Optima

General Insurance
Insights 2020

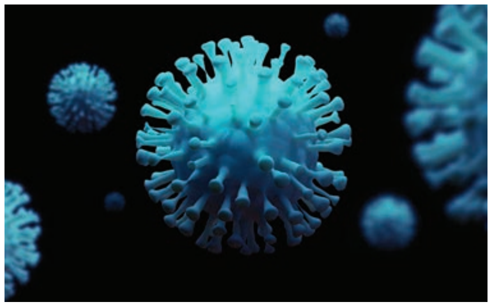
finity

How is COVID-19 re-shaping the Australian General Insurance industry?

Regulation dominated the General Insurance narrative in both 2018 and 2019 in the lead up to, and aftermath of, the Hayne Royal Commission. This time last year we expected regulation to remain the headline industry issue in 2020, as a major year of General Insurance regulatory reform implementation. However, while its importance has not diminished, regulation was emphatically overshadowed in the past 12 months by other events – firstly by the severe bushfire season, and then by COVID-19.

It goes without saying that COVID-19 has been the story of 2020 – both inside and outside of insurance – with its rapid and dramatic impact on almost every aspect of our society and economy. Even regulation has taken a back seat for the interim, with the slated financial services regulatory agenda delayed by at least six months to enable providers to focus on COVID-19 responses.

The impact of COVID-19 on General Insurance has varied greatly by class; these are assessed in more detail in the class of business sections that follow. In contrast, this article looks at industry level COVID-19 impacts through the lens of 'value creation', highlighting where and how it is re-shaping the General Insurance industry today and into the future.



Finity's General Insurance Value framework (developed by Finity for our joint 'Understanding Value in General Insurance' publication with ANZIIF) explores value creation in General Insurance across four broad categories:

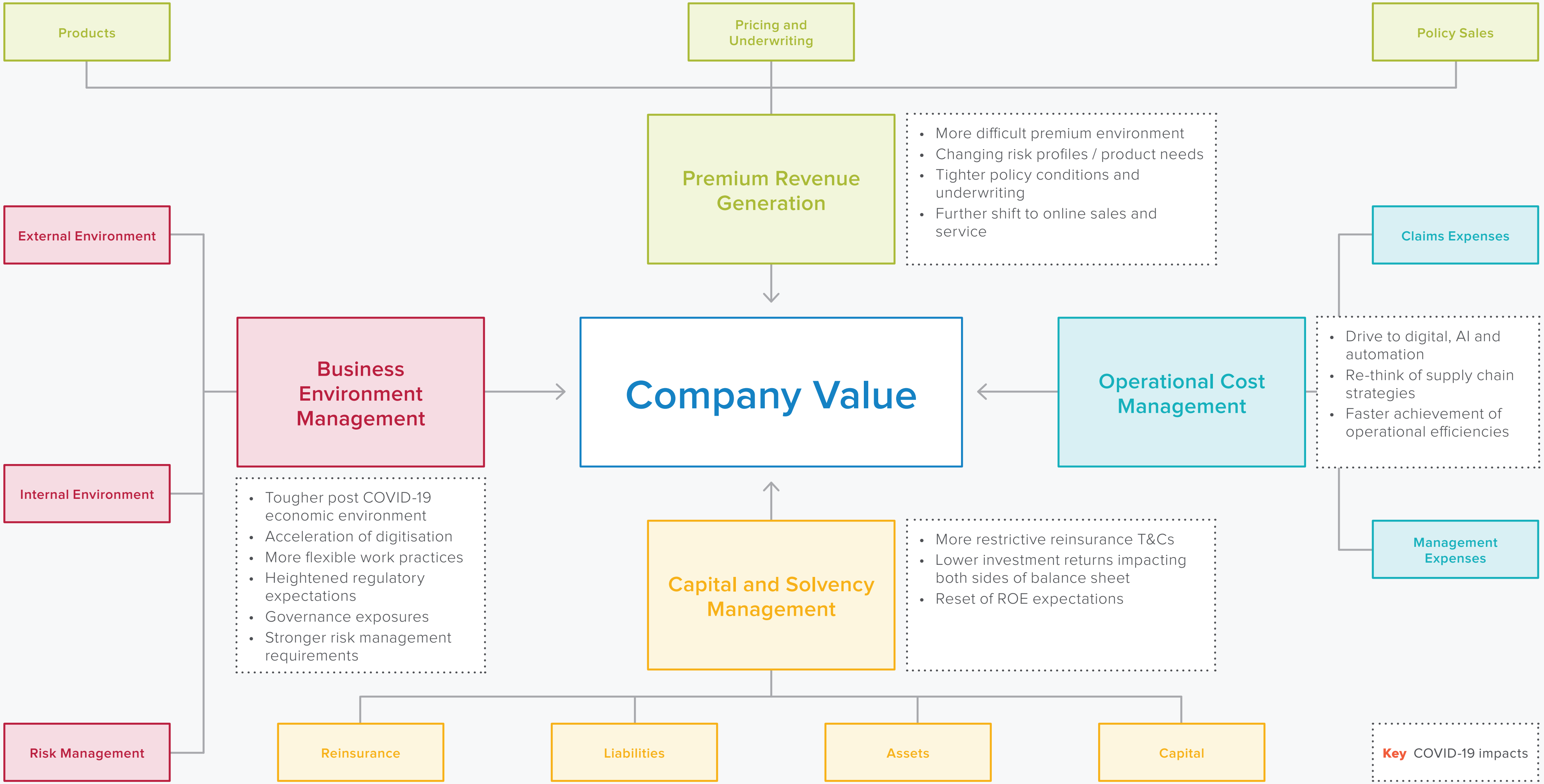
- Business management environment;
- Premium revenue generation;
- Operational cost management; and
- Capital and solvency management.

We have used this framework to make observations on COVID-19's impact on the underlying drivers of value creation. In many areas COVID-19 has been a catalyst to accelerate trends already in motion; in others it has exposed specific vulnerabilities that insurers need to close to protect the value in their business.

By considering what are short term impacts versus sustained shifts in the underlying components of these four categories, insurers can better understand how COVID-19 is likely to re-shape the industry moving forward, and assist individual companies to identify where they need to focus in order to maintain and create value into the future.

The diagram below summarises some of the key COVID-19 impacts we have observed.

We will now work through each of the four broad value creation categories in turn.



Business environment management

External environment

As a result of COVID-19, the external environment has become considerably more uncertain, and a lot more challenging for insurers to navigate.

Some macro aspects of the external environment (e.g. economic factors) will be heavily influenced by COVID-19 for at least the medium term. The post-COVID-19 economic environment (higher unemployment and under-employment, less disposable income, lower economic growth) greatly heightens premium side risks for insurers, further exacerbating growth and affordability challenges.

Other aspects (e.g. customer and societal factors including an ongoing shift to digitisation and more flexible working arrangements) have experienced a marked acceleration of previous trends, resulting in a sustained shift in these areas. While these trends apply across industries, it is also notable that insurers who had more heavily embraced and invested in these areas prior to COVID-19 were more quickly able to adapt and respond to the rapidly changing environment, with less employee and customer disruption than experienced by others.

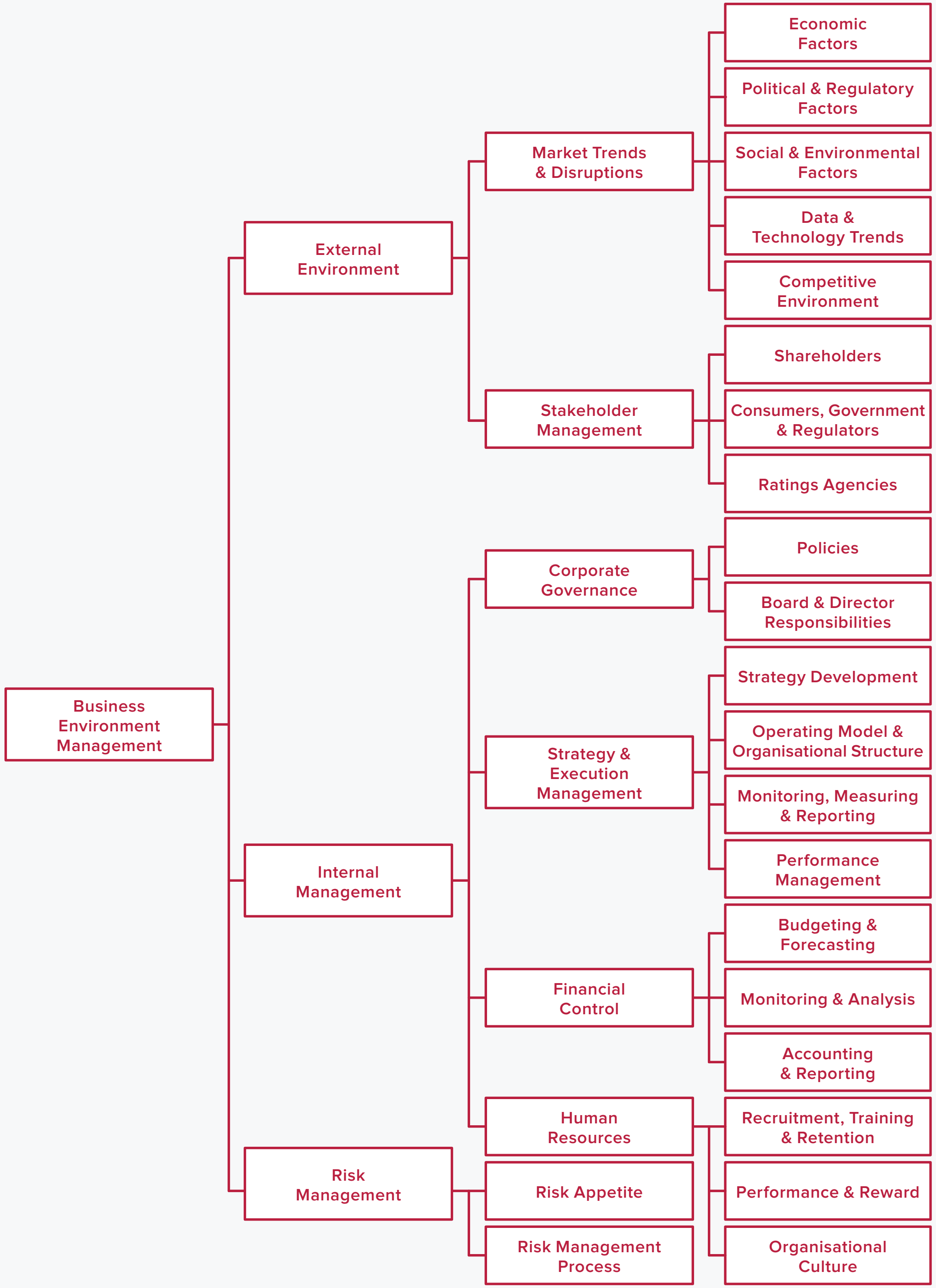
Finally, there are some areas that have seen substantial short term disruption, although these are less likely to endure in the long term. For example, the longevity of short term mobility changes (including the sharp decline in the use of public transport and ride sharing options) will be highly correlated to the duration of COVID-19 itself. Regulation also fits into this category. While most regulatory changes have been paused due to COVID-19, it is only a short term reprieve (if at all – given there have also been additional COVID-19 data requests), as ultimately regulators' expectations of insurers in terms of customer outcomes will only be heightened by a more uncertain environment. We expect regulators to re-engage strongly as we head into 2021, particularly in key focus areas of conduct and culture, and policyholder perspectives and fairness in decision making.

Internal environment

The most fundamental changes – short term and longer term – on the internal environment stem from changes in workforce dynamics. To date there has been a great deal of variation across insurers in terms of support for flexible work practices. One of the major positives arising from COVID-19 has been the demonstrated ability for insurers to work remotely and more flexibly without loss of productivity, and we expect a step-change in the approach to future workforce arrangements as a result. While this opens up a range of new opportunities for more efficient and effective work arrangements, it also raises a raft of new cultural and work safety challenges.

Working from home experiences during COVD-19 mean there is now more emphasis on a collaborative and supportive culture. Together with recent and pending Governance, Culture, Remuneration and Accountability (GCRA) regulatory reforms and some high profile cases, the conduct expected of people and the role of Boards in setting and monitoring culture is now better understood. Ongoing success requires adaptation in leadership and management practices, as well as investment to support new ways of working (e.g. investment in processes and tools to facilitate teamwork and collaboration in a flexible work environment).

Existing strategic plans have been all but set aside in the short term as insurers focused efforts on immediate COVID-19 demands. For the medium term, COVID-19 has also added more uncertainty to strategic planning and forecasting. We expect the COVID-19 experience to continue the existing trend to shorter strategic planning cycles. In a similar vein, we expect COVID-19 to result in



investment re-prioritisation beyond just the short term, with a greater investment allocation to areas supporting longer term operational agility and resilience.

Finally, COVID-19 has also exposed insurer vulnerabilities in a wide range of areas. Two worthy of mention from an internal environment perspective relate to offshore arrangements and governance.

COVID-19 revealed the inherent risks associated with offshored arrangements, and we believe the popularity of these arrangements in the future will be dependent on adequate business continuity and security solutions becoming available.

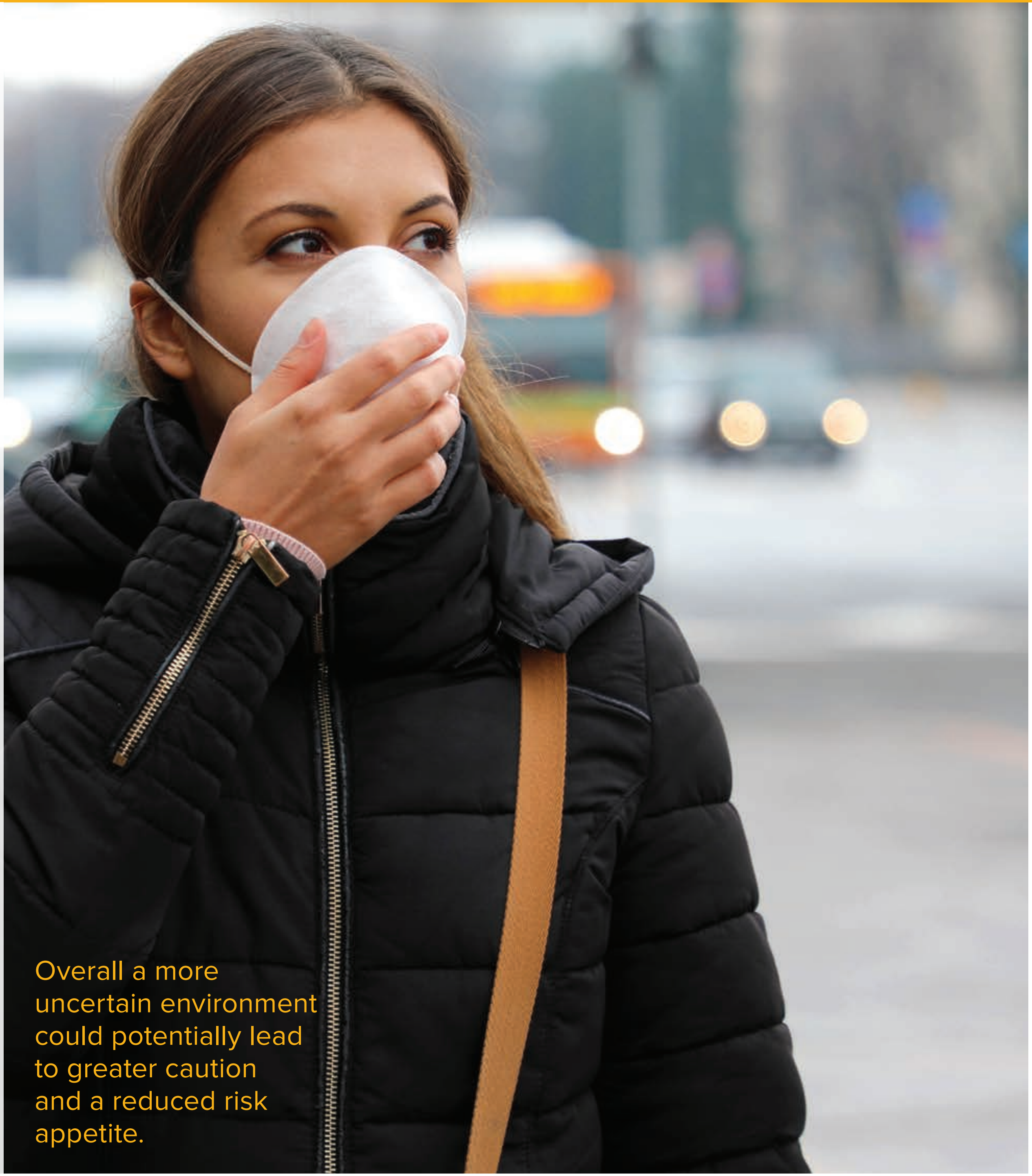
The as yet unresolved issue of business interruption policy exclusions (with their reference to the Quarantine Act vs the Biosecurity Act) is a good example of a governance vulnerability exposed by COVID-19. While the cost of this particular exposure is not yet known, there is a longer term positive outcome for governance with insurers reviewing (and attending to) other previously inadvertent exposures.

Risk management

Overall a more uncertain environment could potentially lead to greater caution and a reduced risk appetite across the industry (with less appetite to write lower margin business in a lower top line growth environment). This, however, will be countered by competitive pressures with insurers competing for a relatively fixed premium pool given the limited system growth opportunities.

While COVID-19 arguably tested insurers' Business Continuity Plans (BCPs) like never before, on the whole insurers navigated the crisis well, and BCPs will be undoubtedly stronger moving forward as a result.

Risk management has already been an area of heightened focus and investment in recent years, primarily driven by regulatory factors. COVID-19 should act to sustain this higher level of investment for longer, as insurers utilise the lessons learned to prepare for future COVID-19 like events.



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Premium revenue generation

Products

The external environment trends discussed above have resulted in sustained changes to the way individuals work and travel, and to the way businesses operate. This in turn requires change to both personal and commercial product design in order to better meet customers' future insurance needs.

Design considerations include both policy coverage (does it protect against risks that are relevant to the customer – especially in relation to new or emerging risks), as well as structure (e.g. a usage based or a subscription model vs a traditional 12 month policy).

Pricing and underwriting

COVID-19 has shone a light on policy wordings and the need to consider how policies respond to a range of emerging risks. While we view the business interruption exposures discussed earlier as a lapse in governance, in other areas (such as Landlords insurance) unforeseen changes in the environment meant insurers had to respond quickly to reduce COVID-19-related exposures, in part by tightening policy wordings. Both policy conditions and acceptance criteria will be more heavily scrutinised moving forward as a result of COVID-19 (in part due to a corresponding tightening of language and exclusions from a reinsurance perspective).

While risk profiles are always evolving, COVID-19 represents a step change – with significant modifications in a number of areas including how businesses operate, how the workforce is dispersed, and in mobility patterns.

Underwriting margins will be under increasing pressure in the medium term as a result of COVID-19, with affordability concerns increasing in line with tougher economic conditions, lower underlying growth putting more pressure on the top line, and lower investment returns anticipated for the foreseeable future. Insurers need to stay abreast of these multiple moving parts and appropriately reflect them in underwriting and pricing practices (including more granular pricing), in order to create value into the future.

Overlaying all this, there are multiple reputational / relational / social license risks for insurers to consider (e.g. what are the reputational implications of increasing premiums in line with claims inflation, in an environment when insureds have lost their jobs or are on reduced incomes?).

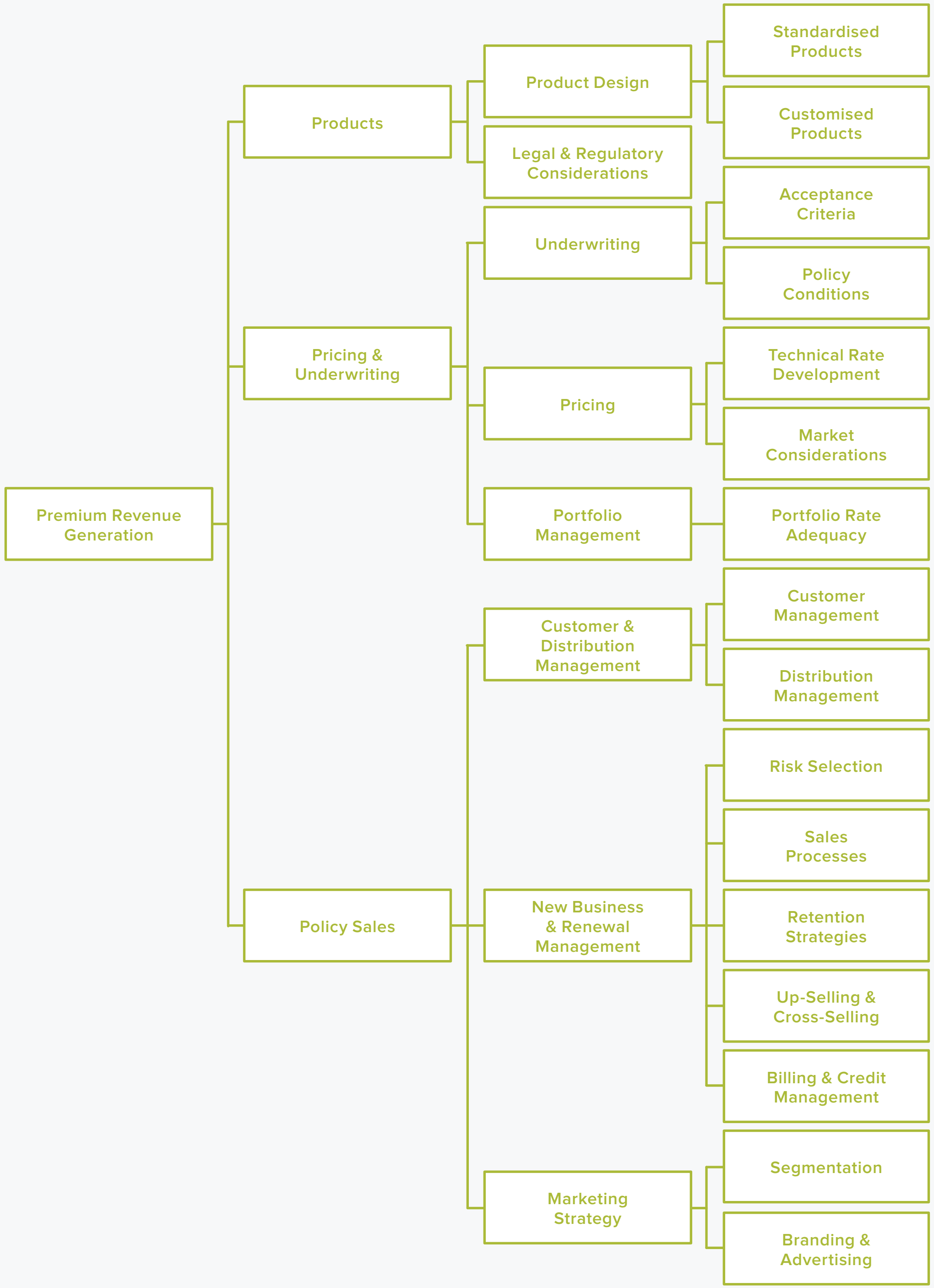
Policy sales

A sustained shift in customers' use of and comfort with on-line channels will accelerate the existing trend towards digital sales (as well as servicing e.g. policy maintenance). This applies to both direct and intermediated sales.

The flight to digital should lead to more shopping around – although in uncertain times and with a greater focus on communities there may also be a leaning towards trusted brands and/or brands associated with support during COVID-19.

The customer digital experience will gain even greater importance in a post-COVID-19 world and insurers (and intermediaries) who have not invested in this area will need to play catch-up quickly – particularly as those who have invested have a clear near term opportunity to exploit their digital advantage.

With lower underlying growth inevitable in the medium term (e.g. fewer new vehicle sales, fewer new business ventures), insurers will need to continue to sharpen and mature marketing efforts (e.g. through improved segmentation and targeting) in order to 'win' in this environment.



Operational cost management

Claims expenses

Claims operations will be a major beneficiary of the COVID-19-accelerated shift to digital, with insurers using technology to simultaneously provide a more efficient process and a better customer experience, while meeting higher compliance standards. A raft of Artificial Intelligence (AI) and digital solutions are already being implemented across the claims value chain (e.g. triaging, assessing and processing claims, workflow management, customer communications, claimant self-service and claims tracking, compliance, fraud management). These aim to streamline and automate the end to end claims process and, while it is still relatively early days, there is a vast amount of value creation upside for insurers as they work towards the ultimate ambition of end to end claims digitisation.

Of specific note, the use of AI to identify and prevent fraud will be even more important in post-COVID-19 times with the potential for higher levels of fraud in more challenging economic conditions. In addition, insurers need to be increasingly cognizant of ‘algorithm risk’ as they progress down the AI / automation path, including establishing appropriate governance frameworks for this emerging risk.

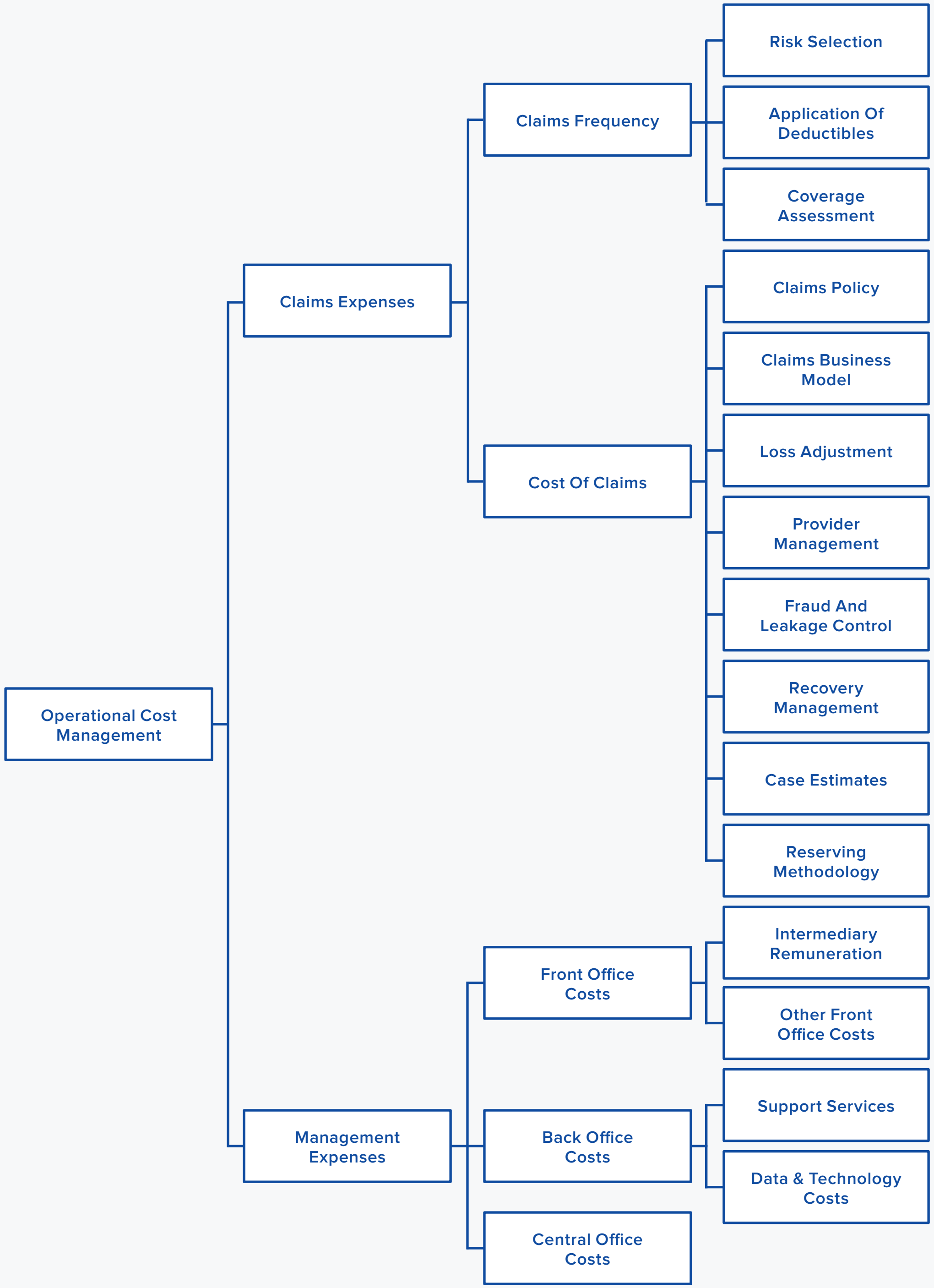
COVID-19 has also forced insurers to re-think their claims models, particularly supply chain strategies. Property classes of business were (and in some cases continue to be) affected by a sharp contraction in supply from COVID-19 manufacturing impacts. This has been exacerbated by COVID-19’s simultaneous worldwide impact, building on past supply pressures that have generally been more localised. Insurers are reviewing supply chain arrangements in an attempt to mitigate future vulnerabilities through, for example, more on-shore sourcing, or sourcing through a wider range of providers. These choices will have flow on cost implications.

Getting a clear view of underlying claims trends and lead indicators is far more challenging in the current turbulent environment. The ability to distinguish one-off short term impacts (e.g. improved motor frequency due to lower traffic volumes) from sustained longer term trends (e.g. improved motor frequency due to sustained mobility changes or safer vehicle technology) is important to understand for both future pricing and claims operation purposes.

Management expenses

Beyond the short term investment costs we expect COVID-19 to have a positive impact on management expenses. The major trends discussed above – in particular the COVID-19-related acceleration of digitisation across all aspects of the operating model, as well as flexible working practices – provide insurers with a significant opportunity to transform operations and to achieve efficiency benefits far more rapidly than the previous trajectory.

While not COVID-19 related, we do expect there will be ongoing expense pressures relating to both higher regulatory and compliance costs, as well as technology costs – with the long-promised benefits of major IT spends so far (on the whole) proving elusive for insurers.



Capital and solvency management

Reinsurance

The substantial reinsurance market headwinds arising from cat losses have been further exacerbated by COVID-19, with leading reinsurers all suffering significant pandemic related losses. This has contributed to further reinsurance market hardening, with reinsurers also reviewing exclusions and tightening language in respect of pandemics (which in turn need to be reflected in insurer PDSs).

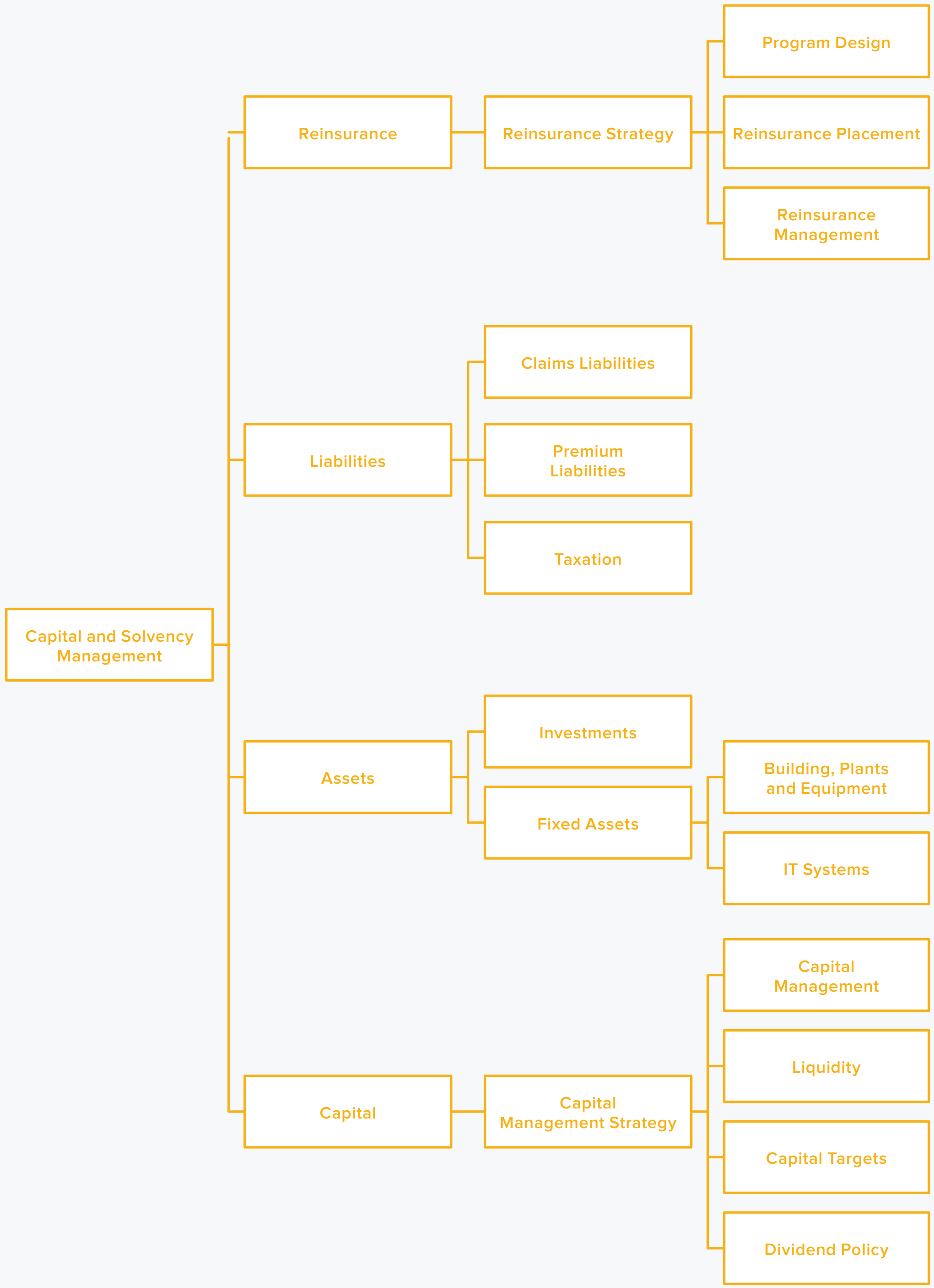
However, despite the drop in capital, capacity was available during the July renewal period and generally insurers have been able to secure needed capacity. Further, there is an expectation that reinsurance capacity will increase moving forward, with the low COVID-19 interest rate environment attracting investors to a higher yield reinsurance market.

Assets and liabilities

COVID-19 will provide medium term challenges for both sides of the balance sheet. Low investment returns on assets will put further pressure on net margins. Liabilities will increase due to low interest rates (with lower discounting) as well as increased uncertainty and volatility (both in specific classes impacted by legal challenges to COVID-19 claims as well as ongoing economic deterioration).

Capital

Lower overall market profitability will require tighter capital and solvency management, while insurers (and investors alike) will again need to re-assess Return on Equity expectations. ROE expectations (previously at a ~15% industry target level) had already lowered in recent years on the back of a lower WACC / low interest rate environment. COVID-19 will put further downward pressure on achievable ROEs. We consider a 10% ROE to be closer to an appropriate target level in the current environment.



Conclusion

COVID-19 has impacted many of the underlying value creation drivers of General Insurance, and introduced significantly greater levels of uncertainty for insurers both in the short and medium term. Some impacts will be temporary, while others represent a rapid acceleration of previously slower moving trends. What is clear is that there has been a sustained shift in a number of areas, requiring insurers to revisit their strategy and re-prioritise existing initiatives.

While navigating the post-COVID-19 economic environment is unquestionably a major challenge ahead for insurers (and a key threat to insurer value), it is certainly not all bad news. Insurers have so far fared the COVID-19 storm well. In addition, the short term costs imposed by COVID-19 (through additional investment required to keep the business running in a COVID-19 world, or as a consequence of inadvertent risk exposures) have at the same time resulted in insurers making meaningful advances in both internal operations and governance in a very short period of time. These internal improvements will soften the impact of a tougher short-medium term external environment, and stand insurers in good stead for long term value creation.

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