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Résumé de l'article

Nous reproduisons ci-dessous une analyse des résultats de 1991 ainsi que les perspectives d'avenir de l'industrie de l'assurance présentées par Monsieur Edward F. Belton lors d'une réunion de la Canadian Reinsurance tenue le 12 mars dernier. En plus de faire le point sur la situation actuelle, M. Belton passe en revue les principaux facteurs de l'environnement externe qui touchent notre industrie, notamment l'économie, les nouvelles habitudes des consommateurs et la déréglementation des services financiers. Bien que le rapport sinistre / primes se soit amélioré, les résultats techniques se sont détériorés et l'indice global est passé de 109,32 % en 1990 à 109,8 % en 1991. Quant à l'avenir, il n'est guère plus prometteur : la concurrence sera plus féroce, la croissance demeurera faible et les profits seront davantage comprimés. Le défi de l'industrie sera d'accroître la productivité sans pour autant nuire à la qualité du service à la clientèle.

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Canadian Reinsurance Annual Statistical Review and Forecast *

by

Edward F. Belton**

Nous reproduisons ci-dessous une analyse des résultats de 1991 ainsi que les perspectives d'avenir de l'industrie de l'assurance présentées par Monsieur Edward F. Belton lors d'une réunion de la Canadian Reinsurance tenue le 12 mars dernier. En plus de faire le point sur la situation actuelle, M. Belton passe en revue les principaux facteurs de l'environnement externe qui touchent notre industrie, notamment l'économie, les nouvelles habitudes des consommateurs et la déréglementation des services financiers. Bien que le rapport sinistre / primes se soit amélioré, les résultats techniques se sont détériorés et l'indice global est passé de 109,32 % en 1990 à 109,8 % en 1991. Quant à l'avenir, il n'est guère plus prometteur : la concurrence sera plus féroce, la croissance demeurera faible et les profits seront davantage comprimés. Le défi de l'industrie sera d'accroître la productivité sans pour autant nuire à la qualité du service à la clientèle.

This year, I would like to take a somewhat different approach to the analysis of industry results and forecasting future trends. Because external forces are impacting the industry in ways much different from the past I would like to briefly review the major factors at work in the external environment, then describe the industry results and discuss the future outlook in the light of the interaction between internal and external forces.

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* This article was presented to the Canadian Reinsurance breakfast meeting on March 12, 1992.

** Consultant, Tillinghast, a Towers Perrin Company

The Economy

What can I say about the economy that you do not read in your newspapers day after day. You are well aware of the fact the economy is in recession that its engines are either in low gear, neutral or reverse. You know that GDP fell 1.5% last year.

You are aware that much of our manufacturing sector has become uncompetitive and that many manufacturers have either gone out of business or out of the country. As many as 200,000 manufacturing jobs have been permanently lost. The natural resources sector is beset by a global surplus of capacity, weak commodity prices and low cost foreign competition. This sector did not even earn the cost of its capital in the '80s.

Unlike the last recession, the services sector is beginning to feel the ripple effect and layoffs are beginning to occur.

Consumers who represent 66% of the economy are experiencing a crisis of confidence, their debt level is at an all time high and their spending has been sharply curtailed.

Both personal and commercial bankruptcies are at an all time high -- something in excess of 70,000 in 1991. Corporate debt levels are also high and profits as a percentage of GDP are at their lowest level since the great depression of the dirty '30s. Governments are saddled with crippling levels of debt as a result of our past willingness to mortgage the future in order to support a standard of living that is not justified by our economic output. With every major sector of the economy burdened by debt and suffering from an income squeeze, no sector is capable of kick-starting a recovery.

Donald Gass, President of the Canadian Institute of Chartered Accountants, put it rather nicely when he said: "Canada is running out of charge cards. We're learning the hard way that borrowing for our future isn't as good as building it".

Quite simply, we have been living beyond our means, the piper now has to be paid and we face a long, slow, uphill climb to economic recovery. The mountain of debt is so high and the

means of reducing it are so limited that some observes are predicting it may take as long as ten years to get the economy onto a sound footing.

That's the bad news. The good news is that our inflation rate is at the lowest level in nearly 30 years and is the lowest of any of the G7 countries. That will help us to become more competitive in the global marketplace.

It is also good news for the economy that interest rates have fallen but that is bad news for insurer's investment income.

It is good news that securities markets have been buoyant. This has helped maintain insurers' capital strength but it has also contributed to surplus capacity. And, yes, there is surplus capacity in the property and casualty business in Canada in spite of suggestions that there is not. I will deal with that topic more fully in my analysis of industry conditions.

The important thing about all of these factors is that the realities of economic life be recognized when strategic plans are formulated, especially when growth targets are set. The imbalance between supply and demand is exacerbated when insurers and brokers are seeking growth far in excess of what the economy can produce.

Sociographics

The recession's impact on the consumer has been dramatic. Conspicuous consumption is out -- frugality is in. In the '80s we boasted about how much we paid for houses and cars -- in the '90s we are boasting about how little we are paying. The yuppie generation which once rejected the conservative spending habits of the generations which survived the great depression, has quietly adopted a frugal life style.

People are looking for value and for bargains but they are not prepared to accept poor quality in return for low price. They want high quality and good service and low prices. These realities have important implications for the insurance industry.

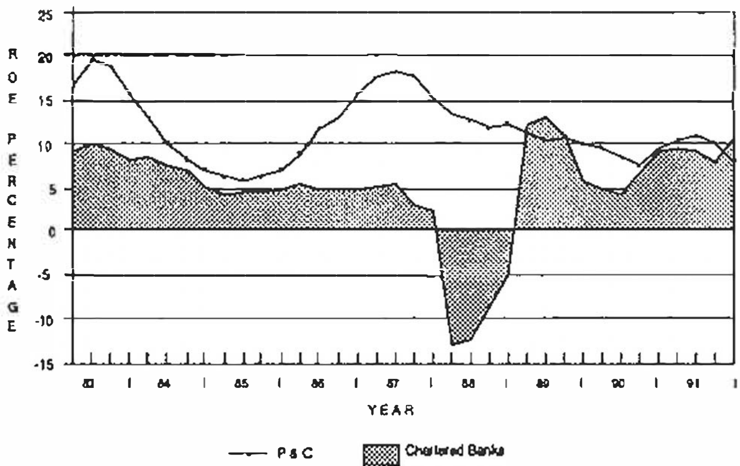
Regulation

Federal:

The dismantling of the barriers between the four pillars of financial services is going to have a profound impact on property and casualty insurance. It may not take place quickly but, over time, the face of the industry will change. New forms of competition will emerge, especially in the distribution system.

If you are curious about why the banks want to get into insurance, this graph of return on equity might explain it.

R.O.E.
P & C Vs Chartered Banks



Source - Statistics Canada
EBALC-1409

If those new competitors are highly efficient and provide top notch service, they will gain market share at the expense of the existing system.

Provincial:

Regulation of prices, rating criteria and marketplace conduct can be expected to intensify as consumers react to premium increases needed to restore acceptable results.

Summary:

The economic, sociographic and regulatory issues I have described are but a few of the external factors that will have an impact on the industry. Let's keep them in mind as we review the 1991 results and the various internal forces at work in the industry.

1991 Results

On the surface, the 1991 results are very similar to 1990 but, hidden below the surface, there are some very troublesome indications. In spite of the Calgary hail storm catastrophe, nothing startling showed up in the fourth quarter figures and the year ended with a combined ratio only half a percentage point higher than the previous year.

As usual, the loss ratio deteriorated in the final quarter but it ended the year a quarter of a percentage point below 1990. As expected, the auto loss ratio continues to improve but there is an indication that the improvement may be bottoming out. Statscan does not produce provincial results but other sources indicate that all the improvement in auto comes from Ontario .. other provinces produced horrible results.

Also as expected, the property loss ratios have worsened. Both personal and commercial property are producing significant negative return on equity.

Liability claims, which showed a clear increase in the third quarter, continued that trend in the fourth quarter. The year-end loss ratio for liability is 7 1/2 percentage points higher than the previous year.

The most disconcerting development in 1991 is what is happening to expenses. They are increasing one and one half times faster than earned premiums and the expense ratio is going up when it should be going down. The need to improve productivity is becoming more and more urgent.

The precise numbers

Net premiums increased 5.21% slightly lower than the 5.65% achieved in 1990.

Claims were up 4.23%, exactly the same as the 1990 increase.

The loss ratio fell from 78.3% in 1990 to 78.05% in 1991.

Expenses increased 7.05%, far outstripping the earned premium growth rate of 4.57%.

As a result, the expense ratio rose from 31.02% to 31.75%.

Consequently, in spite of the improvement in the loss ratio, the underwriting results deteriorated by $118 million with the final underwriting loss for the year being one billion, three hundred and seventy-three million dollars.

The combined ratio ended up at 109.8% compared with 109.32% in 1990.

Investment income, of course, again saved the year. It totaled two billion, five hundred and eighty-four million, up 5.68% over 1990.

As might have been expected with falling interest rates, net investment income before capital gains and losses was up only 3% but a very satisfactory 72% increase in capital gains produced an increase in total investment income of 5.9%. I guess the question is: "How long can it last?" A high level of skill, good timing and a touch of good luck will be required to sustain that kind of investment performance.

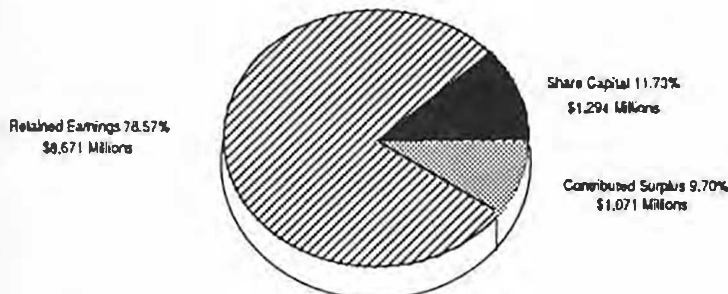
The bottom line, net income after taxes and extraordinary items were $872 million down 9.3% from the $936 million

achieved in 1990. As a result, return on average equity fell to 8.04% from 9.23% in the previous year.

Growth in capital and surplus shows a significant decline to 3.56% from 10.71% in 1990. The reason that this is occurring in spite of strong investment performance is that investment is now being used to offset negative cash flow from insurance operations. One of the contributing factors to the drain on cash flow is the faster rate of claims payout under OMPP. Even without taking into consideration the negative impact of income taxes, cash flow from insurance operations as a percentage of net premiums, was minus 2.78% in 1991.

As is evident from the 1991 results, negative cash flow from insurance operations is biting into investment income which is reducing net income which is the source of retained earnings which, as this pie chart shows, is the source of nearly 80% of capital & surplus.

Sources of Capital & Surplus
Fourth Quarter 1991



Retained Earnings includes Head Office, Investment and General Reserve
Source - Statistics Canada
EB/LC-1401

Retained earnings have been shrinking rapidly from a growth rate of 22.4% in 1989 to 12.9% in 1990 to 4.0% in 1991.

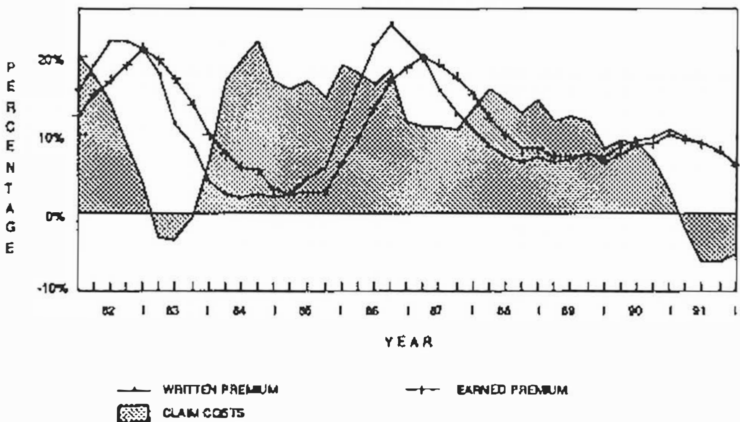
If this trend continues, it will halt the growth of capital and surplus and could eventually put solvency margins under pressure.

That is a quick look at the key numbers for 1991 -- now, let's look at the results for the major classes of business and move to an analysis of marketplace conditions and the outlook for the future.

Automobile

250 Let's start with automobile which because it accounts for 54% of total net premium income, is, if you would pardon the expression, the tail that wags the industry dog.

Automobile
Growth Rates (4 Quarter Moving)
of Premium Income & Claims Outgo



Source - Statistics Canada
EB/LC-1417

Net premiums written by private sector auto insurers amounted to $7.6 billion in 1991, a 6.1% increase over the prior

year. Claims incurred fell by 4.95% to bring the loss ratio down to 78.51%, the lowest it has been since 1983.

We, at Tillinghast, share the view that these results are not as good as they seem. In a recent bulletin to clients, we stated our belief that accident benefits claims are under-reserved by 10% or more because of the P&C industry's inexperience in the administration and reserving of long term disability claims. We believe that the ultimate cost is being underestimated and that claims which are likely to penetrate the threshold are not being identified early enough to permit proper investigation of the circumstances for the purpose of determining fault and establishing the appropriate reserves.

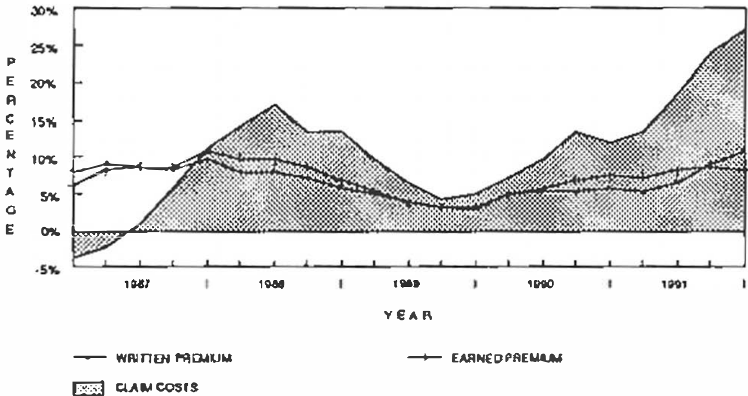
Perennial Problems

For most of the last 30 years, there has been a political cloud hanging over the future of auto insurance in one jurisdiction or another and 1992 is no exception. The government of Ontario's strategy for automobile insurance reform as spelled out in the document entitled "The Road Ahead", if implemented, would unquestionably lead to increased claims costs. While insurers can comfortably absorb some increase, the question is: once the litigation cat is out of the bag, will it go wild?

It is fortunate that implementation has been delayed because the longer the present system remains intact, the greater the opportunity for insurers to discover its true costs and to accurately price any changes to the system. One cannot help feeling that, given consumer resistance to price increases of any kind, this is the wrong time to be doing anything to increase the cost of auto insurance.

Personal Property

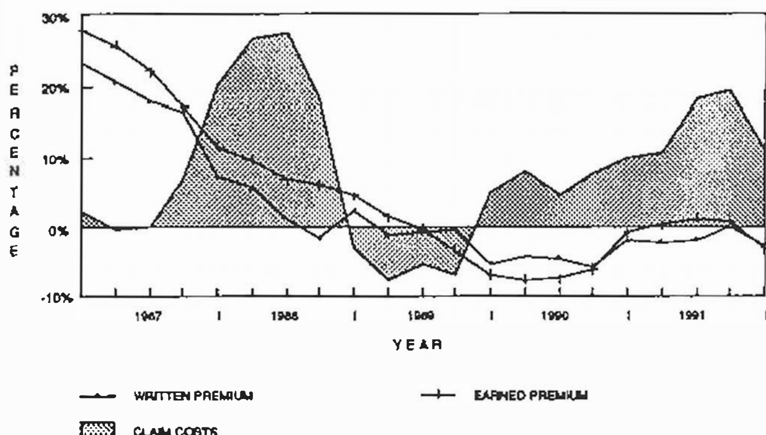
Personal Property
Growth Rates (4 Quarter Moving)
of Premium Income & Claims Outgo



This class of business currently generates annual net premiums of $2.7 billion and it is producing awful results. Premiums increased a healthy 11% in 1991 but claims skyrockcted 27.4%. Over the past five years, the loss ratio has risen steadily from 60% to almost 80%. The combined ratio now stands at 117%. With investment income amounting to 6% of earned premiums, the net loss is 11%. That means that, in 1991, the capital supporting this class of business was eroded to the extent of $286 million.

The underlying problem is easy to diagnose and the cure is obvious -- either claims have to go away down or premiums have to go away up. Admittedly, the Calgary hail-storm aggravated the problem, but, even before that storm occurred, claims had grown 19%. I am told that, in these recessionary times, an extraordinary number of people is losing jewelry and other valuables as a result of a nationwide increase in household burglary.

Commercial Property



Source - Statistics Canada
EB/LC-1420

In 1991, this class of business generated net premium of one billion, seven hundred and sixty-five million dollars down 2.7% from the year-end 1990 figure. At the same time, claims costs increased 11.2% and drove the loss ratio to 81.38%. Devastating! This pushes the combined ratio to 121.6%. With investment income amounting to only 8% of earned premiums, the bottom line net loss is 13.6%. This means that the capital supporting this class was eroded to the extent of $231 million.

In total, in 1991, property insurance took something in excess of $500 million out of shareholders' pockets. If that does not signal a need for corrective action, I don't know what does.

One of the interesting facts about commercial property insurance is that it generates roughly $800 million a year less net premium than personal property. It is hard to believe that the insurable value of all of Canada's commercial enterprises, the huge plants, office buildings, the machinery and equipment and

the business interruption coverage is less than the total insurable value of dwelling risks. I strongly suspect that the relatively low premium income from commercial property is the measure of the extent to which business and industry has moved to alternative risk financing methods or has placed its business directly into offshore markets. To the extent that the claims being retained by corporations are the low severity, high frequency type, the terrible loss ratio for commercial property insurance may be partly the result of anti-selection.

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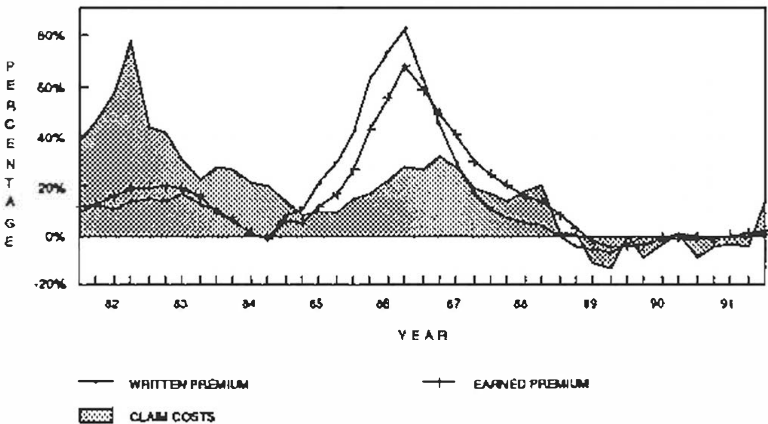
Liability

Liability
Growth Rates (4 Quarter Moving)
of Premium Income & Claims Outgo



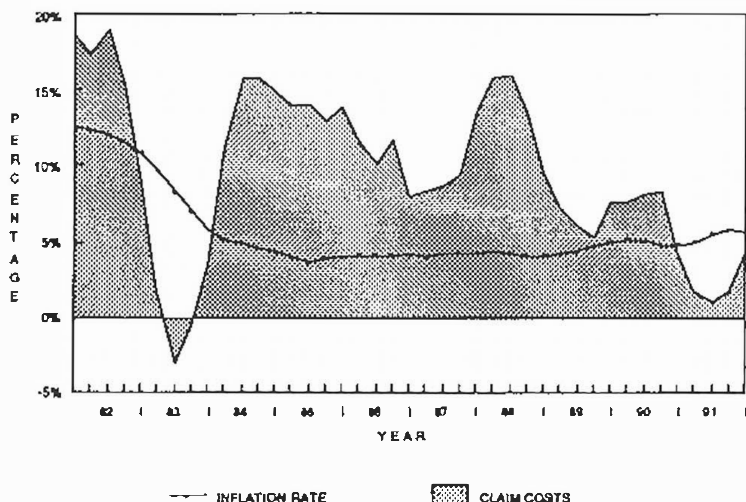
Source - Statistics Canada
EB/LC-1416

In 1991 this class of business generated $1.2 billion of net premiums an increase of one half of one percent over the previous year. For most of the last three years, claims growth has been negative but something happened in the last half of 1991. Claims costs increased 8.4% in the third quarter and 54.2% in the fourth. This brought the year-to-year increase to 14% and drove the loss ratio up to 73.3% from 65.7% in 1990.

We many have witnessed the end of the honeymoon for liability insurance. Perhaps the long ago predicted need for an increase in the claims reserve has finally materialized or maybe it is a reflection of more aggressive pursuit of general liability claims by plaintiff's lawyers who lost much business when OMPP was introduced.

The combined ratio is 110.6% but, because of the heavy claims reserves required for this "long-tail" class, investment income is a healthy 18.6% of earned premiums. This means that pre-tax net income on the class is 8.0% of earned premiums or, approximately, $96 million. Thus, assuming that the prudent premium-to-equity ratio for this class is 1:1, the pre-tax return on required equity is 8.0%, not very satisfactory considering the riskiness of the investment.

Trends In Claims vs. Inflation



Source - Statistics Canada
EBLC-1410

From the end of the last recession to the beginning of this recession, the growth rate of claims costs exceeded the inflation rate by a considerable margin. However, throughout 1991, the reduced automobile claims frequency that always occurs during a recession caused the growth rate of claims costs to fall below that of the inflation rate. As was pointed out in the last edition of The Belton Report, it is very likely that the growth rate of claims costs will surge past the inflation rate in 1992. Economists are forecasting an inflation rate of 2% but the growth of claims costs is likely to be more than double that figure.

As I have pointed out previously, from a consumer relation point of view, this is not good news. It will be hard to explain why property insurance rates have to increase to offset four years of soft market price cutting. Consumers will want to know why claims costs are growing faster than the rate of inflation and the industry had better have the answer! In order to avoid a clash with consumers and, ultimately, with politicians it is abundantly clear that underwriters must redouble their efforts to control claims costs through thorough inspection, good loss control engineering and careful underwriting of the financial risk. The latter point is particularly important in recessionary times because of the increased incidence of arson.

The Driving Force

Ever since the mid '80s when I began measuring the relationship between supply and demand, I have been drawing attention to the fact that P&C insurance is a supply driven business and that surplus capacity is the force that drives soft markets. In the past few months, the existence of surplus capacity has been called into question. Because it is such a critical factor in understanding the dynamics of the marketplace, the issue deserves clarification.

It has been suggested that there really is no surplus capacity in the marketplace or, more accurately, that what appears to be surplus capacity is not going to be used because:

a) Six of the 10 largest companies have premium-to-equity ratios above 2.5:1 and four of them are over 3:1.

b) Thirty six of the sixty largest are over 2.5:1.

c) Some of the surplus capital resides in mutuals which should maintain lower premium-to-equity ratios as a safety margin because they do not have access to capital markets.

d) Some of the surplus resides in Quebec based companies which operate only in Quebec.

e) Some of it is "parked" in branches of foreign insurers.

While there is some validity to all of these points, I believe it is an oversimplification to say that none of the surplus capital is likely to be used and, by implication, surplus capital is not the cause of the soft market and hyper-competition.

Because the industry is so fragmented -- 135 groups of major, active companies, 250 companies in all, the largest with a market share of 6% -- neither the top 10 nor the top 60 companies are pace-setters. None is big enough to be a price leader.

One observer of the industry has compiled a list of groups of companies under common ownership that shows that only 40 primary insurers out of a total of 166 have premium-to-equity ratios of 2.5:1 or higher. Only three of them are in the top 10 by net premiums written and only nine are in the top 25. Obviously, there are many companies with capacity to spare. Of those with premium to equity ratios of less than 2.5:1, there are at least 20 who would be considered aggressive players in the marketplace.

We also have to be very careful about the use of the premium to equity ratio as a guage of capacity utilization. 2.5:1 may be a useful benchmark for guaging the solvency of the industry as a whole but the appropriate ratio may vary quite widely from company to company based on the composition of its portfolio. At one extreme 1:1 may be the appropriate ratio for long-tail, third party liability insurance because of its volatility

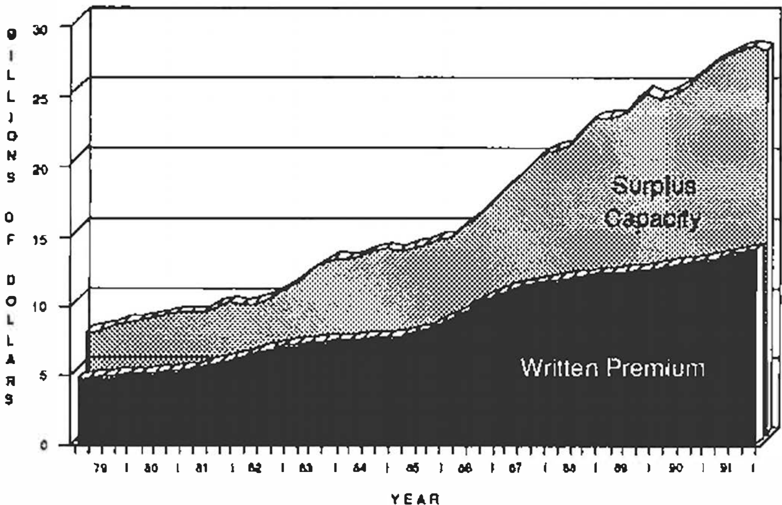
and unpredictability whereas 4:1 might be quite acceptable for a portfolio of private dwelling risks.

In summary, I believe that a lot more research is required to justify the generalization that: "there is no excess capacity, at least none that is likely to ever be utilized."

Perhaps the most powerful evidence that there is surplus capacity is the behaviour of the marketplace itself. If surplus capacity is not driving hyper-competition, what is? While I am convinced that unrealistic growth target is one factor that contributes to the problem, I do not think that pie-in-the-sky planning is the entire explanation for reckless price cutting and deteriorating underwriting standards. Let's examine the influence of surplus capacity in some detail.

This graph portrays capacity utilization based on Statistics Canada data, the only source of quarterly results.

Capacity Utilization
Written Premium vs. Capacity*



*Capacity = 2.5 x Equity
Source - Statistics Canada
EB/LC-1402

Because Statistics Canada does not report statutory capital and surplus that is the proper basis for calculating capacity for solvency test purposes, in calculating capacity, I use a leverage rate of 2.5:1 rather than the 3:1 which seems to be the point beyond which regulators begin to get nervous. The method seems to work.

Using TRAC Report data which does distinguish between total capital and statutory capital the following figures emerge:

•At a leverage rate of 3:1 statutory capital produces net written premium capacity of $27 billion and a capacity utilization rate of 53%.

•At a leverage rate of 2.5:1, total capital produces capacity of $26 billion and a utilization rate of 55%.

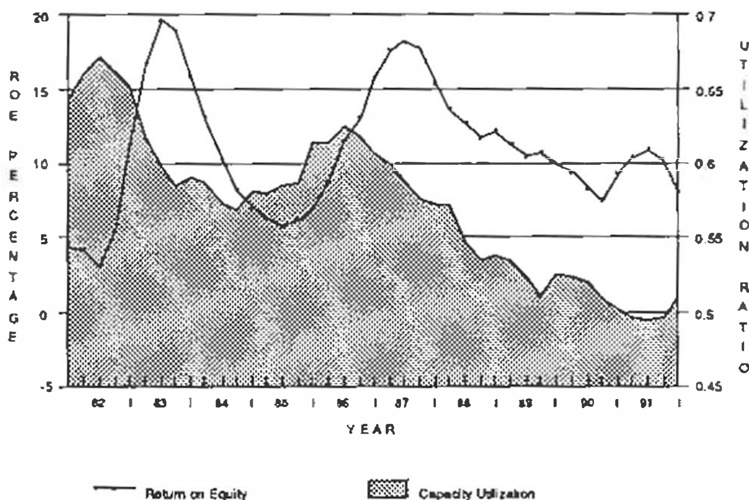
There isn't much difference between the two methods.

However, if a leverage rate of 2.5:1 is applied to statutory capital, capacity drops to $22.5 billion and the utilization rate rises to 63%.

But what is important is that by any of these measurements, surplus capacity is evident.

Even under the most rigorous definition of usable capital, surplus capital amounts to $3.6 billion, which, at a leverage rate of 2.5:1 represent $9 billion of surplus capacity. A case can be made for reducing that figure but it cannot be made to go away.

If there is any doubt that there is a correlation between capacity utilization and profits, this graph should dispel it.



*Capacity Utiliz. – W. Prem. to 2.5 x Equity
Source: Statistics Canada
EBLC-1431

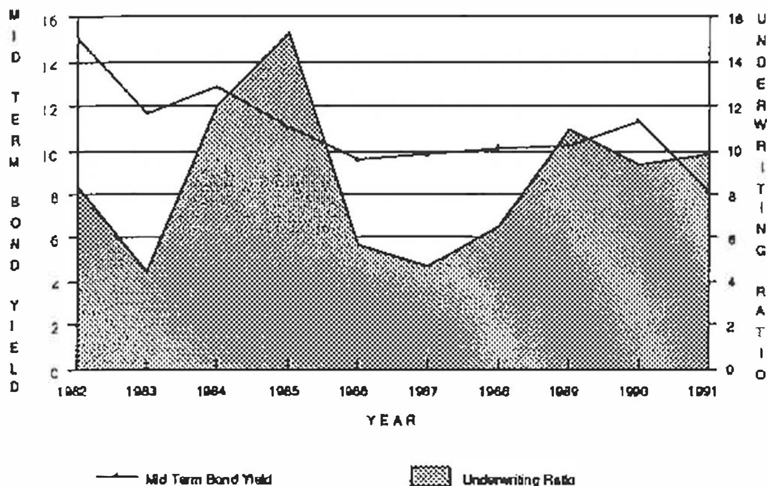
It is quite clear that there is a close relationship between capacity utilization and return on equity. It is a typical supply/demand situation. When supply is low in relation to demand and capacity utilization is high, prices are firm and profits increase but the time lag is usually 12 to 15 months. This leaves no doubt in my mind that the property and casualty insurance marketplace is supply driven.

Cash Flow Underwriting

One factor that used to be offered as an explanation but which I believe has been discredited is "cash flow underwriting". Cash flow underwriting is defined as a willingness to write business at rates that are known to be deficient on the assumption that any underwriting loss will be offset by the earnings on the premium and claims reserves. Tradition holds that this practice is prevalent when interest rates are high. The following graph

indicates pretty clearly that if cash flow is a factor at all, it is a **permissive** rather than **causative.**

Mid Term Bond Yield vs. Underwriting Ratio



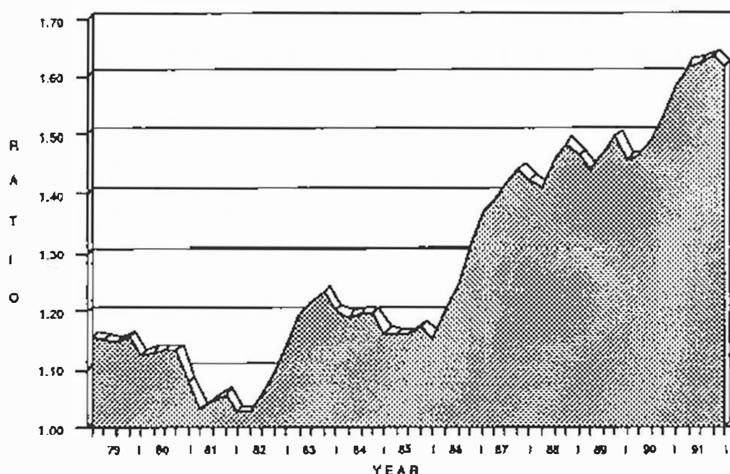
Source - Statistics Canada
EB/LC-1413

If high real interest rates were a driving force, there would be a correlation between interest rates and underwriting results. As interest rates rise, the urge to generate cash flow to invest would lead to price cutting and low underwriting standards which would cause the underwriting loss to increase but the graph indicates that's not to be so. Underwriters are aware that investment income permits them to operate at a combined ratio above 100% but that awareness does not drive them to cut prices, competition does and competition is motivated by the desire for growth. Were it not for competition, underwriters would simply accept the higher profit margin that investment income would bring.

The Impact of the Economy

Bearing in mind my earlier comments about the economy, it is interesting to look at the relationship between supply and demand in an economic context. This graph plots the relationship between equity and GDP.

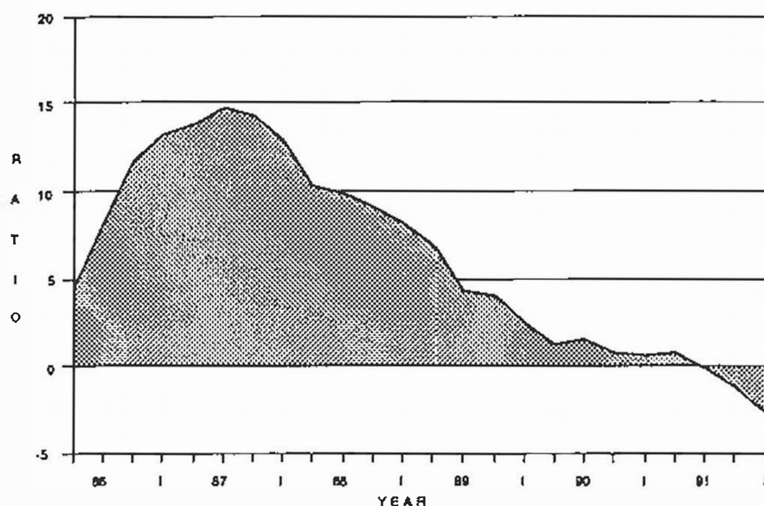
Supply/Demand Monitor No. 1
(Ratio of Equity to GDP)



Source - Statistics Canada
EBLC-1404

It can be seen that growth of the industry's capital and surplus has significantly outstripped growth in the economy since the recovery from the 1981-82 recession. However, it is very significant that in 1991 the growth of equity slowed to 3.56%, the lowest in the last five years. One would not expect that to be the case when the combined ratio is really not that much worse than the previous year. The reason is evident from this graph which shows that cash flow before the application of income taxes and investment income is negative.

Cash flow* vs. Written Premiums



*Cashflow = Net Premiums written less commission & expenses & paid claims
Source - Statistics Canada EB/LC-1426

To the extent that investment income is utilized to offset negative cash flow, less money flows in to retained earnings which is the major source of equity.

Outlook for the Future

There are so many issues to grapple with, we could spend a day or two discussing them but we do not have the luxury of time so let's quickly review the situation and identify the main challenges facing the industry.

In the external environment, we have the prospect of:

- Slow economic growth.
- Low inflation.
- Relatively low interest rates.

- Consumers who want high quality service at low cost.
- Consumers who will want a full explanation of any price increase that exceeds the rate of inflation.
- New forms of competition flowing from changes in federal legislation.
- Aggressive regulation of price, rating criteria and marketplace conduct, particularly in Ontario.

The situation within the industry is:

- An oversupplied marketplace -- too many insurers with too much capital.
- A hyper-competitive marketplace characterized by price cutting, deteriorating underwriting standards and neglected loss control.
- Poor underwriting results in all major classes except Ontario auto which is probably not as good as it looks.
- The prospect that government mandated broadening of coverage will push premiums up at the very time that consumers don't want to pay more for anything.
- Negative cash flow from insurance operations.
- A drain on retained earnings.
- Slower growth of equity.
- An expense ratio which is going the wrong way.

Conclusions and Outlook

It is not hard to see the handwriting on the wall. The business is not getting any easier. It will continue to be highly competitive, growth will be slow, profits will continue to be squeezed and there will be enormous pressure to reduce the costs of claims, acquisition and administration expense. Several conclusions can be reached:

1. Growth by merger or acquisition makes more and more sense.

2. Because the performance of some insurers is worse than the industrywide results indicate, they and their shareholders will be rethinking their strategy.

   We can expect to see more tightly focused marketing strategies, a more selective approach to product and geographic dispersion and more specialization. Whereas, in the past, the strategy might have been to build on strengths and overcome weaknesses, in today's hostile environment the strategy will lean toward building on strengths and abandoning areas of weakness. In other words, the philosophy will be: "Let's put our time, effort and money where we know we do well." The focus will be on marketplace clout and profit potential.

   We may very well see a clear line of demarcation between "full service" and "niche" players with fewer insurers trying to occupy the middle ground.

3. In response to the consumer's need to reduce expenditures, we should see the development of stripped down, plain vanilla products that provide good basic coverage at lower cost.

4. Last and, perhaps, most important of all, expense reduction will be the battle ground of the '90s.

In this no-nonsense decade, the winners will be those who effectively come to grips with problem of improving white collar productivity.

The insurance business like other elements of the services sector is a labour intensive business. People are the key to improving productivity and improving productivity is the only way to cut costs without impairing customer service.

Salaries and employee benefits consume 38% of insurers' general expenses and 16.5% of total operating costs, that is, the

combined cost of commissions, premium taxes and general operating expenses.

Unfortunately, the track record for improving white collar productivity has not been good. Thirty years ago we thought that computerization would improve productivity and lead to reductions in clerical and office staff. It did not happen! In spite of massive investment in data processing equipment, the white collar workforce has been growing at a faster pace than before automation.

No less a personage than Peter Drucker, the famous author of books on management, lecturer, futurist and professor of social science and management said:

"The single greatest challenge facing managers in the developed countries of the world is to raise the productivity of knowledge and service workers. This challenge which will dominate the management agenda for the next several decades, will ultimately determine the competitive performance of companies. Even more important, it will determine the very fabric of society and the quality of life of every industrialized nation."

The Towers Perrin Tillinghast organization believes so strongly that the need to improve white collar productivity is so critical, that we have special consulting units for such performance improving techniques as total quality management, pay for performance and employee effectiveness.

With that brief commercial, I will conclude by saying that the no-nonsense '90s will be a period of enormous challenge and change and I expect that the face of the industry will look different in the year 2000.