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Article abstract

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Reinsurance in Canada : the Decisive Years Ahead

by

Robert Parizeau[1]

Voici un article du président du Reinsurance Research Council *du Canada, M. Robert Parizeau. Son travail paraît simultanément dans le présent numéro de notre Revue et dans celui de* Canadian Insurance Magazine *de juillet.*

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(1) Mr. Parizeau is Chairman of The Reinsurance Research Council.

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In recent years, there have been dramatic changes in Canadian weather patterns, in common with much of the rest of the world, leading to an increased number of catastrophes which have affected reinsurers far more than the ceding companies on a net basis. The Reinsurance Research Council (RRC) has recently compiled a Canadian catastrophe study – the first of its kind to be done in this country.

Surprisingly enough, there has been no central body collecting catastrophe data until now, and this has made the evaluation of catastrophe exposures a somewhat inexact science, particularly for reinsurers outside Canada who often are not fully aware of the changing loss conditions.

The study covers the period 1976-1982 and is based on returns from member companies of RRC. It shows the number of catastrophes in each year being : 1976—6 ; 1977—3 ; 1978—9 ; 1979—5 ; 1980—2 ; 1981—2 ; 1982—3 (also noted are 7 for 1983). Of these occurrences, 27 were in Western Canada, 6 in Ontario and 4 in Quebec (with one of these stretching into the Maritimes).

On the net retained accounts of ceding companies (after deduction of facultative and proportional reinsurances but before excess of loss recoveries), the average pure burning cost for major weather occurrences was 2.049% on the subject property premium income over the 7-year period ranging from a high of 6.366% in 1981 (Calgary hailstorm) to a low of 0.059% in 1977. Undoubtedly, 1983 will rival 1981 as the seven losses total well in excess of $100 million.

Reinsurers have been hard hit on these occurrences for several reasons :

- inadequate catastrophe excess rating, for certain areas,
- deductibles generally low in relation to both class premium income and capital/surplus,
- changing frequency and increasing severity of catastrophe claims,

- changes in coverages (sewer back-up, replacement cost rather than AVC) which accentuate the size of individual claims.

While the renewal season at the end of 1983 showed some signs of hardening catastrophe rates, indications are such that reality could begin to be reflected at the end of 1984 as reinsurers have already been hit by severe weather on April 30 in Ontario.

Proportional Treaties

Results in 1983 have varied widely for proportional business and reinsurers have accentuated their corrective action on continually unprofitable treaties. With the London and European markets drying up to a large extent for Canadian proportional business, the opportunity arose at the end of 1983 – although it was not always grasped – for an in-depth review of many reinsurance programmes. A number of reinsurers went much further than the standard response of recent years – "adjust the commission" – and made major revisions to line and cession guides for surplus treaties, revisions which in some cases have been long overdue.

In a number of instances, it has been noticeable that cessions under surplus treaties have grown disproportionately to either the effects of inflation on sums insured or the growth of the cedant's retained account and can only be the result of increased cessions at a time of falling rates, with fairly predictable consequences. Where companies have tried to correct for underpricing by a stiffening of physical underwriting standards, there have been some welcome improvements in results, particularly on commercial/industrial business. Although by no means all reinsurers have gone in for remedial action, there have been several cedants, in the past year or two, who have been forced to switch from a proportional property programme to a non-proportional one, usually followed by a marked improvement in underwriting standards.

How well retaining 100% of the first fifty or one hundred thousand dollars of every loss can concentrate an underwriter's mind !

Personal lines have generally been profitable in 1983, especially in the Province of Quebec. Although this is not usually a major part of a reinsurer's portfolio, it has had a beneficial effect for those heavily involved with regional companies.

Automobile and Liability

Changing socio-economic and legal conditions across the country, and more specifically in the Province of Ontario, have played a part in producing severe additional exposures to insurers and reinsurers, exposures which have rarely been priced in the primary product and almost certainly not by reinsurers.

Among these, in 1983, we saw the first spate of cases coming through the courts where the effects of the Family Law Reform Act of 1978 in Ontario could really be seen. This Act made it possible for children, grandchildren, parents, grandparents, brothers and sisters of an injured or deceased party to claim for pecuniary loss resulting from death or injury.

It is probably true to say that the effects of this Act on outstanding lawsuits – where the new class of claimant could be added in prior to the court appearance – were seriously underestimated by insurer and reinsurer alike, with the result that both net accounts for cedants and lower/middle layers for reinsurers were badly under-reserved. The spread of changes in the provincial Judicature Acts to allow pre-judgment interest on awards has also contributed to extremely adverse developments for excess reinsurers.

Perspective for current year

In all probability, 1984 will prove to be the "make or break" year for many reinsurers. If, as is anticipated, the direct market has another year of severe underwriting losses, then it is almost certain that reinsurers' results will be even worse. Reinsurers have been blamed in certain quarters, with some justification, for helping to provide the surfeit of capacity which has helped to drive rate levels down and for failing to provide leadership in curtailing abuse of that capacity through amending treaty terms and conditions. Time is, however, running out for those who fail to take corrective action.

The renewal season for 1985 business will almost inevitably see an increase in many catastrophe rates, particularly in light of the April 30th storm in Ontario, although whether or not they will be sufficient will remain to be seen. Excess auto/liability reinsurers will also be looking for increases in rate and changes in coverage as the full effects of Family Law Reform and pre-judgment interest become apparent.

There will be a continuing tightening of proportional capacity for some companies, which could bring about an increase in the volume of facultative placements. This is generally a welcome move as it can bring about pressure to increase rates when reinsurers refuse to bind facultative reinsurances at some of the existing rates.

If results are worse than anticipated in 1984, some reinsurers might decide that Canada is not a place in which profits can be made and might cancel their Canadian portfolios. Although this is a drastic move, it has happened on a few occasions recently.

Amendments to Acts

In September 1982, the Federal Superintendent of Insurance issued a memorandum concerning possible amendments to the Insurance Companies' Acts.

Level of capitalization, limitation on the use of unlicensed reinsurance, minimum net retention, an Industry guarantee plan and actuarial certification of adequacy of reserves were among the topics covered by the Superintendent who invited the Industry to give comments.

At the same time, the Department was exercising a much tighter control over the companies under its jurisdiction. New analytical tests have been developed to assess the results of each company and, in 1984, a questionnaire had to be completed in addition to the normal annual report to the Superintendent, to give certain non-accounting information respecting each company's operations and, more specifically, its reinsurance programme.

Already, important changes have taken place in the market. It is now fairly difficult for a ceding company to place a quota-share treaty if its level of retention is below 25%. Far fewer companies will agree to front for a very large amount of liability without having a meaningful interest in the risk in question. Ceding companies and reinsurance brokers have become much more demanding regarding the financial position of reinsurers. Placements in the unlicensed reinsurance market, irrespective of the quality of the market involved, have been reduced substantially, ceding companies demanding licensed reinsurers.

Apparently, it will take a little more time before the Insurance Companies' Acts of Canada are amended. The crisis in the trust industry, elections just around the corner, pressure from the life insurance companies to see some fundamental changes to the Insurance Acts will all delay matters. Furthermore, comments from all segments of the Industry, including the RRC, clearly showed that some of the proposed amendments could considerably limit the flexibility of the market and bring about a number of side effects which were not really contemplated.

Some observers believe that the Department of Insurance will retain only some of its more basic proposals. One of these might be the actuarial certification of adequacy of reserves. Earlier this year, the RRC stressed to the Superintendent of Insurance that, if such certification were to be requested in Canada, it should apply not only to the net reserves of insurance companies but also to their gross writings so that reinsurers might obtain a more accurate picture of their own reserves much more quickly. If implemented, this measure should, in years to come, have positive effects on all sectors of the market.

Government's priority list

Changes in the Insurance Acts will, without a doubt, remain high on the next government's priority list. The life insurance industry has requested important additional powers. It is interesting to note that, in 1967, banks' assets represented approximately 36% of the assets of all financial institutions in Canada and, those of the life insurance companies including pension funds, about 38%. In 1983, assets of all life insurance companies combined, in Canada, represent only half of The Royal Bank of Canada's assets. The Bank Act is revised approximately every ten years or so and periodically additional powers have been given to the banks. The Insurance Companies' Acts have not been revised in depth for approximately fifty years.

Recently, the Province of Quebec moved to change radically the powers of insurance companies and to reinforce the powers of the Inspector General. Insurance companies, life and non-life, have been authorized to hold shares in any type of subsidiary and, more particularly, in other financial institutions and downstream holdings. The borrowing powers of insurance companies have been broadened and, furthermore, mutual life insurance companies are now authorized to issue preferred equity shares. At the same time, however, additional powers are given to regulatory authorities and companies have to meet certain new additional requirements, such as the creation of an adult committee and, for the property and casualty companies, the appointment of a valuation actuary.

A debate on the inter-relations which should exist between banks, insurance companies, investment brokers and trust companies is now opened in Canada. The Quebec government has chosen its orientations. But the situation is more delicate for the Federal Government as the banking industry, which is under its control, is highly concentrated contrary to the situation in the United States.

Although it is presently difficult to foresee the exact outcome of this debate, it would be surprising if the Insurance Acts were not substantially amended in the years to come, to give additional powers to insurance companies. All this should bring major changes to the property and casualty field and also a greater concentration of financial institutions in Canada. The clientele to be served and the type of reinsurance coverages then needed might be very different in future years.

Work of RRC

RRC is not a rate or policy making board, but a grouping of fourteen professional reinsurers with operating bases in Canada. The Board of Directors is made up of the chief executive officers of each of the companies and convenes six or seven times a year. Three committees, headed by a director, report to the board on technical, financial and legislative matters. The technical committee is made up of senior technical underwriting personnel from all fourteen companies and is, without a doubt, the most active of the three. The two other committees are staffed according to the specific questions which are to be examined.

Studies are made of areas of concern to the Industry in general, and the reinsurers in particular, although items having a direct bearing on excess rates or proportional commissions are strictly taboo. Numerous topics have been and are being discussed ; for example, RRC's position regarding the Access to Information Act and the Privacy Act, the official support given at the beginning of the year for the continuation of the Annual Conference of Superintendents of

Insurance, three specific suggestions to amend Bill C-17 with respect to bankruptcy and insolvency which have received the support of the Department of Insurance and which, hopefully, will be incorporated into the final version of the law. To this should be added numerous communications with the Department of Insurance in Ottawa and with some of the provincial Superintendents.

Recently, the Technical Committee suggested to the Superintendents' Advisory Committee of Automobile Forms and Legislation the "doubling up" of limits under Section A of the policy and the SEF42 (Underinsured Endorsement) be eliminated in view of the impact it has had, and will continue to have, on excess of loss costs and, consequently, on the consumer. The Technical Committee has devoted considerable efforts to standardizing certain clauses used on the Canadian market : Nuclear Incident Exclusion, Excess of Policy Limits and Punitive Damages, Extra Contractual Obligations and Punitive Damages, Special Termination (both for proportional and non-proportional treaties) and a Claims Reporting clause. Some of these should become RRC recommended clauses for next season, while others need more discussions in order to obtain consensus from the various parties concerned.

The Financial Committee recently formed a sub-committee to consider the taxing of reinsurance companies, which are taxed on the same basis as insurance companies. One wonders if it is reasonable for a reinsurance company writing a book of catastrophe business to consider, as profits in a given year, the whole of its earned premiums in that year because no natural catastrophe has occurred. Many countries such as Germany, France, Sweden and Finland, to name a few, have recognized the importance for the reinsurance companies to set aside certain special contingency reserves before income taxes. A financially strong reinsurance market is essential if it is to properly fulfill its economic role and bring support to the insurance market when needed. As the Federal Government is starting an in-depth study on the future orientation of financial institutions in Canada, this is probably the right time for the reinsurance industry to make its particular characteristics known and recognized.

Enlarged membership

RRC regroups essentially professional reinsurers operating an underwriting office in Canada. Although this group stands for a fairly large part of the reinsurance market, it represents only 25% of the number of companies licensed for reinsurance in Canada. Lately, RRC has examined how it could enlarge its membership without losing the flexibility which it now enjoys and which facilitates immediate action on specific issues.

At a recent Board meeting it was decided to have three types of membership : full members, i.e. professional reinsurers with an underwriting office in Canada and writing at least $10 million net ; associate members, i.e. professional reinsurers having an underwriting office in Canada but writing less than $10 million net and also insurance companies writing reinsurance within a specific department ; finally, affiliated members, i.e. those companies writing reinsurance in Canada on a licensed basis, but without an underwriting staff in Canada.

Changes will be made to our by-laws at our next annual meeting in September and, during the coming months, RRC will gradually proceed to the enlarging of its membership. This approach should enable reinsurers writing business in Canada to obtain all the information and data produced by RRC, bring to RRC the input it does not now receive and, finally, give additional strength to the position of reinsurers when discussing with regulatory authorities, RRC thus representing a much larger segment of the reinsurance community in Canada.

The reinsurance industry is going through very difficult times, not only in Canada but around the world. If the reinsurance industry is to continue to fulfill its economic functions, it must return to profitability. In its own quiet way, RRC contributes to, and promotes, the stability of the Canadian insurance and reinsurance market, cooperating fully with the Insurance Bureau of Canada and working in the same spirit as other similar organizations around the world.

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