

## The Prospects for Canadian Reinsurance in the 1990's

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Article abstract

À cause des développements rapides qui s'opèrent en cette matière, nous tenons à mentionner au lecteur que cet article a été préparé tôt en juin 1989 et relate la situation qui existait, à ce moment-là. Après avoir passé brièvement en revue les résultats de l'année 1988, notre collaborateur fait état des perspectives et des tendances générales de la prochaine décennie au niveau des entreprises canadiennes d'assurance et de réassurance.

# The Prospects for Canadian Reinsurance in the 1990's<sup>(1)</sup>

by

Christopher J. Robey<sup>(2)</sup>

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## 1988 Results

As the Canadian insurance industry reported a combined ratio of 106.40%, 1.6 points worse than 1987 and the worst since 1985 ; as the Ontario Automobile Rating Board heard independent actuaries tell them that a premium increase of 35% was necessary to give automobile insurers in that province a reasonable rate of return ; as the market exchanged story after story of rate curring rampant throughout the industry ; reinsurers reported their first underwriting profit in more than fifteen years.

For years, reinsurers have performed more or less in line with the insurance market as a whole, usually with a combined ratio a point or two worse. What happened in 1988 to cause this sudden reversal ?

Probably the key element lies in the reported need for a 35% increase in Ontario automobile premiums. Ontario automobile ac-

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<sup>(1)</sup> This article was prepared in early June, 1989 and reflects the situation known at that time.

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counts for about 25% of the total property/casualty business with private insurers, and in 1988 it produced a loss ratio of 100.8% and a combined ratio of 125.3%. Even after investment income, it gave insurers an operating loss of over 11%.

However, automobile business is reinsured almost exclusively on an excess of loss basis, the few quota shares remaining representing a very small portion of the total volume and being underwritten by very few reinsurers. With no first dollar coverage and the ability to price excess of loss reinsurance themselves, reinsurers have considerable protection from the disastrous results in that class.

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Reinsurers' property premiums are about twice as high as their automobile premiums and this class was again profitable. Commercial business, which is most often the subject of proportional reinsurance, was the most profitable of all. The lack of a catastrophe, after it had seemed that at least two a year was becoming the norm, made things better still.

### **The Judicial Climate**

Another factor which has helped reinsurers proportionately more than insurers is the moderation of a judicial climate which, three years ago, seemed out of control.

Reinsurers have long made clear, and with reason, how high awards in bodily injury cases and the unpredictability of the legal basis for such awards hurts them more than insurers, in proportion to their premium base.

The liability crisis of 1986 was spawned by a series of judgments and awards in the preceding two or three years which led to a pervasive pessimism amongst insurers and reinsurers concerning the future of liability business and, indeed, whether many risks could continue to be insured at all.

Higher courts have now reversed the most dramatic judgments and reduced some of the larger awards, resulting in a more conservative judicial climate. In addition, the dramatic price increases of 1985 and 1986 have resulted in liability becoming a profitable class. Together, these two developments have encouraged insurers, although it would be wrong to say that there is now general optimism about liability business.

### **Ownership of the Canadian Market**

The 1980's were turbulent years for the Canadian insurance industry, with bankruptcies, the liability crisis, growing political involvement and wild swings in results. The face of the Canadian market therefore has a different look now than ten years ago.

A number of American companies have either withdrawn from Canada or substantially reduced their activities, while Europeans have increased their involvement. An example of both trends was the largest takeover of the decade, the purchase of the Travelers of Canada by the Zurich.

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There has been little growth in the Canadian-owned end of the market and it may be that Canadians' share of the market is going into decline, as Europeans see the purchase of Canadian companies as an opportunity to increase their involvement. The purchase by the Nationale Nederlanden of the Western Union (46th largest in 1988) and Commassur (16th largest), when added to their ownership of the Halifax (26th largest) has pushed them well into the top ten of Canadian groups and reversed the increase in the Canadian-owned market share which saw it rise from 28.66% in 1983 to 33.13% in 1987.

Whether or not this is a trend or a short-lived reversal may be shown by the eventual purchaser of the latest American operation to be put up for sale, United States Fidelity & Guarantee.

While there have not been restrictions on ownership of Canadian property/casualty companies, until 1989 non-Canadians could not purchase a Canadian-owned federally registered life insurance company. The creation of property/casualty companies by life insurers has been the main source of new Canadian capital in the property/casualty segment of the industry in recent years and the ownership restriction has thus represented an important buffer against further erosion of Canadian ownership.

However, with the implementation of the Free Trade Agreement with the United States of America, that ownership restriction is lifted as far as Americans are concerned and the acquisition of a Canadian company thus becomes an interesting prospect for expansion for American life insurers.

With the strength of the Canadian life insurance industry, one would expect that Canadian insurers would in turn be looking south of the border for their expansion, and indeed many are already well established in the United States. However, the prospect of the emergence of a single North American insurance market, with Canada as a junior partner, would be little comfort to the mainly smaller Canadian-owned general insurers.

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Along with increased foreign ownership of the Canadian industry has come the export of decision making concerning Canadian reinsurance, with an increasing number of the foreign groups taking their reinsurance decisions outside Canada and, frequently, buying all their reinsurance from outside Canada as well.

#### **Influences on the 1990's**

As the 1980's come to an end, the Canadian insurance market is in a state of transition.

Consolidation of the market has increased the size of the average insurance company. This, coupled with the increased retentions forced on insurers during the tight reinsurance market in the middle of the decade, has greatly reduced the ability of reinsurers to influence the direction of the insurance market.

The new federal reinsurance regulations introduced in 1989, while doing no more than confirming the status quo in the present market, will prevent a return to the mis-use of reinsurance which existed in the 1970's, when small companies assuming very little of their own risk had a disproportionate impact on their larger competitors.

In the last thirty years, Canada has moved from a reinsurance market dominated by direct writing reinsurers to one where possibly as much as 90% of the reinsurance purchased is handled by reinsurance brokers.

The reinsurance brokerage market itself is dominated by large insurance broking groups, the four major Canadian reinsurance brokers being subsidiaries of insurance broking groups which are amongst the top 15 worldwide. One is the subsidiary of the largest Canadian-owned group and the other three the reinsurance arms of the three largest broking groups in the world.

The largest reinsurer in Canada is a subsidiary of the largest reinsurer in the world ; the second largest reinsurer in Canada is a subsidiary of the second largest reinsurer in the world. The seven largest reinsurers in the world and twelve of the largest twenty have Canadian operations, and this does not include Lloyd's.

Of the fifty-six licensed companies writing reinsurance in the general market, twenty-six do not have an underwriting office in Canada and some of the other thirty do not take the final underwriting decision in Canada.

Only one of the fifty-six reinsurers is Canadian-owned, the only other one having had its portfolio purchased by the Skandia earlier this year.

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There is a long list of foreign companies looking into the possibility of becoming licensed in Canada, however there is a suggestion that they are not welcome – two, which were far enough along the way in 1988 that the issuance of their license appeared to be no more than a formality, were unexpectedly turned down at the last minute and are having trouble reviving their application.

Reform of financial institutions in Canada is still in a state of flux, with no clear direction for federal policy and Quebec forging ahead with its own rules.

It now seems certain that banks, the giants of the Canadian financial services industry, will be permitted to market insurance. Already, they are making arrangements to market the products of unaffiliated insurance companies, apparently obeying the letter of the law as it currently stands. However, it seems probable that such arrangements will not be permitted when the new banking law is introduced and banks will be forced to form insurance company subsidiaries if they wish to continue in the insurance business.

Ontario automobile insurance remains in turmoil. The Ontario Government has reversed the decisions of its Rating Board which were due to come in effect on the 1st June 1989, substituting a rate increase of 7.6% while they sought another solution to the political and social problem.



They have now introduced draft legislation to set up a system of no-fault insurance, removing the right to sue except in the case of death and serious injury.

1991 will see the arrival of a federal goods and services tax, although insurance services are exempt, an exemption which is opposed generally by the industry and may not last into the final legislation. Apart from increasing the cost of insurance – already a major political issue – it will add to the administrative costs of insurance companies which are in turn reflected in the premium.

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Finally, we must add to this the increasingly competitive market for property and liability business, as insurers struggle to maintain their market share while reducing their reliance on loss producing automobile premiums.

### **The Prospects for the 1990's**

The prospects for the 1990's depend on a proper weighting of all these influences on the industry, a daunting task at this stage.

Certainly, the regulation of automobile insurance in Ontario and the introduction of the new system, with increased government control, means that the market will now be divided into two – automobile and other. With the industry having lost much of its control over its destiny in the automobile sector, major shifts in competition will be concentrated in the property and liability markets in future. Their smaller premium base risks making the fluctuation in results even more volatile than in the 1980's.

Government control of automobile will almost certainly result in a reduction of the number of companies offering it as part of their product line, a reduction which has already begun. Indeed, if the banks decide that they want it, many insurers will be tempted to say that they are welcome to it.

As free trade with the United States of America produces more of a North American market for Canadian products, Canadian insurers must follow suit. For the foreign-owned companies, this will mean overcoming the reluctance of the Canadian arm to permit any sort of involvement from the usually much larger American arm, in order to take advantage of the opportunities which a North American approach can offer.

For the Canadian-owned companies, it will mean developing strategies to deal with the American exposures which their insureds will have, perhaps making expansion of their insurance operations into the United States an avenue worth considering.

Certainly, the trend towards consolidation of the industry into larger units can be expected to continue, with the creation of brand new insurance companies more and more of a rarity.

### **The Prospects for Reinsurers**

Reinsurers will face equally strong challenges. They are already in a highly competitive market and can expect no dramatic growth in the pool of available reinsurance. Indeed, reinsurance premiums may continue to drop as a percentage of total Canadian premium through the next ten years.

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Reinsurers must also settle for having little influence over the insurance market they serve.

Because of this, it is difficult to see what will bring about a tightening of the reinsurance market. The current licensed capacity is several times greater than required for the run-of-the-mill business, although specialty classes still struggle for coverage. Open market placements with unlicensed reinsurers have almost disappeared.

Although hidden barriers to entry may prevent any significant increase in the number of licensed reinsurers, it is difficult to see why any significant reduction would occur. Such is the strength of the reinsurers licensed in Canada, and their Canadian portfolio sufficiently small in their overall book, that they can ride out poor results for as long as they want. Certainly, those reinsurers which do not have underwriting offices in Canada can reduce their Canadian acceptances, however they can come back in just as easily at the first signs of a hardening market.

It may be that some reduction in capacity will result from the development of a single European market in 1993. As insurers and reinsurers organize themselves to meet the challenges of that market, they will find themselves with more outlets on to the Canadian market than they need. Already, the Swiss Re Group has three wholly-owned subsidiaries competing independently for Canadian business – Canadian Re, Union Re and Switzerland General. Mu-



nich Re has both the Munich of Canada and the Great Lakes, as well as some unlicensed involvement through the New Reinsurance Company of Geneva. Gerling has the Gerling Global and the Frankona, although in this case the financial links do not involve any management links.

Links amongst French insurers and reinsurers, based as they are on interlocking minority interests, are more difficult to follow, but seem likely to increase.

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If this multitude of interlocking ownerships is eventually rationalized, as many as 10% of the current crop of licensed reinsurers could disappear from the Canadian scene, but not with a corresponding reduction in capacity, since it would be the smaller reinsurers, in Canadian terms, which would disappear from the market.

This will also take some time to come about. In the meantime, reinsurers must compete for property business which is losing some of its attractiveness, while struggling to maintain their pricing for liability business and designing new products for whatever form of automobile insurance will be offered.

Two areas of opportunity nonetheless can be identified.

Firstly, there is an increasing awareness on the part of Canadian insurers for the need of catastrophe coverage well in excess of what they are currently carrying. While there is certainly adequate licensed capacity to meet much higher demands, the increased use of the available capacity would result in a hardening of the pricing for existing layers as well as the new layers sought.

However, it is in the opportunity for a new approach to the reinsurance of Ontario automobile business that the greatest opportunities for reinsurers lie and it is ironic that companies in a risk-taking business, facing a shortage of available risks, should have, as a first reaction to change, a desire to minimize risk.

Faced with the prospect of enriched accident benefits in Ontario a year ago, the first response of reinsurers was to seek an automatic commutation of claims, despite the lack of any indication that this was what their clients were interested in.

For the 1990's, opportunities are greatest for those reinsurers willing to embrace risk and share fully with insurers in the long-term exposures non-tort insurance will bring.

It will only be the strongest of reinsurers which would be acceptable as partners in a liability which could run beyond the lifetime of those making the decisions, however such is the strength of the financial backing behind the Canadian reinsurance industry that this should not be a barrier to most of them.

The opportunities will be there for all reinsurers. Separating those able to take them from those left behind will determine the prospects for individual reinsurers in the next decade.

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#### **COLLOQUE SOUS L'ÉGIDE DE LA FACULTÉ DE DROIT DE L'UNIVERSITÉ D'OTTAWA**

##### **Comment maîtriser les risques dans les contrats internationaux**

**Lieu et date :** Hôtel Westin (Ottawa), le 18 octobre 1989

**Thème :** Les contrats internationaux présentent des risques particuliers (politiques, économiques, commerciaux et juridiques) que l'exportateur ou l'investisseur doit maîtriser pour maximiser ses chances de succès et éviter les pertes.

Ce colloque vise à identifier ces risques et à proposer aux participants des façons de les prévoir et de les gérer. Il s'adresse tant aux juristes qu'aux gens d'affaires.

**Conférenciers :** Les conférenciers sont d'éminents spécialistes du commerce international : exportateurs, investisseurs, avocats, assureurs, banquiers, fonctionnaires, universitaires du Canada et de l'étranger.