SOLVENCY MATTERS

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

PACICC

Issue 2 - June 2018

Insolvency protection for home, automobile and business insurance customers

PACICC Priorities

Benefits review

The objective of PACICC's 2019 priority is to modernize its coverage system and benefit levels. PACICC commits to engage member insurers, supervisory authorities and other stakeholders before making any changes.

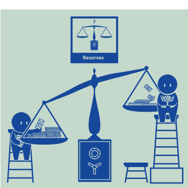
...Continued on Page 2.

Emerging Issues (Glenn Gibson)

What is your Customer Value Proposition (CVP)?

What is the purpose of insurance? It is a "promise" being made by an insurer to a policyholder that if they have an insured loss, the insurer will be there to help them. When a claim is initiated, it is the insurers 'chance to dance.'

...Continued on Page 4.



Solvency Analysis (Grant Kelly)

Inadequate reserves and pricing is the number one cause of insolvency

At the end of each year, insurance companies report the amount of money needed to pay outstanding claims. These estimates are made by professional actuaries and are subjected to several levels of review.

...Continued on Page 5.

PACICC

P&C Risk Officer's Forum

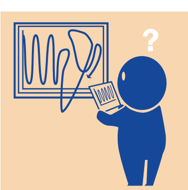
Risk Officer's Forum (Ian Campbell)

Upcoming risk officer's meetings and webinars

Next Forum Meeting – September 5

Keynote: Stephen Smith, Partner, Audit, Financial Services (Insurance), KPMG

...Continued on Page 7.



Beyond Tomorrow (Paul Kovacs)

Solvency challenges over the next 30 years

Thirty years ago, when PACICC was established, the P&C insurance industry followed a well-established cycle. Every seven years or so, the industry would cycle through a hard and then a soft market.

...Continued on Page 8.

Events

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

October 10-12
National Insurance Conference of Canada

October 24
PACICC Emerging Risks Webinar - Artificial Intelligence and Machine Learning

October 31
PACICC Risk Officer's Forum

November
IBC Regulatory Affairs Symposium

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 Guides and the older versions is that, when a PACICC member insurer becomes distressed, PACICC will now have discussions with these regulators at an earlier point in the process and have greater access to information than was available in previous insolvencies.

The Autorité des marchés financiers released its Guide in 2016. PACICC is currently discussing the need to update Guides to Intervention with other provinces.

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 P&C insurers. In August 2017, the Federal Department of Finance released its second financial sector consultation document. The discussion paper outlined a consultation process for all issues affecting banks, life insurers, credit unions and the P&C insurance industry. The document acknowledged the significant risk that earthquake exposure poses to the Canadian economy and recognition that the Government has a role to play in managing this risk. This is a significant achievement on this file. The Finance paper also committed the Government to addressing consumer protection issues related to earthquake insurance.

The process from this consultation paper to legislation is not yet clear. PACICC and IBC staff continue to work with the Department of Finance to develop the case for a liquidity window to resolve contagion risk and are discussing the issue with systemically important provinces (Quebec and B.C.).

Benefits review

The objective of PACICC's 2019 priority is to modernize its coverage system and benefit levels. PACICC commits to engage member insurers, supervisory authorities and other stakeholders before making any changes. PACICC's benefit levels and coverage limits are detailed in our Memorandum of Operation. This document requires Provincial Insurance Superintendents to approve any changes. It is PACICC's practice to consult with member insurers prior to making recommendations to provincial regulators. Contracts signed by the insurance industry and each provincial government prohibit PACICC from lowering benefit levels.

At its April 2018 meeting, the PACICC Board of Directors approved a Strategic Plan that seeks to answer three questions:

1. Should PACICC change or exclude types of insurance coverage?

Approximately 95 percent of all P&C insurance policies in Canada are covered by PACICC. Schedule A, Part A of PACICC's Memorandum of Operation defines the lines of insurance covered by the Corporation. They are:

- Accident and Sickness Insurance
- Automobile Insurance
- Boiler and Machinery Insurance
- Credit Protection Insurance
- Legal Expenses Insurance
- Liability Insurance
- Property Insurance

Each of these lines of coverage is defined in Part B of the Memorandum of Operation. Specific exclusions for each of the lines of insurance are detailed in Part C of the same document. PACICC will consult with member companies, insurance brokers and regulators to ascertain if changes are required to our defined coverages.

2. What are the appropriate levels for PACICC claim limits?

In 1989, PACICC member insurers offered a voluntary compensation payment for loss claims up to a $250,000 maximum per claim. In 2006, the loss limits for homeowners were increased to $300,000. The loss limits for auto and commercial have remained unchanged since 1989. Product innovations, claims frequency and severity and inflation have all contributed to a loss claim environment that is substantially different than 30 years ago. The limits are the first thing that reporters, regulators and policyholders ask about PACICC operations.

In the next insolvency, could the current benefit levels result in a large number of policyholders with claims exceeding these limits? Adjusted for inflation, the dollar values of PACICC's limits have decreased over time. It is less clear how this has impacted consumers – there is no data available to PACICC on the distribution of claims costs across the industry. PACICC's Actuarial Advisory Committee developed a survey that seeks this answer, based on the claims distribution at member insurers – that is, what percentage of consumers are being protected by current claim limits? This question will allow PACICC's Board of Directors to make informed decisions about changes to PACICC's claim limits. This survey was approved at the Committee's May 2018 meeting. We expect to survey member insurers in June 2018, requesting a response by mid-July 2018.

3. Should PACICC make changes for large commercial consumers?

PACICC protects all commercial insurance policyholders up to our claims limits. Some international guarantee funds have sought to focus their benefits on small business owners. PACICC coverage of large commercial risks disproportionately directs resources toward large commercial policyholders. For example, in two of Canada's more recent insolvencies – Markham General and Maplex – commercial policies represented less than one-fifth of total eligible premiums but accounted for one-third of the claims paid by PACICC. This resulted in a net transfer of $1.1 million from personal lines policyholders to commercial policyholders. It is not clear how this change could be implemented. PACICC will establish a working group from members that write primarily commercial coverage to seek input about whether PACICC should introduce limits for large commercial insureds.

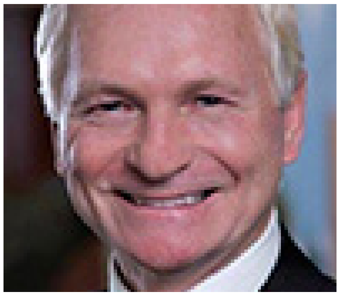
Developing an early-intervention framework for PACICC

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 its Board of Directors would use to decide whether early, pre-insolvency intervention serves the interests of policyholders and members.

Emerging Issues

What is your Customer Value Proposition (CVP)?

- by Glenn Gibson



What is the purpose of insurance? It is a "promise" being made by an insurer to a policyholder that if they have an insured loss, the insurer will be there to help them. When a claim is initiated, it is the insurer's 'chance to dance.' People buy the insurance product hoping that they will never have to use it.

Researchers regularly orchestrate surveys to determine what are Canada's most admired or trusted professions. The results always show 'nurses' and 'firefighters' land in the top five. It's not difficult to figure out why. They answer the bell at any time of the day or night to help us in some of our darkest moments. And they deserve the recognition they get!

In Ontario, we have roughly 7,200 structural fires each year. The majority of the fires are caused by an accident. Most fire losses are insured. A professional loss adjuster is dispatched to the scene to meet the policyholder. This first meeting is a very emotional time when someone is faced with the destruction of personal property. But, it represents an opportunity to build rapport and trust which will carry everyone through the claims journey.

An adjuster shares many of the same moments of distress as nurses and firefighters. The difference is that they are not in the victim's lives for just a few hours. In many cases, their journey with a policyholder can last a year in duration. The adjuster shares a roller-coaster ride of emotions and events that form the timeline behind reconstructing someone's life. If one gets it right – and many times the insurance industry does – it can become a very powerful experience as the adjuster is helping to rebuild someone's life. How many professions allow that opportunity?

With such an opportunity to create powerful moments, does it not seem remarkable that loss adjusters do not make any of the survey lists?

Having a clear customer value proposition is absolutely critical to a business being successful. Is how you handle claims part of this? Why should a customer buy insurance from you? What benefits are they going to get from buying your product? How does your product add greater value or benefits than a competitor's? How will things be different if a customer buys from you? Have you deeply, truly studied a day in the life of your customer? What are the unmet needs of your customer you are trying to address? What is it that the customer really values? Are you owning your customer's problems and finding solutions?

Consider these questions and think about the general insurance product. A clearly articulated claims process – filled with added, unexpected value – would seem to me to be the perfect recipe for developing and executing on a terrific customer value proposition.

Making sure your CVP is relevant is difficult in an era where our industry is ripe for disruption. There are going to be game-changing technologies at play. One new entrant to the U.S. market says it will take "90 seconds" to become insured. They rely on artificial intelligence and chatbots to underwrite their risks. They eliminate deductibles because they view them as a "pain point" for the consumer.

How does this emerging new world play out in a claims environment where you are constantly battling speed versus validation? Where does the time-tested notion of "trust but verify" fit into this new world?

In the short term, it's not likely Canada is going to see a wave of InsureTech products disrupting the insurance economy. We are a cautious group in Canada with strong regulators. We tend to follow the U.K. market in terms of new products and are very cautious about embracing the growing number of U.S. innovations in our sector. If this view is correct, is our market missing an opportunity to elevate its game and create more meaningful and memorable experiences when someone reports a claim? Food for thought.

Glenn Gibson is President and CEO of The GTG Group and a member of the PACICC Board of Directors

Solvency Analysis

Inadequate reserves and pricing is the number one cause of insolvency - by Grant Kelly

At the end of each year, insurance companies report the amount of money needed to pay outstanding claims. These estimates are made by professional actuaries and are subjected to several levels of review – including a peer review of an independent actuary and separate reviews by the firm's auditors, regulators and tax authorities.

Last year, PACICC member insurers released $5.8 billion in reserves. This was the largest release ever recorded by the industry – 23 percent greater than the previous year. Reserve adequacy is a critical measure of financial health. A large release, or a large build-up, in reserves is a signal that a company has experienced a surprise.

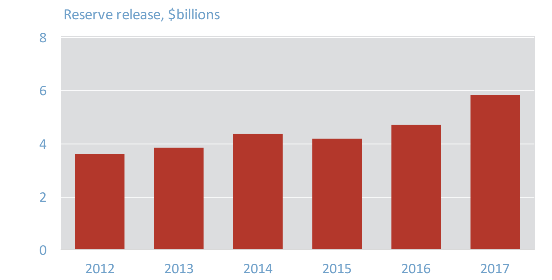
When an insurer releases reserves, it appears on their financial statements as a negative claim. In 2017, insurers reported an underwriting profit of $1.7 billion. Adjusting these results for the impact of reserves, insurers paid $4.1 billion more in claims during 2017 than they collected in premiums. This is not sustainable. Over the long-term, the amount of money brought into the insurance system in premiums must balance with the amount paid out in claims and expenses incurred.

Each insurer determines the amount of reserves needed to maintain its solvency independently, based on the type of insurance it sells, its estimate of claims trends and the amount of money reserved in previous years. In a given year, insurers that reserve less money appear to be more profitable than insurers that reserve more. However, all of the research, in Canada and internationally, into why insurers fail finds adequate reserving is vital to maintain the solvency of an insurer. There is no single right answer to measure reserve adequacy and, in 2017, the amount of reserves released varied widely across the almost 200 insurers that competed in Canada's P&C insurance industry. 145 insurers released reserves at the end of 2017. For 41 of these insurers, the amount of reserves released resulted in an improvement in the reported combined ratio of more than 20 points.

At the other end of the spectrum, 49 insurers set aside more reserves. In 8 of those cases, the increases in reserves were large enough to worsen reported combined ratios by more than 20 percentage points. Overall, 49 insurers released or added reserves last year that exceeded 20 percent of premiums earned.

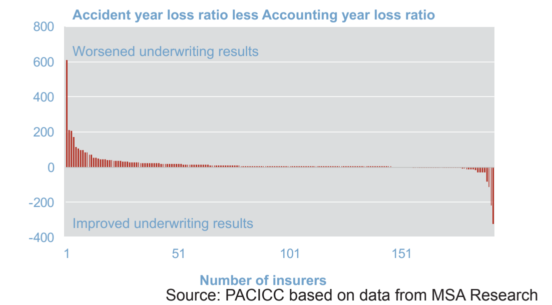
In assessing the solvency risk for an individual insurer, PACICC watches for insurers that consistently under-report reserves, those insurers that report wild swings in reserving practices, as well as insurers that undertake significant reserve releases relative to their capital base. Volatile reserving practices increase the risk of insolvency. In 2017, 7 insurers released reserves that eroded half of their reported capital base. A healthy, solvent, going-concern insurance company should not experience frequent reserve surprises. PACICC will continue to monitor the underwriting performance and solvency of these insurers.

P&C reserve release



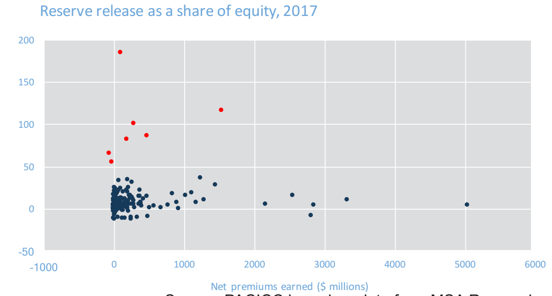
Source: PACICC based on data from MSA Research

Accident year results less accounting year results



Source: PACICC based on data from MSA Research

Company reserve release 2017



Source: PACICC based on data from MSA Research

 Grant Kelly is Vice President - Financial Analysis & Regulatory Affairs

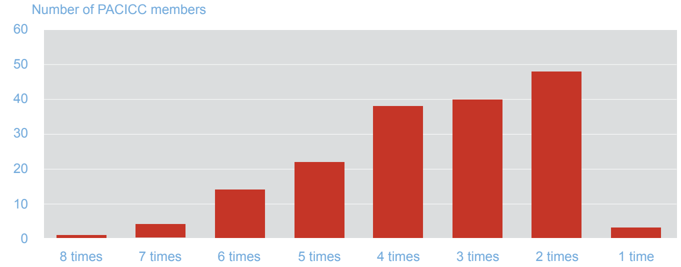
Highlights - First quarter 2018

The first quarter of 2018 was a rough one for PACICC member insurers. The return on equity for the 170 insurers that reported financial results was just 2.7 percent. This is down from the 5.1 percent figure reported in the same period last year. The Combined Ratio rose from 102.9 percent in the first quarter of 2017 to 103.3 percent in 2018.

Total claims costs and adjustment expenses were 11.8 percent higher than the same period in 2017. Claims costs rose despite $3.8 billion less in claims due to catastrophic natural hazards compared to the first 3 months of 2017.

The most significant factors driving the increase in claims costs in 2018 were increasing claims in private passenger auto insurance markets across Atlantic Canada and Alberta. Loss ratios in these markets exceeded 90 percent in the quarter – a loss ratio that high is simply not sustainable.

Number of times an insurer has reported losses over the last nine quarters



Source: PACICC based on data from MSA Research

Reporting poor results in one period does not necessarily heighten solvency risk. Of the 170 early reporting PACICC member insurers in our sample, only 47 insurers reported losing money in the first quarter of 2018 – the industry's Minimum Capital Test is a healthy 240.7 percent of required assets. Solvency risk rises when a PACICC member consistently reports losses. 41 insurers in this sample reported losses in at least 5 of the last 9 quarters. Consistently unprofitable insurers have increased solvency risk and these are the insurers that PACICC monitors more closely.

FIRST QUARTER 2018 FINANCIAL YEAR RESULTS

($ millions)	2018 Q1	2017 Q1	
Direct Premiums Written (DPW)	$10,321	$9,694	6.5%
Net Pemiums Earned (NPE)	$10,307	$9,492	8.6%
Net Claims Incurred	$7,320	$6,550	11.8%
Operating Expenses	$3,327	$3,215	3.5%
Underwriting Income	$(285)	$(216)	31.9%
Net Investment Income	$479	$887	-46.0%
Net Income	$264	$512	-48.4%
Comprehensive Income	$(123)	$733	-116.8%
Combined Ratio	103.3%	102.9%	
Net Loss Ratio	71.0%	69.0%	
Expense Ratio	32.3%	33.9%	

Scource: MSA Research as of May 30, 2018.

Select Solvency Indicator Ratios

($ millions)	2018 Q1	2017 Q1
Average Equity	$39,806	39,956
Return on Equity (ROE)	**2.70%**	**5.10%**
Net Investment Income	$479	$887
Average Investment	$85,624	$91,537
Return on Investment (ROI)	**2.20%**	**3.90%**
Comprehensive Income	$(123)	$733
Comprehensive ROE	**-1.20%**	**7.30%**
Other Comprehensive Income	$(387)	$221
Comprehensive ROI	**0.40%**	**4.80%**
MCT Ratio (Capital Availiable/ Capital Required)	**240.7%**	**261.9%**

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 – September 5

Keynote:	**Stephen Smith**, Partner, Audit, Financial Services (Insurance), KPMG
Topic:	*IFRS 17 (Insurance Contracts)*
Panel:	**Manon Débigaré**, Vice President and Chief Risk Officer, Desjardins General Insurance Group **Tracy Mann**, Vice President, Operational Risk Oversight, ERM, Economical Insurance **Susan Meltzer**, Vice President, Risk, Aviva Canada Inc.
Topic:	*Top 10 ERM Best Practices*
Panel:	**Ian Campbell,** Vice President, Operations, PACICC **Susan Meltzer**, Vice President, Risk, Aviva Canada Inc.
Topic:	*2018 PACICC ERM Survey Results*

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 – October 24

Speaker:	**Charles Dugas**, Director, Insurance Solutions, Element AI
Topic:	*Artificial Intelligence and Machine Learning*

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. 3224.

Beyond Tomorrow

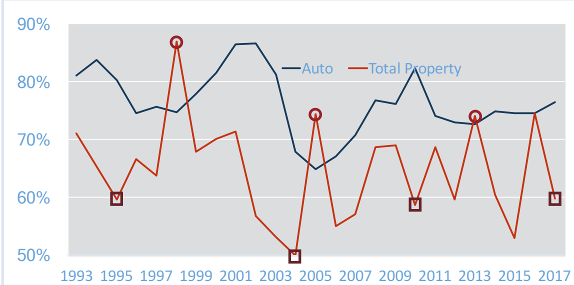
Solvency challenges over the next 30 years - by Paul Kovacs

Thirty years ago, when PACICC was established, the P&C insurance industry followed a well-established cycle. Every seven years or so, the industry would cycle through a hard and then a soft market. However, for some time now, industry results have continued to vary but a regular and predictable cycle has largely disappeared. I believe that we must re-establish stable auto insurance coverage if the historic insurance cycle is to resume over the next 30 years.

There is an extensive body of literature describing the cycle in major insurance markets around the world. Periods of strong earnings result in a build-up of capital, attract new entrants, and lead to a soft market, eroding rates and earnings. Periods of weak earnings lead to concerns about capital adequacy and some firms exiting the market, contributing to a hard market with rising rates, followed by improving earnings. Every seven or eight years, on average, the P&C insurance industry would work through the cycle.

Disruption of the Canadian insurance cycle has come, I believe, primarily from reform of the auto insurance product and rate regulation. Frequent and extensive changes in coverage, coupled with rate controls, broke the cycle. This has been most evident in Ontario, but is also significant across Alberta and Atlantic Canada. The predictable swing between hard and soft markets has been displaced by a period anticipating policy change, followed by adjustment to announced reform and then addressing experience with the new product. The traditional insurance cycle was displaced by an unpredictable auto product reform cycle.

Loss ratios



Source: PACICC based on data from MSA Research

Over the past decade, there has been a marked increase in the frequency and severity of large loss events, like the wildfire damage in Fort McMurray. The use of reinsurance is an important tool for insurers to manage the impact of extreme loss events on earnings. Moreover, the industry has adjusted product coverage and pricing to reflect current understanding of the industry exposure. More than a billion dollars of severe weather claims paid over a year is now normal for the industry. The personal and commercial property markets have largely continued to follow a regular cycle, despite the increase in extreme weather claims.

I believe that the historic insurance cycle will reassert itself across Canada if and when stable auto coverage is re-established. A stable and more affordable auto insurance product would, in my opinion, clarify the value of eliminating rate regulation, increase consumer satisfaction and re-establish reasonable earnings for insurers across the cycle.

From a solvency perspective, there are soft markets during each cycle where some firms exit the business. Prior to the current era of extensive auto product reform, there were predictable periods when the risk of insolvency increased, particularly for new and marginal insurers. Presently, however, there are transitional risks associated with auto product reform and rate regulation that have resulted in insolvencies.

Those of us that believe that a stable, more affordable auto product can be established in English Canada over the next 30 years may also expect a return of the traditional insurance cycle.

Paul Kovacs is President and Chief Executive Officer at PACICC

Denika Hall
Editor and graphic design

Solvency Matters
PACICC
20 Richmond Street East,Suite 210
Toronto, Ontario, Canada M5C 2R9

Website: www.pacicc.ca
Phone: 416-364-8677
To unsubscribe or for other information
email: dhall@pacicc.ca

PACICC