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International Reinsurance Markets and their Effects on the Canadian Market.[1]

by

ANGUS ROSS

At a time when increased rates are proving the rule rather than the exception, I hope to provide you with a reinsurer's view on justification for these increases — some caused by external factors — which are, perhaps, not always evident to the insured, and thus in a small way to ease your task in explaining why rates are going up. The subject of my talk — International Reinsurance Markets and their Effects on Canadian Markets — is a topic of extreme timeliness since now, more than ever, happenings many thousands of miles away, like a stone cast into a pool, are touching Canadian insurance companies with their ripple disturbances and, through these Canadian companies, are creating waves upon the normally placid waters of the insuring public.

The subject of International Reinsurance is a highly complex topic, touching as it does on so many different aspects of financial, legal, governmental and other systems and in doing my research for this speech I have tried to limit myself to those areas where the effects of today's environmental, social and financial changes have had the most direct bearing on the original Canadian market.

To start off, I feel, it would be worthwhile to trace briefly the purpose, origins, and scope of reinsurance in order that a better canvas can be prepared upon which to paint the Canadian picture.

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[1] Speech given to the Montreal Risk and Insurance Management Association, March 20th, 1975.

Various forms of insurance can be traced back over 2,000 years to the times of the Phoenicians, the Romans and other major civilizations whose place in the world is now, alas, relegated to history books. The first records of reinsurance dealings are of far more modern origin, the earliest transaction only having been recorded as recently as 1370 when the most hazardous part of a voyage from Genoa to Sluys was reinsured. It is not entirely surprising that it was in the marine class that reinsurance first developed for in those days of cockleshell craft, the major hazard of loss of goods was certainly in the sea passage, and indeed, marine insurance was really the only class developing at that time. However, abuses of the practice of marine reinsurance led to its being made illegal in England in 1746 and it was not until over 100 years later, in 1864, that marine reinsurance was again legalized in that country whilst in the rest of Europe there was no such restriction. Among the other classes of insurance the earliest recorded fire reinsurance was in August 1813 by the Eagle Fire Insurance Company of New York.

It should be noted that the earliest reinsurances were between companies writing direct insurance business — the professional reinsurers (accepting only reinsurance) developed in the 19th century with the Cologne Re. beginning business in 1852. The Swiss Re. commenced operations in 1863 and the first, still existing, British company, the Mercantile and General, was established in 1907. Thus the early developments began in European countries — strengthened by Empires, Dominions, trading mastery and the vast industrialization which was the hallmark of the Victorian era in Europe. Today, of course, there are many strong reinsurance companies in other countries — such as the United States of America, Japan and South America — but it is to Europe, and to Lloyd's of London that people have turned for experience and expertise.

Turning now from the historical background of reinsurance to its function, we find that there are certain parallels with insurance; just as insurance permits an individual or a corporation to protect himself against certain perils, the occurrence of which could have a major effect on his financial or operating capabilities, so reinsurance permits an insurer to cover itself against certain contingencies which would otherwise seriously affect its ability to continue operations. It can be said that reinsurance has two major functions: to protect an insurance company against one or more unexpected and catastrophic losses which would otherwise impair its solvency and secondly to provide an insurance company with the capacity to underwrite risks of a far larger size than it could handle were it to use its own financial resources alone and not to assume a degree of dependency upon the financial backing of the reinsurer.

There are two basic categories into which reinsurance arrangements fall: proportional and non-proportional. Again, using a generalization, we could say that capacity is most often provided by the former and protection by the latter although these rules are by no means fixed. Under proportional reinsurance, the insurance company will pass a percentage of a risk or risks to the reinsurer, who will receive that same percentage of the original premium and pay the same percentage of original losses. In non-proportional reinsurance, the most common form is excess of loss where the reinsurer will only pay claims when they exceed a predetermined amount, either individually or in total from one loss; for this he charges a premium which might be a fixed amount, a percentage of the company's premium for the classes covered or a percentage scale according to losses recovered. This is, of necessity, a very abbreviated explanation of reinsurance types

and is intended merely to provide a bit of background knowledge applicable to the remarks which follow.

It is in the area of capacity that I will direct the major portion of my remarks, although the catastrophe element, as will be evident, nevertheless has a tremendous bearing on reinsurers' outlook.

It is an unfortunate fact that war and its accoutrements are probably the greatest spur to invention and innovation known to mankind, and it is in the period since the Second World War that we have seen an almost incessant expansion and improvement of industrial and scientific techniques and output and a tremendous increase in the insurable wealth of many nations. There were times during this period when it was felt that the capacities of the insurance and reinsurance markets in general would be tested to the limit and that a point would be reached when additional risk bearing capacity was no longer available. However, apart from the isolated instance of Hurricane Betsy, in 1965, this did not prove to be the case. As an example of this, we can look at the jumbo jets where, before they actually came onto the insurance market, it was felt that there would be a lack of capacity for their hulls (valued at around $25,000,000) and the liability coverages of $100,000,000 to $200,000,000. However, such was the state of the market at the times these machines came onto it that the initially high rates charged were very swiftly pared to a minimum as an over-capacity situation had developed.

But it is, perhaps, in the post-Betsy period that the most striking changes have taken place until we have come to today's market when we are genuinely seeing a reduction in capacity. In the immediate post-Betsy years there were massive rate increases on much original business, reinsurers charged far higher premiums for the catastrophe protection covers and the market changed from one of cheap (and plenti-

ful) capacity almost overnight to one of expensive (and reduced) capacity. Reinsurers made underwriting profits but it was not long before new markets came on the scene, attracted, like moths around a candle, to the profits they saw others pocketing. So competition increased, capacity increased and rates reduced. As underwriting profits reduced (but investment income — as I will soon mention — made operating profits almost a certainty) so national based insurance, and reinsurance companies cast their eyes in other directions — towards foreign markets for reinsurance business. And all went comparatively well until the last couple of years — and 1974 in particular when we began to see signs of an incipient capacity reduction.

But what exactly do we mean when we talk of a reduction in capacity ? The ability of an insurance or reinsurance company to accept business is, in nearly all countries, geared to its financial strength — to its surplus of assets over liabilities. In the post-Betsy period we have seen an illusory phenomenon which appeared to give companies a far greater strength and, thus, the ability to write far more premium than was later proven to be prudent. During these years it was possible for these companies to lose money on underwriting accounts and yet show overall operating profits through investment income; the almost continual rise of stock markets throughout the world being the major factor in this. Unfortunately this led to a decline in underwriting standards, a carelessness which failed to take heed of any advance warnings of the three major items which hit both insurer and reinsurer alike.

Firstly, inflation in court awards, the cost of rebuilding, repairs, and general insured values went up far more than could have been anticipated, thus highlighting the terribly inadequate rating structures appearing in most parts of the globe. Allied to this was a regrettable decision on the part of

many companies to issue 3 year policies which, whilst possibly having been correctly rated and underwritten at the outset, were nevertheless incorrectly rated and underwritten by the end of the first year. In addition we have many large industrial complexes insured on a guaranteed amount basis rather than full insurance to value. Thus, with inflation, these once full insurances became underrated first loss policies, providing satisfaction neither to insurer nor insured. The recent Asbestos Corporation loss is a case in point. Finally, coverages granted are now proving so broad that I can only, with difficulty, conceive of underwriters fully understanding the import of their actions (or inactions). James Bay is an example of this. Now, due to the gradual changeover by many companies from proportional forms of reinsurance (where the reinsurer — to a large extent — follows the fortunes of the insurance company) to non-proportional forms of reinsurance, the reinsurer suffered from the inflationary effects far more than the insurance company. Unable to forecast the sudden increase in the upward inflationary spiral, the reinsurer found himself paying many more claims at a level at which, previously, he could have anticipated few claims — and had based his premiums on prior assumptions that the low number of claims would continue. As most reinsurance contracts are either annual or continuous, only cancellable subject to 3 months prior notice before a certain date (usually December 31, although this varies in some countries) reinsurers had often agreed renewal terms before the inflationary effects became apparent. This is especially true in the liability classes where claims can remain outstanding for many years. Thus reinsurers suddenly found themselves in the position of having to play "catch up" at a time when inflation was fast increasing and undermining their ability to overtake the soaring claims costs.

Secondly, there was an inordinate number of major catastrophes after a fairly lengthy period of relative calm: Mana-

gua, Flixborough, Cat 74, Brisbane and Darwin to name but a few of these well known disasters. These ensured that many underwriting accounts would be in a deficit position and, again, it is reinsurers who bore the brunt of these losses on catastrophe protections whose rates, often, had fallen to uneconomic levels. An excerpt from the Chairman of the Commercial Union's report to shareholders is of interest here.

> "We are sponsoring a special study of the effects of short and long term changes of climate on weather conditions in certain parts of the world, because we may be entering, or even have entered, into a period in which different weather patterns may create damage and consequently losses on scales and in places that we have not experienced in recent years.
>
> When large losses arise through severe weather, such as occurred in Australia and through an exceptionally extensive fire, such as Flixborough, a large number of reinsurers throughout the world bear a high proportion of the losses in excess of a certain level under catastrophe reinsurance arangements which we have with them. During 1974 they have had particularly bad experience and some increase in the future cost of catastrophe reinsurance is therefore inevitable."

Thirdly, and possibly the most devastating blow, stock markets crested the wave and plunged into deep troughs from which they are only just beginning to struggle back up to the surface. As at March 12th, even after strong upturns, the major markets were still a very long way down from the record highs which they had set, in most instances, less than 3 years previously; London was down 47%, New York 27%, Canada 24%, Australia 45%, Japan 25%, Hong Kong 82%, France 36%, Italy 57% and only Sweden, at 9%, was down less than 20%. So insurance and reinsurance companies found themselves in a most unusual situation. In order to reduce underwriting losses and indeed turn their underwriting accounts back to profitability they now have to increase rates to proper

levels — but they are unable to do so and still retain all their prior business as they are not sufficiently solvent to bear the increased premiums. In their March 10th issue, *Best's Insurance News Digest* showed the American insurance industry at December 31st, 1974, had lost 22.8% of its consolidated surplus at December 31st, 1973. So new business is cut, poor risks are cancelled and the markets's general ability to absorb the huge value risks and even the smaller value poorer risks is tremendously reduced. And this position is being experienced not solely by the insurance companies but also by the reinsurance companies, who, as I said, probably bear a larger proportion of major catastrophes than the insurance companies do. Thus, reinsurance companies, which a short while ago would have been delighted to accept large chunks of business from ceding companies, are now in the position where they have to choose very, very carefully, in order to make the best use of their capacity. But how do these factors relate to the Canadian insurers and insurance buyers markets ? — Again, a look backwards into history will provide some interesting features.

Canada as a Dominion of the United Kingdom, almost inevitably found itself with a large number of branch offices — and later subsidiary companies — of the major British insurance companies providing much of the insurance market.

In similar fashion, Canada's proximity to the United States, with its far greater population and industrial base, meant that many of the major United States companies would also be strongly featured on the Canadian market. The true Canadian companies, with far smaller capitalization and assets, and thus a smaller capacity for risk bearing, have very often found themselves in a position of « tailend Charlie » having to follow the dictates of the outside market. As you are no doubt aware, the results of Canadian general insurance

business have not been very profitable over the last decade — in fact 1974 will probably produce underwriting losses in excess of $300,000,000. However, for various reasons, the insurance market has not reacted to these losses in the way in which it should have done. Part of the problem has been that the British and American head offices of the subsidiary companies or branches have been making profits in their other territories and thus the Canadian results have been hidden away; not enough to upset the overall picture they have been left in a corner to grow mouldy. But, unfortunately, or possibly fortunately, mould has a propensity for self-propagation and, in 1974, when Canadian losses, as I mentioned, were severe, losses in the United States, Britain and other countries have also been severe; thus the head offices are now taking a far closer look at their Canadian operations.

A second feature is that the Canadian reinsurance market has never been really developed in the sense that the European markets have been developed. Whilst the major reinsurers were represented here it was not until 1951 that the first reinsurance company was incorporated in Canada and even today there is only one Canadian-controlled reinsurance company. Among the countries represented by reinsurers in Canada are France, Britain, Germany, Switzerland, the U.S.A. and Sweden, to name but half a dozen. Thus the capacity available in Canada has never been large enough to cater to the needs of Canadian insurance companies, especially in these days of highly inflated values, and there has always been a need for the capacities provided by international reinsurers.

Now, I am not about to question the technical abilities of these foreign markets for, as a broker, it is my duty to call upon their services in many, many instances, but I do have a lingering suspicion in my mind that the further away one is from the original risk, the less one is likely to see the hazards

involved therein and, therefore, the lower the rate charged is likely to be. It would follow, therefore, that much Canadian reinsurance business has been placed in outside markets at rates which, in the light of experience, have proven to be somewhat inadequate. (Although this is, of course, not true in all instances). A prime example of this is in the aviation market where severe competition — induced by an over-capacity situation world-wide — sent rates tumbling by 40%, 50% or even more. Additional outside reinsurance capacity meant severe rate cutting by companies in Canada and the profits made in 1971-72 were swiftly eroded by the losses in 1973, and probably 1974 also.

Now it is also a fact that the further away you are from a risk, the more likely you are to react violently to adverse results, comment and rumor about that risk or the territory and this indeed is proving to be the case in many instances. And here again, with the capacities available in the Canadian reinsurance market being unable to fulfill all the needs of the Canadian insurance companies we find that the wheel is beginning to turn round the circle from low rates being quoted by foreign markets who thus obtained the business, to high rates being quoted by foreign markets whose capacity is required for completing placement of the business.

Now one of the costs which an insurance company must take into account in running its business is the cost of the reinsurance protection or capacity which it purchases and, when this cost goes up, as in almost every service, or indeed retail operation, the cost is passed either partially or fully on to the original insured or customer — as is happening today.

So, as we have seen, the international reinsurance market itself is controlled by certain features over which it has, to a great extent, little control; natural forces, such as, earth-

quake, tornado, windstorm, flood; stock markets, and, finally, the results of the primary markets. When the reinsurer loses money he will impose more restrictive conditions or higher costs upon his ceding companies and these costs have to be borne by someone.

And what of the future? — it is obvious that the insurance companies in Canada cannot continue to produce underwriting losses of the severity and magnitude which we have seen in recent years, for if they do so, then the additional capacities and protections granted to them by reinsurers will become increasingly restrictive and expensive. In the same way the results of other territories will affect to an extent the rates charged by international reinsurers on Canadian business as underwriting trends in one area tend to be reflected sooner or later in other areas. Also reinsurers will, to a certain extent, look at their overall figures and make adjustments accordingly.

So, even assuming that Canadian markets do return to a degree of profitability in the near future, I could not expect reinsurance costs to level off too soon and begin again the reductions which were seen once Betsy was cleared from the minds of underwriters. (Whilst many underwriters have notoriously long memories, there are always new markets who have no memories at all!) It is to be hoped, however, that the costs to be passed on to the insured, at least insofar as reinsurance is concerned, will begin to stabilize in the near and, even, possibly, to reduce in the more distant future. Profitability is obviously the signal of a light appearing in the tunnel — but without a large degree of common sense and acceptance of certain facts by insureds and insurance companies alike, then I am afraid that the light at the end of the tunnel could well prove to be a train . . .