UNCLASSIFIED

September 19, 2003

The Honourable Maurizio Bevilacqua, P.C., M.P.
Secretary of State (International Financial Institutions)
Department of Finance
21st Floor, East Tower
140 O'Connor Street
Ottawa, Ontario
K1A 0G5

Dear Minister,

By letter dated August 25, 2003, you asked OSFI for information on the property and casualty (P&C) insurance industry in Canada to better understand the recent increases in the insurance premiums in certain regions of the country. More specifically, you asked that OSFI prepare a report on the property and casualty industry, in those areas covered by OSFI's mandate, that would include:

- Trends regarding revenues, expenses, and profitability of federally regulated property and casualty companies;
- A review of the federal regulatory framework for investments made by these companies; and
- An assessment of the investment practices and performance of these companies in recent years.

I appreciate the opportunity to contribute to your consideration of these issues. As you are aware, OSFI is the prudential regulator of the vast majority of the property and casualty industry. As such, we have a broad perspective on the state of the industry and the factors that are influencing its well being.

OSFI's report is attached. The report concludes that the financial position of the property and casualty industry has been deteriorating for several years and that no single factor is responsible for the current conditions in the industry. Several factors, taken together, need to be considered, including the growing scale of claims, premium revenues that have not kept pace with rising claims, and declining revenues from investment portfolios. The decline in investments is not the largest factor in explaining the pressure on premiums. Claims expenses have risen significantly, particularly for automobile insurance and other expenses have also increased although to a lesser extent. In aggregate, these developments have resulted in weak profits, which have led to unsustainably low returns on equity and overall erosion in capital levels.

Although the first half of 2003 has shown a noticeable improvement in results, this should be viewed with caution as it is too soon to conclude that the trend of deteriorating financial condition has been reversed. Sustainable profitability at reasonable rates of return is important for the safety and soundness of the industry. In this context, it should be recognized that actions related to premiums and costs can have a material impact on the industry. It is important that they be balanced if the prudential position of the industry is not to be adversely affected.

On the issue of the regulatory framework for investments, the federal regulatory framework for property and casualty companies' investments was moved to the "prudent person" approach in 1992, in order to provide institutions greater flexibility to choose a portfolio of investments that is appropriate in light of the risks they face. This framework replaced one that was prescriptive and did not consider whether an institution's portfolio of investments was appropriate in light of the risks the institution faced. OSFI believes the current approach, which is in keeping with the regime applied to other financial institutions and the general approach to managing risk at financial institutions, is sound and remains appropriate.

Finally, OSFI is of the view that the investment portfolios of companies are not excessively risky. The composition of portfolios is generally prudent. Overall investment returns, while lower than the peak year of 2000, have withstood the volatility of the capital markets and recent interest rate declines. Investment returns have continued to enable the industry as a whole to post positive net incomes for all years.

I would be pleased to discuss the report with you or to respond to any questions you may have at your convenience.

Yours very truly,

Nicholas Le Pan
Superintendent of Financial Institutions

Att.