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Résumé de l'article

Nous remercions sincèrement M. John Phelan, président de la Munich du Canada pour avoir gentiment accepté notre invitation de publier la conférence qu'il a donnée à Montréal lors du 3e Congrès d'assurance du Canada. Le représentant canadien de la Munich Re, premier réassureur mondial, qui a perçu plus de 9 milliards de dollars en primes en 1991, était certes bien placé pour dégager les principaux problèmes auxquels tous les réassureurs sont aujourd'hui confrontés, notamment la fréquence des sinistres catastrophiques, les résultats techniques déficitaires de l'industrie de l'assurance, les diminutions des montants de rétrocession disponibles et les augmentations de coûts de réassurance prévisibles. Le conférencier a de plus abordé les changements en cours dans l'industrie et les nouveaux développements qui pointent à l'horizon.

Reinsurance Industry Actual Problems and Some Possible Developments*

by

John Phelan**

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In this article, I will attempt to address three issues: first, the problems presently facing the worldwide reinsurance market, next, the changes made during the treaty renewal season of the

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* Allocution présentée à l'occasion du 3e Congrès d'assurance du Canada, tenu à Montréal les 3 et 4 mai 1993.

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past year-end and finally I will peer into my cloudy crystal ball for a peak at what the future might hold.

Reinsurers - Current Problems

I think that it is fair to say that there are three main problems facing reinsurers today and that these are felt almost universally. The first of these is the frequency of very large natural catastrophe losses. The second is the very unprofitable results that have emanated from commercial/industrial property business for some years now, and the third is the cost of, and availability of, reliable retrocession capacity.

Frequency of Very Large Natural Catastrophe Losses

For the 26 year period 1960 to 1986 inclusive, the worldwide total cost of insured losses from major natural disasters was $12.8 billion.

For the 5 year period 1987 to 1991 inclusive, insured losses from major natural disasters amounted to $30.0 billion.

The insured loss from Andrew is estimated to be $16.5 billion and climbing, the total tally may well be $20. billion or more. If it had passed over Miami, Andrew would have cost around $50 billion. According to the A M Best, roughly $6 billion of the $16.5 billion loss from Andrew is reinsured. The reinsurance loss is, roughly speaking, divided equally between proportional and catastrophe treaties.

Iniki adds another $1.6 billion for a total from these two events of over $18 billion; in one year, more than the total amount for the entire 26 years up to and including 1986.

These figures clearly demonstrate the huge problem that natural catastrophe losses have become for insurers and reinsurers alike.

Munich Re's analysis of natural disasters, in the 30 years from 1960 to 1990, shows a dramatic increase in the frequency of losses and the extent of damage.

During the decades from the 60's to the 70s, insured losses and the number of disasters increased five fold. During the same period, the economic loss increased by 300% even when the factor of inflation is excluded. The gap between economic loss and insured loss has widened considerably during the three decades studied.

In 1989, America accounted for 35% of the number of loss events, 94% of insured losses and 79% of economic losses. In 1990, the American continent was spared but Europe suffered its second "300 year storm" in three years. It, and its companion storms, cost insurers and reinsurers $10.0 billion from an economic loss of $15 billion.

It was Japan's turn in 1991 with Mireille, which caused an economic loss of about $6.0 billion and an insured loss of $5.2 billion.

It was America's turn again in 1992 with Andrew etc., etc., I don't need to mention more about these.

I know some insurers in Canada wondered why catastrophe rates should have risen so sharply at the end of last year. I think the figures above should be sufficient explanation why this has happened and should sound a warning that more is yet to come.

In the world of reinsurance and retrocession of natural catastrophe exposures, Canada is not an island. Costs here will reflect the experience of reinsurers and retrocessionaires in other parts of the globe and will increasingly reflect Canadian exposure to large catastrophic losses especially to potential losses from earthquakes in BC and Quebec. Rates for catastrophe protection must also take into account inadequate original premiums for these perils if they exist at all, inadequate deductibles and the absence of sub-limits to help control the accumulation of exposures while still providing some reliable protection to as many individuals and businesses as possible.

The harsh truth is that Canadian catastrophe reinsurers have had their pool of catastrophe premiums frequently exhausted by windstorm and hail losses. Consequently, they have been unable to create the resources necessary to cover earthquake losses. This simply has to stop.

In addition, Canadian reinsurers cannot escape the cost of retrocession nor can they operate effectively without its protection. These costs must be passed on. Furthermore, the capacity of the retrocession market has fallen sharply and this is reflected in the reduced reinsurance capacity now available in Canada.

All of this will have an impact on proportional reinsurance too. Munich Re did not attempt to limit the cession of natural perils to proportional treaties renewed for 1993; we must seriously consider doing so for treaties renewing for the 1994 calendar year. We cannot continue to accept unlimited liability, nor can any company with limited resources no matter how great those resources may be. Insurers, in their own interest, should insist on such limitations to be sure that their reinsurers are capable of honouring their obligations in full.

Now you will probably say that limitations, or occurrence limits, introduce an element of non-proportional coverage to a proportional treaty. Right you are. If this is true, should reinsurers get a full share of the proportional premium for the limited perils? Of course not. But wait a minute, the original premium is mostly zero for commercial business and inadequate for habitational so one has to say that a full share of zero is still nothing and the inadequate habitational premium may not be sufficient to cover even the limited protection given by proportional treaties. It is worth adding that habitational business is, anyway, mostly retained by insurers in Canada.

In theory therefore, as far as Canada is concerned, we would be prepared to negotiate a return premium as a price for occurrence limits for natural perils if the occurrence limit were well below the probable maximum loss and the original terms and conditions were adequate. Sadly, such an adjustment of premium is entirely theoretical at present but this too must change.

Commercial Property Losses

A second problem facing reinsurers is that commercial and industrial property results in Canada and most developed economies have been very unprofitable for the past three to four years. Insurers' commercial and industrial property clients have been subsidized by profits from other classes, which are not as heavily reinsured.

This has put reinsurers in an untenable position, with no choice but to attempt to put some distance between their results and the results of their clients.

One way of doing this is to limit the amount of loss likely to be endured by proportional treaties. An example of how this can be done is the inclusion in these treaties of loss corridor or loss participation clauses. Most proportional treaties in Canada now contain one or the other of these clauses.

Another way to put distance between reinsurers' and cedents' results is to reduce ceding commissions to the level that experience shows proportional treaties can sustain. Ceding commissions were sharply reduced during the past renewal season and will be under further pressure this year-end if results do not improve or if there is not clear evidence of a hardening market for commercial and industrial property business.

We obviously hope that measures already taken will motivate insurers to increase rates to economic levels. Reinsurers cannot afford to knowingly write unprofitable business indefinitely. If the market is either unwilling or unable to change its present approach towards pricing commercial property business, we will have no choice but to change the way we reinsure it.

How could this be done? There are a number of options that might be explored. For example, natural perils coverage could be excluded and covered on an excess of loss basis. As already mentioned, loss limitation clauses have already become an important feature of prorata treaties as has the reduction of ceding commissions to sustainable levels. This could go further.

It is entirely possible to have negative rates of ceding commission. The pricing of the capacity afforded by proportional reinsurance is becoming evident in these measures. It could be fairly said that reinsurers in many markets are in the curious position of paying their clients to use their products. Curious indeed!

Retrocession capacity/cost

Both of the points I have already mentioned—frequent large catastrophic losses and very poor loss ratios from commercial property business—have caused retrocessionaires heavy losses. This, in turn, has resulted in much increased costs to reinsurers and a sharp reduction in the amount of retrocession capacity available.

Coupled with a reduction of reinsurance capacity for other reasons, this means that there is not sufficient catastrophe reinsurance capacity available for many large insurers. This problem will be exacerbated if the unlimited catastrophe protection now afforded by proportional treaties, is restricted or if reinsurers switch from proportional to working excess of loss treaties. Note I have said "when reinsurers switch". This is an obvious allusion to the fact that proportional treaties must change. What if working capacity were provided only on an excess of loss basis? — First, the price would increase (bear in mind that most proportional treaties now provide free capacity), next, the amount of capacity would probably be less, the exposure to catastrophe treaties would be increased and this would be reflected in the cost of buying that protection and finally the amount of catastrophe protection required would increase, again leading to increased costs and a possible shortfall if the amount of necessary capacity is simply not available.

Changes already made for 1993

Let me now review the measures taken this past year-end and briefly explain their impact:

Loss participation Clause

This is an attempt to reduce reinsurers' losses by involving cedents in claims ceded at a certain level of loss to reinsurers. Such clauses help protect reinsurers, to a modest degree, against strategic decisions taken by cedents to knowingly write certain classes of business at a loss for other, possibly very good, business reasons.

Reduced Ceding Commissions

Again, this is intended to reduce losses suffered by reinsurers and to encourage cedents to rate their business at self sustaining economic levels. It is also a means of pricing the capacity afforded by these treaties.

Revision of Cession practices and Reduction of Capacity

Revision of cession practices and reduction of capacity to achieve a better balance between premiums ceded and capacity granted and to restrict gross capacity to the underwriting ability of cedents to use it. Capacity expands excessively during soft market cycles; it is necessary to reduce such excessive capacity during periods when rates are less than adequate.

Increased Catastrophe Rates

I have already mentioned the reasons for these.

Increased Retrocession Costs

These follow naturally from the number and extent of catastrophe losses during the past six years.

Reduced Retrocession Capacity

This is also the result of heavy losses during the past six years. Retrocessionaires are withdrawing capacity if not withdrawing entirely from the market.

Increased Auto XL rates for OMPP

Our actuarial studies show that we underrated the excess of loss exposure emanating from OMPP. We corrected that mistake this past year-end.

Change in Conditions Clause re Ontario Bill 164, and Very Much Increased Auto XL Rates, if it Becomes Law in its Present Form

Bill 164, if it becomes law as it now exists, will result in very severe exposure for excess of loss reinsurers. Our studies show necessary rate increases up to ten times existing rates for those layers most exposed.

Developments Likely in 1994 and Thereafter

What about the future? Here are some possible developments:

- The restriction or elimination of proportional reinsurance for commercial and industrial property business unless market rates reach economic levels.
- Even if rates are increased appropriately, there will be some restriction of the unlimited coverage now given by proportional reinsurers for natural perils events. Alternatively and preferably such coverages may be excluded and covered instead by catastrophe excess of loss protection only.
- Insurers will be under increasing pressure to adequately price their exposure to such natural perils as earthquake and windstorm. Earthquake deductibles will have to increase and sub-limits will be necessary to contain accumulation exposures. These measurers will become ever more necessary as the cost of catastrophe reinsurance increases and the amount of reliable capacity decreases.
- Continuing shrinkage of reinsurance capacity, both in limits of coverage and the number of reinsurers able to offer reliable security.

- Similar and to some degree consequential rationalization of insurance capacity.
- Increasing involvement of banks' insurance subsidiaries in personal lines insurances
- Continuation of the Development of Risk Management Techniques to retain, finance, transfer, and avoid risk. This may involve captives, reciprocals, internal accounts and I am sure ideas yet to be developed. These options may become more attractive as the price charged for insurance approaches the cost of its benefits.

- Increased automation and with it an acceleration of the shift from the present structure of branches across the country to regional head offices loosely connected at the operational level to their national head offices. Head offices will become smaller but the regional centres will not be correspondingly larger. This will increase efficiency and responsiveness at the local level while reducing costs. All of this will be supported by integrated computer systems between agents/brokers and insurers, as well as between insurers and their reinsurers.
- Reinsurers will become even more specialised than at present. They will become far more active in the pricing, management and distribution of catastrophic exposures, not only from natural perils, but also for such risky and unbalanced business as space risks, technology risks, professional risks and the new risks that will emerge as humankind learns to deal with climatic change and its consequences, an ever increasing world population and the challenges it presents.
- Financial reinsurance is likely to become much more important as traditional sources of capacity and protection become temporarily less able to meet demand. Who knows where futures and options will take us?

In conclusion, let me express the conviction the we, as a community, will do what has to be done and that the words of the English dramatist, James Albery, will not be our epitaph, "He slept beneath the moon, he basked beneath the sun; he lived a life of going-to-do, and died with nothing done."