The future of SME insurance starts now

The Commercial Lines insurance market is one that has historically relied on manual processes, is underpinned by relationships, and so far has been largely untouched by advanced analytics.

There are some good reasons for this, mainly that businesses are complex and there is far more heterogeneity in businesses than there is across individuals.

Of the two million plus businesses operating in Australia, there are a small number of large businesses that are highly complex, and a very large number of small to medium-sized businesses that are comparatively much simpler.

The Small-to-Medium Enterprises (SMEs) segment of the Commercial Lines insurance market has long been viewed as having the potential to become much more sophisticated than what it currently is, both in terms of technology and analytics.

An often expressed view is that if insurers (and brokers, for that matter) don't become more sophisticated in the SME market, they would be ripe for disruption.

Well, it seems the insurance industry got the memo. Over the 12 months to June 2017, two of the largest SME insurers, IAG and Suncorp, have restructured to remove the traditional divide between Commercial Lines and other divisions, effectively rolling out analytics capabilities from other divisions (particularly Personal Lines) across Commercial Lines business.

Along with this, there has been continued focus on automation, as well as continued efforts to uncover potential new data sources.

So significant are the developments in the last year that if we were to look back 5 or 10 years from now, we may well consider 2017 as the start of the future for SME insurance.

SPEAKING OF UNCOVERING DATA...

In May 2017, Finity and Ebix Australia formed a partnership which allows Finity to unearth data from Ebix's transaction platforms – Sunrise Exchange and iClose – to provide market insights to insurers who participate on those platforms. If you would like to find out more about this, please let us know – we would be happy to tell you more about it.

This article takes an in-depth look at the SME insurance market today, focusing on the Business Pack product. The topics we will cover in this article are:

- A brief background on the current state of the SME insurance market
- The main distribution channels – intermediated versus direct
- The key developments in data in 2017 that have the potential to change the SME market.

Current state of the market

We start with a look at the current state of the market for Business Pack: how big is the market, what stage of the premium rate cycle we are in, and how profitable this product is.

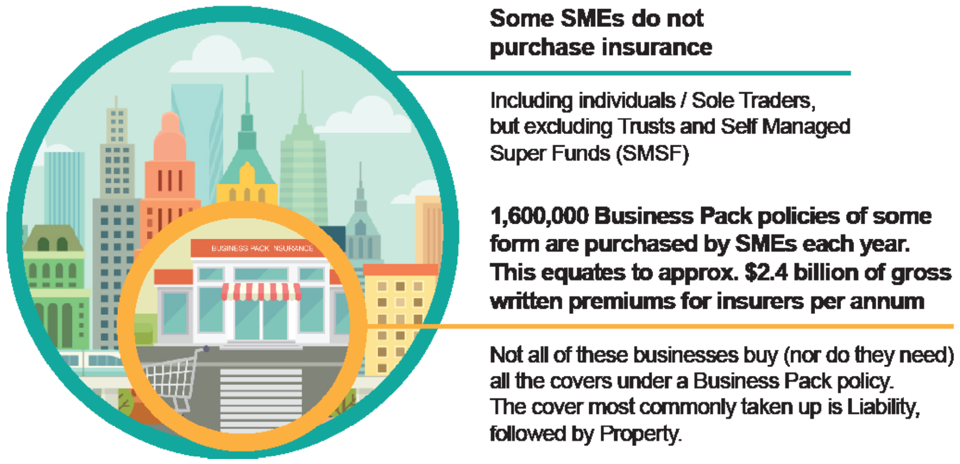
Size of the market

The SME insurance market is serviced by a combination of business packages policies, standalone commercial motor policies, professional indemnity policies, a growing number of management liability policies and cyber policies.

This article focuses solely on Business Pack policies, which is the main product in the SME market. We estimate that approximately $2.4 billion of premiums are written each year for this product in Australia.

As the name suggests, the Business Pack product is a package of many covers, the main ones being Property, Liability and Business Interruption, followed by up to ten smaller covers. The way these covers are packaged varies from insurer to insurer, and in some cases the package may include other major covers such as Commercial Motor, Management Liability and Cyber.

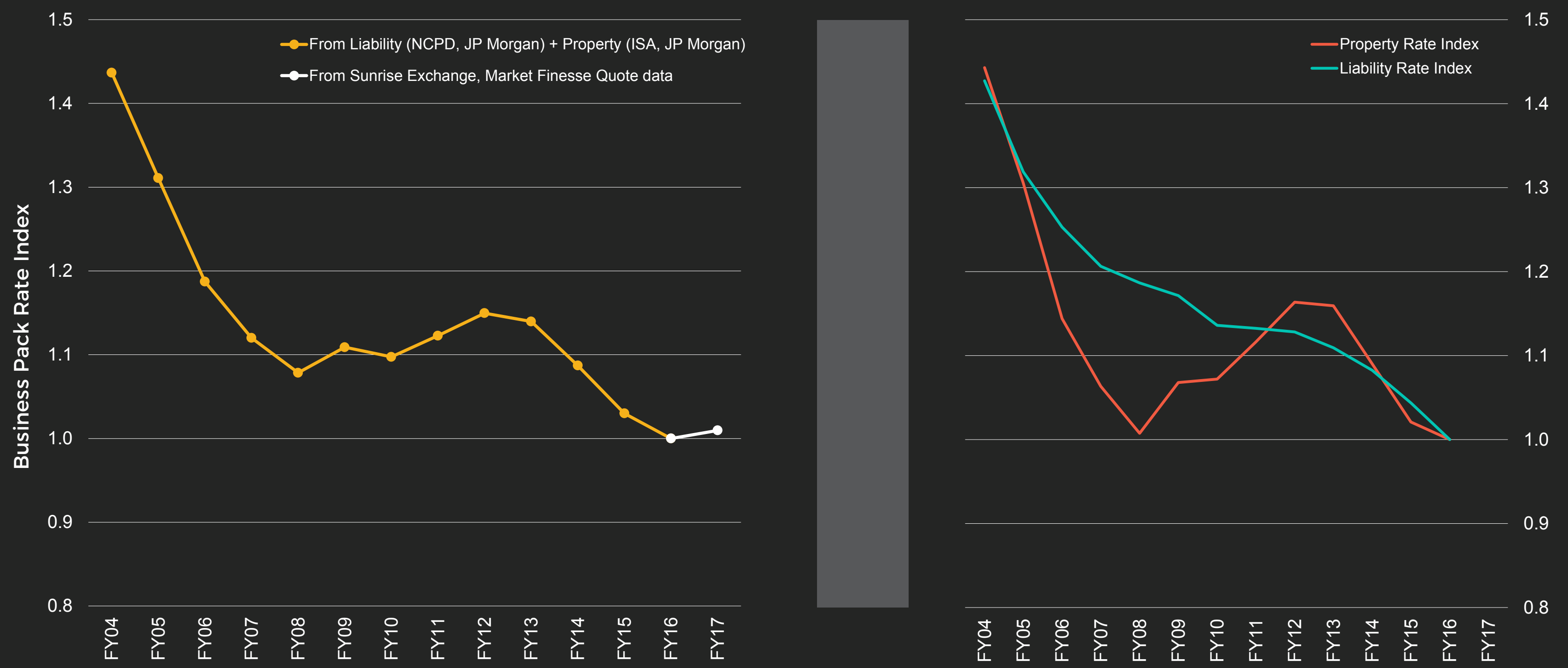
Estimated size of the SME Business Pack market



Businesses select which covers they want with their Business Pack policy. Liability has the highest take-up rate, followed by Property (Buildings, Contents and Stock or a combination of both). Not all businesses own their premises, which naturally constrains how many businesses buy Buildings cover.

The take-up of covers is significant from a portfolio management perspective because profitability varies across different covers.

Business Pack Rate Index[1,2]



1. Business Pack Rate Index is constructed from a combination of the Business Pack Liability and Business Pack Property Rate Indices.

2. The 2017 figure for the Business Pack Rate Index was derived based on a combination of Business Pack transaction data from Sunrise Exchange, as well as Business Pack online quote data from Market Finesse.

Premium rate cycle

The figure above shows our view of the premium rate index for Business Pack insurance.

Premium rates are much lower now than in the early 2000s. From 2009 to 2012, following a spate of natural catastrophes, there was a brief period of rate increases for Property, however this was not sustained.

The downwards trend appears to have ceased in 2017 with a small increase of 2% in the rate index. This is a positive sign for insurers and supports the views of many in the intermediated market that the soft market cycle may be ending.

Profitability

In the figure below, we present our views on current profitability for the Business Pack product overall, as well as by cover. We compared the current loss ratio to a target loss ratio – that is, the loss ratio that is required to deliver a 15% return on capital (ROC).

PROFITABILITY FOR BUSINESS PACK BY COVER			
Product / Cover	*Current "Normalised" Loss Ratio*	*Target Loss Ratio*	*Comments*
Business Pack Overall	*58%*	*51%*	*Current "normalised" COR is at 103%, deliver a Return on Capital (ROC) of approx. 6%.* *Premium rates need to increase by 10% overall to deliver target Return on Capital (ROC).*
Liability	*55%*	*53%*	*Performing at close to target ROC. This has deteriorated in recent years due to the continued softening of premium rates.*
Property	*72%*	*49%*	*Rate increases in the order of 35% are needed to deliver target ROC. Property has traditionally been a loss leader which is cross-subsidised by Liability and Other covers.*
Other Covers	*~40%*	*50%*	*Based on our benchmarks, Other covers tend to perform very well overall, although there may be differences for each cover.*

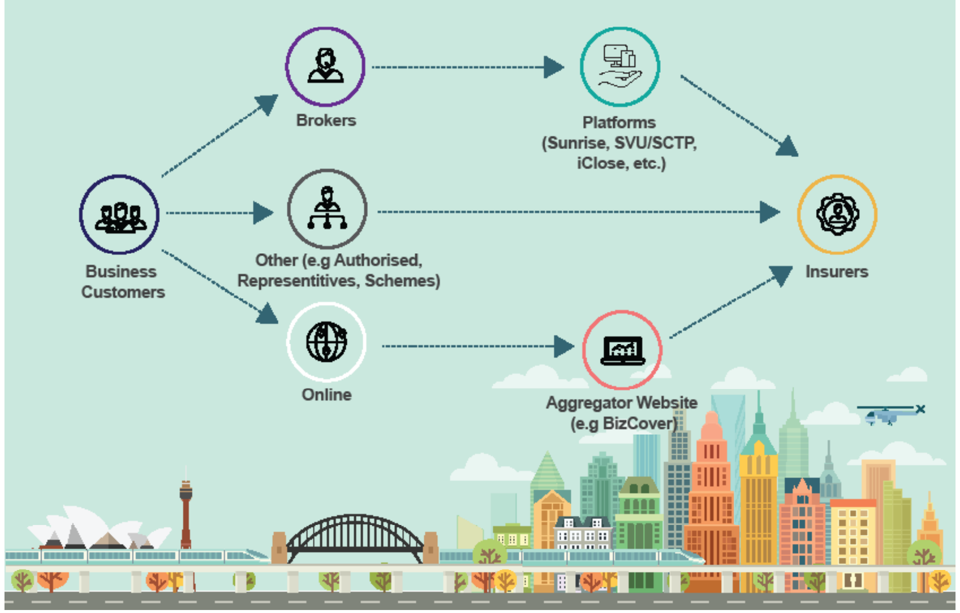
Property cover has traditionally been a "loss leader" and is significantly cross-subsidised by Other covers and to a lesser extent Liability.

Intermediated vs. direct: a tale of two markets?

The financial dynamics differ across distribution channels and impact on expenses, price adequacy and profitability. Therefore, the channel through which the business is written has significant pricing, underwriting and strategic implications for insurers.

The figure below shows the main distribution channels in the SME market.

SME Insurance Distribution Channels



From the average business customer's perspective, there are two main channels – going through brokers or getting a quote online. For certain groups of businesses (particularly those in specific industries or occupations and those in regional areas), there are other options of authorised representatives or schemes. These may be a combination of intermediated and direct.

Even within the intermediated or online channels, there is a range of ways that insurance is sold.

- On the *intermediated* side, Steadfast's SVU/SCTP platform acts as an aggregator of prices across participating insurers, whereas the Sunrise platform facilitates one-on-one interactions between the broker and each insurer.
- On the *direct* side, there is the option for the customer of getting a quote directly from an insurer's website, or going through BizCover, an aggregator website (in fact, the only aggregator website that we're aware of) for business insurance.

Currently only three of the major insurers sell Business Pack insurance online – IAG, Suncorp and Allianz. Suncorp and Allianz are also on BizCover, along with QBE, AIG and Berkley Underwriting, as well as underwriting agencies Dual, RelyOn and Point.

WHAT DOES BIZCOVER WRITE?

Having originally started with selling Professional Indemnity and Public Liability insurance, over the years BizCover has expanded its offering to include Business Packages, Management Liability, Cyber, Personal Accident and Tax Audit. BizCover's website states that it has a customer base of around 55,000 businesses.

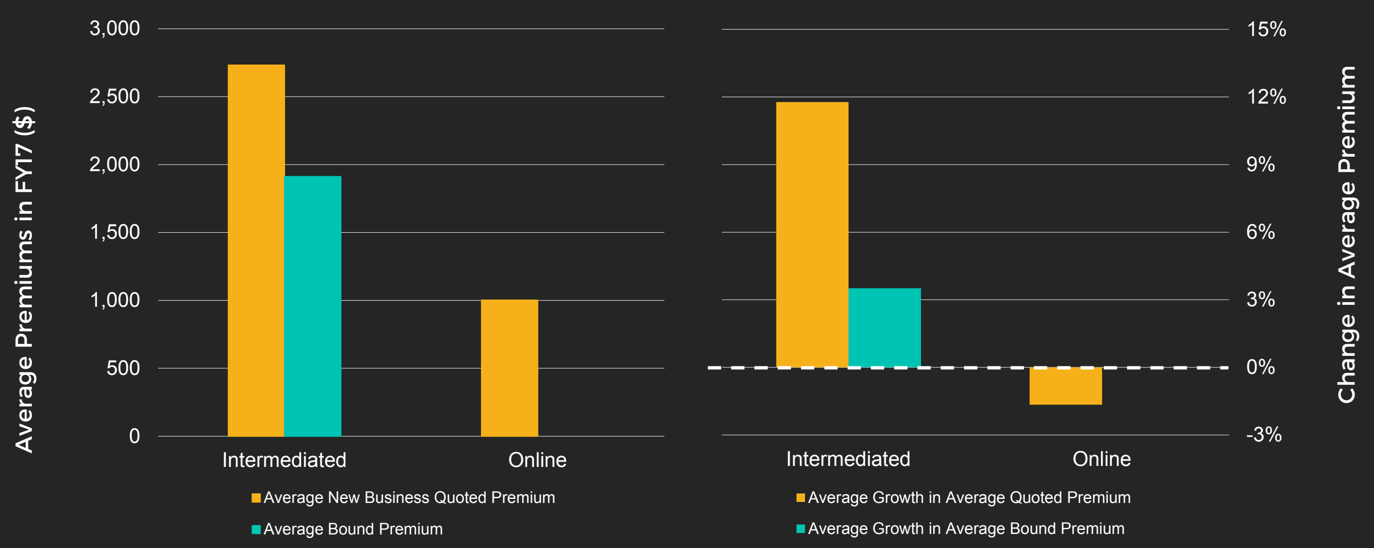
The figure below gives a snapshot of the differences between the distribution channels, including our estimate of the volumes of business going through each channel.

Intermediated vs. Direct: Snapshot for the Year to 30 June 2017

INTERMEDIATED	ONLINE / OTHER
1,000,000 businesses / policies (est. 63% of total policies)	*600,000 businesses / policies (includes the "Other" segment) (est. 37% of total policies)*
$2.0 billion (est.) in annual premiums (est. 82% of total premiums)	*$0.4 billion (est.) in annual premiums (est. 18% of total premiums)*
Average premium of $1,911 (based on data from Sunrise)	*Estimated average premium of $744 for online (estimated based on quote data)*
Customers include the full range of businesses, more weighted towards larger businesses	*Typical customers are micro to small businesses and sole traders*

On average SMEs who go through the Broker channel paid just over $1,900 for their Business Package policy, compared to an estimated $750 for customers going through the online channel. The main reason for this would be the different profile of customers – larger more complex businesses tend to buy insurance through brokers, while sole traders and smaller businesses tend to buy insurance online. A secondary reason may be pricing differences by channel. It's worth noting that because of the different profiles we cannot draw the conclusion from these figures that online is cheaper.

How Average Premium Trends Differ for Intermediated vs. Online[1,2,3]



1. Intermediated channel is based on data from Sunrise Exchange.

2. Online channel is based on quotes collated from insurer websites, for our best view of a "market representative batch" for online business.

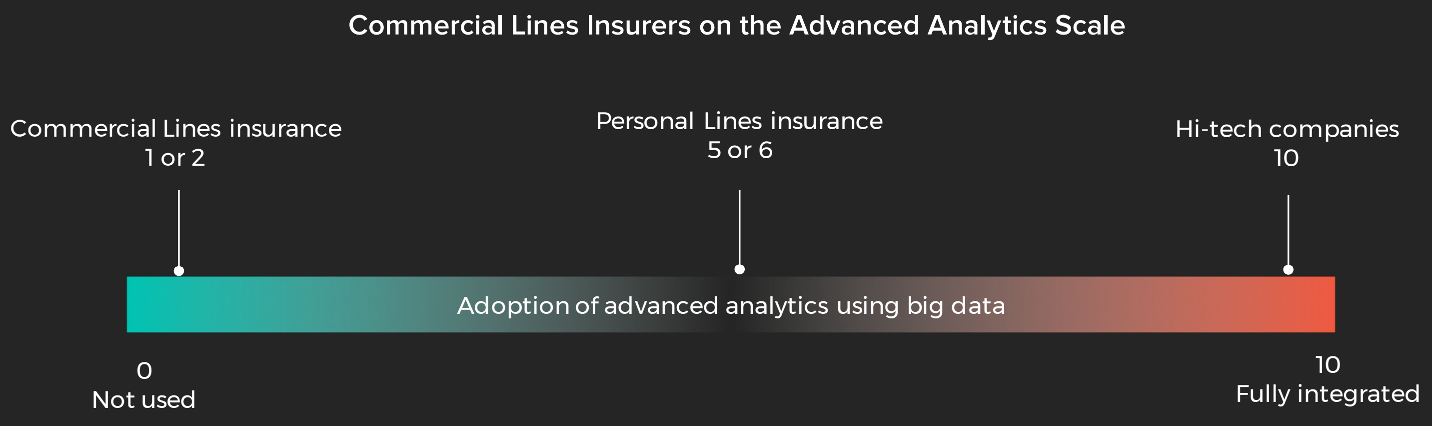
3. The average bound premium is for both new business and renewals.

In the figure above, we take a look at the difference between quoted and bound premiums, and how the change in average premiums in the year to 30 June 2017 differed between the intermediated and online channels.

The figure tells us that:

- The increase in Business Pack premium rates in 2017 is coming from the intermediated channel, and not the direct channel. Average quoted premiums in the online market actually reduced by an average of 2% across all insurers in the year to 30 June 2017. This contrasts with the intermediated channel, where insurers are pushing up the average quoted price for new business by 12% (which translates to approximately 9% - 10% increase in premium rates).
- Increasing quoted premiums does not necessarily translate to an equivalent increase in achieved premiums. Even though average quoted premiums in the intermediated channel increased by 12%, average bound premiums only increased by 4%.

The varying rate increases do not imply that the intermediated channel is becoming more profitable than the online channel, as the two channels would likely have different levels of premium adequacy to start with.



Where is each channel headed in the future?

There is an expectation that the online distribution channel will continue to grow over time, as the profile of customers shifts to an increasingly tech savvy group.

How much the direct channel grows and how fast it grows depends on whether brokers continue to demonstrate their value proposition to existing and potential new customers, and how well insurers are able to engage with customers directly.

Our view is that the online channel will grow, but the increase is likely to be gradual. We expect brokers will continue to play a key role in the foreseeable future, partly because business insurance is inherently complex and particularly so for a business owner who is unfamiliar with many insurance concepts, and partly because the issue of channel conflict remains for the major insurers.

As the online channel grows, we expect to see increased competition in this segment.

Key developments in data

Commercial Lines insurers have been slow adopters of advanced analytics. If we measure on a scale of 0 to 10 the adoption of advanced analytics using big data – where 10 would be the score for high-tech companies such as Facebook or Google and 0 refers to companies that do not use any advanced analytics or big data – we would rate most Commercial Lines insurers as a 1 or 2 on this scale. Clearly there is a range of practices – some insurers are more advanced and may be up to a 4.

For context, most Personal Lines insurers might be around a 5 or a 6. It doesn't necessarily make sense for insurers to get anywhere close to a 10.

Advanced analytics is only useful if you have good quality, reliable and up-to-date information to feed into it. Before now, that data has been sorely lacking in SME insurance. SME insurers have spent many years accepting the lack of data as the norm, seeking to work around rather than addressing the lack of data.

2017 is the year when this changed. There have been developments in the last year, both in terms of knowledge of what data is available and in developing the capability to use it.

Let's take stock of the status of data for SME insurers today and look at:

- What data is already available, which insurers may not be making good use of
- What external data is becoming available
- And what insurers can do with this data

What data is already available

These are the areas where insurers (or rather the analytics teams within insurers) should already have access to data. However, not all insurers do have access; and only some of those that do use the data, use it effectively.

WHAT DATA MAY ALREADY BE AVAILABLE?	
Data	*Description*
Internal data	
Full quote details	*Details of all quotes, including coverage fields, insured details and risk description fields. This doesn't appear to be extensively used*
Policy details	*Similar to the quote data above, but for all policies (bound new business and renewals)*
Detailed claims descriptions	*Using detailed claims descriptions to attribute claims to covers and the causes of loss (or peril)*
Rating history & data on price adequacy	*Historical rating structures, and what is the bound premium vs system generated premium*
External data	
Market Finesse - competitor online quote data	*Quotes from online insurers for a market representative group of customer profiles*
Finperils - natural perils address risk scores	*For each GNAF in Australia, an assessment of the level of flood, bushfire, cyclone, storm and storm surge risk*
Finity Commercial Theft risk zones	*For each postcode in Australia, an assessment of the level of theft risk for commercial properties*
Finity Market Analytics based on NCPD	*Analytics based on the National Claims and Policies Database (NCPD), covers key premium, risk, claims cost trends for Public Liability*
Bespoke databases	*E.g. Public Liability Work Injury (PLW) claims, class actions database*

Even with just the internal data, some level of advance analytics is already possible. Those that make use of it would be well placed to reap the rewards of better pricing, risk selection and ultimately, better profitability.

What data is becoming available?

External big data is the topic that has most of the industry excited. And there are numerous sources of external big data that will become available imminently, or in the next few years.

Here is our view of the web of big external data sources for business customers.

The Big Data Web for Business Customers

Whilst each of these individual datasets provides valuable information, the real value lies in the linking up of this web of data. This enables us to be able to derive, infer and engineer new insights (i.e. data fields) about business customers.

There is a significant amount of work required to turn the raw information into useful intelligence. The types of intelligence that insurers would find useful include market intelligence, business intelligence, location intelligence and claims or risk intelligence.

Finity has invested and continues to invest significantly in developing our products to support insurers in linking up this data web. Here’s our summary of what is becoming available.

WHAT DATA IS BECOMING AVAILABLE?

Type of Information	*Finity's product offering*	*What's the timeframe?*	*What's it about?*
Market Intelligence	*Finity Vantage*	*Now*	*Using data from Ebix's Sunrise Exchange platform, this product provides market insights at an individual quote and policy level, for the intermediated market. The insights cover market dynamics, your competitive position and customer pricing decision-making. Enables insurers to optimise pricing.*
Location Intelligence	*Finpoint*	*Early 2018 - watch this space!*	*Brings location intelligence to insurance using geospatial information about the built environment, including each building, surface area, surrounding trees and much more.*
Claims or Risk Intelligence	*In research & development phase*	*Expected to be in 2018*	*Collating publicly available information regarding claims events, losses, and (where possible) information on exposure. Useful for pricing purposes to supplement insurers' own claims data.*
Intelligence on Businessses	*In research & development phase*	*As far as we're aware, no complete database exists. However, the coverage will only increase over time.*	*Providing key details about businesses such as ANZSIC, risk locations, number of years in business, information on directors.*

What can insurers do with this data?

The potential to tap into large external datasets offers the possibility of transforming the way the SME insurers operate – here's how:

1. Optimise Pricing and Strategy

Data: Market Intelligence datasets (Finity Vantage)

- Using market intelligence to optimise pricing and strategic decisions.
- Enable insurers to make market pricing decisions which strike the desired balance between business volumes and profitability.
- Improve broker relationship management.

2. Optimise Risk Assessment and Modelling

Data: finperils, finpoint, claims or risk intelligence

- Most insurers do not currently price at an individual address level for Business Pack - expect this to change in the next 1 - 2 years.
- Potential to identify new rating factors by using new information from external datasets.
- Better understanding Fire risk, Liability risk and some of the Other covers.

3. Improve Customer Experience

Data: Intelligence on businesses, location intelligence

- Creating a good user experience for customers. Full pre-population is still some time away; partial pre-population however, is possible in the near future.
- The ability for this information to improve customer experience and engagement extends to the claims management process.

4. Sales and Marketing

Data: Intelligence on businesses, location intelligence

- Having addresses, locations and contact details of customers means you can reach customers (particularly direct customers).
- Identifying potential customers based on a full database of businesses / locations.

Conclusion

The SME insurance industry is moving towards a future of using external data and advanced analytics to make trusted data-driven decisions.

We expect to see incremental but significant movements over the next two years and beyond. In five years' time, the industry may be quite unrecognisable from the one that we've known for the last ten years.

Any change that creates both opportunity and risk will bring winners and losers.

The winners will be those who are the early adopters of advanced analytics; those who not only use analytics well to form the right strategy, but also execute the strategy well.

The Business Pack product is not currently meeting insurers' target profitability. A more informed market should mean a more rational market, as well as one that engages with both brokers and customers better and provides better services to customers.