September 19, 2003

REPORT ON THE PROPERTY AND CASUALTY (P&C) INSURANCE INDUSTRY IN CANADA

EXECUTIVE SUMMARY

By letter dated August 25, 2003 (copy attached), the Secretary of State (International Financial Institutions) asked for information on the property and casualty insurance industry in Canada to better understand the recent increases in the insurance premiums in certain regions of the country. More specifically, OSFI was asked to 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.

In terms of trends, the financial position of the property and casualty industry has been deteriorating for several years. No single factor is responsible for the current conditions in the industry – several factors, taken together, need to be considered.

- In the past few years, the scale of claims has been growing, especially for automobile insurance (which represents more than half of the insurance market), reflecting rising medical and rehabilitative claims, rising court awards for pain and suffering in cases of minor strains and pains and an increased number of injury claims that are becoming more expensive to treat.
- As a result of competition and controls over automobile insurance premium rates, premium revenue has not kept pace with rising claims, which has resulted in growing underwriting losses. Claims expenses have risen significantly. Other expenses have also risen but far less than claims costs.
- Revenues from investment portfolios have declined and have made it more difficult for insurers to generate the income necessary to offset underwriting losses. However, the decline in investment returns is not the largest factor in explaining the pressure on premiums.
- Weak profits have contributed to declining return on equity and material erosion in capital levels. These pressures have been further exacerbated by the challenges facing parent organisations in raising new capital, or justifying capital injections into an industry that is producing low returns. As a result, more companies are approaching OSFI's minimum capital target threshold.

Although the first half of 2003 has shown a noticeable improvement in terms of underwriting results, this should be viewed with caution, as it is too soon to conclude that a trend to improved financial conditions in the industry has been firmly established, and rates of return are still well below historical levels. Sustainable profitability at reasonable rates of return is important for the safety and soundness of the industry. Going forward, 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.

Second, the federal regulatory framework for investments is based on the prudent person approach, meaning that companies are expected to follow investment policies that a reasonable and prudent person would apply in respect of a portfolio of investments to avoid undue risk and obtain a reasonable return. This is consistent with both the rules applied to other federal financial institutions as well as the general approach to managing risk at financial institutions. While it allows flexibility, some ultimate limits on various risks are also imposed in the legislation and regulations. OSFI believes this approach is sound and remains appropriate.

Finally, there is considerable variability amongst companies' individual investment portfolios reflecting differing circumstances of individual institutions. However, the investment portfolios of companies are not excessively risky, as evidenced by the high proportion of high quality bonds in most portfolios. Overall investment returns, while lower than the peak year of 2000, have withstood the volatility of the capital markets and recent interest rate declines. Companies tend to adopt low risk investment strategies and do not take substantial speculative positions that would place their policyholders' funds, or capital, at undue risk.

BACKGROUND

OSFI Mandate

OSFI's mandate is set out in legislation and focuses on maintaining and refining a supervisory and regulatory regime that promotes safety and soundness and that provides for early identification and resolution of problems, while taking into account the need for financial institutions to take reasonable risks in order to compete and prosper.

OSFI's mandate is accomplished through three main business functions:

- Supervision and intervention – monitoring institutions' financial condition and risk management practices, and requiring that institutions fix problems in a timely manner;
- Regulatory approvals – exercising the Superintendent's statutory responsibilities with respect to approving certain transactions or activities undertaken by regulated financial institutions; and
- Rule setting – communicating OSFI's expectations through a framework of rules and guidance that promotes safe and sound practices.

The provinces carry out the supervision and regulation of provincially incorporated financial institutions and pension plans. The regulation of market conduct, including insurance contracts, of <u>all</u> property and casualty companies is also a provincial matter. Notwithstanding, market conduct issues are of interest to OSFI when they have the potential to impact on the profitability or capital position, and hence the safety and soundness, of institutions.

Property and Casualty Industry

As at March 31, 2003, OSFI regulated 89 Canadian property and casualty companies and 102 branches of foreign property and casualty companies with assets totalling $70 billion.

The vast majority of the property and casualty industry is federally regulated. It is estimated that, on an unconsolidated basis, premiums written by federal property and casualty insurers are three times higher than premiums written by provincial insurers, excluding the three large property and casualty crown corporations in British Columbia, Manitoba and Saskatchewan.

Unlike the Canadian banking and life insurance industries, there has historically been a significant degree of foreign ownership in the property and casualty industry. As a result, factors outside Canada can have a significant impact on the availability of capital in the Canadian property and casualty industry because Canadian subsidiaries (and branches) of foreign operations have to compete for capital against other worldwide opportunities. The impact on global players of events worldwide can affect their attitude towards investments in the Canadian market.

The domestic insurance industry is also dependent on the global reinsurance industry for the necessary (prudential) spreading of risk. Although this benefits the Canadian industry, it means reinsurance decisions and pricing are not necessarily made in Canada, but rather reflect experience worldwide (for example, large or catastrophic losses outside of Canada often have a greater impact on the pricing and availability of reinsurance in Canada than made in Canada events such as the Ice Storm of 1998, or the on-going forest fires in British Columbia). Over the past few years, global developments have restricted the availability of reinsurance, which has driven up reinsurance prices.

The property and casualty industry is also more fragmented than the banking or life insurance industries. No one corporate group has attained a 10% market share, and 10 companies control roughly 60% of the market share. The large number of property and casualty insurers in the Canadian market place has resulted in a market than can be considered competitive.

TRENDS REVENUES, EXPENSES AND PROFITABILITY

Property and casualty companies' revenues are generated from premiums and investment income. Expenses result from claims as well as operating expenses.
Premiums paid are invested until required to provide for claims and operating expenses. Unpaid claims are reported as liabilities. Slightly more than one-half of the assets are allocated to the investment portfolio to generate income. Assets, other than investments, generally reflect amounts due from policyholders or recoverables from reinsurers.

The property and casualty industry typically incurs losses on insurance underwriting, which are offset by investment returns. For example, over the past 20 years, premiums have not covered expenses in any year, and investment income has been the critical element for turning loss situations into profitable net results.

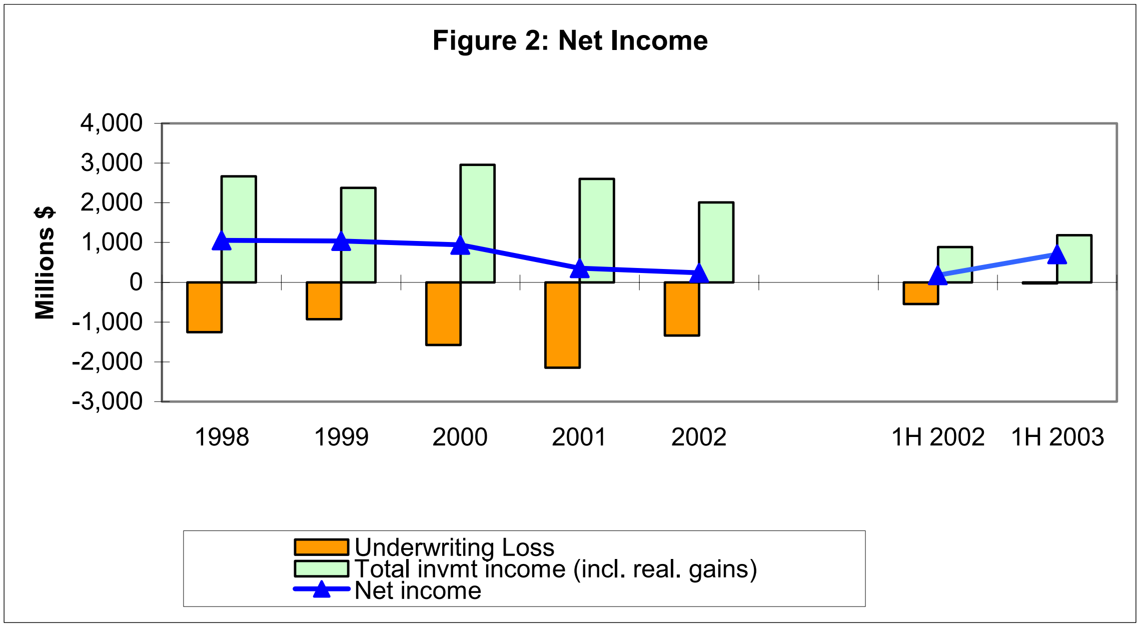
Figure 1: Income Statement
In $ millions

	1998	2002	% change over 5 years
Underwriting revenue*	15,693	21,755	39%
Claims expenses	11,724	16,805	43%
General and acquisition expenses	5,244	6,285	20%
Other	(21)	2	n/a
Underwriting income (loss)	(1,253)	(1,337)	7%
Investment income before gains (net of invmt expenses)	2,002	1,956	-2%
Other revenue and expenses	108	(181)	n/a
Net income before investment gains and taxes	857	438	-49%
Realized investment gains	664	56	-92%
Income taxes	463	250	-46%
Net income for the year	1,058	243	-77%

* Underwriting revenue includes service charges of $49 in 1998 and $83 in 2002

The charts that follow consider the operations of federally regulated Canadian property and casualty companies and branches of foreign property and casualty companies from 1998 to the mid-year 2003 based on reports filed with OSFI[1]. Results for the first 6 months of 2003 (1H 2003) are compared to the same period in 2002 in order to eliminate any seasonal impacts[2]. As shown in Figures 1 and 2, the profitability of the property and casualty industry has been deteriorating for several years as a result of increasing claims costs that were not matched by increases in premium revenue (i.e. underwriting losses), and an overall decline in total investment income. Cost increases, particularly in claims costs, have been a much larger factor explaining pressure on premiums than any reduction in investment income.

[1] A considerable amount of this information is available to the public on OSFI's web-site.
[2] These figures exclude results of reinsurers, which are not due until the end of September.

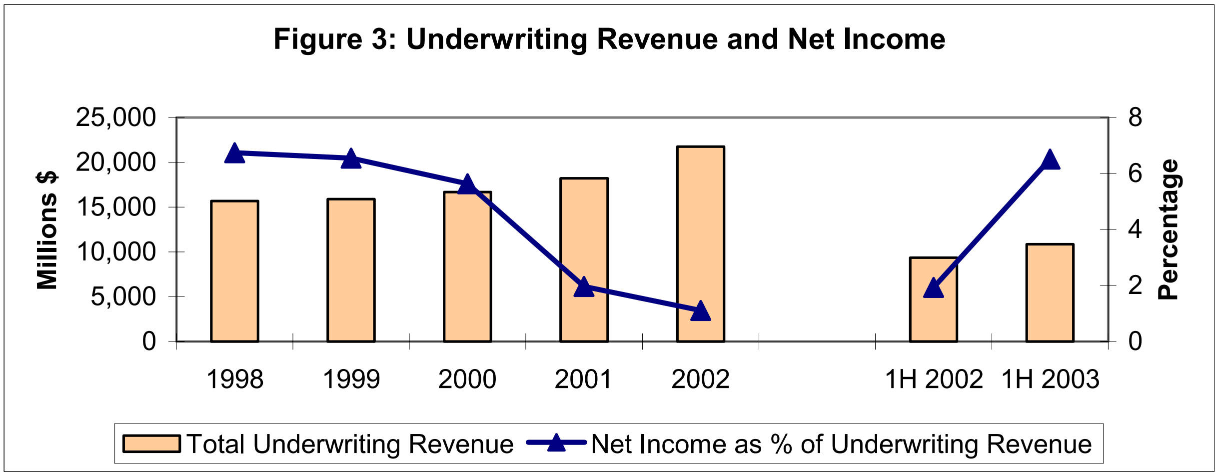


Results for the first half of 2003 show an improvement in operating results in comparison with the first half of 2002. The causes for this apparent improvement lie in the effect of substantial premium rate increases of the past year or so, improved claims ratios, and an improvement in investment returns.

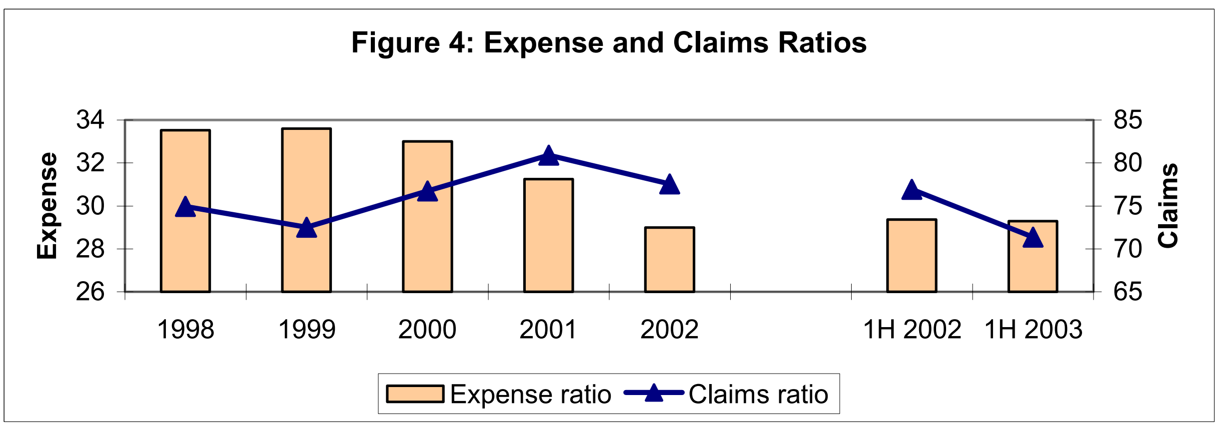
Profitability has been deteriorating for several years due to increasing claims costs that were not matched by increases in premium revenue together with an overall decline in investment returns. The decline in total investment income is not the largest factor in explaining the pressure on premiums. Claims expenses have risen significantly, particularly for automobile insurance, and other expenses have also increased although to a lesser extent. Operating results improved in the first half of 2003 due to increases in premiums, improved claims ratio and increased investment income, but this should be viewed with caution as it is too early to conclude that a trend to improved results has been firmly established. Sustainable profitability is important for the safety and soundness of the industry.

Revenues, expenses and profitability

During the 1998 to 2002 period, although underwriting revenues continued to climb, net income as a percentage of underwriting revenues declined significantly (Figure 3). Insurers were affected by growing claims costs, increased reinsurance prices (as restricted reinsurance availability drove up the cost of reinsurance premiums) and decreased investment income. The first half of 2003, however, showed improved results, primarily as increases in premiums surpassed claims cost increases, together with improved investment income.



Underwriting performance is assessed on the basis of two operating ratios: the expense ratio, or underwriting expenses as a percentage of net premiums earned, and the claims ratio, which is total incurred claims as a percentage of net premiums earned. Over the five-year period to 2002, companies improved their expense ratios and that improvement has been largely maintained into the first half of 2003 (Figure 4). The overall claims ratio, however, grew significantly to a peak of roughly 80% in 2001, before declining somewhat in 2002. That trend was continued into the first half of 2003.



Although both expense and claims ratios have declined significantly since 2001, this is not reflective of actual reductions in claims or expense outlays (Figure 5). Rather, the growth in premium revenue finally outstripped the growth in claims and associated expenses in 2002, and is continuing its pace in 2003. For the first six months of 2003, revenues matched outlays on claims and expenses.

Figure 5: Claims and Expenses Compared to Revenues

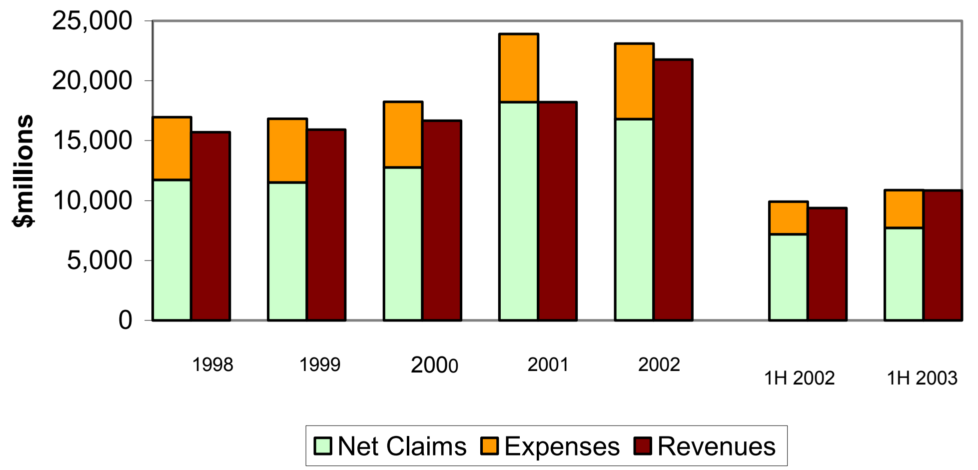


Figure 6: Components of Underwriting Income ($ millions)				
	Underwriting Revenue*	**Claims Expense**	**General & Acquisition Expenses**	**Underwriting Income**
1998	15,644	11,724	5,244	(1,253)
1999	15,683	11,506	5,331	(922)
2000	16,637	12,765	5,490	(1,571)
2001	18,173	14,697	5,675	(2,174)
2002	21,672	16,805	6,285	(1,337)

* Immaterial service charges revenue has been omitted

Up until 2003, stronger underwriting revenues were not sufficient to provide underwriting profits, because claims were growing more quickly than premiums. However, the situation has been improving. In 2002, operating ratios strengthened as increases in premium revenue outstripped the growth in claims and associated expenses. This trend continued into the first half of 2003.

Automobile insurance

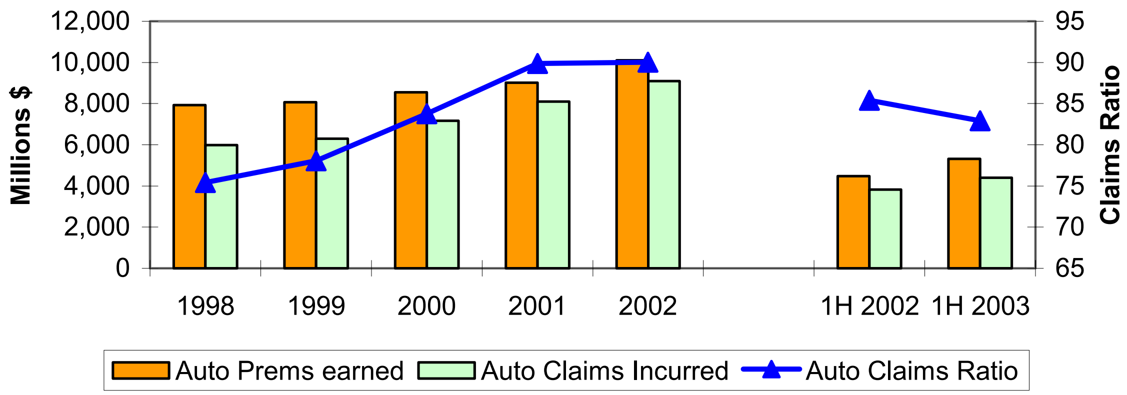
More than two thirds of the property and casualty market is in personal lines – home and automobile insurance. Automobile insurance accounts for over one half of the market in terms of net premiums written. The automobile market is the engine that drives much of the industry, and one half of this business is written in Ontario. Auto rates are controlled in all provinces and territories.

During the 1998 to 2002 period, automobile insurance claims costs and claims ratios rose more sharply than premiums (Figure 7). While in 1998 the claims ratio for automobile was comparable to the claims ratio for all lines, in 2002 the claims ratio approached 90% versus the

2001 peak of roughly 80% for other lines. Industry observers[3] have reported that the higher costs experienced in the last few years reflected rising medical and rehabilitative claims, rising court awards for pain and suffering in cases of minor strains and pains and an increased number of injury claims that are becoming more expensive to treat.

In the first half of 2003, the claims ratio of approximately 83% showed some improvement over the same period in 2002, suggesting that the time delayed effect of 2002 premium increases have now been sufficient to offset the continued increase in claims costs.

Figure 7: Automobile Premiums and Claims

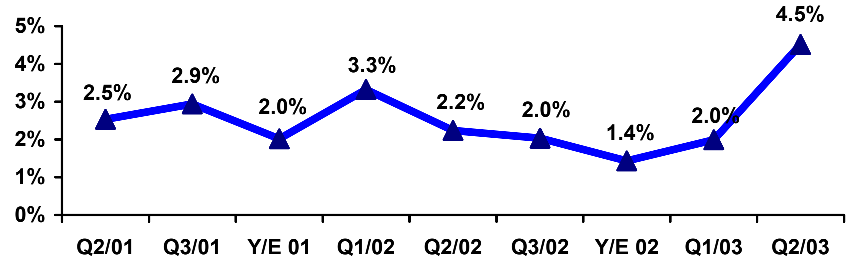


Equity

Consistent with the erosion of profits, return on equity (ROE) for property and casualty insurers declined steadily over the past five years (Figure 8). The 2001 and 2002 ROEs of 2% and 1.4% were well below the level that is sustainable for this industry (e.g. the average ROE for the industry for the past 15 years was 8.1%). ROE improved for the twelve months ending at the second quarter of 2003, but it is still too early to predict whether this is a trend that will be sustained.

[3] IBC, P&C Insurance 101, What's up with insurance premiums? … what is tipping the scales?, (www.ibc.ca)

Figure 8: Return on Equity

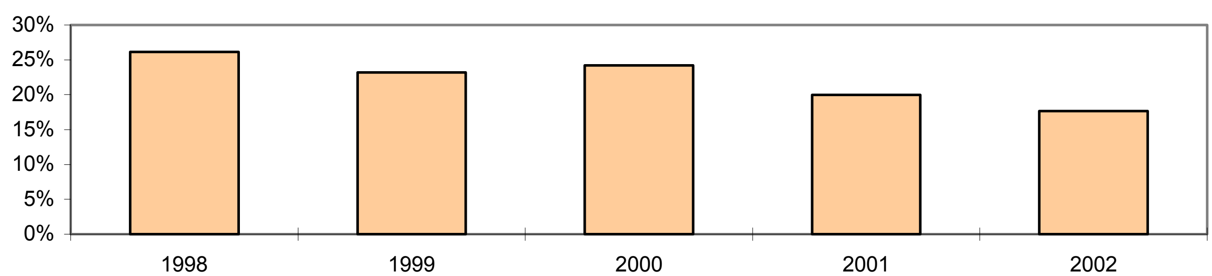


Note: ROE is for Canadian companies and branches of foreign companies combined, using GAAP capital (for branches of foreign companies, equates to head office account + reserves). Net income is on a rolling four-quarter basis, and equity comprises the average of opening and closing equity for the four quarters.

Until year-end 2002, OSFI measured capital adequacy by the Minimum Assets Test (MAT), which considers excess assets available as a percentage of assets required. Companies were required to maintain a minimum MAT margin of 10% to provide a cushion to cope with market volatility and economic conditions and to provide for risks not explicitly addressed by the MAT.

The capital position of the industry overall has been declining over the past several years. The downward trend in the more companies approaching OSFI's minimum capital target thresholds of 10%.

Figure 9: Minimum Asset Test



Beginning in 2003, the MAT was replaced by the Minimum Capital Test (MCT), a risk-based test that assesses the credit and liability risks of individual companies and the capital required to support those risks. This approach is based on principles similar to those underlying the capital tests for life insurers and deposit-taking institutions. As companies face different risks, OSFI expects each institution to establish its own target capital level in excess of the supervisory target. The industry was asked to compute parallel MAT and MCT tests at year-end 2002, before shifting to the MCT test in 2003. A comparison of the MCT results at year-end 2002 to those at Q2 2003 suggests that there has not been further significant reduction in capital during the first six months of 2003.

Figure 10: Trends in MAT margins

	Industry	MAT Margin - 10 largest	MAT Margin 8 largest stock companies*
2002	**18%**	15%	**11%**
2001	**21%**	17%	**12%**
2000	**26%**	21%	**16%**
1999	**24%**	21%	**14%**
1998	**27%**	25%	**20%**
1997	**28%**	25%	**20%**
1996	**25%**	23%	**20%**
1995	**20%**	19%	**16%**

* 10 largest companies excluding 2 mutuals

The larger companies generally have maintained lower capital ratios than the industry as a whole. The MAT solvency margin for the 8 largest stock companies fell to only marginally above OSFI's threshold of 10% by 2002 (Figure 10).

In introducing the MCT, OSFI committed to ensuring the new capital adequacy measures would be neutral vis-à-vis the existing MAT, on an industry aggregate basis, in an average year. It has always been recognized that results for individual companies could vary from this outcome, subject to their risk profile. While capital neutrality was the objective, results have since demonstrated that capital requirements are overall lower under the new MCT.

The pressures on capital facing the industry have been further exacerbated by the decline in return on equity and rating downgrades of parent organisations, which has made it difficult for them to raise additional capital. The prospects for capital injections into the foreign controlled companies are also influenced by the return (ROE) expectations set by their foreign parents, coupled with a general lack of capital (availability) from overseas.

OSFI's response to financial situation

OSFI's approach to supervision is risk focussed and reliance based. "Risk focussed" means that OSFI focuses its efforts on selected issues at institutions using a combination of high level and in-depth reviews and investigations, based on OSFI's assessment of the risks that are likely to materially affect safety and soundness. "Reliance based" means that OSFI relies on boards of directors, on internal controls and compliance processes operating at institutions, and on external auditors and actuaries. OSFI's approach is comparable to that used by other leading regulators and supervisors worldwide.

As part of its supervisory program, OSFI places emphasis on determining whether financial institutions' internal control systems are adequate and appropriate to ensure general safety and soundness as well as compliance with financial institutions' legislation. OSFI's approach is to consider how well the institutions' overall systems work across their consolidated operations. When deficiencies are identified, OSFI works closely with the institution to require quick and effective remedies.

OSFI has been working with companies to ensure they maintain capital ratios above supervisory thresholds on a continual basis. OSFI's enhanced vigilance and current level of intervention activity reflect the deteriorating financial condition of the industry, poor underwriting results and earnings and the challenging investment climate. Companies with higher risk profiles have been subject to more frequent financial reporting and increased intervention.

The solvency margin for the largest companies has been declining steadily. OSFI is working with companies to ensure they maintain capital ratios above supervisory thresholds.

REVIEW OF FEDERAL REGULATORY FRAMEWORK FOR INVESTMENTS

History of Provisions

Prior to 1992, the investment rules for insurance companies consisted primarily of qualitative (but prescriptive) limits, which focused on the soundness of individual investments, supplemented by quantitative limits, which focused on the soundness of the asset portfolio.

The qualitative limits were intended to prevent investments in higher risk securities. Accordingly, the regime placed considerable emphasis on the quality of individual investments (e.g. corporate securities had to typically qualify on the basis of their earnings and dividend histories or other criteria generally linked to the security backing the investment.) The quantitative limits were intended to control investments in assets that tend to generate unpredictable income streams (e.g. real estate, common shares) and could therefore expose the institution to a solvency problem. While these rules were formulated with a view to maintaining a reasonable matching between the nature of assets and liabilities, the overall regime was prescriptive and did not consider whether an institution's portfolio of investments was appropriate in light of the risks the institution faced.

Current rules

In the 1992 legislative review, as part of the reform agenda to implement a more modern and effective regulatory system, a "prudent person" approach was introduced, whereby companies are expected to follow investment policies that a reasonable and prudent person would apply in respect of a portfolio of investments to avoid undue risk and obtain a reasonable return. In addition, a few quantitative limits for specific types of investments were introduced, in order to have some ultimate limits on the various types of risk that an institution could assume.

The government moved to the prudent person approach for a variety of reasons. It provided institutions with more flexibility to choose appropriate investments given the risks that they face (e.g., liquidity risks, credit risks, interest rate or foreign exchange risks), while protecting against undue risk. The focus was on the overall portfolio of investments an institution held, rather than individual investment decisions. Finally, it was consistent with both the general approach to managing risk at financial institutions, as well as OSFI's overall approach to regulation, which was moving to increased reliance on institutions' governance and control processes, rather than prescriptive rules.

Under the current regime, the board of directors of an insurance company is required by law[4] to establish and adhere to investment and lending policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain a reasonable return. In addition, financial institutions must comply with the investment limits set out in legislation and regulations. The limits for property and casualty insurers are summarized in Figure 11.

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[4] The legislative references for property and casualty insurers are: sections 492 and 551 and subsection 615(1) of the *Insurance Companies Act*.

Figure 11

	Canadian incorporated P&C insurers	**Branches of foreign P&C insurers**
Restrictions on commercial and consumer lending	Section 505 - 5% of total assets, per *Commercial Loan (Insurance Companies, Societies and Insurance Holding Companies) Regulations*	Section 617 - 5% of assets in Canada, per *Investment (Foreign Companies) Regulations*
Restrictions on investments in real estate	Section 506 - 10% of total assets, per *Investment Limits (Insurance Companies) Regulations*	Section 618 - 10% of assets in Canada
Restrictions on investments in equities	Section 507 - 25% of total assets, per *Investment Limits (Insurance Companies) Regulations*	Subsection 619(3) - 25% of assets in Canada
Restrictions on aggregate investment in real estate and equities	Section 508 - 35% of total assets, per *Investment Limits (Insurance Companies) Regulations*	Section 620 - No regulation promulgated

Investment and lending policies established by the Board should describe the objectives for the investment and lending programs and the overall risk philosophy of the institution. They should take into account the strength of the institution's capital and its ability to absorb potential losses. The policies should also take note of the liability structure of the financial institution and the anticipated demands for funds and address how maturity profiles are to be established on the portfolios of investments and loans in light of these demands. They should establish limits on the institution's exposure to a person or a group of associated persons and to interest rate and currency risk. In setting these limits the institution should consider its exposure under a variety of potential scenarios. As part of its supervisory program, OSFI assesses the investment and lending policies of institutions.

OSFI supported the move from prescriptive investment limits to the prudent person approach, on the basis that it better reflects risk management practices at institutions and these practices were generally sound. Based on supervisory reviews, OSFI is also of the view that the current investment rules are generally being adhered to. OSFI takes action in any situations where a company's policies are deemed to be materially lacking.

ASSESSMENT OF INVESTMENT PRACTICES AND PERFORMANCE IN RECENT YEARS.

As previously described, the property and casualty industry – both in Canada and internationally – is dependent upon investment returns to offset losses incurred by underwriting activities. It is illustrative to note that in the past 20 years the Canadian property and casualty (federally regulated) industry has not experienced an underwriting profit in any year (i.e. premiums have not exceeded costs of claims and general expenses), and investment income has been the critical element for turning loss situations into profitable net results.

Investments

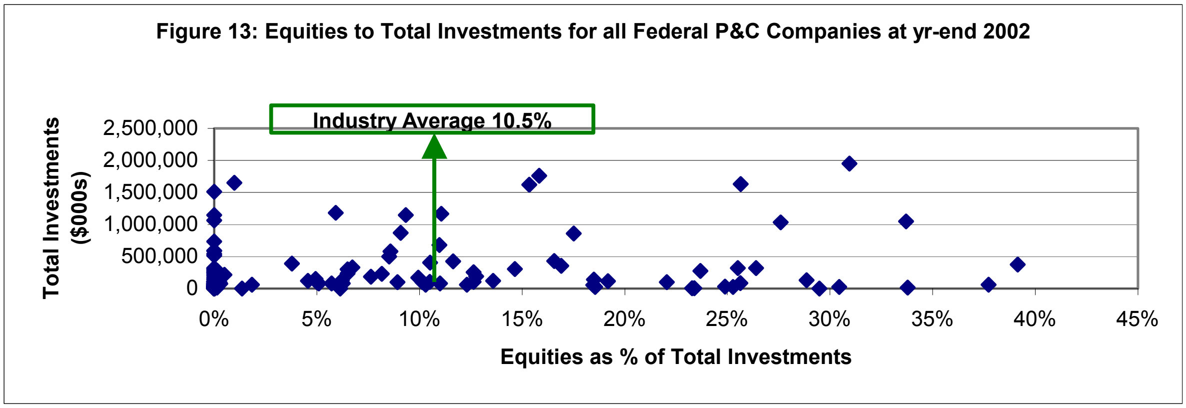
In the federal property and casualty industry, on average slightly more than one-half of companies' assets are typically allocated to their investment portfolio. At the end of 2002, 56% of total assets were represented by investments. The proportion of invested assets has declined by approximately 5% over the past 5 years. Assets other than investments (i.e. the remaining 44% of the balance sheet), generally represent amounts due from policyholders or recoverables from reinsurers.

Figure 12: Composition of Investment Portfolios at year-end 2002

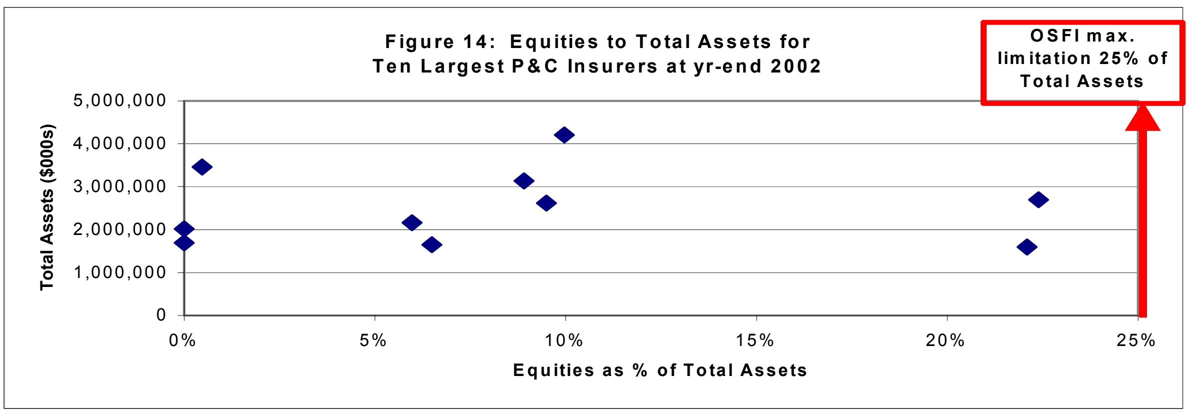
	% of Portfolio	Comments
Bonds	79.9%	55% Gov't/gov't guaranteed, 24% Corporate (incl. below investment grade of 2.7%) Of total bond portfolio: short term (< 5 yrs) = 60% long term (> 5 yrs) = 40%
Preferred Shares	7.1%	below investment grade = 0.8%
Common Shares	10.6%	Equity concentrations have not varied significantly in the past 5 years, and have not exceeded 12 ½%.
Other	2.5%	Primarily comprised of minimal investments in mortgages and real estate

As illustrated in Figure 12, investment portfolios are generally considered conservative. Across the industry, investments in bonds average almost 80% of investment portfolios, of which over half is government or government guaranteed. Investments in below investment grade bonds and preferred shares total less than 4%, and a similarly small portion of the portfolio is invested in higher risk mortgages and real estate. This composition has not changed significantly over the last several years.

Figure 13 illustrates the proportion of equities in companies' investment portfolios. While the regulatory limit on equity holdings is 25% of total assets (as described in the Review of Federal Regulatory Framework for Investments, p. 13), because investments generally account for only 50-60% of a company's assets, for some companies the rules would permit equities to account for as much as 45% of the investment portfolio. There is considerable variability amongst companies' individual portfolios, with equity holdings as a percentage of total investments varying from nil to over 40%. The unique circumstances of companies, such as differences in solvency margins or the companies' investment philosophies, contributed to the differences in their investment strategies.

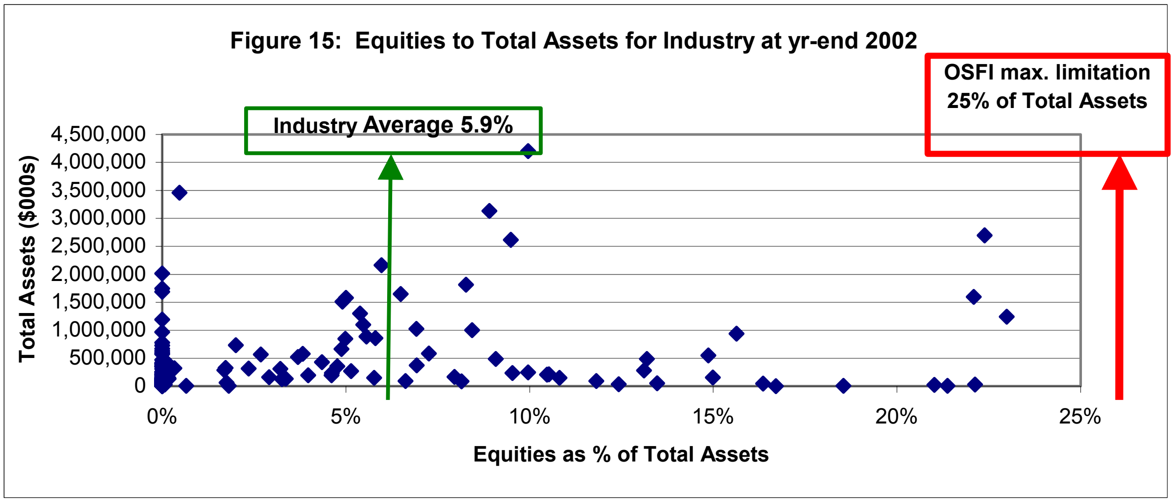


In Figure 14, the comparison of companies' equity holdings as a percentage of total assets (for which the regulations set out a limit of 25%) demonstrates similar trends. Very few companies approached the limit, with most of the larger companies holding equities that represent only 5-10% of assets.



On an industry wide basis (Figure 15), roughly 6% of total assets are invested in equities (representing less than one quarter of the 25% limit). Even in the current environment bonds, especially government (or guaranteed) bonds, have remained the investment vehicle of choice for the industry.

This suggests that the industry has a prudent approach to investments.

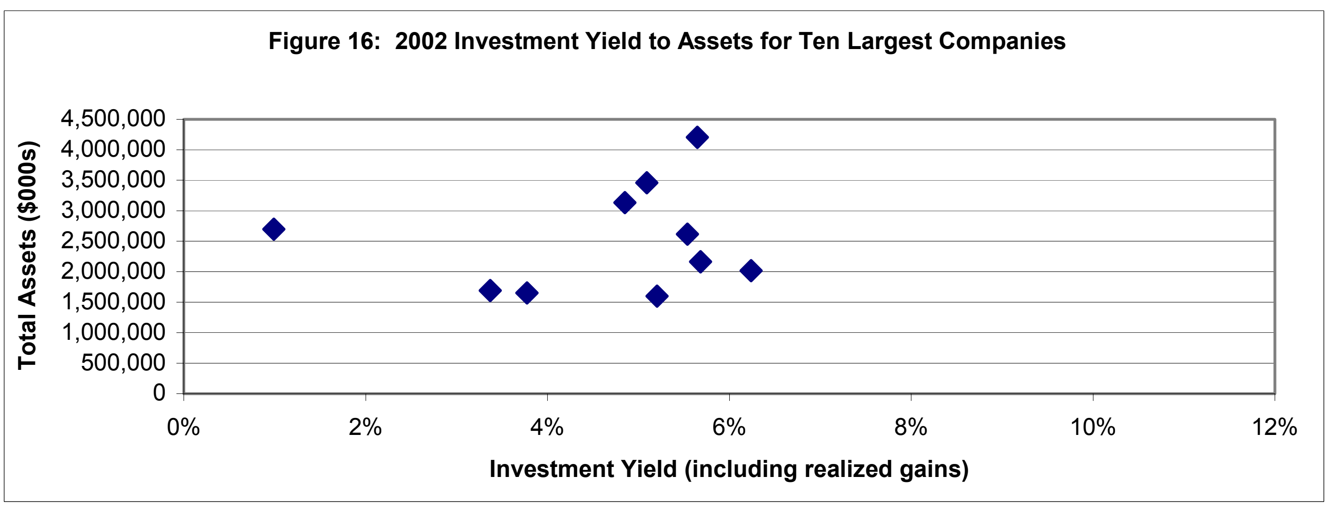


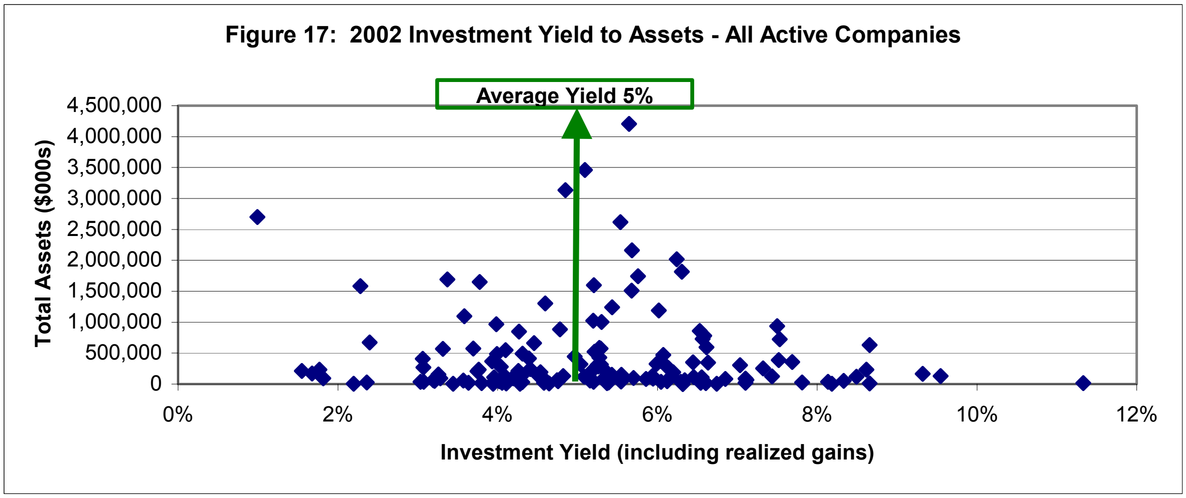
Overall, OSFI considers the industry's investment portfolios and strategies to be prudent.

Investment Income & Yields

Investment yields for the industry have generally declined over the past several years as older, higher yielding debt instruments have matured and companies have had little alternative but to purchase lower yielding issues.

The industry's investment yield including gains for 2002 was marginally greater than 5%, the lowest level in the past five years and considerably lower than the yields of the 1998 – 2000 period, which averaged 7% - 8 ½% (Figure 18). For the larger companies, investment yields tend to cluster around the industry average (5%-6% in 2002, Figure 16) while they are more dispersed for the remainder of the industry (Figure 17).





As seen in the Figure 17, in 2002 no company suffered negative investment yields.

Figure 18: Investment Income History for the P&C Industry

	2002	2001	2000	1999	1998
Investment yield – including gains	**5.2%**	**7.2%**	**8.4%**	**7.1%**	**8.3%**
Investment income – before gains ($million)	**2,060**	**2,127**	**2,136**	**2,023**	**2,064**
Investment expenses	(105)	(74)	(73)	(62)	(62)
Realized investment gains	56	553	890	414	664
Total investment income	**2,011**	**2,606**	**2,953**	**2,375**	**2,666**
Breakdown of Realized Invmt Gains ($ million)					
Bonds	247	257	(1)	22	275
Preferred shares	(27)	(6)	(29)	(14)	(9)
Common shares	(177)	262	913	383	368
Other	13	40	7	23	30
Total realized invmt gains ($ mil)	**56**	**553**	**890**	**414**	**664**

Although investment yields have been declining, investment income, before gains, has been remarkably flat in absolute dollars. Realized gains, however, have declined dramatically since 2000, leading to the lower overall investment yields. As demonstrated in Figure 18, equities accounted for most of the high realized gains in 2000. In 2001, the drop in realized gains resulted from significantly lower equity gains, offset by an increase in bond gains (consistent with the lower equity values and interest rates experienced in global markets at that time). These developments suggest that while equities represent only a small portion of investment portfolios, gains on equities are generally the primary driver behind net realized gains.

Unrealized investment gains are also an important consideration for investment portfolio management. In 1999 and 2000, there was considerable volatility in the valuation of unrealized gains in the portfolios of insurance companies. However, the volatility in the valuation of unrealized investment gains has since stabilized, and hence has not added any additional impetus to the downward trend in overall investment returns in 2001 and 2002.

Overall investment returns, while lower than the peak year of 2000, have withstood both the volatility of the capital markets and interest rate declines. Investment returns have continued to enable the industry as a whole to post positive net incomes for all years. This further supports the conclusion that companies tend to adopt low risk investment strategies, and do not take substantial speculative positions that would place their policyholders' funds or capital at undue risk.

CONCLUSION

The financial position of the property and casualty industry has been deteriorating for several years. 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 investment returns 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. As a result, more companies are approaching OSFI's minimum capital target threshold.

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.

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 this 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.

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.

Secretary of State
Finance

Secrétaire d'État
Finances

Ottawa, Canada K1A 0G5

AUG 2 5 2003

Mr. Nicholas Le Pan
Superintendent of Financial Institutions
255 Albert Street
Ottawa, Ontario
K1A 0H2

Dear Mr. Le Pan:

I am writing to ask you for information on the property and casualty (P&C) insurance industry in Canada. This information would be helpful in providing a better understanding of the recent increases in P&C insurance premiums in certain regions of the country. A great many Canadians have raised with me their concerns regarding the adverse impact of these increases on individuals and businesses. I believe this is an important issue that needs to be addressed.

I recognize that the regulation of market conduct, including insurance contracts and premiums, of all property and casualty (P&C) companies is a provincial matter and that a number of provincial governments and regulators are taking steps to address these concerns. However, because the Office of the Superintendent of Financial Institutions is responsible for the supervision of federally regulated-P&C companies, I believe your office can provide useful information.

Therefore, I would appreciate receiving a report from your office on the P&C industry in those areas covered by OSFI's mandate. The report should include:

- Trends regarding revenues, expenses, and profitability of federally regulated P&C 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 would appreciate receiving your report by mid-September and thank you for your co-operation.

Sincerely,

The Hon. Maurizio Bevilacqua, P.C., M.P.