Insurance Market Mid-Year Update

TABLE OF CONTENTS

GENERAL MARKET OVERVIEW

The first half of 2015 (H1) has been an active period for the Australian insurance market as it continues to respond to competitive pressures. Heightened cyber security risk, political and economic uncertainty, low interest rates and slow economic growth are all challenging the market at a time when there are significant new capital inflows and surplus capacity.

For the third consecutive year H1 natural disaster losses were below the recent 10-year H1 average (US$12 billion versus US$27 billion). Should this trend continue, the market may see no regions globally surpass their 10-year average in 2015. This benign loss environment is the major contributor to insurers' strong profitability and, ultimately, the favourable market conditions for buyers.

Market consolidation has continued in 2015 with a number of mergers and acquisitions (M&As) finalised and new ones announced, both locally and internationally. This increased consolidation activity is symptomatic of a soft market, where insurers are substantially challenged to maintain returns and deploy surplus capital through organic growth. M&As allow insurers to deploy excess capital, diversify revenue, build scale and increase profitability, thereby meeting stakeholders' aspirations.

FIGURE 1 Australian Market Rate Changes

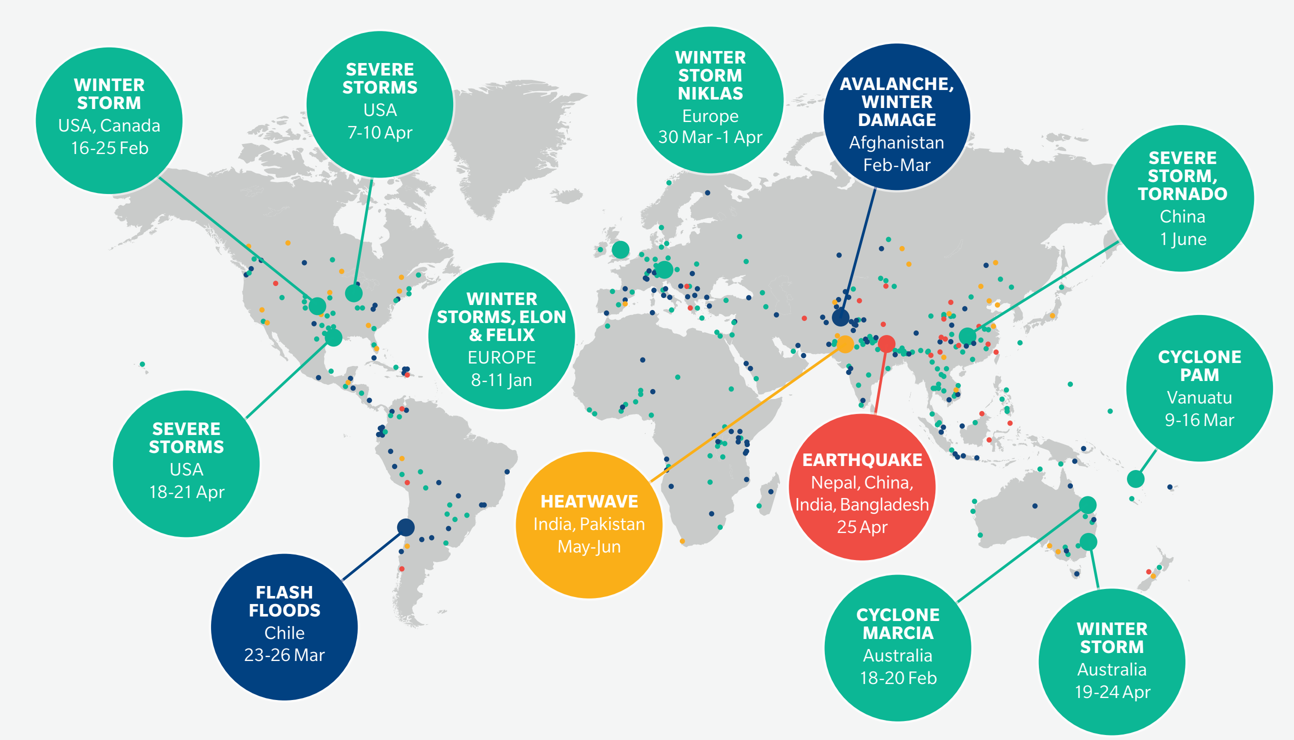
CLASS	PREMIUM CHANGE
PROPERTY	▼ 10% TO 20%
GENERAL LIABILITY	▼ 10% TO 20%
FINANCIAL INSTITUTIONS	▬ -5% TO +5%
DIRECTORS & OFFICERS' LIABILITY	▼ 10% TO 20%
PROFESSIONAL INDEMNITY	▼ 0% TO 10%
MEDICAL MALPRACTICE	▼ 10% TO 20%
CONSTRUCTION	▼ 10% TO 20%
WORKERS COMPENSATION	▼ 0% TO 10%

It is widely anticipated that the US Federal Reserve will raise interest rates in the second-half of 2015 and proceed with incremental rate increases (subject to continuing economic recovery). This is expected to have minimal impact on market capacity in the short term as capital providers will still see insurance as a more attractive investment return.

Locally, the outlook remains positive despite warnings of economic headwinds in Australia spurred by a low growth environment and the continued fall of commodity prices. There appears no end in sight to the soft market conditions, driven by the combination of new capital, surplus capacity and the lack of catastrophes.

In 2014, total insured losses were down despite NATCAT events rising from 490 to 510.

FIGURE 2 **Geographical overview of loss events: January to June 2014**
Source: Munich Re, NatCatSERVICE, 2015



GEOPHYSICAL EVENTS (Earthquake, tsunami, volcanic activity)

METEOROLOGICAL EVENTS (Tropical storm, extratropical storm, convective storm, local storm)

HYDROLOGICAL EVENTS (Flood, mass movement)

CLIMATOLOGICAL EVENTS (Extreme temperature, drought, wildfire)

PROPERTY

The M&A activity, locally and globally, is beginning to change the shape of the market. The Berkshire Hathaway deal with IAG to gain the renewal rights to CGU's major corporate portfolio gives them a springboard for growth in the market. XL has completed its acquisition of Catlin and the merged entity is competing strongly for business. The recently announced mega-deal that would see ACE acquire Chubb will create a very strong entity but it may also create more competition as other carriers seek to destabilise them during the merger process. We fully expect the M&A activity to continue in the global market.

Capacity increased in the property market during H1, with the increase attributable, in part, to the appreciating US dollar, which enabled insurers to pursue their aggressive growth strategies with a higher Australian dollar capacity. This increased capacity is fuelling greater competition.

The few remaining local reinsurance treaties due in H1 renewed with further cost reductions. In addition, facultative reinsurance utilisation by insurers was again relatively low in H1, with insurers retaining more net premium, in turn placing greater pressure on the reinsurance market.

With increased capacity, lower manufacturing costs and benign claims activity (both attritional and natural catastrophe losses), market competition has delivered reduced premiums and improved policy conditions (coverage, limits and deductibles) across most industry segments, including the complex areas of mining, steel, power and oil and gas.

Despite premium reductions averaging 10%-20%, there has been no significant change in insurers' existing client base as client retention continues to be a primary focus and new business is proving difficult for insurers to win. On those accounts viewed as new opportunities, discounts of 20%-30% have been observed.

Insurers have further relaxed policy conditions for natural catastrophe cover across the region. Throughout H1 renewals, it became apparent that insurers were moving away from differentiating New Zealand (NZ) coverage and pricing from Australian risks, with most insurers keen to underwrite NZ risk under an Australian master program. This compares favourably against periods immediately following the Christchurch earthquakes.

Domestically, headline events including the April super storms in New South Wales (NSW) did not have a significant impact on coverage and the pricing of property insurance although they did draw greater attention to non-traditional covers such as non-damage business interruption. Along with pandemic insurance, which gained a higher profile following the global Ebola scare, buyers also exhibited greater interest in "top-up" terrorism insurance following the Sydney Martin Place Lindt Café siege incident.

Long term agreements (LTAs) continue to be offered by insurers and accepted by clients. However, a number of insurers, in an attempt to secure ongoing revenue are modifying the LTAs offered, either by providing an inbuilt loss rebate or by providing a multi-year (two to three years) policy offering, removing the normal LTA insurer caveats such as deteriorating loss history.

While we expect premium decreases to continue through H2, insurers have also signalled they are reaching a "tipping point". A decision needs to be made on the viability of chronic premium reductions should the current luck of below-average claims activity run out. Insurers are concerned the size of their current premium pool is not sufficient in meeting the cost of claims for any unexpected significant losses in the future.

Should current trends continue, 2015 may see no regions globally surpass their 10-year average for natural catastrophe losses.

LIABILITY

Although new entrants into the domestic liability market have not yet had a dramatic impact, competition remains strong amongst existing insurers, resulting in premiums continuing to fall. Many buyers are opting to pocket the savings rather than take advantage of cheaper prices to purchase larger limits, unless they are contractually obligated to. Deductibles have remained consistent, with the exception of injuries to contractors and labour hire, where insurers continue to be conservative and impose higher deductibles.

While average premium decreases of 10%-20% have been offered for non-complex liability risks, premiums for the power and utilities sector have remained relatively flat. Other high-loss frequency and potentially litigious sectors, such as retail, are under close scrutiny with some poor performing accounts experiencing premium increases.

Some property owners have also seen their premiums go up as a result of socio-economic factors such as the excessive cost of defending claims, attributable to the popularity of the "no-win-no-fee" model adopted by many litigation law firms.

The first half of 2015 saw a notable trend in buyers making more considered purchasing decisions, with key determining factors being relationships, claims management and payment performance. While pricing is still a major consideration in renewal strategies, it is no longer the ultimate decision driver.

The majority of June renewals remained with the incumbent primary insurer, despite marketing exercises that have yielded competitive alternatives. In response, underwriters looking to write new programs are focusing more on building relationships with potential clients and understanding their business in greater detail.

Current conditions are expected to remain in the second half of 2015. Insurers continue to offer and encourage LTAs, with some waiving their claims caveat. This may be taken as an indication that premiums will continue to dip, and insurers are keen to lock in multi-year deals now. The London markets have not yet been tested as extensively as the majority of bush fire liability and other complex risks are renewing in the second half of the year.

FINANCIAL AND PROFESSIONAL LINES

The financial and professional lines insurance market remains soft but stable with an average premium reduction of slightly more than 8%[1]. While the Australian market continues to experience robust competition, the London market has, in contrast, sought to maintain expiring positions on renewals but is struggling to generate new business wins against incumbent local insurance market carriers.

Limits and program structure continue to be key factors in financial lines placements, with H1 revealing numerous restructurings of programs, co-insurance considerations and reductions in primary limit offerings. Differing excess layer structures were often used to capitalise on the targeted competitive areas within insurers portfolios.

In contrast to 2014, there has not been an increase in buyers utilising their savings to purchase higher available policy limits. Rather, most appear to be more cost conscious and are taking advantage of the prevailing market conditions to realise the savings.

The continual change in local insurers' appetites in the financial lines market has provided opportunities for innovation and the development of bespoke solutions. But while buyers are showing high levels of interest throughout the risk identification and design process, this has not necessarily translated through to the immediate purchase of coverage. Consequently a "wait-and-see" approach is being experienced on some forms of risk transfer, especially for emerging risks solutions such as cyber liability. The potential introduction of mandatory reporting of privacy breaches under the Australian Privacy Principles is perhaps deflecting away from taking a proactive approach to the opportunity to secure coverage and terms at exceptional value. Increasingly, buyers are prompted by requests for cyber insurance certificates of currency from financiers and other third parties, as awareness of the significant and potentially debilitating financial impact of a cyber-attack grows in understanding.

Looking ahead, premiums in general areas of financial lines are expected to decline further as there are few signs of the competition easing despite mooted market consolidation.

[1] National Claims & Policies Database - Australian Prudential Regulation Authority (APRA)

FINANCIAL INSTITUTIONS

In the financial institutions (FI) space, limits and risk profile remain stable with modest premium changes of -5% to +5% in the first half of the year. FIs are enjoying favourable treatment by insurers, with the notable exception of those heavily involved in wealth management and financial planning, due to the continued severity and frequency of the claims activity.

Insurers are not totally declining these high-risk activities but have adopted a higher level of scrutiny to risk profiles and exposures, while tighter policy restrictions and/or higher premiums are being imposed where possible. The market will keep a close eye on whether new additional primary market capacity and competition will affect the current underwriting approach for these perceived high risk activities.

DIRECTORS & OFFICERS LIABILITY

Capacity in the directors and officers (D&O) market, both domestically and internationally, remains over-supplied. There have been no significant changes or new purchasing patterns in the Australian D&O market, with limits and risks remaining static.

This may change, and increase limits purchased, if Australia follows the global trend, which has seen shareholders increasingly agitate to hold directors accountable for emerging risk areas such as cyber.

The corporate regulator, the Australian Security and Investments Commission (ASIC), released its cyber resilience report in March, highlighting the view that cyber security is no longer a topic relegated to IT specialists but one that belongs front and centre in Australian boardrooms as a matter of corporate governance.

While significant reductions are still achievable under certain conditions, premium reductions averaging 10% appears to be the norm for the corporate sector.

PROFESSIONAL INDEMNITY

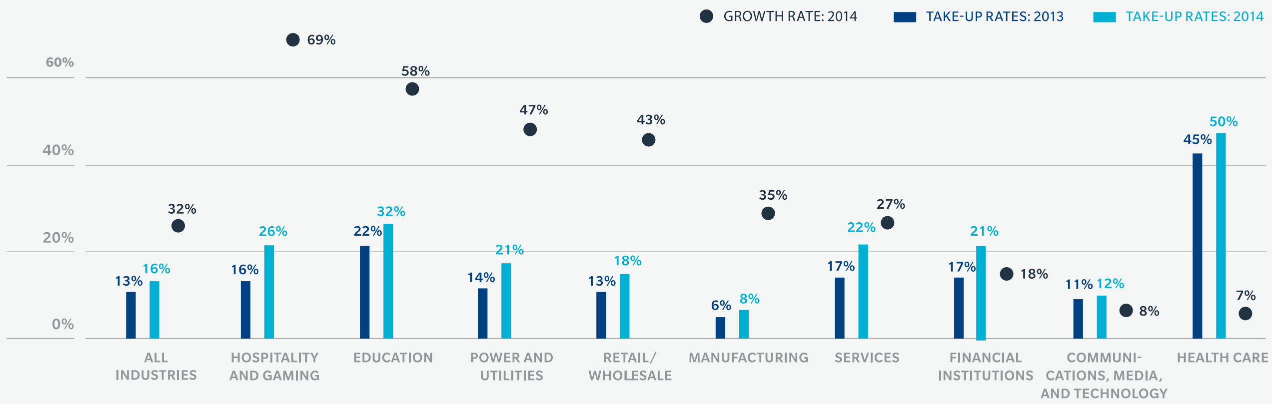
While insurers signalled premium increases for the June renewal period in accountancy, real estate and financial service portfolios, fierce competition continued to dictate the market, resulting in most professional indemnity (PI) accounts achieving rollover to 10% reductions. Policy limits have remained stable while deductible levels have generally stabilised or decreased.

MEDICAL MALPRACTICE

Risk exposures remain static for medical malpractice, with premium reductions averaging 10%-20%. Limits, deductibles, and coverage have all remained unaltered despite the opportunity to improve the terms and conditions of coverage following multiple new Australian primary market entrants bolstering competition in this portfolio.

Many buyers are opting to pocket the savings rather than take advantage of cheaper prices to purchase larger limits.

FIGURE 3 CYBER INSURANCE TAKE-UP AND GROWTH RATES BY INDUSTRY
Source: Marsh Global Analytics



In the above chart, "growth rate" refers to the percentage increase from 2013 to 2014 in the number of clients purchasing standalone cyber insurance. "Take-up rate" refers to the overall percentage of clients that purchased standalone cyber insurance.

CYBER (NETWORK SECURITY AND PRIVACY)

Cyber risk continues to be one of the most pressing strategic priorities for corporate boardrooms and governments around the world, and particularly for target industries such as financial institutions and service providers, healthcare, energy and utility infrastructures. With a global economy becoming ever dependent on e-commerce and cloud computing, the susceptibility to network security and privacy risks is increasing exponentially.

Against estimates that the global premium spend on network security and privacy will grow from US$2 billion to US$5 billion over the next five years, the number of first-time Australian purchasers is increasing but lags in comparison with other global jurisdictions. Tellingly, those early adopters in purchasing cyber programs are continuing to consider the risk and increase the limits purchased.

Insurers' lack of data and policy responses to emerging risk exposure makes the measurement of cyber risk and subsequent capital needs an ongoing process. Consequently, cyber is one of the few financial lines areas not seeing general reductions in premiums at this time.

Collaborative gap analysis and risk identification by buyers and Marsh has led to bespoke coverage requests tempering premiums or translating to opportunities to significantly increase policy coverages and therefore better value risk transfer.

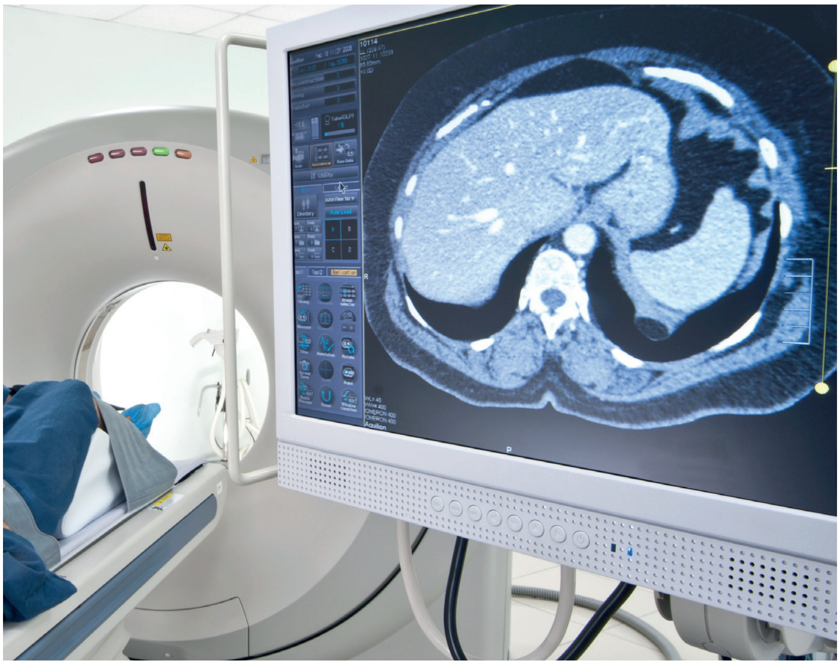
This is especially prominent for power grids and energy and utility infrastructures, whose reliance on automated industrial control systems or supervisory control and data acquisition (SCADA) systems exposes them to significant loss or damage of physical assets from cyber threats, such as network interruption, denial of service, extortion, certain terrorism, malware, viruses and disclosure of data. These all form part of the cyber peril landscape and do not trigger traditional public liability or industrial special risks (ISR) policies.

CONSTRUCTION

Construction insurance underwriters have focused on maintaining existing client relationships through the provision of pricing flexibility, broadened coverage and expanded limits, as well as additional service commitments. Average rate reductions of 10% have been generated with reductions of up to 30% realised on some of the larger, well-managed accounts. New capacity continues to enter this segment, albeit mostly as gap and program fillers rather than genuine alternative lead markets. While local market capacity is abundant, buyers are also looking at longer term account strategies, choosing to forego maximum local terms for a continued presence in the London market.

Insurers are, however, demonstrating a hardened attitude to claims payments in the current soft market, therefore, more prescriptive claims procedures have been negotiated with a majority of insurers in order to expedite the indemnification and payment process.

Current market conditions and program results are expected to continue for the remainder of 2015, with loss-free accounts that are well supervised and managed continuing to generate the better outcomes for insurance buyers.



WORKERS COMPENSATION

The first half of 2015 experienced some of the highest levels of competition in the past decade, largely attributable to insurers' mandate to increase market share. Consequently, buyers have heavily focused on premium and immediate cash flow benefits by opting for "burner" policies where possible, while insurers have, for the first time, started to offer claims experience discounts on excess of loss policies.

The workers compensation schemes in Australia continued to actively pursue reforms. Recent legislative changes in the NSW workers compensation scheme included the adoption of a new premium calculation model, which, while declared to be "revenue neutral", is likely to significantly impact premiums, with projections of up to a 35% increase for some employers in NSW. These unforeseen premium hikes have caught many businesses off-guard and, alarmingly, affected even some of those employers whose claims experience had been improving year on year in the period prior to these reforms. In some cases, calculations have been incorrectly applied, leading to grossly erroneous simulations being shared with employers.

The ACT Government is in the process of exiting the Comcare scheme following a very public expression of frustration over delays in getting its injured public servants back to the workforce, compounded by an 180% premium surge over nine years[2]. It should be noted that changes to federal legislation is required before the formal exit can occur.

The ACT Government has introduced draft legislation that will form the basis of a scheme for public sector employees only, which will operate separately to the current scheme for the private employers in the ACT. There is an extensive consultation process underway which will, in all likelihood, frame the detail that informs any Bill for parliamentary consideration.

[2] http://www.canberratimes.com.au/national/public-service/act-dumps-comcare-20150225-13o86a.html

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