

Perspe

A quarterly analysis of the financial performance of Canada's P&C insurance industry

the new data

(1st half of 2002)

*combined ratio
106.1%*

*loss ratio
76.3%*

*return on equity
(last 4 quarters)
2.7%*

We have only just begun

by Paul Kovacs

New data providing results for the first half of 2002 show that the financial results for Canada's insurers have started to recover, yet they are expected to remain weak for at least the next year or two. Last year was the least profitable on record for the insurance industry. The cost of capital remains well above industry returns, so this year will also prove to be very disappointing. Time and further adjustments are needed for the industry to re-establish moderate earnings.

Recent improvements have come through higher prices and tighter underwriting. Revenues, for example, will grow faster this year than claims costs for the first time since 1995. Revenue growth is the strongest since 1986. Unfortunately the growth in claims costs remains high, particularly for auto insurance coverage, continuing to add to pressure on pricing.

Auto insurance claims costs continue to increase at an alarming rate in Ontario, Alberta and Atlantic Canada. Proposed auto product reform legislation in Ontario is welcome news offering to provide insurers with some tools to improve management of the intense cost pressures. Unfortunately auto reform discussions in other parts of Canada are showing less progress.

The collapse this year in investment markets is disappointing news as reduced income from industry investment portfolios is adding to the pressure on pricing. The industry invests primarily in bonds and other fixed income instruments and this has moderated the adverse impact, nevertheless the weakness is disappointing and unexpected.

Large variation in performance is evident in the industry results by region and by line. The Quebec markets remain the healthiest and commercial markets are improving. Auto insurance markets, however, remain unsustainably weak in Atlantic Canada, Ontario and Alberta, particularly for insurers who are finding adverse development requiring additional loss reserves.

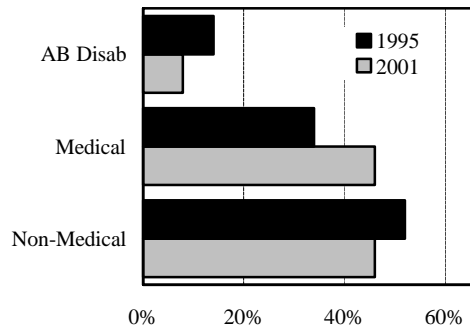
Hard markets for insurers mean very challenging relationships with brokers, agents and consumers. Even during the liability crisis of the 1980s there were fewer property and vehicle owners confronted directly by such significant changes in industry pricing and coverage.

the fourth page

Whither health costs?

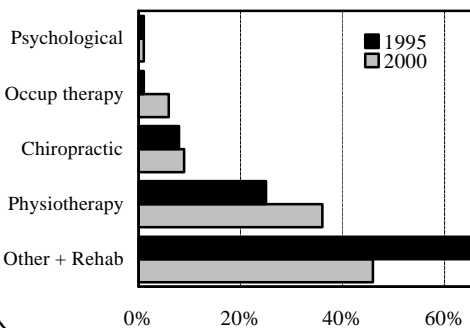
Ontario auto costs

percentage of total

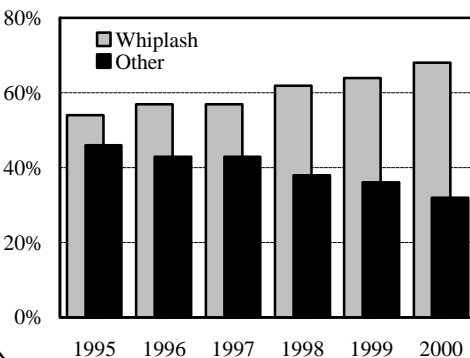


Medical cost allocation

excluding bodily injury



Medical claims allocation



Ontario auto insurance underwent major changes in the last seven years. Non-medical payments are no longer the largest component of their cost. Medical payments, which were one third of auto insurance costs in 1995, jumped to almost half by 2001. Now the cost of treating accident victims in Ontario is the same as the cost of fixing damaged vehicles.

This growth was driven by accident benefit (AB) medical payments, as well as by bodily injury costs for deaths and catastrophic injuries. Since 1991, Ontario auto insurers are required to pay higher accident benefits than any other province with private auto insurance. Ontario's no-fault threshold for AB medical payments was set at \$100,000 per person, compared to \$25,000 for most other provinces. Downloading to insurers of services previously paid by OHIP also played a role.

What has been driving up Ontario AB medical costs in recent years? Physiotherapy, accountable for 25 percent of these costs in 1995, now represents more than 36 percent of medical payments. Occupational therapy is the fastest growing category of AB medical payments. Its costs increased sixfold over the last five years, reaching six percent of total medical (AB) costs by 2000. The share of chiropractic and psychological services increased marginally, while the share of 'other' costs went down from 65 percent to 46 percent.

The growing predominance of physiotherapy likely reflects the rising cost of whiplash injury claims. Whiplash injuries are defined here as a combination of soft tissue head injury claims and soft tissue upper body injury claims. As a proportion of total AB medical claims, whiplash claims increased from 54 percent in 1995 to 68 percent in 2000.

Rising medical costs put increasing pressure on auto insurance rates. In order to reestablish rate stability, medical costs need to be put under control. IBC is currently addressing this issue through the proposals for legislation reform of the Ontario Insurance Act and through the activities of the IBC health care project.

Source: IBC, based on data from IBC's Insurance Information Division.



The new data

The second quarter

The P&C industry's underwriting performance showed some signs of improvement in second quarter 2002, with underwriting losses falling by \$33 million since the same period last year. Second quarter 2002 premium growth outpaced expense growth, but not claims growth. As a result, the loss ratio weakened to 74.3 percent from 72.8 percent last year, while the combined ratio improved by one point to 103.8 percent.

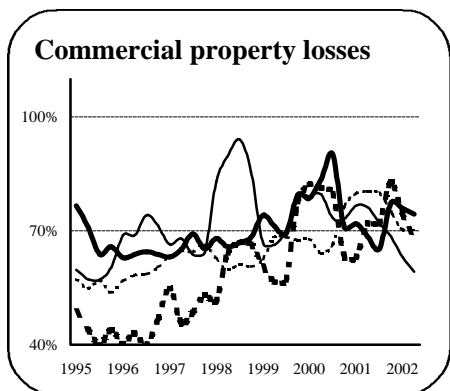
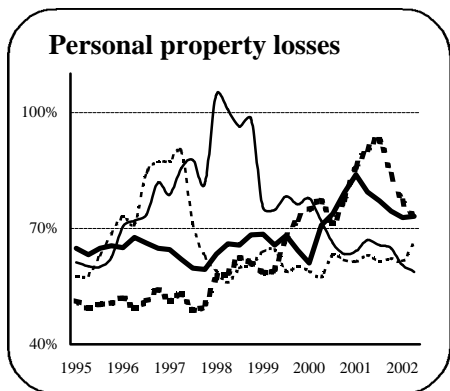
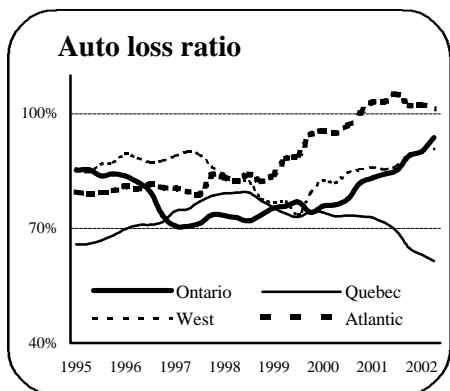
Property insurers in most regions posted some improvement in their loss ratios. But auto insurance markets remain weak. Preliminary data indicates that the loss ratio for auto insurers in Ontario increased to 94 percent for the year ending June 30, 2002, an alarming deterioration, and the loss ratio in the Atlantic Provinces remains above 100 percent.

Unfortunately, the small improvements evident in underwriting results were overshadowed by the breakdown in the investment market. Low interest rates resulted in an 8.2 percent reduction in revenues from fixed-income securities. The sliding stock market enabled insurers to realize gains of only \$27 million.

The first half

The loss and combined ratios for the first half of 2002 fell to 76.3 percent and 106.1 percent from 76.6 percent and 108.0 percent in first half 2001. However, a 28 percent drop in total investment earnings held the industry's return on equity for the year ending June 30, 2002 to just 2.7 percent.

Source for charts: IBC Provincial Loss Ratio Program
Source for table: IBC Quarterly Industry Analysis Survey



IBC quarterly financial survey	2nd quarter 2002 (initial)	2nd quarter 2001	change	1st quarter 2002 (revised)	1st quarter 2002 (initial)	change	first half 2002	first half 2001	change
<i>Millions of dollars</i>									
Financial results									
direct premiums written	7,856	6,540	20.1%	5,933	5,809	2.1%	13,789	11,462	20.3%
net premiums written	7,342	6,135	19.7%	5,298	5,007	5.8%	12,601	10,722	17.5%
net premiums earned [x]	5,622	5,101	10.2%	5,556	5,305	4.7%	11,178	10,039	11.3%
claims incurred [y]	4,175	3,715	12.4%	4,354	4,141	5.1%	8,528	7,690	10.9%
operating expenses [z]	1,662	1,632	1.8%	1,675	1,637	2.3%	3,337	3,152	5.9%
underwriting profit/(loss)	-214	-247	-13.1%	-473	-474	-0.2%	-687	-803	-14.4%
investment profit before gain/(loss)	525	572	-8.2%	517	534	-3.2%	1,042	1,140	-8.6%
investment gain/(loss)	27	72	-62.2%	138	154	-10.4%	165	198	-16.7%
net profit	192	275	-30.1%	108	123	-12.7%	300	377	-20.4%
Ratios									
loss ratio [y÷x]	74.3%	72.8%		78.4%	78.1%		76.3%	76.6%	
expense ratio [z÷x]	29.5%	32.0%		30.1%	30.8%		29.8%	31.4%	
combined ratio [(y+z)÷x]	103.8%	104.8%		108.5%	108.9%		106.1%	108.0%	
return on equity	4.0%	5.7%	*current	2.3%	2.5%	*current	2.7%	5.2%	*last 4
investment yield	5.7%	6.8%	quarter	6.7%	7.1%	quarter	7.3%	7.9%	quarters

False kindness

Excessive and inappropriate regulation can have serious unintended consequences for Canadians.

Inappropriate regulations can have terrible consequences. One disturbing example involves interventions in some parts of Canada to artificially lower the price of insurance for young drivers. This tragic social experiment has contributed to thousands of additional traffic fatalities and hundreds of thousands of preventable injuries over the past quarter decade.

The fourth page

Insurers strive to set prices that reflect the risk of providing coverage. Young drivers are up to three times more likely to be at fault in a motor vehicle collision and so their cost of insurance is higher. Young male drivers have the highest collision rates, so they should pay more for insurance to offset their higher level of risk.

Intense competition imposes discipline on private insurance markets. An insurer will not overcharge a group of customers because this profitable business would shift to competitors. Similarly insurers are not able to intentionally subsidize a group of customers because they would experience mounting financial losses.

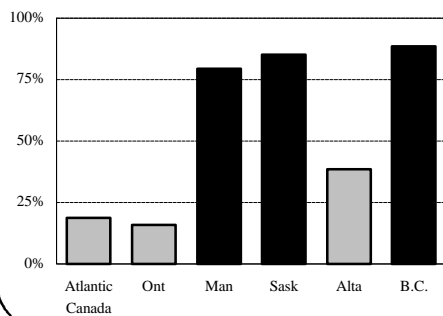
This discipline is absent in several provinces in Western Canada (Manitoba, Saskatchewan and British Columbia) where auto insurance is provided by a public monopoly. Public insurers, directed to use “social pricing”, including low prices for young drivers, have prices that do not reflect risk. Good drivers are overcharged to provide a subsidy for young drivers.

The absence of competition allows large distortions to be sustained.

Young drivers are four times more likely to be the principal driver of a vehicle

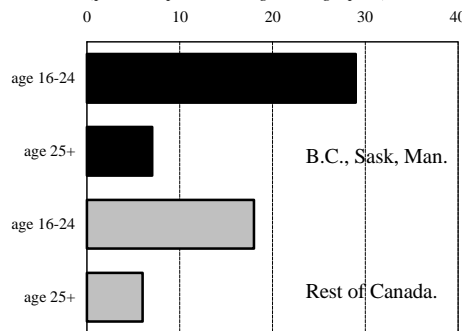
Principal operators of a motor vehicle

(percent of licensed drivers age 16-24)



Injury collision rate by age

(per 1000 persons in age demographic)



in provinces with the distortions of social pricing. They drive more often and travel greater distances than their peers who are not principal drivers. Transport Canada data show that in these provinces, the collision rate for drivers aged 16 to 24 is 64 percent higher than the other provinces. There is no material difference in the collision rate for older drivers.

Taking British Columbia as an example, cumulatively over the past quarter century in this province alone, subsidies for young drivers are estimated to have contributed to more than 250,000 preventable road accidents, 3,000 additional fatalities and unquantifiable suffering for the families affected. Both theoretical pricing models and the data suggest that distorted insurance pricing is the leading contributor of these additional collisions, injuries and fatalities.

There are better ways to reduce the price of insurance for young drivers. A sustained reduction in the price of insurance will occur if collisions decline in frequency and severity. Graduated licensing is a program proven to reduce collisions for new drivers. Improved driver training programs and further reductions in impaired driving also have the potential to reduce collisions for young drivers.

The price of this social experiment can be measured in preventable injuries and fatalities. It serves as a reminder of the serious consequences of inappropriate interventions. And the

greatest tragedy is that these regulatory distortions are continuing.



Perspective is a quarterly analysis of the financial performance of Canada’s P&C insurance industry. The report is prepared by the Insurance Bureau of Canada, the voice of the private general insurance industry in Canada. Analysis in *Perspective* is prepared by Paul Kovacs, Christy Gaetz and Elena Issaeva with data from IBC and A.M. Best Canada’s WinTRAC, unless otherwise noted. For further information concerning this report, contact Paul Kovacs, IBC’s Chief Economist.

Insurance Bureau of Canada

151 Yonge Street, Suite 1800, Toronto, Ontario, Canada M5C 2W7
Tel: (416) 362-2031 Internet: www.ibc.ca Fax: (416) 361-5952