Insurance Market Mid-Year Update

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GENERAL MARKET OVERVIEW

Australian Insurance premiums are forecast to continue to fall across multiple classes, as underwriters seek to maintain and expand their client books, with the exception of a few specific insurance classes such as directors and officers (D&O) and group life. In the case of primary D&O there are signs that the market has started to toughen, while stability is returning to the group life market which has been experiencing hard market conditions for a number of years.

While a number of underwriters attempted to change the market dynamics in the early part of the first half of 2016 (H1) by resisting premium reductions, a shift in their strategy was observed in the latter part of the second quarter in a bid to retain clients and win new business. June renewals saw the market return to the competitive discounting behaviour after experiencing insureds moving their program in search of lower premiums, albeit at lower percentages than in recent years.

Clients continue to focus heavily on cost control during renewals, as businesses in general are still hurting due to the unfavourable economic environment of low growth and the continuation of low commodity prices.

The impacts of market consolidations over the last 12 months are slowly playing out in 2016. There has been no major disruption to the market, it is evident that a number of the merged entities such as XL Catlin and ACE/Chubb, have adopted an aggressive stance in their strategies in order to maintain and indeed grow their client portfolios. Berkshire Hathaway Specialty have been quietly competitive but not overly aggressive, steadily assimilating into the Australian market and focusing on niche opportunities to expand their book. A number of the internationally owned insurers operating in Australia are trying to grow their businesses by expanding their product ranges and discounting premiums against traditional market participants.

With the cost of claims creeping upwards and room for premium discounts dwindling, insurers have reached a "critical mass" dilemma, and therefore are turning to more creative ways to stay competitive. In H1, we have seen an increase in "bundle" deals by packaging up multiple policies, allowing insurers to leverage a greater premium volume and be more competitive on a portfolio basis. For some insurers, this has been driven by an expanding appetite for new risks, while others have been looking to better cross-sell existing product lines.

FIGURE 1 AUSTRALIAN MARKET RATE CHANGES

CLASS	PREMIUM CHANGE
PROPERTY	▼ 0% TO 10%
GENERAL LIABILITY	▬ -5% TO +5%
FINANCIAL INSTITUTIONS	▬ -5% TO +5%
DIRECTORS & OFFICERS LIABILITY	▬ -5% TO +5%
PROFESSIONAL INDEMNITY	▼ 0% TO 10%
MEDICAL MALPRACTICE	▼ 0% TO 10%
WORKERS COMPENSATION	▬ -5% TO +5%
GROUP LIFE	▬ -5% TO +5%
GROUP LIFE (DISABILITY)	▲ 0% TO 10%
DOMESTIC HEALTH	▲ 0% TO 10%
LIFE	▬ -5% TO +5%
ACCIDENT & HEALTH	▬ -5% TO +5%

Britain's decision to leave the European Union (Brexit) is not expected to have any immediate foreseeable impact on the Australian insurance market, despite London being the primary entry point into the European market historically. While there is the possibility for some re-domiciling to Europe, capacity is unlikely to shrink.

Although capacity is likely to remain at current levels regardless of the political repercussions of Brexit, any consequential currency and securities market volatility could lead to a potential increase in claims.

Many of the global insurers and reinsurers have reported disappointing H1 results on the back of increased catastrophe (CAT) losses worldwide. A continuation of this trend in H2 may result in the alteration of strategy for the big losers.

Across the board, "clean" accounts have experienced average premium reductions of **0-10%.**

PROPERTY

Both the CAT and Non-CAT markets have continued to provide premium discounts. Across the board, "clean" accounts have experienced average premium reductions of 0-10%, with some renewals still managing to achieve reductions well in excess of this average, due to market competition, quality of risk and larger premium pools. On the flip side, accounts with recorded losses have experienced average increases of similar magnitude. Insurers are reviewing these accounts on a case-by-case basis.

Property underwriters are examining more closely the long-term sustainability of individual property accounts, as they adopt more sophisticated and technical underwriting practices.

As the market premium pool is slowly eroded, insurers are questioning the value of some accounts following large losses. There has been evidence of deductible readjustments as insurers seek to redress the losses from recent claims activity.

With clients suspecting and insurers hoping, the market has bottomed-out, there has been an increased interest in long-term agreements (LTAs). However, a number of insurers have expressed skepticism in the long-term viability of these agreements after experiencing cancellation of LTAs from opportunistic clients who believe there may still be further premium savings in the event the market continues to soften. Some insurers are opting for longer-term policies instead – policy periods of up to two years; clients paying annual premiums on annually declared property values; no rate review in the event of claims.

Looking ahead, markets are positioning themselves in preparation for numerous property renewals due in the second half of the year. Subject to their H1 results and retention rates, insurers may become more competitive in H2.

Insurers are watching the mining sector carefully, given the increase in mergers and acquisitions (M&A) activity with a number of small start-ups buying sites from some of the major miners as they look to restructure their global portfolios. This activity has been particularly strong in the coal sector.

Insurers are transitioning into a new RMS CAT modelling update which could result in a higher degree of control over rate reductions, and we expect this to continue into H2. Notwithstanding this, the Lloyds market will likely continue to be aggressive in a bid to maintain market share.

Any post-Brexit impact remain to be seen, however there is the possibility for the market to become more competitive in an effort to combat potential currency fluctuations in H2 as a result of Brexit.

"The first half of 2016 has panned out very much as we had expected."

John Donnelly
Managing Director, Head of Placement Asia Pacific

LIABILITY

The market has continued to remain stable through H1, with reductions achievable for well managed and presented risks and good claims history.

With the suppressed economy and mergers and acquisitions in the client community, there has been less opportunities in a shrinking market, which has added an edge to insurers' competitiveness.

The retail property sector is an area which continues to receive closer scrutiny due to claims deterioration. This in an ongoing trend from recent years.

The recent insurer mergers and acquisitions have not impacted competition at this point, and has been offset by a number of new entrants into the Australian market, such as Berkshire Hathaway and AXA.

The London market has experienced some very large losses, such as bushfire class actions, and are cautiously reviewing their Australian portfolio, which are traditionally bushfire, power/utility, rail and heavy construction. Some H2 renewals will be impacted by a reduced appetite.

While most clients will continue to have choice, there are still important buying considerations such as underwriting experience, claims/service performance, policy coverage and ability to adapt to clients' changing business/risk profiles.

FYE 2015 saw nearly a **100%** increase in the number of class actions being lodged over the proceeding annual period.

FINANCIAL & PROFESSIONAL LINES

In H1, the financial lines' market continued to show further signs of volatility and vulnerability, as insurers strain to maintain margins and profitability. Expectations are that while the trends for claims incidents continue to improve, insurers' cost inflation for managing claims will continue to rise, putting further increased pressure on insurers' bottom lines.

As we predicted, 2016 has seen a growing disparity or a "two-speed economy" between incumbent insurers and those seeking further growth through new businesses.

Incumbent key markets (particularly on primary layers) continue to attempt to maintain static pricing, terms and conditions, relying on goodwill over preceding years to encourage loyalty and value via wording negotiations and/or previous claims handling. In particular in the risk management segment, we have seen insurers attempt to hold fast on their renewal pricing and resist any further discounting.

In an attempt to stave off competition on a mono-line basis, insurers have attempted to use strategies traditionally reserved for risk management clients, such as offering further discounts, or "package" deals.

For attacking markets, in order to attract business we have continued to witness aggressive pricing and some broadening of coverage to entice client movement.

DIRECTORS & OFFICERS LIABILITY

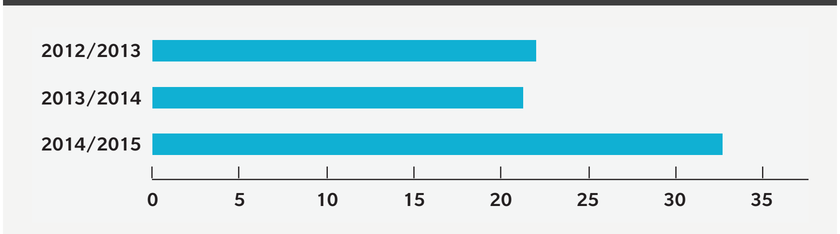
The local D&O market has generally slowed over H1, predominantly amongst primary markets that appear to be reeling from the brunt of current and future claims provisions. Primary premiums have remained generally static, there has however been some contraction in capacity.

Class Actions

2015 saw nearly a 100% increase in the number of class actions being lodged over the proceeding annual period, the bulk of which continue to be related to securities claims.[1]

Economic market volatility has traditionally been a precursor to class action claims against ASX-listed entities, with instability in earnings or decline in a share price increasing the potential for claims.

FIGURE 2 **NUMBER OF NEW CLASS ACTIONS FILED IN AUSTRALIA**
SOURCE: KING & WOOD MALLESONS THE REVIEW: CLASS ACTIONS IN AUSTRALIA 2014/15



The impact of stock market volatility on D&O claims has been highlighted by the flow of class action settlements stemming from the 2008 global financial crisis and the significant stock market shakes in 2010, which translated to long-tail claims only being paid out now.

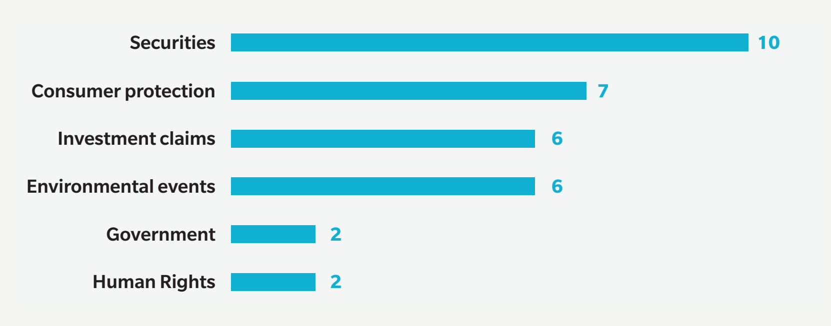
Looking ahead, it will be interesting to see how further market turmoil and poor economic performance particularly in light of Brexit will impact the insurance market, or if global economic instability will have a negative impact on financial lines insurers.

The merged entities (ACE/Chubb, XL Catlin) have broadly maintained existing capacity for renewal business. The general trend, however, for new business has seen modest limit reductions, while several other primary insurers have further reduced their comfort level on D&O entities coverage capacity down to as low as $10 million. Consequently, there appears to be a further increase of importance for insureds to have a strong relationship tie with both their first and second excess insurers (not just their primary carrier), given it is not unrealistic for D&O class action litigation costs to exceed a primary limit of this size.

This has led to attempts by insurers to try and rally and potentially increase pricing in classes such as cyber and D&O. This has been met with competition especially to excess layers. In particular, London-based insurers are becoming more active and aggressively targeting the Australian excess market.

[1] King & Wood Mallesons The Review: Class Actions in Australia 2014/15

FIGURE 3 TYPES OF CLASS ACTION CLAIMS IN AUSTRALIA (2014/2015)
SOURCE: KING & WOOD MALLESONS THE REVIEW: CLASS ACTIONS IN AUSTRALIA 2014/15



Innovation and enhanced policy benefits have therefore seen any of the potential modest gains eroded or insureds moving business, enticed by savings or innovation on policy benefits such as additional dedicated sub-limits and drop down reinstatements.

This has led to more movement in insurer's portfolios on excess layer placements, as insurers struggle to demonstrate differentiation.

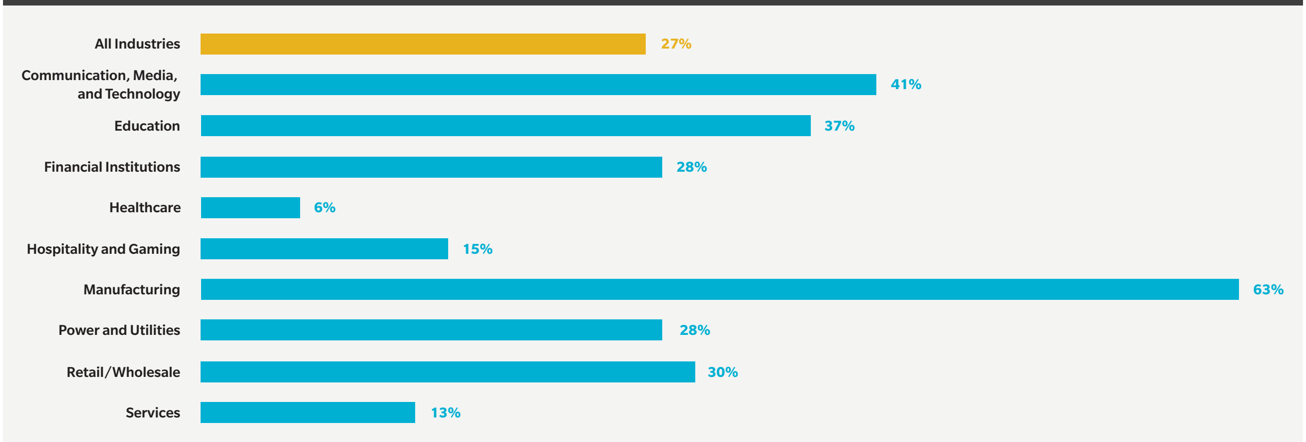
CYBER

Cyber continues to be the "hot topic" with many clients in services, construction, retail and manufacturing actually considering or indeed having purchased cover. While cyber risk mapping can be a long and complex task, clients are showing willingness to commit to properly understanding their exposures in this developing risk area. We have seen an increase in the number of policies purchased, and have also seen early adopters of the coverage increasing their indemnity limits purchased locally, reaching not just tens of millions but where appropriate, hundreds of millions of dollars, similar to the global benchmarking of limits.

Surprisingly, the Australian healthcare sector still appears to be slow in the take up of cyber insurance relative to benchmarking of its global counterparts, despite all recent evidence showing cyber gangs having a preference to specifically target attacks in this industry.

There appears to be a disparity with some healthcare clients wanting to fully understand and map their risk first, before purchasing cover. Many other industries view it may be difficult to predict all possible scenarios and exposures upfront, and have taken to transferring their risk now and refining their purchases as their risk mapping develops. These insureds will gradually increase areas or limits of coverage over time, or carve back where cover is proven to be not required or insured elsewhere, thus reducing the premium spend over time whilst ensuring the business is still protected in the interim.

FIGURE 4 GLOBAL CYBER INSURANCE GROWTH RATES BY INDUSTRY 2015 (MARSH CLIENTS)
SOURCE: MARSH GLOBAL ANALYTICS



We have seen increased client and insurer discussions regarding operational risk versus traditional risk transfer mechanisms.

MEDICAL MALPRACTICE

Limits, deductibles, and coverage have all remained static and unaltered since last year, despite the withdrawal of the major Lloyds syndicate, Marketform from writing the class. Additional capacity and several other new entrants have quickly replaced the void left by their departure.

Many clients decided to take the opportunity through this modest disruption to the market to improve their pricing, terms or conditions of coverage.

In June, we saw for the first time insurers' interest in offering capacity to individual registered doctors.

PROFESSIONAL INDEMNITY

The fierce competition that marked the end of last year appears to have slightly abated with market conditions and capacity for professional indemnity (PI) remaining soft but relatively stable during H1. Modest premium reductions are being achieved for clients with sound risk management and good loss records.

In addition to the usual financial services, accountancy and real estate risks where the market considers the risk versus reward as challenging, we have seen some insurers also start to withdraw from certain legal professions, as well as attempt to reduce capacity or increase pricing in some specialist design or engineering related professions.

FINANCIAL INSTITUTIONS

March 2016 saw the International Basel Committee provide a consultation paper proposing to withdraw internal modelling for the calculation of operational risk capital charge, and its replacement by a Standardised Measurement Approach (SMA).[2]

While Marsh and many clients await the outcome of this paper, we continue to see an increase in client/insurer discussions regarding operational risk versus traditional risk transfer mechanisms and the potential benefits they may have.

Wealth management continues to occupy insurers' minds during renewals, as it clearly does their current claims profiles. Deductible levels also appear to be high on insurers' current radars.

Limits and risk profile remained consistent in H1, although the full effects of recent insurer consolidation have yet to be potentially fully established in this space. The rhetoric around potential economic uncertainty which may in turn affect claims against financial institutions appears to have reignited conversations around what point and pricing should risk be potentially transferred.

[2] Basel Committee on Banking Supervision Standardised Measurement Approach for operational risk - consultative document - March 2016

EMPLOYEE BENEFITS

The employee benefits market has been relatively stable across life and accident and health. Premium increases of up to 10% have been seen in health during H1, with this trend being similar over the last 12 months.

LIFE

In H1 the Australian market for group life, total and permanent disablement and group salary continuance continued to experience rate increases. Rises in rates for disability insurance were between 20% to 40% but we are starting to see more moderate increases (up to 10%) in rates due to stability returning to this market. Many life insurers have taken steps to mitigate escalating claims costs by early intervention in disability claims. Rehabilitation consultants and rehab support are being widely adopted by life insurers as part of their improved disability claims management.

Despite the tight market, Australian group life insurers remain reasonably competitive for new business if it fits their risk appetite. Clients are continuing to look for expertise in cost-mitigating strategies, as well as advice in benefit plan designs.

DOMESTIC HEALTH

Health insurers continue to operate within a regulated, community-rated system. With premium increases averaging three times the general inflation rate, the federal government continues to review options such as premium loading for smokers and the obese, abolishing the government rebate on private health insurance, and removing the rebate on non-medical ancillary benefits such as dental, optical and physiotherapy.

In an effort to reduce the impact of chronic disease management costs, health funds continue to partner with organisations that can provide incentives to individuals for proactively taking steps to stay healthy. By changing individual behaviour, insurers' ultimate goals are to reduce claims and control premium increases.

INTERNATIONAL HEALTH PLANS

Despite the increasing trend towards localising expatriates, international health insurance remains a vital employee benefit and crucial to the overall success of the international assignment.

Medical claims in H1 continued to increase globally, impacted by:

- Rising medical treatment costs driven by advances in medical technology and new treatments.
- Increase in chronic and lifestyle conditions.
- Increased utilisation of services insured.
- Exchange rate fluctuations.
- Overprescribe of drugs and medical services.
- Unregulated medical systems in many countries.

To counter the impact of rising claims, employers are adopting a more strategic approach by considering cost containment measures and employee premium contributions coupled with targeted programs to influence and promote a healthier workforce.

Insurers in Australia have remained price competitive with a clear focus upon retention of well performing plans.

As the real medical impact of the Zika virus is established, clients are focusing on their duty of care to employees and importantly to accompanying family members. A number of expats are expecting their health policies to now support travel and accommodation for medical treatment outside their host country.

Of the managed fund states, Qld continues to provide employers with the nation's lowest rate of **1.20%** of wages.

Within a challenging period for international health insurers struggling with ever increasing value of claims and local admittance issues, clients must balance internal expense management and expats coverage expectations. Now is the ideal time to take a step back and take a critical view of existing health plans with a goal of questioning all aspects of insurance requirements.

WORKERS' COMPENSATION

Market activity in H1 has been relatively timid when compared to prior years with many large employers electing to maintain their current insurer engagements.

In the managed fund states, changes to the premium calculation model in SA, initial uncertainty around the closure of the NSW Retro Paid Loss (RPL) scheme to all new applications for renewal dates post 28 February 2016, as well as the Victorian scheme agent licence tender process which resulted in QBE having been superseded by Employers Mutual (EML) as a scheme agent within that State, has contributed to decreased market confidence which ultimately has a bearing on whether employers made decisions around seeking alternative arrangements across their national programs.

This has now subsided with both the outcome of the Vic tender being known, and NSW icare having confirmed three main changes around the RPL product:

- Rebranded to be referred to as the Loss Prevention and Recovery (LPR) Model.
- Simplified application process.
- Additional options around security requirements now offered.

Of key significance the adjustment factors which ultimately influence the final premium calculation are unchanged. The Marsh Workforce Strategies (WFS) team is continuing to support our LPR employers through the undertaking of feasibility reviews of the newly available deposit options, continued reporting on KPI measures that have been integrated into businesses and providing ongoing updates and support as this evolves.

In SA labour hire employers have seen an increase in wage audits being undertaken by Return To Work SA – aimed at ensuring labour hire companies are declaring the correct remuneration. Marsh WFS has been supporting our labour hire employers through this process, and can offer assistance to all employers in ensuring the wages declared across the national schemes are in accordance with statutory obligations to mitigate the risk of penalties being applicable.

Of the managed fund states, Qld continues to provide employers with the nation's lowest rate of 1.20% of wages. Vic is a close second with 1.27%, SA is 1.95%, in NSW rates are yet to be published.

The underwritten state environment (WA, Tas, ACT and NT) continues to be a soft market and is showing no signs of any immediate change. In many cases, insurers have been forced to reduce rates in order to retain business, resulting in minimal movement of policies between insurers.

WorkSafe WA has issued an update on the progress of the model Work Health and Safety laws in WA. *The Work Health and Safety Bill 2014 (WA)* contains core provisions of the model legislation developed by Safe Work Australia including the primary duty of care of the person conducting business or undertaking and due diligence obligations for officers, with local modifications. If enacted, the bill will replace the *Occupational Safety and Health Act 1984 (WA)* and align WA's WHS laws with the rest of Australia, with the exception of Vic who have resisted the harmonisation process to date. A discussion paper is out now for input from insurers consideration to be given by WorkSafe via the Occupational Health Society.

ABOUT MARSH

Marsh is a global leader in insurance broking and risk management. Marsh helps clients succeed by defining, designing, and delivering innovative industry-specific solutions that help them effectively manage risk. Marsh's approximately 30,000 colleagues work together to serve clients in more than 130 countries. Marsh is a wholly owned subsidiary of Marsh &McLennan Companies (NYSE: MMC), a global professional services firm offering clients advice and solutions in the areas of risk, strategy, and people. With annual revenue of US$13 billion and approximately 60,000 colleagues worldwide, Marsh & McLennan Companies is also the parent company of Guy Carpenter, a leader in providing risk and reinsurance intermediary services; Mercer, a leader in talent, health, retirement, and investment consulting; and Oliver Wyman, a leader in management consulting. Follow Marsh on Twitter; LinkedIn; Facebook; and YouTube.

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