INSURANCE COUNCIL OF AUSTRALIA

9 May 2017

Professor Allan Fels AO
Emergency Services Levy Insurance Monitor
McKell Building
2-24 Rawson Place
Sydney NSW 2000

Email: publicinquiry@eslinsurancemonitor.nsw.gov.au

Dear Professor Fels

EMERGENCY SERVICES LEVY INSURANCE MONITOR PUBLIC INQUIRY

The Insurance Council of Australia[1] (the Insurance Council) appreciates the opportunity to provide a submission to the Emergency Services Levy Insurance Monitor's 13 April 2017 Public Inquiry Issues Paper (the Issues Paper).

The Insurance Council notes that, apart from asking detailed questions about premium pricing which are most appropriately dealt with by insurers, the Issues Paper explores some broad industry themes, including competition, financial performance and general approaches to determining insurance premiums. The purpose of our submission is to provide information and analysis on those themes to help supplement the information that is provided in the Issues Paper.

The Insurance Council looks forward to continue working with the Emergency Services Levy Insurance Monitor to ensure a smooth transition to the property-based levy.

If you have any questions or comments in relation to the submission, please contact John Anning, the Insurance Council's General Manager Policy, Regulation Directorate, on tel: (02) 9253 5121 or email: janning@insurancecouncil.com.au.

Yours sincerely

Robert Whelan
Executive Director and CEO

---

[1] The Insurance Council of Australia is the representative body of the general insurance industry in Australia. Our members represent more than 90 per cent of total premium income written by private sector general insurers. Insurance Council members, both insurers and reinsurers, are a significant part of the financial services system. December 2016 Australian Prudential Regulation Authority statistics show that the private sector insurance industry generates gross written premium of $44.6 billion per annum and has total assets of $121.1 billion. The industry employs approximately 60,000 people and on average pays out about $124.2 million in claims each working day.

Insurance Council members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

Insurance Council of Australia Limited ABN 50 005 617 318
PO Box R1832 Royal Exchange NSW Australia 1225
t +61 2 9253 5100 f +61 2 9253 5111 www.insurancecouncil.com.au

INSURANCE COUNCIL OF AUSTRALIA

EMERGENCY SERVICES LEVY INSURANCE MONITOR

MAY 2017 PUBLIC INQUIRY

Submission from the

Insurance Council of Australia

9 May 2017

Insurance Council of Australia Limited ABN 50 005 617 318
PO Box R1832 Royal Exchange NSW Australia 1225
t +61 2 9253 5100 f +61 2 9253 5111
www.insurancecouncil.com.au

Contents

Insurance Council of Australia Limited ABN 50 005 617 318
PO Box R1832 Royal Exchange NSW Australia 1225
t +61 2 9253 5100 f +61 2 9253 5111
www.insurancecouncil.com.au

INSURANCE COUNCIL OF AUSTRALIA

1. Introduction

The key role of insurance in an economy is the mitigation of insurable risk. Through the acceptance and pooling of such risks, general insurance improves economic welfare in Australia by reducing the cost of self-insurance and freeing resources for more productive uses. Insurance helps ensure that risks are more efficiently allocated and, at a practical level, that individuals and businesses in Australia can pursue economic activities secure in the knowledge that risk has been transferred to their insurer.

Indeed, a strong, stable and innovative general insurance industry is an essential component of a modern Australian economy. The industry employs approximately 60,000 people and on average pays out about $124.2 million in claims each working day[1]. The industry plays a critical role in protecting the financial well-being of individuals, households and communities by restoring their standard of living and helping communities recover following natural catastrophes. The contributions of the general insurance industry to the recovery of communities from natural catastrophes are significant not only in terms of the billions of dollars of claims paid, but also because of the evolving risk mitigation and emergency management initiatives that make for more resilient Australian communities.

Australia's general insurance market is highly competitive. It is important to recognise that pricing is only one aspect of competition; general insurers compete vigorously with diverse product offerings, coverage and claims servicing and performance.

Between 2004 and 2016, home and contents insurance[2] premiums in NSW increased at around 5.5 per cent per annum. A range of factors have contributed to the increase, including the number of natural disasters, higher claim volumes and amounts and costs associated with meeting those claims, higher asset values and sum insured amounts, higher rebuilding costs, changes to regulatory[3] requirements and higher global reinsurance costs.

Indeed, government charges have also contributed to the increases. As emphasised in the Emergency Services Levy Insurance Monitor's Public Inquiry Issues Paper (the Issues Paper), the ESL, GST and Stamp Duty could collectively increase any given rise to a NSW home and contents insurance policy base premium by 44 per cent.

Premium trends should also be seen against the financial performance of the general insurance industry, which has experienced volatile returns in the past. Over recent years, the industry has experienced a marked deterioration in financial performance.

The Insurance Council has consistently argued that the relative imbalance between funding for disaster response activities compared with disaster mitigation is a longstanding economic failure in Australia. Correction of this imbalance, in a manner that incentivises a systemic approach to reducing existing community exposures and preventing future planning mistakes, should be a national priority. The benefits of mitigation are manifold, including improved community safety, economic stability through lower rates of disruption, and lower insurance premiums.

---

[1] Based on data from the Australian Bureau of Statistics (ABS) and Australian Prudential Regulation Authority (APRA).
[2] Classed as 'Building and Contents Insurance' by Insurance Statistics Australia.
[3] Such as the final implementation of APRA's *Life and General Insurance Capital Standards* (LAGIC) in January 2014.

Insurance Council of Australia Limited ABN 50 005 617 318
PO Box R1832 Royal Exchange NSW Australia 1225
t +61 2 9253 5100 f +61 2 9253 5111
www.insurancecouncil.com.au

2. Industry Competition

The Insurance Council of Australia submits that the Australian general insurance industry is highly competitive and is characterised by relatively low barriers to entry, particularly in the retail short-tail classes such as home insurance.

Over recent years, these insurance classes have been subject to additional competition from Australian Prudential Regulation Authority (APRA)-authorised foreign insurers entering[4] the Australian market. New competitors are also emerging from other industry sectors (notably banks, large retail groups and motor vehicle retailers) that have engaged in aggressive advertising as well as offering lower premiums and alternative product features. The level of competition has also been enhanced through technology – particularly the internet and other digital technology – and has provided an efficient and cost-effective way for new participants to compete.

Australia's general insurance industry is comprised of a large number of insurers providing a diverse range of insurance products for consumers. As at 31 December 2016, there were 109 APRA-authorised general insurance businesses operating in Australia, largely unchanged over the past year but representing a net decline of 23 insurers over the past decade. As pointed out by APRA[5], the net decline largely reflects a number of mergers and acquisitions, and rationalisation within some insurance groups that held multiple licences arising from past acquisitions. APRA added that the rationalisation included the privatisation of state government insurers and demutualisation of mutually owned insurers and, in a number of such cases, their subsequent takeover.

Other Stakeholder Assessments of Competition

The Issues Paper remarks that the general insurance industry is often described by industry participants as being highly competitive[6]. However, this is not only the assessment of industry participants. Similar assessments have also been made by the APRA, the Australian Treasury and the Financial System Inquiry (FSI), and also by credible private market observers KPMG and PwC; provided below is a summary of their assessments of competition.

In its recent submission to the Senate Inquiry into Australia's General Insurance Industry, APRA emphasised that:

> "*The personal lines market continues to display healthy competition. Incumbents have maintained a competitive position in all classes of business, while coming under increasing pressure from challenger brands such as Auto and General, Youi and Hollard, which continue to grow their market share. Large retail groups are also continuing to have an impact, as they seek to gain market share, particularly in the domestic motor class of business*"[7].

---

[4] APRA, Submission to the Financial System Inquiry, 31 March 2014. Page 99.

[5] APRA, Submission to the Financial System Inquiry, 31 March 2014. Page 9.

[6] Emergency Services Levy Insurance Monitor Price Inquiry Issues Paper, 13 April 2017. Page 17.

[7] APRA submission to the Senate Inquiry into Australia's General Insurance Industry, released March 2017. Page 2.

Insurance Council of Australia Limited ABN 50 005 617 318
PO Box R1832 Royal Exchange NSW Australia 1225
t +61 2 9253 5100 f +61 2 9253 5111
www.insurancecouncil.com.au

APRA has also observed[8] that strong levels of competition are evident in most classes of general insurance. In the personal lines market, the presence of various foreign insurers as well as large retail groups is having an impact as they seek to build market share, particularly in the domestic motor class of business.

Additionally, APRA explained in its 2015 Annual Report[9] that a number of new entrants, particularly APRA-authorised subsidiaries and branches of foreign insurers, have entered the personal and commercial lines markets over the past decade, offsetting the general trend towards consolidation and adding to the level of competition present.

The Insurance Council notes that the FSI Interim Report[10] made a similar assessment on the level of competition in the general insurance industry, observing that although the insurance sector has generally become more concentrated, some trends are moving in the opposite direction. The FSI Interim Report remarked that a number of new insurers have entered the market, and added that banks and retailers have also entered the insurance market, usually by white labelling products provided by the main insurers, but with some underwriting themselves[11].

The Australian Treasury, in its submission[12] to the FSI, concluded that there has been an intensification of competition and contestability broadly across the general insurance sector in recent years. The Australian Treasury explained that there have been new entrants offering a range of general insurance products and capturing market share by advertising aggressively and offering cheaper premiums and/or enhanced product features. It added that a number of new entrants are offering online services only, and that incumbents are responding by establishing low-cost competitors that operate online.

KPMG's General Insurance Industry Review 2016[13] found that there were competitive market conditions in the Australian general insurance industry and predicted these to intensify and place pressure on premiums. The KPMG Review also found that while the growth rate of new insurers slowed in 2016, these new participants continued to provide significant competition within the personal lines of the general insurance market.

The Insurance Facts and Figures report[14] by PwC Australia similarly reported that the insurance industry is experiencing increased levels of competition from new insurers. The report stated that two new insurers' market shares consistently increased since their introduction into the general insurance market. The penetration and consistent growth of new industry participants are widely acknowledged indicators of healthy competition.

---

[8] APRA *Insight*, Issue 3 2013. Page 8.

[9] APRA 2015 Annual Report, released 7 October 2015. Page 20.

[10] The Financial System Inquiry *Interim Report*, released 15 July 2014. Page 2-39.

[11] The Financial System Inquiry *Interim Report*, released 15 July 2014. Page 2-39.

[12] The Australian Treasury's submission to the Financial System Inquiry, released 3 April 2014. Page 64.

[13] KPMG, *General Insurance Industry Review 2016*, September 2016. Pages 8-9.

[14] PwC Australia, *Insurance Facts and Figures* report 2016, May 2016. Page 2.

Insurance Council of Australia Limited ABN 50 005 617 318
PO Box R1832 Royal Exchange NSW Australia 1225
t +61 2 9253 5100 f +61 2 9253 5111
www.insurancecouncil.com.au

Limitations of Concentration Analysis

The Insurance Council notes the analysis in the Issues Paper regarding the level of concentration in the general insurance industry. We recognise that industry concentration is often used by regulators internationally as an initial indicator of market competitiveness.

Concentration analysis is also used by the Australian Competition and Consumer Commission (ACCC) to aid its assessment of the potential competitive impact of proposed horizontal mergers and, also more generally, the level of competitiveness of particular industries. Despite its widespread use, there is literature showing that there are key limitations to solely relying on concentration analysis[15].

Firstly, important variables (sometime unquantifiable) are unaccounted for by solely relying on concentration analysis that can have a material influence on the level of competitiveness. Furthermore, even when a level of concentration can be associated with a decrease in competition, the costs of this decrease may be offset by benefits to consumers in terms of reduced prices resulting from economies of scale due to market consolidation.

For example, the ACCC applied the Herfindahl-Hirschman Index (HHI) – a widely used concentration analysis technique – to the grocery sector in Australia as part of its 2008 Grocery Inquiry[16]. The ACCC estimated the HHI for packaged groceries in Australia to be between 2,750 and 3,000[17]. While the ACCC took this figure to indicate a high level of concentration, it considered that other factors such as barriers to entry and expansions also needed to be considered before an informed judgement on market competitiveness and the need for intervention could be made.

Emergency Services Levy Insurance Monitor's Survey on Home Insurance Premiums

The Insurance Council notes that the Issues Paper canvasses a survey conducted by the Emergency Services Levy Insurance Monitor's Office to track differences in the price of home insurance for a number of homes in certain suburbs in New South Wales. Based on the differences in observed premiums, the Issues Paper suggests that competition in the home insurance market is not truly competitive, efficient and effective. We consider that this suggestion is potentially misleading as it does not adequately take into account the different underwriting criteria and risk appetites of different insurers competing in the market.

For instance, different insurers may not offer identical policies with identical levels of coverage for each and every insured risk. In some circumstances, an insurer may not provide cover in a policy for a certain risk (or number of risks), if it believes the risk exposure would be too high. Additionally, a relatively higher premium for a certain policy may indicate that the insurer is approaching (or has reached) its capacity limit for the insured risks under that type of policy over a given period.

Indeed, the fact that so many insurers are prepared to offer products across those diverse areas of NSW indicates that there is a robust level of competition, not the opposite.

---

[15] For example, refer to: Roberts, T 2014, '*When Bigger Is Better: A Critique of the Herfindahl-Hirschman Index's Use to Evaluate Mergers in Network Industries*': Pace Law Review, vol. 34, issue. 2.

[16] ACCC price inquiry into the price of groceries ('Grocery Inquiry') 2008.

[17] ACCC, '*Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*'. July 2008. Page 51.

Insurance Council of Australia Limited ABN 50 005 617 318
PO Box R1832 Royal Exchange NSW Australia 1225
t +61 2 9253 5100 f +61 2 9253 5111
www.insurancecouncil.com.au

3. Pricing of Home and Contents Insurance[18]

The Insurance Council notes the analysis in the Issues Paper on trends in NSW home and contents insurance premiums. We have provided the Emergency Services Levy Insurance Monitor with data on NSW home and contents insurance spanning over 12 years[19] to help facilitate a longer term view of premium trends. In drawing any conclusions about these trends, it is important to understand the key drivers impacting these insurance premiums. We note that the Issues Paper has identified some of the key drivers.

The increases that can be seen in NSW home and contents premiums – and also in other States and Territories more broadly – have been driven by a multitude of factors, such as the number of natural disasters, higher claim volumes and amounts and costs associated with meeting those claims, higher asset values and sum insured amounts, higher rebuilding costs, changes to regulatory[20] requirements and higher global reinsurance costs.

As the Emergency Services Levy Insurance Monitor would appreciate, if insurance is to be economically efficient and commercially viable, rigorous risk assessment should determine the underwriting criteria and pricing. This is the basic principle that underpins the sustainable operation of insurance models. This allows insurers to offer insurance at a price appropriate to insureds and enables insurers to put aside reserve funding for future liabilities. Importantly, this also enables insurers to target important risks and provide a diverse range of insurance products for Australian communities.

NSW Home and Contents Insurance Premium Trends

Over the past 12 years to 31 December 2016, average home and contents insurance premiums in NSW increased at an average annual rate[21] of around 5.5 per cent (Chart 1 below refers). Over the past 3 years however, premiums increased at a much lower average annual rate of around 1.4 per cent. In contrast, Average Weekly Earnings[22] in NSW and the national Consumer Price Index[23] increased at average annual rates of around 2.6 per cent and 1.6 per cent, respectively, over the same 3 year period.

Chart 1 also shows how increases in total claims incurred[24] and average sum insured for home and contents insurance have contributed to increases in home and contents insurance premiums in NSW.

Over the past 12 years, total claims incurred for home and contents insurance in NSW increased at an average annual rate of around 7.1 per cent, while the average sum insured increased at an average annual rate of around 4.5 per cent over the same period.

---

[18] This section provides analysis on trends in NSW home and contents insurance premiums. The data for home and car insurance premiums is from [Insurance Statistics Australia](#).

[19] The currently available series of data points for NSW home and contents insurance from Insurance Statistics Australia is from March 2004 to December 2016. This submission utilises data points Dec-04 though to Dec-16 for 12 years of data.

[20] Such as, the full implementation of APRA's *Life and General Insurance Capital Standards* (LAGIC) in January 2014.

[21] Compound annual growth rate (CAGR) used; generally expressed as *CAGR = (end value/beginning value)*$^{(1/\#years)}$ *– 1*.

[22] Australia Bureau of Statistics, *6302.0 - Average Weekly Earnings, Australia, Nov 2016*. Seasonally adjusted figures.

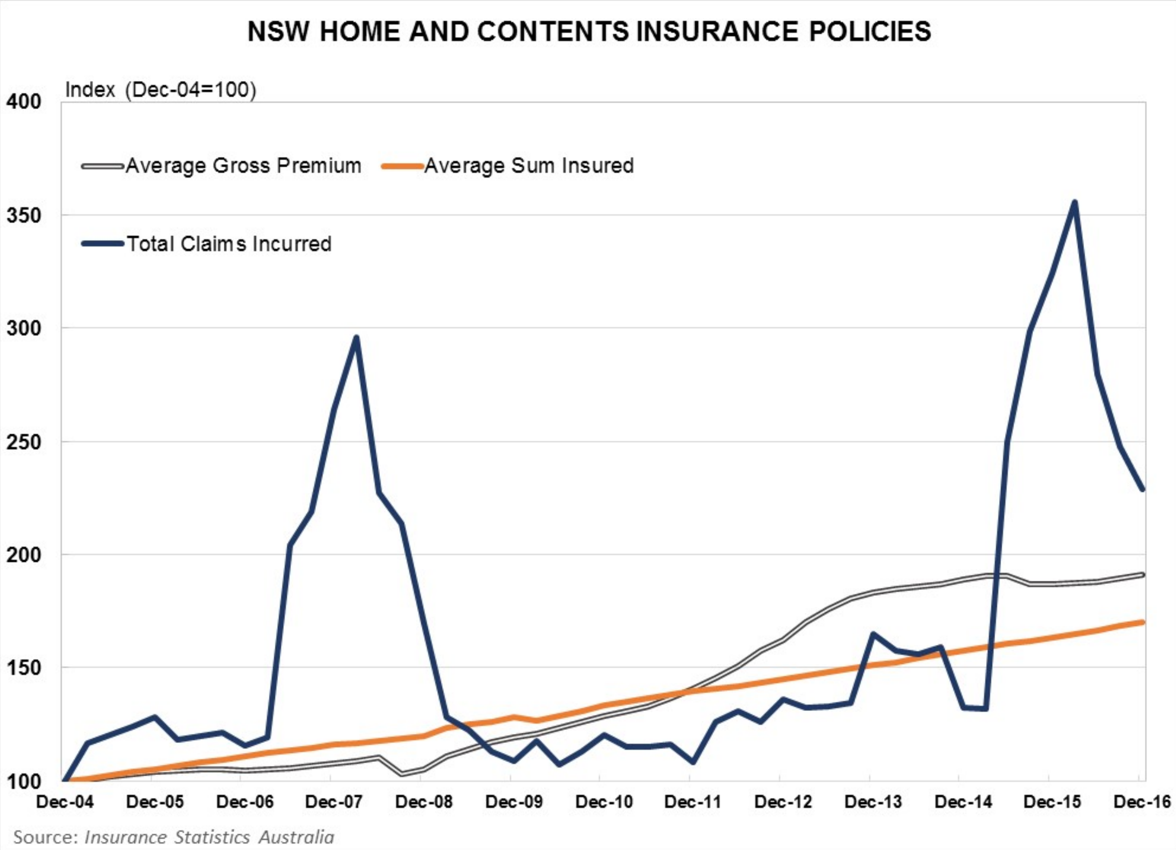
[23] Australia Bureau of Statistics, *6401.0 - Consumer Price Index, Australia, Mar 2017*. Seasonally adjusted figures.

[24] Total Claims Incurred refers to rolling 12-month figure. Source: Insurance Statistics Australia.

Insurance Council of Australia Limited ABN 50 005 617 318
PO Box R1832 Royal Exchange NSW Australia 1225
t +61 2 9253 5100 f +61 2 9253 5111
www.insurancecouncil.com.au

While growth in average home and contents insurance premiums in NSW moderated over the past 3 years (average annual growth of around 1.4 per cent), total claims incurred and the average sum insured for these products increased at markedly higher growth rates of around 11.5 per cent and 4.1 per cent, respectively, over the same period.

Chart 1



Over recent years, weather-related and other natural catastrophes in Australia and in other regions around the world have had huge flow-on consequences for the insurance sector globally such as significantly increased reinsurance costs. In 2015 for example, tornadoes and severe storms devastated many parts of NSW, which led to record claims levels. The estimated insurance loss from declared catastrophe events in NSW that year was around $1.6 billion[25].

Other relevant factors are the rapid expansion in the availability of flood cover in Australia. In 2008, flood cover was only available for 3 per cent of relevant policies. By 2015, 96 per cent of policies purchased in Australia had flood cover.

Furthermore, as a result of the implementation by 1 January 2014 of the outcomes of APRA's Life and General Insurance Capital (LAGIC) review, it has been estimated that the

[25] Insurance Council of Australia *Catastrophe Database*. Estimated loss value for 2011 (original dollars).

Insurance Council of Australia Limited ABN 50 005 617 318
PO Box R1832 Royal Exchange NSW Australia 1225
t +61 2 9253 5100 f +61 2 9253 5111
www.insurancecouncil.com.au

regulatory capital requirements of the general insurance industry increased by 2 per cent.[26] Such an increase in capital could only be achieved through an increase in business costs.

Government taxation also plays a role, with insurance policies subject to varying levels of stamp duty in all Australian jurisdictions apart from the ACT, where stamp duty was fully abolished from 1 July 2016.

[26] Finity Consulting, '*d'finitive APRA GI Statistics*'. Published August 2014. Page 1.

Insurance Council of Australia Limited ABN 50 005 617 318
PO Box R1832 Royal Exchange NSW Australia 1225
t +61 2 9253 5100 f +61 2 9253 5111
www.insurancecouncil.com.au

4. Industry Financial Performance

It is important to look at changes in general insurance premium levels against the background of the broader financial performance of the industry. We note the analysis in the Issues Paper, using data from APRA over a 5 year period, which shows that the financial returns of the general insurance industry can be very volatile (even over a relatively short time frame of 5 years) and that the industry has more recently experienced a deterioration in financial performance from previous years.

General insurers continue to face a significant number of challenges to manage volatility in financial performance. It is critical that general insurers successfully manage this volatility and that the sector remains financially strong and stable, so that it can continue to meet its claims liabilities to policy holders.

To help supplement the information in the Issues Paper, we have provided analysis below on the financial performance of the general insurance industry spanning over 13 years to help facilitate a longer term view of financial performance trends.

Our analysis, also using data publicly released by APRA[27], indicates that there has been a material deterioration in the financial performance of the general insurance industry over recent years, relative to historic longer term[28] performance.

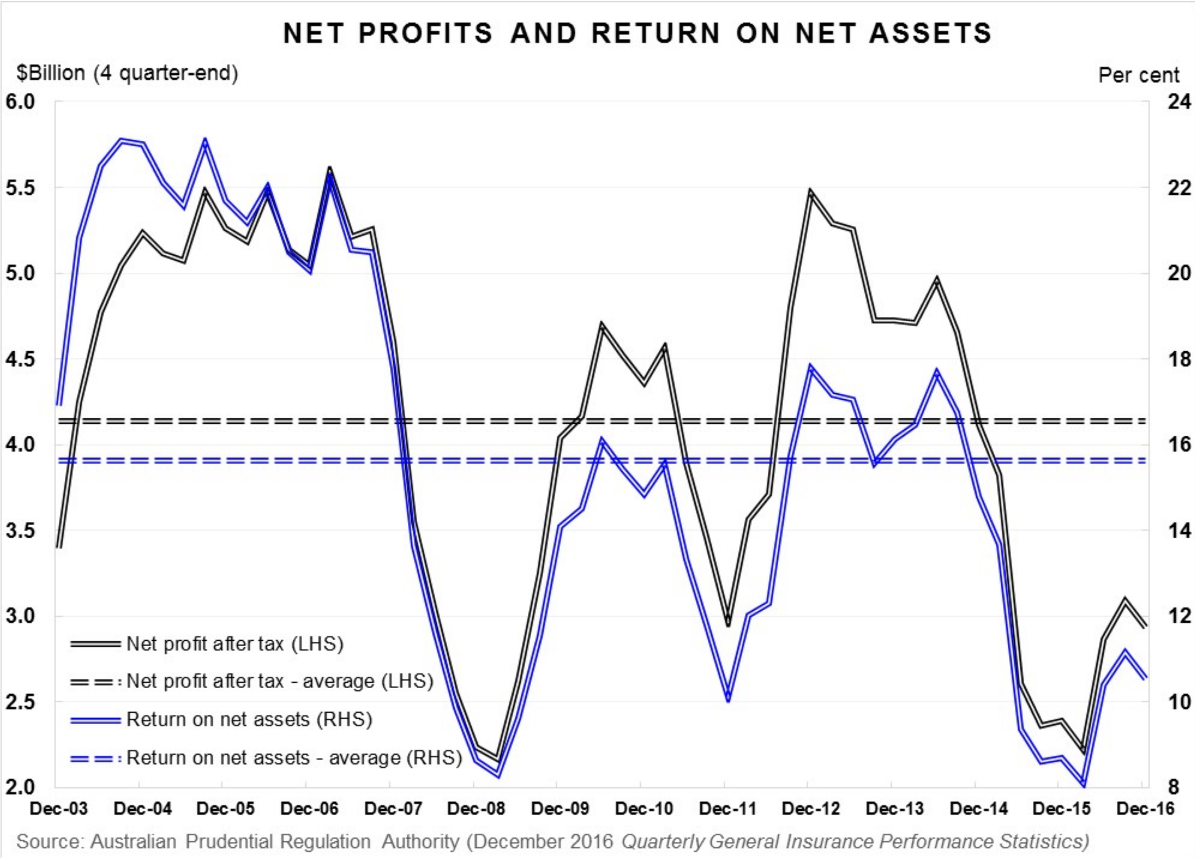
Chart 2 below shows that total net profit after tax in the year ending 31 December 2016 for the Australian general insurance industry was $2.9 billion. While this was up from $2.4 billion in the previous year, it is down around 29 per cent from the longer term[29] average of $4.1 billion, and is at a similar level experienced during the 2008 Global Financial Crisis.

The lower level of industry net profit has had a noticeable impact on industry return on net assets, which measures how effectively and efficiently the industry has been able to use its assets to generate earnings. Chart 2 shows that the total general insurance industry's return on net assets in the year ended 31 December 2016 was around 10.6 per cent. While this was up from around 8.7 per cent in the previous year, it remains much lower than the longer term average of around 15.6 per cent.

[27] APRA September 2016 *Quarterly General Insurance Performance Statistics*.
[28] Captures APRA data 4 quarters ending Dec-03 through to 4 quarters ending Dec-16.
[29] Captures APRA data 4 quarters ending Dec-03 through to 4 quarters ending Dec-16.

Insurance Council of Australia Limited ABN 50 005 617 318
PO Box R1832 Royal Exchange NSW Australia 1225
t +61 2 9253 5100 f +61 2 9253 5111
www.insurancecouncil.com.au

Chart 2



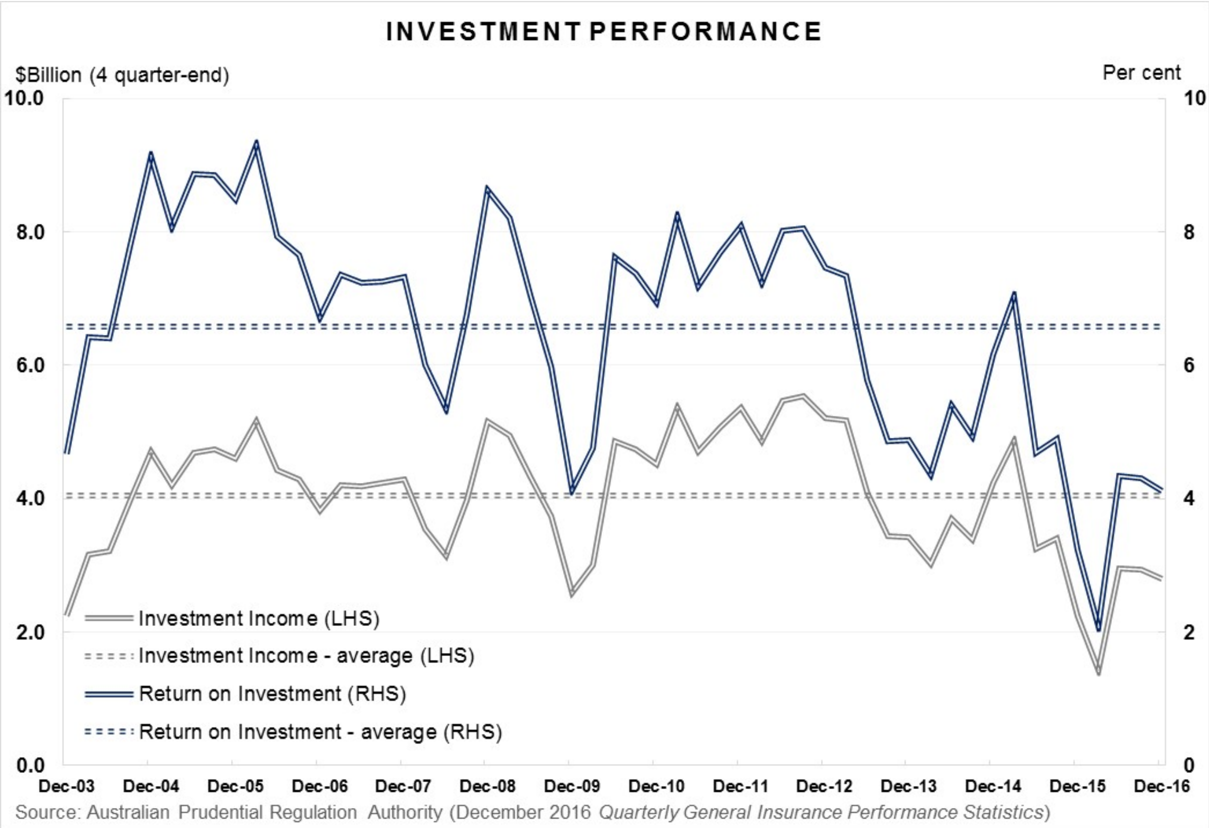
In relation to the general industry's investment performance, our analysis shows that returns have been markedly lower over recent periods relative to historic longer term performance.

The general insurance industry's return on investment in the year ended 31 December 2016 was around 4.1 per cent (Chart 3 below refers). While this is up from around 3.2 per cent in the previous year, it remains lower than the longer term average[30] of around 6.6 per cent. Return on investment is a widely used financial performance measure for evaluating the efficiency of investments.

[30] Captures published APRA data 4 quarters ending Dec-03 through to 4 quarters ending Dec-16.

Insurance Council of Australia Limited ABN 50 005 617 318
PO Box R1832 Royal Exchange NSW Australia 1225
t +61 2 9253 5100 f +61 2 9253 5111
www.insurancecouncil.com.au

Chart 3



The Insurance Council's analysis is consistent with recent analysis by Finity Consulting (and Deutsche Bank), which found that lower investment returns accompanied by continuing low premium growth, mean the financial outlook for the general insurance industry will be satisfactory but not strong. Finity Consulting's view is that "*investment returns are at record lows, which means profitability from underwriting operations is more important than ever – yet it is getting harder to achieve*"[31].

Additionally, Finity Consulting found that low investment returns on shareholders' funds are also impacting the return on equity (ROE). As a result, it estimated that the ROEs for 2015-16 to be in the 9-10 per cent range, the first time in a few years that ROEs have been in single digits.

[31] 2016 *Pendulum report*, co-authored by Finity Consulting and Deutsche Bank. Released 27 July 2016.

Insurance Council of Australia Limited ABN 50 005 617 318
PO Box R1832 Royal Exchange NSW Australia 1225
t +61 2 9253 5100 f +61 2 9253 5111
www.insurancecouncil.com.au