

# SLIPPERY SLOPE

Once again, there was no turmoil from a major M&A, no mayhem from a significant manmade or natural catastrophe, and no uncertainty from a nonsensical legal ruling. For the second year running, there did prove to be a little bit of rest for the weary but industry observers see results hitting a slippery slope.



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**T**he year in review marked yet another wholly unextraordinary one where the big story (once again) is that there really isn't one - at least not in the sense of a CNN-esque breaking report that has a person sitting on the edge of his or her seat. Again, no big M&As and no substantial natural catastrophe or technical losses.

One thing is certain, the lack of stress for the industry the last few years has lead to great stress for this writer: How does one crank out 4,000 words about the industry year after year when there isn't much to be said?



## INDUSTRY PERFORMANCE

According to the Property and Casualty Insurance Compensation Corporation (PACICC), the favourable conditions of the last few years have weakened. Premium and claims trends indicate that while still profitable, the industry's net income and return on equity (ROE) are falling and solvency risk is increasing.

While the cycle is turning for the worse, the downturn is not expected to be as severe as the previous soft cycle because claims costs are not growing at the alarming rate experienced in the late 1990s. Also, insurance companies have better adapted to a low interest rate environment. However, the combination of rising claims costs and economic developments in the latter part of 2007 (i.e. the subprime crisis and the strengthening of the Canadian dollar) warn that 2008 could be a more volatile period for Canadian insurers.

Taking industry results from 2007 and carrying them forward three years over two different scenarios, IBC's vice president of policy and chief economist Jane Voll painted a potentially dark picture of the industry going forward. In Voll's two settings, which she outlined to those attending Swiss Re's annual breakfast April 4, the industry continues its current trend of deteriorating results (i.e. premium shrinkage and claims growth) over a catastrophe-free period. In the second, the same industry performance is replicated, however catastrophes costing \$1.5 bil-

lion, \$500 million and \$500 million are spread over each of the three years, respectively.

For scenario one, "...if we continue 2007's trend of deterioration of premiums and claims, by 2010 we would see a 5 per cent deterioration in the combined ratio (from 93.7 per cent in 2007 to 98.4 per cent in 2010). The ROE would fall from 14.5 per cent in 2007 to 11.1 per cent in 2010," said Voll. "For Scenario 2...we get very close to 100 per cent by 2010 on the combined ratio, losing a lot of money, and ROE would fall to something in the range of 5 per cent," she continued. "We're on a very slippery slope, and what will happen in 2008 is anyone's guess."

For every dollar of revenue they generate in premiums and investment income over the course of an industry cycle, insurers pay 66.7 cents on the dollar for claims, 14 cents of each dollar for taxes, 18.4 cents for operating expenses and almost one cent back to capital. "Not a very attractive position from a shareholder's perspective," Voll noted. Moving into 2008, given the claims growth trend, "In Ontario auto we are looking at a situation now where \$1 of revenue is going to equate to 73 cents of claims, 19.3 cents in expenses, 8.9 cents to taxes, and insurers will be coughing up capital of 1.5 cents on the dollar in order to keep that business afloat."

In the key auto insurance segment, which represents nearly half of the industry by premium volume, claims costs in 2007 increased nearly three times faster than premiums, says PACICC. Such costs have been stable or declining modestly in the liability segment of the automobile insurance product. The February 2008 decision of Alberta Court of Queen's Bench regarding caps on minor personal injuries, if upheld on appeal, will impose significant unreserved costs on insurers in Alberta and Atlantic Canada, and will

likely reverse the trend in liability claims costs.

Noting current trends in Ontario auto, a key segment in the Canadian insurance market representing about one-quarter of the premiums written in the country by private p&c carriers, Voll said the product is currently losing money on both the accident benefits and third party liability side, turning marginal profits into deficits moving into 2008.

As of mid-2007, the loss ratio on the accident benefits side climbed from its 2006 level of 81 per cent to 100 per cent, she noted. "Sometimes we have a situation where we're losing on accident benefits, but we're gaining claims savings on the other side of the product. Not so in Ontario. We're losing from both sides of the house," she said.

After a lull in 2006, property insurance claims costs during 2007 were once again influenced by severe weather. Wildfires in Trail, B.C. and Northwestern Ontario; flooding in Calgary (June), Terrace, B.C. (May/June), Quebec (August) and Surrey, B.C. (September); wind damage in Vancouver (late 2006/early 2007); tropical storm Chantel in Newfoundland and Labrador (August); tropical storm Noel in the Maritimes (November); a tornado in Elie, Manitoba - Canada's first-ever F5 event (June); and seasonal storms in the Prairies adversely affected property lines across the country.

According to Aon Re Global analysis, traditional property catastrophe reinsurance program pricing is anticipated to continue softening during mid-year renewals. Price reductions will be a higher priority for cedents, while terms and conditions are expected to improve, Aon noted in a release April 15. But the underlying fundamentals that drove the softening of price and terms and conditions at January 1, 2008



are expected to continue through the June and July renewal season, Aon reported. Aon Re Global's market expectations for the June 1 and July 1 renewals for Canada include a -7.5 per cent to -12.5 per cent rate-on-line change, a capacity change of 10 per cent to 15 per cent and a stable retention change.

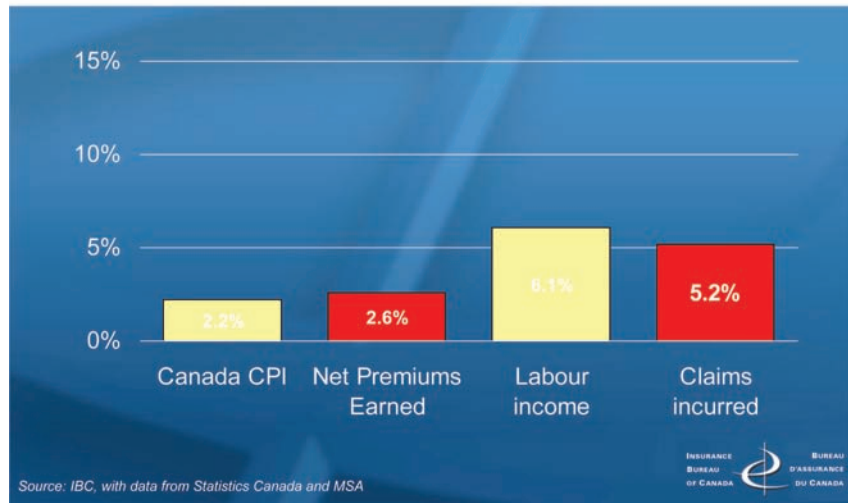
On the liability side, one facultative reinsurance underwriter noted that he has been seeing average premium decreases in the 10 to 15 per cent range on most renewals, with occasional as-is or slight increases if the exposure is up more significantly. He noted that client companies have been reducing renewal premiums in some cases by just 10 to 15 per cent, but in many cases by much higher to retain accounts. Reductions of 25 per cent and even as much as 50 per cent are not unheard of as "nobody seems to want to lose a renewal account right now."

The good news, he notes, is that - so far - casualty terms and conditions have remained firm. "Typically the larger size premium accounts are under the most intense competition and those are the ones that can see up to 50 per cent premium decreases on renewal, and brokers are quite prepared to re-market all their accounts because they are under very intense competition. The London market is very aggressive and seem to be very partial to writing Canadian business," he said.

"Though we like to hope that we are near the bottom of the cycle, we likely aren't, and the market will probably get worse throughout 2008 and 2009. Hopefully we will start to see some tightening by 2010. Casualty loss ratios are sliding, so eventually there will be a market correction and rates will go up. But how long that will take remains to be seen," he said.

Overall, industry underwriting profitability is down, driven by worsening

## Claim growth outpacing other indicators



loss ratios in all lines of business, says PACICC. The number of insurance companies experiencing net losses in 2007 was greater than at any time since 2001 and 2002, a period that saw the insolvency of three Canadian p&c insurance companies.

### THE SUBPRIME CRISIS

According to BestWeek Europe (canadianunderwriter.ca - April 16), the scale of the subprime crisis so far is having the equivalent impact on the insurance industry as a Category 5 hurricane hitting Miami. For Q1 2008, D&O and E&O claims and litigation linked to the subprime crisis are currently up 400 per cent year-on-year, Greg Flood, president of Ironshore Insurance's professional liability facility, IronPro, told BestWeek Europe.

Canadian insurers have little direct exposure to subprime paper as most insurer assets are invested in high quality government bonds and few equities. According to PACICC, alone, neither the subprime crisis nor an economic downturn is directly expected to result in the insolvency of a Canadian p&c insurer, although convergence of the

two could present a challenge. Also, it said, with many p&c insurance companies being part of a financial group or conglomerate encompassing financial institutions outside of the insurance industry, some insurers may have affiliates or parents with subprime exposure.

### STRONG DOLLAR

According to PACICC, the vast majority of p&c insurance company transactions and assets are in Canadian dollars and are unaffected by currency markets. Besides direct transactions and foreign currency denominated investments, insurers may be exposed to currency fluctuations through other channels, including: reinsurance; ownership of foreign subsidiaries; cross-border claims activity; exposure from a foreign parent company; and, through the impact on the broader economic environment.

Foreign parents of Canadian insurers would be exposed to currency fluctuations in the preparation of the consolidated financial statements for the parent company, PACICC says. With Canadian dollar appreciation, the value of the Canadian operations would

have increased. A higher Canadian dollar makes it more expensive for a foreign parent to provide capital to its Canadian subsidiaries. If the higher Canadian dollar persists, particularly against the U.S. and European currencies, and market conditions continue to soften, this may become a larger consideration.

### LOOKING AHEAD

The p&c industry outlook for 2008 is potentially more turbulent than it has been in the past few years, says PACI-CC. Fewer companies are recording an underwriting profit than a year ago. Deteriorating underwriting results, subprime exposures to parents and affiliates, volatility in financial markets - particularly in interest rates - and the threat of severe weather events represent the most immediate risks to insurers going forward. While the industry is well capitalized, having finally rebuilt the capital that was lost during the period 2000 to 2002, large variations persist in insurer financial health.

If the threat of an economic downturn in the United States materializes, it has the potential to reduce growth opportunities and make policyholders more resistant to price increases. In this environment, downward pressure on premiums from the demand side combined with rising claims costs may place increased stress on the solvency of Canadian p&c insurers.

### MANAGING THE CYCLE

Contrary to popular belief, the insurance cycle is not some uncontrollable mystical force that indiscriminately decides when and how its effects will be felt on the p&c insurance industry. It is not an impediment put into place by some unknown deity, nor is it an invisible hand or an unrestrainable market phenomenon. Indeed, it is none of these things. The insurance

cycle is created by humans, specifically through the actions they take or fail to take as actors in the insurance industry.

In essence, the financial position of (re)insurers governs the cycle as industry players tend to increase prices and pull back on capacity when growth of surplus is flat or negative, investment returns are weak and catastrophic losses high; and lower prices and increase capacity when surplus is growing, investment returns are strong and claims costs are manageable. Because of price swings, (re)insurers often have to cope with extreme fluctuations in revenue and expenditure, which often deeply impact their profits.

According to the Swiss Re publication "The insurance cycle as an entrepreneurial challenge" (2002), written by Rudolf Enz, deputy head of economic research & consulting at Swiss Re, these price fluctuations are detrimental in two ways: "On the one hand, they make it difficult to plan ahead for revenues and expenditure, on the other, they increase the cost of capital to the company."

In the publication, Enz emphasizes the critical fact that in periods of lower prices, (re)insurers traditionally write more business (i.e. take on more risk and, thus, greater loss potential) than they do when prices are higher. This is counterintuitive because basic economics dictates that the opposite would be more sensible (i.e. that carriers take on more risk when prices are high and less when prices are low).

According to Enz, "there are - at least theoretically - supply-side strategies with which better results can be achieved over the cycle, with roughly the same volatility, than by passively standing by and allowing the cycle to take its course."

The strategies are largely based on



two approaches: varying business volume, and steering risk capital. "This entails reducing market share in phases with lower prices and increasing it again in high-price periods. The (re)insurer's equity changes in parallel: in high-price phases it has to be increased, in low-price phases reduced again," says Enz.

The best way to manage business volumes is to direct capacity to where the highest economic value resides, i.e., to those lines, segments or geographic regions where the return will be the greatest. This means walking away from business when the price does not cover costs. If pricing is not quite where it should be, but there is still room for profit, it may be more reasonable for the company to write lower shares or to reduce exposure by insisting on higher deductibles/retentions or lower upper cover limits. Tightening terms is another way of reducing loss potential.

The challenge comes in properly diagnosing the market situation, i.e., in determining where in the price cycle the industry is, and where it is going - and doing so in time and with accuracy. Such a diagnosis requires a future-oriented market analysis. The accuracy of this analysis and the successful implementation of a company's cycle management strategy, says Enz, depends greatly on the company's access to underwriting expertise as it is this knowledge and experience that is needed to estimate how much longer

the soft market is going to last and when prices are going to rise significantly again.

Managing a company's adjustment of business volumes all comes down to proper timing. Monitoring the market, predicting market trends and accurately assessing prices all play an important role. However, if a company's timing is off, the fallout is the same as it would be if it did not take any action at all. It may even be worse, because the company may have damaged business relations with brokers, cedents or insureds without getting any economic payback.

The first step in all of this, however, is to not only admit that the industry has a problem managing the cycle, but to admit that it is primarily responsible for the cycle. Then, and only then, can the industry work to solve the problems presented by it.

### WATER DAMAGE AS A TREND

When speaking to insurers about loss trends, ICLR is hearing more and more concerns being expressed about water-related damage - both overland flood, and sewer backup. It has become apparent that the industry requires more investigation, including hard science, into the facts surrounding such losses, as they are costing companies a great deal of money each year. Indeed, several insurers have described scenarios where, depending on the region in which business is being written, they are getting hit with more frequent but less severe losses, rather than less frequent big hits.

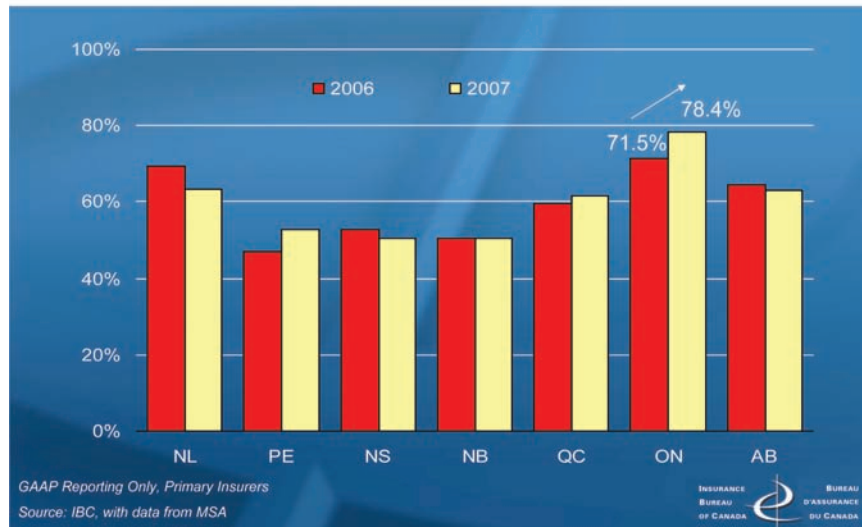
Hearing the call for research, ICLR on December 5, 2007 released a major study on public perceptions of sewer backup. The paper is based on a survey of a total of 805 homeowners in Edmonton, Alberta, and Toronto, Ontario, and included both homeowners who had never experienced sewer

backup damages and homeowners who had suffered sewer backup damages at some time in the past. The intention of the research is to increase awareness and understanding of homeowner perceptions of sewer backup and homeowner risk mitigation in Canadian municipalities, and to provide practical information for municipal government staff responsible for managing basement flood risk.

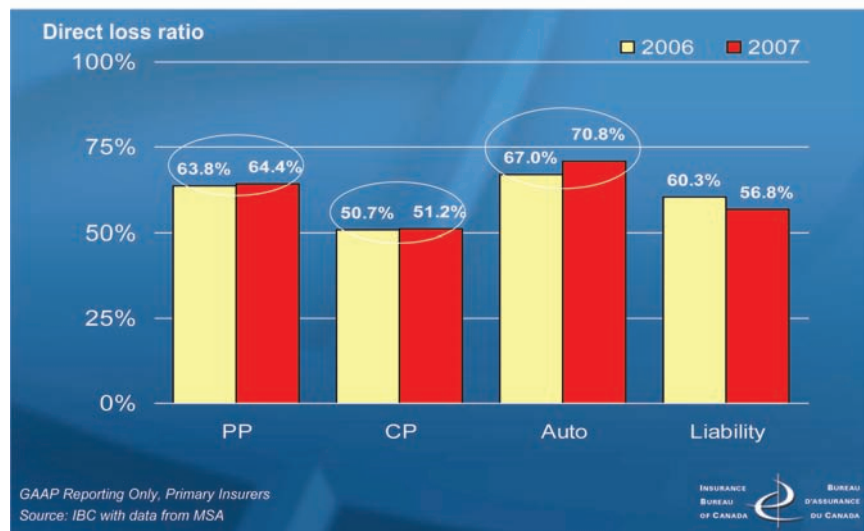
Results from the study, authored by ICLR research coordinator Dan

Sandink, suggest that homeowner risk perceptions and mitigative adjustments related to sewer backup are low. Furthermore, there existed the perception that the municipal government holds the majority of the responsibility for damages caused by sewer backup. Considering the costs of upgrading sewer systems, the unpredictability of heavy rainfall events and the expectation that heavy rainfall events will increase as a result of climate change, homeowners in Edmonton and Toronto will need to become more

## Auto Direct Loss Ratios



## 3 of 4 Lines of Business are Weaker





involved in the mitigation of sewer backup risks over the short- and medium-terms.

From the government side, municipalities should work to provide effective hazards education programs, and encourage homeowners to take measures to reduce basement flood risk. Municipalities should also be ready to provide information to homeowners in order to take advantage of ‘windows of opportunity’ - the short time that follows hazard occurrences when the public is most receptive to hazards information and most willing to take actions to reduce hazard risks. Formal, ongoing programs, such as Edmonton’s basement flood education program, ensure that information and materials are ready as soon as a disaster hits a community.

As part of basement flooding and sewer backup hazard education programs, homeowners need to be made aware that insurance coverage for sewer backup is generally optional and can be provided at a very low cost. Homeowners who aren’t sure if they have this type of coverage should be encouraged to check their policies or call their insurance brokers or insurance companies.

On the overland flood question, specifically as it pertains to homeowners, ICLR is also embarking on a project with a major Canadian market player, looking into the question of the insurability of food in Canada. The results of this work will be made public in due course.


### IN THE COURTS

Though it was a busy year in the courts for insurance-related decisions (see Christopher R. Dunn’s Top 10 Insurance Coverage Decisions: The Cases You Should Know About From 2007; Claims Canada magazine, February/March

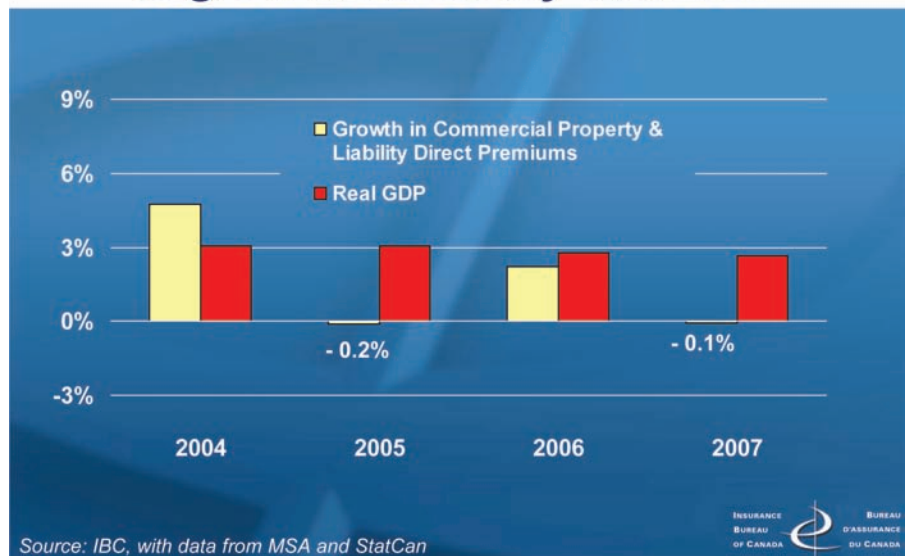
## 2007 Comparative Results

%	Primary Insurers	Reinsurers
CR	93.7	88.6
ROE	14.5	14.5
ROI	5.7	5.7

\* No Reinsurers



## Commercial premiums continue to grow more slowly than GDP



2008, [claimscanada.ca]); the cases worth highlighting here are Citadel General Assurance Co. v. Vytlingam and Lumbermens Mutual Casualty Co. v. Herbison. Both relate to ownership or use of a motor vehicle, and both were put to bed by Supreme Court decisions last October 19.

According to the Supreme Court decision in the Vytlingam case: “The V[ylingam]s were motoring along an

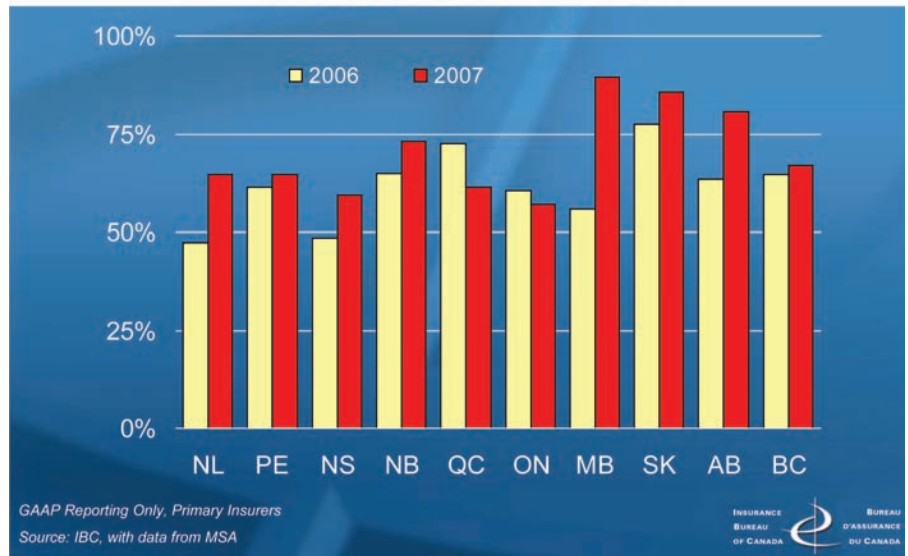
interstate highway when their vehicle was struck by a large boulder dropped from an overpass by F[armer] and R[aynor], catastrophically injuring M[ichael] V[ylingam] and causing C[handra] V[ylingam] and S[uzana] V[ylingam] serious psychological harm. F[armer] and R[aynor] were prosecuted, convicted, and imprisoned. The V[ylingam]s received statutory no-fault benefits from their Ontario insurer and, since F[armer] was inadequate-

ly insured, they sought to recover the civil damages F[armer] had caused from V[ylingam]’s insurer pursuant to the inadequately insured motorist coverage found in s. 3 of the Ontario Policy Change Form 44R. Under this endorsement, “the insurer shall indemnify an eligible claimant for the amount that he...is legally entitled to recover from an inadequately insured motorist as compensatory damages in respect of bodily injury to...an insured person arising directly or indirectly from the use or operation of an automobile.” As F[armer]’s vehicle had been used to transport the rocks to the scene of the crime and thereafter to escape, both the Ontario Superior Court of Justice and the Court of Appeal, citing *Amos v. Insurance Corp. of British Columbia*, [1995] 3 S.C.R. 405, found the insurer liable and allowed the V[ylingam]’s claims.”

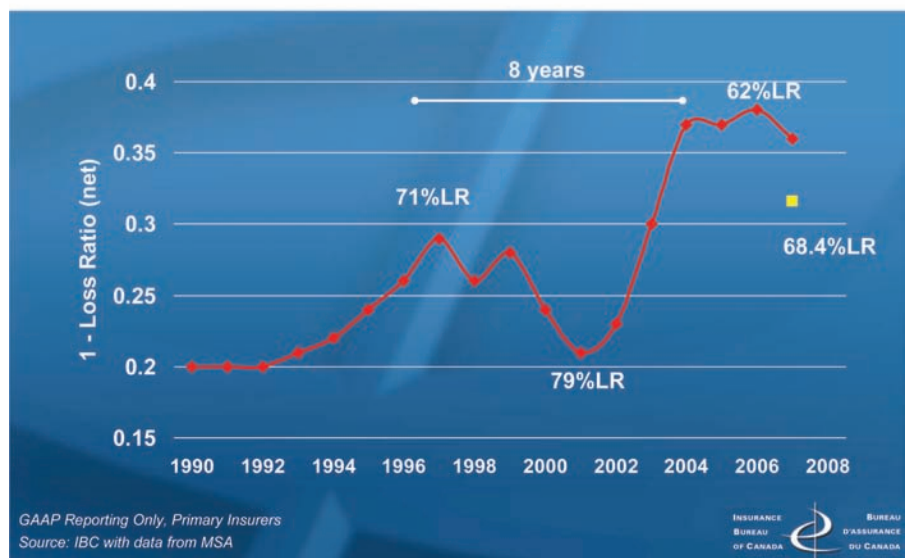
According to the Supreme Court decision in the *Herbison* case: “W[olfe], a member of a yearly deer hunting party, was driving to his designated hunting stand before sunrise when he thought he saw a deer. He got out of his truck, removed his rifle, loaded it, and shot at a flash of white, hitting H[erbison], another member of the hunting party. W[olfe] was found liable in negligence to H[erbison] and H[erbison]’s family. H[erbison] and his family sought recovery from W[olfe]’s insurer under a standard motor vehicle liability insurance policy which, as required by s. 239(1) of the Ontario Insurance Act, provides coverage for loss or damage ‘arising from the ownership or directly or indirectly from the use or operation’ of an automobile owned by the insured. The trial judge dismissed the claim against the insurer, but a majority of the Court of Appeal set aside the decision and found the insurer liable.”

Explains Dunn: “In order to succeed,

## Personal Property Direct Loss Ratios



## 1st Year of Soft Market Phase



both Vytlingam and Herbison had to prove their injuries resulted from the “use or operation” of a motor vehicle. Vytlingam succeeded at the trial level as the judge found a sufficient connection between the use of Farmer’s vehicle to transport the boulders to the scene and the subsequent accident. Herbison failed at trial as the judge concluded the shooting was incidental to the use or operation of the Wolfe motor vehicle.

Both decisions were appealed, and the Court of Appeal supported the insureds, upholding the motion judge’s decision in Vytlingam and overturning the motion judge’s decision in Herbison. The Court of Appeal found the activities giving rise to the loss - the throwing of the boulder and the shooting of the gun - each had a sufficient nexus to the use or operation of the vehicles to fall within coverage.”

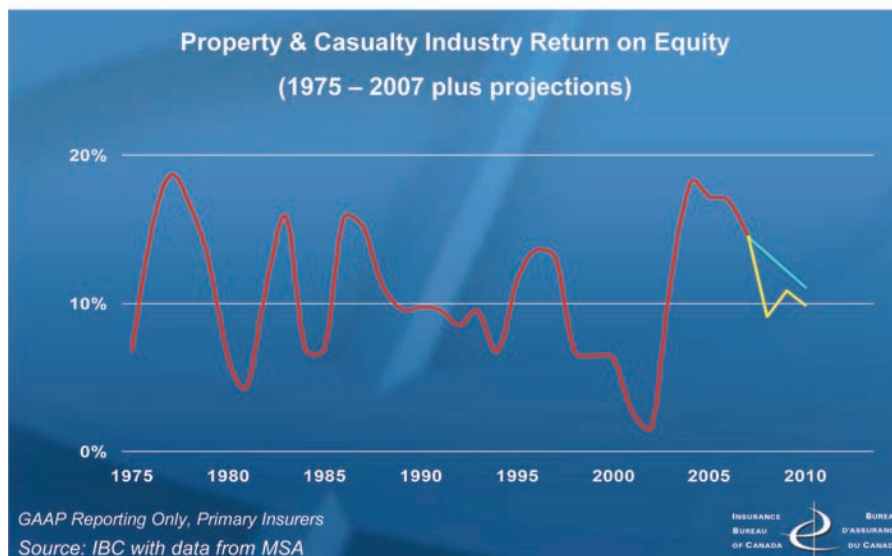
He continues: “Both insurers successfully appealed to the Supreme Court of Canada. The Supreme Court did not agree the required nexus was present. Even the use of the broad term ‘directly or indirectly’ in the policy did not eliminate the requirement of an unbroken chain of causation between the use or operation of the motor vehicle and the resulting injury. Wolfe’s interruption of his motoring to start hunting and Farmer’s walk to the overpass from his parked vehicle each broke the chain of causation.”

## REGULATION

The Office of the Superintendent of Financial Institutions (OSFI) in May of last year announced that the coming into force of certain amendments to Part XIII of the Insurance Companies Act would take place on January 1, 2009. The amendments will affect all foreign insurers and reinsurers carrying on business in Canada as branches. (OSFI announced on February 13, 2008, that it would push back the date the changes would come into force, to January 1, 2010.)

The amendments were intended to harmonize the Act with the Winding-Up and Restructuring Act. According to J. Brian Reeve (Bill C-37 Update: OSFI Defines ‘Insuring in Canada a risk’; Canadian Underwriter, November 2007) “OSFI was concerned that in the event of the insolvency of a Canadian branch of a foreign insurer, foreign policyholders could potentially argue that they were eligible to be covered by the assets that were vested in trust in Canada. In such a situation, there might be an inadequate amount of assets in Canada for the Canadian policyholders that the assets were originally intended to cover. The changes to Part XIII are intended to eliminate this concern.”

## A Cyclical Industry



With the changes incorporated into Bill C-37, there will be a change to the basic test of when a foreign insurer is required to report its Canadian business to the Office of the Superintendent, and to maintain assets in a vested trust account in Canada to cover them.

At an A.M. Best Canadian conference, held in Toronto on September 21, 2007, representatives of the Canadian reinsurance market assured attendees that despite changes to Part XIII of the Insurance Companies Act, their Canadian branches are here to stay. Jean-Jacques Henchoz, CEO of Swiss Re Canada, assured guests that Canadian branches still hold value. “I think we are acknowledging that there is market specificity here and we’re here for the long term,” he said. “There is still business to do here and opportunities,” he noted. “I don’t think that Part XIII will change anything from the current set-up.”

## CONCLUSION

While the Canadian p&c segment had another strong financial year, there are clear signs of weakening in several lines.

Claims costs are rising, and pricing is on the decline. On the upside, wordings and conditions appear - for the most part - to be holding up, at least for now.

Once again, the industry experienced no major mergers or acquisitions. Nor were there any large losses on the man-made or natural catastrophe side. The pair of like-Supreme Court decisions that came down last October were a refreshing change from some of the rulings handed down in recent years.

As noted in this very space last year, given the potential flip-side, for yet another year there did prove to be at least a little rest for the weary.

And, again, the Canadian p&c industry has chosen to take it while it can get it. cu

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*Charts/Graphs used throughout this article are courtesy of the Insurance Bureau of Canada (www.ibc.ca).*