.

The average net loss ratio had been around 80% since 1999, and has since dropped to be in the range 65% to 75%. This appears to be the result of slightly fewer claims and costs being held or only slightly increased. I have been told that the cost of repairs has increased somewhat, but the effects of the lower NZ dollar are yet to be felt fully in the cost of spare parts. Labour costs have apparently not increased very much lately, but may be expected to do so at a greater rate in the next year or two.

It now seems that, as for other commercial classes, competition has increased for this business during 2006. Are adjustments being made to the factors in the rating formula to retain large customers?

6.7 Other commercial classes

There are other classes of commercial business. These are included in the ICNZ returns, but volumes are relatively low and there is some lack of homogeneity within the sub-categories of business. Not unexpectedly, brief analysis of the results does not yield much insight to the recent experience of these classes.

6.8 Domestic house and contents

In 2002, it was noted that this business had been relatively 'soft', but policyholders appeared to be receptive to premium increases because of the publicity that has been given to the increases resulting from September 11 and the reinsurance market problems. Suggestions of possible premium increases of about 10% over the next year or two were made. It was feared that the frequency of burglaries was increasing. Also, greater controls were being introduced to monitor claims carefully to limit the potential for fraudulent claims.

In fact, premiums written appear to have risen by more than 25% for Buildings and by about 20% for Contents since 2002. However, this does not necessarily indicate a significant increase in premium rates, if policyholders have taken inflation into account and reviewed their sums insured.

The underlying frequency of 'normal' domestic claims appears to have remained fairly steady. However, there can be considerable variation in overall frequency of claims, particularly for Domestic Buildings, as high numbers occur at times usually reflecting the occurrence of a severe weather event. In general, claims costs appear to reflect increasing values of items covered. Perhaps, in view of the increases in house prices and building costs, it is not surprising that the average gross cost per claim for Domestic Buildings has increased greatly over the last 3 or 4 years, possibly by as much as 40%.

The increase in average claim cost for Contents appears to have been about 15% over the last 3 years, still rather greater than the general level of inflation. The industry loss ratio has crept up from being generally in the mid-sixties to over 70%.

Although the sums insured on individual household risks are usually relatively low, it has already been noted that most insurers need to consider aggregations in target areas subject to earthquake, storm or flood. Weather events have been the cause of significant fluctuations in the overall level of industry GLR in recent years. However, there should be considerable cause for concern in that the underlying loss ratio for Domestic Buildings appears to have risen from around 70% as seen in periods to June 2003, to around 80% in more recent quarters, with the spikes going well above this level. The severe weather in the Bay of Plenty, and particularly in Matata, resulted in a record high (in recent years anyway) for the industry NLR of almost 120% in the June 2005 quarter. (Reinsurance had had a more significant effect on the overall result for this class in the March 2004 quarter.) The June 2006 quarter was also very tough, there being a number of storm events in that period, resulting in an overall NLR of 115%.

It might be feared that experience could deteriorate even further if the economy starts to turn downwards in the next year or two.

6.9 Private Motor

This class generally has fairly stable results. The 2004 year appears to have been better than average for the industry, but the trend in loss ratios over recent periods indicates that outcomes are slipping back towards the levels of four years ago.

Private motor rates appear to have generally increased on average by almost 5% per annum since early 2001, and further increases of similar order seem likely over the next year or so.

The statistics indicate that frequency of claim has probably decreased over the last 4 years, and certainly the frequency per \$1000 premium has dropped. However, this feature could be due in part to some changes in claims recording by one or more companies. The calculation of average cost per claim depends on the numbers of claims, but almost certainly there have been sizeable increases in cost, possibly by up to 8% per annum. This is most likely linked to changes in the mix of vehicles in the New Zealand motor fleet.

6.10 Pleasurecraft

A grand example of seasonal results! For many years, it has been the March quarter that has had the 'high' loss ratio (usually the industry average is over 80% for this quarter, although there is a wide range of variation between companies and it may be expected that at least one company will suffer a loss ratio over 100% in the March quarter). Loss ratios in the September quarter are always 'low', often below 40%. Not surprisingly, analysis of frequency of claims and average cost per claim shows that the March quarter has more claims, and they tend to be more expensive as well.

6.11 Travel

Not unexpectedly, this business is also seasonal. The earned premiums are generally higher for the June and September quarters than for the December and March quarters. The average cost per claim is also significantly higher for those two quarters. One might associate this with people taking longer overseas trips during the Northern hemisphere summer. However, it is perhaps less obvious why the frequency of claims appears to have been consistently highest in the December quarter.

To some extent, the public is steered towards particular travel insurance policies by their travel agent. Over recent years, there has been more competition and advertising to attract individual clients. Also, we understand that some large blocks of travel business have moved between underwriters. Patterns are not clear, but perhaps it is surprising that despite the competition the industry net loss ratios seems to have fallen from generally around 70% (allowing for seasonal variances) before 2002, to below 60% now. It is noted that insurers have to closely monitor travel business for problem claims.

7. Disaster management

7.1 General comments

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. Many insurers, brokers and reinsurers, and some actuaries, have their own models to project losses that could be suffered in a major event.

Scientific research into such matters as earthquakes and weather is continually developing. Other natural hazards that could cause considerable damage in New Zealand are volcanic eruptions and tsunamis, whether following a distant earthquake and travelling across the ocean, or a large event off the New Zealand coast. These hazards are assumed to have extremely low frequency, but losses could be very costly. The extent of cover given by private insurers may be limited, but should be reviewed and taken into consideration by underwriters.

An earthquake can be highly destructive over a wide area and so this peril tends to be the most important in deciding on the extent of cover required and in the cost of the upper levels of catastrophe or reinsurance. Because of the Earthquake Commission (EQC), private insurance market losses from an earthquake affecting an urban area are likely to be greater in the commercial classes. There have been recent suggestions that the limits on cover provided on dwellings (and contents) by the EQC may be reviewed upwards. Any increase in EQC cover, which is on a first loss basis, would reduce the amount of extra earthquake cover on Domestic Building risks in the private insurance market.

All insurers, and particularly those with large domestic business portfolios must also assess the possibility of significant losses resulting from severe adverse weather in various parts of the country.

7.2 Severe Weather

There are fears that severe weather events in New Zealand are becoming more frequent, possibly related to global climate changes. This means that assumptions must be reviewed to update the approaches used in when setting premiums and perhaps applying limits to risks that can be underwritten in certain areas. It is important that premiums allow for the expected frequency and cost from all underlying risks, and so they must include adequate provision for the cost (in retained claims and for reinsurance) of 'unusual' events that occur with less predictable frequency and severity. As commented earlier, it may be that the formulae used in calculating the premiums currently being charged for Domestic Building cover by some insurers underestimate the 'catastrophe' risk in many parts of the country. In some very vulnerable areas, a more drastic response would be to stop providing full cover for some properties, particularly those that have suffered repeated damage.

7.3 Demand surge

There is an extra factor to consider when insurance is provided against events that can affect many policyholders simultaneously, perhaps over a very wide area. In estimating the claim costs, some allowance must be made for 'demand surge'. It appears that there are frequently significant extra costs involved in getting timely repairs carried out following a large event, as supplies of labour and materials are in short supply, when compared to the much increased level of demand in the affected area.

7.4 Terrorism

As I noted at the start of this paper, in 2002 there was much concern about the potential for losses from terrorist activity. There were discussions between insurance industry representatives and the New Zealand Government concerning the possibility of setting up a terrorism pool with government participation. However, there were problems in trying to assess the cost of the cover, how the risks could be fairly allocated and who would bear the cost in the long run. I have heard little about the proposals since 2002, and wonder if the lack of apparent terrorist activity meant that the subject just dropped out of active consideration. In many parts of the world terrorism still presents real danger, and some cover can be obtained (at fairly high cost) for terrorism risk in various overseas markets.

8. The future of the NZ general insurance market

8.1 Return on equity

It was reported in 2002 that managers were focusing on achieving a good return on equity, and in the face of uncertain levels of investment return would be looking for underwriting profit. The figures for return on equity can be derived from the published financial statements for most insurers, although the corporate structures of some large New Zealand general insurers are such that this information is not available. Also, for some companies the calculations are complicated in recent years by changing corporate structures. It does appear that in most cases results improved significantly from 2001 to 2004. (For example, looking at their financial statements for years ending in 2001 and 2004, one company's return on equity increased from 9% to 17%, and for another it increased from 10% to 33%). However, it seems that there was little further improvement in results for most companies in 2005, and 2006 is likely to be no better.

8.2 Changing focus

Some commercial lines underwriters have suggested that management focus has shifted away from 'quality underwriting' (assessment of each risk and underwriting at the 'right' price, which meant that some risks were hard to place), to market share and premium growth. There does not seem to be scope for much real expansion in the NZ general insurance market, which is fairly mature, although there has been recent growth in property values. Brokers report that competition means that commercial risks with good recent claims history can expect to be able to negotiate significant premium reductions. If there is pressure to increase market share, and the good risks must be offered premium reductions to stay, what is competition likely to achieve in regard to standards of underwriting for other risks?

For some specialist classes of business, claims are infrequent but can be very costly, and so attempting to increase market share in these areas without exposure to unnecessary extra risk requires considerable underwriting skill and judgement, and perhaps in regard to future experience an element of luck too. Overall, it seems highly probable that underwriting profits will be adversely affected over the next few years by this change in focus.

The underlying cost of claims under householders' policies has been growing steadily. If the values of properties and items insured are increasing, this should be reflected in higher sums insured and so in premiums payable. If premium rate increases are required as well, will it be possible to impose such increases in a competitive market? Each insurer may be reluctant to be the first to move.

8.3 Can insurance be provided for property in vulnerable areas?

If weather patterns are changing and some areas of the country are becoming prone to more frequent damaging events, these factors must affect the terms on which insurance can be provided. It is understandable that insurers are becoming reluctant to continue providing full cover for some properties, particularly those that have suffered repeated damage. However, this must be considered as a fairly drastic measure, and it may be expected that such steps will trigger reactions from many quarters, including government.

Following several recent floods and land slips, particularly those in Matata, there was discussion about whether the planning authorities should act to restrict the usage of areas prone to disaster. Slightly different considerations apply in regard to new properties or uses as opposed to continued usage of existing properties in vulnerable areas. Local authorities and developers should make greater efforts to assess risk prone areas and limit future exposures. But for existing properties, is it possible to continue to offer any insurance at rates that are both adequate and affordable in risk prone areas? Can industry pools or alternative schemes be set up, with support from government and/or local authorities, to offer some protection in future if standard insurance cannot be provided?

8.4 Underinsurance

Underinsurance can become an emotive issue when losses occur, and particularly following a disaster, when those without insurance receive payments from relief funds, and those who paid for their own insurance are regarded as less eligible for such payments. This has been recognised following several events overseas (for example, after Hurricane Katrina) as well in New Zealand. It may be difficult to avoid this type of problem unless mandatory schemes are applied in the vulnerable areas.

It is difficult to assess the extent of underinsurance in New Zealand, but it is almost certain that this problem exists and is fairly widespread. Underinsurance may arise in a number of ways. Many insured people will have thought about the level of cover that they required when they first took out their policies, but they may not considered the matter in any detail since then. Many policyholders do not fully appreciate the basis of their insurance cover and the need to allow for all rebuilding costs, including the cost of clearance of debris and professional fees for new plans. In addition, people tend to forget that they should increase their contents cover to allow for new purchases. Insurers make efforts to get their policyholders to consider these matters at renewal, but it is hard to measure the success achieved. Automatic increases of sums insured may be too much for some and too little for others.

Also many people and businesses find insurance expensive and do not want to pay more at renewal even if they realise that they should increase their cover, not understanding the effect that underinsurance may have on any claims. This may include some people who choose to limit their premiums by accepting relatively high excesses or deductibles, without fully understanding the nature and extent of their retained risk.

The extreme of underinsurance is no insurance. Some people would like to be able to purchase protection but cannot afford it, and are very hard hit if a loss event affects them. There are also people who can afford insurance, but consider the costs excessive and choose not to buy cover.

I understand that the industry has had some discussions with the Government on possible steps that might be taken to provide adequate, equitable and affordable protection against losses from natural hazards. Clearly there would be advantages to all parties if a solution could be found that would reduce the levels of underinsurance. More information on the problem is required and the Insurance Council has started to collect data for an investigation.

8.5 Other factors that may affect future results

Further problems could arise from effects that wider economic issues may have on the New Zealand insurance market. The possibilities for changes in interest rates and in the exchange rate of the NZ dollar are widely debated. If interest rates were to increase, investment returns would improve but there would be capital losses on fixed interest assets held (and opposite effects if interest rates were to fall). Would a fall in the NZ dollar cause problems if that lead to increased costs of repairs to or replacement of imported items? Perhaps such changes would again increase pressure to achieve underwriting profits.

If the New Zealand economy as a whole weakens, problems for policyholders of all types tend to increase. This has a knock-on effect on claims experience, as claims consciousness increases, and there may be an increase in the number of fraudulent claims, so that monitoring of claims has to be tightened.

If global warming, or other climate change, continues to cause a growing number of severe weather events around the world in future years, the global cost of insurance will rise. This will affect reinsurance costs for New Zealand insurers. In turn this may mean that they again have to reassess their exposures in target areas and reintroduce limits to coverage and higher premiums for cover given in the most vulnerable areas. At present there do not seem to have been any moves to consider the inclusion of New Zealand disasters among the subjects covered by issuers of catastrophe bonds. There has been discussion of the use of these instruments in Australia, so perhaps they will come to this market.

8.6 Final remarks

Are the above comments unnecessarily pessimistic? Or should we merely note that insurance markets are subject to cycles? It has been suggested that the average length of a cycle tends to be about seven years. The New Zealand insurance market seemed to be emerging from a trough in 2001/2, so it is probably not unexpected that its performance has probably reached a peak and be starting to head down again now.

As in 2002, there is still a view that there will be a reduction in the number of insurance companies operating in New Zealand over the next few years. It is likely that small insurers will find compliance with new regulatory requirements difficult and expensive. Merger and acquisition activity could extend to larger insurers as well.

Adverse external factors can affect outcomes from time to time, and management focus varies as it reacts to insurance results. However, it does seem as if the reaction to recent poor performance of householders' policies (particularly domestic buildings) has been slow. Also, it is to be hoped that competition will not be so intense or prolonged as to seriously erode results for commercial classes.

It appears that there will be adverse conditions affecting the New Zealand general insurance market for the next few years. It is to be hoped that these will not apply for more than a few years – rather as no-one expected the improving conditions forecast in 2002 to last for more than three years!