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

PACICC

Issue 3 - September 2018

Insolvency protection for home, automobile and business insurance customers

PACICC Priorities

Reducing systemic risk/Catastrophic earthquake

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...Continued on Page 2.

Emerging Issues (Kathy Bardswick)

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...Continued on Page 4.

Solvency Analysis (Grant Kelly)

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...Continued on Page 5.

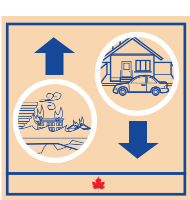
Risk Officer's Forum (Ian Campbell)

Upcoming risk officer's meetings and webinars

Next Forum Meeting – October 31

Keynote: **Louis Durocher**, President and Chief Executive Officer, Heartland Farm Mutual Inc.

...Continued on Page 7.



Beyond Tomorrow (Paul Kovacs)

Solvency challenges over the next 30 years

Some projections anticipate that, within the next 30 years, expected annual catastrophic loss ("Cat") claims paid by Canada's insurers will exceed combined auto and fire claims.

...Continued on Page 8.

Events

September 23-26
RIMS Canada Conference

September 23
CIAA Annual Conference

September 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 15
IBC Regulatory Affairs Symposium

November 27-28
Financial Protection Forum

December 6
KPMG Annual Insurance Conference

February 4-6
Cat IQ Connect

PACICC Priorities

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. PACICC and IBC staff continue to meet with the Department of Finance to discuss the need for the Federal government to provide a loan to PACICC following a catastrophic earthquake. PACICC would use this loan instead of assessing surviving insurers to pay the legitimate claims of policyholders from insurers that failed due to the earthquake. This would prevent a PACICC assessment from causing the failure of insurers that survived the earthquake. Under the PACICC-IBC proposal, insurers would use PACICC's proposed Extraordinary Assessment Mechanism to repay the loan. This model forms the basis of the current discussions with Finance.

The discussions are continuing but it will take time before there is a final decision from Finance.

The Extraordinary Assessment Mechanism is a key part of the IBC-PACICC proposal. PACICC plans to work with IBC's Finance Committee to receive additional industry feedback on the proposed Extraordinary Assessment Mechanism to ensure that it is ready to play its role in reducing systemic risk for insurers.

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 last meeting, the PACICC Board of Directors approved a Strategic Plan that seeks to answer three questions:

1. 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 that of 30 years ago. The limits are the first thing that reporters, regulators and policyholders ask about PACICC operations.

In July 2018, PACICC engaged Ecklers to develop a survey of PACICC members with the goal of developing claims distribution curves for homeowner, commercial and auto insurance. The goal is to inform the PACICC Board of the current percentage of policyholders that would be protected by the current policy limits if a member insurer became insolvent today. It will also provide the Board with information on what happens to this percentage of protection at different levels of protection.

PACICC is a member of the International Forum of Insurance Guarantee Schemes. This is an informal group of policyholder protection plans across the globe that has allowed PACICC to compare policy limits internationally.

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

- 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.

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's existing Memorandum of Operation explicitly provides PACICC with a number of tools to intervene prior to a wind-up order including providing a loan to a distressed insurer a loan, or providing reinsurance or assisting in the sale of a book of business. In 30 years, the Corporation has never exercised these powers.

PACICC's research has found that, over the past 15 years, more than 150 private insurers have exited the Canadian market. PACICC was not called upon to protect consumers at any of these companies. PACICC will seek to clarify, in advance, the limited set of circumstances where PACICC's intervention prior to a wind-up order could benefit insurance consumers, regulators and member insurers. The criteria its Board of Directors would use to decide whether early, pre-insolvency intervention serves the interests of policyholders and members will also be clarified.

Early intervention will be the focus of the 2019 edition of *Why insurers fail*.

Emerging Issues

Our climate is changing, are insurers doing enough?

- by Kathy Bardswick

One would have to have been living on another planet the last few months not to have been bombarded by the many disturbing headlines associated with climate change: Record-setting temperatures across much of the planet, flooding in India, devastating wildfire losses in California, 40 dead from heat in South Korea, more than 60 dead in Japan, and an entire Greek town wiped out by a fire moving so fast it killed over 90 people.

Closer to home, there were over 70 heat-related deaths in Quebec this summer, hundreds of wildfires burning out of control in British Columbia and northern Ontario, and water-related losses experienced once again across Canada.

Finally, the **State of the Climate 2017** report was just released (contributed to by more than 500 scientists from over 60 countries and definitely worth the read). One of the most disturbing facts in the report is the speed and magnitude of sea-level rise; averaging 3.1 cm per decade over the last 4 decades, but each successive decade recording an increasing number.

As active members of the Property and Casualty insurance industry, we care. We respond admirably to this devastation each and every day. We help individuals, businesses, and communities pick up the pieces. After all, that's why we exist.

But do we care enough?

Many of us are familiar with the history of the global industry, beginning with mariners' insurance as far back as the 11th Century as some would suggest, but really formalized and catalyzed in Edward Lloyd's coffee house in the 17th Century, further catalyzed by the Great Fire of London. Here in Canada, the history may not be so readily recalled…the first company, the Phoenix Assurance Company, opening in Montreal in 1804 with a focus to "provide discounts for soundly built and suitably protected property and to penalize dangerous ones, thus raising the awareness of fire's danger and encouraging the construction of safer buildings."

This was truly a noble commitment in 1804. And today, that commitment remains but the environment is much more complex, requiring more sophisticated responses and a deeper resolve. Our industry is participating in the dialogue at the federal, provincial and local level, but I can't help but question whether we are making the impact we are capable of. Are we individually as leaders asking ourselves the tough questions: Does my organization have a strategy that reflects both the challenges and opportunities of a (minimum) 2°C increase in global temperatures? Is my organization providing the leadership that the Phoenix Assurance Company provided back in 1804 or the leaders provided post the Great London Fire of 1666? Are we using the plentiful and sound science available to us to assist our clients to accurately and bravely respond to and leverage risk? Are we doing our part as individual players and as an industry to have our voices heard and acted on? If not, why not?

Our industry came into being as a result of catastrophes facing communities much like the ones we face today…weather losses for mariners, fire devastating whole communities. Weather has upped its game considerably since then…have we?

Kathy Bardswick is the former President and CEO of Co-operators Group and a current member of several Boards.

Solvency Analysis

PACICC claim limits - by Grant Kelly

Since 1989, PACICC has offered a voluntary compensation payment for loss claims up to a $250,000 maximum per auto and commercial claims. In 2003, the loss limit for personal property claims was increased to $300,000. This analysis focuses on the homeowner's insurance policy limit. The policy limits are the first thing that policyholders, regulators and other stakeholders see about PACICC. Consumers and regulators do not see that PACICC's Memorandum of Operation includes a "hardship clause" which allows the Board to make available or increase a compensation payment where compensation was either unavailable or inadequate. This is to be done on a case-by-case basis.

It is clear that, over time, the dollar value of PACICC protection has eroded since 1989. According to the Bank of Canada inflation calculator, $250,000 in 1989 dollars is worth just $138,000 today – a decline in value of 45 percent. PACICC is currently surveying member insurers to develop a claim distribution curve of member insurers. This will enable the PACICC Board to set policy limits to protect a fixed percentage of policyholders. This is similar to the approach taken by regulators when they allow insurers to use internal models. In the European Union, solvency regulation requires insurers to hold capital up to a 99.5 percent chance of ruin. PACICC expects survey results in the fall of 2018.

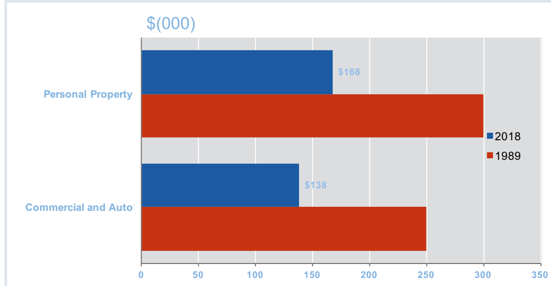
As an alternative, the PACICC limit could protect an average homeowner from an average maximum loss under their policy. Using Using CatIQ's new FSA Level Industry Exposure Database, PACICC examined the fire coverage limits purchased by consumers by postal codes forward sortation area (FSA). A FSA is a geographical region in which all postal codes start with the same three characters. A maximum loss was estimated using the total policy limit per risk (this includes building replacement, contents and additional living expenses less deductibles). There are major variations across FSAs. Some' have million-dollar homes. Most do not. In most FSAs, consumers policy limits are much larger than PACICC's current levels. It is clear that the average maximum loss facing consumers in every province in Canada exceeds PACICC's current policy limits. In fact, the average policy limits in British Columbia, Alberta, Saskatchewan, Ontario and the Yukon are more than double PACICC's current homeowners policy limit.

In 38 States, the limits have been increased from $250,000 to $300,000. Internationally, policyholder protection plans established over the past decade in Europe and Australia pay all eligible claims without a limit. PACICC analysis of past insolvencies finds that having no limits disproportionately directs resources toward large commercial policyholders. PACICC's limits have worked to protect the vast majority of policyholders in the 12 insolvencies that have occurred in the past 30 years.

The question to be addressed is how can PACICC set an appropriate loss claim limits that balance adequate protection for policyholders, reasonable expectations for claims payment while minimizing the cost to member insurers.

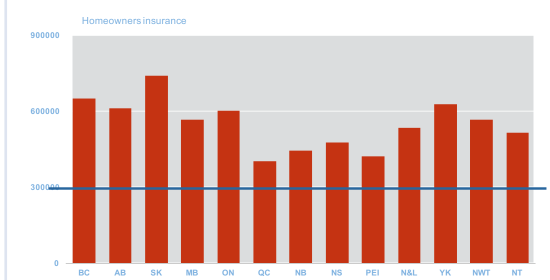
CatIQ's new FSA Level Industry Exposure Database: http://www.catiq.com/Media/2018/CatIQ_Launches_Insurance_Industry_Exposure_Database_for_Canada

PACICC limits have eroded in value over itme



Source: PACICC based on data from Bank of Canada

Loss limit per risk



Source: CatIQ Inc. www.catiq.com

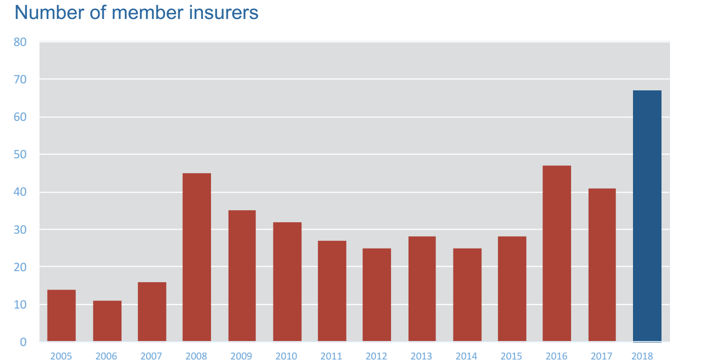
USA Claims limits, 2018

Limits per policy	States
$50,000	U.S. Virgin Islands
$100,000	New Mexico, Tennessee
$150,000	Alabama, Oklahoma,
$300,000	USIGF Model Act, Arizona, Arkansas, Colorado, Delaware, District of Columbia, Florida, Georgia, Hawaii, Idaho, Indiana, Kansas, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, Puerto Rico, South Carolina, South Dakota, Texas, Utah, Virginia, Washington, West Virginia, Wisconsin, Wyoming
$400,000	Connecticut
$500,000	NAIC Model Act, Alaska, California, Illinois, Iowa, Louisiana, Rhode Island, Vermont
$1,000,000	New York
$5,000,000	Michigan

Solvency Analysis Con't

Canada's P&C insurers experienced a 55.8 percent fall in their reported net income in the second quarter of 2018 compared to the same period in 2017. In a competitive industry, it is normal for some PACICC member insurers to report losses in a single period. PACICC has noticed a troubling trend in industry results. Between 2005 and 2015, approximately 25 of PACICC's 200 member insurers reported negative net income in any quarter. For most insurers, this was a short-term blip and they quickly rebounded to profitability in following quarters. Since 2016, the average number of unprofitable insurers has jumped, on average, to 45. So far in 2018, one third (67 of 188) of PACICC member companies reported losses. This trend is not sustainable.

PACICC members reporting losses



Source: PACICC based on data from MSA Research Inc. www.msaresearch.com

For the industry, there were two factors driving the fall in net income. In the 2nd quarter of 2018, there was a $465 million drop in realized gains. This is the profit reported by an insurer when it sells an investment for more than the original purchase price. This decline in realized gains is normal for insurers during a period of rising interest rates. This sort of temporary fluctuation is normal for insurers and does not generally indicate solvency troubles.

The other factor that drove poor 2nd quarter financial results is significantly more troubling – poor underwriting results. According to MSA Research, auto insurers in Nova Scotia, New Brunswick and Alberta reported unsustainable loss ratios in the first half of 2018. The national loss ratio for personal property insurance rose from 65.0 percent in 2017 to 78.9 percent in 2018. These trends are more worrisome to PACICC. Sustained profitability is the most important factor in maintaining solvency of insurers and PACICC continues to monitor the operating results of the industry.

SECOND QUARTER 2018 FINANCIAL YEAR RESULTS

($ millions)	2018 Q2	2017 Q2	
Direct Premiums Written (DPW)	$15,372	$14,540	5.7%
Net Pemiums Earned (NPE)	$11,823	$11,432	3.4%
Net Claims Incurred	$8,238	$7,258	13.5%
Operating Expenses	$3,658	$3,632	0.7%
Underwriting Income	$(16)	$599	-102.7%
Net Investment Income	$592	$891	-34.1%
Net Income	$546	$1,218	-55.2%
Comprehensive Income	$608	$658	-7.6%
Combined Ratio	100.6%	95.3%	
Net Loss Ratio	69.7%	63.5%	
Expense Ratio	30.9%	31.8%	

Select Solvency Indicator Ratios

($ millions)	2018 YTD	2017 YTD
Average Equity	$50,004	$48,830
Return on Equity (ROE)	**4.2%**	**8.1%**
Net Investment Income	$1,177	$1,932
Average Investment	$107,279	$111,189
Return on Investment (ROI)	**2.2%**	**3.5%**
Comprehensive Income	$608	$658
Comprehensive ROE	**2.7%**	**6.9%**
Other Comprehensive Income	$(360)	$(280)
Comprehensive ROI	**1.5%**	**3.0%**
MCT Ratio (Capital Availiable/ Capital Required)	**236.8%**	**237.5%**

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 – October 31

Keynote:	**Louis Durocher**, President and Chief Executive Officer, Heartland Farm Mutual Inc.
Topic:	*CEO Perspective on ERM*
Discussion:	**Raymond Thomson**, Associate Director, Property/Casualty Ratings Division, A.M. Best **Gordon McLean**, Senior Financial Analyst, Property/Casualty Ratings Division, A.M. Best
Topic:	*A.M. Best's New Stochastic Capital Adequacy Model* *The Impact of ERM in A.M. Best's Rating Methodology*
Panel:	**Brandon Blant**, Vice President, Risk Management, Intact Financial Corporation **Danielle Harrison**, Chief Risk Officer, The Co-operators Group Limited **Christopher Walton**, Vice President and Chief Agent for Canada, General Reinsurance Corporation
Topic:	*Feedback on OSFI Annual Risk Management Seminar Discussion Topics*

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 of Insurance Solutions, Element AI
Topic:	*Artificial Intelligence and Machine Learning - 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. 3224.

Beyond Tomorrow

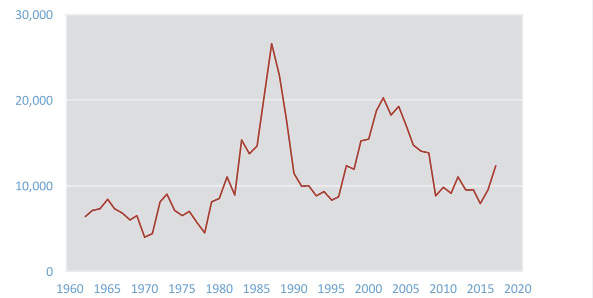
Solvency challenges over the next 30 years - by Paul Kovacs

Some projections anticipate that, within the next 30 years, expected annual catastrophic loss (“Cat”) claims paid by Canada’s insurers will exceed combined auto and fire claims. I believe that Cat risk cover will define the future of Canada’s insurance industry. What are the implications of rising Cat claims for solvency risk?

The three most active years for the construction of single family homes in Canada were 1986, 1987 and 1988. Over the past 30 years, the number of people living in Canada increased by 40 percent, but new home construction never again reached the peaks experienced in the late 1980s. At that time, the management of fire coverage was the critical risk that determined the success of insurance brokers and companies.

The three most active years for the purchase of new vehicles in Canada were 2015, 2016 and 2017. Auto coverage presently accounts for about half of the premium income for most brokers and insurers, so it is critical to find profit in this competitive and evolving business. Some projections anticipate a 50 percent reduction in personal auto ownership over the next 30 years due to vehicle automation and emerging transportation alternatives to ownership. The insurance industry will likely experience several decades of declining demand for personal auto coverage.

Single-Detached Homes Toronto Completions



Source: Statistics Canada

Insurance claims paid as a result of extreme weather damage to property increased five- to ten-fold over the past 30 years from a small initial base. There is the potential for an even larger increase in Cat damage claims over the next 30 years, given the projected increase in the frequency and severity of extreme weather and the prospect that Canada will eventually experience an earthquake near a major urban centre. Thirty years from now, it is possible that average annual expected insurance claims paid as a result of Cat events may be two to three times that of personal auto or residential fire claims.

In 1992, Hurricane Andrew revealed that many insurers were not prepared for a catastrophic extreme weather event. Several insurers failed, and the insurance market in Florida remains in turmoil more than 25 years later. Since that time, there have been several major loss events in Canada and elsewhere around the world and very, very few insurers have failed. As Cat loss events increased in frequency and severity, there has been a reduction in insolvencies – not an increase. This reflects greater insurer attention to the management of Cat risk – Cat models to ensure adequate reinsurance coverage, loss models to ensure rate adequacy, and actions to clarify coverage and improve risk selection.

Evident progress in the management of Cat risk by member insurers has allowed PACICC and others to focus on preparedness for the risk of low probability, very large loss events (Mega-Cats). Exposure to severe weather events will grow over time with change in the climate, but primarily represents an earnings risk for healthy, well-managed insurers. However, a catastrophic earthquake in Vancouver or Montreal has the potential to result in much larger claims, and losses with the potential for widespread solvency risk. Finance Canada, PACICC, IBC and others are actively working to establish mechanisms to address the risk of low probability, extreme loss events.

Over the next 30 years, severe weather management will increasingly define the P&C insurance business. This will demand growing attention to Cat and Mega-Cat exposure.

Paul Kovacs is President and Chief Executive Officer at PACICC

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