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IV – Liability insurance today and the reinsurance market

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Article abstract

La communication de M. Robey à la réunion du 27 septembre 1985 a été donnée en français. Nous la reproduisons en un texte anglais, afin qu'elle puisse rejoindre à la fois nos lecteurs francophones et anglophones. M. Robey y présente les problèmes très graves auxquels la réassurance doit faire face, en ce moment. Nous nous joignons à lui, en souhaitant que chacun apporte sa collaboration, afin que l'on trouve une solution.

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- Harnet Stamp & Coin Ltd., vs J.A. Madill et Commercial Union et al, jugement rendu le 16 novembre 1983 et portant le numéro 500-05-025808-781 du district de Montréal ;
- L'Écuyer, André vs La Royale du Canada, jugement rendu le 11 janvier 1984 et portant le numéro 160-05-000222-803 du district d'Alma ; (Appel rendu)
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IV – Liability insurance today and the reinsurance market, by Christopher J. Robey[9]

La communication de M. Robey à la réunion du 27 septembre 1985 a été donnée en français. Nous la reproduisons en un texte anglais, afin qu'elle puisse rejoindre à la fois nos lecteurs francophones et anglophones. M. Robey y présente les problèmes très graves auxquels la réassurance doit faire face, en ce moment. Nous nous joignons à lui, en souhaitant que chacun apporte sa collaboration, afin que l'on trouve une solution.

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All four speakers today will be discussing the same subject, however each will do so from his own perspective, in my case, it is that of the reinsurance market which, by its nature, also provides an international perspective.

"Liability Insurance Today" is without doubt an appropriate subject for a discussion on the current problems of our industry.

[9] M. Robey est vice-président exécutif de le Blanc Eldridge Parizeau Inc., membre du groupe Sodarcan.

Even if reinsurers consider Ontario automobile insurance to be the greatest problem they face at the moment, it is only because of the importance of the premium volume in automobile compared to that in liability. It is interesting to note that all the problems associated with automobile insurance in Ontario, with the partial exception of S.E.F. #42 and #44, can be found also in general liability. Indeed, S.E.F. #42 and #44 also have their impact on liability insurance, since the problems stemming from them concern the interpretation of policy wordings.

Because of the international nature of reinsurance, the decisions which reinsurers will take on liability insurance in Canada will be greatly influenced by their experience elsewhere in the world and particularly in the United States. What in Canada is considered to be a problem with general liability, in the United States is considered a crisis, to the point that *Fortune magazine* recently published an article under the heading : *A World Without Insurance.*

It is therefore logical to expect that the solutions which insurers propose for dealing with the crisis in the United States will greatly influence the choice of solutions for the problem in Canada.

General liability is mainly reinsured on an excess of loss basis, although quota share reinsurance is also found. As far as concerns quota share reinsurance, the problems for reinsurers are the same as those for insurers, since quota share is no more than a sharing between the parties of the original policy. With the results which we presently know in liability insurance, it has become almost impossible to find a reinsurer willing to accept a quota share treaty for this class of business at a rate of commission acceptable to the ceding company. After all, with the loss ratio for the market as a whole in excess of 100%, some reinsurers feel that it should be the ceding company which pays the commission.

As far as concerns excess of loss reinsurance, the problem for the reinsurer is different, since he establishes his own pricing policy and is involved, on a non-proportional basis, only on the more important losses. It must be remembered that, although the problems with such losses are the same as for insurers, the impact is greater on the reinsurer, since, on the one hand, it is often only the reinsurer's share in a loss which is increased while, on the other hand, the rein-

surer generally does not have the same premium base to permit it to absorb such shocks.

This brings us to the identification of the problems which reinsurers must face in the industry, i.e. :

- inflation ;
- increasing awards, generally called social inflation ;
- pre-judgement interest ;
- judicial interpretation of policies ;
- late reporting of losses and the difficulty of establishing adequate reserves ;
- the Family Law Reform Act in Ontario and similar legislation in other provinces ;
- exposures in the United States of America ;
- pollution, including the so-called "Spills Bill" in Ontario ;
- catastrophic exposures ;
- the definition of "occurrence".

Let us look at these problems, beginning with inflation.

It seems that inflation is currently under control and economists do not expect a major increase in the rate of inflation in the immediate future. However, it must be remembered that the most important losses which occur today will not be settled until 1991 or later, which underlines the importance of predicting the impact of inflation during this five or six-year period. After all, in 1976, the annual rate of inflation was only 7.5% but between 1976 and 1982, the cumulative rate of inflation was 76%.

For the reinsurer, the impact of inflation on the original loss is much greater than for the original insurer. For example, let us take a treaty with a priority of $500,000 and a loss with a value, on its occurrence, of $600,000 ; the cost for the reinsurer is $100,000. If the impact of inflation increases the amount of the loss, over a six-year period, to $800,000, which is only an annual rate of inflation of 5%, the increase in the original loss will be one third, while the cost for the reinsurer will have increased threefold, from $100,000 to $300,000. For its part, the ceding company will have suffered no increase in its net loss, its priority remaining $500,000.

The stability or index clause, which is commonly used in Europe, can give the reinsurer some protection against inflation, since it shares its impact with the ceding company. However, this clause is not greatly used in Canada, primarily because of the difficulty for a ceding company to determine, when the loss occurs, what reserve it should establish for its priority at the time of settlement, and also because of the difficulty for the reinsurer and the ceding company to evaluate the credit which should be given on the reinsurance premium.

Let us move on now to the second form of inflation, that is the increase in judgements, or social inflation.

You are all certainly aware of the case of the 14 year-old boy who has obtained a $6,300,000 judgement against the City of Brampton. This case is in appeal, but even if the judgement is ultimately reduced by half, it will remain one of the highest awards ever in Canada ; and how many future claimants, do you think, will recall the results of the appeal, compared to those who will recall the original judgement ?

As with economic inflation, the inflation in judgements also has a non-proportional impact on reinsurers, added to the fact that the past becomes of little significance in the rating of today's treaties. Reinsurance rating has never been as precise as insurance rating and we all know, from our results, with what precision insurance is rated.

For excess of loss layers where a loss frequency is expected, reinsurers must not only adjust past losses to today's values but also then convert them to the value which they project for them at the time of their final settlement, as if they had occurred in the current year. Even a well-qualified actuary would have great difficulty in accomplishing this, since there are simply too many unknowns to be taken into account to arrive at a reliable result.

When we arrive at the rating of the other layers, for example excess of $500,000, it becomes more or less speculation and we can see why the September Rendez-Vous of reinsurers is held in Monte Carlo and the N.A.I.I. Convention in the United States so often is at Las Vegas.

It is almost impossible to foresee the number of losses which an individual ceding company will pay at this level and the only solution for a reinsurer is therefore to underwrite relatively small shares in layers at this level for several ceding companies, hoping that it will collect a sufficient amount of premium from all the sources in order to pay the losses which are inevitable.

This reminds us that reinsurance, just as insurance, is based on the principle of dividing the losses of the few amongst the many. It is this principle which means that all ceding companies will pay more for their reinsurance because of the Brampton loss and, eventually, all insureds will pay more for their insurance.

The question of pre-judgement interest should no longer be too great a problem for reinsurers, since its impact is now well known and the reinsurer therefore has the possibility of adjusting its rating to take it into account. However, it should be noted once again that the effect on the reinsurer is not proportional to that on the ceding company. Most treaties in Canada include interest in the ultimate net loss before application of the priority, so that in the case of a loss which exceeds the priority on the basis of indemnity only, the reinsurer will pay all the interest, before and after judgement, but will earn interest only on the reserve which it can set up in excess of the priority.

Indeed, even if the original rating of the ceding company has been increased to take into account the payment of this interest, the excess of loss reinsurer will only obtain the premium which results from the application of its reinsurance rate to the original premium, despite the fact that it will pay 100% of the interest.

Let us look now at the judicial interpretation of policy wordings, a problem which has been imported from the United States.

In my opinion, it is a problem which has been blown out of proportion in Canada at the moment. One hears often of Borland vs Muttersbach, the case involving the Royal and the total amount payable under S.E.F. #42, and Wigle vs Allstate, another S.E.F. #42 case, this time concerning an unidentified vehicle. Wigle vs Allstate is final, but Borland vs. Muttersbach is in appeal and the appeal will be heard during October. You are all undoubtedly aware of these two cases, but I wonder how many of you are aware of Myers vs

Royal, another case involving S.E.F. #42, but this time a judgement in favour of the insurer, the judge having decided that the Family Law Reform Act in Ontario cannot be invoked to increase the number of possible claimants under the endorsement.

In my opinion, the problem in Canada at the moment is caused more by weaknesses in the policy wordings than by unreasonable interpretations by judges. I underline here that I am only speaking of the interpretation of policy wordings ; the tendency to stretch the principle of negligence to extremes is a serious problem for which I certainly consider judges responsible, but also our society, since we must not forget that an action must be begun before a judge can take a decision.

Because of the influence of the American industry on ours, reinsurers are afraid that the American tendency on the interpretation of policies will find its way into Canada. Let us remember the new American general liability policy which Insurance Services Office calls a "C.G.L." policy, but with the important nuance that the "C" now means "commercial" rather than "comprehensive", because too many judges have interpreted "comprehensive" as meaning that everything is covered, the insured not even being obliged to read his policy.

The next problem we shall look at is linked with those already discussed, but accentuated by the optimism which seems to be the rule amongst too many of those in charge of claims departments. Since it is clearly very difficult, in view of the problems which abound today, to estimate with precision the final cost of a loss at the time it happens, it is therefore inevitable that reinsurers, who are second in line, suffer important delays in receiving advice of losses, resulting in inadequate reserves. To show you that this is not a new problem, a Lloyd's underwriter told me a few months ago that he had just received the first advice of a loss which occurred in 1896.

Of course, once a reinsurer has been advised of a loss, the ceding company and the reinsurer must share the responsibility for any underevaluation.

The late advice of losses creates several problems for the reinsurer, one of which is that the reserves for outstanding losses are not reliable and therefore the information which must be used for setting

rates for the future is equally unreliable. Another problem is that the reinsurer pays income tax on profits which have not actually been earned and, as a result, fails to earn all the investment revenue to which it is entitled. Finally, since management decisions are often taken on the basis of loss information, poor decisions can easily result from the use of poor information.

Let us now look at a problem which has been recognized primarily in connection with automobile insurance but which nonetheless has an impact on liability, the Family Law Reform Act in Ontario and similar laws in other provinces. Again, since the application of the law increases the cost of the loss, the impact is greater on excess of loss reinsurers. However, in my opinion, this problem is exaggerated, since the amounts which are given under the law are not great, compared to the amounts given to individuals who were able to recover prior to the legislation. In the case of Mason vs Peters, which alerted the industry to the problem, the total loss was increased by $50,000, but the majority of other cases seem to be settled for an additional $10,000 or less.

In addition, the law has been in force since 1978 and the judgement in Mason vs Peters was brought down in 1982, consequently reinsurers have had three years in which to make the necessary adjustments, which should be enough.

Let us move on now to the question of exposures in the United States. The most apparent problem today is presented by the export of products. This exposure has changed substantially during the last 20 years, perhaps in a way which escaped the attention of most insurance and reinsurance underwriters.

Twenty years ago, Canadian exports to the United States were less important and the Canadian operations of American companies were generally limited to the manufacturing of products for the Canadian market only ; but, with the encouragement of Canadian executives and the federal and provincial governments, the importance of exports has increased and the Canadian subsidiaries of multi-nationals receive more and more often mandates for the manufacture of products for the world-wide market, resulting in an

increase in exports, especially to the United States, as the following figures show :

Exports to the United States in 1964 : $ 4,271,100,000. Percentage of Gross National Product : 8.49%.

Exports to the United States in 1974 : $20,629,000,000. Percentage of Gross National Product : 13.98%.

Exports to the United States in 1984 : $82,796,262,000. Percentage of Gross National Product : 19.67%.

Considering the great difficulty with which American insurance companies face the problem of products liability, it is easy to understand the dangers for a Canadian company which receives such a loss, without having in place the expertise necessary to evaluate it. If we add to this the possibility of a bad faith judgement, which in certain states results in elimination of the policy limit, not forgetting the possibility of punitive damages, it is easy to understand the apprehension of reinsurers.

However, in the case of direct exports, the risk can be identified, while the problem is more difficult in the case of exports through third parties, without the knowledge of the manufacturer. We have seen one case where the insured, a small manufacturer in the west of Canada selling only to a local clientele, received a claim from Alaska because of a part which it had manufactured for a grain elevator. You can imagine the surprise of the insured, not to mention the reaction of its insurance company and that company's reinsurers.

Even if the most evident problem results from the export of products, we should not forget the dangers in the export of services and let us remember that there is now much discussion of the development of free trade between Canada and the United States.

Another problem which can only increase in severity is that of pollution. Everyone talks of it, and especially in Ontario where the "Spills Bill" has come into force in November, but possibly without insurance and without reinsurance.

We have been informed by the Reinsurance Research Council of Canada that reinsurers represented by the Directors of the Council, which are all the professional reinsurers with an underwriting office in Canada, are not willing to grant coverage for these risks. It is not yet clear how they will refuse this coverage, but it seems certain

that an exclusion will be included in all treaties from the 1st January 1986.

The subject of pollution leads easily into that of catastrophic losses. We generally think in terms of hurricanes or earthquakes when we think of catastrophic risks in reinsurance, but asbestosis has changed all that, since it represents a potential loss in the billions of dollars, the law suits from which will create an explosion of jurisprudence on the entire subject of general liability in the United States.

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Urea formaldehyde foam insulation is not a loss of the same importance, however for certain Quebec insurance companies, it offers a catastrophe potential.

One can only speculate on the astronomical costs of the clean-up of our rivers and the Great Lakes, damage caused by acid rain and you can certainly add more examples to the list.

Of course, our industry exists to absorb catastrophic risks, but the problem today is that we have not created any reserve in the past for the catastrophes which have taken place and, at the present level of rates, nor are we creating any such reserve for the future.

The problem is less severe in Canada than in the United States, since employers liability is not in the hands of private industry, nonetheless it remains an enormous risk.

Tied to the risk of catastrophe is the problem of the definition of "occurrence". Jurisprudence in the United States, particularly because of asbestosis, has resulted in the possibility for insureds to combine several policy years to benefit from an accumulation of limits, rather than be subject to a single annual limit.

It is possible to change the wording of the policy, however such a change can only apply to tomorrow's occurrences and the catastrophes from now to the end of the century have either already happened or are in the process of happening. It is difficult and frightening to think of the potential.

Thus far, we have discussed facts which are well known, however now we shall move into the realm of fantasy and what I shall say represents more a personal point of view ; so let us look into our crystal ball.

Firstly, we see the immediate future, less fantasy since it is already knocking at our door.

The first reaction we shall see from reinsurers, and are already seeing, is one of panic.

Reinsurers will require much more information this year to take on less liability at a higher price. All ceding companies, except those writing only personal lines, will be obliged to give much more information on their general liability portfolios, whether they are a long time client of the reinsurer or a new one.

Moreover, the reinsurer will want to know what its ceding company is doing concerning changes in its policy wordings and rating and it will not be content only with good intentions ; it will want to know what the ceding company has already done and may require that future plans be put into place by the ceding company as a condition precedent ; that is to say, if they are not put into place, there may not be any reinsurance.

Apart from these conditions, there will also be a reduction in the amount of cover available in Canada. This reduction in capacity will probably not be felt so much in the occurrence limit available, except for the most hazardous risks, where a marked reduction in the capacity of the facultative market will be felt, but it will rather be in the area of limitations to or even total exclusion of certain types of risks, such as pollution and liability for products exported to the United States.

In addition, it is probable that higher layers will be subject to an annual aggregate limit, such as has been the case for several years in property treaties. This will create a serious problem for ceding companies, since, although in property business it knows when a catastrophe has happened and can immediately go to the market to purchase additional reinstatements, this is not the case for general liability, where it can take several years before the actual cost of an important claim is known and it would be much too late then to purchase additional reinstatements.

The ceding company will therefore find itself obliged to decide whether or not to purchase additional reinstatements when its basic treaty comes into force and there is no scientific basis on which such

a decision can be taken – it is simply a question of purchasing all the protection for which the ceding company is willing to pay.

The conditions imposed by the reinsurer will undoubtedly create problems for insureds, who will find it more difficult to obtain insurance against certain risks. Some insurers will simply refuse to give coverage, while others will be ready to give it, but only for the amount they are able to retain net of reinsurance.

It is probable that the insured will need several insurers to obtain coverage close to the limit which it will be seeking against pollution and it is also probable that each insurer will require its own policy wording for its share, rather than participating in a subscription policy.

As far as concerns liability for products exported to the United States, it will perhaps be only a company with an American operation which will be able to give the limits required, and only on the basis of an American policy wording, reinsured in American treaties and rated in accordance with American pricing.

The text of the American policy will probably be on a claims made basis rather than an occurrence basis. As you no doubt know, Insurance Services Office in the United States has developed two new policy wordings, one on an occurrence basis and the other on a claims made basis. The Insurance Bureau of Canada is presently adapting the two policy forms for use on the Canadian market.

Reinsurers in the United States consider 1986 as a transition year from the occurrence to the claims made policy form and several have already stated that, from January 1, 1987, they will no longer reinsure original policies on an occurrence basis. You perhaps read in the *Globe & Mail* at the beginning of the month that even Lloyd's has raised the possibility of withdrawing from American liability business. The claims made policy will also have a clause to limit the retroactivity of cover on an occurrence basis which, in the great majority of cases, will be to a date no earlier than the inception date of the first claims made policy, to avoid giving double coverage for occurrences which have already taken place.

There is already pressure from reinsurers for the use of the claims made policy in Canada and we can expect this pressure to increase greatly during the coming renewal season for reinsurance

treaties, as well as in 1986. A certain number of American reinsurers have already decided to offer only the claims made policy form in Canada in 1986.

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Let us now go a little further into the future and therefore a little further towards the realm of fantasy.

Our industry abhors a void and a void will exist in various sectors of the general liability insurance market. We can therefore expect that specialized markets will develop to cover such risks as pollution, products, liability, chemical companies, etc.

The Reinsurance Research Council has already suggested to the Insurance Bureau of Canada the creation of a pool of all members of the industry to offer coverage on the "Spills Bill" in Ontario and the Insurance Bureau of Canada is studying this approach. After all, in automobile, truckers will be able to obtain from the Facility their liability insurance under the "Spills Bill", if it is not available from the open market.

However, it is difficult to imagine how our industry will be able to agree on rating criteria for the large variety of risks involved. Such a pool already operates for nuclear risks, but because of the catastrophic nature of the nuclear hazard, the norms required by government for nuclear installations are uniform and very strict. A general liability pool will have much greater problems in rating the large variety of exposures which it will face.

If the industry does not develop such a pool, we may see individual companies create their own pools to offer the cover required. In addition, some companies with large assets will perhaps develop their own specialized services. Gradually, a market will appear to fill the void.

The premiums will be huge and, because of the inevitable delay in finalizing claims, profits will also seem huge, at least for those companies which are not making them.

If this seems familiar to you, you should not be surprised. We are all aware of the cyclical nature of our business ; what we have not yet learned is how to avoid the cycles and there is no element in this

cycle which suggests to me that we have learned how this time around.

Let us continue on our trek towards the realm of fantasy.

With the profits which these specialized companies will show, at least on paper, the risks will become more attractive to other companies and competition will begin over again. At that point, rates will drop, underwriting standards will as well and, a little later, we shall be back in another crisis.

52 The elements of the next cycle will not be the same as those of the last – perhaps we have never succeeded in avoiding these cycles because each one, although apparently identical on the surface, is made up of different basic elements.

One element which may play an important role in the next cycle for general liability and for commercial risks as a whole is the reform of the regulations governing financial institutions, begun by Bill 75 in Quebec and the subject of a discussion paper issued by the federal government. The development of sales networks for financial services, which is one of the developments foreseen by these reforms, could have an enormous impact on the marketing of personal lines, where the efforts of companies with such a network will necessarily be concentrated.

The federal reforms may be delayed or even forgotten because of the failure of the Canadian Commercial Bank and the Northland Bank, which is presently the priority for the Minister responsible and the Finance Committee of the House of Commons, but we can expect nonetheless a movement towards the creation of sales networks by groups such as Power Financial, Trilon, E.L. Investments and the Laurentian Group, whether or not the federal law is modified, since there is certainly sufficient imagination in those groups to advance their interests under the laws which currently govern them.

We can probably therefore anticipate three years of competition for personal lines and, as a result, companies will not face the same competition for their commercial risks, the profits being made on commercial business being required to subsidize personal lines.

If the banks receive permission to create similar sales networks when the Bank Act is revised in 1990, it will probably set off a fur-

ther three years of competition. After this, companies which lost the personal lines battle will seek out profitable sectors in order to enable them to get back their market share. After analysis, they will discover that certain companies made sizeable profits on commercial business and they will direct their attention towards this sector.

It is not necessary to explain the result to you and if our scenario develops as described, which I admit is far from certain, the next crisis in liability insurance will be in 1995.

What can we do to avoid the next crisis ?

We must certainly put greater effort into the drafting of our policy wordings. It is no longer sufficient for underwriters to put on paper what they want to cover and not cover, have it checked by company lawyers and then publish it ; rather, the preparation of policy wordings will also have to be examined in minute detail by a group of independent lawyers, who specialize in the defence of insurance companies, since these are the people who best understand how a policy may be interpreted by other litigation lawyers and by judges. We should not expect these lawyers to guarantee their policy wordings against any possible mis-interpretation, since we would not be willing to insure them against this risk ; however, we should end up with a policy which will give us greater protection then we have at present.

It will also be necessary to consider the possibility of imposing certain limits on the quantum awarded under some headings, as has already been done by the Supreme Court of Canada for pain and suffering. Certain American states are beginning to put liability limits in place, but on a very selective basis.

In addition, the development of structured settlements will go further towards meeting the real financial needs of the injured party than the present system of lump sum payments.

However, it may be that the best alternative will be to eliminate from the law all question of negligence and to establish insurance on a first party basis, that is to say reimbursement for the damages suffered by the insured himself, regardless of any question of negligence. This system already is functioning in several countries for workmen's compensation and in Quebec for automobile insurance. The Insurance Bureau of Canada has developed such a system for

automobile insurance in the common law provinces, which could easily be adapted to all other forms of liability. Gross negligence could be dealt with under the criminal law, in order to maintain the deterrent effect of the existing system.

Our industry will also be obliged to find a solution to provide cover against inflation, but this should not be impossible if we consider the problems which we have faced in the past and those which confront us at the moment.

54 We have gone from today's crisis to arrive at what may be tomorrow's. I am convinced that our industry possesses the talent and expertise necessary to find solutions and to convince the legislators to apply them.

The challenge for all of us, each in our respective sectors of activity, is to begin now to concentrate our efforts on ensuring future success.

September 25, 1985

V – Les tribunaux et la nouvelle dimension de la responsabilité pour blessures corporelles, par l'honorable juge René Letarte, j.c.s.

Depuis une dizaine d'années, au Canada et au Québec, plusieurs phénomènes ont perturbé le domaine de la responsabilité à un point tel qu'un véritable climat de panique s'est emparé de certains milieux : le monde de l'assurance est menacé, les primes s'accroissent à un rythme effarant, les contrats cessent d'être renouvelés et plusieurs secteurs de l'assurance de responsabilité sont petit à petit désertés par des assureurs qui essuient des pertes de plus en plus considérables.

À titre d'exemple, l'*Actualité Médicale* du 12 août dernier se demande si les médecins sont toujours assurables et fait état d'une véritable crise débutant vers 1976 et qui a d'ailleurs amené une société de l'importance de *Gestas* à abandonner virtuellement tout le domaine de la responsabilité professionnelle. Alors que chez certains spécialistes de l'assurance, on estime devoir imposer des primes d'au-delà de $100,000 pour certains médecins, comme c'est le cas aux États-Unis. Le docteur Georges-Henri Gagnon, de la Fédéra-