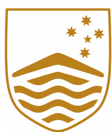

Australian National University

Guest speaker spotlight: Michael O'Neill

Michael O'Neill is an ANU alumnus who graduated with a Bachelor of Actuarial Studies (Honours, University Medal) and a Bachelor of Law in 2003. He also has a PhD in Finance and is a Fellow of the Actuaries Institute. Since graduating, Michael has spent 14 years in the fund management industry with Investors Mutual, following 4 years as an Actuary with the Commonwealth Treasury. He is also an Adjunct Associate Professor of Actuarial Studies with Bond University. The SMF was lucky enough to host Michael as a guest speaker in March 2022 to hear his insights on the insurance sector. His responses during the Q&A session with the SMF team have been summarised below.

While the Fund has looked into banks in the past, insurance is completely unchartered territory. Could you shed some light on the insurance sector?

Insurance is an interesting but tricky sector that is difficult to analyse compared to more traditional industrial companies. Basic industrial companies tend to have simple products and physical infrastructure, and company cash flows are easier to understand. Financials are often not amenable to the same approach. Both the cash flow statement and balance sheet are less transparent. There are also challenges due to regulation and complexity in operations. For these reasons, it is best to start from the perspective of financials generally being lower-quality companies with associated risks. However, they have some good qualities attached to them as well.

What would you look for when you are analysing insurance companies compared to banks? What qualities define a good financial company?

The first step in assessing banks and insurers is to examine the quality of the franchise and the barriers to entry in the industry. For banks, we've seen a rise of new smaller entrants that are less concerned about margins and are out there competing for the big four's customers in consumer credit and payments, as well as a rise in mortgage brokers who now control distribution of around 2/3 of new mortgages. Other considerations include a bank's digital offering and access to wholesale funding and deposits. Although interest rates should assist margins on deposits, you can expect some of this to be competed away in margins on lending.

For insurance, if you focus on general insurers who sell retail products such as home and car insurance, barriers to entry are stronger, with competition on the quality of service rather than price. Retail insurance particularly home and car requires physical delivery of a service, e.g., a fleet of tradespeople sent to repair damages from recent widespread floods. The physical delivery of these services is key, and the quality of delivery is largely enabled by scale. The scale of an insurance company is, therefore, a good indicator of company quality.

The balance sheet of financials is another indicator of company quality. However, this looks different for banks and insurers. Banks collect short-term callable deposits and wholesale funding, and invest funding into long-term loans, particularly mortgages. Insurance companies collect premiums and hold reserves to pay out claims which can be longer-duration obligations extending beyond the premium year. The difference between premiums collected and claims paid out is what Warren Buffett refers to as the insurance "float", effectively a loan from policyholders than can be invested to earn a return.

How do you envision the future of regulation in both insurance and banking? How will it affect profitability and valuation?

Increased regulation is one of the most talked-about risks in the banking industry. However, given it is already one of the most regulated industries, with the compliance burden increasing considerably over the last few years, the risk of further regulatory intervention shocks is low. The main issue is more one of increasing costs to comply with regulation.

The focus of local regulators has now extended to other areas, such as gaming, second-tier lenders, neobanks and smaller superannuation funds. These areas face a real risk of increased regulation and will have to deal with the burdens of higher cyber security and governance standards.

Similar to banks, insurers have already experienced significant regulatory burdens and are facing higher compliance costs. The main regulatory risks are related to the possibility of introducing policies aimed at addressing insurance affordability that might distort the market.

There was a piece in the *AFR about the super cycle of insurance premiums* ***and how the increased cost will distort insurance premiums. What impact will this have on Australia and the world, and how do we factor this in when evaluating insurance companies?***

The rising cost of claims is pushing up insurance premiums. Insurers are pricing for both higher incidence of natural perils, inflation and supply chain disruptions. Companies will be insulated if they can better manage cost inflation, for example, through fixed pricing arrangements with motor repair networks, and more flexible workforces for managing disaster response particularly to recent floods. The major domestic insurers who have adopted these strategies are benefiting from higher premiums and higher retention rates, while managing claims cost inflation. Smaller insurers are struggling to manage costs in this way, so will likely underperform the larger, higher-quality insurers and lose market share.

Reinsurance is also getting more expensive. Up until recently, new entrants to the industry had access to cheap capital, from both equity and reinsurance markets, and the larger volume of capital in the system invited more competition. Now reinsurance is becoming more expensive with significant losses from floods and other perils and increasing costs of capital, and is likely to be rationed towards larger scale local players. This increases the relative bargaining power of companies with strong market positions and thus decreases the competitive threat.

What about the unaffordability of insurance, as seen in Lismore in the context of recent floods for instance? On a macro level, what impact will it have on the revenues of insurance companies as more people in flood or bushfire-prone areas cannot afford insurance?

In Australia, recent flash flooding has caused significantly more insurance losses than other natural perils, and has been the trickiest to forecast and underwrite. Major insurers have benefitted from granular flood mapping at the household level. By insisting on guaranteed flood cover, an insurer may price itself out of the market for a small proportion of homes built on flood plains. In response to this issue, some governments have introduced reinsurance arrangements to socialise the cost of risks in cyclone prone regions for those who would otherwise be uninsured, and these arrangements might be extended to flooding more generally. There is certainly room to implement more proactive measures to mitigate floods, such as flood levees and building more flood resilient homes.

Can you explain why the demand for insurance increases after natural disasters occur and insurance companies raise premiums?

After a natural disaster, the reinsurance companies that face the vast bulk of the financial costs of these events will invariably increase their premiums. Insurance companies are then quick to pass on these premiums to consumers. Concurrently, insurers make significant efforts to mobilise a huge workforce to address claims, which helps to retain customers and build their brand. They may even play a role in the community, helping both insured and uninsured people to mitigate damages. There an implicit expectation of social responsibility on insurers, and disaster assistance certainly helps people recognise both the value of insurance and the quality of their company. In addition, an event reminds people of the value of insurance, so that the desire to insure rises for those who can afford the premium.

Prepared by Anvi Ghiya (Relationship Officer)

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