

Reinsurance and Insurance: The Moment of Truth

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Article abstract

L'auteur de ce travail présente les problèmes actuels de la réassurance et de l'assurance au Canada, en s'efforçant de présenter les problèmes dans toute leur acuité. D'où son titre : The moment of truth. En se penchant sur ce double champ d'action, il a constaté les difficultés à travers lesquelles passent les assureurs en ce moment. Il ne cherche pas à les minimiser; il les présente telles qu'il les voit avec toute leur gravité, en indiquant les solutions essentielles, aussi bien en assurance qu'en réassurance.

Reinsurance and Insurance : The Moment of Truth⁽¹⁾

by

Robert Parizeau

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The topic of my talk today is *Reinsurance and Insurance : the moment of truth*. First, I shall review the reinsurance market, which is going through a period of dramatic change and reassessment and, to finish, I shall comment on some developments which are taking place in our industry today.

For some companies, for some management teams and underwriters, it is now a matter of survival. Worldwide, results in the reinsurance market are bad. In Canada, the combined index for licensed reinsurers was 113% in 1980, 121% in 1981, 113% in 1982 and 1983, 115% in 1984 and 112% in 1985. It is interesting to note that, for the first time in many years, reinsurers' results in 1985 are substantially better than the industry's overall. In the United States, the same index for reinsurers was 127% in 1984 and 121% in 1985.

A number of companies have ceased writing business ; others are in financial trouble ; 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. At the

⁽¹⁾ This paper has been delivered recently by Mr. Robert Parizeau at the Insurance Institute of Ontario. Mr. Parizeau is President of Sodarcac Inc.

present time, we can estimate that, worldwide, 50% of the companies which were active in reinsurance in 1982 have now withdrawn from the field. This has obviously created a large capacity crunch which has had major consequences on the primary market.

By definition, reinsurance is meant to provide stability to the insurance industry. When results, internationally, are at the level they are today, drastic changes are needed. For many years, the geographical spread gave reinsurers a certain element of stability. Unfortunately, now, results are bad in almost all major markets, Canada being only one amongst many and not the worst.

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Over-capacity, underrating, inflation, lack of professional expertise, all are part of the problem. The reinsurance market has developed very rapidly in the 1970's. In Canada, only twenty or so reinsurers were licensed to do business in 1970. Today, there are more than forty-five reinsurers and at least a dozen insurance companies in the field. Approximately fifty-five new reinsurance companies were formed in the United States between 1970 and the early 1980's and a number of primary insurers have also joined the club. The same situation developed in other parts of the world – 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 having no experience in international reinsurance, has created an over-capacity and 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 privileged in the driver's seats for a number of years. This environment has undoubtedly given rise to a number of questionable practices. The market has become increasingly undisciplined and some of the basic reinsurance principles have been forsaken.

In the mid-1970's, the pro rata retrocession market mushroomed. A newcomer could quickly build up a reinsurance portfolio by supporting another reinsurer who would give him, in consideration of a substantial override, a cross-section of his basic portfolio until such time as this newcomer could develop his own book of business. The newcomer himself needed support for his operations and was often supported by another newcomer on the market. The blind leading the blind ! One can imagine what was left of the original premium after it had been retroceded two, three or four times,

with each party taking an overrider. This went on for a few years. With the delays involved in international reinsurance accounting practice, it took a long time before the parties realized they were all sitting on a time bomb. Gradually, in the late 1970's and early 1980's, a growing number of reinsurers excluded retrocession business from their assumed portfolio. By the end of 1984, retrocession had become a bad word and the pro rata retrocession market had almost completely vanished.

370 For all practical purposes, most reinsurers must now keep the bulk of their business for themselves, relying essentially on excess of loss protection. Some have the financial resources to do so ; others do not. Reinsurers are no different from insurers. The more they keep for themselves, the more careful they are in their underwriting practices.

In the past, when some national markets showed signs of tightening, brokers could turn to international markets. The situation has changed dramatically during the last two seasons ; market flexibility no longer exists. The entire international reinsurance market, led by the most influential reinsurers, has decided to take the necessary steps to improve the profitability of reinsurance operations and to put its house in order.

This has compelled reinsurers to completely review their underwriting practices, to demand reduced commissions, increased rates, improved accounting and cash provisions and, especially in 1985, to put restrictions on coverage where exposure did not seem to be commensurate with the premiums which could be developed from that type of risk. In some instances, some reinsurers withdrew completely from certain classes of business such as product liability, professional liability and aviation, creating serious problems for the primary market. In addition, reinsurers have turned toward non-proportional reinsurance where they can follow their own judgment and be masters of their own fate. In the long run, this will create a greater divergence between the results of insurers and those of reinsurers.

Basically, our local reinsurance market is made up of subsidiaries or branches of foreign companies, with the exception of the reinsurance departments of a few Canadian insurance companies and that of The National Reinsurance Company of Canada. Managers in

Canada have been under very strict instructions to make their portfolio profitable and to take whatever steps are necessary to achieve this 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. Many reinsurers started their last underwriting season very late because they had not yet completed the placement of their own protection.

For a number of ceding companies, the shock was great, since, for many years, reinsurance had been available in a very competitive environment.

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There has been a tightening in the terms of property treaties : commissions and treaty capacity have been reduced and, in many cases, tables of limits and underwriting guides have been extensively reviewed. On the whole, however, especially in the case of surplus property treaties, the market was receptive unless past results had been very bad.

The situation was very different in the case of automobile and liability proportional and non-proportional treaties, particularly in Ontario. Some major 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 greatly affected by numerous changes in legislation, especially in 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 is more like it. This has been compounded by the introduction of prejudgment interest. On such large claims, ceding companies were often able to pass on the bulk of the impact of that legislation to their reinsurers.

To this have been added financial burden of the uninsured and underinsured motorist coverage, and the Family Law Reform Act. These have hit the market at a time when reinsurers were completely

reassessing their position with regard to liability business in North America.

372 The year 1985 has therefore marked an important turning point in the insurance and reinsurance industry, both in Canada and on the international market. The major crisis which has plagued our industry in the past few years has brought about the disappearance of a number of insurance and reinsurance companies around the world. The results of this crisis now appear in several forms : a massive premium increase for certain types of risks, a severely reduced capacities for others and, for some classes, a total absence of available cover. In some liability classes, the position is extremely serious. In Ontario, the insurance industry formed two pools to cope with this difficult situation : one for pollution – following the passing of the *Spills Bill* – and the other for difficult to place liability risks.

Professional liability, as well as product liability with American exposure are two areas where no real solutions have yet been found. Recent initiatives of the American federal government give encouragement that some of the current abuses inherent in the civil justice system may be checked, but this will take time.

It is obvious that the system of indemnification in Canada must be reexamined to stop transferring to the insurance industry the cost of social measures for which other means of financing prove inconvenient. Many of the recommendations contained in the Slater report should, if adopted, help in finding long-term solutions.

In the meantime, however, interim solutions must be found, notably where product liability is concerned for all exports to the United States. Collaboration between private enterprise and government authorities is essential to reach a rapid solution, to the satisfaction of all parties concerned. The very solvency of insurers as well as the livelihood of many Canadian manufacturing businesses are at stake here. We will undoubtedly have to consider a nationwide pool supported by the federal government. In the short-term, government support seems indispensable, just as it was in the case of the Ontario pollution pool.

We can only hope that the present crisis will improve the dialogue between the various parties involved (insurers, intermediaries, consumers and governments) so that, together, they can develop

lasting solutions rather than temporary and perhaps very costly compromises. Hopefully, the present situation will help the public and government to better appreciate the role played by insurers, reinsurers and brokers.

Government authorities may at last decide to establish a policy for general insurance, as they have for the other financial sectors (banks trusts and life insurance companies), which will permit the creation of conditions necessary to attract significant amounts of Canadian capital to the insurance industry, an important condition to stabilize our industry.

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Along with Australia, the insurance market in Canada probably has the worst performance in the industrialized world. The market is very fragmented and, contrary to the situation in most industrialized countries, it is dominated by foreign interests. Foreigners have often tolerated from their Canadian subsidiaries or branches in Canada results that they could never have accepted for any length of time in their homeland. The fact that Canadian-owned companies have a small share of the market for large commercial and industrial risks has delayed the development, in Canada, of proper technical skills. The situation is entirely different in the other financial sectors such as the life insurance industry where Canadian companies do dominate the market.

The role of government authorities is not only to control the industry but also to create an environment in which strong financial institutions can develop in Canada and fulfill their economic functions. In some European countries such as Finland, Sweden and Germany, and to a lesser extent France, the government allows the industry to create a stabilization reserve fund before income tax; such reserves help to stabilize results from year to year, limiting the drastic rate changes which, periodically, the industry is obliged to make. Is it quite normal, for example, for a reinsurer to pay full income tax in a given year on his book of catastrophe business because, during that specific year, no natural catastrophe has occurred? The major part of the premium should be set aside so that, when a catastrophe does occur, the reinsurer can adequately support his clients. It is interesting to note that the Ontario Task Force has made specific recommendations on this subject. It is worth mentioning that measures such as these taken in Germany, the Scandinavian coun-

tries and France, have been implemented by socialist oriented governments. If those governments have agreed to make such decisions, there must be very good technical reasons to do so !

The federal government will, and probably very shortly, bring amendments to the Insurance Acts. Many of the changes will help improve the stability of our industry.

374 The requirements for an insurance company to keep a minimum retention on its writings is a very sound principle. Many problems have developed because insurance companies could reinsure just about anything without retaining a significant interest.

Another important element put forward by Mr. Hammond is the actuarial report on technical reserves. In 1984, the Province of Quebec adopted this concept and every company licensed in that province must now file such a report. While it will take some time before this is fully operational, it should eventually considerably improve the reliability of financial statements of both insurance and reinsurance companies in Canada and give more credibility to the results of the market.

Solvency requirements will also be increased. Two other solvency test will be added to the present one defined in Article 103 of the Insurance Act : one will be based on premiums and the other on claims, both introducing, for the first time, certain restrictions as to the amount of reinsurance a company can do. In practice, it will greatly decrease the number of fronting arrangements made by small companies, and it will also force insurance companies to keep a much larger percentage of their gross acceptances.



While we are going through a very difficult period, I am sure that the Canadian market is on the way to recovery. Companies will soon be financially stronger and operations technically sounder. Industry and governments are trying hard to find long-term solutions ; the Slater report is a good example. The deregulation of financial institutions, and the possible entry of banks into our field, might, however, entail other types of consequences and, in the years to come, it will be very important to be atuned to the thinking of the federal government.

Our present environment leaves very little room for amateurs. For insurers and reinsurers and insurance and reinsurance brokers, success will depend, to a large extent, on their technical and creative skills in bringing solutions to the new challenges which a post-industrialized society continuously brings.

La clientèle de demain

La maison Clarkson Gordon, Caron Bélanger, Woods Gordon nous a fait parvenir la vingtième édition de son enquête sur la clientèle de demain. Comme par le passé, la brochure est fort intéressante par ce qu'elle prévoit, aussi bien que par la manière dont les renseignements et les commentaires sont présentés au lecteur. L'étude va du vieillissement de la population au retour vers l'est d'une partie de ceux qui ont été attirés par les provinces de l'Ouest, comme l'Alberta et la Colombie britannique, à une époque où l'activité économique était très grande. Comme on le sait, les ennuis de l'industrie pétrolière ont renversé le courant dans une population qui cherche du travail avant tout. Les auteurs étudient également l'évolution du milieu familial : l'effet du creuset ethnique dans l'Ouest, en particulier, la diminution du nombre de femmes au foyer, la répartition des ménages, l'importance de la femme dans des ménages par âge de soutien, la marche des mariages et celle des divorces. On aborde également la question de l'emploi, du nombre de femmes considérablement accru dans le marché du travail, le surcroît d'employés à temps partiel, le travail au noir, les femmes au travail, l'essor de l'économie parallèle.

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Comme l'on voit, il y a là une étude intéressante, abondamment illustrée de graphiques. Il ne faut pas y chercher un travail savant, mais une série assez poussée de statistiques et leur interprétation, en fonction de l'avenir, sans oublier, évidemment, l'importance de l'informatique, des 'systèmes experts', de l'intelligence artificielle, des nouveaux horizons offerts par la technologie qu'on appelle informatique, robotique, bureautique ou qu'on lui affuble d'autres épithètes.