

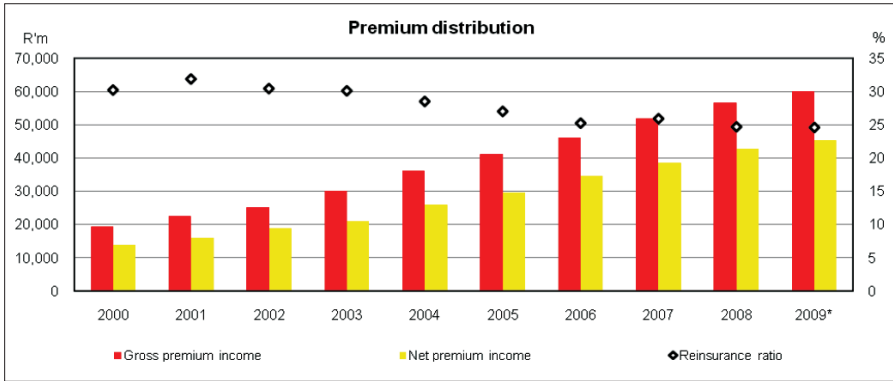
The South African short term insurance industry

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The year 2009 provided little relief for the industry, as the underlying economy remained inhibited and liquidity conditions tightened further. While interest rates have declined by a cumulative 600 basis points from June 2008 to date, and the economy is technically out of the recession, real GDP contracted by 1.8% in 2009. As such, the moderate premium growth registered by the short term insurance industry in 2008 is forecast to have persisted in 2009. Despite the declining rates of return on money market securities, the recovery of the stock market underpinned the growth of balance sheets on the back of unrealised gains.

Depressed economic performance, low levels of disposable income among individuals and earnings pressure on businesses have made it difficult to achieve appropriate rate increases and led to a degree of volume attrition. Accordingly, gross premium income growth is estimated to have decreased to 6% in 2009 (2008: 7%), translating into industry GPI of around R60bn. Consumer price inflation ("CPI") of 6.3% in December 2009 and the abovementioned economic contraction suggest that market penetration remains low, at around 3%. Although still holding dominant shares, Santam and Mutual & Federal (M&F) continue to lose market share, largely to the direct market. This notwithstanding, they still jointly account for about 35% (excluding subsidiaries) of domestic gross premiums written (from 50% in 2001). Over the same period, the four largest insurers' (Santam, M&F, Zurich and Hollard) collective market share has progressively declined from 60% to 52%. Notwithstanding the growth achieved by bank-aligned and direct insurers (through affinity marketing, product innovation and improved distribution lines), the top eight insurers (each with premiums in excess of R2bn) accounted for a combined 74% stake, six percentage points lower than the market share reported in 2001. More recently, declining disposable incomes, compounded by high interest rates prevalent in 1H 2008 and tighter lending on vehicle and property sales have constrained motor and fire premiums (which typically account for in excess of 75% of GPI). Success achieved in specialist lines in recent years is expected to underpin industry growth in the medium to long term, as players diversify risk by penetrating higher margin niche markets, while continued lending restrictions in the face of moderate economic growth should check the progress of traditional lines of business despite the enabling interest rate environment.

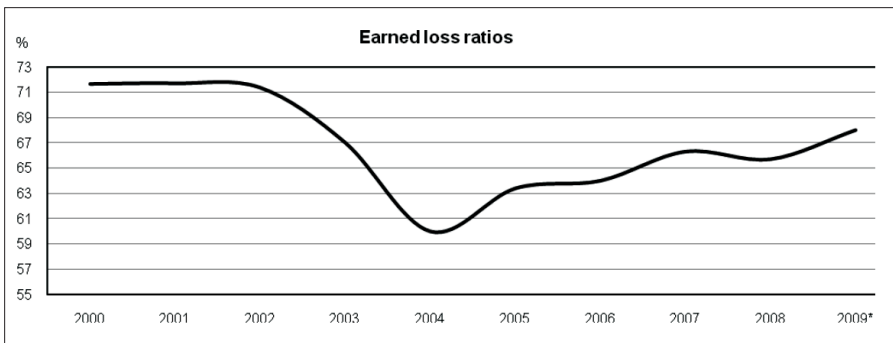
The years 2008 and 2009 saw a further narrowing of the industry underwriting margin from the 12% high reported in 2004, largely owing to a higher incidence of motor and property claims. In particular, 1H 2009 witnessed a substantially higher incidence of industrial accidents and fires, which exerted pressure on property books, with insurers unable to price adequately for risk. The frequency of motor accidents continues to increase, with accident damages accounting for over 70% of claims. This is exacerbated by above inflation increases in repair parts, driven by technological advancements and a volatile Rand. The rising number of vehicles on the road, inadequate road infrastructure, along with inexperienced and unlicensed drivers, point to a persistent, systemic problem. Currently, a low 30% of all vehicles are estimated to be insured, as there are no standing regulations governing vehicle or accident cover.



* 2009 figures are GCR estimates.

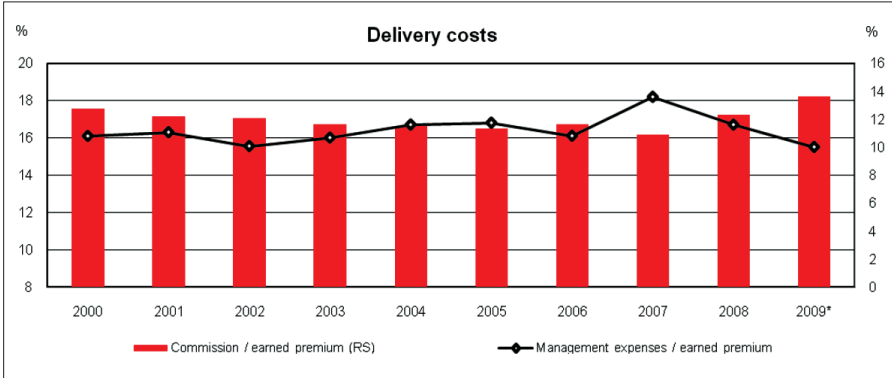
As predicted, NPI growth slowed to 9% in 2008 (2007: 12%), and is estimated to have declined further to around 7% in 2009. While about 85% of net premiums written were derived from motor and property lines, growth was underpinned by niche markets, with the engineering class registering strong improvements in revenue. It was further noted that the reallocation of the miscellaneous class over the last 18 months has given rise to further improvements in other classes, distorting growth statistics. Notwithstanding the prevailing low interest rate environment, it is likely that growth will remain moderate in the medium term in the face of constrained disposable incomes and profitability.

The ratio of reinsurance premiums to GPI declined to 24% in 2008 (2007: 26%) and is expected to have decreased moderately in 2009. While larger insurers maintained the largest retention on their motor, property and accident books in order to broaden margins, smaller insurers increased their reinsurance in the face of higher risk. Reinsurance rates should harden in the medium term in keeping with global trends and the increased perception of risk in the domestic market, which should see international reinsurers become more selective about the type of risk they are willing to absorb. The higher cost implications of reinsurance, coupled with volatility evidenced in retained earnings is expected to keep retention ratios relatively flat going forward.



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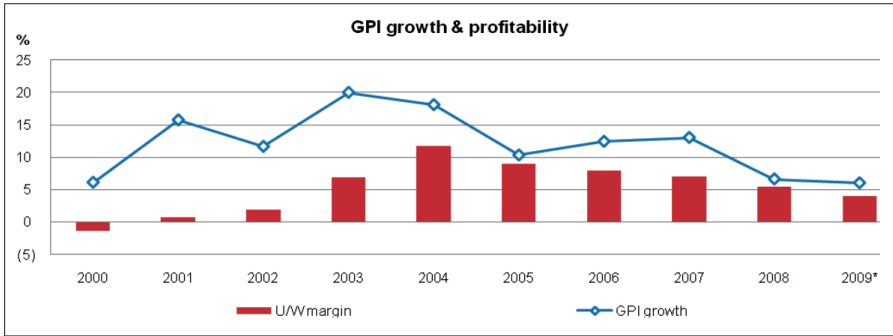
As predicted by GCR, the industry claims experience continued to worsen in F08, with the earned loss ratio rising from a low of 60% in 2004 to 66%. Notwithstanding the continued refining of provisions to cater for changes in risk profiling, the loss ratio is expected to have risen further to around 68% in 2009, driven by the high volume of claims experienced by multiline insurers. The above-mentioned factors (which include general cost inflation) should continue to drive loss ratios going forward.



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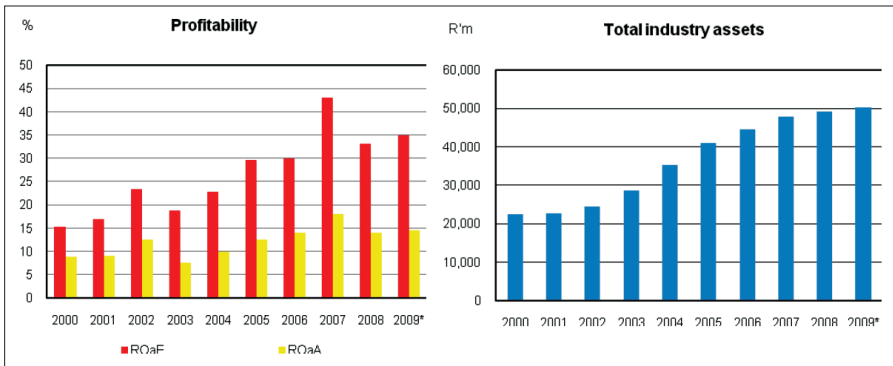
The net commission ratio increased to 12% in 2008, from 11% previously. GCR estimates that commission costs to earned premiums increased to around 13% in 2009. The upward trend evidenced was primarily owing to higher retention levels and a reduction in reinsurance commissions. Positively, the industry successfully contained management costs through various rightsizing measures. This saw the management expense ratio decline to 17% in 2008, from 18% in 2007. Notwithstanding increased marketing pressures, GCR envisages that the management expense ratio improved to 16% in 2009. Overall, the delivery cost ratio, which reached 29% in 2007, is expected to have remained largely unchanged in 2009.

An overall underwriting result of R2.2bn was achieved in 2008, down 18% from 2007. Driven by the deteriorating claims experience, this translated to an underwriting margin of 5.4% in 2008 (2007: 7.2%). The underwriting margin is expected to have declined further to around 4% in 2009, driven by the tough economic and poor underwriting conditions, particularly in the first six months. Following the significant fire losses registered in 1H 2009, corrective action taken by some of the larger players in the second half of the year stemmed further losses, which together with continued profitability in the direct market supported a positive underwriting result. The industry is expected to maintain underwriting profitability for the tenth consecutive year in 2010, albeit that the underwriting margin has declined significantly from the 12% high reported in 2004.



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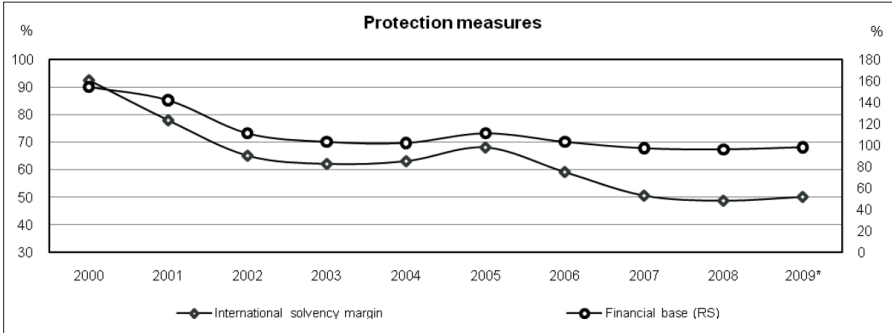
The marked volatility in capital markets saw insurers suffering substantial losses on stock portfolios in 2008. While the industry evidenced some movement in investment weightings in favour of less volatile money market investments in 2009, an appreciable recovery in the stock market drove an improvement in investment income (including unrealised losses/gains). As such, although the industry reported a decline in ROaA and ROaE to 14% and 33% respectively in 2008 (2007: 18%; 43%), these rates are envisaged to have improved marginally in 2009. Going forward, it is expected that a shift in investment portfolio weightings will take place as insurers try to balance out investments to take advantage of the recovery in capital markets.



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In light of the global credit crisis and the increased volatility experienced on stock exchanges, it is not surprising that increased emphasis has been placed on capital management. As mentioned, one of the first steps entailed the rebalancing of investment portfolios to reduce the capital required to back market volatility exposure. In addition, an ever increasing number of insurers are making use of derivatives to hedge the performance of their equity portfolios. Effectively this will result in insurers not receiving the full benefit from a strong recovery in equity prices. There is also a lot of speculation on the timing of re-entering the equity markets, as over many years, South African insurers reported good returns from investing shareholder capital on the equity markets.

Insurers' focus on capital efficiency saw the industry international solvency margin decline consistently from 2005. In 2008, equity market volatility saw solvency decline further to 48%, from 50% in 2007, whilst the statutory ratio declined to 38% (2007: 40%). It is envisaged that the latter improved to 40% in 2009 and that the industry international solvency measure has risen to around 50%. The financial base ratio (including technical reserves) eased to 96% in 2008 (2007: 97%) and is expected to have improved marginally in 2009, to reflect modest changes in reserving and retained earnings.



* 2009 figures are GCR estimates.

Going forward, economic recovery is expected to be moderate; with GDP growth for 2010 forecast at just 2.3%. This is premised on the possibility of a second global recession, volatile international commodity prices and constrained domestic output. This notwithstanding, increased demand for medical, motor and property insurance should support growth in the short term, helped by positive sentiment from the 2010 World Cup. However, the economic recovery is likely to be gradual and the pressure on disposable income among individuals and earnings pressure on businesses will continue to make it difficult to achieve the appropriate rates for risks insured. The increased frequency of large industrial accidents and fire claims are also a loss driver.

In terms of net premium, statistics show that the short term insurance industry is expected to grow at a CAGR of about 10% between 2010-2013, with growing demand for liability and engineering insurance supportive of future growth. Overall profitability in the short to medium term is not, however, expected to reach the highs reported pre-2005.

The move to a risk based capital model should see significant changes in solvency and reserving in the medium to long term. However, the impact is likely to vary substantially from one company to the next, depending on current capitalisation levels and business mix, amongst other factors. While initial challenges are envisaged, the new regulatory solvency framework should result in improved risk management and more effective use of capital, conditions necessary to ensure sustainable profitability in the long term.



For further information, please contact the insurance division at GCR on 011 784 1771