Assurances

The Canadian Market: A Period of Change and Major Reassessment

Robert Parizeau

Volume 53, Number 2, 1985

URI: https://id.erudit.org/iderudit/1104433ar
DOI: https://doi.org/10.7202/1104433ar

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Publisher(s)

HEC Montréal

ISSN

0004-6027 (print)
2817-3465 (digital)

Explore this journal

Cite this document

Parizeau, R. (1985). The Canadian Market: A Period of Change and Major Reassessment. *Assurances*, *53*(2), 141–149. https://doi.org/10.7202/1104433ar

Article abstract

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ASSURANCES

Revue trimestrielle consacrée à l'étude théorique et pratique
de l'assurance au Canada
Les articles signés n'engagent que leurs auteurs.

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L'abonnement $20
Le numéro $6
À l'étranger
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Administration
410, rue Saint-Nicolas
Montréal, Québec
H2Y 2R1
(514) 282-1112

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53e année ***Montréal, Juillet 1985*** ***Nº 2***

The Canadian Market : a Period of Change and Major Reassessment(1)

by

Robert Parizeau, President
of Sodarcan, Inc.

Dans ce texte, M. Robert Parizeau expose la situation actuelle dans le marché de la réassurance. Comme il le signale, celui-ci subit des modifications profondes, dont nos lecteurs prendront connaissance sans doute avec beaucoup d'intérêt, tant le conférencier serre la réalité de près.

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It is indeed a great pleasure for me to be with you today. Last September, in Sherbrooke, on the occasion of the Annual Meeting of your Association, I reviewed certain developments in our business and, more specifically, the increased concentration and vertical integration observed in recent years both at the level of insurers and intermediaries. Today, I will talk about the reinsurance market which

(1) Texte d'une conférence de M. Parizeau, donnée à la *Canadian Insurance Accountants Association*, à Toronto le 19 mars 1985.

is, at present, going through a period of drastic change and major reassessment.

For some companies, for some management teams and underwriters, right now, it is a matter of survival. On a worldwide basis, results in the reinsurance market are bad. In Canada, the combined index for registered reinsurers in 1980, 1982 and 1983 was 113% ; in 1981, it was 121%. It is too early to forecast figures for 1984, but a combined ratio of 115% is probably quite realistic. In the United States, the Reinsurance Association of America has just published

the 1984 results : the combined index is 127% on net earned premiums of $6,3 billion.

In their last annual report dated June 30th 1984, the Münchener Rück, the largest reinsurance company in the world, showed a net operating profit (after investment income) of only 44 million Deutsch Marks, which represents one-half of 1% of their net premium income. The situation is bad for all the major reinsurers throughout the world.

A number of companies have ceased writing business ; others are in financial difficulty ; many captive companies deeply regret ever having taken an interest in international reinsurance, as do a number of primary insurers who set up reinsurance departments.

By definition, reinsurance provides stability to the insurance industry. When results reach the present level on a worldwide basis, drastic changes are needed. For many years, the geographical spread of reinsurers gave them an element of stability. Unfortunately, at the present time, results are bad in almost all major markets, Canada being only one among many.

The reasons for the present situation are, without a doubt, well known to all of you. They are not very different from those affecting the primary sector. Over-capacity, underrating, inflation, lack of professional expertise, all are part of the problem. The reinsurance market has developed very rapidly since the "70"s. In Canada, approximately twenty reinsurers were licensed to do business in 1970. Today, more than forty-five reinsurers and at least a dozen insurance companies are assuming some reinsurance business. Approximately fifty-five new reinsurance companies have been formed in the United States since 1970 and a number of primary insurers have also joined the club. The same situation has developed in other parts of the world, in Europe, Asia, South America and the Middle-East, all this encouraged by a rather lax regulatory environment in most countries. The proliferation of newcomers, most of them having no experience in international reinsurance created an over-capacity and constituted a huge secondary market which was used extensively by brokers who were then able to reduce rates and improve terms for their clients who have been in the driver's seat for a number of years. There is no doubt that this environment has given rise to a number of questionable practices. The market has become increasingly undisciplined and some of the most basic principles have been forsaken.

When assessing the evolution of the international reinsurance market, however, it is important to put it in perspective with other financial services, like wholesale banking, for example. Let us not forget that, until very recently, bankers throughout the world were lining up to lend money to Mexico, Poland and a number of other countries which have been forced, during the past two or three years, to restructure their debt. In a number of cases, everyone realizes that these debts can never actually be repaid. It is not so long ago that Canadian banks lent a single client amounts in excess of their capital.

At some point in time, the banking community throughout the world went a little wild, to say the least, a very surprising situation considering long-established traditions and the legal environment in which banks operate. To a large extent, reinsurance is to insurance what banking is to commerce and industry. However, until very recently, and even today, reinsurance is far less regulated than banking and is upheld by fewer traditions. Indeed, there exists a club of great professionals who continues to observe time-honored practices, but its "members" have been outnumbered by newcomers who have created an entirely new environment. In my early days in the business, and after all, I am not that old, arbitration was rarely heard of and going to court was out of the question. If there was a problem, the parties concerned knew that they had to sit down and reach a reasonable compromise. Today, all too often, when a problem arises, it is submitted to arbitration, or simply brought to court. This attitude is most unfortunate and certainly does not reflect the principle of "utmost good faith".

In the mid-70's, the pro rata retrocession market mushroomed. A newcomer could quickly build up a reinsurance portfolio by supporting another reinsurer who would give him a cross-section of his basic portfolio until such time as this newcomer could develop his own book of business. Often, the newcomer himself needed support for his new operation and might even be supported by another newcomer on the market. One can well imagine what was left of the original premium after it had been retroceded two or three times, with each party taking and overrider.

144 This went on for a few years. With the delays involved in international reinsurance accounting, it took a long time before the players realized they were sitting on a time bomb. Gradually, in the late 70's and the early 80's, a growing number of reinsurers excluded retrocession business from their operations. By the last season, retrocession had become a bad word and the pro rata market had almost completely vanished.

For all practical purposes, reinsurers had to keep their business for their own account, relying only on excess of loss protection. Some had the financial resources to do so ; others did not. Reinsurers are no different from insurers. The more they keep for themselves, the more they are careful in their underwriting practices.

The virtual disappearance of the pro rata retrocession market by the end of 1984 drained international reinsurance capacity considerably. This compelled many reinsurers to drastically review their underwriting practices, to demand reduced commissions, and improved accounting and cash provisions and, in some cases, to put restrictions on coverage where exposure did not seem to be commensurate with the premiums which could be developed from this type of risk.

In the last season, a retrocession market for excess of loss protection was available, but prices had increased dramatically and the market had shrunk. Last year, many reinsurers started their underwriting season very late because they had not yet placed their own protection and did not know exactly how much this protection would cost them, and how much they would have to recuperate from their clients.

The instability of the international monetary system has also contributed to reinsurer's problems, especially those writing long tail accounts, such as general liability business. At the end of 1976, the American and the Canadian dollars were at par ; at the end of 1980, one American dollar cost $1.20 Canadian and, at the beginning of March this year, the rate had gone up to $1.40.

As an example, let's take a claim of $300,000 U.S. which occurred in 1976. If it was reported and paid in 1976, it would cost $300,000 Canadian. If the same claim (which occurred in 1976) was reported and paid in 1980, it would cost $360,000 Canadian ; if it was reported for the first time in 1985 and paid in 1985, its value would amount to $420,000 Canadian. No rating structure has ever taken this aspect into consideration. You can protect yourself against currency fluctuation on your known liability but the situation is much more delicate for unknown liability.

At the end of 1976, one pound sterling was equivalent to $1.71. At the end of 1980, it was equivalent to $2.86 and, at the beginning of March this year, to $1.50. A 1976 claim reported and paid in 1980, or reported and paid in 1985, has two different values where, in fact, it is the same claim in original currency.

This is a problem which the reinsurance community has not always mastered. Several reinsurers have made substantial profits or have suffered substantial losses due to foreign exchange, not because of speculation but essentially due to mismatching of assets and liabilities.

The crisis affecting reinsurance has made regulators, auditors and valuation actuaries focus on reinsurance operations. Lloyd's of London took major steps to increase its control over its underwriting syndicates. In the United States, we have seen a steady flow of new reinsurance regulations and guidelines from state insurance departments and especially from the New York Insurance Department. The American Institute of Certified Public Accountants has, over the past few years, paid much greater attention to reinsurance transactions and has, from time to time, issued specific recommendations. Actuaries are carefully developing methodologies so as to properly assess technical reserves.

Many companies doing reinsurance business are not necessarily in a position to cope with all the new regulations, legal or otherwise, gradually being put into practice. The crisis in the reinsurance industry is far from over. The system must adjust. There will, no doubt, be a few reinsurers withdrawing from the market place for one reason or another.

Given all this, one can see that reinsurance buyers have had a difficult time during the last season.

A very substantial decrease in the market overall capacity and the decision by some of the most influential players to take the necessary steps to improve the profitability of reinsurance operations have greatly impaired market flexibility. In the past, when some national markets showed signs of tightening, brokers could turn to other international markets. The situation has changed dramatically during the last season. The entire international reinsurance market recognizes that there are certain problems and now wishes to set its house in order.

Let us now look specifically at the Canadian scene.

Basically, our local reinsurance market is made up of subsidiaries or branches of foreign companies. Managers in Canada were under very strict instructions to make their portfolio profitable and to take whatever steps were necessary to achieve that goal. The timing was right as the unlicensed market which has always played a major role in Canada, was not really in a position to offer alternatives, especially since the Federal Superintendent of Insurance has indicated his reservations regarding unlicensed reinsurance. To a number of ceding companies, the shock was great, since reinsurance had, for years, been available in a very competitive environment.

There was no doubt a tightening in the terms of property treaties : reduction in commissions and in treaty capacity, and, in many cases, tables of limits and underwriting guides were extensively reviewed. On the whole, especially in the case of surplus treaties, the market however was receptive unless past results had been very bad.

The situation was very different in the case of automobile and liability, particularly here in Ontario, for proportional and non-proportional treaties. Some important reinsurers have actually withdrawn from such classes.

In Canada, automobile liability and general liability premiums account for approximately 25% of total premium income. During the past few years, loss, ratios have averaged well over 80% on the net retained account and have been substantially affected by numerous changes in legislation, especially in the province of Ontario. Some of these changes have had a considerable retroactive impact on reinsurers, as many insurers have, in the past, carried relatively low deductibles on their excess of loss contracts.

In 1979, a $300,000 settlement was considered large. Today, a figure of one million dollars would be more like it. This is compounded by the introduction of prejudgment interest ; on large claims, ceding companies were often able to pass on to their reinsurers the bulk of the impact of that legislation.

If the consequence of the uninsured and underinsured motorists cover and the Family Law Reform Act are also taken into consideration, one can then appreciate why some important reinsurers on this market have taken such drastic decisions during the last season, regarding automobile liability and general third party liability in Ontario. The recent decision in the case of Borland vs. Muttersbach and Royal Insurance Company is forcing reinsurers to completely review the exposure which they initially believed they were carrying and the exposure the judicial system now apparently wants them to carry.

Unless precise measures restricting the liability exposure are taken, one can expect the excess of loss automobile liability market in Ontario to shrink even more drastically and become prohibitively expensive ; this would have major consequences at the primary level, especially for the smaller companies which are often Canadian owned.

Mr. Cliff Fraser of the State Farm, in his recent report as Vice-Chairman of the Superintendents' Advisory Committee on Automobile Insurance stated : "Our courts, at times, appear to be courts of compensation rather than courts of law. If the policy is to compensate regardless of fault or to ignore the principle of indemnity, then, possibly, a complete move from the Tort system to one of so-called no-fault concepts may have merit. It seems, today, we have the worst of both worlds."

The situation is serious. The insurance and the reinsurance industry must take a much more proactive approach to prompt changes in legislation if it wishes to prevent the situation from getting out of hand.

The Reinsurance market for professional liability is even worse. There are almost no Reinsurers left for pro rata reinsurance and excess of loss reinsurance capacity has shrunk considerably and is very expensive. Here again, recent judgments have not only increased indemnities on future claims, but have also raised costs substantially on all outstanding losses. This problem is not restricted to Canada ; it is worse south of the border.

While we can complain bitterly about certain legislative Acts which are increasing liabilities considerably for the insurance and reinsurance companies, certain measures proposed by Mr. Robert Hammond in 1982, could improve stability in our industry.

The requirement for an insurance company to keep a minimum retention on its writings is a very sound principle. Many problems developed because insurance companies could reinsure just about anything without retaining a significant interest. Although Mr. Hammond has yet to confirm his intentions, these have already had a very positive effect. At the present time, it is virtually impossible to place a quota share treaty if the ceding company does not retain at least 25%.

Another important element put forward by Mr. Hammond is the actuarial certification of technical reserves. In 1984, the Province of Quebec adopted this idea and every company licensed in that province must now file such a certification. While it will take some time before this measure is fully operational, it should, eventually improve the reliability of financial statements.

The Reinsurance Research Council has pointed out to the Federal Superintendent and to the Quebec Superintendent that such certification should be made not only on the net account of each company, but also for their gross writing.

This would provide reinsurers with additional assurance that their reserves are sufficient and that their financial statements reflect their true position. Delays involved in accounting and inaccurate reporting are, without a doubt, drawbacks in our business. Though the situation in North America is much better than in most other countries, there is, however, still room for improvement.

The present predicament of the international reinsurance market is creating a great deal of uncertainty but it should benefit the primary sector in the end. The return to profitability is a sine qua non condition for the reinsurance industry to play its role of support of the primary sector.

However, when the pendulum begins to swing the other way, there is always a danger that it goes too far. Reinsurance brokers, without a doubt, will play, as they have always done, a vital role to make sure that, while it is essential that reinsurers' results come back to profitability, competition and market availability are maintained.

Reinsurers who are presently in a sound financial position and who are not swamped by massive losses from previous years can consider selective expansion now that conditions are improving.

Our present environment leaves very little room for amateurism. For reinsurers and for reinsurance brokers, success will depend essentially on their technical and creative skills in bringing solutions to the new risks which modern society continuously brings.

I would have liked to touch upon many other aspects in this overview. I can only hope that these few comments will give you a better understanding of some of the drastic changes now taking place in the Canadian and international reinsurance community.

Le monde fascinant des insectes. Chez Audubon Larousse. Paris

Cet album est vraiment magnifique. Il est illustré d'un très grand nombre de planches en couleurs et il présente le sujet dans une langue simple et intéressante. Un grand livre.