Insurance Market Update

Half 2 • 2016

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Executive Summary

Welcome to the Aon Insurance Market Update Half 2 2016

This year we have looked to add more insight from our data and analytics platforms to help you get the right information so you make informed decisions. At the Aon Risk Conference in October we headlined the event The Risk Revolution and focussed on the ever changing fast moving risk environment we now face. That is why we have expanded our report to include the up and coming risk concerns of Crisis Management and Environmental to give you a broader picture.

Multi–Speed Market leads to buyer dilemma

In the current market we are seeing insurers change their pricing strategies in an attempt to return to more profitable levels which are being hampered by the growth ambitions of existing and new entrants to the market who are looking to grow market share and generate return on their investments.

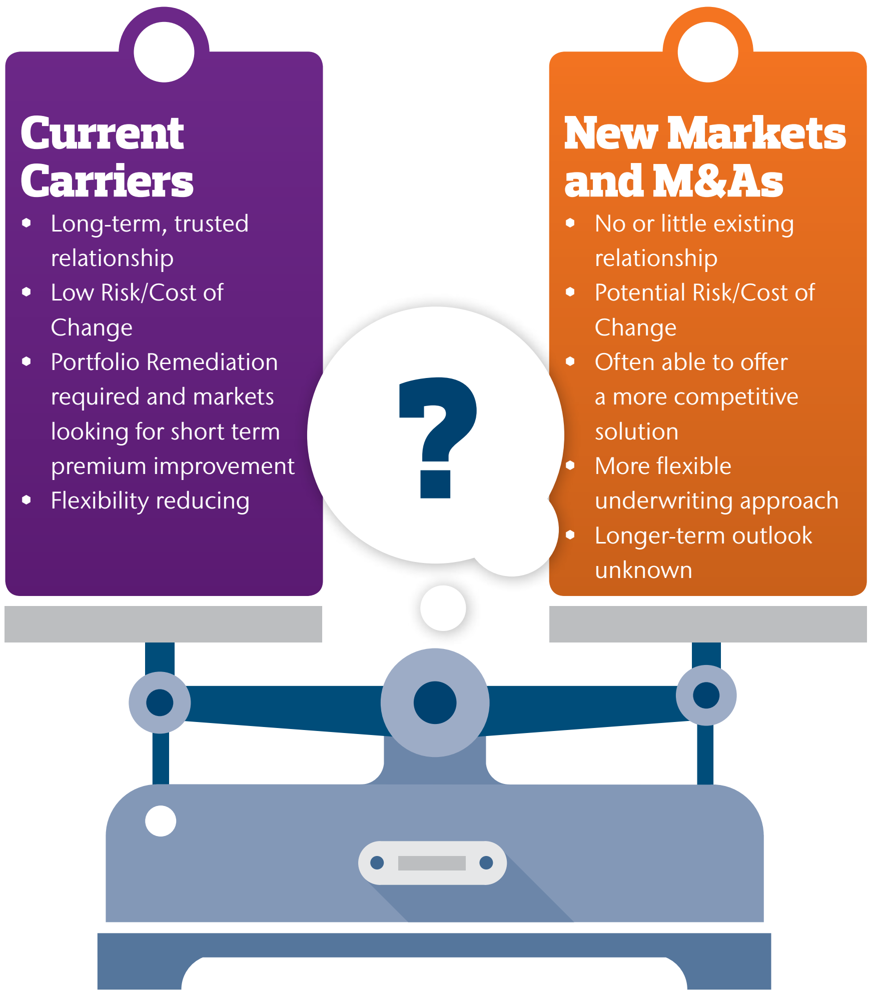
The argument for continued premium reductions

- Reinsurance supply advances to new peak
- Reinsurance landscape starts to shift with pension funds starting to buy reinsurers
- The global benign claims environment continues
- Alternative capital starting to enjoy the diversity the sector can bring
- Global market dynamics will continue to be a challenge for Australian insurers
- International markets keen to diversify from US

The argument against

- Continued rate pressure, low interest rate environment and attritional loss activity starting to significantly dent profitability
- Profit pressure and inability to further reserve release prompts some insurers to draw a line in the sand
- Signs appearing that insurers will retreat capacity and authority to HQ and divest non-core assets
- Can insurers innovate beyond price? There is simply not enough product!
- The loyalty versus price equation

The balance of these two counteracting forces is now reaching a pivotal point and creating a buyer dilemma putting many long-term buying strategies under immense pressure and causing an interesting conundrum for many risk buyers; do they take advantage of the attractive options available or take a more cautious approach with existing relationships, remembering that premium rates continue to sit at almost record lows. Indeed, have buyers got too used to ever reducing risk transfer costs?



What does this all mean for the Australian Market?

The balance between a very cautious insurance market desperate to return to profitability and the ever growing capital growth in the reinsurance capacity that underpins it, makes the coming months a very critical time for insurers in Australia. Carriers are desperately trying to get price increases across many lines but will they be able to achieve it? At the very least, this mounting pressure will limit the reductions that have been available for so long.

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Managing Director &
Chief Broking Officer, Pacific

Ben Rolfe
Chief Operating Officer,
Aon Broking

Contents

Property

At a glance

- Premiums remain under pressure amid continued intense competition
- Carriers increasingly focused on profitability but willing to innovate in order to differentiate
- Some evidence of seasonality starting to emerge as budgets drive behaviour
- Multi-speed market appearing in most areas

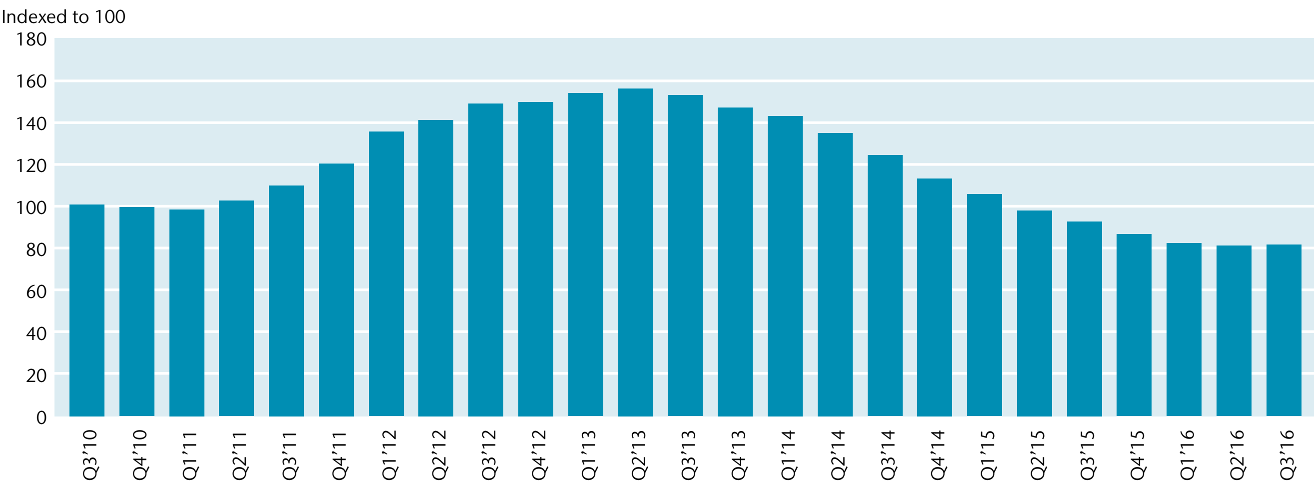
Profit pressure prompts rate reduction slowdown

In the current economic climate, buyers are more focused than ever on getting the right coverage at the right price. There is keen scrutiny of the cost and quality of coverage and also focus on the benefits of a long term relationship with carriers.

Carriers meanwhile are also facing the pressures of low global economic growth, sustained low pricing and pressure from investors to boost profitability.

As a consequence we are starting to see the market push closer to the bottom in terms of pricing; market softening is abating and rate reductions have slowed over the last three quarters and are beginning to flatten out in most areas, though insurers remain reluctant to walk away from business. New entrants continue to come into the market or expand their presence in new areas which, for the moment at least, is limiting the ability for prices to increase as many insurers would like to see.

FIG 1: Australian Insurance Market MD/BI Rates – 2010 to 2016
Source: GRIP Data*



Property premiums are at a 6-year low, outlined above by indexing July 2010 rates at 100 and tracking quarterly rate changes experienced by Aon's Australian clients since this time. Index currently sits at 81.6, following a low of 81.2 in the prior quarter.
* Aon GRIP is a proprietary database of client risk and insurance placement information collected by Aon, generating insights into client buying behaviours and carrier appetite. It is a world-leading global repository of such information.

FIG 2: Median Property Rate Movement – All Australian Industries

Source: GRIP Data and ACL Vertex Data

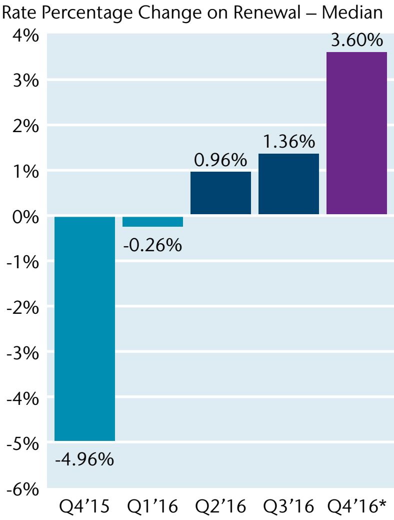


FIG 3: Median Property Rate Movement – Low Hazard Occupancies

Source: GRIP Data and ACL Vertex Data

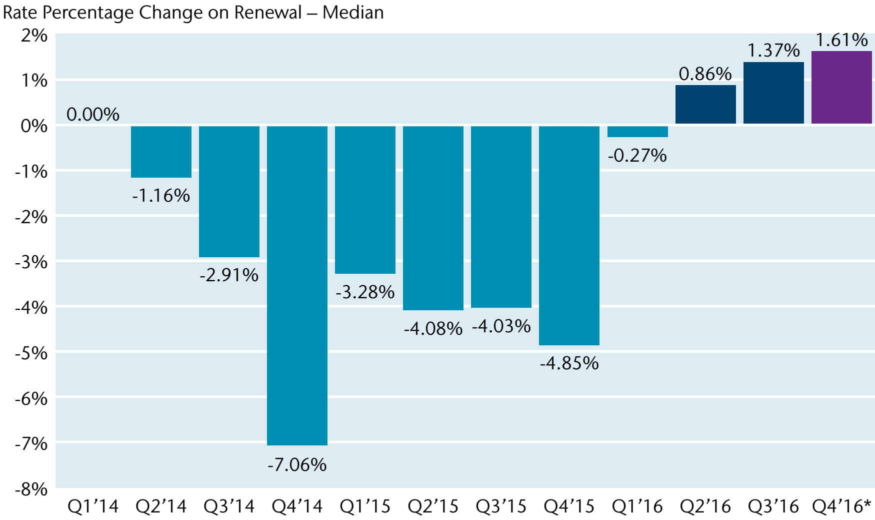
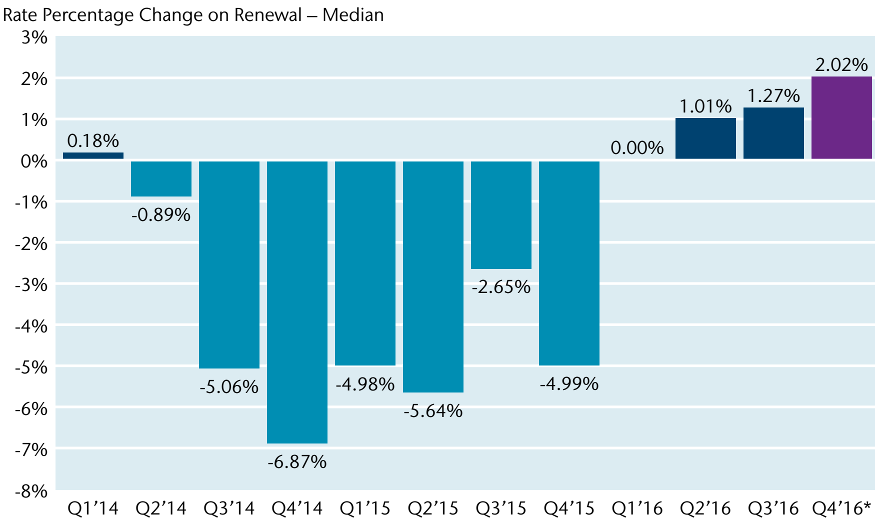


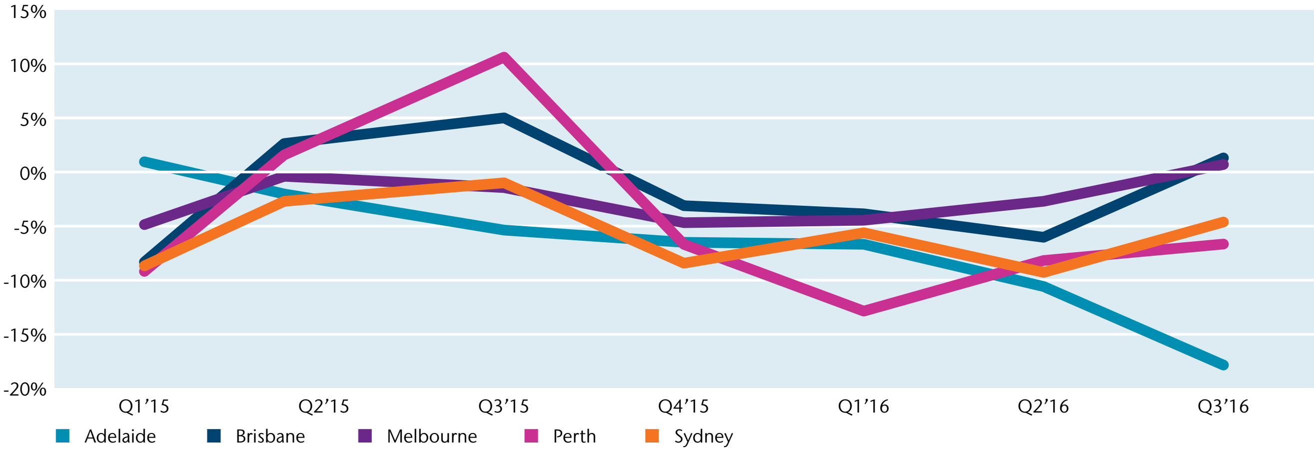
FIG 4: Median Property Rate Movement – High Hazard Occupancies (Construction, Energy, Food Systems, Agribusiness & Beverage, Manufacturing, Power, Transportation & Logistics and Water, Sanitary and associated services)

Source: GRIP Data and ACL Vertex Data



* Forecast
Policies can be of any duration and have renewed in the period shown

FIG 5: Average Percentage RateChange on Renewal by Top 5 Offices
Source: GRIP Data Source:ACL Vertex Data



Even so, the lower premiums of recent years have not been matched by reducing expenses which has placed carriers' profitability under continued pressure, particularly with insurer ability to release reserves diminishing. In addition the scale of organisations seeking coverage has impacted the overall premium pool. This is driving a renewed search for new premium, albeit with a wary eye on profitability.

There is no doubt that the way in which renewal pricing is reviewed by insurers is changing. If we look at the distribution of rate movement for our larger clients over the past 4 quarters there is a significant shift from a fairly static mid-single digit rate movement to one that is far more focused on client policy profitability. Those with claims or in more challenging occupancies or geographies are being selected against for the first time in recent memory.

FIG 6: Rate Distributionfor past 3 quarters – All Australian Industry
Source: Aon Risk/view Data 20/10/2016

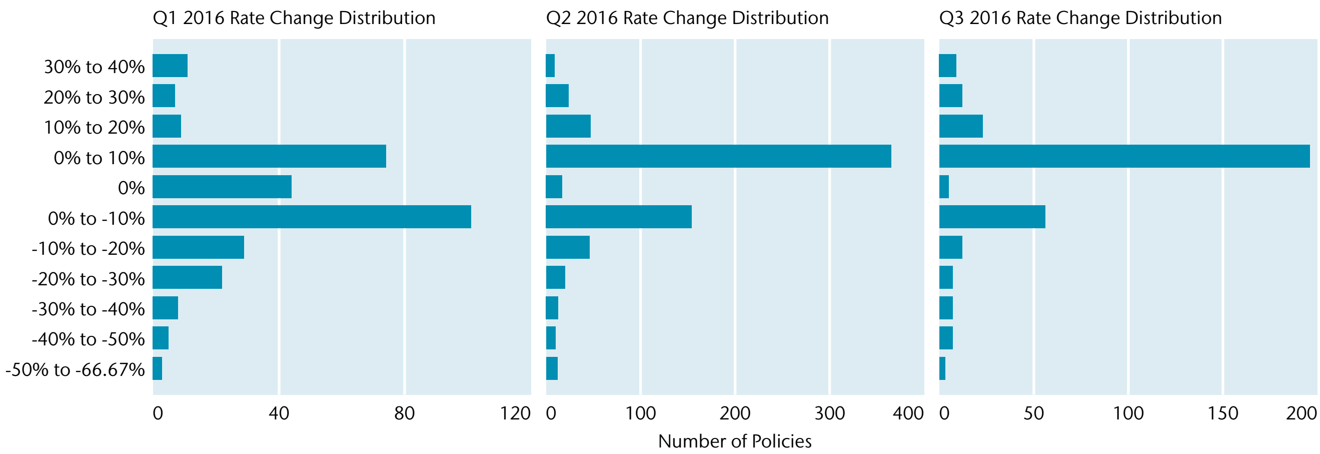


FIG 7: Rate Distribution for past 3 quarters – Higher Hazard Occupancies (Construction, Energy, Food Systems, Agribusiness & Beverage, Manufacturing, Power, Transportation & Logistics and Water, Sanitary and associated services)
Source: Aon Risk/view Data 20/10/2016

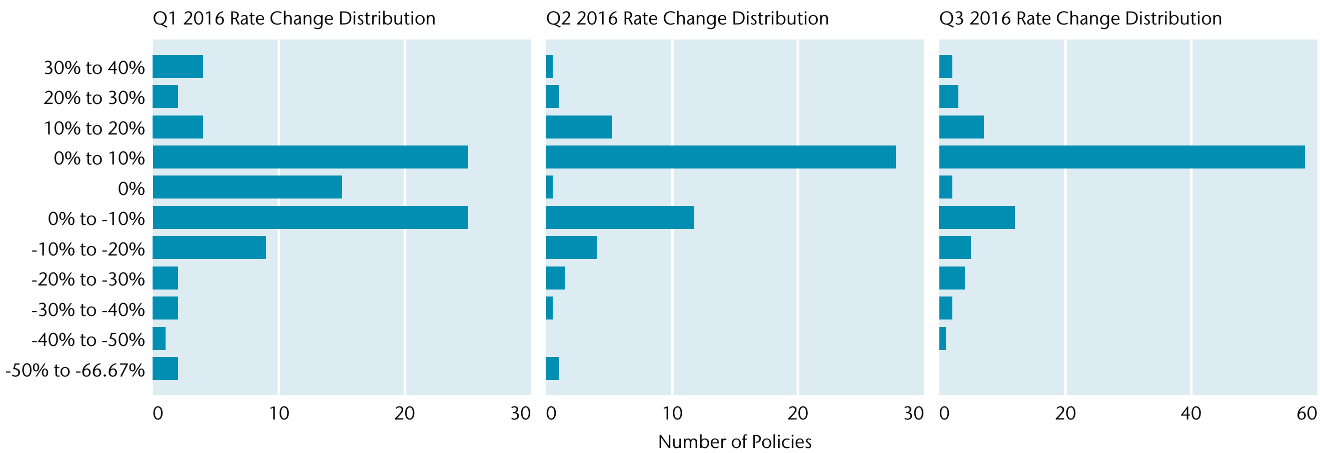
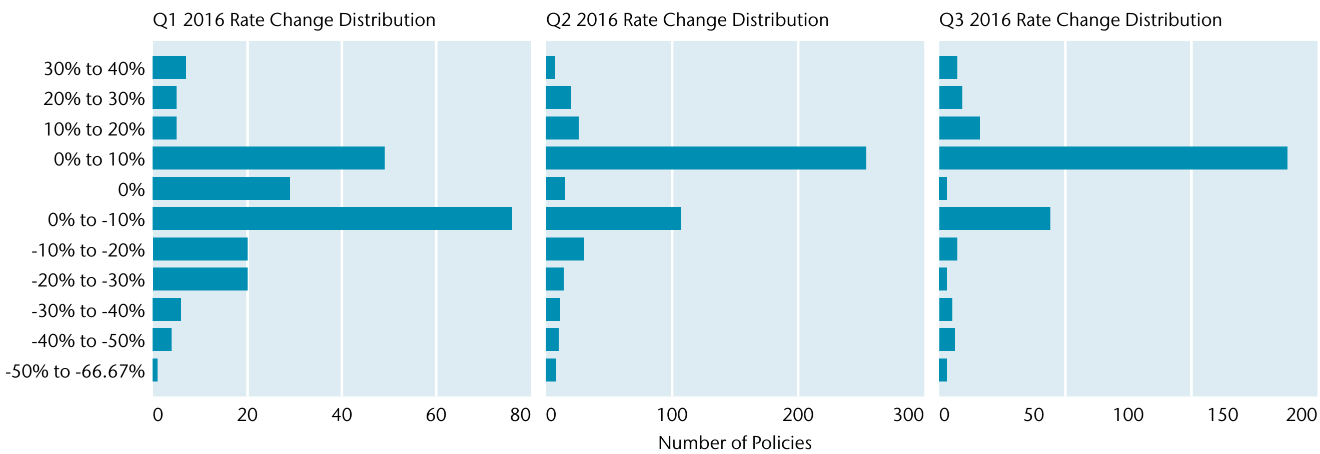


FIG 8: Rate Distribution for past 3 quarters – Lower Hazard Occupations
Source: Aon Risk/view Data 20/10/2016



Innovation beyond pure price

Insurers are starting to leverage their abilities across multiple policies to differentiate and drive growth with whole-of-account solutions emerging which may include property, Contract Works, Directors & Officers, liability, and workers compensation in a package deal. Whilst buyers have been wary of such arrangements in the past because of counter party exposures, the renewed confidence in the Australian regulatory environment and cost pressures are making such moves far more appealing to many.

Insurers continue to look to differentiate by building a broader value proposition for clients. This may be through in this initiative service level agreements around claims, global policy capabilities, additions to policy coverage, access to key decision makers or the building of stronger relationships. There has been limited success however in the current environment.

Whilst all insurers are pushing the boundaries with regards to value and service, unfortunately a continued lack of true innovation remains with many of the key wants of clients still unanswered.

How long can a benign claims environment last?

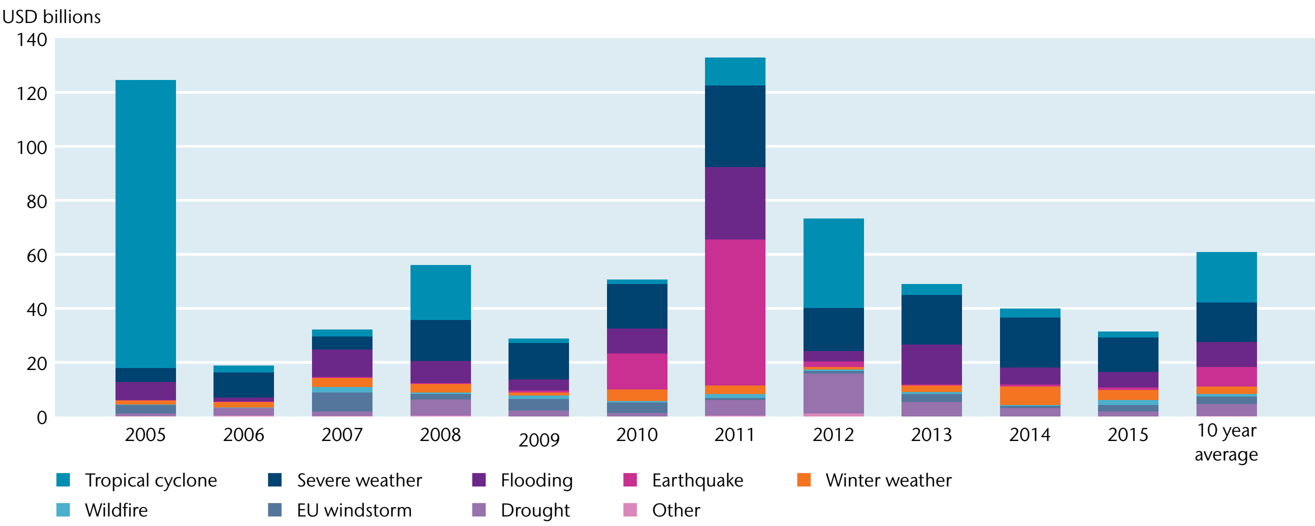
According to Aon Benfield, the global Natural catastrophe claims continue to reduce and the last two years have been well below the rolling ten year average (See Fig 9).

This said, events so far in 2016 appear to be bringing losses from such events back to more normal levels. It is estimated that the insured losses from Hurricane Matthew will get close to USD 9bn whilst first half losses in 2016 reached USD 30bn for the first time since 2011. The Quantum effect of the recent (Nov 16) earthquake events in New Zealand and Japan remain unknown. Whilst unlikely to have any impact on capital, these events continue to erode premium adequacy and insurer profitability.

More recently, the $5bn November Earthquake in New Zealand is another reminder that the Pacific region has the potential to drive substantial losses.

Given insurer discipline surrounding deductibles and cover for older buildings since the 2010 it is unlikely that cover will be impacted to any great extent but insurers are starting to re-question their capacity deployment in New Zealand and particularly the South Island. The impact on the Wellington region by this most recent event will also put a spotlight on insurer capacity aggregation and will likely be a key driver in treaty renewal discussions in January. There will undoubtedly be upward pressure on very depressed New Zealand earthquake premium pricing but as we ask elsewhere in this report, what does this mean? Will this be an enabler for premium uplift or will it simply allow insurers to draw a line in the sand? The reality is that some will be more impacted than others and those looking to gain market share in the region may try to use this to their advantage at a time when others are actively pulling back. We have already seen evidence of a reduction in appetite for cover in The South Island and we will need to watch this carefully over the coming months.

FIG 9: Global Natural Catastrophe Claims Value
Source: Aon Benfield Insurance Market Update 2016



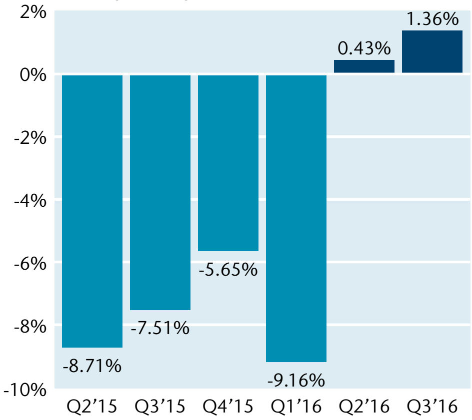
Global Capacity

Global capacity remains abundant and shows no signs of reducing any time soon with interest rates still low and capital providers keen to diversify their portfolios. Whilst there have been exits from the market in recent times (Tokio Marine Global Syndicate, Argo Global from Property and Atrium and Axis retreats to Head Office), these have been more than made up for by new or changed entrants looking for growth.

All told, we are still seeing a strong competitive market but insurers are looking more closely at the bottom line. In certain markets we are still seeing slow rate reductions; when incumbents dig in their heels there may be an opportunity to seek alternative providers who want to grow market share.

FIG 10: Median Property Rate Movements – Global/Corporate size organisations in Australia
Source: Aon Risk/view Data 20/10/2016

Rate Percentage Change on Renewal – Median



All Periods Rate Change Distribution

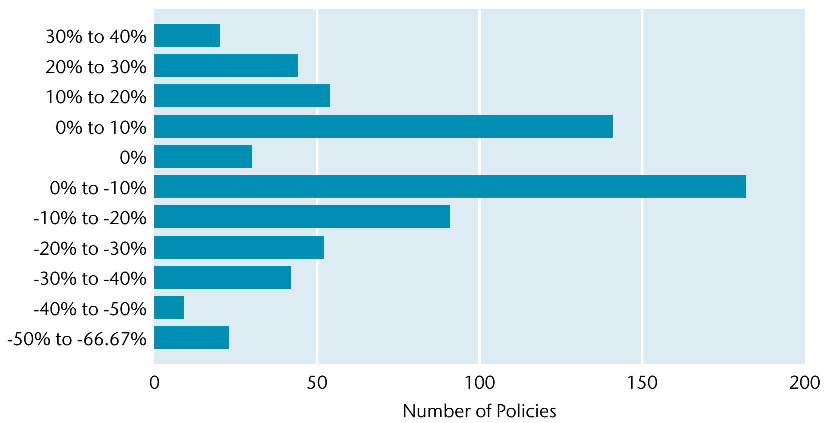
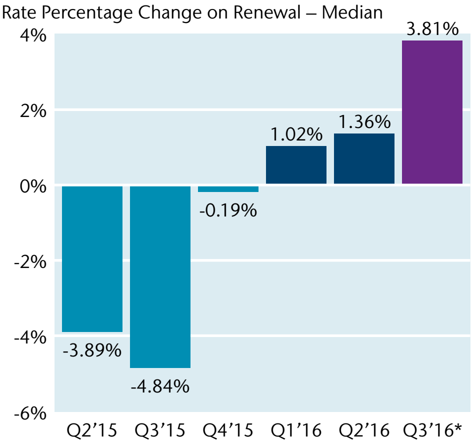
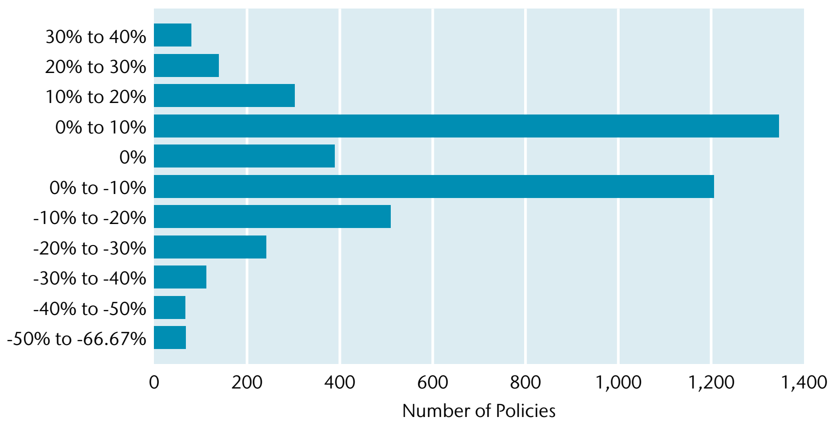


FIG 11: Median Property Rate Movements – Commercial size organisations in Australia
Source: Aon Risk/view Data 20/10/2016

Rate Percentage Change on Renewal – Median

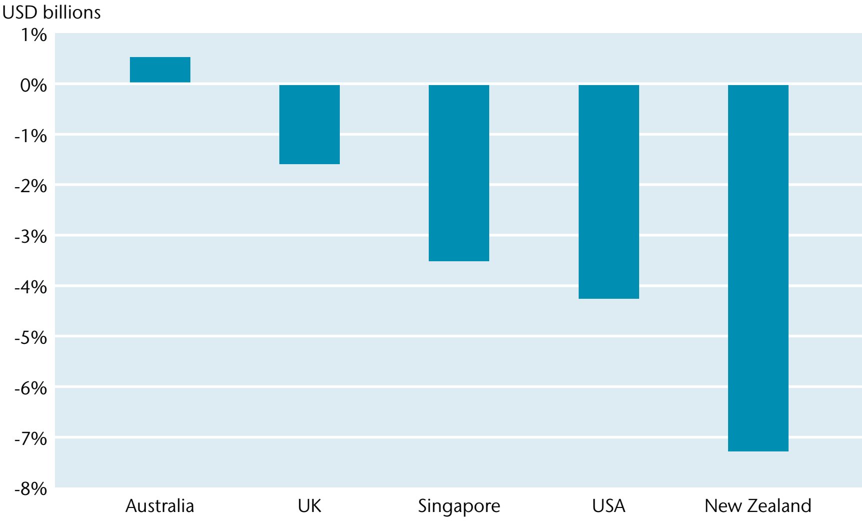


All Periods Rate Change Distribution



* Forecast
Policies can be of any duration and have renewed in the period shown

FIG 12: Q3 Average Property Rate Movement by Geography
Source: Aon Risk/view Data 20/10/2016



Buyers should also be aware of global market conditions with continued softening in other parts of the world continuing to allow choice for buyers. The impact this will have on the ability of local carriers to see positive rate movement is yet unknown but should not be underestimated. This said, there are signs that some of the large domestic insurers are willing to see premium volumes drop significantly to improve profitability.

The loyalty versus price equation

Differential pricing is mostly available for renewals compared to new business. There remains a fine balance between a buyer being rewarded by their incumbent provider for a longer term view or moving to get a better price for shorter term gain. During a period when rate reductions are slowing (and sometimes increasing), organisations have to weigh the price versus relationship equation.

A cohort of buyers are interested in the opportunity to secure pricing for two to three years; effectively forging a contract for two to three years which locks in pricing and capacity.

This is becoming more prevalent where insurers are looking to differentiate themselves in the market and also assure premium flow. For the client this may offer the opportunity to lock in premiums as we approach the bottom of the pricing cycle – akin to locking in historically low interest rates on a mortgage.

Looking ahead

There is no doubt that risk transfer costs will remain low but there are certainly signs, in Australia at least, that where rates have fallen faster than most territories in recent years, pressure to increase pricing will build.

Buyers should continue to focus on selling their risks to the market and differentiating themselves in order to drive the best possible outcome. They will however be more challenged as to where these options come from – change of insurer, multi-policy leverage or changed policy structures.

We are seeing some evidence of seasonality creeping into the market. This is not that there is a best time to buy, but over a 12 month financial year as they search for profits and growth, insurers may look to rebuild business in the final quarter of their financial year if they have lost business or the retention rate slid during the first six months. Buyers need to be mindful of this and analytics will become a key part of insurer selection during strategy sessions as we enter 2017.

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General Liability

At a Glance

- Stable market conditions for foreseeable future
- Sector specific hardening rather than general market upturn
- Potential to lock in longer term arrangements

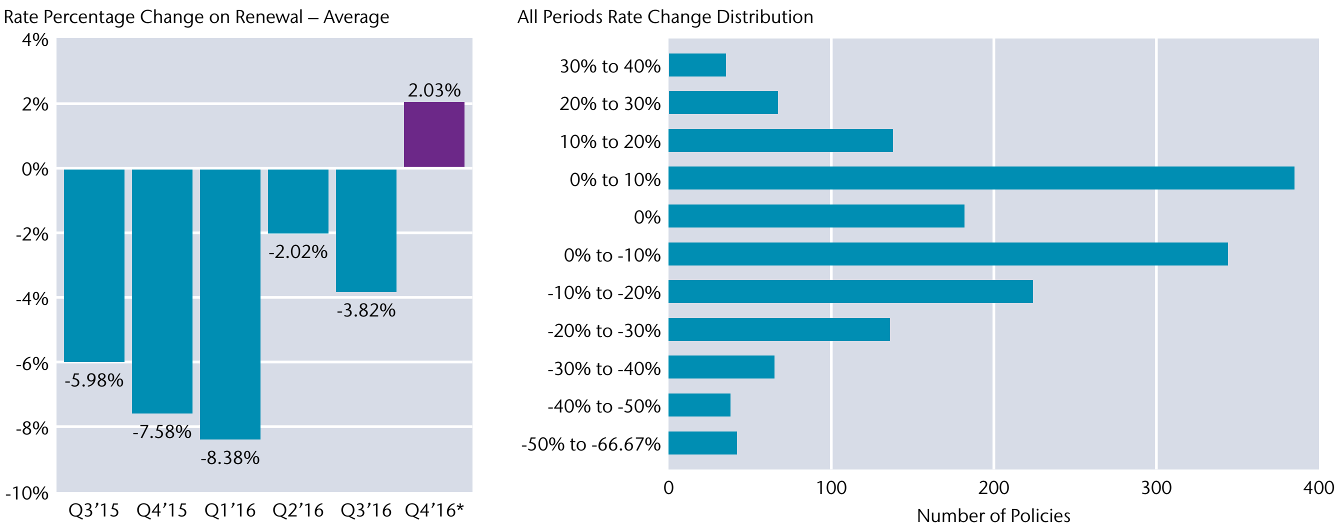
Steady market as insurers focus on expense ratios and profits

The outlook in general liability is “steady as she goes” for the foreseeable future. We are seeing evidence of some sector specific hardening, with particular scrutiny to bush fire liability and sexual abuse exposures. Despite this, it remains a buyers’ market though the size of rate reductions is decreasing.

Technology has lowered the barrier to entry, which combined with abundant global capital has led to significant surplus capacity.

However, insurers are increasingly focused on achieving underwriting profits and an acceptable return on capital/profit margin in a competitive market. They are paying particular attention to efficient management of their expense ratios and conducting careful analysis of their accident year versus underwriting year results, in order to understand their true portfolio performance.

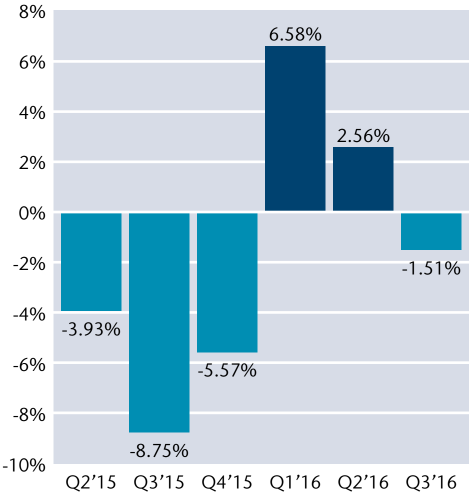
FIG 13: Overall Australian Market Premium Movement
Source: Aon Riskview Data 20/10/2016



* Forecast
Policies can be of any duration and have renewed in the period shown

FIG 14: Manufacturing Australian Market Premium Movement
Source: Aon Riskview Data 20/10/2016

Rate Percentage Change on Renewal – Average



Policies can be of any duration and have renewed in the period shown

All Periods Rate Change Distribution

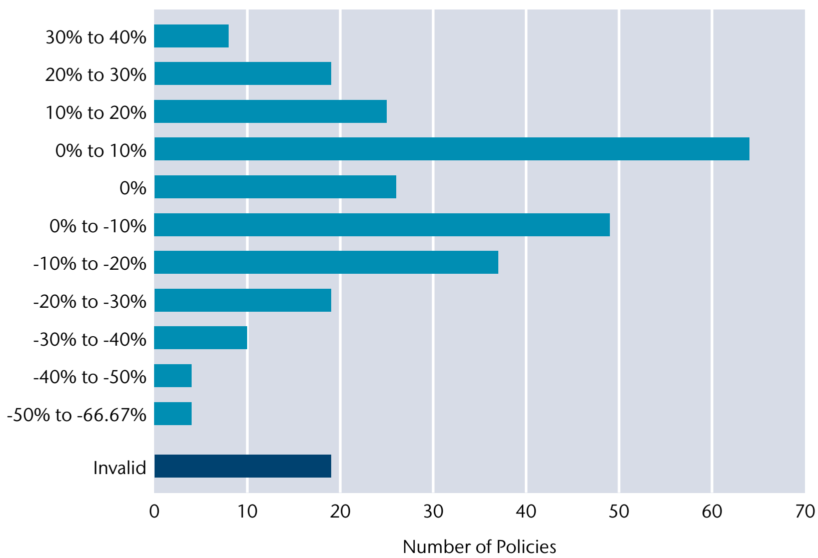
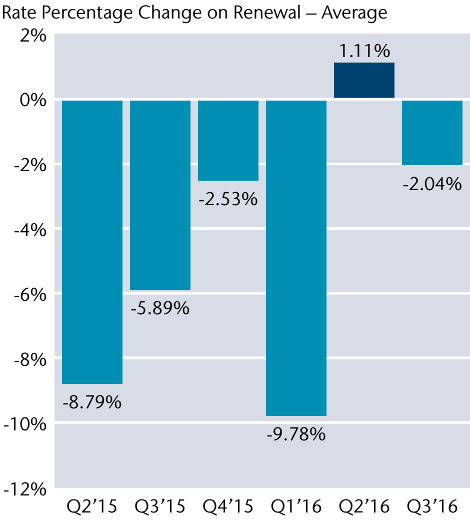


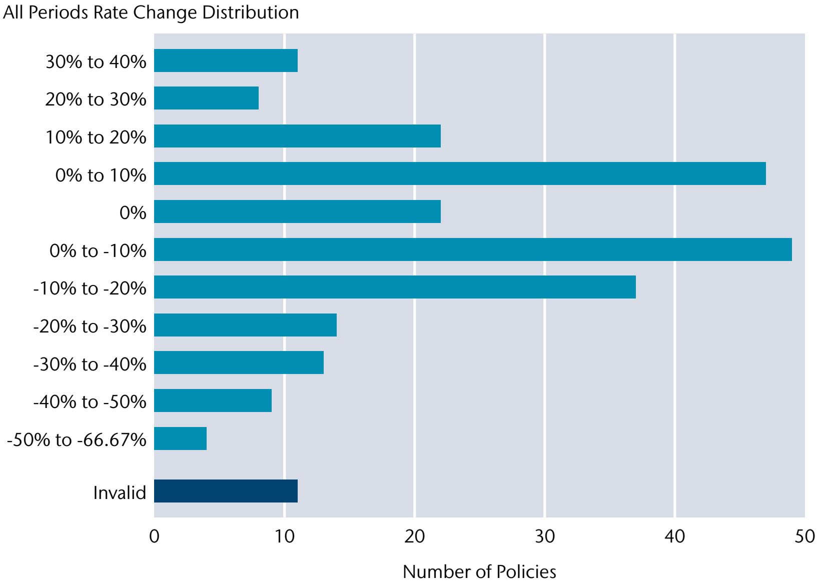
FIG 15: Food Systems, Agriculture & Beverage Australian Market Premium Movement
Source: Aon Riskview Data 20/10/2016

Rate Percentage Change on Renewal – Average



Policies can be of any duration and have renewed in the period shown

All Periods Rate Change Distribution



In negotiations they remain eager to delineate their value proposition compared to the rest of the market and some are now offering casualty risk management services as part of their product offer.

As a general trend, organisations which are able to demonstrate effective and proven risk management plans and procedures will benefit as more insurers compete to win their business. This is the case for organisations of all sizes.

Current risk landscape

There is a degree of economic and political uncertainty, both in Australia and internationally. As in other sectors, the potential impact of Brexit will need careful ongoing monitoring to ensure effective coverage is maintained if and when the UK exits Europe.

Insurers are also mindful of exposures that may arise from the Royal Commission into Institutional Responses to Child Sexual Abuse. Organisations potentially impacted will need to demonstrate first class risk management policies, processes and procedures in order to secure adequate coverage.

Cyber risk is being closely scrutinised, with trends pointing to more specialised cyber coverage for effective risk transfer.

Should I stay or should I go?

As liability is generally a long tail line of business, there is a dividend for buyers who have long term relationships with their insurers. Highly engaged clients continue to value the benefits flowing from such arrangements. However, insurers accept that good corporate governance requires regular reviews to ensure the best balance of cover and pricing. The question to lock rates into a long-term agreement is therefore a case-by-case discussion.

History shows that at the bottom of a pricing cycle insurers are more reluctant to enter into long term arrangements as they try to time a pricing upturn. We are beginning to witness such behaviour with some insurers now requiring head office sign off before entering into long term agreements.

Looking ahead

The size of rate reductions is decreasing, but at this stage we expect to see sector specific hardening rather than a general market upturn.

Given that this remains a buyers' market, forward looking organisations may seek to leverage this by locking in long term agreements where possible, subject to their individual risk profile.

Insurers are willing to agree on longer term policies, but have a series of guardrails that organisations will need to follow to secure potentially multi-year or open-ended insurance agreements.

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Professional Indemnity

At a Glance

- Split market with construction professionals and financial planners facing squeeze
- Capacity remains but widespread premium reductions are ending
- Rising insurer scrutiny demands improved risk management as differentiator

Split market as key professions squeezed

While clients have experienced modest premium reductions during 2016, there are signs that the market in general is bottoming out, the claims tail is catching up, and as a result the years of widespread premium reductions are coming to an end. According to APRA's PI statistics for 2015, the net loss ratio for PI (non-facility) is 62 per cent resulting in a combined number upwards of 80–90 per cent.

As the class moves through cycles there is an increasing split in market response; for the more traditional, low risk professions the market remains highly competitive reflected in the rates on offer. Other professions are facing rate stabilisation to low upward pressure. This is having particular impact on financial planners, valuers, quantity surveyors, engineers, mining services and design-construct companies.

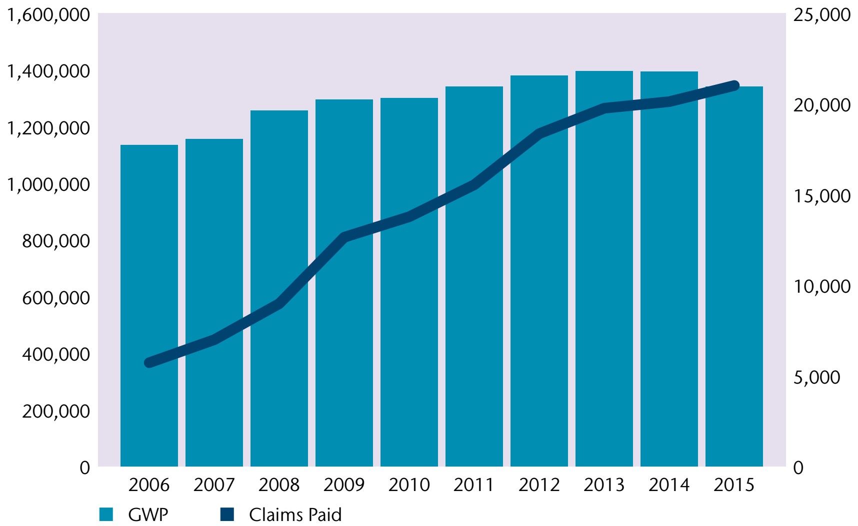
62%
Net loss ratio for PI (non-facility) APRA 2015

London has traditionally been a competitive alternative PI market for larger and/or more complex risks. Recent Australian claim settlements (see Fig 16) however have led to a more stringent underwriting review process, tightening of rates and generally a more cautious approach to Australian business.

Financial planners persist as a continual challenge with the number of insurers willing to write policies in this part of the market quite small. Insurers are particularly aware of planners who operate as part of an aggregator business model.

In terms of professionals' geographic location and focus there has been little change. Professionals operating in underdeveloped countries or the more litigious US market continue to face greater insurance challenges.

FIG 16: Professional Indemnity vs Claims Paid Year 1 – Australia All Industries
Source: APRA 2015 National Claims and Policies Database



Shall I stay and shall I pay?

Whilst insurers value long term client relationships there is a push for underwriters to review the profitability of each account and overall deployment of capital. Clients that continue to expect year on year premium reductions are likely to experience insurers' reach walk away prices. So long as there is an oversupply of capacity there will be alternative markets for the majority of risks however the quality of capacity, breadth of coverage and long term viability may be compromised in the process.

Claims landscape

The market is near the end of the Global Financial Crisis claims tail with 2012–13 proving unprofitable for many insurers. In an attempt to retain business and reduce rate reductions over the past five years, insurers have focused on coverage enhancements. As the sophistication of wordings increased, clients have become more aware of first party mitigation and contractual covers historically not available. Whilst a positive development for clients, the resultant claims have had an impact on the sector.

Looking ahead

There is clear evidence the market is in a transient position showing signs of change.

In this environment, organisations and individuals seeking or renewing coverage need to start early, focus on risk management initiatives and succinctly demonstrate to insurers the calibre of their people and operations in order to stand out from their peers; this is not necessarily time to move but to seek the best deal.

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Directors & Officers

At a Glance

- Compliance burden and regulatory activity is rising, souring claims landscape
- Side C coverage for listed entities under significant pressure
- Insurers charging more for capital, pulling back on capital on offer, or both

Soft market toughens up

After 15 years of relatively soft markets with lower excesses and reduced premiums the tide is starting to turn – and fairly rapidly with regard to Side C (company securities claims insurance) cover for listed companies.

What has been a lengthy period of gross oversupply of capital is now over and most companies are making tighter margins. While there is still coverage, premiums are under pressure and in some sectors significantly under pressure.

Three sectors in particular – mining, oil and gas and energy – face particular challenges. One miner has faced a 600 per cent increase in premiums.

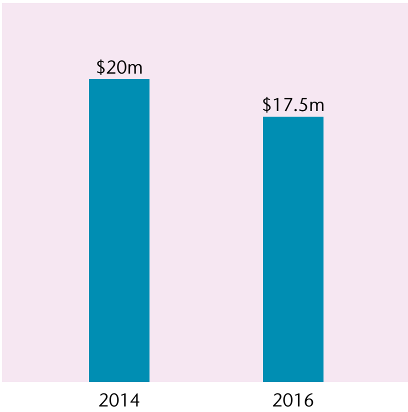
Given that the insurers are capital constrained we will see an increase in prices and expect further increases in future years. Figure 17 shows how insurers are using capacity management to reduce their exposure to the current claims environment.

However, on the other side of the coin of those ASX companies who purchase c-side cover the median limits have increased by more than 20% since 2014 in response to the same claims environment, with these two contributing factors the outcome is inevitable; increases in prices.

The local market is also starting to lose appetite for the banks, but they still have the option of the London market which is still receptive.

There is a trickle down impact for smaller clients, especially in the area of employment practice claims for unfair dismissals and breach of statutory regulations. SMEs however remain, in general, underinsured in this area.

FIG 17: ASX 100: Median Primary Limits of Liability
Source: Aon Riskview Data 20/10/2016



Claims outpacing premiums

In the last financial year there have been seven filed class actions representing approximately 1/5 of actions represented in Fig 18 and four securities class action settlements totaling around $200 million, not including the defending companies' costs. The annual D&O premium pool is around $240–$250 million demonstrating that recent claims have proven disproportionate to the pool.

The rise of sophisticated litigation funders and class action law firms are extending their focus beyond major corporations and also sweeping up smaller matters. The market cannot sustain this level of claims so is pulling back on Side C.

FIG 18: New class actions filed
Source: The Review: Class Actions in Australia 2015/2016

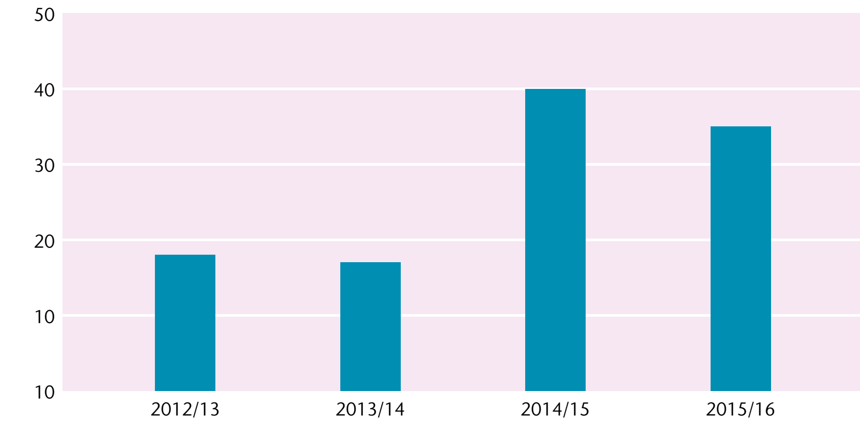
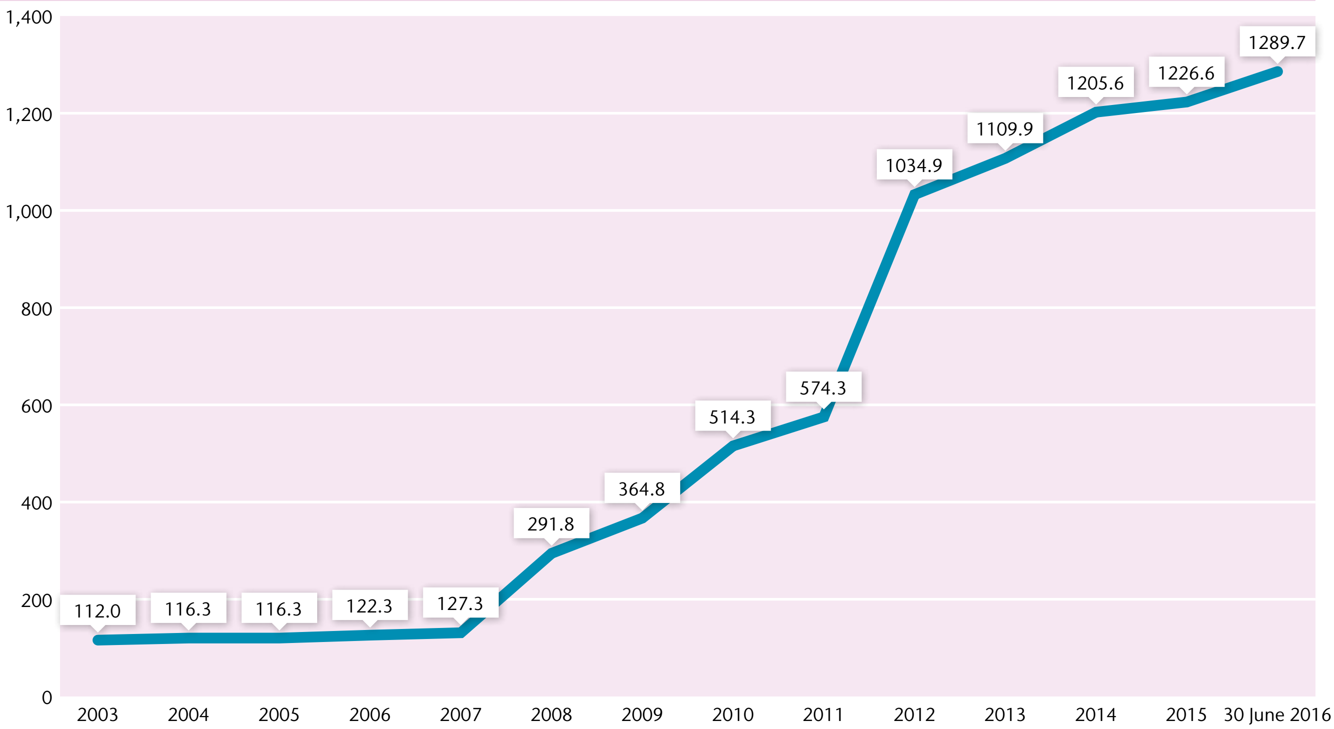


FIG 19: Significant securities class action settlements
Source: The Review: Class Actions in Australia 2015/2016



Regulators flex muscle

Regulators continue to flex their authority, with; ASIC, WH&S, the EPA, AUSTRAC, ACCC and a series of Royal Commissions having impact across multiple sectors. The ASADA investigation of the Essendon Football Club, and Fair Work Australia's investigation of 7-Eleven stores are just some recent examples.

A series of high profile corporate failures and insolvencies have also taken their toll.

Separately the Royal Commission into Institutional Responses to Child Sexual Abuse is performing a critical task unflinchingly. It is however having a significant market impact as the legal costs of supporting directors who are called to appear continue to mount – costs estimates have run into the tens of millions of dollars, possibly higher, and the inquiry will not conclude until well into 2017.

Fresh challenges with cyber and economy

There remains still some naiveté regarding cyber exposures and the role that D&O coverage would play in the event of a data breach or cyber-attack. Some boards may be of the belief that any cyber claims might be handled by D&O – but insurers are alert to the issue. Specialist cyber protection is generally a more appropriate way to transfer cyber risk than relying on D&O.

There is a sense that directors are somewhat paralysed to make decisions because of uncertainty in the economy at home and internationally, and that is reflected in recent sentiment analysis conducted by the Australian Institute of Company Directors. The rise of the professional director may also be impacting boards' willingness to make assertive decisions.

(10–15%)

Potential Side C capacity forecast

Looking ahead

Insurers are charging more for capital, they are pulling back capital on offer, or both.

They are not however pulling back on coverage – but organisations should expect to see an increase on excesses especially on Side C and a more granular focus on operations from insurers.

Side C capacity could contract by as much as 10-15 per cent.

Regulatory scrutiny, particularly of the banking and finance sector is expected to remain a feature of the corporate landscape with possible actions also arising from the findings of the Royal Commission into Institutional Responses to Child Sexual Abuse.

Meanwhile litigation shows no sign of abating, placing further pressure on corporations and their insurers.

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Cyber

At a Glance

- Mandated data breach notification expected, spurring demand for coverage
- Insurers increasingly sophisticated about policies and pricing risk
- Security gap remediation required for best rates

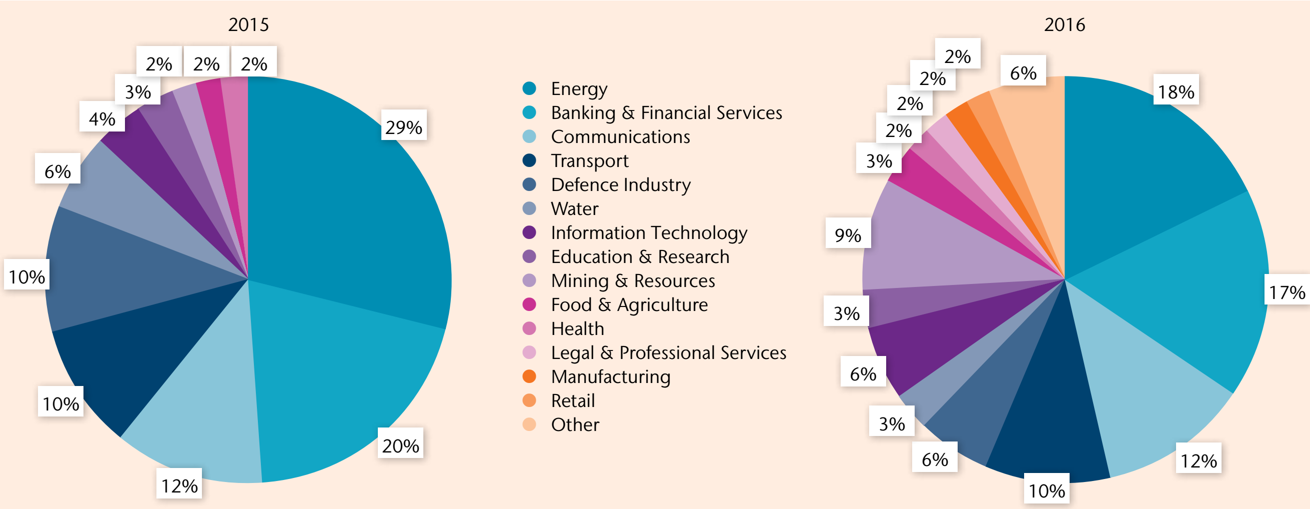
Cyber risk awareness rises though too few organisations are properly insured

Cyber coverage remains low in Australia with only about 1 in 50 organisations having any form of cover. The anticipated introduction of mandated data breach notification should spur organisations into action, preferably well in advance of the legislation coming into effect.

Organisations awareness of cyber risk is rising and boards are starting to plan for when, not if, they suffer a cyber-attack or failure. The attack on the ABS' Census site threw the issue into sharp focus, while a growing appetite for cloud computing is prompting fresh risk analysis, particularly around potential business interruption.

In the recently released ACSC Threat Report 2016, CERT Australia responded to 14,804 cyber security incidents affecting Australian business, between July 2015 and June 2016. 418 involved systems of national interest (SNI) and critical infrastructure, and it is noticeable to see that the wheel has changed over the last 2 years. The affected industries are no longer dominated by energy, banking and financial services and a larger number of industries are now reporting incidents (see Fig. 20).

FIG 20: Reported Compromised Systems by Industry 2015 vs 2016 ACSC Threat Report
Source: CERT Australia ACSC Threat Report 2015 and 2016



Over the last six months a range of new policies have emerged. These are far more inclusive, and cover not just hacking but can include accidental actions and failures, and also detail incident response plans and strategies.

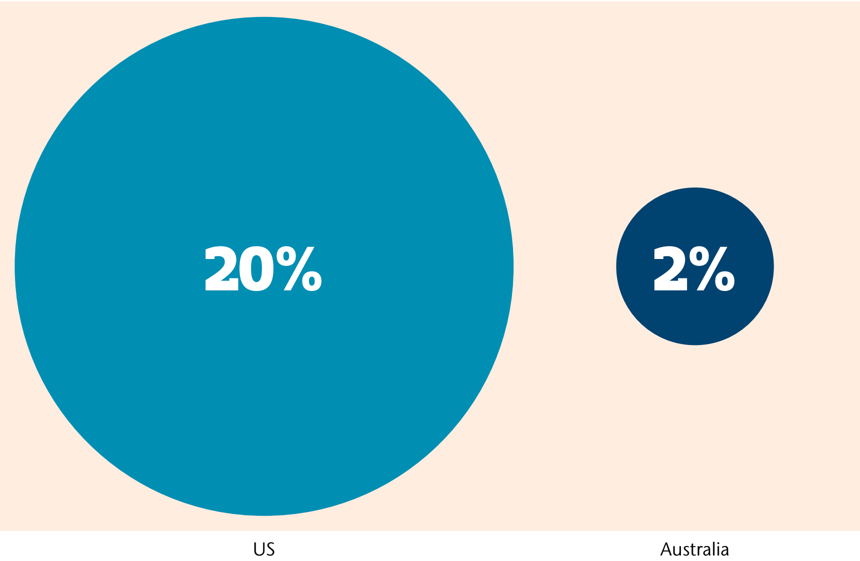
Competition in this sector is rising. Major global firms and local organisations – which tend to focus on SMEs – are active in this sector.

However, put three insurers in front of the same risk and you will still get three different responses. There is still work to be done on pricing cyber risk, though pointers from the more mature US market are proving helpful.

Mandated data breach notification looms

The mandated data breach notification amendment to the Privacy Act has been tabled on a list for consideration by Parliament. The proposal has had bi-partisan support and is widely expected to pass both Houses. The Bill's structure provides organisations a year's grace to prepare for the changes, but this could be law by December 2017. Once passed the law could affect companies if even a single tax file number or health record is breached.

FIG 21: Cyber Insurance uptake US vs Australia



In the US there are 47 states with data breach laws and about 20 per cent of the market has cyber insurance coverage. In Australia coverage is less than 2 per cent. The mandated breach notification should lift that – but ideally not at the last minute.

Insurer and insured understanding improves

Traditionally it has been problematic to put together an accurate understanding of where cyber risks lie. IT tools may help assess technology vulnerabilities – but these only address one element of the issue. Insurers also seek to understand cyber-related employee risk and how that can be priced.

We have seen some organisations start to develop tools that will give ratings for exposures, and it is likely that in the future the market will settle on one which will deliver more clarity.

Captives deliver alternative approach

To help organisations lower their total cost of insurance and risk, some organisations are considering alternative methods of risk financing – including using captive insurance.

A captive is a bona fide insurance or reinsurance company owned by a non-insurance company parent, which insures or reinsures the risks of its parent and/or affiliated companies. It is similar in principle to a conventional insurance company.

Including cyber risk in a captive, rather than simply self-insuring the risk, allows the organisation to evaluate how the risk will behave in a formal insurance structure subject to underwriting and claims adjustment disciplines. Over time, that experience and data can be used to negotiate program structures with insurance carriers and better inform cost allocations of cyber loss.

Aon's recent Cyber Captive Benchmarking Survey revealed that participation in cyber by captives rose globally by roughly 30 per cent in 2016 and this growth trend is expected to continue.

Taking control in the cyber stakes

Companies seeking coverage are advised to perform a gap assessment against ISO standards or best practice. This is best performed by an independent assessment organisation.

Insurance coverage will prove expensive unless organisations are able to demonstrate remediation of any identified gaps. Savvy organisations are now structuring a remediation investment in parallel with insurance coverage.

Specialist coverage trumps general

Most organisations new to cyber insurance remain unclear about where specialist coverage kicks in. It is no longer a grey area however with regard to cyber incident response. If response is handled well then there is also a reduced risk of third party claims, or impact on D&O or PI policies.

We often run through scenarios with clients to provide gap analysis of their insurance under different scenarios.

Looking ahead

Cyber risk is fast moving and often unpredictable. It is important to revisit existing policies ahead of renewal to ensure that they have kept pace with market trends and emerging risks. This is particularly important for critical infrastructure and utilities which can face major cyber impacts.

Some insurers are better placed to write policies for industrial technologies using SCADA control systems; others focus on other sectors such as finance which is a leader in adoption of cyber insurance. The London insurers are also active in this field.

Policies, rates and coverage are in flux and it is important to remain alert to new features and benefits available at renewal; there may be more features available for the same price.

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Financial Institutions

At a Glance

- Steady market, flat pricing with limited opportunity for price reductions
- Increased financial sector scrutiny creates potentially strong headwinds
- Opportunity to negotiate scope of coverage

Steady market but limited pricing flexibility

There has been no dramatic change in the financial institutions sector over the last six months; and the insurance market has remained relatively flat in terms of pricing.

Whilst insurers are typically seeking modest rate increases across their financial institutions portfolio of clients, there continues to be an abundance of capacity in the market which is keeping pricing levels relatively stable. There continues to be opportunity to drive pricing reductions, typically through the utilisation of Asian or London based insurers – such reductions however are typically at the sub -5 per cent level.

The across the board material savings, with reductions as high as 30–40 per cent, which were once enjoyed by the sector are no longer on offer.

Insurers focus on profitability

Insurers are increasingly focused on portfolio profitability. The market has been soft for ten years with an abundance of competition and new capacity; however over that period insurers have sustained material losses which, in conjunction with a contracting pricing and low-interest rate environment, have significantly impacted profitability.

Increased regulatory oversight and a resultant rising tide of claims emanating from regulatory investigations have impacted insurer profitability and continue to challenge underwriters.

Over the decade there has been more than $1 billion worth of shareholder class action settlements. Given the D&O Insurance premium pool is roughly $240 million a year this has had a mounting impact across the market.

Some actuarial studies have suggested that from a D&O perspective alone, insurers would need to lift rates 70 per cent to return to profitability.

Banking sector scrutiny

Australia's five major banks deliver insurers with a significant premium pool – but can also incur significant losses.

Additional local headwinds will emanate from greater banking sector scrutiny which has been promised by the Federal Government, the ongoing inquiry into rate fixing, and the spectre of a banking Royal Commission proposed by the Labor party, all adding significant uncertainty to the mix.

While Brexit remains on everyone's watch list, its impact will depend on how long it takes to facilitate and unwind the UK from Europe.

Looking ahead

Looking forward we anticipate upward movement among those clients which do not benchmark well from a risk perspective. Organisations with a large retail client exposure such as stockbrokers and financial planners are also likely to face continued challenges.

The insurance market is effectively at a point where price reductions are potentially not achievable. Organisations need to prepare – not necessarily for increases - but should understand that reductions are no longer generally available.

There are still opportunities in lieu of reductions to drive broader cover, and financial services firms should work with brokers to ensure fit-for-purpose and expanded policies are negotiated to offer coverage with particular emphasis on anticipated regulatory investigation and ongoing economic uncertainties.

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Crisis Management

At a Glance

- Threat landscape shifting rapidly and unpredictably
- Greater competition among insurers impacting premiums and coverage
- More affordable for smaller organisations

Table 1: Australian Market Product Recall Insurers

2006	2016
AIG	XL Catlin
	Liberty
	AIG
	Talbot
	Allianz
	HDI-Global

Competition rises, but premium pool insufficient

There has been a significant increase in the number of insurers offering coverage for crisis management including corporate protection (kidnap, extortion and related perils), terrorism and product contamination & recall. No longer the domain of just two or three companies, the additional capacity and rise in specialist teams in the area has made coverage more affordable and helped ensure that emerging trends are covered.

While the new capacity in the market has helped push premiums down, crisis management remains a niche area. When the market is affected by an incident, it has significant impact – the premium pool is still not as big as insurers would wish.

An increase in incidents and claims in product recall has seen both the local and the London market experience sizeable losses. Legal expenses in corporate protection insurance, are rising, with families increasingly suing companies over duty of care. In addition, employees are proving more active in claiming that they were not properly protected with adequate tools, training and security support.

Threat landscape shifts

The crisis management spectrum includes an array of different insurances for special contingencies such as corporate protection (traditionally called kidnap for ransom), terrorism and political risk also specialist products to address product contamination and recall.

A new wave of terrorism sweeping the globe has knock-on potential for Australian organisations, particularly those with global operations. While terrorism was once the province of established groups focussed on paralysing governments where civilians were not the main target, it increasingly involves home-grown radicals and lone-wolf operators – leading to a rise in attacks on civilian soft targets with consequent impact for global organisations.

Since January 2015, 31% of all attacks in Western countries have targeted private citizens and public gatherings, making this the most targeted general sector in our database in the past year. This marks a significant change from 2010–2014, when attacks against private citizens and public gatherings made up just 25% of recorded incidents, second to attacks on police, military and government, which totalled 43% of attacks. This means that terrorism re-emerged as a significant business risk over the past year, with major high-profile international attacks targeting tourism related sectors (hotels, resort, airports and civil aviation) and crowded public spaces (including retail and sports venues).

There is a lot of activity in the kidnap and extortion side, though these may go unreported prompting a false sense of security in some organisations. According to the Australian Bureau of Statistics there were 527 extortion incidents and 550 kidnap incidents reported in 2014.

The public's embrace of social media has also impacted organisations' efforts to deal with product recalls. Recalls may prompt a business interruption, but when consumers take to Twitter, Facebook and Instagram to share experiences it has become a greater challenge to manage recalls and remediation, along with efforts to rebuild trust.

Awareness levels remain patchy

Internationally the risk transfer opportunity for crisis management coverage is better understood. Australian organisations often maintain a relaxed approach based on overweening confidence in existing processes and an expectation that the unthinkable could not happen.

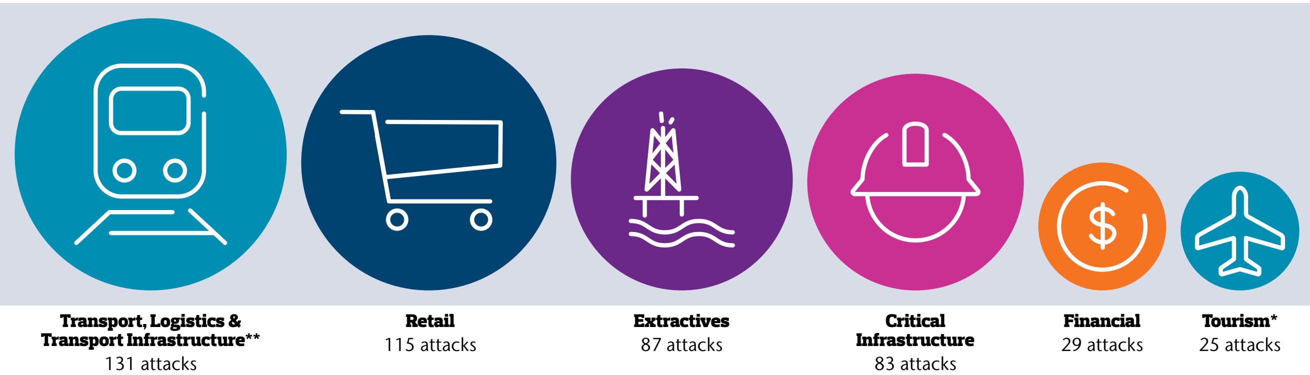
There is also a continued misconception about the cost and complexity of crisis management lines, along with a significant underestimation of what is required to re-build brand confidence leaving organisations without proper cover exposed.

Organisations meanwhile continue to grapple with the issue of cyber-crime and the rise of ransomware, such as Cryptolocker, which can see corporate computer systems paralysed until a ransom is paid to extortionists. There is cyber cover which is separate from special contingency cover and the split between the two needs careful consideration. Cyber insurance will cover data breaches, but not ransomware extortion attempts which need to be under special contingency policies. There is some level of cross over between the two insurance classes and this needs thorough attention.

Special sectoral considerations

- Mining companies – often prone to kidnap, ransom and extortion events emanating from high risk countries where drilling and exploration is underway.
- Education – travelling academics, researchers and students remain at risk
- Food and consumer durables – food and non-food manufacturers, suppliers and distributors at risk of product recall

FIG 22: Top 6 targeted business sectors in 2015
Source: Aon Terrorism & Political Risk Map 2016



* primarily hotels and resorts, and civil aviation
** transport companies mass-transportation, aviation, logistics and transport infrastructure

FIG 23: TPV Score Changes for 2016
Source: Aon Terrorism & Political Risk Map 2016

Increased TPV score for 2016	Decreased TPV score for 2016
Angola	Belize
Belgium	Colombia
Bosnia & Herzegovina	Comoros
Burundi	Cote d'Ivoire
Guyana	Jamaica
Moldova	Kenya
Mongolia	Myanmar
Morocco	Norway
Nepal	Philippines
Ghana	Slovenia
Qatar	Serbia
South Africa	Thailand
Sweden	Timor Leste
Tunisia	
Turkmenistan	
Uzbekistan	
Zambia	
Zimbabwe	

Looking ahead

There is still a long way to go before there is widespread understanding of the crisis management insurances option in Australia; that it is affordable and available, and an important element of risk transfer.

Traditionally crisis management lines have been considered an issue mainly for the big end of town which has a longer term understanding of the value of brand. However, smaller businesses – especially those which are part of a supply chain to big business – can face profound impacts. A product recall will lead to business interruption, necessitate supply chain adjustments, lead to possible contract loss and worst case result in the affected company folding.

Crisis management insurances are now more affordable for smaller companies.

For all scales of organisations rising competition in the market means special corporate protection coverage for kidnap and extortion is far more affordable than previously and while coverage for product contamination and recall can cost a little more, it remains affordable and cheaper than going out of business.

For those companies dealing heavily internationally the 2016 Terrorism and Political Violence Risk Map is available at connect-aon.com.au. The Aon Terrorism & Political Violence Map 2016 findings point to a more negative outlook for terrorism and political violence risks than we found in the 2015 map. This year, we raised 18 countries risk ratings and lowered 13. This marks the first net increase in global political violence and terrorism risk ratings in the map since 2013.

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Environmental

At a Glance

- Businesses may not fully understand the financial impacts of pollution events
- Perceived low hazard industries can be exposed to loss
- Investment in new ideas and solutions continues as liability increases

How a Business Can Be Exposed

- Ownership of land where there is legacy contamination from former uses and activities
- Hazardous materials such as oil or asbestos are spilt or released due to improper handling, storage or disposal
- Onsite pollutants wash into watercourses or contaminate properties during storm and flood
- Spillage from a vehicle, boat or train accident results in fire or contamination
- Climatic events harshly impact manufacturing or agricultural businesses
- Leaking underground storage tanks at commercial or residential sites pollute soil and water
- Rampant mould in a residential building or legionella leads to personal injury claims
- Operations in other countries where pollution events can incur increased responsibility from changing legislation

Addressing Legal Liability

If you own, manage or operate a business that exposes people or property to hazardous materials or chemicals, the fall out can be significant. Unhealthy indoor or outdoor environments can lead to law suits, while pollutants spilt or released can cause widespread contamination. Remediation of polluted areas can also be very costly.

Most regulatory agencies follow a "Polluter Pays" approach with respect to legal liability for pollution, but we are increasingly seeing the regulatory agencies widening their ability to seek a remedy from parties other than the Polluter. For instance, in Queensland, Victoria, and New South Wales, directors and officers can incur personal liability for acts of the company if they were in a position to influence the company's actions. In Queensland, the regulatory agency has the ability to issue an environmental protection order directly to a person with a relevant connection, allowing the corporate veil to be pierced under the Chain of Responsibility legislation.

Business owners may have a good understanding of their environmental risks but may fail to identify the impacts with respect to changing legislation and liability. The European Union's Environmental Liability Directive was implemented to respond to "environmental damage" defined as damage to protected species and natural habitats, damage to water and damage to soil. Certain activities and operations carry strict liability regardless of whether the operator was negligent. The intent is to restore the specific damaged environment but if that cannot be done, then the operator may need to give back to the environment by enhancing a different site.

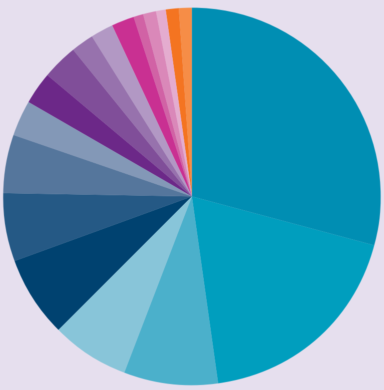
Effective July 1, 2016, certain types of facilities in Korea are required to have mandatory environmental insurance. Again, the driver is to provide protection of the environment, especially from high risk activities. This legislation increases the environmental responsibilities of companies in Korea, both local and multinational. Under the "Act on Liability for Environmental Damage and Relief Thereof", different maximum limits of liability and mandatory environmental insurance limits are assigned to three risk groups (high, medium and low). Business owners with operations in Korea need to be aware of the increased exposure from the new legislation.

Some business owners may have the perception they are in a 'low risk' industry. These perceptions, combined with tight legislation and a trend for greater fines and penalties, means their exposure to loss can be high. Environmental insurance policies are specifically designed to manage business risk, provide a response to clean-up costs driven by legal requirements and reduce exposure to loss. Fixed-site Pollution Liability policies will respond to pollution at, on, under or from a specific site. Insurers can offer coverage for both new and historical pollutant conditions arising from sudden or gradual release of contaminants.

Most contracting activity can be insured with Contractor's Pollution Liability insurance with protection against construction risks and claims arising from completed operations. A single contractor or all contractors on a specific project may be insured. While a range of insurers offer environmental cover in a competitive marketplace, policies differ in breadth of coverage. Those at risk need to ask whether they are receiving the best cover for their individual situation and obtain assistance from their brokers.

FIG 24: Environmental Insurance Purchasers by Industry (Total Number of Policies sold by Aon)

Source: Aon Environmental Insurance Market Update Q2 2016



30%	Construction
19%	Natural Resources
8%	Industrials & Materials
7%	Pharm-Chem
7%	Real Estate
6%	Financial
5%	Misc. General Industry
3%	Agribusiness & Food
3%	Consumer Goods
3%	Professional
2%	Public Sector
2%	Railroads
2%	Technology
1%	Aviation
1%	Entertainment
1%	Health Care
1%	Marine
1%	Transportation

Who is Seeking Protection?

When the general public considers pollution, they may conjure images of mines or shipping companies. And while the natural resources industry does account for 19 per cent of our customers purchasing environmental insurance, industries seeking coverage are as diverse as real estate (seven per cent), finance (six per cent) and technology (two per cent).

The entertainment industry seeks protection from environmental disaster, the pharmaceutical industry leverages expertise to minimise risk and professionals also want to be covered. The construction industry (30 per cent) makes up our second largest consumer of insurance products targeting pollution.

Indoor air quality and disease outbreak has become a hot topic for the hospitality and healthcare industries who see environmental risk as a real threat to business. This has prompted increased demand in clients seeking extra cover in those areas.

Special programs can also be designed for healthcare, education, energy companies and aviation. Aon will assess the particular risks of each client and industry sector and develop an environmental insurance program that addresses those risks.

For example, in the United States, Aon has introduced a new environmental insurance product for the rail industry to counter risks of catastrophic pollution. Cantilever Excess Pollution Liability insurance provides additional capacity excess of standard general liability and marine coverage.

In addition to calls for assistance from the rail sector, we are experiencing renewed interest from bankers, commodity traders, private equity firms and financial institutions for environmental risk transfer products. As well as seeking cover for operational risk, many wish to use environmental insurance to minimize long term liabilities from legacy contamination in M&A and property transactions.

Rates tightening, paperwork changing

While the environmental insurance market is still relatively soft, we are seeing rates tightening up for certain industries. Some environmental insurers have revised their Fixed-site Pollution Liability forms, introducing more restrictive terms. These are challenges that can be worked through to preserve important features of coverage.

Table 2: Australian Market Environmental Insurers

2006	2016
AIG	AIG
	Chubb
	XL Catlin
	Liberty
	Allied World
	Allianz

Recently, we have noted that some insurers are treading more cautiously when it comes to providing cover for companies involved in mergers and acquisitions. Issues can arise where industrial sites are being insured. Claim limits may be lower than previously offered and there is a renewed focus on due diligence. Conversely, as parts of the market become more restrictive, new markets are opening up in this evolving space with enhanced coverage from insurers who continue to revise environmental liability products to keep pace with emerging concerns, such as those in the property development industry.

Aon can work with insurers to offer large companies manuscripted environmental insurance programs with highly negotiated policy language.

Whatever a client needs, tailoring an appropriate environmental solution often involves thinking outside the boxes.

Looking ahead

Environmental loss is still not on the radar of all companies, but it will have increasing impact.

Market appetite and sophistication is growing, and we expect to see continued demand for M&A coverage. This is set against a backdrop of increasing regulatory focus on environmental issues around the world, and claims, when they do arise, are often of a catastrophic scale.

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Workers' Compensation

At a Glance

- Premiums start to flatten in most markets
- National options shrink, injecting split insurance complexity best managed by brokers
- Proactive safety and return to work initiatives rewarded

Rates start to flatten – though not everywhere

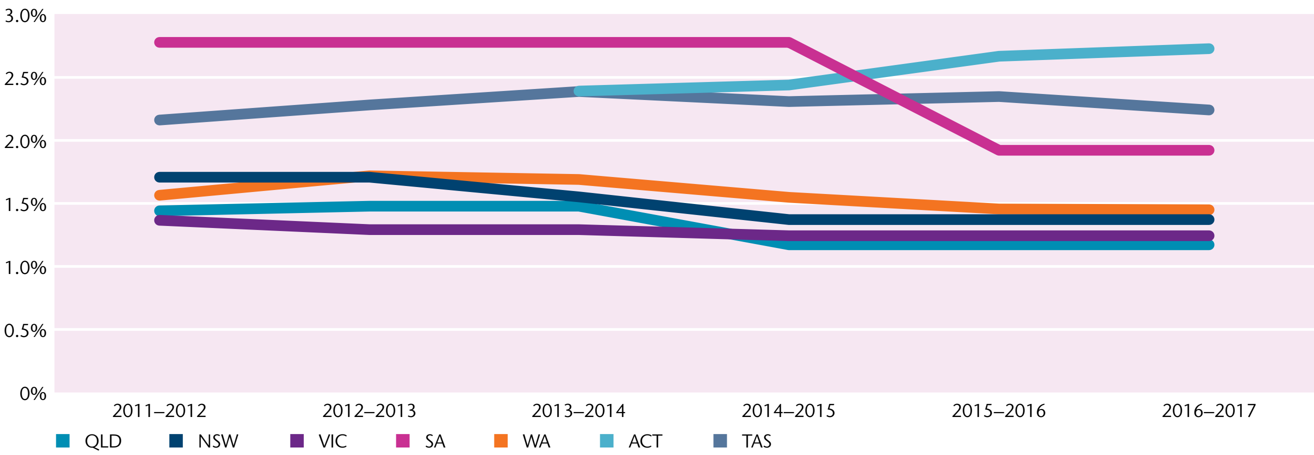
Premiums have enjoyed a downward trend in the past but actuarial analysis is now revealing signs of general flattening. However, for clients able to demonstrate improved risk profiles through their work health safety or injury management systems, we are still able to negotiate better deals.

In the privately underwritten jurisdictions (WA, ACT, NT and TAS) insurers still have appetite for growth, however, their underwriting is more selective with a greater focus on profitability than was seen in 2015.

In the government underwritten schemes (NSW, VIC, SA and QLD), the recent 'step change' rate reductions were linked to significant benefit reforms and since their implementation rates have remained stable. This is unsurprising as there are both political and commercial factors at play in these jurisdictions.

There are exceptions – the ACT for example is seeing increasing rates because of common law claims and associated litigation costs. This is due first, to the lack of a threshold for common law claims to pursue damages claims in the ACT, and second, to active plaintiff solicitors.

FIG 25: Australian Market Environmental Insurers



National coverage options shrink

The major change impacting the sector is the fragmentation of the workers' compensation market in terms of which insurers/agents are able to provide multijurisdictional coverage.

There had been a choice of three national providers with a fourth offering national coverage through a partnership arrangement. However, following a regulatory review, QBE lost its licence in Victoria and has since commenced working in partnership with a claims agent to provide a national solution.

As a result there are now only two truly national providers with two more offering Australia-wide coverage through partnership deals.

The NSW regulator is slated to review the market next year and further change is possible with market participants speculating about a consolidation from five to three agents.

Fragmentation injects client complexities

Clients with a national footprint are now faced with choosing between two truly national providers or two partnership solutions. This makes management of workers' compensation more difficult and complex.

With the prospect of there eventually being only one national insurer/agent, we believe more organisations with national operations will opt for split insurance programs choosing the best provider in each jurisdiction. This injects more complexity and there is likely to be increased reliance on brokers for program co-ordination. Although there will be fees associated with using a broker, this may be considerably more cost-effective than attempting to manage the complexities in-house.

Disconnect between premium and claims

The decision by NSW's iCare (formerly WorkCover NSW) to take the workers' compensation premium function in house leaving NSW agents to handle claims is expected to create a disconnect between the premium and the claims functions and will need careful management, this is another area where clients may increasingly look to their insurance broker for support.

Looking ahead

Organisations with national footprints may need to consider split insurance for different States and Territories. This could inject unexpected management complexity which a broker would be better placed to handle.

Rates are generally flattening, with companies able to demonstrate proactive initiatives better placed in negotiations.

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Reinsurance

At a Glance

- Ample capacity to support current growth aspirations and risk transfer needs
- Reinsurance continues to grow in relevance as a proven mechanism for sharing risk, managing capital and controlling earnings volatility
- A valuable product supporting a whole range of critical management objectives
- Critical societal role of reinsurance in rebuilding communities in a post-loss environment

Reinsurance Supply Advances to New Peak

Reinsurance capital is currently at peak levels, as further declines in interest rates have built the stock of unrealised gains on bond portfolios and boosted the relative attractiveness of non-correlating insurance risk among institutional investors. Aon Benfield estimates that global reinsurer capital rose by 4 percent to a new high of USD585 billion over the six months to June 30, 2016 (see Fig 26). This calculation is a broad measure of the capital available for insurers to trade risk with and includes both traditional and alternative forms of reinsurer capital. Overall reinsurer capital has increased by more than 70 percent since 2008.

At the same time, more reinsurance is being purchased. The cession ratio across the global property and casualty insurance industry showed a small uptick for the first time in several years in 2015 and a further increase is considered likely in 2016.

FIG 26: Global reinsurer capital by year
Source: Aon Benfield Analytics

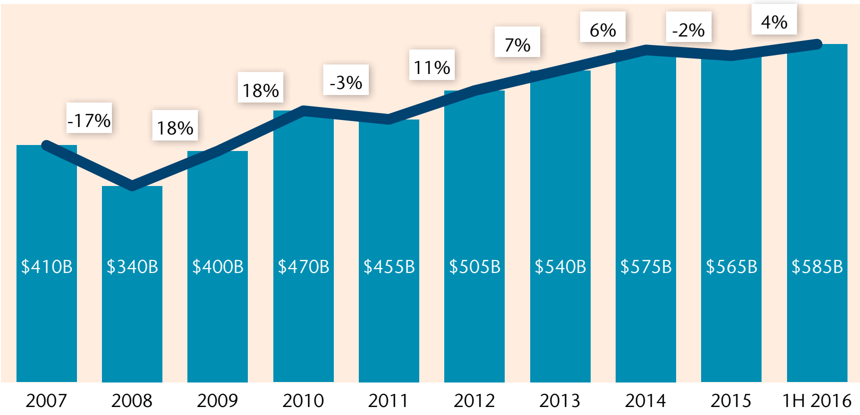
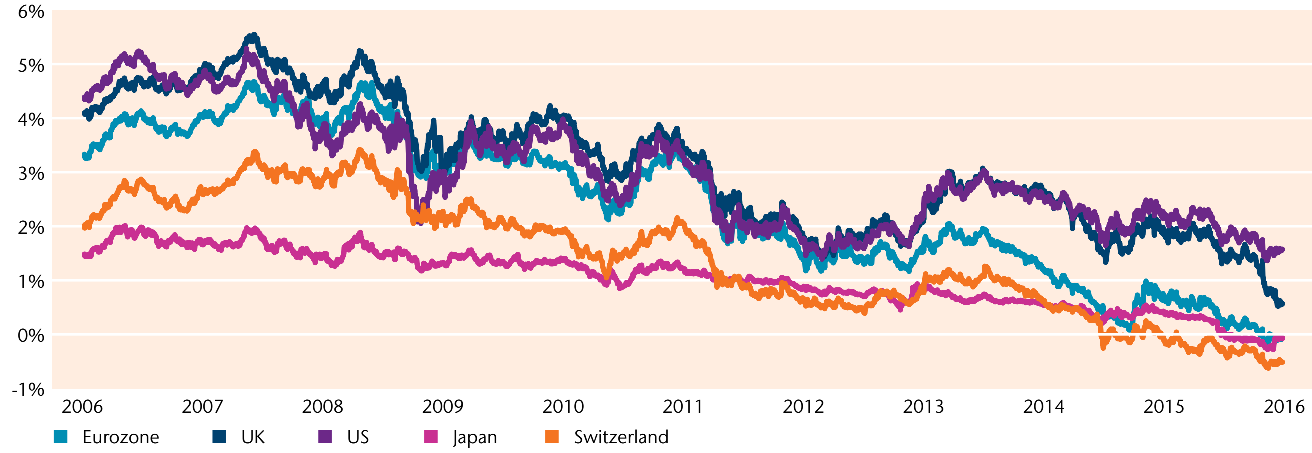


FIG 27: 10 Year Government Bond Yields
Source: Bloomberg



Macro factors drive traditional capital

Traditional capital rose by 3 percent to USD510 billion over the six months to June 30, 2016, driven mainly by unrealised gains on bond portfolios associated with declines in interest rates during the period (see Fig 27). A secondary factor was modest weakening of the US Dollar relative to other currencies.

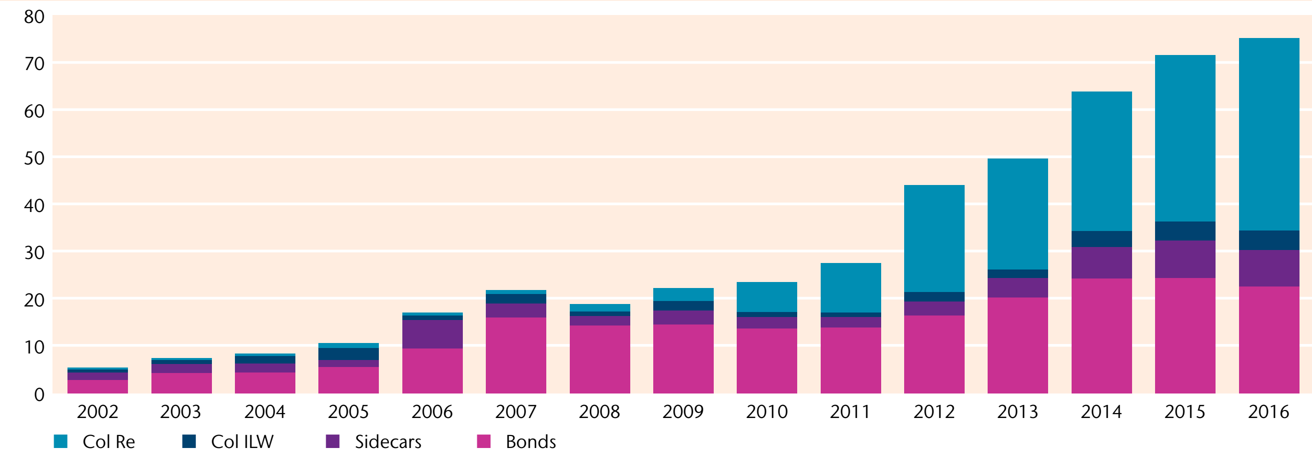
The low interest rate environment that has persisted in the developed world since the financial crisis is having a pervasive effect on traditional (re) insurance carriers that are mainly invested in cash and bonds, as well as significantly influencing market behavior. Some of the consequences are summarised below:

- Reported capital positions are inflated by unrealised gains.
- Ordinary investment yields have declined by around 40 percent.
- Asset risk has increased in the pursuit of better returns.
- Insurance risk is relatively more attractive as an asset class.
- New business models based on total return strategies have emerged.
- Debt is available on favourable terms.

Insurance risk continues to attract capital market investors

Alternative capital rose by 5 percent to USD75 billion over the six months to June 30, 2016, principally reflecting additional deployment into collateralised reinsurance structures (see Fig 28). Catastrophe bond issuance slowed to USD3 billion in the period, despite a record first quarter.

FIG 28: Alternative Capital Deployment
Source: Aon Securities



Reinsurance capacity outlook

Ample capacity currently exists to meet expected reinsurance demand. However, price competition and weakening investment returns have eroded reinsurers' expected profitability and earnings have become increasingly sensitive to catastrophe loss experience. In the absence of major events, retained earnings are not expected to be a significant driver of traditional capital growth going forward, given the amount of capital now being returned to investors.

For alternative investment managers, the appeal of insurance risk has been enhanced by recent volatility in other asset classes and the weaker outlook for interest rates. Expected returns have declined, but they remain attractive relative to opportunities seen elsewhere, and further growth is therefore expected going forward. The lack of correlation with broader capital markets (except in the most extreme scenarios) remains a key consideration.

Demand Trends Upward

Insurer capital was impacted by strengthening of the US Dollar during 2015, but has now returned to similar levels seen at the end of 2014. Earnings were impacted by a more typical level of insured catastrophe losses in the first half of 2016, but unrealised gains on bond portfolios stemming from recent declines in interest rates provided support.

The lower pricing points delivered by alternative capital are clearly a factor in increased demand, but the broader point is that reinsurance is growing in relevance as a proven mechanism for sharing risk, managing capital and controlling earnings volatility in the current environment. This is partly explained by the global trend towards risk-based regulatory regimes, which fully recognise the beneficial impact of reinsurance on cedants' capital positions.

Recent catalysts for increased demand also include the emergence of poor underwriting results in certain casualty classes, out-sized losses from regional exposures and the introduction of Solvency II. The latter has prompted additional demand for solvency relief covers, including retrospective solutions dealing with reserving risk, and longevity risk transfers. A specific area of growth has been US mortgage credit, where Aon has assisted Freddie Mac in placing over USD5 billion of reinsurance coverage since 2013. At a time of heightened earnings sensitivity, reinsurers are increasingly utilising cost-effective retrocession coverage to manage tail risk within their risk tolerances.

Reinsurance is undoubtedly a very valuable and multi-faceted product that is being used to support a whole range of critical management objectives. These include creating efficient corporate structures, maximising business positions, developing new products, supporting target ratings, managing expenses, controlling aggregate exposures and optimising solvency capital ratios.

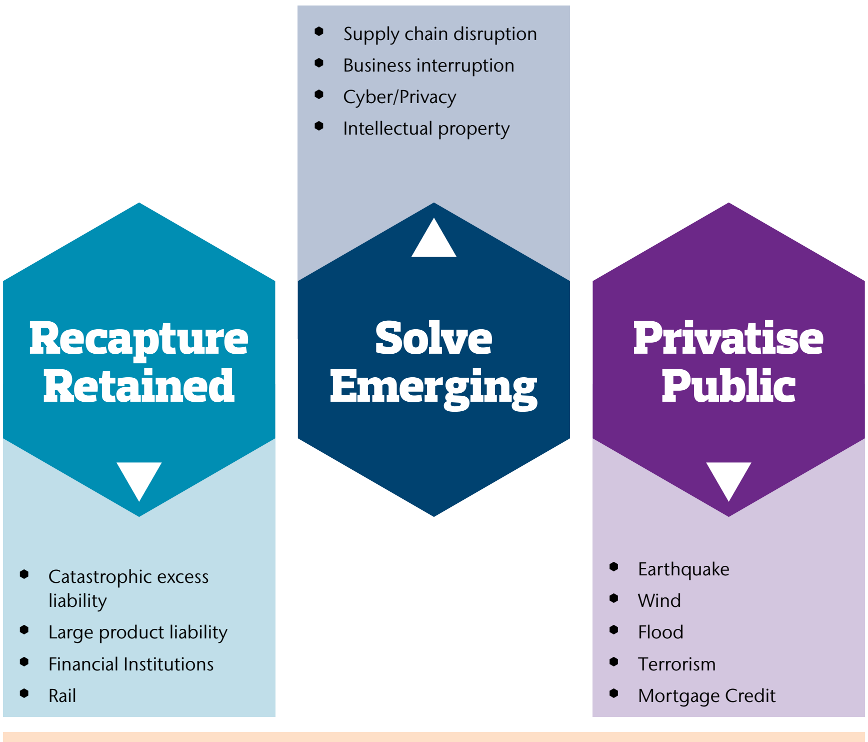
It Is Not Too Much Capital, It Is Not Enough Product

The challenge for the (Re)Insurance industry is not one of an oversupply of capital – rather it is instead an issue of not enough new product. As an industry we have analysed and optimised existing products to the point that losses are lower, frequency is lower, and risk-transfer is lower (more risk being retained) all while insufficiently addressing emerging risks. Has the world ever been as uninsured for risk as it is now? How do we generate more opportunity for the industry?

Rarely spoken about is the critical societal role of reinsurance in rebuilding communities in a post-loss environment. Aon Benfield remains committed to closing the 'protection gap' between economic and insured losses around the world. At a time of plentiful capital, it is sad to note that only a fraction of the losses from the earthquake in Italy during 2016 will be recoverable, demonstrating that this is not just a feature of developing markets. Closing the cat protection gap offers a huge opportunity for the industry when we consider that of global catastrophe losses:

- 45% of economic loss is covered by insurance in the United States;
- 23% of economic loss is covered by insurance in EMEA;
- 13% of economic loss is covered by insurance in the Americas;
- 10% of economic loss is covered by insurance within APAC.

Diagram 3: The Challenge Facing (Re)Insurance industry



"[For reinsurers] Generating catastrophe demand is very important for many reasons. It's a great product, far too much of that risk is held by governments and the public sector ... and we're very good at it".

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