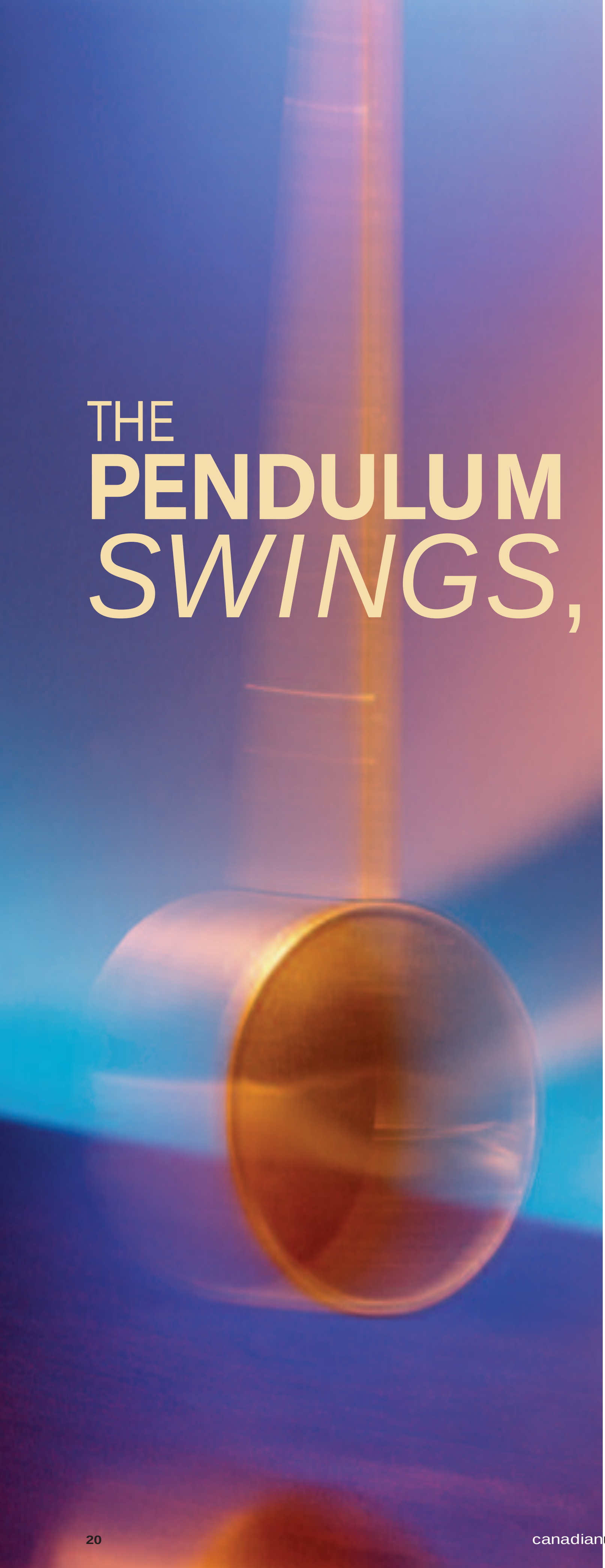

By Glenn McGillivray,
Managing Director,
Institute for Catastrophic Loss Reduction

THE PENDULUM *SWINGS,* AGAIN

The perfect storm which came together in the early 2000s to hit the global property and casualty sector particularly hard was supposed to prompt the permanent demise of the insurance cycle, that great equalizer that is a burden to everyone but is the fault of no one. According to pundits 9/11, the dramatic decline in investment markets, a record number of bond defaults, numerous large catastrophe losses, a spike in asbestos and environmental claims, and the ensuing flight to quality were supposed to have changed "everything", including the business of property and casualty insurance. The pundits were right to some degree; the forces did change everything - for a while.

But it appears that the industry may be back to its old tricks.

Despite the historic downturn (which saw the Canadian p&c industry's worst and second-worst year on record in 2002 and 2001, respectively) and the many lessons that were learned the hard way; there is evidence to suggest that adherence to strict underwriting may be starting to tear at the seams, if only slightly.

THE NUMBERS

According to figures gleaned by MSA Research and summarized by Joel Baker in the May 2006 issue of Canadian Underwriter ("2005 A Year in Review", Canadian Underwriter, May 2006), the Canadian p&c segment wrote $35.3 billion in direct written premium in 2005, up only marginally from $35.1 billion the year prior. Underwriting expenses, including claims and acquisition costs, came in at $28.8 billion, up from $27.6 billion in 2004 (general expenses, however, were down by almost 5 percent). Overall, underwriting revenue was down 18 percent over 2004, translating into a combined ratio of 92.4

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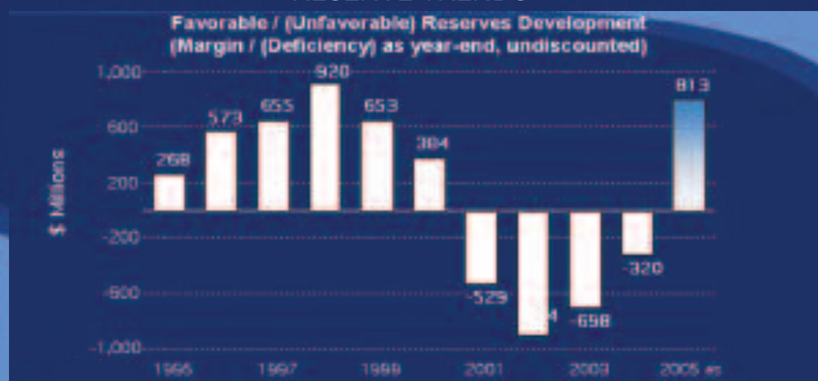
RESERVE TRENDS



Source: IBC with data from MSA

Excluding Loyd's

percent as compared to 90.5 percent the year prior. Net after tax income was up 2.5 percent to $4.5 billion against $4.4 billion in 2004 (pre-tax income came in at $6.2 billion, meaning the industry paid $1.7 billion in taxes). ROE, however, was down over three points from 2004, to 18 percent over 21.1 the year prior, reflecting a larger capital base.

Two things are notable about the industry's 2005 result. First of all, positive runoff from prior years came in at a whopping $943 million on an undiscounted basis (this, after substantial negative reserve development in each of the prior four years). Second, realized gains on investments were up 84 per cent over 2004, coming in at close to $1 billion. Both high positive runoff and high realized capital gains are difficult to replicate over consecutive years and could, therefore, point to some comparative weakness that may show itself in 2006 and 2007 results.

On the reinsurance side, the 18 member entities of the Reinsurance Research Council together booked net income after tax of $239.7 million, down from $376.9 million booked by 20 companies in 2004. The group recorded an underwriting loss of -$55.2 million (down from an underwriting profit of $166 million for 2004). The 18 brought in $1.77 billion in net written premium ($2.1 billion in 2004) and $1.9 billion in net earned ($2.2 billion in 2004). The aggregate combined ratio for the group was 102.9 per cent, up from 92.4 in 2004.

STABLE TO SOFTENING

According to the numbers, the early stages of a soft cycle may be seeping in. Some of the figures noted above show flat year-over-year premium growth, a decline in underwriting income and a notable drop in net premiums written as a percent of net premiums earned, which measures to what degree and how fast net premiums earned will replace current earnings. All are early indicators of a softening market.

While overall "stable" is the word being used to describe most prices in most lines (see editor David Gambrill's, "National Broker Survey: Signs of Softening", Canadian Underwriter, April 2006 issue); anecdotal evidence suggests that pricing

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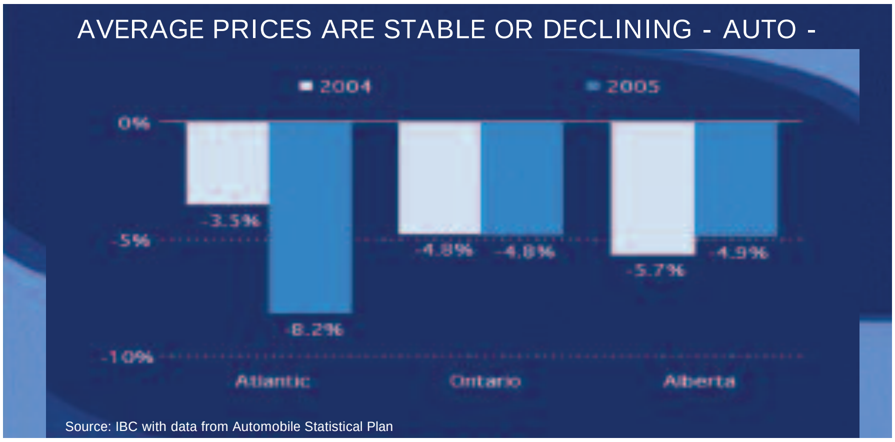

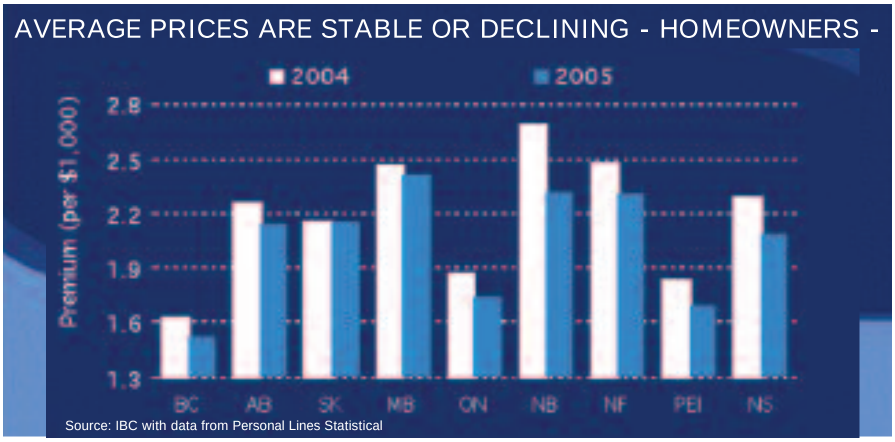

for some risks in some lines is loosening, with downward pressure being exerted on large, well-engineered commercial risks with good loss experience and "middle of the road" risks that aren't too complex. The good news is that there still appears to be firm resolve with regard to commercial property risks with poor loss experience.

On the liability side, according to one facultative casualty underwriter, rates are either staying as-is or are going down by up to 10 per cent on average, with rare instances of 25 per cent reductions off expiring. Brokers are pushing for maximum decreases, he noted, but have been settling for either as-is or slight reductions (about half the files his company looked at were renewed as-is). He noted that the market is very competitive and definitely softening, but unlike property - where premium cuts have been much larger and started earlier - there is a cautious undertone: "Nobody is being overly aggressive in casualty."

He reports no major changes in terms and conditions. The main issue, he said, is the introduction of the new IBC general liability (GL) wording with a policy general aggregate. So far, only a few companies have adopted it since 1/1/2006. According to market sources, some companies have introduced the new form but are offering a multiple aggregate, up to five times the occurrence limit. Brokers apparently don't like the new form as it restricts cover, and they will likely push for the current, unaggregated, CGL policy form. Some companies likely won't switch over to the new form or may offer both the old and the new.

On the Ontario auto side, a bellwether segment in the Canadian p&c market, average rate changes approved by FSCO for the first, second, third and fourth quarters of 2005 were -1.12 percent (representing 7.50 percent of the market), -1.62 percent (representing 45.79 percent of the market), -1.62 percent (representing 61.82 percent of the market), and -2.56 percent (representing 23.77 percent of the market), respectively.

Another sign of softening is evidenced by the rise of coverage "giveaways," such as first-accident forgiveness on the auto side. Several major auto insurers have

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recently made announcements of the offering. Hence, in a remarkably short time, motorists have gone from being afraid to file a claim for fear of their rates skyrocketing or their carrier cancelling them, to being given grace for their first at-fault accident. This may be taken to imply that the days of artificially low auto accident claims, where people either left damage unrepaired or paid for it out of their own pocket, may be over. The industry will likely see notable increases in auto claims in the coming months.

BANKS AND INSURANCE

A hot topic in the mid-1990s, and one that has never really went away, has had new life breathed into it, likely as a result of a mandatory five-year review of the Bank Act (due by October) and a new (Conservative) government in Ottawa.

Igal Mayer, president and CEO of Aviva Canada, noted in the December 2005 issue of Canadian Underwriter ("Primary Insurer CEO Outlook: Steady as She Goes"): "By the time you read this, a federal election may have been called or one will be looming [the election was called for January 23.] This could be the most significant federal election for our industry in decades, as Bank Act reforms may be addressed early in the next government's mandate. The current Canadian insurance marketplace could face the prospect of having five bank giants as new competitors. And while we arguably already face two such competitors, allowing five to distribute within branches could forever change consumer behavior towards insurance buying. This could also have significant short- and long-term repercussions on the industry, potentially providing the catalyst for another wave of consolidation as existing players bulk up to do battle."

Mayer is right to be concerned, as battle lines are clearly being drawn. According to A.M. Best: "Canada's largest banks have asked the Supreme Court of Canada to consider whether the Alberta Insurance Act should be ruled 'constitutionally inoperable or inapplicable to federally-regulated banks that promote the sale of insurance to their customers.'" At the Alberta Court of Appeal, the court has recently ruled in favour of the Alberta Insurance Council, which took action against the banks for selling creditor insurance in branches without a licence. According to Best, the Bank of Montreal, CIBC, HSBC Bank Canada, National Bank of Canada, Royal Bank of Canada, Bank of Nova Scotia, Toronto-Dominion Bank, and the Canadian Bankers Association have sought leave to appeal the decision of the Alberta court to the Supreme Court of Canada. Says Best: "Attorneys general from British Columbia, Ontario, New Brunswick, Quebec and Saskatchewan have lined up against the banks and in support of the Insurance Council of Alberta, the regulatory body responsible for licensing and discipline of insurance agents, brokers and adjusters in the province." According to A.M. Best, the banks' appeal "comes ahead of a report to be released by the Department of Finance that would outline the government's position on this issue."

Additionally, in 2005 RBC opened two retail insurance operations next to bank branches. On July 11, RBC Insurance opened its first retail insurance office next to an RBC branch in the Woodside Square

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Mall in Scarborough, Ontario. On October 17, it opened its second retail insurance office adjacent to the Royal Bank branch in Hamilton's Centre Mall. Some critics maintain that the openings break the spirit, if not the intent, of Bank Act restrictions on selling insurance out of bank branches. (On April 3 of this year, RBC also announced that RBC Insurance will offer nationwide the ability to get a quote and purchase personal property and auto insurance completely online, becoming the first company in Canada to do so.)

Commenting on the Speech from the Throne made on April 3, 2006, The Globe and Mail noted that "Banks have been changing their lobbying tactics in recent months as the government prepares to issue a white paper on the Bank Act. Instead of pushing mergers, which they seem to have all but given up on, some are asking Ottawa to loosen restrictions that have historically prevented them from selling life [sic] insurance through their branches. Few believe that the Conservatives are willing to let banks begin selling insurance at the branch level, although some are hoping for compromises that would enable them to promote insurance through their retail network and make customer referrals." (Bank mergers left off Tory agenda - April 4, 2006).

The next few months will be telling.

IN THE COURTS

Unlike recent years, 2005 offered few big-headline decisions. However two of note, reported on the same day, garnered much attention (and provided yet another example of how Canada may be going the way of the U.S. vis-à-vis outrageous litigation).

On June 15 a pair of key court rulings ordered two insurance companies to pay almost $1 million each in damages for two unrelated lawsuits representing appeals for incidents that occurred in 1999.

In the first case, a boulder that two men purposely dropped off a highway overpass struck Michael Vytlingam's family car. Injuries incurred from this accident left the 18-year-old disabled for life. Citadel Insurance paid the family approximately $1.5 million for care and other expenses. However, because their policy also contained a "family protection coverage endorsement," the Vytlingam's were able to claim an additional $1 million against any shortfall not covered by "an inadequately insured motorist" who causes the injuries. Citadel sought to deny the "family protection coverage" payout, maintaining that perpetrator Todd Farmer did not drop the boulder as a result of the use or operation of his vehicle. The courts ruled differently, and

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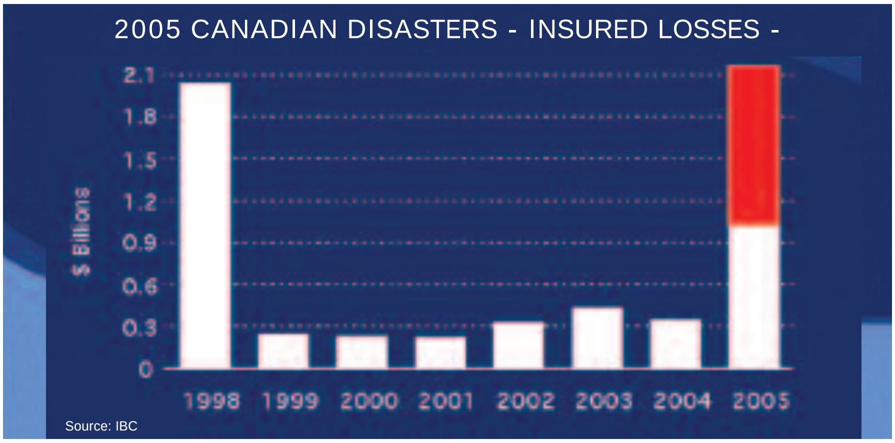

the Vytlingams succeeded in obtaining the additional $1 million in damages.

The second case involved the story of Ontario hunter Fred Wolfe. After his pick-up truck's headlights illuminated a figure he believed to be an animal, Wolfe stepped out of his vehicle and fired his rifle. The figure turned out to be fellow hunter Harold Herbison, whose family successfully sued Wolfe's auto insurer, Lumbermens, for $832,000 in damages. According to Randy Bundus, vice president and general counsel for the Insurance Bureau of Canada, "The rulings go farther than most people in the industry, or outside the industry, would expect their auto policy to extend." He said the two cases may be appealed to the Supreme Court of Canada because both appeal cases involved two-to-one split decisions.

So, with decent results, a relatively quiet merger and acquisition agenda, and only a few significant court cases to discuss; the top story for 2005 appears to be on the natural and man-made disaster side.

NATURAL CATASTROPHES

When thinking of natural catastrophes and insurance against the backdrop of 2005, one can't help but consider the hurricanes that ravaged Florida and the Gulf coast. After all, just three of the storms triggered more than half of the USD 83 billion wracked up in natural catastrophe and man-made disaster losses tallied worldwide last year (Swiss Re) - a record by far.

But it's important to note that Canada had quite a year of its own, with insured losses caused by natural catastrophes triggering claims of more than $1 billion. Though a far cry from the USD 78 billion (USD 83 billion minus USD 5 billion for man-made disasters) recorded for natural catastrophes worldwide in 2005, total claims were enough to add roughly three points to the industry's combined ratio, a metric not to be taken lightly.

Heavy downpours and flooding in Alberta June 6-8 and 17-19 triggered an estimated $300 million in insured damage, and a November 9 tornado in Hamilton, Ontario, left several homes uninhabitable. While not triggering large insured losses

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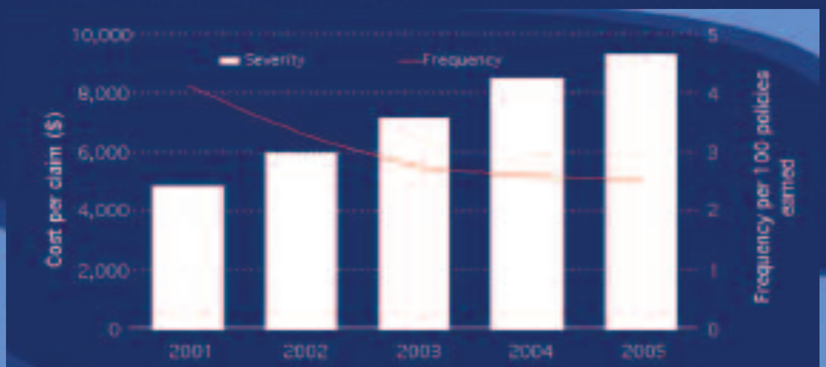
AVERAGE CLAIM* COST RISING - HOMEOWNERS -



Source: IBC with data from Homeowners Statistical Exhibits

* Total claims for all coverages

(no aggregate numbers are available, however one school roof will require about $10 million to replace), the twister proved to be interesting because it was the third-latest in the season to touch down in Canada (the second-latest occurred in Leamington, Ontario, on November 29, 1919, and the latest in Exeter, Ontario, on December 12, 1946). The storm likely woke some people up to the possibility of tornadoes striking urban areas where they have not been experienced before. The F1 tornado in Hamilton, while weak compared to the F4 that hit Edmonton on July 31, 1987 or the F3 that ripped through a trailer park in Pine Lake, Alberta on July 14, 2000, was still powerful enough to drive a cotton Q-Tip into the aluminum siding of a house.

Aside from these events and others (including January rainstorms in Vancouver, May rainstorms in the Maritimes, and October rainstorms in the eastern Townships of Quebec), 2005 also delivered the costliest natural catastrophe in Ontario history, the second most expensive on record for the country. It, too, was caused by extreme rainfall.

On August 19, as much as 153 millimetres (and, by some accounts, 175 milllimetres) of rain fell on parts of northwest Toronto in a two- to three-hour deluge that impacted a wide swath of real estate from Kitchener-Waterloo to Durham Region. As a result of the torrential downpour, infrastructure was washed away, basements were flooded and cars were damaged by falling trees and rising flood waters. What's more, two tornadoes set down in the Salem/Fergus, Ontario, area, damaging several properties, and a tornado warning was issued for Toronto, a rarity. The Insurance Bureau of Canada has said that insured damage from the storm will exceed $500 million (prior to the August 19 storm, the 1991 Calgary hailstorm was the second most costly natural catastrophe in Canadian history at $416.5 million, in 2003 dollars). Because of the deluge, Royal & SunAlliance said that it received 25 percent of its annual intake of claims in a single weekend (see Counting the Claims, CU, January 2006).

The storm may have some insurers rethinking their exposures in large urban areas. While much attention is placed on

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ALL EYES MAY BE ON EVENTS TAKING PLACE OUTSIDE THE COUNTRY

companies' exposures to earthquakes on the West coast (and rightly so), it seems that little attention has been paid to non-earthquake accumulations in such places as Toronto, where a company's geographic concentration may be tightly clustered, and where not everything may be known about full replacement values, particularly for contents. The main culprit here, it appears, is the proliferation of finished basements, many containing media rooms with costly home theatre equipment.

MAN-MADE DISASTERS

Just as the ice storm in 1998 brought insurers around to the fact that a billion-dollar natural loss event was not outside the realm of possibility in Canada; 2005 sent the same message on the man-made disaster side as a fire at a Suncor oil sands facility in Fort McMurray, Alberta on January 4 chalked up property and business interruption claims totalling $1.095 billion (broken down into $115 for property and $980 million for business interruption). Though the loss appeared to fly under the radar screens of many in the business, it added about three points to the industry's combined ratio (at least to companies' statutory results, much of the loss appears to have flowed through domestic books on to home offices and reinsurance companies based outside the country). Regardless, the event was significant enough to prompt OSFI to issue a bulletin on May 4 reminding those carriers that have claims of their reporting and funding responsibilities regarding the loss. The loss represents the largest insured loss due to man-made disaster in Canadian history.

All told, natural catastrophe and man-made disaster losses added close to six points to the industry's combined ratio in 2005. IBC's vice president of policy and chief economist Jane Voll said March 21 that if the natural and man-made events which took place last year occurred four years earlier, when the Canadian p&c industry was at its weakest in recent memory; the combined ratio would have come in at 120.6 percent (instead of the 111 percent it recorded), its ROE at -3.3 percent (instead of 2.6 percent) and 64 companies would have had a solvency score of under 10 percent (rather than the 23 recorded). Her point (a good one) is that disaster losses - both natural and man-made - don't follow market cycles; they happen when they happen. And if they happen when the industry is at a low point, the impact would be far more severe.

GOING FORWARD

In light of the largely run-of-the-mill annum for Canada's p&c sector last year, this year all eyes may be on events taking place outside the country which may have an impact on the domestic market; namely, the 2006 North Atlantic hurricane season.

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How The Private Companies Rank (Total Business) N.P.W.
(Excluding Life & Purely A&S Companies)

	% Of Market	2004 N.P.W.	2003 N.P.W.	% Change

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Another rough year on the catastrophe front would spell three in a row, and could possibly force substantial hardening of catastrophe and, perhaps to some degree, property reinsurance markets. If this happens as primary pricing in Canada continues to soften, an interesting (and potentially harmful) divergence may occur.

One thing that definitely will be watched are pending changes to cat models (Risk Management Solutions, probably the most-used cat model in Canada, is set to release updates in its U.S. and Caribbean hurricane models and its eastern U.S. and Canada earthquake models on May 19. Other modelling companies will follow, at least with updated hurricane models).

Issues to consider here include:

• RMS's increase in PMLs by 40 percent on average across the Gulf Coast, Florida, and the southeast, and by 25-30 percent in the mid-Atlantic and northeast coastal regions relative to those derived using long-term 1900-2005 historical average hurricane frequencies. The impact of the increase on Canada is not known.

• RMS's addition of a new post-loss-inflation (now called Loss Amplification) model into its Canada Quake (and hurricane) models. While OSFI's earthquake guideline states that companies have to (somehow) take post-loss inflation into account, it will now be included in the model. This may adversely impact com-

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How The Private Companies Rank (Total Business) N.P.W.
(Excluding Life & Purely A&S Companies)

	% Of Market	2004 N.P.W.	2003 N.P.W.	% Change

panies that were taking post-loss inflation into account in a less conservative manner, even if their PML doesn't change due to the new model's changes in hazard frequency and severity parameters. Issues arising from this change include:

- To what extent is (or should) reinsurance pricing driven by the models?

- To what extent is (or should) Canadian reinsurance pricing be driven by changes elsewhere?

- When the models change significantly like this, when will the resulting change in implied technical price filter through to reinsurance pricing - immediately, over the short term, long term, or not at all?

- The reason for hurricane model changes is to capture the "multi-decadal" pattern exhibited in hurricane activity. Previously, the model captured the "ultra-long term average" behavior of hurricanes. To what extent is it appropriate to focus on a short time period (five years in this case) rather than the longer term for reinsurance pricing? Shouldn't reinsurance pricing take a longer view than five years?

- To what extent is (or should) primary pricing be driven by the models?

- Are primary insurers in Canada adequately pricing for catastrophic losses, according to these models?

- Given that the most frequent catastrophes in Canada are in fact not modelled (ice storm, winter storm etc.) are primary insurers adequately pricing for catastrophic losses?

Furthermore, after Katrina some reinsurers stated that catastrophe rates would have to rise immediately and by large percentages in Canada in order to pay for U.S. losses. However, this did not occur. Also considering that Canada experienced some major cat losses last year (at least relatively speaking) the market exhibited little if any response to these events. Are rates, therefore, already adequate? Has the cycle peaked?

The last few years saw many people proclaiming the end of the reinsurance market cycle due to technical underwriting. With both interest rates and technical pricing on the rise, what will happen next?

The Canadian primary market waits with bated breath. CU