Consider this

Shelter from the storm:

How short-term insurers are navigating a tough claims environment

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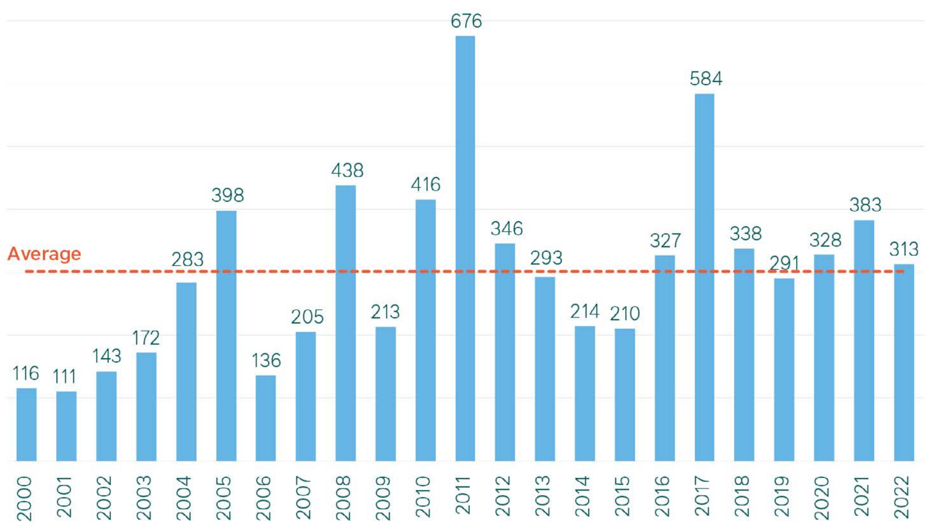
Rudi de Coning
Equity Analyst

The likelihood of loss has been a persistent driving force behind humanity's sharp awareness of its environment, encouraging a responsiveness to probable dangers and valuable prospects on the horizon. Risk management strategies evolved alongside the globalisation of the world, with one significant development being the pooling of resources to disperse losses. While the practice of spreading losses dates back to ancient times, it was modernised by Lloyd's of London in the 17th century. Ship owners, merchants and underwriters convened in the famous coffeehouse to insure their valuable cargo traversing the open seas. With growth, insurers often found their portfolios becoming concentrated in specific risk exposures - for example a fleet travelling the same trading route - prompting a necessary and strategic desire to reduce the risk exposure. Reinsurers play a pivotal role by enabling insurance companies to offload portions of their risk exposures in exchange for a share of the collected premiums. Today, the insurance and reinsurance industry stand as a bulwark, extending protection to numerous businesses and individuals who would otherwise struggle under the financial weight of a major loss event.

Insurance claims value increases amid rising frequency and severity of natural disasters
Today, global reinsurance dedicated capital totals over US$600 billion, acting as expanded capacity to the insurance industry, and is particularly important in absorbing the impact of natural disasters. This capital is becoming increasingly vital: the severity of natural disasters has been increasing due to climate change, as well as the increased levels of population and wealth concentration along coastal areas. Global economic losses from natural disasters were mostly above the 21st-century average over the past seven years, as seen in Graph 1.

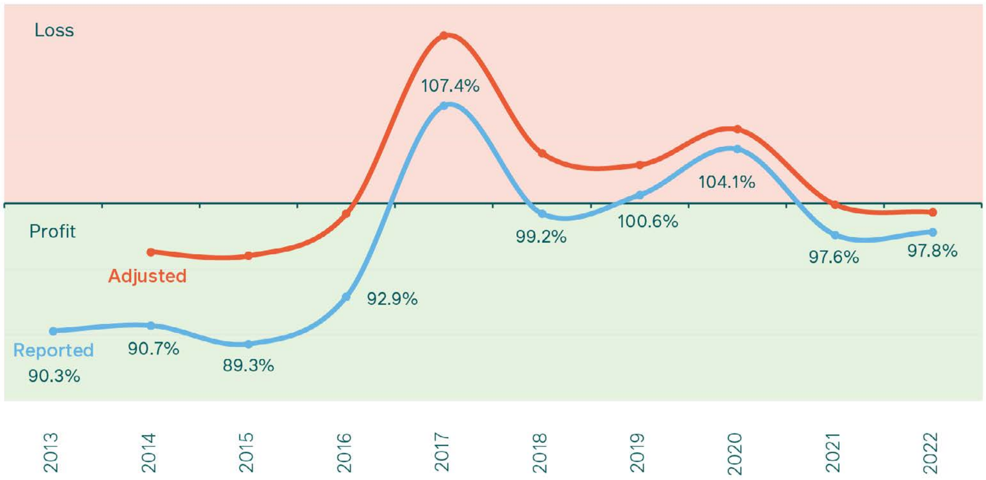
Graph 1: Global economic losses from natural disasters (2022 $bn)



Source: Catastrophe Insight, Aon

Insurers report a “combined ratio” as a measure of profitability on the insurance business they write. This ratio combines the loss ratio (claims paid) and expense ratio, both measured over earned premiums. In a profitable insurance company, the combined ratio is less than 100%, indicating they manage expenses well, with enough scale, and exhibit good risk selection, i.e., they do not pay out more claims than the premiums they receive. Graph 2 shows the pressure on reinsurers’ combined ratios due to the impact of natural disasters and the 2020 Covid pandemic. Note that the adjusted time series account for reserve releases, which have reduced over time.

Graph 2: Global property & casualty reinsurers' combined ratios



Source: Gallagher Re

While the insurance gap, indicating the amount of assets not covered, has been shrinking, only 42% of the losses in 2022 were insured. A lower gap increases the ability of insurers to cover claims. Firstly, it spreads the risk among more policyholders. Secondly, having more policyholders allows a better understanding of the risk as more risk assessments are completed; and a third contributor, often overlooked, is the opportunity to generate additional investment income off the premiums collected. This investment return supports insurers’ return-on-equity (ROE) performance as investment markets are often lowly correlated to the underwriting cycle. Short-term insurers - as the name suggests - have shorter-term investment assets to account for volatile cycles and to ensure ample liquidity to pay claims.

Increasing pressure on South African short-term insurers

South Africa has, perhaps surprisingly for some, been a relative low risk in the context of the global experience, up until the past three years. Excessive claims resulted from the pandemic, the KZN riots, and severe weather events including flooding in coastal areas and hailstorms inland. These events fed through to global reinsurers’ profit & loss statements as our local insurance companies utilised reinsurance cover to fulfil promises to clients. South Africa’s level of risk of potential future claims consequently increased, coinciding with the global trend of higher claims mentioned before. The secondary impacts of these events added additional pressure on claim ratios; for example, motor repair costs have increased due to parts shortages following from disrupted supply chains with the onset of lockdowns. Apart from lowering the insurance gap, insurers and reinsurers need to increase pricing to account for the potential of higher claims in the future, referred to as a “rate hardening” cycle. Compounding the challenges, local insurers have faced increased claims pressure due to load shedding and the adverse impact of a weakening economy on theft.

South African insurers, however, have proven their quality, trading through many challenging underwriting cycles. Santam has underwritten risks for more than 100 years, while OUTsurance has proven its model outside of South Africa, a feat few achieve sustainably. Management actions encompass both proactive and reactive responses to fluctuations in underwriting conditions, consistent application enhances the chances of successful outcomes. Several key strategies will be explored.

Success comes through accurate pricing, data analysis, client communication and sound underwriting principles

Given the experience of the past three years, local insurers have found themselves aligning with global reinsurers in raising pricing, an instrumental measure in mitigating risk shortfalls. Insurers can dynamically institute changes in pricing and excess payments for specific cohorts of clients, averting scenarios where low-risk clients subsidize higher-risk counterparts.

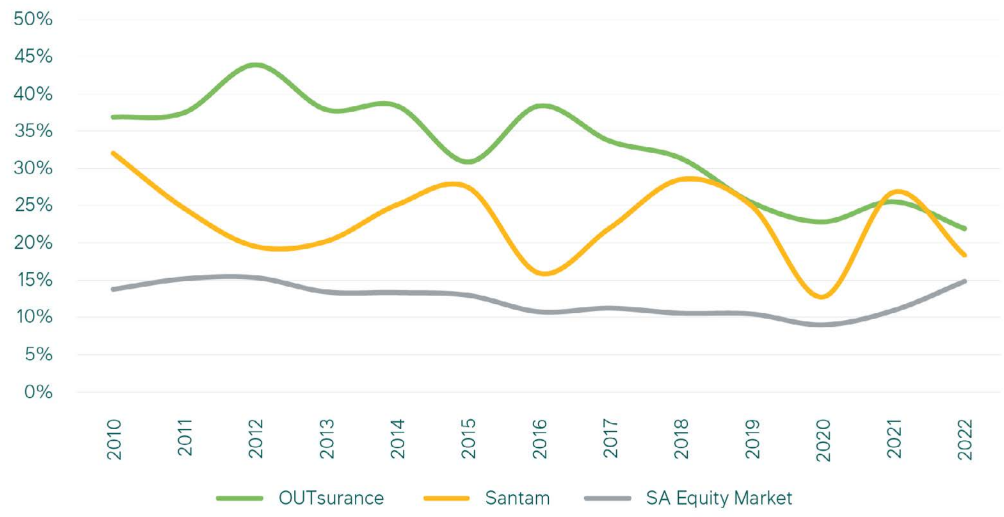
Robust data analysis plays a pivotal role in inspecting fraudulent claims and identifying irregular claim patterns. A well-established history of client claim patterns becomes fundamental in refining risk pricing, serving as a potent differentiator. Geocoding, the process of precisely determining the geographical coordinates of properties, enhances underwriting. This includes the ability to avoid insuring properties in flood-prone areas and to verify claims originating from locations known to be affected by a specific event.

Effective client communication supports claim prevention, as insurers can proactively signal heightened risks to clients and recommend easily implementable preventive measures, such as the installation of surge protectors. The practice of posing targeted questions to clients significantly diminishes the incidence of false or deceitfully submitted claims. OUTsurance's well-known cash-back feature provides clients with the opportunity to receive a refund of their paid premiums if they refrain from making claims for three consecutive years. This serves as a highly effective incentive, encouraging clients to actively participate in sound risk management.

Adherence to sound underwriting principles is evident in the fundamentals of both Santam and OUTsurance. These companies have consistently demonstrated performances exceeding the South African equity market's ROE, as depicted in Graph 3, successfully navigating challenging conditions over the past three years, although still experiencing falling ROEs.

Santam and OUTsurance boast long-standing reputations as well-managed, defensive companies, making them valuable to investors. Both trade at a premium to the SA equity market on a price-to-book value measure, with OUTsurance enjoying a higher rating due to better-than-peer underwriting performance. At M&G Investments, we recognize the intrinsic quality of these firms and tactically include them in our portfolios when their valuations are aligned with our valuation framework. South African short-term insurance companies, along with the state-owned SASRIA, have played an important role in supporting numerous companies and individuals, particularly those in the retail and property sectors, as they sought to recover from significant losses related to Covid and other disasters. The resilience provided to the economy by insurers is often overlooked. Despite the challenging conditions, these companies continue their steadfast and diligent underwriting practices, positioning themselves to navigate the current adversities successfully.

Graph 3: Return-on-equity



Source: M&G Investments

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