3
SUPPLEMENTARY INSURANCE COSTS FOR THE PERIOD 1998 TO 2005

The Finance and Administration Committee recommends the adoption of the recommendations contained in the following report, August 11, 2006, from the Commissioner of Finance, as amended to include the following additional recommendation:

3. The Commissioner of Finance report back to the Committee with a summary of the Region's insurance claims experience.

1. RECOMMENDATIONS

It is recommended that:

1. Council authorize the payment of approximately $3,365,766, plus any applicable taxes, to the Ontario Municipal Insurance Exchange ("OMEX"), to satisfy the obligation by the Region of York associated with its unfunded insurance liabilities for the period January 1, 1998 to December 31, 2005.
2. The Regional Treasurer be authorized to reallocate this amount from the anticipated 2006 budgetary surplus and deposit it into the Insurance Reserve until such time as the payment is due.

2. PURPOSE

This report recommends the payment of the OMEX supplementary assessment for unfunded insurance liabilities for the period 1998 to 2005 as prescribed under the OMEX Subscriber's Agreement as a result of an actuarial review of its underwriting group.

3. BACKGROUND

The Regional Municipality of York was recently notified by its principal insurer, OMEX, that a supplementary assessment was necessary to cover unfunded liabilities in those underwriting groups that it participated in between 1998 and 2005.

3.1 Municipal Insurance Market Overview

The insurance market continues to be difficult for most lines of municipal coverage, including liability, transit and property. As a result municipalities are still experiencing significant increases in premiums and/or coverage restrictions upon renewal. Some municipalities have even been denied ongoing coverage by their insurer.

Municipalities continue to be the target for the litigiously inclined through the "deep pocket" theory of joint and several liability where one percent of the liability can result in it assuming 100% of the cost of the claim.

Transit and automobile insurance has also been adversely affected by provincial legislative changes over the past several years. Insurers that have experienced larger than expected losses are still catching up through premium increases. In fact, some insurers are no longer offering automobile/transit coverage as it is not a profitable line of business.

In addition, the property insurance market has suffered as a result of several natural disasters such as hurricanes and tsunamis that have occurred globally as well as the September 11th, 2001 terrorist attack in the United States.

Finally, the insurance market as a whole has been plagued since the early 2000s by lower than anticipated rates of return on their investments which has traditionally been used to offset some of the cost of their claims.

3.2 Reciprocal Insurance Exchanges ("Reciprocals")

The insurance market has always been subject to cycles of boom and bust of an unpredictable duration.

Hard markets often have given rise to the creation of new and innovative approaches to help lower the cost of premiums and obtaining coverage. The formation of "Reciprocals" was one such innovation.

Originally thought to be a short term response to a hard market, Reciprocals, insurance pools and captive insurance companies have been a cost effective means of financing insurable losses. The number of industry specific groups utilizing these mechanisms continues to grow. In Ontario the best known Reciprocals are: the Ontario School Board Insurance Exchange (OSBIE); the Canadian Universities Reciprocal Insurance Exchange (CURIE); Municipal Electric Association Reciprocal Insurance Exchange (MEARIE); and OMEX. Reciprocals are the result of a homogenous group, corporation or other entity in the same business joining together and agreeing to share each other's losses on a not-for-profit basis. The underlying principle of a Reciprocal is similar to that of traditional insurance; achieving "spread of risk" from which loss experience is evened out and made more predictable.

Like traditional insurance companies, Reciprocals are licensed and governed through the *Insurance Act* and monitored by the Financial Services Commission of Ontario (FSCO). They operate similar to other insurance companies with a few notable exceptions:

- they are not incorporated, but rather are a collection of "members";
- members retain responsibility for funding all liabilities that occur during their membership period; and

- they operate through a principal attorney with an advisory board.

In most cases Reciprocals provide coverage on a primary basis for the first layer of a claim (eg. $2 million) and then use reinsurers or specialty markets to cover the excess layers. Handling the primary losses in their own layer is one of the methodologies utilized to stabilize the loss patterns and yet still have coverage for the occasional shock loss.

Provincial regulations dictate that all insurance companies, including Reciprocals, must maintain fully funded reserves in order to cover the cost of all known and potential claims for which it may be responsible. The adequacy of these reserves is determined from time to time by an independent actuarial review. Reciprocals will not usually maintain a large buffer of reserves to cover unexpected claims because of their ability to call upon its members to make up any funding shortfall through supplementary assessments.

3.3 Ontario Municipal Insurance Exchange

OMEX was licenced as a Reciprocal in 1989. It has grown from eight in 1998 to 35 member municipalities as at December 31, 2005, principally from its ability to control escalating insurance costs. Seven of the nine municipalities in York Region are now members of OMEX. The Region has been a member since September, 1996. Through OMEX, the Region purchases insurance coverage for property, transit, auto, crime, boiler and machinery and municipal liability.

The relationship between OMEX and each member municipality is governed by a Subscriber Agreement that was approved by Council and signed in September 1996. As a member, York Region belongs to several underwriting groups based on the types of coverage it contracts.

Membership within each underwriting group is for a five year period which renews automatically. Notwithstanding, a municipality has the ability to terminate its participation in OMEX after any fiscal year upon six months written notice. However, should a municipality decide to leave OMEX, it still remains responsible for any unfunded liabilities that arose during its membership period including supplemental assessments and this must be paid immediately upon withdrawal. Any payments made for liabilities that are not eventually realized will be paid back proportionately to each member of the underwriting group regardless of membership status.

As prescribed by regulation, OMEX undertook an actuarial review of its outstanding liabilities and reserves as at December 31, 2005 which indicated that the potential cost of claims outstanding exceeded the reserves paid by current members to meet such obligations. As a result, on June 29, 2006 the Advisory Board declared the need for a supplemental assessment from all underwriting groups including those to which the Region belongs. The amount of supplemental assessment charged to each member is calculated based on a formula contained in the Subscriber's Agreement. The Region's supplementary assessment for the period January 1, 1998 to December 31, 2005 is $3,365,764.

4. ANALYSIS AND OPTIONS

York Region has benefited significantly as a result of its membership in OMEX to date. Staff have tested the market on several occasions and found that OMEX premiums were consistently at or below what was being offered by traditional insurers for the coverages it required. In 2001 the Region assumed responsibility for obtaining insurance coverage from its transit contractors based on the substantial savings that it could obtain through OMEX. The Region also moved its property insurance from traditional insurers to OMEX in 2004 as a result of the savings that it was offered.

4.1 Supplemental Assessment

Reciprocals use their best efforts to prudently forecast the true cost of claims at the time they set their premiums. However, unforeseen events can occur which produce a different result, often several years down the road. One reason that Reciprocals can offer lower premiums is because they do not need to build large buffer reserves to deal with these unforeseen events. They can share the additional obligation, when and if it is ever required, among all its members. The funding of this additional obligation is referred to as a supplemental assessment.

The reason OMEX experienced increased costs for the underwriting period from 1998 to 2005 is due to a number of factors which were not anticipated at the time the original premiums were established:

- Ontario municipalities are part of an increasingly litigious environment and have been increasingly targeted as the "deep pocket" in joint and several actions;
- settlements have increased significantly, particularly with respect to road authority and public transit related claims in part due to changes in provincial legislation;
- the inability of OMEX to obtain stop loss protection in 2004 and 2005 from the reinsurance market following the September 11th terrorist attacks; and
- the cost of additional exposures to municipalities from new programs and service responsibilities (e.g. ambulances) that were downloaded from the Province.

A review of York Region's actual underwriting losses for the period 1998 to 2005 confirm that it experienced higher than anticipated claim costs particularly in the areas of transit and municipal liability.

OMEX was aware of the shortfall during its 2006 premium deliberations and made significant adjustments to bring its premiums in line with the actuary's funding recommendations (Attachment 1 shows premiums paid to OMEX over the year). As a result, staff feel confident that this underfunding problem has been addressed on a go-forward basis. In addition, new claims and actuarial procedures have been implemented by OMEX to alert the Advisory Board well in advance of potential problems.

OMEX has advised that member municipalities will be given the option to pay the supplemental assessment over four years starting in 2007. However, at this time staff are recommending that the Region recognize and fund this liability immediately. This will eliminate the need to establish a long term liability and will allow freedom to make future insurance choices without incurring a penalty should the Region decide to leave OMEX.

5. FINANCIAL IMPLICATIONS

No provision was made for a supplemental insurance assessment as part of the 2006 Regional Budget and the Insurance Reserve only contains sufficient funds to cover self insured portion of existing and some future claims. However, preliminary analysis has shown that the unbudgeted surplus in 2006 will be more than sufficient to cover the full cost of the supplemental assessment. Therefore, it is recommended that the full supplementary assessment amount of $3,365,766 be reallocated from surplus to the Insurance Reserve, until such time as the payment is made.

6. LOCAL MUNICIPAL IMPACT

There is no direct local municipality impact with respect to the Region's portion of the supplement. However as seven of the nine municipalities are also members, they will also share in their individual portion of any supplemental assessment for their underwriting group.

7. CONCLUSION

This report recommends that the supplemental assessment charged to the Region by OMEX be paid in 2006 from surplus budgetary funds.

The Senior Management Group has reviewed this report.

(The attachment referred to in this clause is attached to this report.)