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UNDERCOVER ANALYSIS: ASSESSING COMPANIES IN THE INSURANCE SECTOR

By Alan Lok, CFA, Eunice Chu and Guruprasad Jambunathan

Insurance is a curious sector. In years gone by, it was regarded as something of a cash cow, with the likes of Warren Buffett treating the float as a source of money to be invested elsewhere. Insurance companies were also seen as sclerotic, with time-consuming processes that often placed the customer last. It's not because these firms didn't care. Instead, the characterisation reflected an ingrained culture that didn't quite know how to change.

With the arrival of technology, the forces of disruption were quick to spot the inherent opportunities in the sector, and the attention of digital suitors now envelops insurance firms. These suitors include cloud computing, big data analytics, artificial intelligence, the blockchain, drones, and the internet of things.

The reshaping of the industry is taking place in several domains:

- **Customer acquisition and marketing:** the emergence of a more targeted approach when identifying customer groups
- **Claims:** a rise in automated handling with on-demand case information
- **Underwriting and product pricing:** with a deeper well of customer information to hand, costs are becoming fairer and more accurate

How should we analyse insurance counters?

DEMAND DRIVERS

Insurance is an umbrella term that covers various types of product offerings, so begin by finding out what the company you are analysing sells. Is it household policies or corporate cover? In which markets does it specialise (e.g., institutional or industrial)? Is its customer base in developed territories or those still emerging?

With this product information in hand, establish which macroeconomic factors are affecting the demand for insurance. Examine changes in income levels, business activity, and GDP growth, bearing in mind that, when times are tough, insurance can get pushed down the priority list and customers may fail to renew their policies or avoid cover altogether until the climate improves.

Affordability is a critical aspect to note. Compare the cost of the company's products with the average income levels of its target markets. People are more willing to expose themselves to risk if the cost of a policy is at odds with the cover provided, so look as well at how prices are evolving. Is pricing in sync with changes in personal income?

How do levels of competition affect the prices the company charges for its products? To answer this question, learn about the company's market share in terms of the number of policies sold and premiums earned. Find out where it sits relative to its peers (e.g., Is it a top-three or a top-five player?). Also, try to establish if any factors will help or hinder the arrival of new entrants: Will the market become saturated or will it remain static?

COMPANY ACTIVITY

Turn your attention to the company's specifics and study its track record in investing premiums. This analysis is important, as it will determine the health of the aforementioned float (i.e., the difference between claims paid and premiums collected).

From an expansion perspective, assess the company's businesses strategy and track record in launching new products and its ability to attract clients to those products. Consider whether the company treats new customers fairly once it has attracted them. Helpful benchmarks are the company's claims settlement ratio and grievance ratio.

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ENVIRONMENTAL, SOCIAL, AND GOVERNANCE

We closed the previous section by touching on the treatment of customers, which is an integral part of an insurance company's approach to environmental, social, and governance factors. Among other things, establish the total amount of claims that are currently under dispute and if the firm is presently facing any litigation or legal proceedings. Also, how does the company protect the privacy of its clients and ensure the safety of the data it holds?

MARKET STRUCTURE

Assess the current structure of the insurance market and the long-term factors that are expected to drive its growth. What type of policies dominate the market and how are they being sold—directly via online platforms or offline through brokers or bancassurance channels? Are there specific products market leaders and how will they evolve? For example, travel, home, and vehicle insurance are well-established as online offerings; however, specialist business insurance is likely to be purchased offline through a broker.

An understanding of market maturity is another useful tool, so screen the penetration levels of different products in the company's operating sphere in relation to overall economic maturity. How are these levels expected to evolve and which products will benefit (or lose out) from these changes?

THE RACE TO INNOVATE

Earlier, we noted the innovative disruptors that are transforming the insurance sector. In concluding this sector analysis, we highlight a crucial factor that will dictate the future direction of the industry: the receptiveness of a new breed of consumers to on-demand products. Insurance companies that can reshape their business models to accommodate the click-and-buy generation will be the leaders of tomorrow.

Moreover, as smart-home sensors become a standard part of our residences, wearable health sensors become inseparable from our wrists, and cost-effective drones assess building damage, insurance firms will find they have an efficient and accurate big-data platform to help them to filter out high-risk groups. Pricing will be fairer as honest customers will be less exposed to the activities of fraudulent claimants.

This framework provides only a concise snapshot of the factors we think you should examine in an insurance company business model. To find out more, our complete framework, together with three clusters of questions about the life insurance, health insurance, and property and casualty insurance segments, are available at www.arx.cfa.

About the Authors

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Infographic showing the step-by-step process of analyzing the Insurance industry

01 PRODUCT AND MARKET SEGMENTATION

- What type of insurance product do they sell
- What market segment do they specialize in
- Customer base
- Affordability

02 STRUCTURAL INFLUENCES

- Macroeconomic factors
- Penetration levels and protection gap
- Barriers to entry
- Brand reputation
- Market concentration

03 BUSINESS OPERATIONS

- Sales channels
- Client acquisition performance
- Track record in launching new products
- Overall business strategy

04 GAUGING PERFORMANCE

- Investment management
- Net premiums written and earned
- Policy retention rate
- Claims ratio, expense ratio and combined ratio (CoR)
- Underwriting margin and new business margin
- Process efficiency initiatives

05 RISK MANAGEMENT

- Reserves to anticipated loss
- Solvency levels
- Asset-Liability mismatch
- Risk mitigation policies and measures

06 ESG

- Proportion of AUM in line with ESG principles
- Number of claims in dispute
- Protection of client privacy
- Safety of customer data

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Insurance

1. What are the products offered by the company?

a. What are the products offered: life, health, property and casualty?
b. Which customer segments does the company cater to: household, trade, corporate, institutional and industrial?
c. Which are the regions and countries the company operates in?

2. What are the macroeconomic factors affecting demand for insurance?

a. How do changes in income levels, business activity and GDP growth affect demand?
b. How much of the demand is driven by tax breaks, if any, provided on insurance products?
c. Which other social and demographic factors affect demand?

3. How affordable are different insurance products and services in the company's key markets?

a. How does the cost of different products compare with average income levels of the target demographic/ market segment?
b. How is affordability evolving? What will drive affordability – changing income levels or the cost of insurance?

4. What is the level of market concentration?

a. How much share do the Top 3 / Top 5 players have in the key markets?
b. What is the company's market share, in terms of number of policies sold, premium written, premium earned and SA?
c. How much market share does the company hold in different products and segments across geographies?

5. What are the factors facilitating / impeding entry of new players?

a. What is the investment required?
b. How difficult is to get approvals and licence?
c. How easy is it to get the right skill sets and expertise?
d. How expensive is to build agent network and acquire customers?

6. What is the structure of the insurance market and the sales channels? How are these evolving?

a. Are there state-run insurers in the company's market? If yes, then how big and strong are they? How large is the private sector?
b. What is the mix of policies sold, Annual Premium Equivalent (APE) earned and SA through different sales channels: direct – offline, direct – online, agency, bancassurance, corporate agency/broker etc.? Are there specific products which are easy to sell through specific channels?
c. What is the mix of policies sold, APE earned and SA between individual and group policies?

7. What are the long-term factors that are expected to drive growth? How are these expected to evolve?

a. What are the penetration levels of different insurance products in the company's markets, in relation to the stage of economic development they are in?
b. How are penetration levels expected to evolve? Which products are likely to benefit or lose out from the changing penetration levels?
c. What is the sum assured (SA) and premium income as % of GDP?
d. What is the protection gap ratio (ratio of protection lacking/protection needed) and size of the coverage opportunity across different products and segments?
e. Does the company has a strategy to leverage emerging technologies such as Internet of Things and smart sensors to harvest usage and behaviour data to reduce claims and offer better products and cheaper prices to customers?

8. How has the performance been on operational measures? How do these compare with that of peers and how are these expected to evolve?

a. What are the growth trends in new policies sold, APE and SA?
b. What is the split of new policies sold, APE and SA between existing products (products in existence for more than a year) and new products?
c. What is the growth rate of new policies sold, APE and SA for existing products?
d. What is the policy renewal/retention/persistency rate of various existing products?
e. What are the technology-enabled initiatives the company has implemented to improve process efficiencies in operations and claims administration?

9. What is the company's strategy and track record in launching new products?

a. How frequently are new products launched? How does the company decide what to launch when?

b. How do the number of policies sold, average APE and average SA compare to similar products in the company's existing portfolio and in the market?

c. How does the average APE and SA of new products compare with that of the existing products?

d. How does the acquisition cost of new products compare with that of similar existing products in the company's portfolio and in the industry?

e. Does the company use big data and prescriptive analytics to design new products and to price them?

10. How has been the company's performance on client acquisition?

a. How many new clients are acquired through new products sales vs sale of existing products?

b. What is the split of number of policies, APE and SA between existing and new clients?

c. How does the average APE and SA of newly acquired clients compare with that of existing clients, for similar existing products in the company's portfolio and in the market?

d. How does the company's client acquisition costs compare with those of peers?

11. How has the track record been on customer service measures?

a. What has been the claims settlement ratio and grievance ratio?

b. How does the company prevent mis-selling of its products? What are the regulations in place to protect customers from mis-selling? How has been the company's track record in this aspect?

c. What is the extent of cross-selling? How is this measured and tracked?

d. To what extent the company is using digital channels to provide customer service?

e. How useful are analytics in identifying customer needs and market products accordingly?

12. How has the company's performance been on financial measures? How do these compare with that of peers and how are these expected to evolve?

a. What is the growth rate of annual Net Premiums Earned (NPE) and Net Premiums Written (NPW)?

b. How has the NPW/NPE ratio trended over time?

c. What is the company's claims ratio, expense ratio and combined ratio (CoR)?

d. What are the company's underwriting margin and new business margin?

13. How well has been the company's track record in managing investments?

a. What is the asset allocation strategy? What are the details for each fund type and asset class and region?

b. What is the currency mix of the investments?

c. What are the company's investment income and yields?

d. What is the sensitivity of investment income and yields to changes in interest rates and volatility in exchange rates? Does the company use hedging to manage these aspects?

e. What are the trends in the company's Assets Under Management (AUM) and Fee income?

f. What is the credit profile of investments in fixed income securities?

14. How strong is the company's balance sheet? What do the capital adequacy ratios look?

a. What is the size of investment assets, reserves, provisioning and subordinated debt?

b. What is the debt-to-total capitalisation ratio?

c. What is ratio of reserves to anticipated loss?

d. What is the average tenor of assets and liabilities?

e. What is the extent of the Asset-Liability Mismatch (ALM)?

f. How do solvency ratios compare with regulatory requirements and with industry standards?

15. What are the details of the company's risk management strategy?

a. How does the company maintain underwriting discipline?

b. How do the underwriting practices of the company compare with those of the peers?

c. How does the company measure performance on risk mitigation and underwriting discipline? How is the track record rated by the company in relation to that of the peers?

d. How do large unforeseen claims affect the business? What is the strategy to mitigate associated risk?

e. Does the company use technologies such as bit data analytics, machine learning to prevent, detect and mitigate fraud? Are there plans to deploy distributed ledger solutions to protect data and authenticate customers and contracts?

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Life Insurance

16. What are the details of the company's product portfolio?

a. Does the company offer both protection and investment products?

b. What are the different types of investment products offered: whole life, universal life, variable life, and retirement products?

c. What is the mix of policies, APE and SA across different products? How is this evolving?

d. What is the mix of policies, APE and SA between linked vs non-linked and participating vs non-participating products?

17. What is the structure of the life insurance market and how it is evolving?

a. What is the mix of protection and investment products in the industry and for the company?

b. What is the share of insurance products in household savings?

18. What are the long-term factors that are expected to drive growth? How are these evolving?

a. What is the birth rate and population growth rate in the company's markets?

b. What is the size of working age population? How is the dependency ratio expected to evolve?

c. How do trends in average life expectancy in the company's markets affect demand for life insurance?

d. How is life insurance perceived by the populace in the company's markets: as a risk cover, an investment vehicle or a tax-saving instrument? How is this evolving?

e. What is the level of household savings? How much of this is invested in financial assets?

19. What are the risks to the company's assumptions on Mortality/Longevity? What is the strategy to manage any adverse impact?

Health Insurance

20. What is the structure of healthcare services in the company's key markets?

a. Do the residents have access to universal healthcare? If not, are there proposals under consideration?

b. If there is no universal healthcare, what proportion of the total healthcare expenditure do the residents spend out of their pocket?

c. How common is employer-provided health cover? Is it mandatory for employers to provide this benefit?

d. Is the healthcare sector public, private or mixed? If it is mixed, what is the share of each?

e. What is the company's target segment for selling health cover: individual, institutional, government or mixed? What is the mix in terms of number of policies, APE and SA?

21. What are the long-term factors that are expected to drive growth?

a. How do trends in average life expectancy in the company's markets affect demand for health cover?

b. How are healthcare costs evolving in relation to income levels?

c. Does the company rewards, or has plans to reward, healthy behaviour (eg. not using tobacco products) of customers by offering lower prices? How does the company intend to implement this?

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Property & Casualty Insurance

22. What are the long-term factors expected to drive growth? How are these expected to evolve?

a. What are the trends in macroeconomic growth and property ownership in these markets?

b. What are the trends in private automobile ownership and accidents involving them?

c. Does the company rewards, or has plans to reward, disciplined behaviour (eg. responsible driving) of customers by offering lower prices? How does the company intend to implement this?

d. Does the company's product mix include cyber insurance?

23. What are the likely implications of the shift from ownership to access-based consumption models?

a. How does the company view the advent of ride-hailing services, car subscription services and autonomous driving? How are these likely to affect the motor insurance market?

24. What is the company strategy to deal with increasing uncertainty of natural phenomena arising out of climate change? Does the company believe the frequency of occurrence of extreme weather events is on an upward clip?

Environmental, Society and Governance

25. What are the details of the company's ESG principles, practice and track record?

a. What proportion of the company's own AUMs and those held for clients is managed in accordance with ESG principles?

b. What is the proportion of financial instruments and investment property is held in accordance with ESG principles?

c. What is the value and proportion of customers protected by, and total revenue generated from, microinsurance products?

d. Is the company currently facing any litigation or legal proceedings? What are the details?

e. What is the total amount of claims that are currently under dispute?

f. What are the company's investments and programmes in research and technology to develop or acquire new ways of identifying, assessing and managing risk and improving investment performance?

g. How does the company protect the privacy of clients and ensure the safety of client and business data?