

# Explaining the Canadian property and casualty insurance industry's profits and prices in light of historical context

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Revised: February 18, 2005<sup>1</sup>

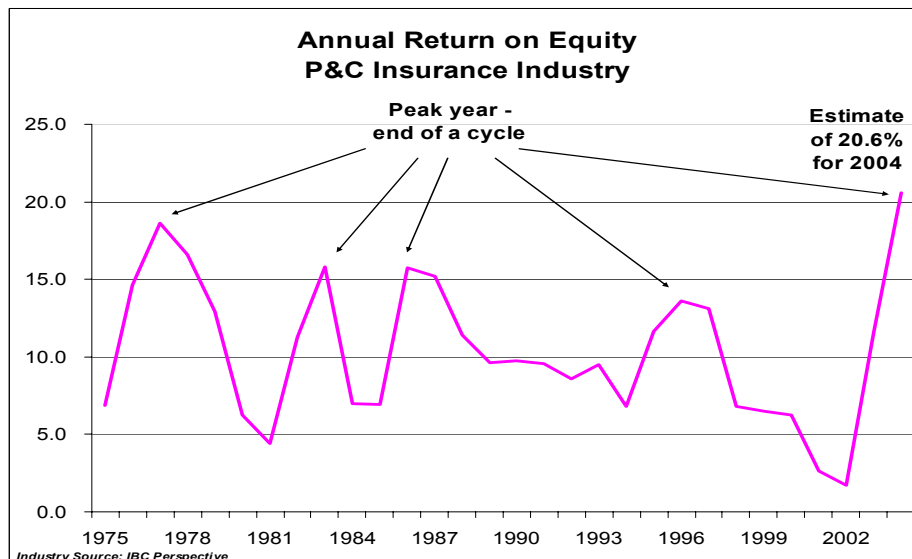
The Canadian property and casualty insurance industry's profit in 2004 will likely set a new record. Some are accusing those who insure cars, homes and businesses of gouging their customers with high premiums while pocketing excessive profits. How profitable is the property and casualty ("P&C") insurance industry? Are its profits excessive? What does the industry's profit level mean for the price of insurance? This article answers these questions with an analysis of the industry's current profitability in light of its longer term historical results.

The industry's return on equity ("ROE") was 11.6%<sup>2</sup> for 2003 and, is projected to be 20.6% for 2004. Without a doubt, it will be the highest ROE for the industry in over 25 years.

However, in 2002 it was only 1.7% and in 2001 it was only 2.6% - the two lowest annual results in 25 years. And, it was below 7% each year from 1998 to 2000. Profits from just a few years do not provide a representative picture of the ongoing profitability of the P&C insurance industry – just like we do not presume that one year's performance of our RRSP equals its performance over time. This is because the industry's profit improves and deteriorates in a wave-like fashion, in multi-year cycles. The industry's cyclical pattern is well established and current evidence suggests it is continuing. Analyzing the industry's cyclical results provides a meaningful context for the large profits expected to be announced for 2004.

## How much profit does the Canadian P&C insurance industry earn?

To get a picture of how much money general insurers earn, the industry's annual return on equity is presented in the following chart (source of data: Insurance Bureau of Canada):



- For the previous 27 years, the annual ROE has averaged 10.1%. This is a decent return, but by no means exceptional or excessive.
- During these 27 years there have been four cycles.<sup>3</sup> These cycles vary in length between three and ten years, with an average length of seven years.
- The average annual ROE of each cycle is in the range of 8% to 12%, which is reasonably close to the long term average of 10.1%. The average annual profit of a particular cycle is more closely representative of the ongoing earnings of the industry.

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- The four cycles and their average ROEs are as follows:
  - 1978 to 1983: 11.2%
  - 1984 to 1986: 9.9%
  - 1987 to 1996: 10.6%
  - 1997 to 2004: 8.7% (including the 2004 estimate of 20.6%)

This annual profit data indicates that the industry's earnings for each business cycle has been fairly steady over time. Further, it represents a reasonable return for investors, without being excessive for consumers.

Surprisingly, this latest cycle (1997 to 2004) has actually yielded the lowest return (8.7%) of the last four cycles, even though the current year's ROE will likely set a record.

This implies that the latest two years of high profits are the necessary correction for the industry to earn a cyclical return that is not even up to its historical norm. In fact, this current cycle has yielded a notably lower return than the historical average.

This analysis presumes that the current cycle is ending in 2004, in other words, that 2005 earnings will decline, making 2004 the peak earnings year (the end) of this cycle. Auto insurance premiums have already begun to decrease in 2004 or earlier, in all provinces where auto insurance is delivered by private industry. Also, most business insurance products have begun to see reduced price increases, or price decreases, across the country. Average claims costs continue to rise, which means underwriting profit margins have already begun to decline on policies issued in 2004. This will begin to show in earnings in 2005.<sup>4</sup>

The industry's current profit levels are justified in the context of its current business cycle's earnings and in comparison to its historical long term level of earnings. Further, that level of return is not close to being excessive. It is a respectable return for investors whose capital is at risk in covering Canadians' liabilities, properties and automobiles.

However, this provides little comfort to consumers who have seen their premium rates sky rocket in recent years. Why have auto insurance rates increased so much? Why are such high premium rates necessary to sustain the industry's earnings below its historical earnings? Before answering the "why," let's first consider current premium levels in their historical context as well.

### **Are today's premium rates excessive?**

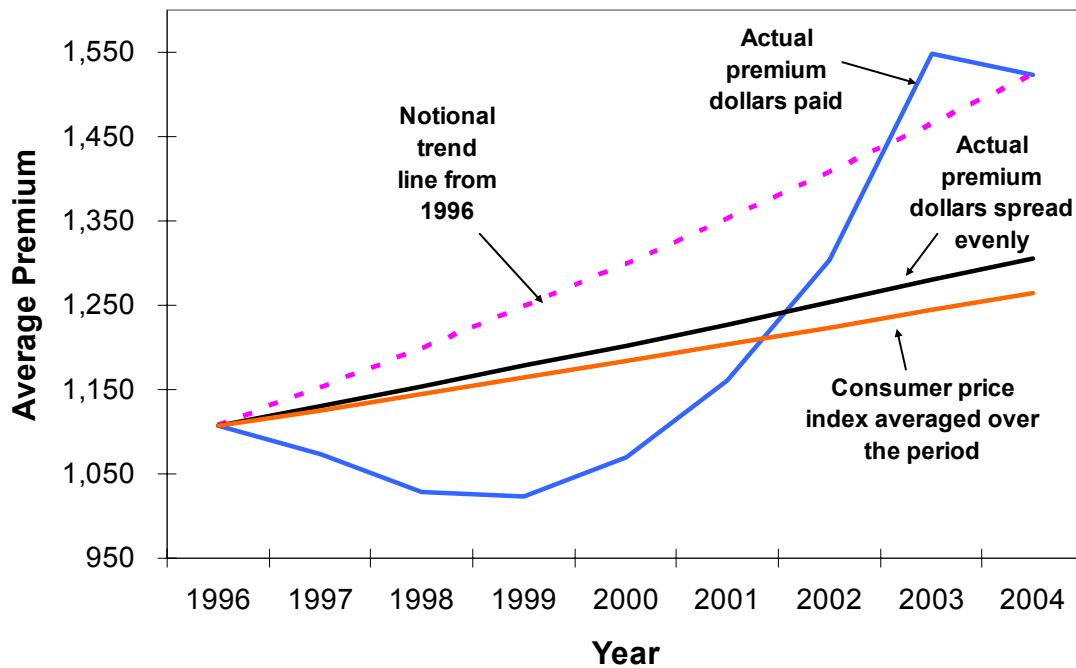
Although premiums have increased significantly for many over the last couple of years, they are not, in fact, that high today, as compared with prior years. To demonstrate, the following graph and analysis are based on the annual average premium for The Dominion of Canada's automobile insurance policies:

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### Average Annual Premiums Canada Automobile

The Dominion of Canada



- In 1996 at the end of the previous cycle, our average premium for auto policies (Canada-wide) was \$1,107. In 2004, it is \$1,523, an increase of \$416 or 38%, eight years later.
- That represents an average increase of 4.1% per year. However, our policyholders did not actually pay that rate of annual increase because average auto premiums dropped for the first half of this business cycle, before rising in the last half of this cycle.
- From 1996 to 1999, our average premiums decreased each year – four years of decreases – to \$1,023 in 1999, down 8% from 1996. Then, the average premium increased from that low by \$500, or 49%, to today's average. The recent annual price changes are more severe than the total change over the cycle.
- The actual premium dollars paid by our Canadian drivers, on average, over the nine year period add up to \$10,839 in total (or \$1,204 per year).
- If those same dollars that were paid over the nine-year period were instead paid following an even annual rate of increase (starting from the 1996 annual premium), the annual average rate of increase is only 2.1%. **That is, the total premium dollars actually paid from 1996 to 2004 equate to an average annual price inflation rate of 2.1% from the 1996 level.**
- During these same nine years, the Consumer Price Index ("CPI") increased on average by 1.7% per year.
- In other words, the average premium dollars our auto policyholders have actually paid over this last cycle, contained average annual increases just above CPI inflation – thanks to price decreases for half of those years.

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Today's insurance prices are at a justifiable level, in terms of the annual prices charged throughout this business cycle.

Nevertheless, premium rates have increased significantly in the last several years. Aren't the recent years more indicative of the direction of future pricing? Will this recent trend continue at the expense of consumers while insurers sustain the current profit levels?

The answer is "No." Prices have already begun to decrease for automobile coverage and for some business coverages. The cycle is continuing as it has in the past. Earnings and prices have peaked and are declining, as 2005 will undoubtedly confirm.

### **What is causing recent premium rate increases?**

Now back to why rates have increased above general inflation over time. And, why do they change dramatically and unevenly? There are basically two reasons:

First, claims costs, especially in auto insurance and general liability, have been rising well above the CPI inflation rate. In automobile lines, main cost contributors are medical cost inflation (above 7% per year), excessive fees of paralegals, costly dispute resolution infrastructures and fraudulent behaviour (inflating claims) – especially minor injury claims. All other things being equal, premiums normally have to rise, well above standard inflation rates because claims cost inflation is so high.

As mentioned above, automobile rates have decreased or are now decreasing. The premise for the recent decreases is various cost containment measures that many provincial governments have finally put in place. (Unfortunately, we believe some government measures are ill advised and will actually increase costs. The terms and conditions of automobile policies are mandated by provincial law and insurers and their customers have very little choice and practically no control over the underlying costs.) If the majority of provincial measures deliver their intended effect of containing claims costs, prices should remain relatively stable. But if the measures do not take hold (e.g. because they are diluted by the courts or circumvented by fraudulent behaviour), rates will have to increase to compensate.

Second, insurance premiums are subsidized by investment income. Since claims payments lag behind the collection of insurance premiums, insurers generate a timing "float." After paying operating costs and premium taxes, insurers invest the net float, which is held to pay claims as they are settled. Most of the industry's investments are in high quality bonds, mostly government bonds. Interest rates have been low for some time which reduces the subsidy generated from interest income. This was somewhat masked by stock gains from the "technology bubble." Although stocks represent less than one quarter of the industry's investments, the tech bubble's stock gains generated a high subsidy for premiums in the late 1990's. Insurers passed along these gains to customers through declining premium rates in the late 1990's. (Remember that the industry's ROE was under 7% from 1998 to 2000 inclusive.) After the bubble collapsed in 2000, insurers like others, experienced some stock losses and earned only low rates of interest on their bonds. This represented a large drop in the subsidy coming from investment income. Premiums had to rise to compensate. (The tech bubble delayed the rise in premiums, to the benefit of policyholders.) Looking forward, interest rates will likely rise gradually over the next few years (so we're told). Investment income will likely provide the same, albeit low, level of subsidy it has been providing in recent years. Therefore, premium rates should not need to rise because of investment income.

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### Why are the industry's business cycles characterized by dramatic swings?

Price volatility is a product of the dramatic swings in the P&C business cycles. Here's a brief explanation of what causes the cyclical swings in the P&C industry. There are three key factors:

- a lag in measuring the cost of insurance, and the lag's impact on pricing,
- changing investment returns, which subsidize underwriting results, and
- the economics of competition.

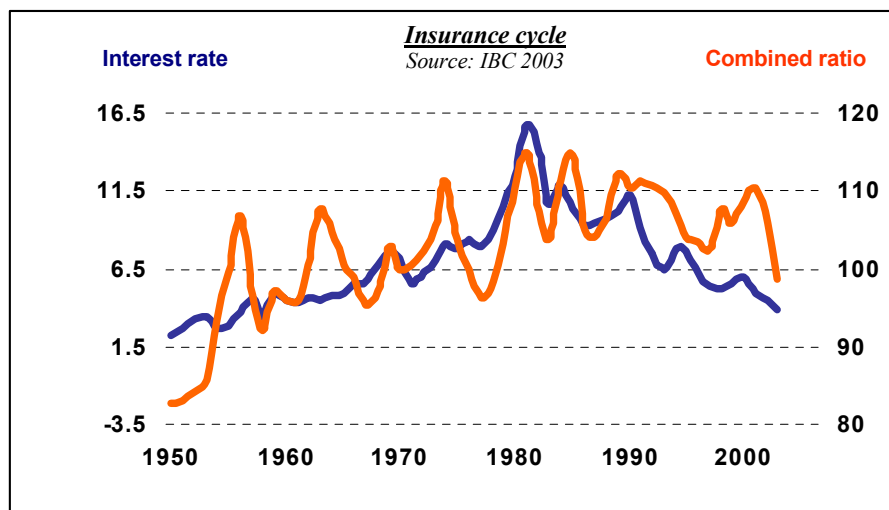
### **Cost measurement and pricing lag**

First, general insurers price and sell products, the cost of which is not known for several years. Since the cost of a year's claims emerges gradually, there is also a lag in assessing price adequacy and reacting with appropriate price adjustments (in varying degrees by line). The cost measurement lag causes results to change slowly as insurers continuously re-measure their costs (claims development) and attempt to achieve "price adequacy." The cost lag itself contributes to the gradual wave-like trend – it often takes a few years to confidently assess the direction of claims costs and the frequency of claims. The degree of swing can also be affected by the extent of miss-estimation which is more likely when products change. Other factors that affect the swing are government regulation and the impact of court decisions affecting claim payment amounts, so it is impossible to predict precisely how much future - or even existing - claims will cost. Also, how many claims will be made going forward is very difficult to predict.

### **Investment subsidization**

Second, as mentioned above, insurers combine underwriting results and investment income to achieve their target ROE. Underwriting results tend to move in the opposite direction of expected investment returns, which subsidize underwriting results. On average over the long-run, underwriting results and prices move in the opposite direction of interest rates, the main component of investment income. The chart below tracks the five year Canada bond yield with the industry's combined ratio (source: Insurance Bureau of Canada).

The combined ratio is the most commonly used metric for measuring underwriting results. It is calculated as the sum of claims costs, commissions, premium taxes and the insurer's own operating costs, divided into net earned premiums. When the ratio is below 100%, there is an underwriting profit. If over 100%, the insurer has paid out more in claims and expenses than it has brought in through premiums. This ratio does not include investment income which completes the profit equation.



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### ***The economic forces of competition***

Third, the benefits of competition are probably the most important factor in the length and intensity of the insurance cycle. The underlying force in the P&C business cycle is the excess supply of capital in what is a mature market. Competition is always pressuring prices and results downward (or at least below costs). The P&C business cycle is characterized by price competition which leads to reduced earnings and then another trend of price increases. This general pattern varies with the level of investment subsidization and the degree of accuracy in measuring claims costs.

Ultimately, private competition benefits consumers by creating those parts of the cycle where insurers will compete for consumers by offering lower prices (or lower price increases).

The bottom line is that competition is good for consumers in the long run. Insurance consumers are paying less for insurance, over time, than if competition was not present. Admittedly, this long term price advantage comes at the inconvenience of some volatility in prices. One way to achieve more stability with competition would be for governments to be more responsive to industry recommendations for containing costs and allowing choice, when things are going "smoothly," and not waiting to react rashly when there is a crisis.

### **To summarize**

In light of the P&C industry's profit performance over time:

- The P&C industry's profits are decent over time, but clearly not excessive.
- The presently high profits are justifiable in terms of providing a reasonable return for this latest business cycle – a return that is actually substandard in comparison to the previous three cycles and in comparison to the long term average.
- The increase in the average auto premium is not as high as it seems. Although premiums have increased notably in recent years, this follows several years of rate decreases. Average auto premiums paid during the latest business cycle equate to an annual average increase only moderately above the average Consumer Price Index.
- The recent increases in premium rates were justified to cover increasing costs and low interest income. Automobile rates have decreased, or are now beginning to decrease, in all jurisdictions in Canada where auto insurance is delivered by private industry.
- The Canadian P&C industry is competitive. Although price volatility does occur as a result of competition (and thanks to the cost measurement lag, changes in investment income levels and external influences changes to product costs), a key benefit of competition is lower prices over time.

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### **ENDNOTES**

- <sup>1</sup> Revised to reflect the Insurance Bureau of Canada's projected profit for the industry, published February 18, 2005, replacing the author's previous estimate.
- <sup>2</sup> In this article, the industry's return on equity for a particular year is a weighted average of all insurers' results, sourced from the Insurance Bureau of Canada. The multi-year averages for the industry, such as the average annual return on equity for the cycles, are simple averages - each year is equally weighted, for simplicity. The author believes that weighted averages would not be materially different since the industry is mature with volumes changing moderately over time.
- <sup>3</sup> The author measures a "cycle" as being the period from the year following a peak earnings year to the next peak earnings year, essentially from the top of a cyclical wave of annual results, to the next. A "peak" earnings year is the year with the highest earnings in a series of improving years, before subsequently deteriorating in a series of subsequent years. Another equally appropriate way to define insurance cycles is to use the combined ratio (which measures underwriting results) whereby each cycle ends with the best underwriting result. The two approaches do not result in notably different definitions of cycles.
- <sup>4</sup> Premiums are typically earned on a straight-line basis over the periods covered by the underlying policies - normally one year. Therefore, price changes are generally half earned by insurers in the year they are billed and half in the following accounting period, on average.