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Some observations on Excess of Loss Treaty Claims Reserving in Canada

by

Mr. Len S. Harding

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L'assurance, comme la réassurance, a depuis quelques années des problèmes dont la solution n'est pas facile. Dans certaines revues anglophones, on a fait paraître, au sujet des questions qui se posent en réassurance (excédent de sinistres), une étude fort bien faite de M. Len S. Harding, vice-président de la Mercantile and General Reinsurance Company. Avec l'autorisation de la revue⁽¹⁾ et de M. Harding lui-même, nous reproduisons son texte. Il date du début de 1981. D'un autre côté, les problèmes étant les mêmes, l'étude est encore d'actualité, croyons-nous. La voici :



The very unprofitable underwriting results in 1980, 1981 and 1982 of Reinsurers registered in Canada as shown below,

Year	Net Premium Written \$	Net Premium Earned \$	Earned Loss Ratio %	Combined Ratio %	Underwrit- ing Loss \$
1980	451,441,356	419,085,297	77.20	113.70	58,544,869
1981	540,097,574	501,761,474	83.40	122.10	109,543,049
1982	591,483,976	578,636,266	80.00	113.50	80,647,173

(source : Canadian Underwriter Magazine)

must cause any responsible Reinsurer serious concern, particularly now that Interest Rates have fallen and the probability of Investment Income outweighing Underwriting Losses becoming much more remote. It is interesting to note that the ratios of the General

(1) *Reinsurance*.

(2) Depuis les choses ont changé, toutefois.

Companies (Private Sector) for the years in question were somewhat better⁽²⁾.

Year	Earned Loss Ratio %	Combined Ratio %
1980	75.80	110.30
1981	80.90	115.50
1982	74.00	107.00

(source : Canadian Underwriter Magazine)

Much of the underwriting grief of the last decade can be attributed to the failure on the part of Companies and Reinsurers alike to charge adequate premiums, particularly in Commercial lines, commensurate with the risk assumed plus a margin for expenses, taxes and reasonable profit.

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However, in order to arrive at an adequate premium for the risk assumed one must know the true claims cost for such a risk. Not only must the actual amounts paid together with any outstanding case reserve be known but also any anticipated "Additional Case Reserve" (ACR) and reserve for "Incurred but not Reported" (IBNR) claims. The principle applies to individual risks or a Treaty.

Inaccurate Loss Reserves will lead to incorrect and often inadequate premium charges. Many liability claims mature long after the period for which the rate was set and without some action being taken to "load" rates for this fact it means the premiums charged by the Insurer for the primary cover and by the Reinsurer for the Treaty protection will both be seriously less than that which should have been charged to cover the eventual cost of the claim and still leave a margin for reasonable profit. Perhaps equally important they will lead to unsound management decisions. Understated Reserves will produce financial results which falsely indicate the Company or Reinsurer can afford to reduce rates or relax the terms of cover provided. To do so will lead to unwarranted and very unsound competition which could in turn lead to insolvency of those following such an irrational practice.

In recent years Canada has been subjected to an "explosion" in legislation and several socio-economic changes all of which have had a significant effect on the ultimate cost of claims. Unfortunately, it

(2) Depuis les choses ont changé, toutefois.

would appear that some Companies and Reinsurers have chosen to ignore the effect these changes have on loss reserves which may partly answer why there is a general inadequacy in loss reserves.

The following are but a few of the examples of legislative and socio-economic changes to which I have referred : –

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1. *Family Law Reform Act (Ontario) 31 March 1981* – This Act allows for damages to be awarded for loss of care, guidance and companionship. In some cases claimants have included ex-wives, step-brothers and sisters, nieces and nephews, aunts and uncles. Apart from the possible increase in awards due to the increase in the number of claimants there will likely be an increase in the cost of investigation and defence because of the number of plaintiffs.

2. *Gross Negligence* – The law in Ontario no longer requires an injured passenger in an automobile to prove gross negligence when suing for liability. This change increases the frequency of claims.

3. *Increase in Provincial Statutory Third Party Liability Limits Under Automobile Policies* – Increases in Statutory Limits continue to take place. These increases are more often than not “written in” to the primary automobile Insurers policy without charge. However, in many instances all of the additional liability is passed on to the Reinsurer under the Excess of Loss cover.

4. *Prejudgement Interest* – This is now allowable in Ontario and while it is payable in the case of Automobile insurance, within the policy limits it does add substantially to the cost of the claim. The rate of interest is usually that which was in effect the month prior to the date the writ was issued. The interest is claimable from the date written notice is given. A rate of interest of 10% awarded for 7 years has a significant effect on the claim’s value ; once again this is often passed on to the Excess reinsurer.

5. *Underinsured Motorist Endorsement (SEF 42)* – There is evidence of more claims arising from this “first party” cover which tend to involve very severe injuries. These claims are often late reported because of the fact it is difficult for ceding companies to obtain information as to the adequacy of the Third Party’s liability limits. The premium charge for this cover is extremely low (on average \$10.00) in relationship to the exposure.

6. *Uninsured Motorist Cover* – The insured is now covered under his own automobile policy in the event that he is injured by an uninsured motorist. The cover is limited to the statutory limit applicable in the province where the accident occurred (see Item 3 above).

7. *Defence of “Volens” and “Inevitable Accident”* – This defence has for all intents and purposes gone and the defence of “inevitable accident” is now virtually impossible to prove.

8. *Tax Laws* – Due to the tightening of tax laws it is conceivable that arrangements for structured settlements may become less attractive. In Ontario a Sales Tax of 7% is imposed on the cost of labour as well as materials in automobile repairs.

9. *Environmental Pollution* – The Ontario Government is currently contemplating introducing an act commonly referred to as the “Spills Act” which would not only place an absolute liability on those parties who have polluted the environment but also on the owners and controllers of the spilled pollutant although someone else caused the pollution.

10. *Improved Rehabilitation Facilities* – There is more sophisticated equipment available, often very expensive, to assist disabled persons and extend their life expectancy.

11. *Women’s Liberation* – There are more women in managerial positions and in the professions today and furthermore there is greater recognition of equal rights for women which not only adds to the exposure but also increases the cost of any claim involving loss of income.

12. *Claims Counsel* – It is evident from the review of claims that the plaintiff’s counsel is becoming more innovative in the presentation of their client’s case in an effort to gain the ear and sympathy of the jurors.

13. *Elements of Insurance* – It would seem that the fundamental elements of insurance e.g. fortuity, indemnity, subrogation and good faith have been, and continue to be, severely eroded. No attempt seems to have been made to compensate by way of premium charge for this erosion of principles.

Some primary insurers follow the practice of setting their reserves to the level of their net retention. This practice effectively pre-

vents the reinsurer from learning about the claim until loss payments exceed the retained level and the primary insurers need to recover the excess from the reinsurer. There are other situations where the claim is reserved to the level of the policy limit with no regard to expenses for investigation etc. which often can, in a major claim, be a very significant sum of money. Consideration must also be given to the party costs which generally range from 10% to 15% ; the legal fees of the defendant which can range anywhere from \$5,000 to \$50,000, adjusting fees anywhere from \$1,000 to \$20,000 plus the fees of expert witnesses, medical, legal expenses and any accident benefit claims. In either case the reinsurer's result becomes seriously distorted and the rate or premium charge for future cover becomes inadequate. One solution to these problems would be for the reinsurer to undertake a review of the primary company's claims. This review can be a help to the primary company in understanding the need to give full and accurate information to the reinsurer with regard to all claims with a potential to engage the cover provided by the reinsurer. It will also serve the reinsurer to understand the claims reserving philosophy of the company.

In spite of the attempts of some reinsurers to ensure claims are correctly and accurately reported and reserved, it would seem that we are still chasing rainbows. If we want to protect ourselves, we must act immediately to tighten the terms of the agreements we provide.

General Insurance Register. Stone & Cox Supplement.
1984-85. \$70.00.

Ce livre d'une centaine de pages contient des chiffres relatifs aux affaires traitées au Canada par les compagnies canadiennes aussi bien que les compagnies étrangères. On y trouve également le répertoire des courtiers d'assurances au Québec et dans le reste du Canada. Il y a aussi la liste des experts en sinistres et divers autres renseignements fort utiles pour l'exercice du métier de courtier. Il y a là un excellent instrument de travail.