Insurance Biz 101

Why profit is not always a bad word

Ed note: Running an insurance company is – in today's economic climate – more complicated than ever. Companies are under heightened scrutiny – in part because of upheaval in world economies and the recent collapse of major companies and financial institutions. Many results are driven in part by external regulatory and compliance requirements over which the company has no control. And, of course, companies must comply with regulations, file regular financial reports and regularly prove to regulators that they have sufficient capital and resources to meet their obligations.

This new **Insurance Biz 101** *column aims to help you – our insureds – know and understand more about the business of LAWPRO and the obligations we face as a regulated insurance company operating in a climate of increased scrutiny and control. Why should you care? Because we believe it is important that you understand why we make the business decisions we make. Because most of those decisions directly affect you. And because, as a member of the Law Society of Upper Canada (our shareholder) you should evaluate LAWPRO like an owner.*

Our first column tackles the question lawyers often ask when they see our annual financial results: Why does LAWPRO even have to make a profit? In future columns we will unravel the complexities of new accounting standards that will fundamentally change how we report our financial results.

If you have a business topic you've always wondered about, let us know. You can help ensure this column addresses your questions about LAWPRO operations.

Should LAWPRO even try to make a profit?

The answer to that question lies partly in the tightly regulated environment in which we as a licensed insurer operate.

To be able to provide any type of insurance, a company must first be licensed to provide one or more specific classes of insurance by the appropriate regulator in each jurisdiction in which it intends to do business.

As a provider of malpractice and title insurance in Ontario, LAWPRO is licensed and regulated by the Financial Services Commission of Ontario (FSCO), and is licensed appropriately by regulators in other jurisdictions to provide TitlePLUS title insurance. We are required to operate and comply with very specific regulations and standards governing Ontario insurers. Moreover, we are required by FSCO to report our financial results regularly and – most importantly – provide proof of our ability to meet our financial obligations and satisfy solvency tests.

The most important of these benchmarks is the Minimum Capital Test – the MCT. This is a mandatory solvency test set by FSCO in conjunction with the federal Office of the Superintendent of Financial Institutions (OSFI). The MCT is one way the province's insurance regulator can determine how stable and secure an insurer is. Simply put, the MCT is the ratio of the company's available capital (assets) to the amount of *capital required* (a defined calculation set by FSCO), expressed as a percentage. So for example, if a hypothetical company has $100 million in assets and $70 million in capital requirements, its MCT would be 143 per cent (100 divided by 70 x 100).

Although strictly speaking this fictitious company's available capital exceeds its requirements, it would not meet the minimum capital adequacy test of 150 per cent set by FSCO for property and casualty insurers (the insurance class to which LAWPRO belongs). This firm would likely be placed under close FSCO supervision – a prospect insurers strive to avoid. Keeping MCT at levels considered adequate and appropriate by FSCO requires diligent monitoring of the many variables that go into the MCT calculation. The MCT for the insurance industry in Canada as a whole hovers in the 250 - 260 per cent range; commercial insurers, because of market volatility and issues around premium increases, tend to have MCTs in the 300+ per cent range.

How then is the MCT determined?

Determining the MCT is not a simple process of measuring assets against liabilities. Instead it is a complicated and strictly prescribed calculation, especially when it comes to calculating the minimum capital requirements of a company.

Broadly speaking, the *capital available* part of the equation refers to a company's net assets – including, of course, investment gains and net income.

The *capital required* part of the equation is the result of a complex set of calculations that are applied to a specific set of a company's various assets and liabilities, such as the insurer's claims reserves (i.e., its unpaid claims).

What does this all mean for LAWPRO? It means we need to watch specific numbers closely.

The first is our *capital required* – which is based largely on our claims liabilities, over which we have little control and which tend to grow year over year.

We also monitor two factors that affect the amount of *capital available* – which simple math tells us needs to continue to grow (and perhaps outpace) the capital required to maintain a healthy MCT. To do this, we need to either increase net income (i.e., post a profit) or achieve significant unrealized gains on the surplus portion of our investment portfolio.

What MCT is right for LAWPRO – and how does that affect premiums?

LAWPRO's MCT fell to 206 per cent at the end of 2009 from 238 per cent in 2007. As of mid-2010, the MCT has fallen below the 200 per cent level to 186 per cent, driven largely by an increase in claims reserves.

Although an MCT around 200 per cent exceeds minimum thresholds set by FSCO, it may not provide LAWPRO with sufficient capacity to absorb unexpected losses (resulting, for example, from several large claims) or weather deteriorating market conditions (that lead to poorer than expected investment returns, for example).

Based on our recent analysis, LAWPRO believes that an MCT of 220 to 230 per cent is an appropriate long-term operating goal that balances our unique ability to propose an annual base premium (and effectively raise capital through the premium collection process) against our risk profile.

To ensure a healthy and stable MCT in the 220+ per cent range (and keep our regulator onside) we have limited options. There's not much we can do to reduce claims reserves when the number of claims reported and the costs of resolving them keep increasing – so we're unlikely to be able to do much about the *capital required* line of the MCT equation.

So that means we have to find ways to increase our assets – i.e., the *capital available* portion of the calculation either through healthy investment returns or by posting solid profits. Volatile investment markets of the past few years make the former more difficult: And the historically low central bank rate means that as our investments mature we have to reinvest at lower rates of return than we might have seen five years ago.

One factor we can control – and which also is our major source of income – is, of course, insurance premiums. Calculating the proposed insurance premium for the coming year thus becomes a complicated process that takes into account the continued increase in claims costs as well as our ability to generate a positive bottom line in support of an MCT in the desired range, among other factors.

For 2011 and onwards, premiums must be set at levels that generate more than break-even income: They must be set at levels that contribute to a healthier, more stable MCT. To achieve a stable to slightly increasing MCT ratio, we estimate that LAWPRO needs to generate annually at least $5 to $7 million of net income (to which premium income contributes) and/or unrealized gains on our surplus investment portfolio.

So, although many lawyers may think a perfect budget for LAWPRO would forecast a break-even outcome (without profit or loss), in fact a growth in assets through net income or unrealized gains on the surplus portfolio is essential to keep us on-side with our regulatory tests. In other words, by running very hard, we are hoping to not lose ground further on the MCT and in fact make up some ground in coming years.