Solvency Matters

A quarterly report on solvency issues affecting P&C insurers in Canada

PACICC

Issue 1 - March 2018 Insolvency protection for home, automobile and business insurance customers

PACICC Priorities

P&C intervention guidelines

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...Continued on Page 2.

Emerging Issues (Brandon Blant)

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...Continued on Page 4.

Solvency Analysis (Grant Kelly)

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...Continued on Page 5.

PACICC
P&C Risk Officer's Forum

Risk Officer's Forum (Ian Campbell)

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Next Forum Meeting – April 5

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...Continued on Page 7.

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...Continued on Page 8.

Events

April 5
PACICC Risk Officer's Forum

April 12
PACICC Annual Meeting

April 24
IBC Financial Affairs Symposium

May 15 -16
Canadian Insurance Financial Forum

May 16
PACICC ROF Webinar – Marijuana

June 21-22
Canadian Institute of Actuaries Annual Meeting

Sept 5
PACICC Risk Officer's Forum

Sept 23-26
RIMS Canada Conference

Sept 23
CIAA Annual Conference

Sept 27-30
Insolvency Institute of Canada Annual Meeting

PACICC Priorities

P&C intervention guidelines

In March 2018, OSFI released its new *Guide to Intervention for Federally Regulated Property and Casualty Insurance* Companies. This is an important milestone for PACICC. Working with regulators to clarify the roles and responsibilities prior to a future insolvency benefits Canadian insurance consumers.

The most important difference between the new P&C Intervention Guide and the old version is in Stages 3 and 4 of the regulatory process. PACICC will now have more discussions with OSFI at an earlier point in the process and have greater access to information than was available in previous insolvencies.

British Columbia's Financial Institutions Commission (FICOM) and Alberta Finance have communicated to PACICC that their goal is to adapt, the OSFI Guide and to issue provincial Guidelines. They reaffirmed this commitment recently in discussions with PACICC staff. In April 2016, Autorité des marchés financiers was the first regulator in Canada to announce an updated intervention guideline for P&C insurers.

When OSFI, Quebec, British Columbia and Alberta have finished issuing new Guidelines, this will cover almost 95% of PACICC member insurers. PACICC has communicated its willingness to work with other regulators to establish or update their P&C insurance intervention guidelines.

Reducing systemic risk/Catastrophic earthquake

PACICC's priority for 2018 is to support Finance Canada as it considers how to limit system-wide risks that a catastrophic earthquake could pose to federal P&C insurers. PACICC had numerous discussions with Finance officials and provided written submissions on this issue during 2017. We continue to work in close partnership with Insurance Bureau of Canada (IBC) and are in active discussions with Finance Canada. IBC and PACICC made two recommendations to Finance Canada:

Recommendation 1: Allow PACICC to borrow from the Consolidated Revenue Fund to finance liquidations following a catastrophic earthquake

PACICC and IBC requested that the Federal Government enable PACICC to access a credit facility drawn on the Consolidated Revenue Fund (CRF) to provide emergency lending assistance (i.e., liquidity provision) for policyholder compensation in response to institutional failures. Under this proposal, insurance companies that mismanaged earthquake risk would still fail. Companies that prudently capitalized and appropriately managed this risk would not be subject to the secondary shock of having to finance the liquidation of their failed competitors. The unintended chain of second-round failures that would otherwise occur due to PACICC's assessments on surviving insurers – that is, systemic financial contagion risk – could be avoided. PACICC proposes to repay the loan by introducing an Extraordinary Assessment Mechanism that would allow it to place an assessment on future insurance underwritten by its members.

Recommendation 2: Make two small changes to the Insurance Companies Act

The Financial Administration Act (FAA) was amended after the financial crisis to give the federal Minister of Finance the authority to enter into financial stability arrangements (Part IV.1) to promote the stability or maintain the efficiency of the financial system in Canada, including a contract to: "make a loan to an entity", "provide a line of credit to an entity", and "guarantee any debt, obligation or financial asset of an entity." Consequently, given that such a credit facility would be structured as a loan or guarantee, the FAA already authorizes payment out of the Consolidated Revenue Fund under these systemic arrangements.

- The Insurance Companies Act (ICA) can be amended to ensure that insurers belong to a P&C compensation association that is recognized by the Minister and that the compensation association has the authority to levy assessments on industry members (i.e., PACICC). This would be consistent with existing provisions of the ICA (Section 449). Such a requirement in the ICA could be justified for systemic risk reasons, as it is desirable for all insurers to be subject to the mechanism.
- A Regulation can be enacted to designate PACICC as a compensation association. Among other things, the Regulation would prescribe the terms of the agreement between the Government and PACICC, including what PACICC is to do with the funds advanced (that is, compensate policyholders under its Memorandum of Operation) and the terms of the lending assistance agreement (i.e., rate of interest, if any; repayment period; etc.).

Benefits review

The priority issue for PACICC in 2019 is an examination of its coverage and benefits. PACICC has conducted research to help benchmark best practices of insurance guarantee funds in other jurisdictions. The results of this research will inform the Corporation's planned review of coverage and benefits. Consultations will be held with key stakeholders, including: member insurers, insurance consumers, regulators and liquidators. The last review in 2006 resulted in one significant change being made – the limit on personal property coverage was increased to a maximum of $300,000 per claim. Insurance regulators have requested that PACICC review current limits for personal property claims owing to the significant increase in house prices since the last review and new knowledge about the potential for multiple total loss claims as a result of a wildfire or earthquake.

Developing an early-intervention framework for PACICC

PACICC's priority issue in 2020 is developing a framework for early-intervention to address troubled insurers. Changing circumstances (including the joint development of intervention guidelines between PACICC, OSFI and several provincial solvency supervisors) have increased the likelihood of PACICC being asked to intervene to protect policyholders prior to a winding-up order. PACICC will seek to clarify, in advance, the criteria the Board of Directors would use to decide whether early, pre-insolvency intervention serves the interests of policyholders and members.

Emerging Issues

Reflections on risk management - by Brandon Blant

Several years ago, between sessions at a North American risk conference, I summoned the courage to approach the Chief Risk Officer (CRO) of a large financial institution whom I held in high regard. I asked him whether he thought that the CRO should have the right to veto any business activity that he deemed to be too risky. He paused for a moment and then responded, "a veto is like the nuclear button, you always want to have one but you never actually want to use it". It was at that moment when I first considered the difference between influence and power. Some CROs have the right to veto included in a mandate approved by their Board of Directors but is it really necessary for them to have this authority to be effective?

In my view, the most constructive risk management discussions take place when the risk manager is at the table during the decision making or product development phases. Having the chance to ask questions and to promote a balanced view of opportunity and risk generally results in sounder decisions. Including the risk management perspective at this crucial stage may not end up completely changing the direction from North to South, but it may enable the organization to course correct and head Northwest.

The challenge, of course, is to evaluate the impact of the risk manager's contribution to a particular business unit or the organization as a whole. Such evaluation is generally qualitative in nature and based on the CEO and/or Board of Directors judgement. It is not a simple task to evaluate the impact of the risk manager since we can never know how things would have turned out had there been no input from the risk manager. In order to develop a better understanding of the effectiveness of a risk manager's contributions to decision making, here are a few questions to consider:

1. Is the risk manager sought out for his/her opinion before important decisions are made? Or is the risk function viewed more as a compliance requirement in the overall business process?
2. Does the risk manager "pick their battles" or is there constant opposition to virtually any initiative?
3. Does the risk manager bring information or analysis to the table that business leaders have not already considered?
4. Does the risk manager analyze information in a manner that brings insight that is not apparent to business leaders?
5. Does the risk manager ask questions that result in further relevant research before business leaders proceed with an initiative?
6. Is the risk manager transparent in terms of his/her opinion and the information he/she possesses (to other business leaders, the CEO, and the Board of Directors)?

This is by no means intended an exhaustive list of factors to consider; rather, these are just a handful of questions to provoke the reader's thoughts on this subject.

Putting sticks in the wheels of an initiative when one disagrees with the direction may be tempting for a risk manager. So is using a veto, if one has that power. But the negative consequences of not using soft skills like persuasion and influence balanced by facts and analysis to secure buy-in from others may ultimately lead to reduced access to those critical moments in the decision making process. By building your credibility over time and refraining from using a veto, the risk manager has a much better chance of getting, and maintaining, a seat at the table. Or, better yet, being sought out for his/her opinion.

There's an expression that you only know who's swimming naked when the tide goes out. It takes a few extra minutes to put on a bathing suit but it will save you some embarrassment when the tide inevitably goes out. In my view, trying to convince business leaders to put on a bathing suit is a better strategy than trying to use your power to stop them from going in the ocean.

Brandon Blant is Vice President - Risk Management at Intact Financial Corporation

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Solvency Analysis

Confidence in the P&C industry remains steady - by Grant Kelly

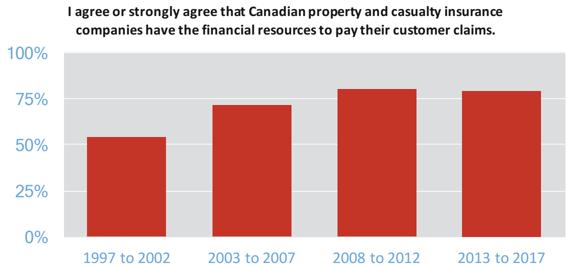
PACICC uses public records to monitor the financial health of Canada's P&C insurers in preparation to protect insurance consumers. A 2017 poll of 1,500 P&C insurance consumers across Canada commissioned by PACICC found that approximately 80 percent of respondents agreed or strongly agreed with the statement that Canada's P&C insurance companies have the financial resources to pay customer claims. This figure is significantly stronger than consumer confidence reports from the late 1990s. There are several factors behind growth in consumer confidence. Canadians saw strength in their financial system, and in the government's actions, compared to instability reported in other countries after the financial crisis. Moreover, it has been more than decade since a Canadian P&C insurer failed. That these qualitative factors are relevant is increasing consumer confidence.

One additional quantifiable factor contributing to increased consumer confidence is the long-run trend that insurers are using their capital base more conservatively. In 1975, for example, Canadian insurers wrote almost $2 of premium for each dollar of capital, on average. 2017 was the third straight year where the industry's capital base was larger than the total premiums underwritten by insurers – insurers underwrote 94 cents of insurance for each dollar of capital. This measure suggests that the risk of an insurance company failing is lower than it was 40 years ago.

For most insurers in Canada, the key reason behind their growing capital base is sustained and stable profitability. Retained earnings are the number one source of capital for Canada's P&C insurers. In total, Canada's insurance industry had almost $50 billion in capital in 2017 - 56 percent of this comes from retained earnings. 39 percent of the industry's capital base represents the money that the owners of the business invested. The most important factor for the general health and well-being of the P&C insurance industry is sustained profitability.

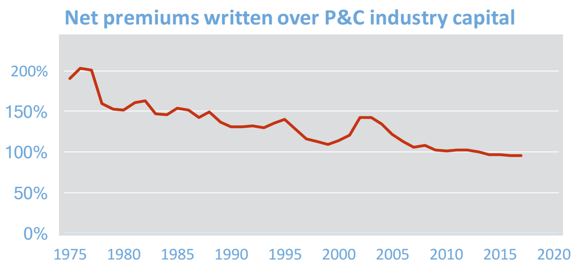
Part of PACICC's mandate is to seek to maintain a high level of consumer and business confidence in Canada's property and casualty insurance industry through the financial protection we provide to policyholders. A strong majority of Canadian insurance consumers report that they are confident in the industry's ability to fulfil the promises made in their insurance contract. This confidence has been steady over that past six years. A well-capitalized and profitable industry provides stability for insurance consumers, promotes competition and attracts new entrants to the market.

P&C consumers are confident



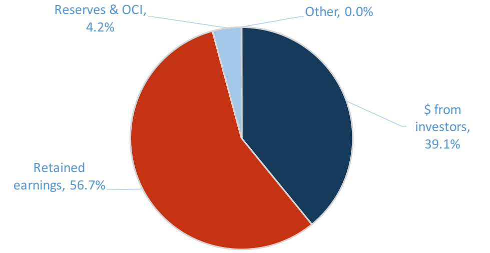
Source: PACICC based on data from Leger

Premiums to capital ratio



Source: PACICC based on data from MSA Research

P&C industry capital, 2017



Source: PACICC based on data from MSA Research

PACICC Grant Kelly is Vice President - Financial Analysis & Regulatory Affairs

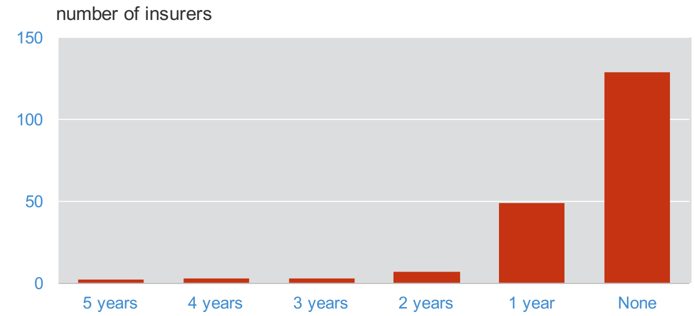
Solvency Analysis Con't

2017 Year-end highlights

Overall, Canada's P&C insurance industry reported modest profitability in 2017 with a return on equity (ROE) of 7.8 percent. This is below the industry's long-run average ROE of 10 percent. Profitability is vital to its solvency. These industry numbers mask the wide variation in results across individual companies. PACICC has reviewed results from almost 200 member insurers. Of these 40 (or approximately 20 percent of those reporting so far) lost money last year. Having one bad year does not necessarily threaten their solvency, but these are the insurers that PACICC watches more closely – particularly considering that 18 of them also lost money in 2016.

One area that PACICC pays significant attention to is poor pricing and inadequate reserving of insurance risk. Our *Why Insurers Fail* research series finds that inadequate pricing and reserving is the number one cause of failure in Canada and internationally. PACICC notes that two Canadian P&C insurers have reported inadequate reserves for each of the past five years. Three other member insurers reported inadequate reserves in four of the past five years. Another three member insurers reported inadequate reserves in three of the past five years. While one bad year does not necessarily cause an insolvency, a long-run trend of unprofitability and adverse development does raise insolvency risk.

Insurers with consistent adverse claims development



Number of times that a member insurer reported adverse development between 2013 and 2017

Source: PACICC based on data from MSA Research

All values are from MSA Research as of March 22, 2018. Values are in millions, except where noted.

2017 FINANCIAL YEAR RESULTS

($ millions)	2017	2016	
Direct Premiums Written (DPW)	54,478	52,571	3.6%
Net Pemiums Earned (NPE)	46,684	46,425	0.6%
NET Claims Incurred	29,940	31,439	-4.8%
Operating Expenses	15,243	14,813	2.9%
Underwriting Income	1,745	459	280.2%
Net Investment Income	3,333	2,935	13.6%
Net Income	3,866	2,350	64.5%
Comprehensive Income	3,303	2,479	33.2%
Combined Ratio	96.8%	99.6%	
Net Loss Ratio	64.1%	67.7%	
Expense Ratio	32.7%	31.9%	

Select Solvency Indicator Ratios

	2017	2016
Average Equity	49,538	48,787
Return on Equity (ROE)**	**7.80%**	**4.80%**
Net Investment Income	3,333	2,935
Investment Quarter End***	105,898	110,286
Average Investment	108,092	111,912
Return on Investment (ROI)**	**3.10%**	**2.70%**
Comprehensive Income	3,303	2,479
Comprehensive ROE**	**6.70%**	**5.10%**
Other Comprehensive Income	-562	131
Comprehensive ROI**	**2.60%**	**2.80%**
MCT Ratio (Capital availiable/ Capital Required)	**243.2%**	**256.7%**

PACICC Risk Officer's Forum

Upcoming risk officer's meetings and webinars - by Ian Campbell

The Risk Officer's Forum seeks to enhance risk management within the P&C insurance industry by:

- Discussing and sharing risk management best practices within the industry;
- Reviewing and communicating topical risk management information;
- Serving as a risk management resource for PACICC and for insurance regulators;
- Disscussing major existing risks and significant emerging risks within the industry; and
- Providing resources and information to facilitate research of risk management and related governance topics.

Officer's Forum Meetings

Three half-day Forum meetings are held each year in the Toronto offices of Goodmans LLP (333 Bay Street, Suite 3400). A complimentary buffet lunch is served at 12:00 noon. The meeting is from 1:00-4:00 p.m. The meetings begin with a guest speaker on a topical industry issue. This is followed by a rotating panel of industry risk officers who discuss current ERM issues. Discussion is collegial, frank and interactive. Regulators may only attend as guest speakers. Media are not permitted to attend.

Next Forum Meeting – April 5

Keynote:	**Penny Lee**, Senior Director, P&C Insurance Group, Insurance Supervision Office of the Superintendent of Financial Institutions
Topic:	*Update on Current Industry Issues*
Facilitator:	**Mike Stramaglia**, Executive in Residence, Global Risk Institute in Financial Services
Topic:	*Risk Culture*
Panel:	**Sanjeev Agarwal**, Chief Risk Officer, AIG Insurance Company of Canada **Paul Field**, President and CEO, Old Republic Canada, Old Republic Insurance Group **Randy Musselman**, Chief Risk Officer, Chief Compliance Officer and Corporate Secretary The Guarantee Company of North America
Topic:	*Top 10 ERM Best Practices*

Future Forum Meetings and Topics

September 5 IFRS 17 Insurance Contracts; 2018 PACICC ERM Survey Results; and Regulation of Market Conduct

Emerging Risks Webinars

Three Emerging Issues Webinars are held each year (always from 1:00-2:30 p.m. EST). The webinars connect Forum members across Canada in a deep-dive discussion on technical aspects of a specific ERM issue. Questions are received in advance to help guide discussion. Copies of all past webinars are available on the PACICC website (www.pacicc.ca).

Next Emerging Risks Webinar – May 16

Speaker:	**Brenda Wells**, Director, Risk Management and Insurance Program, East Carolina University
Topic:	*Legalized Access to Marijuana: Implications for P&C Insurance*

Ian Campbell is Vice President - Operations at PACICC

For event registration information (pre-registration is required) or to be included in future Risk Officer's Forum member advisories, please contact Ian Campbell, Vice President, Operations, PACICC at icampbell@pacicc.ca or 416/364-8677, Ext. 3244.

Beyond Tomorrow

Solvency challenges over the next 30 years - by Paul Kovacs

In the 1980s,16 P&C insurance companies were closed because they were insolvent. Consumer confidence in our industry was at the weakest level that I recall. Fortunately, over the past 30 years consumer confidence has strengthened significantly. Industry practices have improved, particularly with respect to pricing and loss reserves. Solvency regulation is more rigorous. And PACICC has been in place since 1989 to protect consumers if an insurer does fail.

What solvency challenges might we expect over the next 30 years?

In 1989, there were many small insurers in Canada. No companies covered more than 5 percent of the market. Most of the planning to create PACICC assumed that failures would largely involve the liquidation of smaller companies. Indeed, the 21 companies that have failed since PACICC was founded thirty years ago were predominately smaller insurers that failed primarily due to inadequate pricing an reserving.

Today, more than 160 insurance companies that are members of PACICC cover less than 1 percent of the Canadian market. It is likely that the majority of the insurers that fail over the next 30 years will be smaller insurers given that most companies are small. Insurance is the business of managing risk, a business that includes unexpected shocks.

PACICC has demonstrated that it is effective in supporting the liquidation of smaller insurers. PACICC has been successful in protecting insurance consumers. The cost of liquidation has been affordable for the insurance industry. Moreover, consumer confidence in the insurance industry is strong, in part because of PACICC.

An emerging challenge for PACICC is the risk - the very low risk - that a larger insurer may fail. P&C insurance groups that cover more than 5 percent of the market are currently responsible for more than half of the private insurance sold in Canada, up from nothing in 1988. Moreover, consolidation and concentration in the industry is expected to continue over the next 30 years.

HIH Insurance, the second largest insurer in Australia failed. A Canadian company, Confederation Life, was the world's largest life insurance failure when it was shut down. The risk of insolvency for larger insurers is very low, but it is not zero.

PACICC's experience supporting the liquidation of smaller insurers has served consumers and the industry well over the past 30 years. Over the next 30 years, PACICC and others will also need to improve preparedness for the small risk that a larger insurer may experience severe distress.

Presently, PACICC, Finance Canada, IBC and others are actively working to address the risk of disruption in the insurance industry due to a catastrophic earthquake, a hazard that could challenge the solvency of large and small insurers.

Since the recent global financial crisis, Finance Canada has been working with PACICC's counterparts in banking and life insurance to establish new legislative authority and operational capacity to resolve severely distressed financial institutions. The objective to give a resolution authority power to take a severely troubled institution away from its current owners and management then inject capital and restructure the company so it can be acquired by new owners. Liquidation can be more disruptive for consumers and more expensive to implement relative to other resolutions options for larger institutions.

Over the next 30 years, PACICC needs to maintain its established strength to support the liquidation of smaller insurers, but also build its preparedness to address the risk that a larger insurer may fail due to a catastrophic earthquake or other shock.

Paul Kovacs is President and Chief Executive Officer at PACICC