Property and Casualty Insurance

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Canada

(V.8.91.09)

1990–1991

PROPERTY AND CASUALTY INSURANCE

FOREWORD

In a rapidly changing global trade environment, the international competitiveness of Canadian industry is the key to growth and prosperity. Promoting improved performance by Canadian firms in the global marketplace is a central element of the mandates of Industry, Science and Technology Canada and International Trade Canada. This Industry Profile is one of a series of papers in which Industry, Science and Technology Canada assesses, in a summary form, the current competitiveness of Canada's industrial sectors, taking into account technological, human resource and other critical factors. Industry, Science and Technology Canada and International Trade Canada assess the most recent changes in access to markets, including the implications of the Canada-U.S. Free Trade Agreement. Industry participants were consulted in the preparation of the profiles.

Ensuring that Canada remains prosperous over the next decade and into the next century is a challenge that affects us all. These profiles are intended to be informative and to serve as a basis for discussion of industrial prospects, strategic directions and the need for new approaches. This 1990–1991 series represents an updating and revision of the series published in 1988–1989. The Government will continue to update the series on a regular basis.

Michael Wilson

Michael H. Wilson
Minister of Industry, Science and Technology
and Minister for International Trade

Introduction

Canadians are served by a well-developed financial system in which a variety of institutions provide a rich and diverse selection of financial services. Increasingly, these institutions have been expanding the range of services that they provide to business and to the public.

This profile on the property and casualty insurance industry focuses on companies that assume the risk of certain forms of financial liability in return for the receipt of premiums. The specific risks it underwrites are those associated with loss of or damage to property as well as losses due to injury to a third party and related claims. This industry profile does not deal with the insurance brokerage industry nor with life and health insurance. Industry profiles describing other financial services are available on

- *Banking*
- *Life and Health Insurance*
- *Venture Capital*

Structure and Performance

Structure

The Canadian property and casualty insurance industry is made up of companies incorporated in Canada, either federally or provincially, as well as companies incorporated outside Canada that operate in Canada on a branch basis. They may be either stock companies owned by their shareholders or mutual companies owned by their policyholders.

These companies do very little business outside Canada from their Canadian-based operations.

The industry is highly regulated. Federal regulations require federally incorporated companies to have the financial resources to meet their obligations to their policyholders, and control the entry of foreign companies into Canada. Provincial regulations set the financial requirements for provincially incorporated companies. Provincial legislation stipulates measures related to consumer protection and contract law.

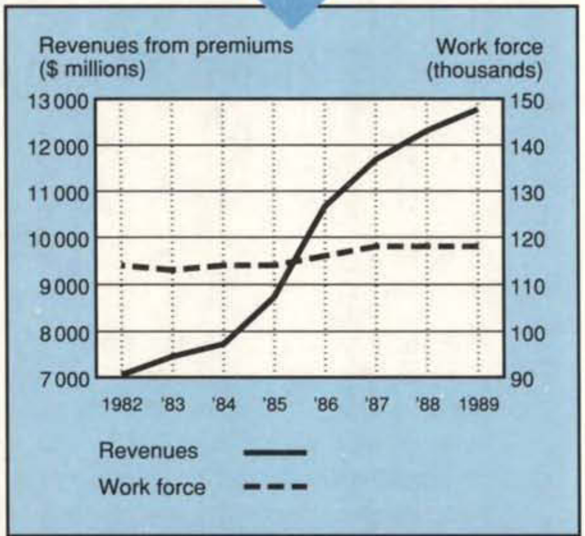
Companies wishing to conduct business in several provinces usually incorporate federally. These firms as well as non-resident companies are subject to federal insurance legislation and are supervised by the Office of the Superintendent of Financial Institutions (OSFI).

Those companies focusing their business in only one or two provinces usually seek provincial incorporation. However, all companies, whether federally or provincially incorporated, must be licensed in each province in which they wish to conduct business. Provincial regulatory bodies also have jurisdiction over the contractual provisions of insurance policies and the licensing of agents and brokers. The Superintendent of Insurance of each province has the primary responsibility for supervising the financial condition of companies incorporated in its jurisdiction.

Entry into the industry is relatively straightforward. Investors wishing to incorporate a new insurance company must demonstrate that they have adequate financial resources and that the management has expertise in the insurance industry. In practice, a minimum initial capital of $5 million is required to incorporate a new federal insurance company, although this amount will be raised to $10 million if proposed amendments to existing legislation are accepted. The OSFI requires higher amounts of capital for companies that wish to engage in more risky lines of insurance, such as environmental risks. In general, less capital is required to incorporate a provincial insurance company.

There are no federal restrictions on foreign acquisitions of existing or new Canadian companies or on the transfer of ownership in foreign firms between non-residents, aside from the restrictions applicable under the *Investment Canada Act*. The Province of Quebec, however, limits foreign ownership of new or existing Quebec-incorporated property and casualty and reinsurance companies. No non-resident investor can own more than 10 percent, and no group of non-resident investors can own more than 25 percent of these companies.

Some 350 companies were licensed to offer various types of property and casualty insurance in Canada in 1989. Of these, 185 were Canadian incorporated companies: 105 were registered federally and 80 provincially. An additional 165 non-resident companies were licensed to operate in Canada on a branch basis. These figures exclude the small, provincially incorporated mutual companies in Quebec and Ontario, which represent less than 5 percent of the market.



Work Force and Revenues from Premiums

There are many types of property and casualty insurance, each designed to cover specific classes of risks. The main risks covered by property and casualty insurance include protection for individuals and organizations against losses due to theft, fire or other physical damage, as well as liability claims resulting from injuries to other persons or damage to their property. The most common products are automobile, property, liability, marine, aircraft and surety insurance.

Automobile insurance is the largest class. It is heavily regulated at the provincial level, with each province setting minimum levels of compulsory coverage. Property insurance is the second largest class of business, and is about equally split between personal and commercial lines.

Private sector insurance companies in 1989 collected about $12.8 billion in premiums (see figure). Automobile insurance accounted for 51 percent of this amount and property insurance took a 32 percent share. In addition, provincial government insurance companies (mainly automobile insurance companies in British Columbia, Saskatchewan, Manitoba and Quebec) collected premiums of almost $2 billion in the same year.

Companies tend to specialize in the lines of insurance they offer. A company with a large share of the market for a particular type of insurance tends to have smaller shares of other types. As a result, overall market concentration is low. For example, the seven largest companies providing automobile insurance in 1989 accounted for 36 percent of the total market for private sector automobile coverage across Canada. While these seven companies were active in other lines of insurance also, accounting for 25 percent of all property insurance premiums written in Canada in 1989, only four of them ranked among the top seven companies writing property insurance.

Some firms also specialize in serving a particular geographic region. For example, five firms were ranked number one in at least one province, but only two of the five were among the top 10 across Canada.

While most head offices are located in Ontario and Quebec, there are head offices and offices of major firms in every province. The wide distribution of property and casualty headquarters and administrative work force across Canada is due to the importance of local and regional factors in providing services to clients. In 1989, the work force in the general property and casualty insurance industry consisted of approximately 118 000 people. Of these, 46 000 or 39 percent were employed by the insurance companies in head office, administrative, policy and claims-related work. The largest portion of the work force, about 56 percent, were independent brokers/agents who carried out the majority of the sales-related work. The remaining 5 percent of the work force were adjusters and industry association employees.

Based on premiums collected, the property and casualty insurance industry is controlled by non-resident companies. In 1989, Canadian-controlled companies accounted for 40 percent of total premiums collected. In comparison, British-controlled companies collected 23 percent, while American and other foreign companies accounted for 37 percent.

An important element of the insurance industry as a whole is the reinsurance business. Reinsurance is insurance for insurers. When insurance companies underwrite insurance contracts having a significant payout potential, they will often attempt to reduce their potential liability by seeking reinsurance on the policy. The reinsurance companies assume a share of the original insurer's risk in return for a share of the premium. The Canadian property and casualty industry relies heavily on international reinsurance markets, most of which are located in the United Kingdom, the European Community (EC) and the United States. Lloyd's of London is the best-known international insurance market and underwrites a wide range of insurance risks.

Performance

The property and casualty insurance industry worldwide is cyclical. It is characterized by periods of intense price competition and rate cutting according to the availability of capital, which determines the industry's capacity to underwrite risks. At the peak of the insurance cycle, when property and casualty insurance companies have high levels of capital or capacity, they cut prices and extend coverages in an attempt to capture market share. As claims costs and other expenses increase and reduce profitability, available capital decreases. The declining capital base leads to reduced capacity and increasing prices as companies withdraw from the market. After the increased prices have restored profitability, new capital is attracted to the industry, and the cycle repeats.

Swings in the insurance cycle are augmented by the nature of the products sold. First, property and casualty products have remained relatively unchanged for the past 25 years. As a result, the main features are common to all firms. Because there is little product differentiation from company to company, consumer loyalty to a particular firm is weak. Second, the terms of most coverage are short. Purchasers may transfer their business to another insurer without penalty after the contract expires. Hence, there tends to be very little company loyalty during periods when premiums are changing rapidly.

Fluctuations in the insurance cycle are also amplified by the relatively inelastic demand for property and casualty insurance. In many cases, the requirement for insurance products is set by non-price factors such as legislation, demands of lenders and other business constraints. For example, consumers typically do not buy more house insurance because the premium has decreased.

The supply of property and casualty insurance is closely tied to interest rates and the availability of reinsurance. The demand is closely linked to the level of economic activity and personal wealth. The influence of recessionary periods on company performance is often difficult to predict. On the one hand, slow economic performance may reduce demand. On the other hand, it can also reduce the frequency of claims and hence policy payouts. During recessionary periods, for example, drivers are more careful and use their cars less, which usually results in fewer accidents.

Insurance premiums are paid in advance, but some of the money is not required until claims arise. During the interval, the companies may build up funds that can be invested until needed. Therefore, companies may earn profits from both sources: the premiums paid for underwriting risk and the returns on investment of insurance funds and equity. Unlike life and health insurance companies, property and casualty insurance companies generally do not offer annuities and insurance policies with long-term asset accumulation and savings options.

Property and casualty premiums in Canada increased at an average annual rate of 10 percent between 1978 and 1989. This represents an average annual real rate of growth of 2 percent. During this period, the industry has not reported a profit on its insurance underwriting operations and has become increasingly reliant on investment income. In recent years, rate increases in some classes of business, such as product and professional liability, along with investment income, have been needed to achieve net profitability. In 1989, an underwriting loss of $1 369 million was offset by investment income of $2 130 million to generate net profits of $919 million.

This slow pace of premium increases highlights a significant weakness for the industry. The normal swings in the insurance cycle combined with low net profits could present Canadian consumers with periodic contractions in the availability of property and casualty insurance, particularly liability insurance.

Moreover, consumers are pressing governments, especially at the provincial level, to limit future price increases. Because it coincides with a downward swing in the insurance cycle, this resistance is forestalling premium increases to the level that the industry claims is necessary to ensure its financial health.

The industry is also facing downward pressures in the demand for insurance. In British Columbia, Saskatchewan, Manitoba and Quebec, where provincial Crown corporations have monopolies on providing basic automobile insurance coverage, private sector property and casualty insurance companies are limited to competing for optional and excess coverage. Moreover, commercial consumers are increasingly engaging in self-insurance. This arrangement allows the companies themselves to provide the coverage needed for the basic risks involved in operating a business, turning to the industry only for excess coverage to protect them in the event of a catastrophe.

The rate of return on equity for the property and casualty insurance industry is volatile and on average has been below that of other financial institutions and other major industry groups. The Canadian industry reported an improvement in the return on equity in both 1986 and 1987 to 15.5 percent and 14.9 percent, respectively. Since then, profits have declined continuously from their peak in 1987. The return on equity was 12.1 percent in 1988 and declined further to 9.9 percent in 1989.

Strengths and Weaknesses

Structural Factors

For a domestic service industry such as insurance, strengths and weaknesses are more appropriately assessed in terms of the efficiency and effectiveness of its performance at home and relative to counterparts in other countries. Direct international competition is relevant only in a very narrow context. Key factors that determine the effectiveness of participants in the industry are marketing skills and the ability to meet consumer demands with respect to price, service, convenience and product.

Within Canada, property and casualty insurance companies are competitive on the basis of price, service and, for many companies, their knowledge of niche markets. These strengths have allowed them to maintain for a long time a 40 percent share of premiums written, despite strong competition from the non-resident companies. Many non-resident companies are long-established, world-class organizations, with worldwide networks to support their Canadian operations as required. Indeed, size and experience are requirements upon which all non-resident companies are judged in order to obtain Canadian accreditation.

Canadian-controlled companies are not competitive internationally. They are small by international standards, and few have developed the expertise required to penetrate a foreign market in which local and regional factors play important roles. Instead, they are generally inward-looking and have been able to maintain adequate growth rates within Canada. Most of the larger property and casualty insurers in Canada are foreign-controlled and were established to operate only in Canada.

Property and casualty insurance companies rely heavily on reinsurance to spread their risks. Without adequate and reasonably priced reinsurance, there is not sufficient capital committed to the Canadian market to cover Canadian risks. The reinsurance market is international. Access is subject to price and availability cycles as well as international influences such as exchange rate fluctuations, worldwide losses and the international perception of Canada and the United States as one North American market. For example, a liability crisis occurred in the mid-1980s, in part because the international reinsurance market, in response to high settlements awarded by U.S. courts, limited the amount and types of risks it would cover in the North American market. This situation reduced the availability and increased the premiums for property and casualty insurance in Canada, adding to consumer dissatisfaction with the industry.

Trade-Related Factors

The Canadian property and casualty insurance industry is not active in foreign markets. Only about 2 percent of the 1989 total premium volume was written outside Canada, mostly as an accommodation to Canadian policyholders. Therefore, the Canada-U.S. Free Trade Agreement (FTA) will have little effect on the industry. There are no tariff barriers to trade in insurance services between Canada and the United States and few, if any, disputes affecting this industry.

Similarly, a North American free trade agreement involving Canada, the United States and Mexico is unlikely to have a significant impact on the Canadian property and casualty insurance industry.

As for non-tariff barriers, Canadian property and casualty insurance companies wanting to conduct business in the United States must first receive authorization from each of the 50 states, and requirements may vary from state to state. In contrast, foreign companies entering Canada register under the federal jurisdiction only. Moreover, court settlements in the United States are often much higher than those in Canada, which could expose companies to much larger financial risks.

Technological Factors

The insurance industry was one of the first to apply electronic data processing (EDP) technology to its business and office procedures. The central offices of insurance companies perform a large number of routine clerical tasks. Such a situation is ideally suited for EDP applications.

The industry has undergone two waves of technological change. The first occurred in the early 1970s when large mainframe computers came into extensive use throughout the industry. These computers sharply decreased processing costs, reduced work force needs and centralized clerical functions at head offices. Regional and agents' offices also could be plugged into the companies' central data processing system.

The second wave came in the early 1980s as low-cost mini- and microcomputers made their way into the offices of both small and large firms. These computers dramatically reduced the price of computing power and hence operating costs. Lower computing costs also increased the use of real-time network communication systems by small and medium-sized firms.

With the growth of EDP and the reliance on technology to maintain their competitive position, many property and casualty companies have developed their own systems software and EDP-support departments. Even the smallest insurance companies have adopted electronic technology to some extent. Its spread has been assisted by falling costs of computers and by the increasing availability of commercial software designed for the industry. As a result, industry productivity has increased in a wide range of labour-intensive processing operations. Related innovations such as optical character recognition equipment and microfilm technology also have significantly reduced unit labour costs in data storage and retrieval, computations, billings and claim processing as well as bids and proposals.

The next wave of technology in financial industries will see the proliferation of portable computers and attachments that will bring the database closer to the consumer. Within the property and casualty insurance industry, however, there is some difficulty in moving EDP technology downstream, because independent agent/brokers usually represent more than one insurance company. While the insurance industry has already developed technology for a single agent dealing with a single company, technology that would allow an agent to deal with several companies simultaneously is still being developed.

The advantages of such technology will be far-reaching. The technology will allow for extensive client databases, which will facilitate the cross-selling of insurance products and billing for insurance products from unrelated firms. It will also move the data entry functions out of the insurance company and into the agent/broker's office, thus reducing the company's expenses. This technology remains at the pilot project stage in both Canada and the United States. Existing systems involving several agents are simple and need to be tailored to suit the individual company needs. Although the benefits will be great, high establishment costs may put considerable pressure on small and medium-sized firms that cannot afford the technology but require it in order to remain competitive.

The current level of EDP technology application in the Canadian industry is comparable with that of its U.S. counterparts. Both industries face pressures to extend the application of technologies to corporate sales, actuarial and management functions. Adoption in these areas will continue until the mid-1990s.

The costs of installing and maintaining technology operations and keeping abreast of new developments are high for all segments of the financial services industry. In property and casualty insurance, however, the costs are not borne equally by all participants in the Canadian marketplace. Whereas Canadian-owned companies must develop and install their own systems, foreign-owned competitors in Canada are able to rely on technology systems developed by their parent firms and then passed on to the Canadian subsidiaries. Foreign companies could reap considerable cost advantages as a result.

Evolving Environment

World financial markets have undergone a number of changes in the methods used to meet the needs of corporations, governments and individuals. All competitors are being forced to react more quickly to market pressures. Increasingly, financial institutions must devote more resources to strategic planning, new product development and technology in order to remain competitive.

The blurring of functions and markets has had an impact on all financial institutions, not just insurance companies. In Canada, the federal government is reviewing its legislation governing federally regulated financial institutions to help ensure that the Canadian financial system remains effective, efficient and competitive.

Recently released policy proposals would allow banks, trust companies, insurance companies and securities firms to compete more freely for shares of the financial services market. While giving far broader powers to the financial institutions, the federal proposals acknowledge the need for greater regulatory powers and tougher rules for corporate self-governance.

The proposals would break down traditional barriers among financial institutions and allow the development of diversified financial companies. At present, it is not clear whether the proposals would encourage property and casualty insurance companies to attempt expansion beyond their traditional boundaries. Rather, if new financial conglomerates are formed, property and casualty insurance companies may be the targets for takeover. This situation reflects industry difficulties in attracting adequate capital for its core business, not to mention capital for expansion purposes.

Another feature making the property and casualty insurance companies vulnerable to takeover is their focus on risk assessment. They have a specialized knowledge that is not generally available to other financial institutions involved in asset accumulation and management. As a result, firms contemplating entry into the property and casualty business are likely to do so through acquisition rather than through starting up their own firms. This trend has already emerged over the past several years in the efforts by financial conglomerates and life insurance companies to increase their investment in the property and casualty insurance industry.

Injections of additional capital by acquiring firms could help strengthen the property and casualty insurance companies by supporting attempts to increase their market share. However, if the trend continues, the additional capital could encourage more price competition as well as more market volatility, thus amplifying the insurance cycles. Wider swings combined with the growing internationalization of the industry could result in increased market concentration.

Current Canadian legislation separates property and casualty insurance from life and health insurance. Most of the world's largest insurance companies, however, issue products from both sectors, either through a single company or through companies linked by common ownership and corporate identity. Diversification of financial service companies could encourage this type of integration in the Canadian industry.

Many of the factors that contributed to a crisis in liability insurance in the early 1980s continue to affect the property and casualty market. First, modern society has introduced new risks and hazards, creating a demand for insurance products to protect companies against events such as environmental pollution disasters. Second, a more consumer-conscious public has sought compensation for losses through the legal system at the same time as courts have awarded large settlements. Firms have sought corresponding insurance coverage against these actions. The increased demand could have some detrimental effects on the availability of liability insurance lines, including automobile liability.

The wide swings in premiums in the 1980s have made consumers more sceptical about the need for price increases. For their part, companies will need to develop fair pricing practices and also will have to be seen as being fair in their pricing. Consumer groups in Canada and the United States have already been successful in placing pressure on governments to slow price increases. In some U.S. states, consumers have been successful in having propositions to roll back premium increases placed on election ballots.

At the time of writing, the Canadian and U.S. economies were showing signs of recovering from a recessionary period. During the recession, companies in the industry generally experienced reduced demand for their outputs, in addition to longer-term underlying pressures to adjust. In some cases, the cyclical pressures may have accelerated adjustments and restructuring. Given that the property and casualty insurance industry is in the downside of an insurance cycle, declining profits and rates of return are forecast for the near future. The overall impact on the industry will depend on the pace of the recovery.

Low rates of return and poor earnings records are some of the reasons that the Canadian property and casualty insurance industry has failed to attract sufficient domestic capital. Paradoxically, the overall industry is considered to be over-capitalized. As a result, market conditions are likely to remain volatile in the near term, and industry ability to attract capital will remain slim.

Traditionally, the shortfall in domestic capital has been filled by offshore capital from foreign companies. However, insurance companies in the United States and some other countries recently have been experiencing losses in their domestic operations. The resulting need for capital has led several companies to scale back their foreign activities and to repatriate capital. While adequate capital is currently available, the traditional reliance on imported capital could create future problems for Canadian insurance consumers. Expansion of the economy requires additional capital to fund the corresponding increases in insurance coverage. As a net importer of capital, Canada may have to compete with other more lucrative markets, such as the Far East, in order to get this capital.

The concept of the financial supermarket is another evolutionary factor likely to affect insurance carriers. Financial supermarkets will provide one-stop shopping for advice on insurance, pensions, tax planning and short-term investment strategies. The impact on property and casualty insurance companies is uncertain. Since these companies are unlikely to expand much beyond their traditional boundaries, possible participation in financial supermarkets is likely to be as subsidiaries or affiliates of other financial institutions that would sell the products to the public.

Of greater concern to the property and casualty insurance industry is a proposal for expanded business powers that would allow banks and other federal financial institutions to establish their own insurance subsidiaries. This proposal, however, would prohibit deposit-taking financial institutions from retailing insurance through their branches. The combined impact of these proposals is uncertain.

Increased competition and technology change could affect the delivery mechanisms of the financial industry. Deposit-taking financial institutions have traditionally relied on branch networks, whereas property and casualty insurance companies have used sales forces of agents and brokers. On the one hand, changing computer and telecommunications technology such as lap-tops and faxes allows for more flexible ways of delivering services, even directly into the consumer's home. On the other hand, branch networks can provide a focal point for the networking of services, thus providing preferred access to consumers. This is another issue where it is too early to predict the outcome.

Competitiveness Assessment

Canadian-controlled property and casualty insurance companies are competitive domestically and have maintained a significant market share, despite competition with much larger foreign competitors. However, they remain small by international standards. In 1989, the largest Canadian-owned property and casualty company reported total premium volume of $0.7 billion; only four other companies in the Canadian industry reported premium volume in excess of $0.5 billion. In the United States, on the other hand, the 10 largest companies each reported premium volume in excess of $3 billion in 1989. Each of these U.S. companies is part of a large diversified financial services company.

In Canada, financial holding companies are generally not as well developed, for regulatory or business reasons. Greater reliance on the financial holding company structure in Canada could increase the size and competitiveness of Canadian-controlled property and casualty insurance companies in the domestic market. It could also encourage the development of foreign operations through links with the domestic life and health insurance industry.

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PRINCIPAL STATISTICS

	1982	1983	1984	1985	1986	1987	1988	1989
Companies[a]	348	351	350	350	349	342	350	350
Work force[a] (thousands)	114	113	114	114	116	118	118	118
Revenues[a] ($ millions)								
Net premiums	7 056	7 456	7 724	8 738	10 670	11 686	12 307	12 769
Net investment income	1 111	1 178	1 310	1 413	1 509	1 706	1 927	2 130
Total revenues ($ millions)	8 167	8 634	9 034	10 151	12 179	13 392	14 234	14 899
Net income[b] ($ millions)	455	740	362	383	1 004	1 165	1 042	919
Return on equity[a] (%)	11.3	15.6	6.9	6.9	15.5	14.9	12.1	9.9
Market share[a] (% of Canadian-controlled companies)	32	34	33	33	36	37	39	40

[a]See *Financial Institutions, Financial Statistics*, Statistics Canada Catalogue No. 61-006, quarterly (industry group 733, property and casualty insurers).
[b]See Insurance Bureau of Canada, *Facts* (Toronto: IBC, 1991).

REGIONAL DISTRIBUTION[a] (as of 31 December 1989)

	Atlantic	Quebec	Ontario	Prairies	British Columbia
Work force (% of total)	7	29	38	19	7

[a]See Insurance Bureau of Canada, *Facts* (Toronto: IBC, 1991).

MAJOR FIRMS

Name	Country of ownership	Location of head office
Allstate Insurance Company of Canada	United States	Markham, Ontario
Continental Insurance Company of Canada	United States	Toronto, Ontario
Co-operators General Insurance Company	Canada	Guelph, Ontario
Dominion of Canada General Insurance Company	Canada	Toronto, Ontario
Economical Mutual Insurance Company	Canada	Waterloo, Ontario
General Accident Assurance Company of Canada	United Kingdom	Toronto, Ontario
Guardian Insurance Company of Canada	United Kingdom	Toronto, Ontario
Laurentian General Insurance Company Inc.	Canada	Montreal, Quebec
Lloyd's Non-Marine Underwriters	United Kingdom	Montreal, Quebec
Royal Insurance Company of Canada	United Kingdom	Toronto, Ontario
State Farm Mutual Automobile Insurance Company	United States	Scarborough, Ontario
Wawanesa Mutual Insurance Company	Canada	Winnipeg, Manitoba
Wellington Insurance Company	Canada	Toronto, Ontario
Zurich Indemnity Company of Canada	Switzerland	Toronto, Ontario

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