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Sidney Gordon

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Article abstract

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The property and casualty reinsurance market in Canada

by

SIDNEY GORDON, B.A., F.I.I.C.

M. Sidney Gordon a prononcé cette conférence à un colloque de la Reinsurance Offices Association de Londres le 17 avril 1980. Il a une longue expérience de la réassurance au Canada qu'il a acquise comme directeur de Sterling Offices of Canada d'abord, puis comme président de Universal Reinsurance Intermediaries. Aussi est-il bien placé pour en présenter les hauts faits, les faiblesses et les résultats. C'est le sens de ce travail, dans lequel il étudie l'organisation de la réassurance, ses problèmes, ses difficultés et les conditions de son essor. Il a raison d'écrire qu'avant d'entrer dans le domaine de la réassurance, au Canada, un réassureur étranger fera bien de se rendre compte à la fois de ses limitations et de ses possibilités. Il ne peut que rendre rêveurs ceux qui se préparent à pénétrer dans un marché qui, en ce moment, connaît des coupes de tarifs de quarante à soixante pour cent pour les risques commerciaux, des dépenses accrues et des perspectives sinon douteuses, du moins limitées. Il y a là une situation qui peut, qui doit changer et qui, sans doute, changera éventuellement, mais quand?

What I would like to do today is to give you an outline of the insurance climate in which the Canadian property and casualty reinsurance market functions, tell you about some matters which affect insurers and reinsurers equally, such as tests for solvency and restrictions on investment, and then give you a picture of the Canadian reinsurance market itself.

Reinsurers in Canada operate in an insurance market which produces about $6,000 million in annual property and casualty premiums. About 50% is derived from automobile, nearly 40% from property, 8% from general liability and the remaining 2% or 3% from miscellaneous classes such as boiler and machinery, guarantee, hail and aviation. Professional registered or licensed reinsurers in Canada in 1978 wrote between $400 million and $500 million in premiums with about 40% of it written in three reinsurance Groups. It is not possible to say how much unlicensed reinsurance is transacted without an immense amount of research but I have seen some figures recently which indicate it might be as much as is written licensed. Most unlicensed reinsurance is transacted in the form of cessions under British worldwide treaties, under American Head Office treaties and under quota share treaties to foreign companies which have invested in Canadian insurance companies. In any event, the volume of property and casualty premiums currently available to licensed reinsurers in Canada is probably something less than 10% of gross insurance premiums.

Insurance and reinsurance are closely regulated by both Federal and Provincial governments. The supervision of solvency is, in most cases, the responsibility of the Federal government. Contrary to the anxiety expressed in the U.S.A. about the possibility of Washington becoming involved in regulating the insurance industry, in Canada we have respect for the civil servants who run our Federal Department of Insurance so effectively. The Department has operated for more than a century and in that time it has had only one insolvency at a Canadian Head Office or Canadian Branch of an overseas company. It occurred about 15 years ago when the President of the Company in question did something with the assets which he should not have done.

Provincial governments, while also involved in regulation and inspection, are more concerned with the supervision of policy forms and, in some Provinces, a limited type of rating control in respect of automobile insurance. There is much liaison among the Departments of Insurance which has led to a large measure of uniformity and there is also liaison between the Departments and the industry for the purpose of discussing the needs of the insuring public and for the purpose of making government aware of the problems which confront insurance and reinsurance companies.

The ties of Empire linger in the existence of two Federal Insurance Acts: The Canadian and British Insurance Companies Act which embraces Canadian-incorporated insurance companies and the branches of British insurance companies operating in Canada, and the Foreign Insurance Companies Act which regulates the Canadian operations of non-resident insurance companies other than British. The Acts apply equally to reinsurance companies.

A company incorporated under the laws of Canada which seeks to transact the business of insurance must be registered under a Federal Insurance Act. A company incorporated under the laws of a Province of Canada may seek to be licensed under a Provincial Insurance Act or, if it chooses, may become registered under a Federal Insurance Act.

For a non-resident insurance company the option of Federal registration or Provincial licence does not exist. British and foreign insurance companies must become Federally registered in order to transact business in Canada.

Generally speaking, the statutory reporting requirements of the Federal Acts are adopted by the Provinces. The Provinces apply similar solvency rules to those in the Federal Acts.

The size of Canada and its small population might be considered inhibiting factors in the development of an insurance portfolio. We are the world's second biggest country, albeit with vast uninhabitable areas, but we have a population of only 24 million. The population is, however, virtually 100% insurable. Most of it is reasonably accessible along a 100-mile ribbon paralleling the U.S. border which is where the bulk of our population lives and lives well, by any standard.

The Canadian insurance market is said to be crowded. We have about 100 companies or groups which write 90% of the premium income available to private insurance companies. Competition is fierce just now and stories abound about ratés being cut 40 or 50 or 60 percent, about rising expenses, and about poor prospects for growth in the near future.

A recent news item said that an attempt to raise premium levels for automobile and home insurance had failed. Two large British insurers tried to do something about the market's low-rate structure by increasing premium rates. One company lost 12% of its automobile renewals in a three-month period leading it to reduce rates closer to the industry average. Some companies are offering a commission bonus for new business in 1980.

Currently, the insurance buyer is delighted with the low rates he pays. He is also confused about the higher rates he paid last year and the year before. He is much more inclined to think that he was over-charged previously than that he is being undercharged now. It is not the best of climates in which to develop an adequate rating structure.

The spectacular business news which periodically is generated in Canada has yet to include mention of either the insurance or reinsurance industries. The financial community, while necessarily involved with these industries, focuses instead with pride on Canada's ability to produce such essentials as food, minerals, forest products, oil and natural gas. Insurance and reinsurance while playing an important part in the economy of Canada, as they do in most developed countries, do not attract significant amounts of capital from within Canada itself.

But still, companies - both insurance and reinsurance - keep coming from overseas and occasionally are formed internally with Canadian capital. There must be some attractions.

Canada is a safe haven for money especially as it looks as if our dollar will not go much lower than 84 cents U.S. Our interest rates are high and usually (but not now) slightly higher than those in the U.S. in order to encourage an inflow of capital rather than an outflow. Our financial institutions are strong and money may move without hindrance once it has got past our Foreign Investment Review Agency and that has not been difficult. It may become more difficult. The Foreign Investment Review Agency was formed in 1974 to examine all foreign investment and to ensure it ultimately benefits Canada.

Regardless of whether our Federal government is Conservative or Liberal, it is reasonably stable if not downright dull. It does not unduly inhibit the development of business. It taxes business at a slightly lower rate than you enjoy in the U.K. I must interject that the industry thought the application of our

Anti-inflation Board regulations were not as equitable as they might have been and that they were, indeed, inhibiting. More about that later.

A variety of authoritative statistics are produced in Canada which assist, among others, new companies with decisions regarding rating, classes, territories and with the investment of their money.

Whatever it is that attracts new insurance or reinsurance ventures in Canada, one must presume their managements are aware of the underwriting losses which will inevitably be sustained during the early years of development.

For a British or Foreign company the criterion discussed in Board Rooms might be whether or not the consolidated Head Office financial report will look better or worse for being in Canada. In almost all cases and in almost all years it has looked better. The reason is investment income on Canadian funds that would not be available to the company unless it were licensed in Canada.

While complete 1979 statistics have not yet been published, I have been told they could show a four to five-point underwriting loss. Prior years statistics will be found in the "Facts" booklet which has been distributed. This year will likely be a little worse than 1979 and 1981 might show a turn in the other direction but will likely still produce a two or three-point underwriting loss. It is indicated that premiums written grew at a lesser rate than inflation reflecting sluggish economic growth and uneconomic rate levels. Perhaps what is needed is a downturn in short-term interest rates to give an initial and substantial push to insurance rates. Interest rates are assuredly the great cover-up of underwriting losses.

Insurance management, despite current evidence of over-competitiveness, is competent, knowledgeable and devoted to the struggle of making a dollar or two as reward for each year of unbounded effort.

One tends to think about Canadian insurance as being foreign-dominated. Canadian companies do, though, have a fairly large slice of the pie - probably about 45%. In any event, the placing of most of the business is in the hands of independent agents and it is they who determine which companies get the business or, at least, about 70% of it. The remaining 30% is in the hands of the so-called direct-writers.

In Quebec, there has been a shift of business, supported by the agency system, toward the French-Canadian companies. This was a natural development after many British and Foreign companies moved their head offices to Toronto. Most French-Canadian companies operate only in Quebec but their development has been rapid and along sound lines. They bore the brunt of the syphoning off of more than $200 million when the Quebec government entered the automobile personal liability field in March 1978.

One French-Canadian company has a flourishing and successful inwards reinsurance department. While not Federally registered, it is one of about 12 Provincially licensed companies recognized by the Federal Department of Insurance as having the status of Federally registered reinsurers. The Federal stamp of approval on a reinsurer carries considerable weight with cedants and with reinsurance brokers.

Few Canadian insurance companies operate in foreign countries so that reinsurers are almost always dealing with Canadian risks only when underwriting a Canadian reinsurance treaty. There are probably half-a-dozen insurance companies with offices in the U.S.A. and there are one or two which have given underwriting authority to their shareholding companies in Europe. This reluctance to venture into foreign fields does not, as you know, influence our Life insurance companies which have made a significant penetration of international markets.

Times change, though. There is growing interest among insurers of all nationalities in Canada in providing insurance services for Canadian contractors engaged in overseas projects financed by the Canadian government under what are known as the Export Development Corporation and the Canadian International Development Agency. Likely, a pool will be formed to underwrite such risks and the engineering departments of leading professional reinsurers will be significantly involved. While this is currently in the able hands of an insurance and reinsurance industry committee, the concept originated with the Reinsurance Research Council of Canada which is an organization whose purpose and aims are similar, in some respects, to those of R.O.A.

Ventures overseas by Canadian companies might well increase in relation to increases in surplus funds after solvency margins have been taken care of. In the past, financial resources have been used almost entirely for local development but there could now be unencumbered funds looking for something to do - other than increasing capacity for Canadian business. As a matter of fact, the ratio of written premiums to capital and policyholders' surplus is currently less than 2 which indicates there is considerable room for growth in whichever direction the industry chooses to go.

This then is broadly the climate in which reinsurers in Canada operate. A difficult climate but the sun does shine through a little. It is meant to bring out the best in reinsurers.

An important factor in insurance and reinsurance life anywhere is the matter of solvency. We have all heard about the perils of reinsuring with small, untried and obscure reinsurers wherever they may be domiciled. One hears references to their being shaken out by the next major disaster.

Solvency tests in Canada are identical for insurers and reinsurers. The procedures we use are frequently copied in other countries but sometimes not as diligently as they might be.

In the past, the distinction between non-resident and Canadian-incorporated companies was particularly evident in their respective solvency requirements. Whereas a Canadian-incorporated company was required to maintain total assets at least 15% in excess of its liabilities, a non-resident was required to deposit securities having a market value at least equal to its liabilities. It was a strange anomaly penalizing the Canadian company. The 1977 amendments to the Federal Insurance Acts make the solvency requirements the same for Canadian and non-resident companies. The new rules require all companies to maintain assets sufficient to meet liabilities plus a 15% margin on outstanding losses.

At long last a step has been made toward a more precise calculation of the operating profit. The Insurance Accountants Association, working in co-operation with the Institute of Chartered Accountants and the Department of Insurance, initiated a change in reporting requirements by which costs are now related directly to the earned premium income. This influence of Generally Accepted Accounting Practices has resulted in the introduction of Deferred Acquisition Costs which means that the portion of acquisition costs which do not relate to the premiums earned in the period appear as a balance sheet asset.

Understandably, there has been introduced a test of recoverability of deferred acquisition costs. In broad terms, the deferral is limited to the lesser of 30% or the portion of unearned premiums that may reasonably be considered as not required for payment of claims and for expenses other than acquisition expenses. The estimated claims ratio is used in this calculation.

The effect of this change on accounting method was an increase in companies' surpluses. However, despite the pure accounting consequences of the change, the Department of Insurance has not permitted the solvency requirements to be diluted. Deferred acquisition may not be claimed as an asset for solvency purposes.

Tied to the subject of solvency is the regulation of investments. The approach is a conservative one.

As a condition of becoming registered, an insurance or reinsurance company must make deposits with the regulating authority. For companies registered under the Canadian Insurance Acts the amounts are specified by legislation and regulation. For Canadian-incorporated companies the amounts are one-half the amounts required for non-resident companies.

For the basic classes of Property, Automobile and Liability a Canadian company must deposit $500,000 and a non-resident $1 million.

All initial deposits must be in the form of securities of, or guaranteed by, Canada or a Province of Canada. The Acts permit securities of the United Kingdom, any Commonwealth country or of the government of the country in which a non-resident company was incorporated. However, the Department of Insurance discourages other-than-Canadian securities for deposit.

Beyond these initial deposits there is some investment latitude. Even then, only investments authorized by legislation or regulation may be considered for solvency purposes.

It is interesting, also, to note that beyond the initial deposits, a Canadian company physically controls all its own investment paper whereas for the investments of a non-resident to be admissible, the paper must be under the control of the Minister of Finance either deposited in Ottawa or vested in a Trust.

Investment in common shares is limited to those with a 4-year divident record. Not more than 30% of the shares of any company may be owned by an insurance company except if the insurance company has surplus assets beyond solvency requirements, it may invest the surplus in common shares up to a further 10%. Not more than 25% of total assets may be invested in common shares. For preferred shares, there needs to be a 5-year dividend record.

Mortgages may be negotiated only if the property is not mortgaged to more than 75% of its value. Real Estate for the production of income may not involve more than 4% of total assets for any one parcel. For other than production of income, not more than 2% of total assets may be involved in any one parcel of real estate. Total investment in real estate may not exceed 15% of assets.

In October 1975 the Anti-Inflation Act was passed, and this had significant implications for the insurance industry, particularly up to the end of 1979. The AIB brought us wage and price controls and eventually these controls applied to all property and casualty insurance and reinsurance companies. Excess revenue was defined and companies were obliged to return it to policyholders. The formula, in effect, compared the year of account with a past base-period. It resulted in a situation known as: the rich getting richer and the poor getting poorer. If a company suffered an underwriting loss in the base-period, it could not make an underwriting profit during the controlled years. If it made a profit in the base-period, it could go on making profits.

Anti-inflation Board regulations came to an end in December 1978. Excess profits for that year could be disposed of by rebates to policyholders, by freezing personal-lines rates for 1979 or by granting discounts on renewals. The rate-freezing intensified competition. Some companies who had granted rebates or discounts found themselves competing with the frozen rates of other companies causing all rates for 1979 to trend downward toward the rates charged in 1978. It was virtually impossible to increase rates for 1979 without losing substantial amounts of business to competition.

In 1979, the National Commission on Inflation was formed to monitor prices, profits, compensation and costs. The Commission has the power to require submission of information and publish reports to promote public understanding. It does not have the power to roll back prices nor increases in profits.

The after-effects of the Anti-inflation Board will be felt for some time to come. It drained out of the insurance industry about $350 million. I believe it is correct to say that no reinsurance company was called upon to rebate any amount to its cedants which in itself is a commentary on the profitability of the reinsurance market. I cannot help but wonder how it would have been done if it had had to be done.

The professional reinsurance market comprises Canadian subsidiaries of British or Foreign professional reinsurance companies or their Canadian branches except for one reinsurer which is Canadian-controlled.

These reinsurers operate in one of three different ways. First, some have their own Canadian offices and staffs. Second, others are members of reinsurance management groups. Such management may include the underwriting function or it may include everything except the underwriting function in which case the underwriting is done by Head Office personnel. Third, some foreign reinsurers have only a nominal chief agent in Canada to meet legal and accounting requirements and, in this event, the business itself is underwritten and serviced from the Foreign Head Office.

In addition to the professional reinsurers we have a number of insurance companies which have established active and competent reinsurance departments. Some of these departments are able to throw the resources of the primary underwriting function of the insurance company into the servicing of reinsurance clients and this can count for a great deal especially where new insurance companies are involved.

There are about 30 to 35 professional reinsurance companies operating in Canada. I have given an approximation because I am not sure of being able to catch up with each one in the recent influx. This represents about a 50% increase over 1975. By nationality their ownership is American, British, Canadian, Danish, Dutch, Finnish, French, German, Italian, Norwegian, Swedish and Swiss. If I have forgotten anyone, please forgive. What has caused the influx? I think some of it must be due to a spill-over effect from the U.S. market which has in recent years received all that publicity about half the world's premiums originating there. On the other hand, the total insurance premium income in Canada is little more than that written by the largest company in the U.S. Our total insurance premium income in Canada is about the same as that produced in Chicago and its suburbs. The influx may also be due to the devalued Canadian dollar and our relatively low price-structure. The thinking could be that the Canadian dollar will strengthen and that in the meanwhile costs are more controllable than they are in Europe or in the U.S. The influx has nothing to do with underwriting profits.

In 1978 registered reinsurers had an underwriting loss of $12 million. Investment income was $45 million. I anticipate a substantially higher underwriting loss for 1979; the figure should be available in a week or two. The results for 1979 include the losses resulting from a freak tornado in Woodstock, Ontario, in August. Insurers paid out approximately $50 million for that event.

The incidence of catastrophes in Canada has increased dramatically over the past seven or eight years and caught most reinsurers with their rates down. Our changing climatic conditions are well-documented in several government publications. When I speak of catastrophes in Canada I am speaking mainly of events which would hardly be worthy of mention in the U.S.

Demands for reciprocity are few in Canada. While in a country the size of Canada there are opportunities to improve spread of risk territorially through reciprocity there is a certain feeling that reciprocity is more likely to be a matter of taking in one another's washing. This lack of interest in reciprocity may diminish, though, if surplus financial resources cannot be employed usefully at home.

Some of the surplus funds became available because of the involvement of Provincial governments in the insurance business. Two of them, at least, accept incoming reinsurance business. Saskatchewan, Manitoba, British Columbia and Quebec all have government insurance offices. They have syphoned off about $1,000 million in annual premiums - most of it is automobile premiums written on a monopolistic basis.

Indexation came rather later to Canada than it did to most other countries. The Stability Clause or Index Clause is more acceptable to insurance companies now than it was even three or four years ago. The rate of inflation in Canada had been lower than in the U.K. and some countries on the Continent and this combined with the fact that the so-called long-tail was not quite as long in Canada made it less urgent for the Stability Clause to become operative in automobile and general liability contracts. The rate of inflation in Canada is now 10% a year. It has been as high as 12%. Certain reinsurers have pressed for the Stability Clause and have been singularly successful. Their success has depended to a large extent on the competitive rates which go hand in hand with indexation.

The Federal Government produces comprehensive statistical data and one may take one's choice as to which index or progression chart most closely resembles the type and amount of inflation felt by insurance and reinsurance companies. The most popular index for the purposes of the Stability Clause is known as the composite weekly industrial wage index. This index was 100 in 1961. It was 375.5 in September, 1979. A year earlier it was 346.4 which means it had risen 8.48% in that 12-month period.

As an exercise, I took in my own office 85 automobile claims, at random and from several clients, which occurred in 1974. At December 31 of that year the amount paid and outstanding was $3.6 million for the 38 claims which had been reported. At the end of 1979 the amount paid out outstanding for all 85 claims was $5.1 million. More than half the claims were for less than $50,000 from the ground up. The largest claim was $194,000. Of the 85 claims which occurred in 1974, 80 had been settled by the end of 1979. It would seem that the tail is, indeed, shorter in Canada.

Thanks to a legal system which is based on the same legal system as that of the U.K. (with the exception of the Province of Quebec which is based on the Napoleonic code) outrageously large awards are almost unknown. I am unable to find anybody in Canada who knows of an automobile third party bodily injury claim which has resulted in the payment of more than $1 million to an individual. As you know only too well, seven-figure loss settlements in the U.S.A. are common.

The reinsurance brokerage-house population of Canada is seven as far as I can determine. Four are more or less Canadian, two are American and one is British and I am speaking of the country in which their shares are held rather than where they were incorporated. Two of the Canadian reinsurance brokerage houses are new and very small at the present time. In all likelihood, at least 80% of the business handled by brokers is spread among four of them - two Canadian and two American.

There is a tendency for brokers to consult with licensed markets first and to give preference to them in the placing of their business. There is not much pro-rata business placed unlicensed by brokers but excess covers are distributed domestically and among customary overseas markets.

Brokers comply with requests from insurance company managers for 100% licensed reinsurance either directly with licensed markets or if that is not possible then fronting arrangements are concluded. The licensed reinsurer usually secures itself with reserve deposits for both unearned premiums and outstanding losses. Letters-of-credit are losing favour since the Federal Superintendent of Insurance limited their use to 15% of assets.

Professional reinsurance companies in Canada are among the first to agree that there is at least as high a degree of professionalism among reinsurance brokers in Canada as there is among the reinsurance companies themselves.

One of the more pressing problems facing the reinsurance industry in Canada today is the recruitment of qualified personnel magnified, of course, by the recent entry of several reinsurers. There is some recruitment from overseas and so far our Immigration Department has been co-operative in permitting these people to enter Canada with landed-immigrant status.

In Canada we have the full range of relationships between reinsurance brokers and professional reinsurers. Some reinsurers accept business only from brokers, some solicit business direct and solicit business from brokers and some will negotiate only directly and will not accept business from brokers. The latter group comprises mainly the large American reinsurance companies.

Just to be holier than thou I can say that Canadian brokers do not withhold funds from reinsurance companies for any inordinate amount of time. Payment is prompt and one hears few complaints. I would say that in my own company all money received is distributed within two weeks and 90% of that amount within the first week.

Canadian reinsurance brokers are circumspect in choosing reinsurers for their clients. They examine the financial reports of overseas reinsurers using the solvency tests of the Federal Department. It is not 100% safe. Fringe reinsurers may understate unearned premium and outstanding loss reserves but even this can sometimes be detected. It is of course easier to make rule-of-thumb checks on the unearned premiums than on outstanding losses. Canadian reinsurance brokers have in the past had the happy knack of ceasing to place business with certain reinsurers months before other markets have become aware that all is not well.

For any reinsurer contemplating entering the Canadian market, it is important to understand the market and to accept whatever limitations there may be. Some insurers believe that reinsurers are fouling their nest, the insurers' nest, because of the support some reinsurers give to dubious insurance ventures in what is believed to be a search for reinsurance income for its own sake.

There is no question that reinsurers are influenced in Canada by the example set by their Head Offices in Europe and the U.S. We tend to think in Canada that we are halfway between two cultures and similarly between two influential insurance markets. In each case we seem to draw from the best of both of them. It leads to lively insurance and reinsurance markets with reasonable amounts of co-operation and gentlemanliness laced into a lively spirit of competitiveness and free-enterprise.