BFL CANADA

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The Cover Note

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EDITORIAL

Barry F. Lorenzetti

At the beginning of a new year, we always wonder what our world will have in store for us in the upcoming months in all the areas of our lives. Being insurance brokers, the state of the insurance market is one area which, obviously, we watch very closely.

Since sharp movements can have a significant impact on the cost of its insurance portfolio, every business is also very interested in the state of this market. We are all affected by the cycles of ups and downs of the insurance market, sometimes favorably – as has been the case in recent years – and sometimes unfavorably. Considering that the market has been remarkably weak for a while now, the consequences of a change at this time would most probably be detrimental to most organization.

Premium levels have been depressed for several years and, although many expected the market to take a turn a couple of years ago, circumstances have dictated otherwise. Certain niches, lines of insurance and geographic areas did get slightly harder over the past two years, some permanently, some temporarily, but overall, the market remains very soft. Some accounts still bring fierce competition among insurers and rock bottom premiums, while others, less fortunate in their loss experience, have seen increases reflecting that situation.

What should we expect for 2014? Well, it seems that yet again, the market will continue on its current course. With all the natural disasters happening around the world, you may wonder why the market doesn't turn.

First, we have to remember that despite the fact that these natural phenomena cause massive damage, more often than not an important portion of these damages does not fall under the category of "insurable damage".

Moreover, the 2008 financial crash has produced structural changes which are not yet well understood and whose perennity is also uncertain. Despite the fact that the stock exchange is performing very well, one could say that some aspects of the financial world are in a state of limbo; we seem to have lost some of our bearings and cannot take anything for granted anymore.

What we do know for sure, and you will probably have heard about this, is that currently there is an overabundant capacity in the insurance market as well as many new players, thus increasing competition. This keeps premiums at very low levels that some would even describe as unsustainable.

Is this a temporary situation that is bound to disappear once the aftershocks of 2008 finally recede, or is this the new "normal"? I wish I could tell you, but we will have to stay tuned for at least another year to find out!

In this issue, our main article, written by Jacques Dufresne, EVP Eastern Region for BFL CANADA, reviews the state of the insurance market and David Vanasse, President of BFL CANADA Consulting Services, for his part, discusses share redemption in case of disability.

Finally, at the beginning of this new year, I would like to wish all of you a healthy and prosperous 2014! ♦

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THE STATE OF THE MARKET

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SUMMARY 2013

In 2013, the technical results of Canadian insurers and reinsurers were slightly negative. This is due, amongst other things, to the catastrophic losses of an unprecedented level that Alberta and Toronto experienced during last summer's floods.

However, in the United States, an increase in profitability was observed due to the following factors:

- a relatively calm hurricane season that caused very little damage;
- the release of excess reserves by insurers[1];
- a rise in premiums reaching 4% on average.

Overall, the addition of new insurers to the market boosted available capacity, thus generating strong competition and, consequently, pressuring premiums downward.

Last year, we also witnessed a sharp rise in catastrophe bond subscriptions (cat bonds), especially by pension plans and hedge funds. Indeed, these new investors are seeking to provide their shareholders with vehicles providing higher returns. In contrast to other available investments, catastrophe obligations are more tempting in that respect. Furthermore, investors such as pension plans and hedge funds constitute an advantage for the insurers and reinsurers issuing these bonds: they do not incur any risk of debtor insolvency in case the coverage is triggered.

In any event, this type of bond's significant increase in popularity has nevertheless caused a downward pressure on the price of traditional reinsurance contracts expiring on January 1st 2014.

Other than the issue of catastrophe obligations investments, the year 2013 has not been a noteworthy year, neither provoking any important movement in pricing nor having any material effect in the course of events.

[1] Indeed, when insurer's reserves are higher than what is required, they have the option of releasing some amounts in order to influence their results positively. During the last few years, because of the soft market, a major part of the excess reserves gathered during the previous hard market have been released.

2014 TRENDS

In Canada, the market remains volatile. Some insurers – maybe more affected by the losses related to the Calgary and Toronto incidents, or maybe sensing an opportunity to correct their results – will be tempted to ask for higher premiums. In some instances, we could observe small increases in property insurance (3 to 5%) and in liability insurance (0 to 5%), as well as an overall rise of deductibles in flood risk areas.

However, just as was the case in 2013, the important presence of new players – and thus of extra capacities – will put downward pressure on prices in Canada and internationally. Depending on the type of risk and loss experience, we could see decreases in premiums, as small as they may be, in all the markets. These redu-ctions could be more signi-ficant where a marketing exercise is performed. Consequently, insurers will be torn between their desire to improve their results and the intense competition they've been engaging in for several years already.

Nevertheless, some sectors seem to be specifically targeted for increases by insurers. These include energy and mining in terms of general liability, on a worldwide basis. As for directors and officers insurance, the North-American market should move by approximately 5%.

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ACTIVITIES IN CANADA IN 2014

Some measures and developments that could seriously impact the Canadian and North-American market are expected during the upcoming months, such as:

- an extraordinary surge in losses caused by cyber-risks that should encourage, as soon as 2014, a high demand for insurance;
- the possible implementation of new rules regarding risks measurement and capitalization for earthquakes. This project has been under study by the Office of the Superintendent of Financial Institutions for some time now, and could burden insurers with new capitalization requirements;
- the possible study, in the upcoming months, of a Canadian flood insurance plan, echoing a large number of requests for change to the flood insurance situation in Canada after the events of last July in Alberta;
- the end in December 2014 of the Terrorism Risk Insurance Protection Act in the United States. The uncertainty of its renewal could lead insurers to restrict, as soon as 2014, the scope of coverage against terrorism for contracts expiring after 2014.

AFTERMATH OF 2014

According to Swiss Re, we are entering a soft and mature market, even though some signs seem to indicate a definite hardening in the years to come. These signs include:

- the exhaustion of some insurers' excess reserves; fewer insurers will have the luxury to compensate or correct their results by using surpluses;
- the enactment of a European capital adequacy regulation (Solvency II) which will temper bolder insurers;
- the volatility in financial markets that continues to affect the investment incomes available to insurers, although there has been a certain improvement in 2013;
- the persistent low interest rates that also affect insurers' investment income. ♦

WHAT WOULD HAPPEN IF YOU OR ONE OF YOUR SHAREHOLDERS OR PARTNERS BECAME DISABLED?

David Vanasse, President, BFL CANADA Consulting Services Inc., Montreal

Have you anticipated everything in your shareholder or partnership agreement? Have you set up the necessary procedures in case of a shareholder or partner's death or disability?

You already have a shareholder or partnership agreement? Congratulations. You have therefore laid down the rights and obligations of each party, the management principles for your company and what measures to take in various cases.

You have probably included arrangements specifying what would happen if a shareholder or partner decided to part ways with the company, or in case of death.

But does your agreement lay down the terms of a contingency plan ***in case of disability***?

- Will the disabled person want to retire from the business, or will other shareholders or associates require him or her to retire?
- Are the time and amount of repurchase hard to determine if your partner or shareholder becomes disabled?
- Is the disabled person at a disadvantage when it comes to negotiating?
- Will profits decrease?
- Would the company incur any fees to replace the disabled shareholder or partner? Will it continue to pay him or her?
- Do you think the rights and interests of the disabled shareholder or partner could be in conflict with the ones of the other shareholders or partners?
- What if the shareholder or partner sold its share to an unwanted third party?
- What have you planned as funding to enable the application of a redemption agreement in the occurrence of total disability and what is intended to prevent your company from draining its resources?
- Shouldn't your business be protected against losses resulting from a disability?
- Are there any financing options established to redeem the shares held by a shareholder or partner ***in the case of death or disability***: working capital, loan from a financial institution (revaluation of credit), company's assets, ***insurance***?

The majority of you have already thought of getting a life-insurance in order to repurchase the shares held by a deceased shareholder or partner, but shouldn't you also redeem these same shares in case of a prolonged disability? There is a buy-out insurance on the market that aims to furnish the required sums needed to buy back a company's interests from an owner or shareholder that has become completely disabled. This helps protect the organization's operational capital by avoiding digging in the organization's resources. The policyholder can receive payment for a repurchase of shares if the person insured is unable to accomplish the important tasks required by his day-to-day occupation.

It is something to keep in mind. ♦

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