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Résumé de l'article

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## Canadian Insurance and some of its Current Developments and Problems[1]

*par*

RICHARD HUMPHRYS[2]

*Dans cette conférence prononcée devant les membres de la* Canadian Institute of Actuaries, *le 11 novembre 1982, M. Humphrys étudie avec beaucoup de clairvoyance les problèmes de l'industrie de l'assurance. Pendant longtemps, il a été le surintendant chargé de contrôler les aspects les plus divers de l'assurance-vie et des assurances en général. Dans ce texte, il présente les difficultés actuelles et il laisse entrevoir certaines décisions qui seraient éventuellement prises pour donner aux assureurs une plus grande sécurité dans leurs opérations. M. Humphrys s'attaque au problème avec la plus grande simplicité. Aussi, sommes-nous certains que nos lecteurs y trouveront le même intérêt que nous.*

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[1] Speech delivered before the Canadian Institute of Actuaries on November 11, 1982.

[2] Mr. Humphrys is Special Adviser for the Department of Insurance.

*de nécessaire à cette provision essentielle de l'assurance autre que vie ». Venant d'un ex-surintendant des Assurances, l'admission est à la fois importante et bien caractéristique de l'homme prudent et renseigné qu'est M. Humphrys. A.*

I am going to speak this morning about life insurance, and property and casualty insurance, some contrast between these two broad classes, some current developments and problems and what role the actuaries can and should play. My main emphasis will be on property and casualty insurance since this group, for the most part, is well-schooled and well-experienced on the life insurance and pension side. But perhaps not so many of you have a close acquaintance with property and casualty insurance except as customers, and perhaps even fewer have thought much about the role of the actuary in this field.



I know that some of you in the audience are experts in property and casualty insurance being Fellows of the Casualty Actuarial Society and, therefore, some of what I have to say is familiar to you. But it may well be that you also have not thought much about the contrast between the two broad areas of insurance and the differing roles of the actuary.

I am not myself a Fellow of the Casualty Actuarial Society but I have, in the course of my career, had a close contact with the property and casualty insurance business. I have had reason to become aware of the special problems of this kind of business and I have had to deal with a number of cases where survival was at stake. Fortunately, not many of these proved to be insoluble, but some did. So I speak with some personal knowledge of certain aspects of the business and these are perhaps the aspects that are of most concern to the public and the shareholders.

The years of exposure that I have had on the regulatory side to property and casualty insurance, life insurance, pension plans and general financial intermediaries have given me a broad perspective, and in this light, I have always found the property and casualty business interesting, fast-moving, exciting and, in my view, in need of increasing numbers of technically skilled people. This need has grown rapidly in recent years as the Canadian industry became more and more autonomous, even though still dominated by foreign ownership. If I were at the outset of my career today, I would certainly want an FCAS as well as an FAS degree.

First, about life insurance. The role of the actuary in life insurance and life annuities hardly needs to be rehearsed before this group. The preparation of mortality tables has traditionally been a priority. The early efforts were devoted towards a search for underlying mathematical laws. More recently, tables have been developed with concern as to the future trends thus leading to projected mortality tables.

The next priority was the calculation of premiums based on mortality assumptions and the future expectations concerning interest and expense. But what a contrast in recent years as compared with three, two or even one generation ago. With interest rates and expenses at the levels they have now achieved, the importance of mortality has paled compared with its once dominant position. Adding to this the forces of competition that are driving the life insurance companies to the savings deposit business to maintain or regain its share of the public savings, we find that interest rates and expense rates are the dominant considerations.



That is not to say that mortality is not important. Not at all. When we look at some of the assumptions being made concerning term insurance with adjustment for non-smokers, the rates have become so low that it seems impossible that the business should continue, except perhaps in very large portfolios. Here, mortality assumptions are critical.

Mortality is still important too in the pension field, although again interest rates have reached a level that the resulting discounting factors would screen considerable changes in mortality.

I may say, in passing, on the question of mortality, we seem to have changed from the early efforts to find a number of underlying mathematical laws, to efforts to determine the possibility of significant extension of human life. We now ask : "Is there in fact some genetic limitation to the life span ?" I think that all actuaries concerned with mortality studies should be very conscious of current work in this area. It may well be that we are on the threshold of startling changes in mortality at upper ages, at least to the extent of squaring the mortality curve if not an extension of life span. If this should happen in a short space of time, as for example a decade, the effect on pension plans would be enormous.

It may be that this seems idle speculation. One need only cast back to the days when we seriously considered actuarial cal-

culations at zero rate of interest to realize what kind of unexpected things can happen. The rapid changes in recent years have destroyed many traditional beliefs and assumptions.

It's worth noting too that the prevalence of participating life insurance in this country greatly reduced the pressure on actuaries as far as the determination of premium rates were concerned. The problem in that context was not solvency but rather one of equitable distribution of excess margins included in the premium rates. This is an important and difficult problem but is not fraught with the same fears and pressures as arise in questions of solvency.

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Actuarial reserves, i.e. the amount that should be in hand to cover future claims and expenses after taking into account future expected premiums or pension contributions, is the third major preoccupation of the actuaries. Here again, we find things changing from the days when it was easy and comfortable to set up reserves on a very strong basis and let events release the excess reserves to income as experience unfolded. Nowadays, the competition does not permit this kind of luxury. Instead, reserves have to be very much more closely tied to the actual expectations and we look to capital and surplus for safety margins, and capital and surplus margins are not as easy to come by as they once were.

Interest rates, fluctuating as they have done in recent years, have brought actuaries to the point of despair so far as long term predictions are concerned. Instead, we find moves in the savings field to shorten term of interest guarantees and in fact to put more and more of the business on a day to day basis rather than on the structure of long term guarantees. This, of course, puts the interest risk back on the customer and turns an insurance operation into a kind of mutual fund.

In summary, I think that in life insurance, events have pushed the actuary into a much more difficult role where he has to look very seriously at his margins in terms of the ability of the company to meet its obligations rather than, as in the past, in terms of contingency reserves and distribution of dividends. He also has to move to a much shorter term in all his considerations in a less predictable environment, particularly as regards interest and expense. Thus, I think the actuary in the life insurance field has found himself pushed very much towards the kind of world that the casualty actuary has lived in for a long time. Actuarial problems now swing much more to investment than to mortality and the problems of

matching are now dominant as contrasted with traditional pre-occupations with mortality.

Now, for property and casualty insurance. I should say first that this is big business in Canada. Premiums written in Canada in 1981 amounted to $9.9 billion and direct claims incurred to $7.7 billion. This compares with insurance premiums in that year for life insurance and annuities amounting to about $8 billion. So you can see that the premium volume is in excess of the premium for life insurance and annuities in Canada. About $2 billion of the $9.9 billion represents accident and sickness business done by life insurance companies but that also comes within the concept of property and casualty business in some respects.



There are a large number of companies in the field, some 250, excluding over 100 life companies doing accident and sickness business and the business is widely spread. There are about 15 companies with premium income over $100 million and two-thirds of these are foreign companies or subsidiaries of foreign companies. Thus, we see that the big companies are for the most part foreign-controlled in contrast to the life insurance business in this country where most of the big companies are either mutuals or Canadian-controlled stock companies.

As is the case for life insurance, the great problems for property and casualty companies are the underwriting, i.e. in a broad sense, matching the premiums to the risk, and reserves but beyond that, the generalization and the similarity end.

Underwriting, if it is not to be purely subjective, requires a statistical background of claims experience and classification. The problem is difficult enough in the life field and we are all aware of the voluminous statistical material constantly becoming available through industry-wide mortality studies, general insured mortality, impaired lives, specific risks. In the property and casualty field, statistical data are no less needed but are much more difficult to obtain, to classify and to analyse.

The compiling of statistics showing claim frequency and average claim costs under automobile insurance is well-organized. It is under governmental auspices though carried out by the Insurance Bureau of Canada. All companies must contribute. The classifications are extensive, many regions, several classes according to the use of the automobile and further subdivided by the accident-

free record of the driver. But to move from those figures to premium rates requires adjustments for trend, type and make of car, age, sex and marital status and perhaps other underwriting standards imposed by individual companies.

To add further to the problems, the industry and governments are, as you know, deep in discussions swirling around the validity and social acceptability of existing rating systems, particularly where age, sex or marital status are involved. Work is now going on to devise new statistical reporting plans and new rating standards. The need for, and market for, technical analysis of these statistics as justification for premium levels is not only in companies and industry organizations but in governmental service as well. Automobile insurance premiums are now under official control in some provinces and are under continued surveillance by regulatory officials in others.



There is always a problem in the use of such studies as to the extent of subdivision. Rates cannot always be set and maintained at a scientific level. Regional disparities are great and there is plenty of opportunity for specialisation. Pockets of competition may force rate changes. There is always pressure to fragment statistics to an extent probably not justifiable from a statistical point of view. So even with massive statistics, the analysis, use, grouping and underwriting decisions continue to involve much judgment.

Moving outside of automobile but still in the area of personal lines of insurance, statistical returns are much less complete on an industry-wide basis but much material exists. A lot of effort goes into assembling underwriting information sufficient to classify risks and to give a statistical basis for estimating loss expectations by class. Pooling of information is essential because even the largest companies would not have enough data to give a good base. The problem is very difficult because of the wide variety in risk, the variations in coverage and the rapidity of change. In personal lines, the existing statistical plans involve some 10,000 cells of experience data. A lot of technical effort is put into these matters by industry organizations such as the Insurance Bureau of Canada and the Insurers Advisory Organization but more is always needed.

The development of reliable industry-wide statistics and rating information in commercial lines is relatively recent. Classification there is even more difficult than for the personal lines, in fact, I would say much more difficult.

It is interesting to note that participating insurance has had only a modest development in the property and casualty field even in the personal lines. In the early days, there was quite a development of what was known as insurance on the premium note system. This was principally for personal lines and had its origin in rural areas. Under this system, the policy-holder would sign a note for a specific amount but he would only pay a fraction of this. Should the money paid not be adequate, there would be an assessment on the note. This is participating insurance in reverse. However, this has practically died out in the Canada scene. There was also years ago some inssuance of insurance on the mutual principle with the payment of dividends but with the rising costs in an inflationary environment, all companies have scrambled to make ends meet and dividends have disappeared. Thus, there is virtually no participating insurance in the property and casualty field in Canada except perhaps a small volume in the hands of farm mutuals. There remain some purely mutual operations known as reciprocal exchanges but these are highly specialized and do only a minor proportion of the business.



Participating insurance can only flourish where it is possible to charge initially a premium higher than the expected claim cost. Where competition is fierce, as it is in the property and casualty field, this evidently does not sit well with policyholders. Companies have therefore found themselves constrained to meet competition head on and to lower the quoted rate to the greatest possible extent. This puts a good deal of pressure on the underwriter and on the actuary if he is involved in the premium setting.

The problem of rate setting has led to a number of different supervisory approaches. In some jurisdictions, rates are controlled and all companies must charge the same rates. This stifles competition and has pretty well disappeared. In this country, years ago the so-called board companies were members of a group that pooled statistics and set premium rates on a joint basis. Other groups of companies tended to set their rates by reference to the board rates. This practice has, however, pretty well disappeared by reason of our competition legislation and there are now no organizations that bind themselves to accept or to charge joint rates.

The uncertainty and difficulty in obtaining a statistical background for rate setting of course leaves the company in a much less certain position concerning the adequacy of its premiums than in

the case of life insurance. As a consequence, retention limits have to be set at levels where companies can afford a serious mistake in their premium quotations. This raises the importance of fixing limits of retention and of determining adequate levels of capital and surplus having regard for the retention limits and the nature of the business transacted by a company. Retention limits are of course operated in terms of reinsurance rather than in terms of the original policy.

The role of the actuary would be very important in setting retention limits because there could be and should be technical studies as to the extent of the risk that a company can expose itself to and what variation it can stand. Studies are needed of maximum possible claims, expected claims and the extent to which companies can stand variations in anticipated experience. This is an important role for actuaries in the property and casualty field, one that I think is much more developed in the European scene than here.

Coming now to the important questions of reserves, these have to be considered in two major categories. One is the policy reserves, i.e. the amount in hand to cover expected future claim costs and expenses during the unexpired portion of the policy. The other is the claims reserves, i.e. the amount to be set up as the estimated liability under claims that have been reported to the company but are in the process of being settled. It also includes as an important element a provision for claims that have occurred at the date of the financial statement but where no notice of the claim has yet been received by the company. These are known in the industry as the IBNR reserves, incurred but not reported.

As far as the policy reserves are concerned, a good deal more work needs to be done than has been observed in the Canadian scene in the past to determine adequate levels of policy reserves. In the past, the practice has been merely to hold the unearned premiums calculated usually on a pro rata basis and after some deduction for acquisition expense. This, of course, makes adequate provision for future claims in the unexpired portion of the policy only if the original premium was adequate. Some information can be gained by the actual experience up to the statement date on the policies in force.

Concern over policy reserves has not been perhaps great in the past because the general view used to be that the unearned premium would always be adequate since a company could cancel a

policy at any time and the unearned premium would be the measure of its liability. But this is an unsound view, particularly in the environment of today. It may be argued perhaps on a bed rock basis of solvency but for a policy reserve for an on-going concern, one must look to claims expectations and not to cancellation values.

Mid-term cancellations are simply not politically acceptable in mass lines, such as automobile and household insurance, and companies have to recognize that fact. Even in commercial lines, mid-term cancellations can give a lot of trouble. If any company were forced to do this to an extensive degree, it would be a dead duck in the market place. The fact is that companies and their actuaries must now look very much more closely than they have in the past on policy reserves as being provision for expected claim costs rather than merely as a measure of the liability on cancellation.



We have not in the supervisory scene in Canada got to the point of demanding a certificate as to the adequacy of policy reserves in the property and casualty field but the matter deserves serious study, and it is clear that it is not sound or practical to continue merely on the basis of the unearned premiums. If nothing can be done as respects the determination of policy reserves on a scientific basis, then one is forced back to controlling the original premiums in order to make sure that there is enough on hand to cover expected claim costs in the unexpired portion of the policy. This, in fact, was the solution adopted in some jurisdictions in the past as I mentioned earlier. Competition, however, seems to have destroyed this which again raises the importance of determining adequate policy reserves and of having adequate amounts of capital and surplus.

The testing of premium adequacy involves, of course, the comparison of the premiums applicable to the period under study, the earned premiums, against the claims and related expenses arising during that period. This sounds simple but it is not, particularly because the actual cost of claims is not known certainly for some considerable time after the period under study has expired. The estimate made of the cost of unsettled claims is vital in determining the underwriting experience and so the premium adequacy.

Which brings me to the question of claims reserves. These are perhaps the most sensitive element in the balance sheet of a property and casualty company. It is here, in my experience, that

trouble comes first. If a company is facing serious financial pressures, it always seems that the claims reserves are the first place where the company tries to salvage something to improve its apparent financial position. Establishment of claims reserves is an extraordinarily difficult operation and is very much a subjective matter. There is plenty of literature on the subject but mathematical techniques have not yet been developed that give a reliable testing base.



Companies may establish claims reserves on a case basis or on a formula basis or both. Much depends on the estimate of the claim in the documents that are submitted at the time the claim is filed. But it is often extremely difficult at the outset to determine what the ultimate payment might be, particularly under liability claims. The persons reviewing the claim may be optimistic or may be pessimistic. The whole atmosphere in a company including its financial results has an effect on decisions about claims reserves. Inflation has a major effect.

While some may think that the establishment of claims reserves is not a particularly actuarial problem, except perhaps for instalment payments under accident and sickness policies, still it seems to me that actuaries are the most appropriate of all professional groups that I know of to play an important role in this difficult problem. It involves an estimate of the actual payout under claims that have been filed and this requires a judgment based on the nature of the claim, the amount asked for by the claimant, the professional views on file from lawyers and others, the trends in claim settlements, the replacement costs of damaged property, depreciation and a whole host of other factors. Actuaries, of all the professions, are those trained to weigh a variety of imponderable influences and come up with actual dollar figures that represent some distillation of the multitude of circumstances affecting the results.

All this is not to say that it should be the actuary's job to examine every claim file and form a judgment as to the amount of reserves to be established, but there have to be some guidelines. There have to be policy principles and there has to be some kind of procedure for checking trends and going back and measuring the appropriateness of systems that have been used in the light of actual payout experience. This is a highly technical problem and

one that needs a lot more study and a lot more technical discipline than has been evidenced so far.

By way of illustration, consider for a moment the question of allowing for expected investment income in establishing claims reserves. A life actuary would almost automatically expect to discount such reserves to take interest earnings into account. But this has not been traditional in the property and casualty business. In fact, the tradition has been to focus first on the underwriting results, that is to say, the comparison of premiums earned with claims and expenses incurred. Investment income is then brought in in a way that seems, to some, almost an afterthought. This approach may have had a certain validity when interest rates were two or three percent and when leverage was low. But now, with the high interest rates – and they are still high notwithstanding the recent decrease – and leverage ratios approaching two or three times what they used to be, it is no longer valid to ignore investment income. In fact, under current conditions, companies can scarcely expect to have a continuing underwriting profit. If they did, the return on equity would be very high and competition would quickly lead to rate cutting. So, an underwriting loss is nowadays almost the normal way of life. This is strange and misleading. There should be a better way to present accounts, leading to greater stability in earnings and premiums.



To get back to claims reserves, the common test, as in mortality studies, is to look at the experience. How did you actually do as compared with your expectations ? And we do that. Run-off tables are completed for financial statements showing or attempting to show how actual claim settlements compare with the reserves. Unfortunately, such tables are usually prepared on a broad basis and give only a rough test. They may show good results while masking some very bad trends. This whole area of actual to expected needs plenty of analysis and plenty of wisdom in judging the results because of rapid changes in underlying forces – inflationary trends, concentration of values, changing social attitudes, for example in liability settlements, and mechanical and technical developments.

I suppose that over the years, there has been a general attitude that a company will do the best it can, will follow the run-off and revise methods if experience shows persistent underreserving. In the background, there was the presence of strong margins of capital and surplus so that errors in reserving would not spell dis-

aster, just a fluctuation in the net operating returns. Nowadays, though, the capital and surplus margins are thinner. Whereas we used to think that a one to one ratio was as far as a company should go, i.e. premiums, net of reinsurance should not exceed capital and surplus, we now find that companies write 2, 3 and even 5 or 6 times capital and surplus. If you take unearned premiums at one-half of the written premiums and outstanding claims at about 1½ times unearned premiums, you can see that small errors in claims reserves can make a great hole in the capital and surplus margins.

*12* A most important element of claims reserving is the provision to be made for those claims that have occurred but have not yet been reported to the company. There is always a lag in reporting claims and this lag varies by the nature of the business, by region, etc. The provision for incurred but not reported claims in fact has to be done on a formula basis. Many companies merely go by past experience measuring the claims reported in the first two or three months in the year that have occurred prior to the start of the year against the claims actually reported and use these kinds of ratios in the future. However, as any actuary will quickly appreciate, this is valid only if all the surrounding circumstances stay the same. It can lead to serious underestimating of claims if the company is rapidly increasing its volume or if claim costs and claim frequency are rising or indeed if the volume of business shifts from one class of insurance to another, a technical problem of considerable difficulty.

By reason of the nature of and importance of claims reserves, it seems of major importance to have an objective view concerning their adequacy. As a consequence, serious consideration is being given to requiring an actuarial certificate on a regular basis concerning this matter, but perhaps I should say an actuarial opinion rather than a certificate.

After the remarks I have made about claims reserves, many may feel that the whole question is too full of uncertainties to expect any one to put his name and his professional reputation on the line in a statement of opinion. But it is not all chance. First, there are clear company patterns. Some companies always seem to do well. Others are always short or uncertain. So there are patterns. Second, someone has to, in effect, put his name on the line, be it the company officer who signs the statement, the auditor who gives his opinion concerning the fair presentation of accounts or the

regulatory official who permits the company to continue in business. So it is being done. And I would like to see it done on a professionally responsible basis by people with appropriate knowledge and technical training.

My last remark points up one of the difficulties faced in this respect in Canada and perhaps elsewhere. This is that there are not many technically qualified actuaries to take on a role such as this. Towards the end of my term of office as Superintendent, I did raise this question with the CIA and suggested that consideration be given to the need of actuarial opinions in this area. I thought that the Institute would address the problem of improving the supply of technically qualified people for the purpose. Obviously it is not possible to generate a great number of Fellows of the Casualty Actuarial Society overnight, but it may well be that as an interim measure, some kind of special study course and qualifying examination could be put in place that would provide a body of technical experts to address this problem.



Of course, one of the reasons that there are few casualty actuaries in Canada is that the great bulk of the business has long been in the hands of branches of foreign companies and subsidiaries of foreign companies. In these cases, the technicians are usually at the head offices rather than at the branch offices in Canada or in the Canadian subsidiaries. As a consequence, there has up to date been only a limited demand in Canada for casualty actuaries. This is changing now by reason of the growth in volume and the increasing autonomy of the Canadian branches or subsidiaries and I think we will see a growing market in the future for professional actuarial opinions concerning claims reserves and possibly policy reserves as well, not to mention the broad question of underwriting standards and statistics.

I have mentioned in one or two places the matter of reinsurance, particularly in relation to premiums and retentions. I want to make a further reference to this before I close. The adequacy of claims reserves as reported by most companies is very much dependent on the validity of the reinsurance arrangements in place. We have found from recent experience not only in Canada but almost world-wide that reinsurance arrangements do not always represent a completely reliable asset and, at the same time, we have a number of companies, I would even say many companies, where if their reinsurance went sour, they would be insolvent.

The problem seems to be located mostly with intermediaries. Where we have had trouble, it has only rarely involved an insolvent reinsurer but rather has involved a chain of intermediaries leading at the best to delays and reporting problems and at the worst, to denial of claim and charges of theft or fraud against the intermediaries. This kind of thing was an important element in two of the three small companies that are now under liquidation here. If a small company has reinsured the great majority of its business, even if the reinsurance is good, there can be months and even years of delay in collecting if unreliable intermediaries are involved. A company could face insolvency merely because of the delay. In fact, one of our cases came to a crisis because of the denial ab initio of a major reinsurance treaty. It may take years to litigate this question but in the meantime we have no option but to stop the company's operations.



So the question of reliability of the reinsurance receivables also becomes an important factor in stating an opinion concerning claims reserves. It gets quite interesting, doesn't it ?

For some reason that has always been a mystery to me, Canadian capital has not been attracted in large amount to the property and casualty field. As a consequence, we have only a few major Canadian controlled companies in this field and virtually no business outside Canada. This is in startling contrast to the life insurance field where Canadian life insurance companies dominate the field in Canada and have long had an international reputation. It seems to me that Canadians should have as much technical expertise and capital available to transact the property and casualty business both at home and abroad as do countries such as Switzerland, Norway, Finland, but it has just not developed. Perhaps the Canadian temperament does not respond to the wide swings in experience and the almost wild uncertainties of the property and casualty business in the current environment. But perhaps too, greater technical expertise applied to this business would remove some of the uncertainties.

Well, I think I have talked long enough to give some kind of feel for the significance of the actuary in the general insurance business and some feel for the contrast between this kind of business and the life business. I think that the life actuaries should be more familiar with the property and casualty field. They would find it interesting, exciting and challenging. The business is facing some

testing times now. It is very susceptible to inflation, it is exposed to public and political attack at every stage, particularly in the personal and automobile lines. Experience has shown that governments are ready to move in and take over the business if they think it is politically expedient. Thus, the problem is difficult to manage, is under close political and public surveillance. It is growing in premium volume but not in profits and is facing difficulties in getting adequate capital to provide the necessary safety margins as premiums are thinned down by competition and by inflation. But I think the business will survive. It needs, I think, a strong injection of technical expertise and particularly that expertise that knows and understands the Canadian environment. I hope that Canadian actuaries will become interested in this field and that we will see a growth in casualty actuaries in Canada and in the role they play in the development of this business in Canada. This will not only improve protection for the policyholders but will increase investor confidence and perhaps lead to an increased participation in this industry by Canadian capital.