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A look into the reinsurance mirror

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Article abstract

En ce moment, la réassurance, comme l'assurance directe, a des problèmes au Canada comme dans le reste du monde. Ceux-ci font l'objet de l'étude de M. John M. Coker. Nous croyons que le lecteur en prendra connaissance avec intérêt, car si les propos de l'auteur portent sur 1982 en particulier, la plupart sont restés à peu près les mêmes.

A look into the reinsurance mirror[1]

by

JONH M. COKER, A.C.I.I.[2]

En ce moment, la réassurance, comme l'assurance directe, a des problèmes au Canada comme dans le reste du monde. Ceux-ci font l'objet de l'étude de M. John M. Coker. Nous croyons que le lecteur en prendra connaissance avec intérêt, car si les propos de l'auteur portent sur 1982 en particulier, la plupart sont restés à peu près les mêmes.

The Canadian Property and Casualty insurance market is still in a loss cycle which is by far the worst and most costly ever experienced. Remarkably, the Industry has had little trouble in securing reinsurance support to partially subsidize losses, and there is confidence this support will continue. This reflects the widely reported increases in Personal Property and Automobile rates which contributed to a 1982 decline in the Industry's combined ratio of claims and expenses.

Some observers of the Canadian market have made frequent references lately, in the trade press and in newspaper reports, to the « marked improvement » of Canadian non-Life insurance results in 1982. The annual reports of some major international companies have also included such favourable comments. There is considerable danger for insurers and reinsurers who take these broad statements at face value. Results of the Industry, and particularly those of 1982, require much more careful research and evaluation.

It is difficult to derive consistent figures on Canadian Property and Casualty business but the published data of licensed reinsurers allows a comparison of the net combined ratios of insurance versus reinsurance, as exemplified by Exhibit I. Licensed reinsurers experienced, in each year, the higher combined ratios, for an average,

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(1) Source : *Canadian Insurance/Agent & Broker*, July 1983.

(2) Mr. Coker is Chairman of The Reinsurance Research Council.

over the period, of 110.69%— more than 5.6 percentage points above that of insurers.

The number of reinsurers licensed in Canada almost doubled in the last decade. Exhibit II, however, shows the growth or decline of those (non-Accident & Sickness) reinsurers who did report in each of the last six years. Here one can see a striking pattern well describable as « leaning into the punch ». Growth in reinsurance premium occurred as the Industry moved into a loss cycle but declined in more profitable periods. Most of the premium growth from 1980 to 1982 reflects licensed reinsurers underwriting the business from outside Canada.

Domestic reinsurers, maintaining skilled staffs giving « on the spot » service, but unwilling to grow under such conditions, are thus squeezed by climbing expenses. Quite frankly, these reinsurers deplore the effects of « innocent capacity » located abroad and are disturbed by any statements that could imply the Canadian market, as such, is yet really returning to true profitability, as distinct from recording the relative improvement which our research indicates.

1982 : relative improvement

It is indeed true that there was a relative improvement in the published underwriting result of 1982, but before it can be assumed that the long-awaited return to underwriting profitability by this market is at all imminent, we must put last year's result into perspective by research into factors that combined to produce it.

Let us look into our « reinsurance mirror » to see what this relative improvement reflects. Substantial rate increases were effected in the Personal Automobile and Personal Property classes, in late 1981 and early 1982 as, indeed, they needed to be.

Credit for the relative improvement cannot be attributed, however, to rate increases alone. Weather played an important part—the winter of 1982/83 was one of the mildest on record in Canada—the lack of the usual snow and ice conditions in most areas resulted in a marked drop in automobile accident frequency. This drop was further accentuated by sharp increases in the price of gasoline, which, coupled with the large number of Canadians unemployed, reduced automobile usage substantially. The « total Automobile » claims ratio fell to 77.5% from 1981's 91.4%. The mild winter obviously also ameliorated the claims experience on the Property classes, despite which the overall claims ratio was

69.8% ; the ratio for the commercial content speaks for itself hereunder.

In our country, one definitely cannot depend on continued mild winters and any benefit derived from such rare occurrences must be considered an aberration, a windfall perhaps, but one certainly unlikely to recur with any frequency. Amazingly, it seems some underwriters react in a peculiar way to even the slightest hint of an apparent return to prosperity ; since late 1982 in Quebec, and now in other parts of the country, they have already begun to cut the fairly recently increased Personal Lines rates. At the same time, too many of them still fail to take badly needed remedial action on Commercial Property pricing, despite net claims ratios of 76.9% in 1981 and, in 1982, the mild winter notwithstanding, 73.9% . This was accompanied, last year, by an annualized inflation rate of 10.8% .

In fact, with the arguable exception of medium-sized commercial risks, further rate reductions, not increases, are, albeit incredibly, again the norm. (One recent placement on the properties of a major metropolitan school board was written on an « All Risks » basis, with a $500,000 deductible, at a rate of 0.0087% —less than 1 cent per $100 of insurance). Where rates cannot, literally, be reduced any further, broadening of forms is the rule of the day. A similar situation characterizes the general liability business where it often appears that a broker can still place a major risk, with some carriers, at almost any price he cares to name ; this despite a 1982 claim ratio of 84.4%.

The high interest rates, « inherited » from 1981 and still prevalent in much of 1982, also contributed to the, so to speak, « laissez faire » attitude (cf. « cash flow underwriting »).

Any research into the drop in the combined ratio in 1982 must also be conducted from a more technical viewpoint. A number of factors suggest that even the degree of relative improvement may well be misleading. Two of these are loss reserving and deferred acquisition expenses.

Market underreserved ?

One can detect a significant change in reserving practices of the Canadian market over the last three years. Statistics Canada reports results of the combined Property/Casualty industry, together with details of such factors as outstanding loss reserves. These reserves should grow more or less as the Industry's earned premiums grow, barring major shifts in portfolio mix or a significant acceleration of writings. According to Statistics Canada, this has not been the case, viz :-

	1980	1981	1982
Growth in Earned Premiums	6.01%	11.51%	18.16%
Growth in Outstanding Loss Reserves	5.77%	8.99%	7.05%
Percentage Shortfall	0.24%	2.52%	11.11%
Shortfall in Outstanding Loss Reserves ($000.000)	$8.8	$97.6	$468.7

If this shortfall in these reserves is even partially unjustified then we must conclude that 1982's relative betterment is over-stated—that, in spite of abnormally favourable weather, unusually low loss frequency and the absence of severe shock losses or catastrophes, the Canadian market reduced its dollar underwriting loss in 1982 by less than an identifiable shortfall in outstanding reserves.

Deferred acquisition expenses

Another important « hidden factor » in Industry statistics is the (often substantial) effect of deferred acquisition expenses. Put briefly, insurers and reinsurers normally carry forward full acquisition expenses on unearned premiums at the end of each year (i.e. equity in U.P.R.). For published statistics and annual statements, however, the amount which can be deferred is the U.P.R. at year-end minus the product of the estimated claims ratio and non-deferrable expenses but not to exceed, in total, the actual deferred acquisition expenses. Thus, as claims ratios increase, deferrable acquisition expenses reduce and the combined ratio goes up. Conversely, as claims ratios improve, the deferrable acquisition expenses grow and the combined ratio reduces. The net result of these « sums » almost certainly, albeit unquantifiably, gave a worse appearance to the 1981 out-turn but a better one to 1982's.

Other « reflections »

There are some other reflections in our Canadian « reinsurance mirror » which insurers and, especially, reinsurers should perceive.

Catastrophes : Inadequate rates, broad forms, loss reserves etc, are not the only worries of beleaguered Canadian reinsurers. We, and our less well informed non-domestic competitors particularly, must also not be oblivious of the increasing exposure, in recent years, to losses of this type. Canada used to be regarded as relatively free therefrom ; that is no longer the case, however, as the following list shows :-

Year	Month	Cause	Location	Insured Loss $(000,000)
1983	May	Tornadoes/ Windstorm	S.W. Ontario	10
1982	August	Frost	S.W. Ontario	80
	August	Hail	Saskatchewan/Red Deer	15
	August	Hail	Saskatchewan/Prince Albert	20
	July	Hail	Alberta/Coaldale	8
1981	July	Hail	Alberta/Calgary	120
	July	Windstorm	Ontario	10
1980	June	Windstorm	Saskatchewan/Yorkton	5
1979	April	Windstorm	S.W. Ontario	5
	August	Windstorm/Hail	Saskatchewan/Saskatoon	5
	August	Tornadoes	S.W. Ontario	60
	August	Tornado/Hail	Saskatchewan/Saskatoon/Regina	10
1978	Jan.	Windstorm	S.W. Ontario	10
	July	Hail	Saskatchewan/Yorkton	2
	Nov.	Windstorm	Saskatchewan/Saskatoon	2

(The above figures, essentially, are « guesstimates » because, unfortunately, there is no central body in Canada properly quantifying catastrophe losses).

While the evidence points to the need for accurate accumulation figures this is a problem which too many insurers seem still unwilling to address seriously. Domestic professional reinsurers, not unnaturally (reflecting painful experience !), take a very different view.

Court awards : These are another cause for serious concern in that while we have seen a welcome, albeit probably temporary, reduction in the number of (automobile) accidents, unfortunately this has been accompanied by severe increases in the level of settlements. An indication of this was the recent tragic case of a quadriplegic (resulting from a swimming pool accident) where the court assessed damages at $3,121,764 although it dismissed the action.

Claims of over $1.000.000 are no longer rare and of over $500.000 are becoming commonplace. With substantial « social inflation », interest (both pre-and post-judgement) and increasing delays in settlements, reinsurers of middle layer (Auto and non-Auto) Liability Excess covers are being particularly hard hit.

Market capacity : How long will reinsurers have to contend with increasing exposures and diminishing returns ? How long can insurers and reinsurers afford renewed competition for Personal Lines and, simultaneously, the continuing unabated price war for Commercial business ? To attempt some response to these questions let us again « look into our mirror » for two reflections of the market's capacity, i.e. the relationship of net premiums written, and of unpaid claims, to equity, viz :

Year	Net Premiums Written(3) $(000,000)	Equity(4) $(000,000)	N.P.W. as % of Equity
1975	3,310	1,741	190.1
1976	4,134	2,043	202.3
1977	4,814	2,413	199.5
1978	4,643	2,924	158.8
1979	4,970	3,262	152.4
1980	5,328	3,515	151.6
1981	6,028	3,757	160.4
1982	7,056	4,133	170.7

One accepted yardstick is that net premiums written can be as much as 300% of equity. On that basis the market is capable of writing up to around $12 billion, or 70% more than it wrote in 1982. Given such an apparently enormous over-capacity it is hard to envisage this factor influencing early correction of present pricing policies. It certainly seems we cannot hope for a capacity crunch caused by any lack of these resources ; a point worthy of very careful consideration by those studying the pros and cons of an insurance exchange in Toronto.

(3) Figures are from Stats. Canada Catalogue 61-006.

(4) « Equity » as calculated by Stats. Canada includes Share Capital, contributed Surplus, Investment contingency and general reserves, retained earnings and Head Office accounts.

Claims reserves—equity :The ability to absorb volume increases is one thing but what about claims? The following table examines the relationships of unpaid claims to equity:-

Year	Provision for Unpaid Claims $(000,000)	Equity** $(000,000)	Unpaid Claims as % of Equity
1975	1,980	1,741	113.7
1976	2,405	2,043	117.7
1977	3,013	2,413	124.9
1978	3,404	2,924	116.4
1979	3,660	3,262	112.2
1980	3,871	3,515	110.1
1981	4,219	3,757	112.3
1982	4,517	4,133	109.3

There is a widely accepted criterion that unpaid claims can equal up to some 250% of equity. On such a basis the market as a whole could, theoretically, support an unpaid claims level of $10 billion ; thus, even with the shortfall calculated earlier in this article huge capacity is still available.

Mirror, mirror on the wall...

It is ironic that, on the one hand, high interest rates (indeed very high relative to the inflation rate) helped to spark and feed the initial cash flow underwriting frenzy which accompanied the market's entry into the current downswing. On the other hand, the dramatic drop in those interest rates, towards the end of 1982, facilitated continuation of the illogical competition by the resultant increase in bond values, thereby ameliorating solvency problems for many companies. Moreover, the timing of the reduction of investment income coincided with the return to profit of Personal Lines results, reflecting mainly the (now apparently transitory) rate increases thereon and, with the mildest winter for many a long year, causing many underwriters to expect a much better market result in 1983. This, again in turn, contributes to the present intensified cut-throat competition.

Many international economists predict, however, that interest rates will rise again towards the end of this year, or early in 1984, and that, if so, bond values will probably drop again but, surely, it is doubtful they will fall far enough to tighten overall market capacity. Higher interest rates will, therefore, simply add fuel to future competition unless we re-learn the lesson that underwriting profitability, not stock and bond markets' movements, is the real key to true viability.

R.R.C'.s[5] primary mission is research ; that which has been done for this article indicates that 1982's improvement was only relative, comprising much of an illusory and transitory nature. With the exceptions of the weather and interest rates/bond values, over which we have no control, our insurance and reinsurance industry cannot continue to emulate Lord Nelson and his telescope.

It can, indeed must, take positive and timely action to cope with the other ills that beset it, some of which we have illustrated herein.

It is no secret that our Federal Super-intendent of Insurance is sufficiently concerned to promote legislation aimed at achieving more stability in our Industry, with the accent on facets such as higher levels of capitalization/surplus, controls on unlicensed reinsurance, an Industry guarantee fund etc. Some of this finds Industry favour and some does not. Either way, the legislation will be no cure-all. Better market (i.e. self) discipline, proper pricing commensurate with the coverage given, fairer distribution of risks between insurers and reinsurers reflecting a resumption of the truer partnership roles of the past, are among problems that call for urgent attention. The tragedy is that they are still not being addressed, the mystery is why not.

Our « mirror » does not lie, it shows us as we are. Realistically, we cannot succeed, as Cinderella did, in becoming « the fairest of them all » but it is within our power to present a much « fairer » face to our mirror. To do so the market must achieve underwriting profitability. The author does not doubt that this will come, if only because the alternative is unthinkable, but unfortunately, he cannot yet see, in his mirror, any such reflection. Using the mirror as a heliograph one could very well imagine the first message sent would be : The time for action is now !

(5) Reinsurance Research Council.

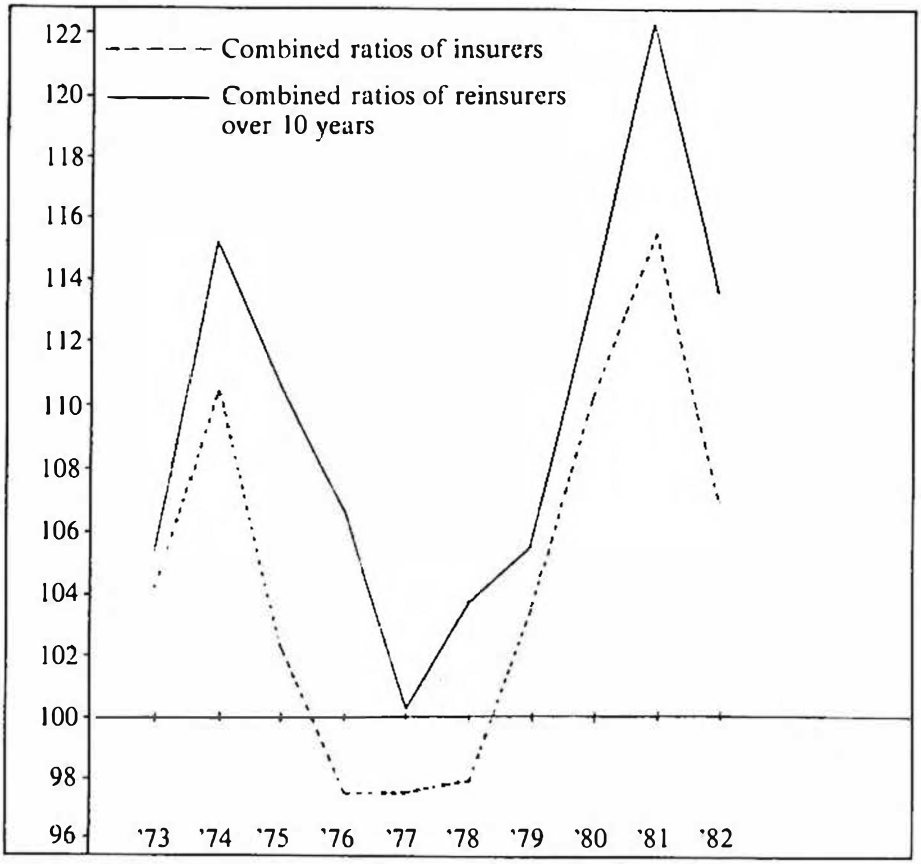

EXHIBIT I : Comparison of the net combined ratios of insurance versus reinsurance.

Year	Selected Reinsurers' Growth Over Previous Year	Total Industry Underwriting Results ($000,000)
1978	(0.4%)	+ 46
1979	(2.2%)	– 186
1980	9.3%	– 591
1981	20.8%	– 933
1982	17.9%	– 522

EXHIBIT II : Growth in net premiums of sisteen major reinsurers and insurance industry underwriting results (excluding A&S).[6]

(6) Source : *Canadian Insurance* Magazine, Stats. Issue – Canadian Business only.