



6 August 2024

Dr Daniel Mulino MP | Federal Member for Fraser
Chair
House of Representatives Standing Committee on Economics
Parliament House
Canberra ACT 2600

Suzanne Smith, Executive Board Member

Melbourne
535 Bourke Street (Level 24), VIC 3000
GPO Box 9836, Melbourne VIC 3001
Australian Prudential Regulation Authority
03 9246 7500 | apra.gov.au

Dear Chair

Inquiry into insurers' responses to 2022 major floods claims

APRA has prepared the following submission to supplement evidence provided at the public hearing on 2 February 2024 and at the subsequent private briefing to the Committee on 21 May 2024. This submission outlines the key drivers of profit and loss for general insurers (GIs) and the general insurance industry, including relevant data to assist the Committee with its Inquiry.

APRA's Role

APRA's role is to ensure that the financial interests of Australians are protected by establishing and enforcing prudential standards and practices designed to ensure that under all reasonable circumstances, financial promises made by insurers – to fulfil valid policyholder claims – are met within a stable, efficient, and competitive financial system. APRA's prudential standards for GIs fall within three core categories: capital, governance, and risk management. To remain prudentially sound, APRA expects insurers would ordinarily set premiums that accurately reflect risk, recoup costs over time, and ensure they are able to access sufficient reinsurance protection. Beyond ensuring that an insurer's pricing practices are managed within an insurer's overall risk management framework, APRA does not have a role in overseeing or regulating the premium pricing decisions of insurers.

APRA collects and publishes data on areas such as financial performance, investments, claims, solvency, capital adequacy as well as key performance ratios to help provide transparency of trends in the insurance industry. Drawing on APRA data, this submission provides additional information about premium levels, profit and the drivers of profit at the GI industry level. The submission also provides data and trends at the home insurance product line level where retail customers have experienced significant increases in their premiums.

Overview

A thriving insurance industry – where insurers have confidence to participate in the market and retail customers and businesses can access the protection they need – underpins the economic activity of the country. The GI industry is currently facing significant challenges that are impacting households and other customers in the form of higher premiums. Interest rates, inflation, supply chain strain, the increasing frequency and severity of extreme weather

events, rising housing prices and tight labour market conditions are among the factors contributing to the increases in premiums and pressures on the profitability of the GI industry.

The data provided covers the GI industry as a whole and includes more granular data specific to the home insurance product segment to illustrate emerging sustainability issues and pressures; the impact to retail customer premiums; and both insurer and product line profitability. Our analysis also examines the relationship between premiums, costs and underlying risk. As claims have increased in size and number, premiums have increased in response. In addition, we show that insurer profitability is volatile due to the nature of underlying components beyond primary risk, including reinsurance and investment returns.

Risk reduction and risk avoidance are essential to helping reduce the cost of home insurance for consumers. This requires a whole-of-system approach, including involvement from insurers, all levels of government, regulators and consumers. Given the importance of access to insurance for Australian households and businesses, APRA is encouraging insurers to provide customers with greater transparency around premium pricing and useful mitigation activities.

We trust this supplementary submission is of assistance to the Committee. For your reference we have included a glossary of commonly used terms at the end of the submission.

Yours sincerely,

Suzanne Smith

Executive Board Member

Change in General Insurance over time

While Gross Written Premiums (GWP) have increased, claims have also grown in number and size.

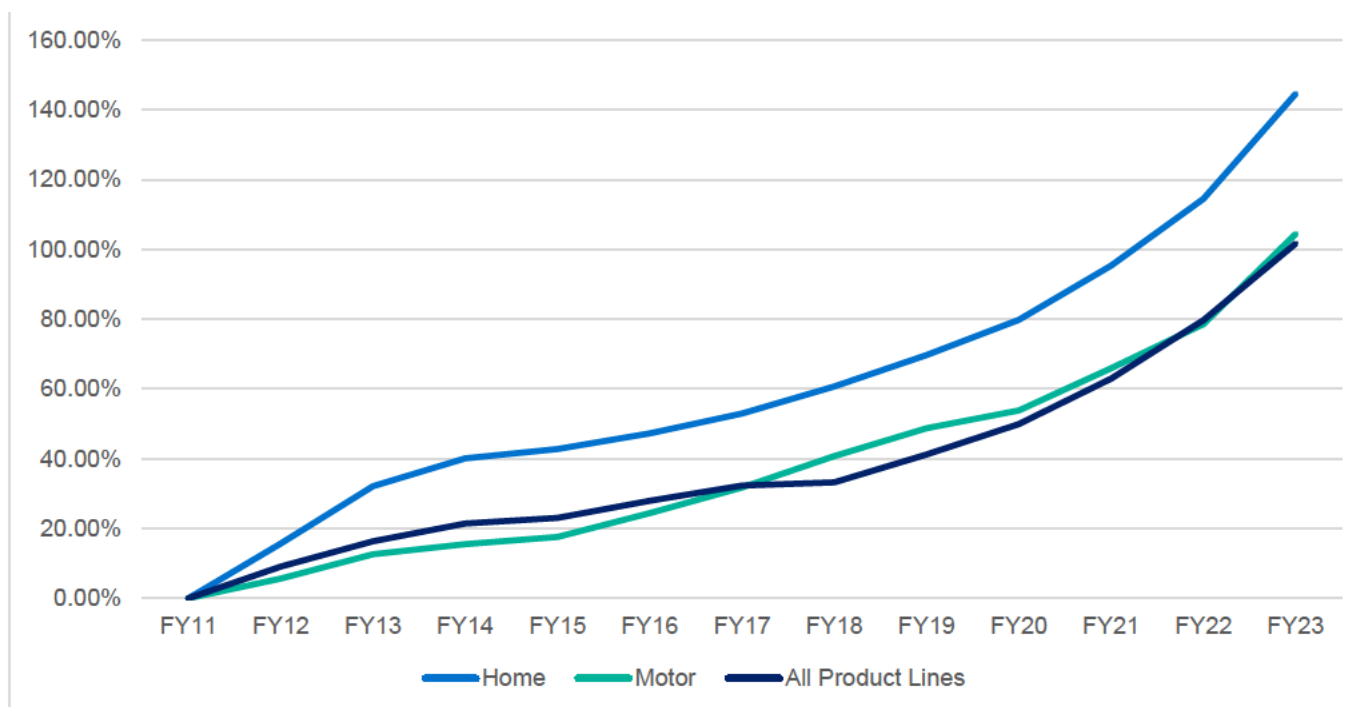
In this section, we look at the GI industry overall and then look at home insurance in particular.

Figure 1 shows the cumulative percentage change in GWP for all insurers across all product lines and across the main retail lines of business of home insurance and motor since 2011.¹ GWP measures the total value of premiums collected by an insurance company.

- The total value of GI premiums has doubled since 2011, with GWP increasing from \$34bn to \$69bn. Within this, home insurance GWP has increased from \$5.3bn to \$13bn. In this time, however, there has not been a comparable growth in the policy numbers (see Figure 2 below), indicating that premium increases for customers have been the major driver of GWP growth.
- Over time, premiums for home insurance policies reflect claims paid on these policies and weather events are a significant contributor to claims (more information on claims is shown in Figure 4 below). As a result, the increased frequency and severity of weather events (as well as the exposure of policy holders to these hazards and the increased cost of remediation) have contributed to the increase of both premiums and claims in the home insurance sector.

Figure 1: Cumulative Percentage change in GWP over time (2011 Base)

Source: APRA quarterly general insurance statistics²



¹ 2011 is taken as the baseline year due to changes in accounting standards that took effect in that year. Some other charts in the submission use a different year as a starting base, mainly due to changes in APRA's statistical publications and for clarity.

² APRA Data, [Quarterly General Insurance Statistics](#)

Figure 2 shows aggregate insurers' written risks for home insurance. **Figure 3** shows data for all insurers' claims, and premiums for home insurance over the past decade.

- The blue line in Figure 2 shows the number of written risks, which can be broadly characterised as the total number of homes insured.

In Figure 3, the blue bars show the cost of total claims, which have been trending upward at a much faster rate than written risks. While there is natural volatility in claims year to year, there has been a general upward trend in the overall volume and cost of claims.

Reasons for this include:

- An increase in the number of claims due to more frequent and severe weather events, particularly floods, combined with an increased number of households now under threat from catastrophe events that were not at risk in the past; and
- An increase in the cost of claims, particularly due to sustained inflation in the construction and resources sectors.

The orange bars in Figure 3 show the aggregate of all insurers' GWP for home insurance, which has also been increasing over time as insurers have raised premiums in response to the increasing risk as evidenced by the rising number and cost of claims. Despite rising GWP in home insurance, home insurance as a product line remains unprofitable (see Figure 6 for more detail).

Figure 2: Aggregate Insurers' Written Risks – Home Insurance

Source: APRA quarterly general insurance statistics

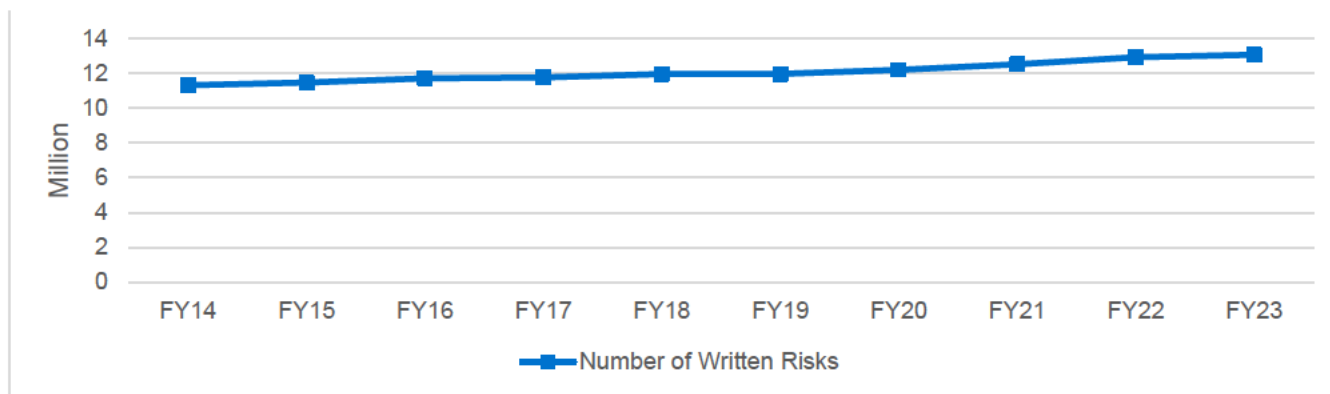


Figure 3: Claims and Gross Written Premiums (GWP) – Home Insurance

Source: APRA quarterly general insurance statistics

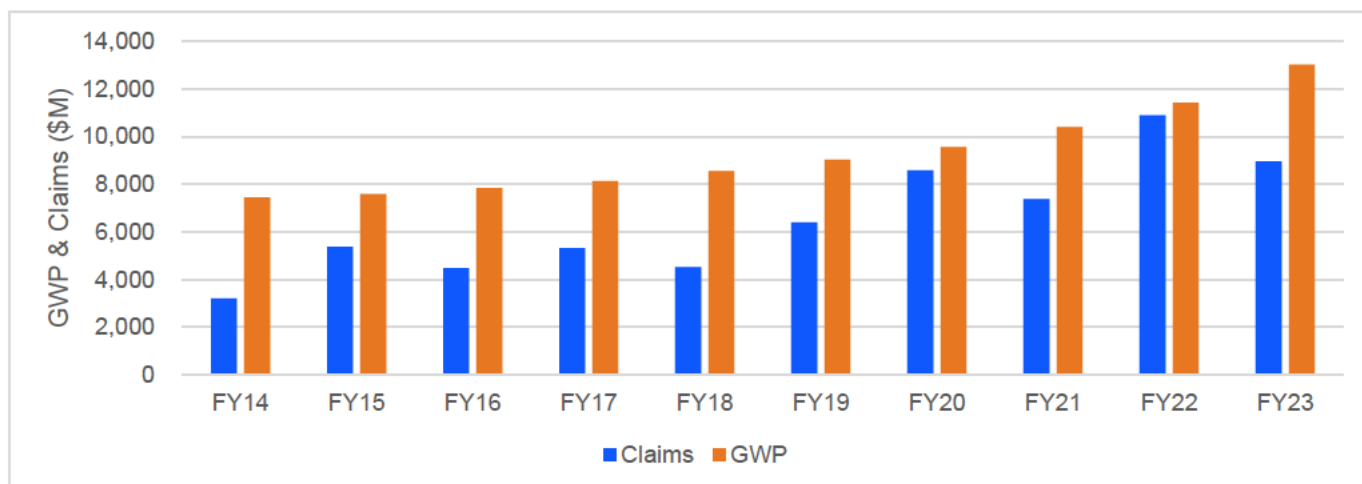
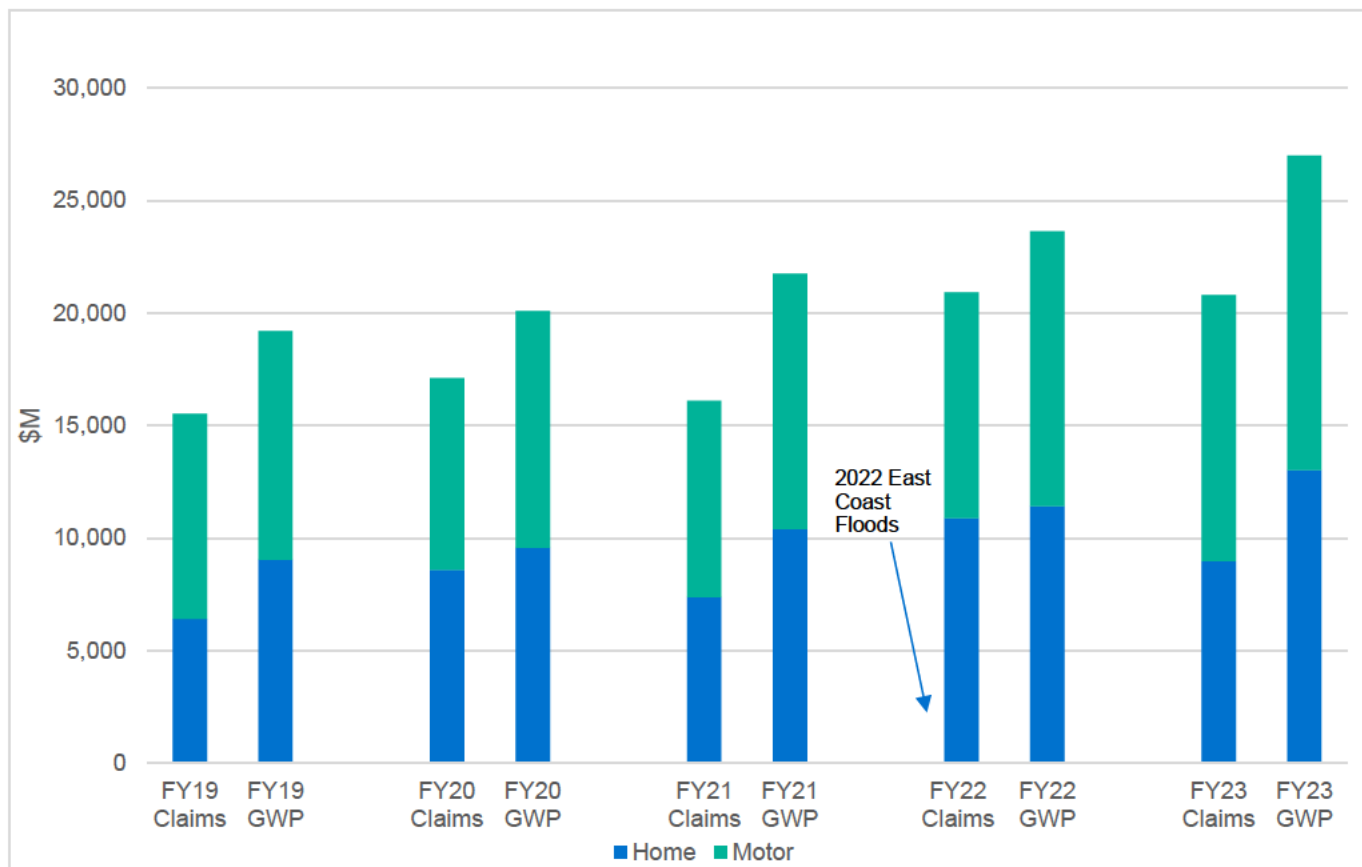


Figure 4 shows the respective growth in GWP and claims across key retail business lines (home and motor) over the past five years.

- Each pair of columns shows the GWP and claims cost for the specified financial year.
- Columns are composed of home and motor, allowing a comparison of each across different years.
- Both GWP and claims have materially increased since FY19 (as shown above). As the arrow indicates below, there was a marked increase in the cost of household claims from FY21 to FY22 associated with the significant flooding events that year.³ This elevated level of claims has also occurred in significant business lines such as motor due to broader inflationary pressures. GWPs have increased in response to the elevated costs. Impacts on profitability are explored below.
- Home insurance is making up an increasingly larger proportion of insurers' GI books compared to other lines of business. However, home insurance has not made an underwriting profit profitable in recent years (see Figure 6 and Figure 10), indicating longer-term sustainability issues for general insurers.

Figure 4: Premium and Claims Growth across different business lines

Source: APRA quarterly general insurance statistics



³ The costs of individual catastrophes are estimated by the ICA. See here: <https://insurancecouncil.com.au/industry-members/data-hub/>

Profitability

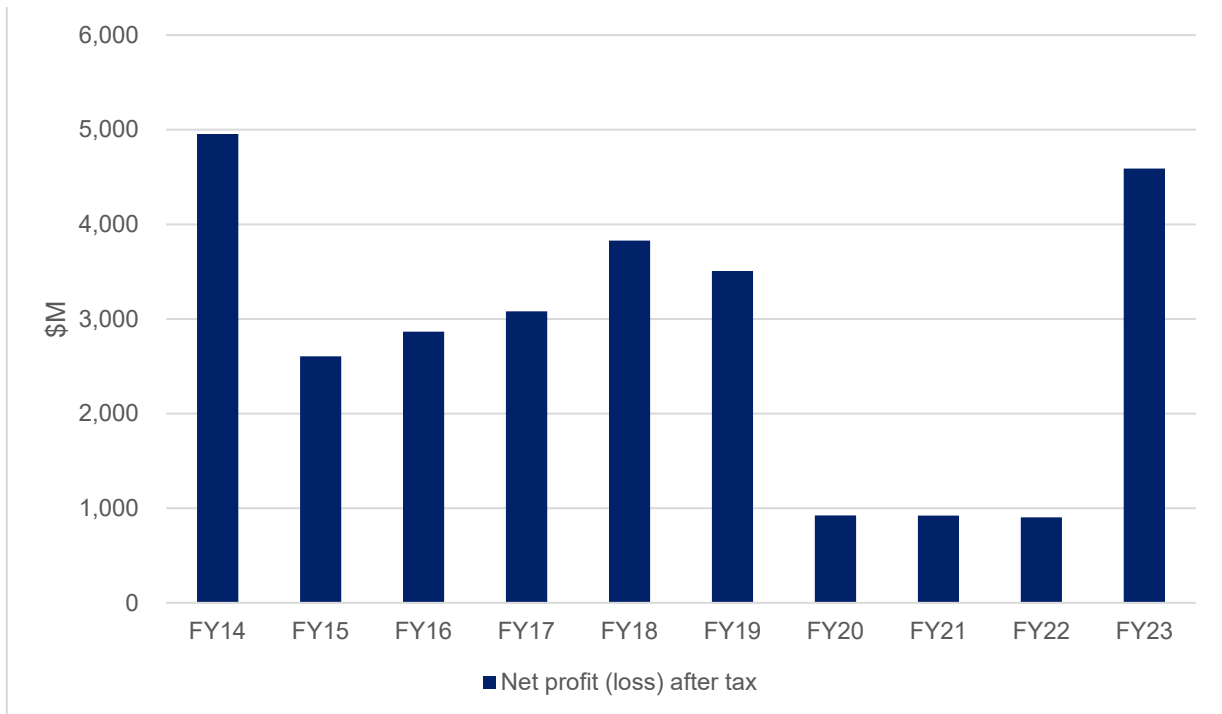
Profitability in insurance is volatile, primarily due to uncertainty in underwriting results and investment returns.

Profitability of the insurance industry is a product of premiums received less incurred claims, underwriting expenses (general expenses associated with running the insurance business), reinsurance costs, plus or minus investment returns or losses. Despite insurers' headline profitability, claims costs are increasing for the home and motor lines of business, suggesting longer term sustainability issues in these lines of business.

Figure 5 sets out net profit after tax across GI. Figure 5 shows that net profit is inherently volatile for an insurer.

Figure 5 – Net Profit After Tax

Source: APRA Quarterly General Insurance Statistics



Through **Figure 6** we analyse all product lines and home insurance through one of the most important metrics for an insurer: the combined operating ratio (COR). The COR measures an insurance company's underwriting profitability by comparing its incurred claims and expenses to its earned premiums. A COR below 100 per cent indicates underwriting profitability, while a COR above 100 per cent indicates underwriting losses, meaning that incurred losses and expenses outstrip earned premiums.

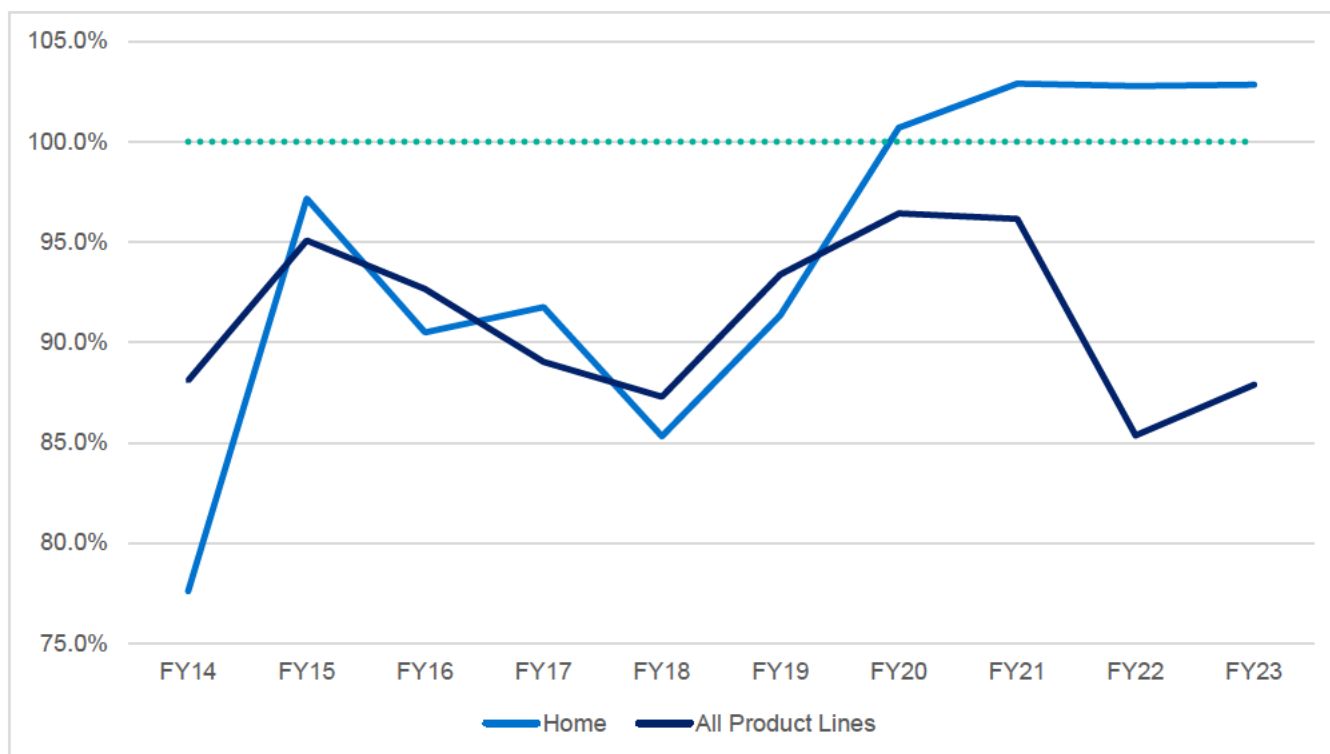
- The COR and profit have a broadly inverse relationship. A lower COR means insurers are generating profit from their insurance business, whereas a higher COR means insurance profits are lower.

In Figure 6, the dark blue line is the COR across all product lines. The light blue line focuses on the COR for all insurers' home insurance line of business. Home insurance policies are the most susceptible to flood and other significant weather events. Home insurance has been unprofitable at an industry level for several years, with CORs above 100 per cent since FY20.

- In FY20 and FY21, COR for all product lines was above 95 per cent, corresponding to decreased levels of profitability.
- In FY23, changes to COR were due in part to large reserve releases relating to Business Interruption insurance through COVID as well as insurers adjusting their pricing and risk selection responding to changing market conditions and emerging pressures.
- Note that even though premiums rose in home insurance, this rise did not increase profitability as CORs remained above 100 per cent for this line of business.

Figure 6 – Average Insurers' Combined Operating Ratio – All Product Lines and Home Insurance

Source: APRA quarterly general insurance statistics



Premiums and underlying risk

The increase in underlying risk, increased reinsurance costs and more frequent and costly claims is leading to premium increases.

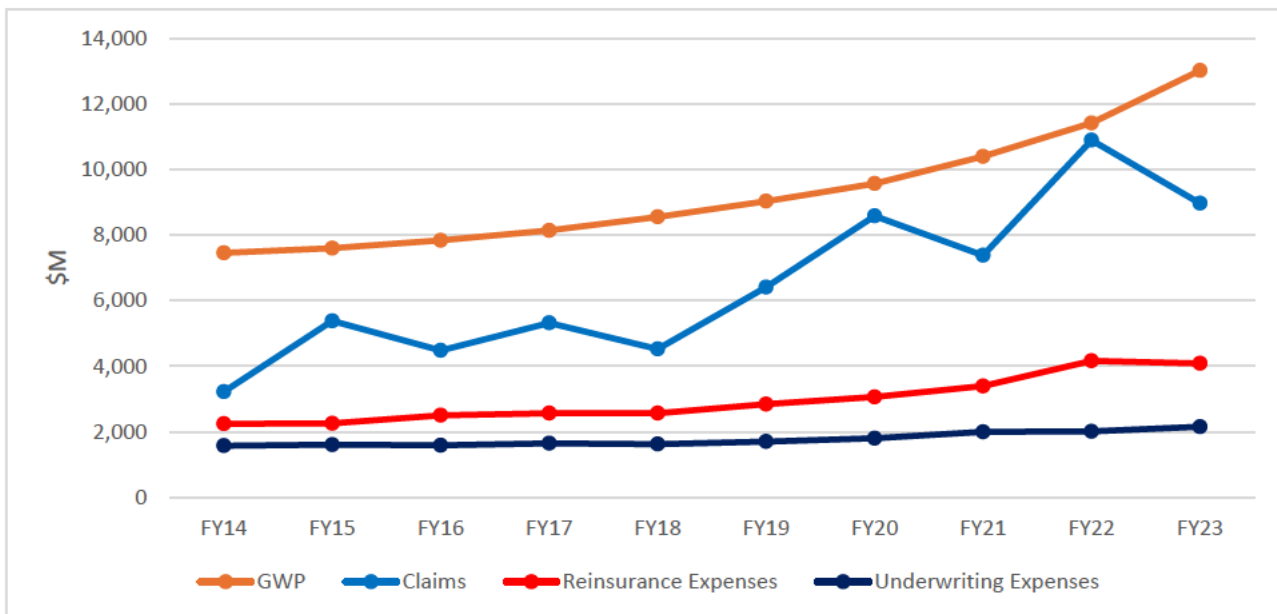
With higher reinsurance costs (see Figure 12) and loss-making lines of business, insurers are increasing premiums to reflect the higher underlying risk.

More frequent and severe weather events occur across Australia have contributed to the increase in the number and cost of insurance claims, particularly for home insurance. In response, reinsurers have been increasing pricing and reducing cover. Reduced reinsurance cover can be expected to increase earnings volatility for insurers who are retaining a greater proportion of the underlying risk.

Figure 7 focuses on these trends for home insurance. It shows a breakdown of the following home insurance policy components: GWP, claims, underwriting expenses, and reinsurance expenses. There is a higher growth rate in claims and GWP relative to both underwriting and reinsurance expenses. This indicates that the increase in underlying risk is the primary driver of increased premiums. Reinsurance expenses have risen in recent years, which has also contributed to recent premium increases.

Figure 7 – Aggregate Insurers’ Policy Components – Home Insurance

Source: APRA quarterly general insurance statistics

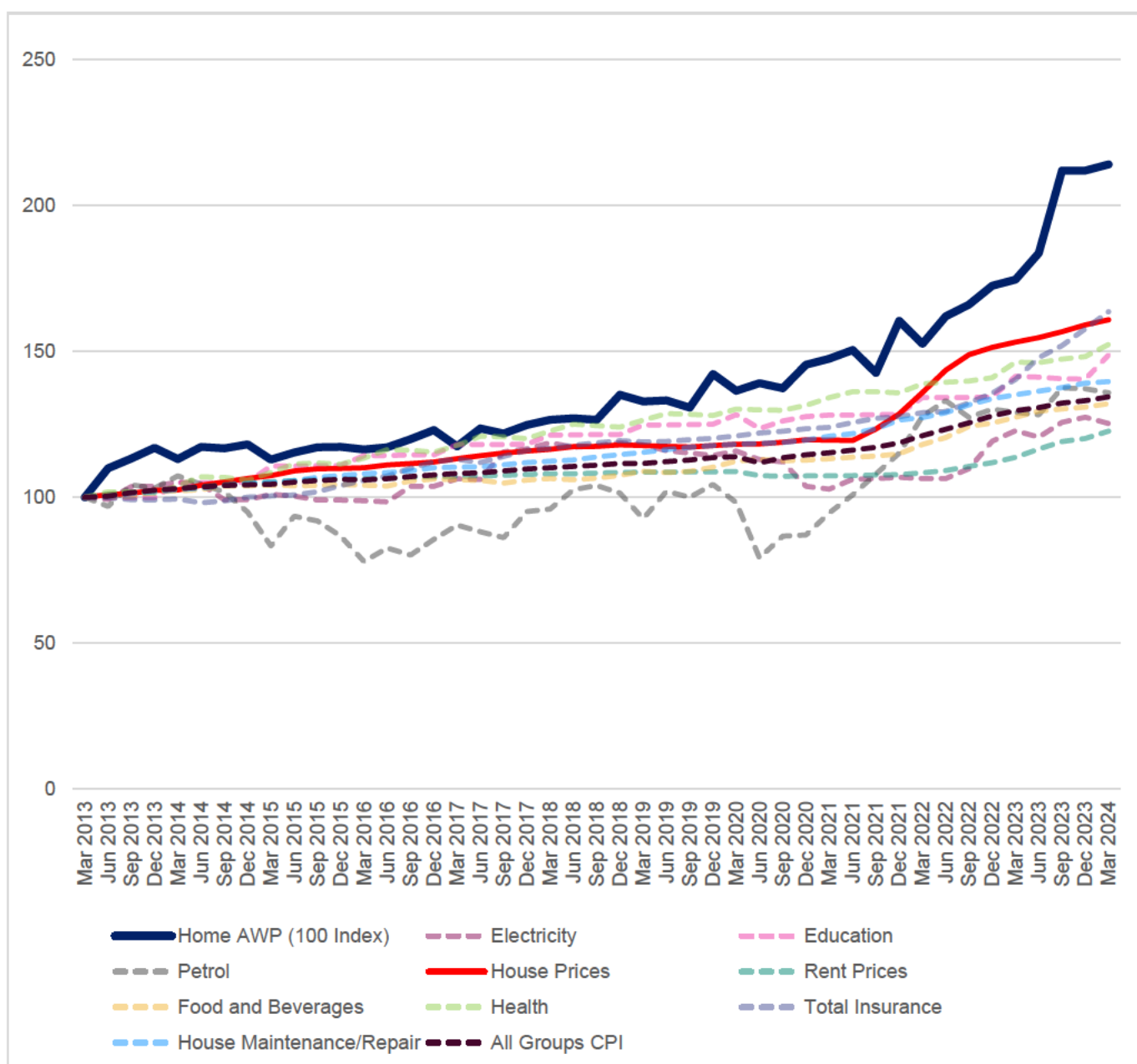


In considering the impact of rising premiums on consumers, we have looked at how increases in insurance premiums compare to other key services at the household level. **Figure 8** charts home insurance premiums against other CPI contributors.

- When focusing on individual policy holders (solid dark blue line), home insurance premiums are growing at a faster rate than other major expenses for consumers (electricity, food and beverage, and rent).
- A home insurance premium of \$1,000 in March 2013 would cost the same household more than \$2000 in 2024.
- Note that claims costs are a compound of several key CPI indicators, such as house prices (solid red line) which have increased significantly and at a higher rate than overall CPI (dotted black line – 'all Groups CPI').

Figure 8 – Indexed Home Premiums vs Other CPI Contributors

Source: APRA Quarterly General Insurance Statistics and ABS CPI



Investment Returns

Investment returns are an important yet volatile component of insurance profitability.

While insurers can generate significant income from investments, this income is volatile. Further, when investment returns are allocated to the home and motor product lines (based on an APRA modelling assumption), it can be seen that there has not been growth in investment returns to offset the increases in claims costs over recent years.

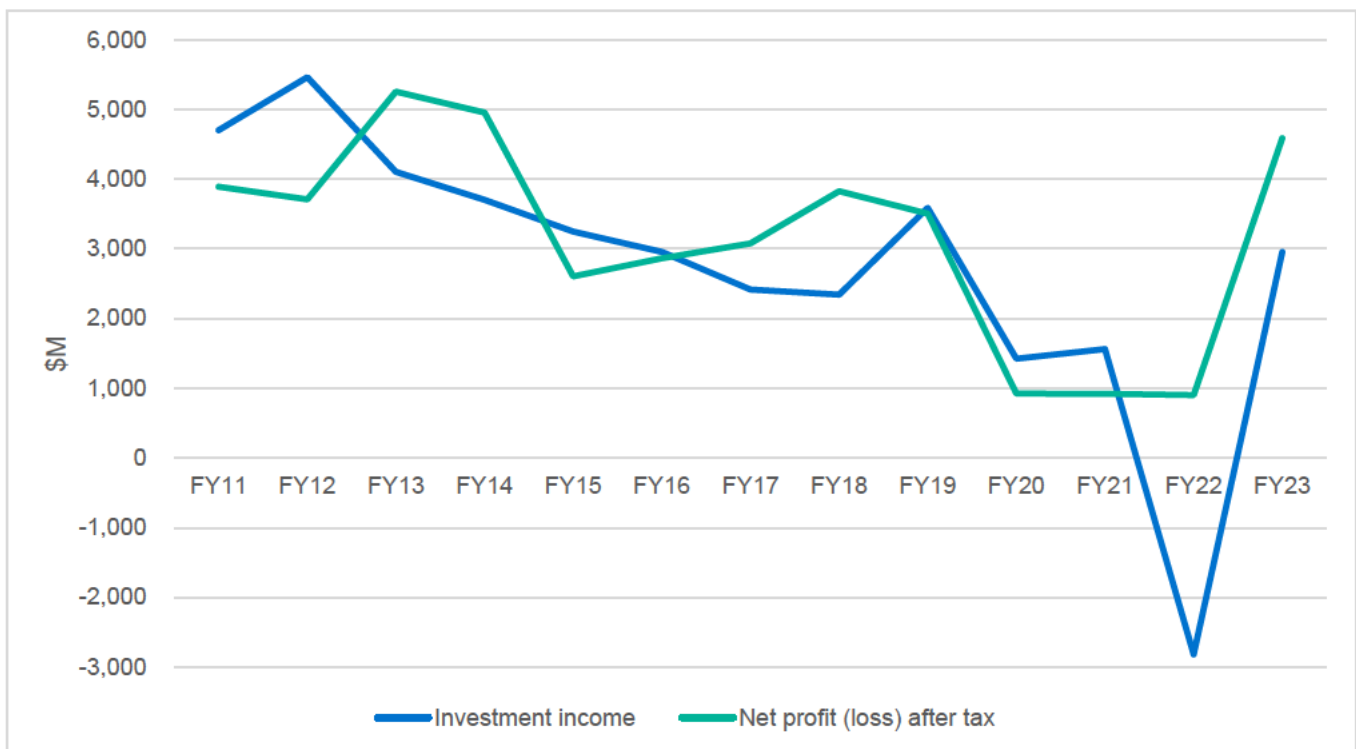
Premiums that insurers receive from the insurance business and shareholder funds are invested to meet future claims and to generate returns for the shareholders. Investment return modelling is factored into the pricing of premiums, and the performance of these investments contributes to insurers' overall profitability (see Figure 5 above).

Figure 9 tracks overall investment income against profit.

- The blue line tracks investment income since 2011. The green line tracks net profit after tax.
- Insurers will invest in a wide array of investment vehicles to ensure they have assets that back both their short and long tail insurance liabilities.
- The aggregate income across these investments is volatile.

Figure 9: Investment Income vs Profit

Source: APRA Quarterly General Insurance Statistics



It is important to break down underwriting results and investment income by line of business to get a clearer picture of performance.

Figure 10 and **Figure 11** attribute investment income to home and motor respectively by allocating investment returns to assets which back the insurance liabilities across these respective product lines. APRA has allocated investment income on insurance liabilities by class of business in proportion to the overall size of reserves. This provides a reasonable but approximate estimate of the investment returns that can be attributed to the home and motor lines of business.

- The size of underwriting results relative to investment returns shows that underwriting is the main business activity through which insurers seek to generate profit through the adequate selection and pricing of risks.
- Underwriting is very sensitive to changes in claim frequency and volume (as well as inflation and weather events) and the level of investment returns have not been enough to counterbalance underwriting results and prevent an increase in premiums.
- Figure 10 shows relatively strong underwriting results in home insurance since 2014 which have deteriorated significantly across recent years due to increased severe weather events and high inflation.
- Investment returns notionally allocated to this line of business are not sufficient to offset the deterioration of underwriting results. This deterioration has been driven by claims increases due to the 2022 East Coast Flood event for example, and hence premiums have risen to reflect this increased risk.
- Figure 11 highlights the sensitivities of the underwriting result to changes in risk. The significant increase in the motor underwriting result during FY20 is a direct result of decreased activity (and therefore decreased claims) due to COVID-19 lockdowns.
- There has been a decrease in the underwriting result for motor from FY22 to FY23, as the benefits of substantially lower claim frequency during COVID lockdowns unwound. The inflationary environment has substantially affected claim rates and costs.
- The investment returns notionally allocated to motor liabilities are not significant enough to have a material impact on the overall profitability.

Figure 10: Home Insurance – Underwriting and Investment Results

Source: APRA Quarterly General Insurance Statistics & APRA's own analysis

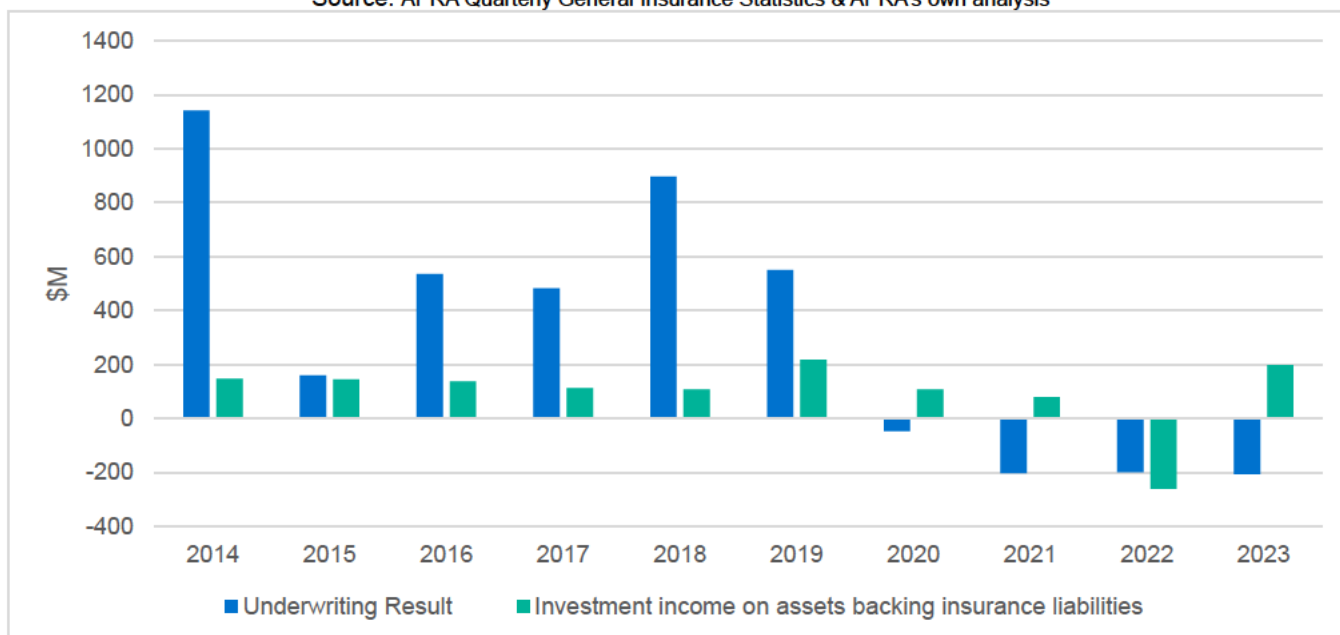
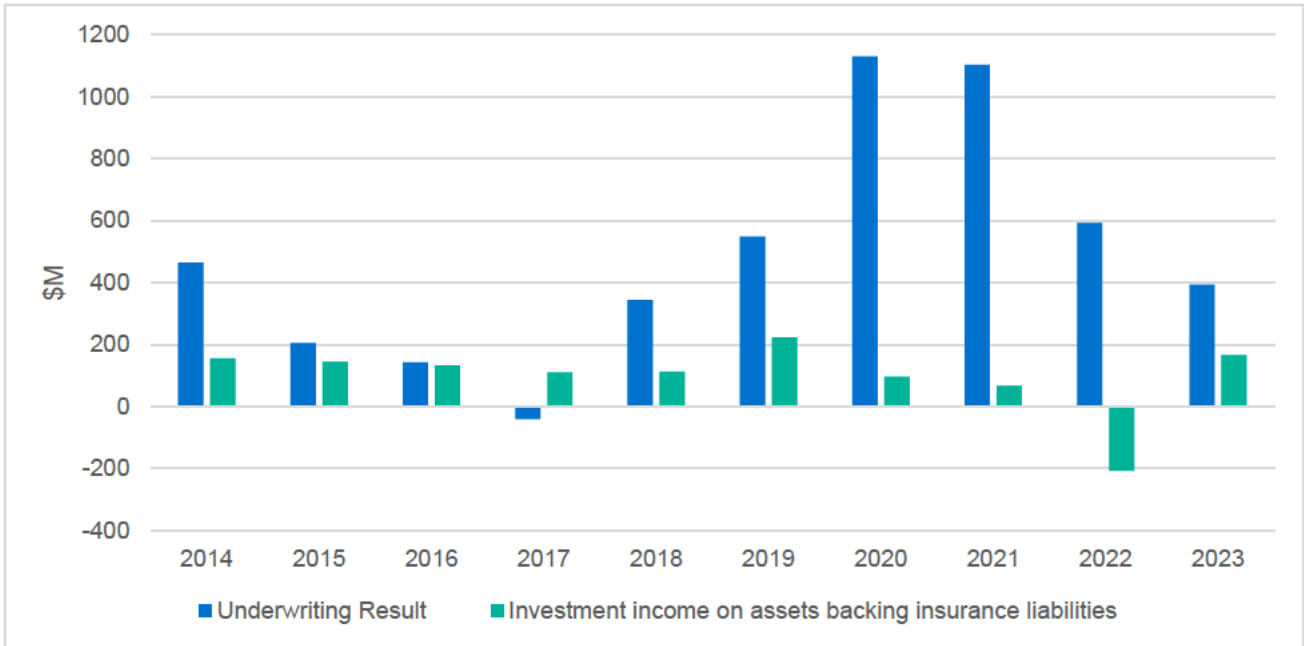


Figure 11: Motor Insurance – Underwriting and Investment Results

Source: APRA Quarterly General Insurance Statistics & APRA's own analysis



Reinsurance

Reinsurance costs are rising due to global factors, including how reinsurers are assessing risk in Australia, presenting a challenge for domestic insurers.

Reinsurance is a critical part of insurers' risk management strategies. The cost and availability of reinsurance has changed due to a range of factors, including the increased frequency, and severity of natural catastrophes and the supply chain disruptions brought on by the COVID-19 pandemic and geopolitical factors. As a result of increased reinsurance costs, we are seeing a trend towards both higher premiums for insurance companies and increased retention of risk.

Not only is reinsurance coverage costing more, at the same time, less of the primary insurer's risk is being covered by reinsurance at this higher price. As a result, a greater proportion of claims costs are borne by insurers with no reinsurance support.

Figure 12 sets out reinsurance costs across all product lines. **Figure 13** shows the reinsurance costs for home insurance in blue and motor in green.

- Figure 12 shows that reinsurance costs across all product lines have increased consistently since FY11.
- Figure 13 focuses on home insurance. It suggests that reinsurance costs in this line of business are the major driver of the overall increase in industry reinsurance costs in Figure 12, with the highest increase and fastest rate of increase since FY11.

Figure 12 – Reinsurance Costs – All Product Lines

Source: APRA Quarterly General Insurance Statistics

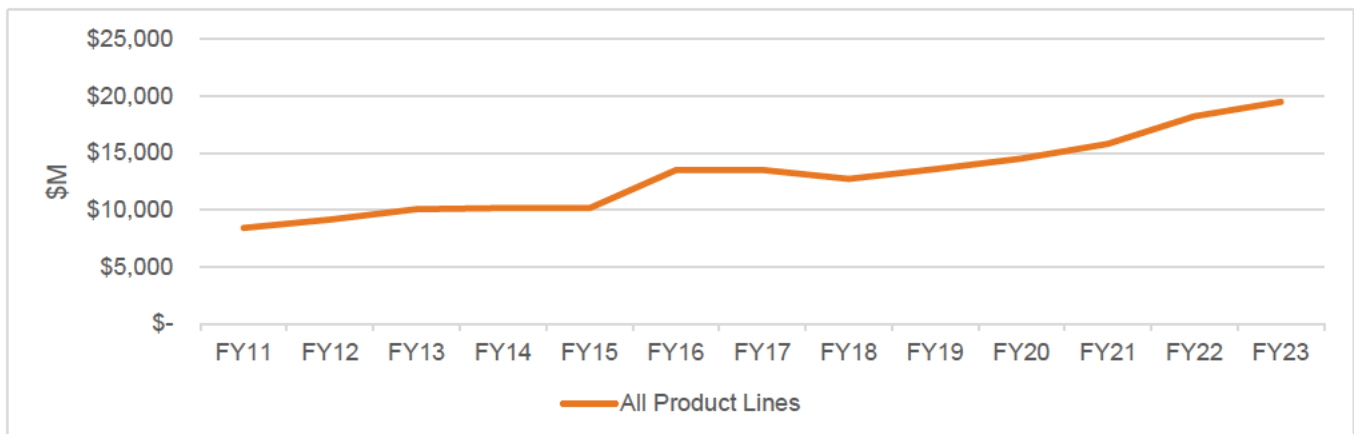
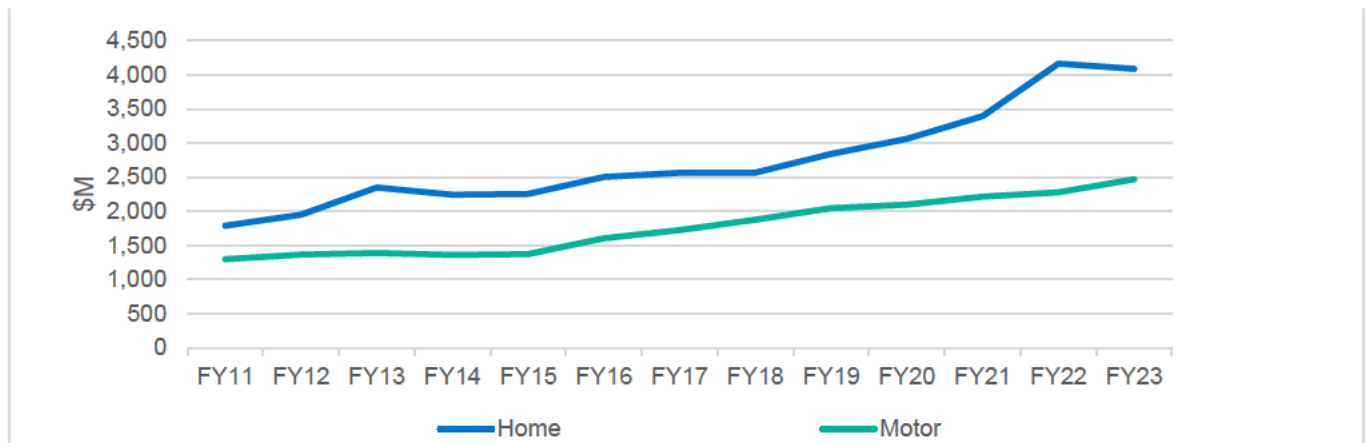


Figure 13 – Reinsurance Costs – Home and Motor

Source: APRA Quarterly General Insurance Statistics



Glossary

Business Interruption – A type of insurance coverage that replaces business income that is lost in a disaster, such as fire, flood or other natural catastrophes.

Combined Operating Ratio – A combined operating ratio for a general insurer is an indicator of profitability which compares costs to incomes. It measures expenses (claims, reinsurance, underwriting costs) to income (GWP). A ratio below one means income is higher than expenses, and a ratio above one means expenses are higher than income. Note that the combined operating ratio does not account for investment returns.

Gross Written Premium – The total value of premiums that an insurer has collected over a certain period (usually one year).

Long Tail – The opposite of short tail insurance, claims may not be reported within 12 months and can sometimes take years to settle. Many injury compensation and professional indemnity lines of insurance are long tail.

Natural Catastrophe Event – Large natural disasters that cause a significant number of insurance claims in a region.

Reinsurance – Insurance for insurance companies. Insurance companies purchase reinsurance to protect themselves against significant losses, as well as to reduce their capital requirements set out by APRA.

Short Tail – Short tail lines of business are ones where the insurance obligations are settled relatively quickly and there is no lasting liability for the insurer. For short tail insurance, claims are usually known and settled within 12 months. Most home and motor insurance lines are short tail.

Underwriting Result – The profit or loss generated from an insurer's underwriting activity. It is calculated as the earned premium minus costs and claims.

Written Risk – A single policy can have multiple written risks that capture the underlying risk exposure. For example, a single car insurance policy can cover 2 cars (2 risks).