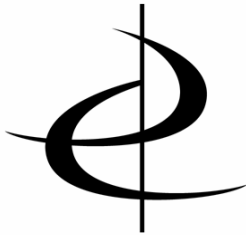


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Sharpening Canada's Competitive Edge: Comments from the property and casualty insurance industry

Submission to:

*Canada's Competition Policy Review
Panel*

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INSURANCE BUREAU OF CANADA

Canadians in all walks of life depend on insurance coverage for their cars, homes and businesses to protect themselves against unintentional loss. Property and casualty (P&C) insurance plays a vital role in supporting a strong dynamic economy by providing greater peace of mind with respect to many of the risks involved in modern life. The P&C insurance industry also works to improve the quality of life in our communities by promoting loss prevention, safer roads, crime prevention, improved building codes, and coordinated preparation for coping with disasters.

The Insurance Bureau of Canada (IBC) is the national trade association representing the private general insurance industry. Members account for roughly 90 percent of the non-government, non-life insurance business in Canada. The P&C insurance industry is one of the largest employers in Canada, providing some 100,000 jobs. In 2006 the industry paid more than \$20 billion in claims, including rehabilitation expenses to those injured in road incidents and other circumstances, replacement of stolen goods, and repairs to damaged homes and vehicles.

Section 2: Canada's Insurance System in a Global Context

The P&C insurance industry in Canada, with assets exceeding \$110 billion, is a major part of the social and economic fabric of Canada. In addition to its investment activity, the industry underwrites the personal and economic risk associated with living and operating a business in our economy. As risk managers and investors, P&C insurers support innovation in virtually every aspect of the Canadian life.

As investors and risk managers of the Canadian economy, the insurance system creates incentives for innovation in business practices and in product markets. These incentives encourage individuals and businesses to properly assess risk and reward innovative business solutions that mitigate risk and create new opportunities. Insurance incentives support product development, rewarding safety and security features in products such as automobiles and homes with premium discounts. Further, innovation is happening at every point in the development, production, marketing and claims settling stages of the P&C insurance process. The development of new products, increasingly effective and efficient distribution and improved service to consumers are key areas of competition among insurers.

Each of our answers reflects the experience of the insurance industry.

- 1. Should Canadians be concerned about foreign takeovers of Canadian firms? How important is domestic control and ownership of Canadian business activities to Canada's economic prospects and ability to create jobs and opportunity for Canadians?**

IBC Response:

The P&C insurance industry is Canada's most open and competitive financial service. The majority of the world's largest insurance companies compete in Canada with Canadian-owned companies. Only 4 of the 10 largest private insurers operating in Canada are Canadian-owned.

Canadian insurance consumers benefit from this competition in, at least, two important ways. Using the model of competition developed by Dr. Michael Porter of Harvard University, the more diverse the competitors in an industry in terms of cultures, histories and motivations the greater the scope for competition.¹

A second way that Canadians benefit from open competition in insurance is that allowing international players into the Canadian marketplace facilitates the diversification of risks internationally. For example, the risk of a major urban earthquake in the Greater Vancouver Area is diversified internationally through the purchase of reinsurance. Reinsurance is commonly referred to as "insurance for insurers". Reinsurance is one of many tools used by insurers to guarantee that they will meet every obligation to pay legitimate claims. In recent years, reinsurers have helped insurance companies pay the claims from several major events. Among these were the ice storms in eastern Ontario and southern Quebec in January 1998 and Hurricane Juan in Atlantic Canada in 2003. Reinsurance is vital to the health and prosperity of Canadians.

¹ <http://www.quickmba.com/strategy/porter.shtml>

2. How important are company headquarters to Canada's economic prospects and ability to create jobs and opportunity for Canadians? How important are global divisional head offices? What factors influence their location?

IBC Response:

It is very important that Canadians have well-paying sustainable jobs located in communities across the country. These do not necessarily have to be head office jobs. Our industry offers jobs in almost every community in Canada.

In most cases, insurers are required under the Insurance Act to establish a Canadian subsidiary having a head office in Canada. Therefore, global divisional offices are very important in Canada's P&C insurance industry.

There are a limitless number of factors that influence the decision to locate a head-office of a new business. The most comprehensive list of factors that can influence these decisions in the financial sector is the Global Financial Centres Index (GFCI) published by the City of London, United Kingdom.² This index rates the competitiveness of the world's financial centres.

The GFCI ranks financial centres against each other and identifies the changing priorities and concerns of finance professionals. Toronto ranks as the 13th most desirable place to establish a new financial services company according to this index. According to this study, the key factors for financial centre competitiveness were, in order of importance:

1. the availability of skilled personnel;
2. the regulatory environment;
3. access to international financial markets;
4. the availability of business infrastructure;
5. access to customers;
6. a fair and just business environment;
7. government responsiveness;
8. the corporate tax regime;
9. operational costs;
10. access to suppliers of professional services;
11. the quality of life;
12. cultural and language issues;
13. the quality and availability of commercial property;
14. the personal tax regime.³

² http://213.86.34.248/NR/rdonlyres/3BC399CF-9037-450E-83E7-F0E6D0748FD5/0/BC_RS_GFCI207_FR.pdf

³ <http://www.zyen.com/Activities/On-line%20surveys/GFCI.htm>

3. How do Canada's policies impacting direct investment, both inward and outward, affect Canada's competitiveness as a destination for FDI and as a platform for global growth?

In answering this question, hawse have deliberately avoided attempting to provide an exhaustive prescription for a promoting direct investment and improving Canada's competitiveness. Instead, the proposals address the specific concerns that come out of insurers' experience as Canada's risk managers in supporting innovation and sustainable development.

For Canada's innovation performance to improve, public policy actions must re-establish a supportive business environment which fosters investment and promotes innovation. There is now broad consensus that inappropriate and unnecessary regulatory intervention creates disincentives to innovation. Despite this consensus, however, the P&C insurance industry is witnessing increased regulatory intervention at a time when the risk of insolvency is at an all time low and customer satisfaction levels are at their highest levels ever. These actions have begun to artificially reduce the scope and pace of innovation in an industry that touches all aspects of the Canadian economy.

An effective action plan for innovation in the financial services sector should:

- **Provide regulatory flexibility and incentives**

Although outside the focus of public attention, financial services supervision has been undergoing revolutionary changes worldwide. Canada has been an active participant in the changes that have been occurring, at least at the federal level. Over the past decade, industrialized countries have become less reliant on government regulation and more reliant on corporate governance and industry standards. Greater government reliance on industry self-management (e.g. standards of sound business practices, codes of conduct and rating agency evaluations) would reduce the need for some elements of the traditional solvency monitoring system. Industries like P&C insurance that have no systemic risk, and demonstrate strong capitalization and sound business practices, should be subject to less intrusive monitoring and regulatory intervention. The near absence of solvency risk should be rewarded with a more stable regulatory environment including, perhaps, a moratorium on changes in solvency regulation practices.

While the new supervisory principles and approaches being adopted internationally have been in principle adopted by the federal financial service regulator, provincial regulators, where the majority of financial service regulation occurs, have generally not adopted them.

- **Require cost/benefit analysis for new regulatory initiatives**

All significant regulatory initiatives should include a formal analysis of expected benefits and costs. Currently cost/benefit analysis has not become an essential part of Canada's approach to regulation. Such analysis can help determine if an initiative should proceed and can help identify problems in advance should there be a decision to go ahead with the initiative. This provides for consideration of whether a market based alternative would be sufficient.

- **Streamline and harmonize existing regulation**

There are differences in solvency and market conduct regulations among the federal, provincial and territorial governments in Canada, with the greatest variation in areas related to market conduct. Jurisdictions have differing priorities, legislative agendas, resources and capacities for implementation. Consumers ultimately pay for overlapping regulation. Recognizing that federal, provincial and territorial governments all have a role to play in insurance regulation, greater effort should be made to co-ordinate and find consistency within the current division of powers. Federal and provincial regulators should seek to identify and evaluate all circumstances where Canadian regulations differ significantly from those of other major jurisdictions.

- **Recognize the distinctiveness of P&C insurance in the financial services sector**

The risk management and intermediation function of P&C insurance is fundamentally different from that of wealth management and financial intermediation. Property and casualty insurance contracts are typically of a short time horizon, generally a year. Wealth management contracts, for example a life policy, are for a longer time period. Further, the greatest solvency risk for wealth management institutions is found on the asset side of the balance sheet. For example, banks run the risk of a debt not being repaid. The greatest solvency risk for P&C insurers is on the liability side. Poor risk management and unforeseen risks can suddenly increase an insurer's costs.

The industrial structure of the P&C insurance industry is also fundamentally different from that of other financial service industries. In both banking and life insurance, a half dozen very large players dominate the Canadian market. In contrast, the P&C industry is highly competitive with 220 companies. No single company has a market share in excess of 12 percent. The relative size of P&C insurance companies and the protection of policyholders through the Property and Casualty Insurance Compensation Corporation means that there is no systemic risk associated with the industry. In contrast, the failure of a bank or life insurer has much more serious consequences for the economy.

4. **Do Canada's economic policies appropriately reflect our increased integration with the North American and global economy? How might these policies be changed to better reflect this new competitive environment?**

In general, Canada's economic policies of fiscal responsibility, low and stable inflation, and reducing trade barriers have allowed us to smoothly integrate into the global economy. We strongly support continuing these policies.

We are also heartened by the reductions in corporate income taxes announced by the Government. Lowering tax rates will make our economy more competitive globally.

However, the list of things that can be done to improve the competitiveness of our economy is virtuously endless. One specific step that we recommend is harmonizing sales tax regimes with provincial governments that have not already done so. A significant problem with the current regime is that the different sales tax regimes result in insurance consumers paying tax-on-tax. This is a dead-weight loss on our economy.

Section 3: Investment Policies

- 1. What impact has the Investment Canada Act (ICA) had on the Canadian economy and Canadian competitiveness, and specifically on our ability to attract FDI?**

We believe that Canada has benefited from the opening of the Investment Canada Act. The rules are comparable with other industrialized nations and clear to international investors. Canada's P&C insurance industry has always had significant involvement from international investors. Under the current ICA, economic fundamentals and the competitive environment are the primary factors in attracting FDI.

- 2. What changes to the ICA and Canada's investment review regime would help Canada address the challenges and complexities of the modern global economy, within the constraints of Canada's international obligations?**

One significant change that has occurred since the ICA was adopted is the development of investment pools by sovereign states. We believe that it would be appropriate to have FDI by a sovereign state to be subject to a higher level of scrutiny than a private investor.

- 3. What, if any, changes to the investment review process would enhance Canada's competitiveness and improve Canadians' understanding of the benefits of FDI?**

See above.

- 4. Should the net benefit test be adapted to reflect the new competitive environment? If so, how?**

See above.

SECTORAL INVESTMENT REGIMES – QUESTIONS

Canada maintains specific regimes to govern, review or restrict investment in six sectors: telecommunications, cultural industries, broadcasting, transportation services, uranium production and financial services.

- 5. What changes, if any, are required to Canada's sectoral investment regimes to minimize or eliminate negative impacts on Canada's competitiveness?**

The Government of Canada undertook a comprehensive policy review of the investment regime for the financial sector in 2006. As part of this review, IBC undertook an exhaustive survey of our member companies and confirmed no major structural reforms were needed. IBC did make submissions to the Department of Finance detailing a number of smaller changes that would make Canada's insurance industry more competitive.

- 6. What have been the impacts of these investment regimes on productivity and competitiveness in the specific sectors?**

In general, the investment regime for financial services has served Canada well. There is one change currently being implemented that may have unintended consequences on competitiveness of Canada's insurance and reinsurance industries.

During the 2006 review, Part XIII of the *Insurance Act* was changed. This defines the scope of the Canadian regulatory system and has fundamentally changed the business environment for commercial insurers and reinsurers in Canada. IBC opposed this change and significant confusion remains among insurers and investors. We believe that the January 1, 2009 implementation date for the change does not allow sufficient time for insurers and reinsurers to adjust their business systems and process.

7. Are there alternative mechanisms that would achieve the non-economic policy objectives of the sector while also ensuring maximum competitiveness of firms operating in the sector?

IBC does not advocate major structural reforms to the investment regime of Canada's financial sector at this time.

Competition Law

COMPETITION LAW – QUESTIONS

1. How does Canada's competition policy affect Canadian competitiveness in an environment of globalization and free trade?

Canada's competition policy regime provides a workable framework for the global insurance marketplace. Where Canadian-based insurers report problems attracting international capital to Canada the reasons are usually;

- 1) Canada's regulatory capital requirements are dramatically greater than other industrialized nations; or
- 2) Canada's corporate tax rates make investments in Canada less competitive to other markets.

2. What changes to Canada's competition regime would enhance the competitiveness of Canadian firms in the global economy? What international best practices, if any, would strengthen Canadian competitiveness as a destination for foreign investment if we were to adopt them?

In her December 11, 2007 speech to the Economic Club of Toronto, the Commissioner of Competition described her statutory mandate to enforce federal laws against anti-competitive behavior. She also outlined the Bureau's contribution to the prosperity of Canadians by protecting and promoting competitive markets and enabling informed consumer choice. IBC supports this role.

The Commissioner also noted the important role that the Competition Bureau plays as a statutory advocate for competition. We would encourage the Bureau to examine the activities of government-owned auto insurance monopolies in British Columbia, Saskatchewan and Manitoba. Canada is unique among the OECD in allowing

government-owned auto insurance. In these Provinces, the government-owned insurer “competes” with private insurers to sell auto insurance beyond the mandated minimum product. These publicly-owned insurers are not governed by Canada’s competition policy. They do not pay taxes. Their distribution contracts with independent brokers include clauses that are not consistent with Canada’s competition policy. IBC strongly believes that they should be.

We encourage the Competition Bureau to be more active as an advocate for competition in the Canadian economy. This may include representations before other government bodies. This is often not headline-grabbing, but it is important work and would benefit the Canadian economy.

3. Does Canada’s approach to mergers strike the right balance between consumers’ interest in vigorous competition and the creation of an environment from which Canadian firms can grow to become global competitors?

IBC is satisfied that the recent changes to the *Insurance Companies Act* that allowed the federal Superintendent of Financial Institutions with greater authority to review mergers, were positive for our industry. We do not suggest making further changes at this time.

PROMOTING CANADIAN DIRECT INVESTMENT ABROAD – QUESTIONS

1. What barriers, either formal or informal, do Canadian firms face when seeking to make investments and acquisitions abroad?

Canada’s insurance industry is connected into the global insurance marketplace. There are Canadian As mentioned earlier in this submission, the largest barrier that a Canadian insurer faces are the disproportionately high Canadian solvency regulatory requirements. There is little integration between international solvency regimes that can result in overlapping capital requirements.

2. How should the government adapt its policies to promote increased Canadian direct investment and acquisitions abroad? What measures have been adopted by other countries that are relevant to Canada?

Canada should work to ensure that our capital requirements are equal with those in other nations.

3. Are there policies or approaches that would be useful in addressing the particular challenges faced by small and medium-sized enterprises as they seek to become global competitors and participants in global value chains?

Canada’s solvency regulation regime should be changed to reduce the cost of providing insurance for small and medium-sized businesses. In particular, the regulatory treatment of Provision for Adverse Deviations (Pfads). Pfads are an essential component to the reserving process. Insurers set aside reserves to ensure they have the financial capability to pay future claims. Pfads provide the appropriate buffers to ensure that reserves are adequate to meet the possibility of reasonable volatility in business across

lines. Additional margins on claims reserves are superfluous on top of Pfads (i.e., margins on margins). Therefore, the current margin requirements on claims reserves should be removed or, at the very least, the margin factors applied to claims reserves should be re-assessed, as discussed below.

The main quantitative test used by the Office of the Superintendent of Financial Institutions (OSFI) is called the Minimum Capital Test (MCT). The MCT determines the capital required for various classes of business by applying factors to unpaid claims and unearned premiums. The factor applied to unearned premiums is 8% regardless of class. The factors applied to unpaid claims reserves vary from 5% for property to 15% for liability. The result of these factors is that, relative to premiums written, the capital requirement varies significantly across lines of business; liability business requires 4.3 times the capital required by property business and 5.0 times that required by other automobile lines. As well, automobile liability and personal accident business require, respectively, 3.0 times and 3.2 times the capital required by other automobile. The following table provides an illustration:

Comparison of Margin Requirements by Line

	Property	Auto 3 rd party Liability	Auto PA	Auto Other	Liability	Notes
Net Premiums Written (NPW)	100	100	100	100	100	Notional \$100 NPW volume
Unearned Premium (UPR)	50	50	50	50	50	Assumes 1 year policies
Outstanding (O/S) Claims	20	87	96	6	116	Based on Outstanding Claims to NPW
Total UPR+O/S	70	137	146	56	166	
Margin on UPR	8%	8%	8%	8%	8%	
Margin on O/S Claims	5%	10%	10%	5%	15%	
Cap Req'd on UPR	4.0	4.0	4.0	4.0	4.0	
Cap Req'd on O/S Claims	1.0	8.7	9.6	0.3	17.5	
Total Capital Required	5.0	12.7	13.6	4.3	21.5	
Capital % of NPW	5.0%	12.7%	13.6%	4.3%	21.5%	

Source: IBC based on MSA (2004 aggregate data)

Clearly, liability business is inherently more risky and more susceptible to under-reserving than property and other automobile business and, consequently, requires more capital underpinning. In the same regard, automobile liability and personal accident contain risks in excess of other automobile business. However, IBC questions whether the current risk factors are appropriately capturing the relative risks between lines of business. There are obviously different mathematical approaches to assessing relative risk, so IBC recommends that these relative risks and respective factors be re-assessed.

Finally, it should be noted that the MCT penalizes companies that incorporate more conservative estimates into their reserving process. With a higher amount placed in reserves, companies receive a higher margin requirement. IBC believes this is a counterintuitive incentive.

Small changes to the solvency regime would reduce the cost of providing liability insurance to small and medium-sized business and would allow Canadian insurers to underwrite the risks of these businesses as they strive to become global businesses.

4. What impact does a higher-value Canadian dollar have on CDIA?

IBC has no official position on the appropriate value of the Canadian dollar. A high-value Canadian dollar would make more affordable for Canadian insurers to make direct investments in other countries.

Becoming A Destination For Talent, Capital And Innovation

1. How can Canada better promote inward FDI? What policy change could contribute to the achievement of this objective?

Recommendation (1)

Review the mix, fairness and efficiency of taxes on financial services

Federal and provincial capital taxes are levied in Canada on finance, insurance and non-financial businesses. The rates are higher for finance and insurance compared to non-financial businesses. That capital taxes create economic disincentives to investment and innovation has been recognized by several government committees. The Technical Committee on Business Taxation [1998] recommended over time the reduction, if not the elimination, of the capital tax. Similarly, the report of the Task Force on the Future of the Canadian Financial Services Sector also recommended the elimination of special capital taxes on financial institutions.

Further, regulatory capital and investment requirements and the nature of risk management in the Canadian economy requires a significantly high degree of capitalization in the property and casualty industry. As such capital taxes are particularly burdensome to the industry. The taxation of capital can unnecessarily increase the risk of insolvency. In addition, capital taxes created disincentives to investment.

Recommendation (2)

Phase out cascading premium and other transaction taxes

The federal government should undertake a review of the mix, fairness and efficiency of business taxes applied to the P&C insurance industry. Insurance premium taxes fall on business capital expenditures in a manner similar to that played by the abolished manufacturing tax which have increased business input costs in a cascading manner. This cascading erodes the competitiveness of Canadian businesses.

Further, the introduction of additional corporate tax relief measures at the federal level would improve the operating environment for businesses in Canada and foster an environment of investment and innovation.

Recommendation (3)

Require cost/benefit analysis for new regulatory initiatives

We recommend that regulators be obligated to perform a full and public cost/benefit analysis before implementing any significant regulatory initiatives. Federal and provincial governments should review current and planned regulatory initiatives affecting financial institutions, to ensure a supportive business environment that will promote innovation and lasting competition.

Recommendation (4)

Streamline and harmonize existing regulation

We recommend that the federal government support the continued streamlining and harmonization of federal and provincial regulatory practices. Federal and provincial regulators should evaluate circumstances where Canadian regulations differ significantly from those in other major jurisdictions, with a stated goal of ensuring greater consistency in international regulatory practices.

Recommendation (5)

Introduce regulatory flexibility and incentives

The federal government should introduce more flexibility into the regulatory framework. The regulatory environment should move away from the “one-size-fits-all” approach to regulation to a system that makes the administrative burden for smaller institutions commensurate with their size and the nature of their business activities. Regulatory requirements in the financial services sector continue to be based on those required for large multi-product financial conglomerates which place a disproportionate burden on smaller players in the sector, particularly P&C insurance.

Further, industries like P&C insurance, demonstrating strong capitalization and sound business practices, should be subject to less intrusive monitoring and regulatory intervention. The near absence of solvency risk should be rewarded with a more stable regulatory environment including, perhaps, a moratorium on changes in solvency regulation practices.

Recommendation (6)

Launch a permanent national effort on injury prevention

Injuries are exacting an enormous, but largely avoidable toll on Canada's society and economy. We need to do more to prevent injuries. IBC recommends that the federal government help to preserve the universality and affordability of Canada's health care system by investing in a national injury prevention program that seeks to promote healthier lifestyles and reduces the risk of occupational/recreational injury and death.

Federal government leadership of the injury prevention initiative will help to ensure a national scope and consistency of effort. But the program must also enlist the long-term commitment of provincial governments, worker safety and compensation programs, health agencies, consumer product manufacturers, as well as the insurance industry.

Recommendation (7)

Increase support for evidenced-based rehabilitation research

More than three and half billion dollars per year is spent by provincial health ministries, workers compensation organizations and insurers on rehabilitation services. We believe that Canada's research effort for injuries and rehabilitation should be proportionate to their contribution to the total costs of disease and injuries. Establishing this goal for supporting research on rehabilitation makes economic sense.

Recommendation (8)

Launch a Canadian Strategy for Disaster Prevention

A *Canadian Strategy for Disaster Prevention* should actively support community risk assessments and disaster prevention investments, it should include disaster prevention communication with the public and among key stakeholders, and it should be coordinated with countries and communities around the globe. Working together, insurers, governments and other stakeholders have the knowledge and ability to build a Canada that is more resilient to natural hazards. We can save lives, reduce disaster loss payments and shorten community recovery time, reduce personal hardship and produce a more resilient and competitive economy.

A national strategy for disaster prevention will save lives. It will save money by reducing future expenditures on disaster recovery and reducing community recovery time. It will strengthen the Canadian economy, one community at a time and, most importantly, it will reduce the devastating personal hardship that results from natural hazards.

Recommendation (9)

Support research in risk management, sustainable development and disaster mitigation

Governments need to recognize and support research networks and clusters in risk management, sustainable development and disaster mitigation. Supporting increased knowledge, innovation and expertise in these areas will foster sustainable development and growth in Canadian communities and allow Canada to become a global leader in these areas.

Further, the federal government should seek to strengthen Canada's ability to manage the risk of increasing damage caused by natural disasters by investing a portion of future federal budget surpluses in infrastructure projects (including roads, transportation and sewer systems) which will reduce Canada's growing vulnerability to losses from natural disasters.

- 2. In particular, what mix of policy changes would be required to make Canada the preferred point of entry to, and location in, the North American market for the high-value activities of non-North American business entities?**

See above.

- 3. Is the modernization of Canada's competition and investment laws sufficient for successfully attracting foreign direct investment in Canada? What other priorities and policy issues should governments address**

See above.

- 4. What impact does a higher-value Canadian dollar have on Canada's competitiveness as a destination for investment?**

See above.

- 5. What further could be done in Canada to promote an ongoing review of Canadian competition, investment and productivity performance aimed at Canada's sustained competitiveness?**

See above.