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Remarks by Julie Dickson, Acting Superintendent
Office of the Superintendent of Financial Institutions Canada (OSFI)
to the
2007 Property and Casualty Insurance Industry Forum

Cambridge, Ontario
Thursday, May 24, 2007

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Canada

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Opening

On the face of it, 2006 was a very good year for the Property and Casualty (P&C) industry. Any sector with returns of around 20 per cent will be looked upon with envy by other players in the financial sphere. This remarkable level of return is even more impressive in that it is the third straight year where consolidated returns have been very strong.

While the environment of positive returns speaks to the general health of the industry, we cannot forget history, recent history in fact. I think we all remember that not so long ago circumstances were vastly different.

The Office of the Superintendent of Financial Institutions (OSFI) is a safety and soundness regulator, and in our view, sustainable returns are the best defence against safety and soundness issues. The improvement in industry results, I believe, stems from a conscious effort by the industry to move away from the boom and bust of the classic business cycle that we have seen in the insurance industry.

In good times, smart companies prepare. They study their risks, assess their product prices, and constrain their costs. Knowing that good times cannot go on and on, prudent companies take time during the good times, to plan for the tough times.

That said, do we think the insurance cycle has been relegated to the dustbin of history? No, we do not. But I believe that some of the oversight mechanisms put in place over the last few years, combined with a conscious effort by industry, may help guard against the volatility we have seen in the past.

State of the Industry

Let me put forward a few observations about what we are seeing, and how what we see may affect our view of the industry going forward.

The 2006 Return on Equity (ROE) of about 20 per cent, on the surface, continues to be remarkable. But with the most recent downturn still fresh in our minds, it

should serve as a reminder. We have all seen when circumstances produced returns that led to the serious erosion of capital adequacy levels.

Still, last year's results were at a level that was perhaps only wishful thinking a few years ago. But at the same time, the 2006 results revealed that the industry is truly a disparate group, with results being generally good for most participants, many instances of specific results being truly phenomenal, and some results where we see some softening.

The important point is that the results are not homogeneous, they show considerable variability. We have seen that even companies in similar markets can be quite dissimilar when reporting bottom line numbers.

Hazards on the Horizon

So how sustainable is an ROE of 20 per cent? Relatively minor changes in the economic environment could return the industry to the single digit ROEs of the past. And it demonstrates how quickly a downturn can appear, in that none of the potential hazards alone would seem to be a harbinger of doom.

In the last quarter or so, we have started to ask ourselves, "what if":

- There were no realized investment gains in 2007.
- There were no more aggregate reserve draw downs in 2007.
- There was a modest increase in the automobile claims ratio of - say 5 per cent.
- We saw a bit less than a modest increase in commercial lines claims ratios – say 10 per cent.

Some of these elements are occurring right now, and if they do come to pass concurrently, then the industry would find itself in the position of single digit (8 per cent) ROEs. This would perhaps quiet some of your critics, but it would hardly satisfy your economic stakeholders.

One can easily appreciate that if this occurs within the industry as a whole, then the natural distribution of actual results by company will show significant dispersion around the mean. This will of course hold special interest to OSFI.

There are certainly some questions out there. Is the market cycle unalterable, or will everybody's recent memories of the early 2000s act as a counterbalance to what was previously believed to be the result of inevitable competitive pressures? Where will the balance between intermediated sales and direct sales end up? Along the same line, will costly investments in IT infrastructure be the cure-all for lowering costs and improving broker relationships? The market place is still extremely crowded and that usually would suggest winners and losers, or

will some participants, anticipating the future, willingly sell to more efficient producers?

There are also some significant and immediate risks that face the industry today. Key questions are:

- Catastrophic exposures (which we heard about earlier today), both natural hazards and man made hazards, what further steps are necessary for the industry to take? Have the lessons learned from other jurisdictions been fully digested?
    - No matter how well the industry discharges its obligations in a catastrophe, there will be coverage and response time disputes, and those may be the only messages that will hit the press.
    - If your responsiveness is in question, your regulator may quite suddenly be the Attorney General.
    - We have seen that no amount of planning for the unexpected is too much - the need for in-depth planning cannot be exaggerated.
- In terms of automobile exposures, is claims inflation stirring again?
- What steps need to be taken to work proactively with the market conduct regulators and provincial governments, to avoid the turmoil of the early 2000s?

It is your observations and interpretations of the way your markets are developing that will help us find answers to some of these questions. Your actions will guide our assessments, help us assess the risks facing the industry, and help us gauge the appropriateness of individual companies' risk management processes.

Capital

Capital is a topic near and dear to everyone's heart. Especially ours.

Currently the industry is well-capitalized, perhaps even over-capitalized, with a combined Minimum Capital Test/ Branch Adequacy of Assets Test (MCT/BAAT) of about 250 per cent. This is certainly in excess of the internal capital targets set by the institutions.

Some perceive that capital is the only thing we think of – as important as it is, it is not the only thing – but when we do consider it, what we think is important is the right level of capital and how you got there. Capital that is commensurate with the quality of risk management and demonstrated earnings capability is key.

We have a test, the MCT, that we think works pretty well. It was initially tested in 2002, and implemented in 2003, a stressful time, and we think it was responsive to the right stimuli. Can it be improved? No doubt, and what we have learned

from the Basel process, and are learning from the Minimum Continuing Capital and Surplus Requirements (MCCSR) review process in terms of modelling, will undoubtedly provide some additional insight.

We have heard some in the industry call for the use of more complex modelling. There is of course the admonition of, 'be careful what you wish for'. Complex modelling will be expensive, and will not necessarily result in lower capital requirements. And at the same time, we might also be giving up one of the more commendable features of the MCT -- its simplicity.

So while we are ready to discuss different approaches to modelling as we go forward, we must also be cognizant of the implementation costs of such approaches.

Currently, we are following what is being done world-wide on the topic of models, and have begun some preliminary discussion with the industry.

The Canadian institute of Actuaries (CIA) is developing a survey on the use of economic capital models by P&C companies, which we expect to be released shortly. Even though the P&C industry is a couple of years behind the other industries in terms of process, it should be able close the gap quite quickly, as some ground work has already been done and its products are usually simpler to model.

Internationally, we are looking at the work of the International Association of Insurance Supervisors (IAIS) and Solvency II, and the framework implemented in the United Kingdom (UK) and in Switzerland. We are moving at a pace that is similar to Solvency II and our expectation is that our system will have many similarities.

Some in the industry have the impression that in the UK, the Financial Services Authority (FSA) has "approved models" and also allows unlimited use of such models. This is not the case. The FSA does not allow companies to use models to calculate capital requirements. They use results produced by a company's internal model as a starting point for discussing what the capital target of the company should be.

A model might mean an advanced stochastic model. Or it might mean scenario testing like the Canadian Dynamic Capital Adequacy test (DCAT), which has been in place for some time. I think all regulators are of the same mind when it comes to models – we need to be cautious and test the waters before we jump in, and even then, we will be wearing lifejackets.

I would also add that we are not waiting to finalise the work on the Life side before starting with the P&C industry, and that we do not intend to impose what was done for the MCCSR. We will, however, still be looking at what was done in

Basel II, in the Life industry, and internationally, before developing something specific to P&C.

So there is certainly more work to be done in this area, but I feel that things are progressing, and we expect to see some concrete developments in the near future.

Capital Distribution

Hand in hand with the high level of capitalisation, and significant profitability levels, is the question faced by many Boards, what to do with all this capital?

Some have responded by increasing dividend payments to shareholders. These are dividends which, until the last few years, have averaged around $400 - $600 million a year. With the steady increase in profitability since 2002, dividends have grown to approximately $1.7 billion for 2006, which represents a dividend payout ratio of 55 per cent of net income. Some would think that OSFI should be expressing grave concern about the outflow of capital from the system. We are not.

OSFI understands that the financial services industries are international in scope, and with its degree of foreign ownership, perhaps none more so than the Canadian property and casualty industry. With this comes the understanding that the Canadian P&C industry is mature and domestic growth is hard to come by, so capital is mobile by nature, and that it should, and will, follow the best returns.

Too much capital sloshing around gives rise to the natural desire to find something to do with it. This may lead to the writing of business with a focus on the short term, while ignoring economic fundamentals. This can exacerbate the underwriting cycle, and lead to a loss of discipline in underwriting decisions.

Lots of capital may give a regulator some solace for the *Safety* part of the safety and soundness mandate that drives our supervisory approach. But too much capital can undermine our *Soundness* assessment.

The importance of soundness is amply demonstrated when we see examples of breakdowns in controls at any financial institution. Proper risk management, underwriting standards and control measures are critical and attention must be paid to these areas at all times, not just when times are tough.

Closing

There is no question of the cyclicality of the property and casualty business, and the diligence that is required to break that cycle. So if there is one thing you should take away from here today, it is to reflect on the past.

OSFI is seeing signs that companies have learned the lessons of the past, but at the same time we see softening in some areas. So while the good times roll, our message is prepare, plan and proceed cautiously, because travelling in a circle may be easy, but we all know where it leads.

Thank you.