SOLVENCY MATTERS

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

PACICC

Issue 4 - December 2018

Insolvency protection for home, automobile and business insurance customers

PACICC Priorities

Reducing systemic risk/Catastrophic earthquake

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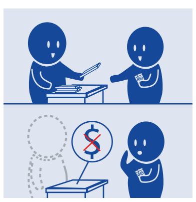

Emerging Issues (Gale Rubenstein & Graham Smith)

Insolvency Readiness

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Solvency Analysis (Grant Kelly)

PACICC's Liquidation History

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Risk Officer's Forum (Ian Campbell)

Upcoming risk officer's meetings and webinars

Next Forum Meeting
Wednesday, April 3, 2019

Next Emerging Risks Webinar
Wednesday, February 20, 2019

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Beyond Tomorrow (Paul Kovacs)

Farewell and best wishes

I have chosen to retire as President of PACICC. As the organization approaches its 30th anniversary, it has been an honour and privilege to lead PACICC for the past 15+ years...

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Events

February 4-6
CatIQ Connect

February 20
PACICC Emerging Risks Webinar - A Conversation with Insurers Regarding Risk Identification

April 3
PACICC Risk Officer's Forum

April 4
Property & Casualty Insurers' Risk Managment Conference (IBC & GRI)

April 11
PACICC Annual General Meeting

April 15-16
5th Annual International Cyber Risk Management Conference (ICRMC)

May 15
PACICC Emerging Risks Webinar - A Brave New World - Where are We Headed?

May 23-24
InsurTech North

PACICC Priorities

Reducing systemic risk/Catastrophic earthquake

PACICC's priority for 2018 has been 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 Insurance Bureau of Canada (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 levy to repay the loan. This model forms the basis of the current discussions with Finance.

The team at Finance Canada working on this issue has increased in size and Finance Canada staff demonstrate an increasing knowledge on the issue resulting from their regular discussions with PACICC, IBC and others. It is clear that the Government is unlikely to announce actions to resolve this issue before the federal election next year, and the time required to implement solutions will be even longer. PACICC and our member insurers will remain exposed to the risk that the Corporation could be unable to respond to the expected needs of insurance consumers following a catastrophic earthquake over this period.

Finance staff regularly inquires when they can expect that PACICC's proposed levy will be implemented. This is a key component of the IBC-PACICC proposal, allowing PACICC to repay any money loaned by the Government. Establishment of the proposed levy will not resolve PACICC's exposure, but it could be a step forward that may help to encourage earlier action by Finance.

At their November 2018 meeting, PACICC's Board reiterated the need to continue efforts to reduce systemic risk in partnership with IBC. They also asked PACICC to re-engage with member insurers in 2019 on the proposed levy.

Refunding PACICC Liquidation Dividends

All member insurers that were put into wind-up by their regulator and required PACICC to assess insurers have now been resolved. There are no outstanding or unresolved claims. Because PACICC has made a recovery (between 30 percent and sometimes as high as 100 percent) in most of the insolvencies it has supported, the Corporation will refund all dividends from liquidation funds, associated with the winding-up of Markham General, GISCO, Hiland, Canadian Millers', Canadian Universal, Ontario General and Beothic. The combined balance of these liquidation funds on August 31, 2018 was $21.0 million.

PACICC Benefits Review

The objective of PACICC's 2019 priority is to modernize its coverage 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.

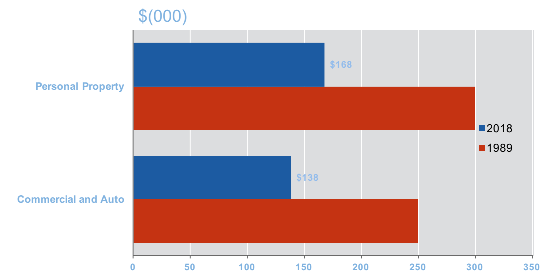
PACICC Priorities Con't

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

1. What are the appropriate levels for PACICC claims limits?

PACICC claims limits were determined in 1989. Adjusting strictly for inflation, the limits for auto and commercial insurance policyholders have eroded by almost 45 percent. The $250,000 limit promised in 1989 is now equivalent to $138,000 in 2018. The limit promised to homeowners' insurance policyholders was adjusted, partly to recognize the impact of inflation, to $300,000 in 2006. The $300,000 limit in 2018, when adjusted for inflation, would be equal to $168,000 in 1989.

PACICC limits have eroded in value over itme



Source: PACICC based on data from Bank of Canada

It is clear that over time the dollar value of PACICC protection has eroded. According to the Bank of Canada inflation calculator, $250,000 in 1989 dollars is worth just $138,000 today – a decline of 45 percent. Adjusting for inflation, $446,000 would be equal to a promise of $250,000 in 1989.

In the summer of 2018, PACICC surveyed member insurers to measure the percentage of claims currently on their books that would be covered by PACICC's current limits. This report was presented to PACICC's Board at their November 2018 meeting.

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

PACICC's lines of coverage are 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. PACICC has established a Commercial Insurance Working Group to develop options to ensure that PACICC makes best use of its resources to address industry insolvencies and to make recommendations to PACICC's Board for changes to commercial coverage. This group met in late November 2018.

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, 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

Insolvency Readiness

- by Gale Rubenstein and Graham Smith

The P&C industry has become increasingly empathetic to its policyholders and efficient at responding to the crises, often weather-related, that have rocked communities across Canada, mobilizing to meet urgent needs without requiring policyholders to go through trauma to produce records that may well have been destroyed or addresses when they are without homes or clear plans for where they will spend the night. Canadians have come to rely on the industry in their time of need. Just as the industry has mobilized to meet the needs of its policyholders in their times of crisis, it must also mobilize to ensure that the industry itself is prepared to respond to a crisis of its own so it remains able to fulfill its important role in the lives of Canadians.

The tenth anniversary of Lehman's bankruptcy filing in September prompted much discussion about the factors leading both to its failure and to the financial crisis, the responses, lessons learned (and forgotten) and speculation about what may be the next "big" failure. PACICC has been working to identify the potential sources of P&C insurer insolvencies, for large and smaller companies. Paul Kovacs has discussed catastrophic events and "mega-cats" in this newsletter, presenting a sobering perspective on the potential size and impact of continuing weather-related events.

But these are not the only kind of events that can have severe repercussions for the industry and for an individual institution. Catastrophic events can also be financial and can destabilize even large financial institutions. The hubris and complacency of financial players in the years leading up to 2008 have not been banished forever. The important point is that, while every kind of financial institution is different with its own specific risks and exposures, all institutions are exposed to the risk of ever more complex financial instruments that may not be well understood, the mobility of consumers and of capital and, effectively, the wild fire impact of social media and loss of confidence in an institution. The crisis of Home Capital is not directly relevant to a P&C insurer but there are instructive elements, including the speed with which matters began to unravel, notwithstanding there was no issue as to the company's capital position.

The industry has been focusing on risk management measures. I would suggest that "insolvency readiness" is an important form of risk management for the industry as a whole, and the responsibility of its leadership to policyholders and the economy. I use that term to refer to recovery and resolution planning, processes that have been ongoing for domestically systemically important financial institutions, thus far only certain banks, spurred on by the work of the Financial Stability Board, an international body reorganized and invigorated in response to the financial crisis. In essence, scenarios are developed that challenge the institution's viability. The institution must respond with a plan to recover from the challenge. The process requires the institution to understand its business, those parts that are core and of value and those that may be shuttered or sold, and to analyze its corporate structure and capacity to access liquidity within the structure. It requires the institution to identify its ability to access information, both financial and operational, quickly and reliably. It further focuses the institution externally.

- Who should be contacted domestically and internationally from a regulatory and business perspective so that they do not panic and react in a destructive manner?
- Does the treasury function potentially allow for money to be trapped in another jurisdiction if a regulator does panic?
- What are the cross-contractual rights that would enable another institution to offset or at least allege a cross-default that would prevent access to both capital and liquidity?
- What are the communication levers the institution can readily use and how will the message be developed?
- Does the governance and management structure allow for informed but fast decisions, commanding respect and loyalty among those who are charged with carrying out a plan that may result in the loss of their jobs?

PACICC has made great strides in building an infrastructure that can assist and support such efforts. Its developing relationship with OSFI and provincial regulators and focus on early intervention planning will allow it to do its own crisis management exercises but also to assist in realistic scenario design and, potentially, the writing of a "playbook" that no one hopes ever to use. The industry would be remiss if it did not tap into these resources. By being insolvency ready, an institution may in fact avoid insolvency.

Gale Rubenstein and Graham Smith are partners of Goodmans LLP and have represented the liquidators of numerous financial institutions, including P&C companies such as Northumberland, the Markham General, United Canada, Canadian Millers' and the Canadian branches of Reliance, Home, English & American and Orion. They have also consulted with OSFI and CDIC on financial institution recovery and resolution planning, as well as advising on amendments to the *Winding-Up and Restructuring Act.*

Solvency Analysis

PACICC's Liquidation History - by Grant Kelly

During 2018, all of the insolvencies that required PACICC to assess member insurers were completed. All eligible claims were paid. All unearned premium rebates were refunded. The final accounting of these estates shows that PACICC collected $68 million from member insurers in assessments to provide liquidity to these estates. Liquidators paid more than $121 million in claims payments and reimbursement of premiums. At the end of the process, PACICC will have refunded $57 million to member insurers from these estates.

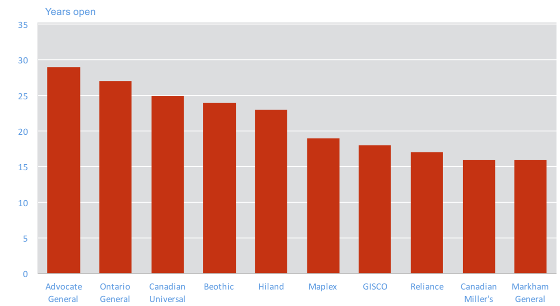
Looking back at the history of these estates highlights three key lessons. First, settling the estate of an insurance company takes a really long time. On average, it has taken 22 years from the date the court issued a wind-up order until the final distribution of funds to PACICC. This is in large part due to the legal process required by the *Winding-Up and Restructuring Act*. The good news is that the process appears to be quickening - the last five insolvencies that PACICC was involved in took less than 20 years to close the estate. This is progress.

Lesson two - the most common reason that companies fail is due to inadequate pricing and under-reporting reserves. In the Markham General insolvency, the estate ultimately paid more than $15 in claims for every dollar of reserves reported at date of insolvency. At Canadian Millers', the estate paid $3.60 in claims for every dollar of reserves. In the case of Ontario General, Canadian Universal and GISCO, regulators stepped in just prior to the wind-up forcing the insurers to strengthen reserves.

Once the estate is finally settled, PACICC returns any money provided by the estate back to member insurers. There is no pattern or trend evident in the amount PACICC is able to return. 99.4 percent of the initial assessment collected was ultimately returned to members in the Canadian Universal estate. Just 33.2 percent of PACICC's initial assessment can be returned from the Canadian Millers' estate. These figures give some indication in the size of the problem that management and the regulator faced at the time of the insolvency.

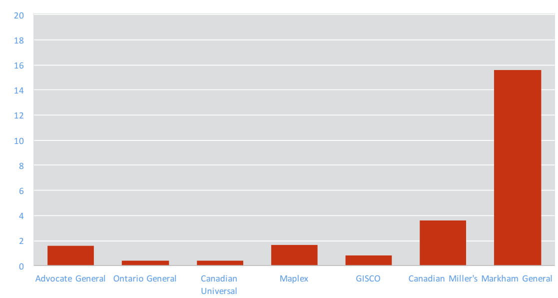
Looking back at the closed estates that PACICC has dealt with, three things are clear. It takes decades to wind-up an insurance company. Next, insurers that under-report claim reserves make the process very expensive for PACICC member insurers and, third, there is no clear pattern in the amount that PACICC member insurers can expect to ultimately be refunded.

Time to close estate



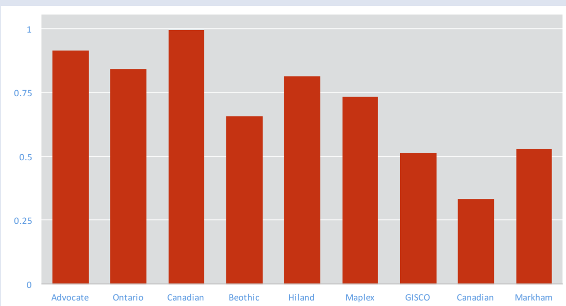
Source: PACICC Annual Report

Claims paid vs. book reserves at insolvency



Source: PACICC Annual Report

Dividend to assessment



Source: PACICC Annual Report

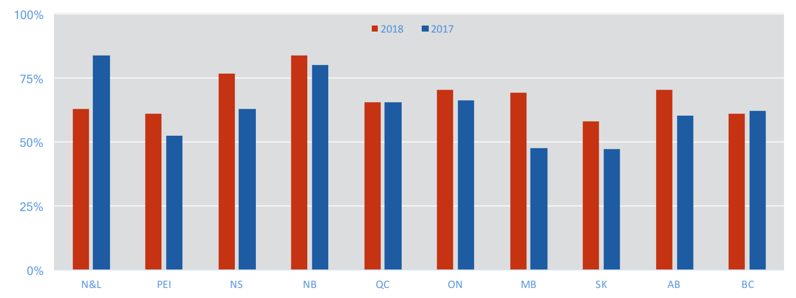
PACICC Grant Kelly is Vice President - Financial Analysis & Regulatory Affairs

Solvency Analysis Con’t

Through the first nine months of 2018, Canada’s P&C insurers reported lower profits compared to the same nine-month period in 2017. Overall, 2018 P&C third-quarter YTD return on equity is 5.2 percent. This is down 1.8 percent from the 7.0 percent ROE reported at this time last year. The decline in profitability is due to a 10 percent increase in claims costs.

Importantly for insurers, Ontario’s auto insurance, which represents approximately 25 percent of the entire market, remains profitable with a loss ratio of 68.9 percent. Claims costs in Canada’s other auto markets are rising. Auto loss ratios in New Brunswick, Nova Scotia and Alberta are in fact approaching unsustainability.

Loss ratio, 3rd quarter VTD



Profitability is not uniform across the 175 insurers that reported their financial results – 53 PACICC members have reported negative net income thus far in 2018. These insurers represent 30 percent of the premiums written to consumers. The key difference between insurers reporting losses vs. those reporting profits is that claims costs grew by 17 percent for those with losses. Claims increased by only 9 percent for insurers reporting profits.

Sustained profitability is a vital component for maintaining solvency among insurers. PACICC will continue to monitor the profitability of our member insurers.

THIRD QUARTER 2018 FINANCIAL YEAR RESULTS

($ millions)	2018 YTD	2017 YTD	
Direct Premiums Written (DPW)	$41,028	$38,684	6.1%
Net Pemiums Earned (NPE)	$34,855	$33,142	5.2%
Net Claims Incurred	$23,767	$21,614	10.0%
Operating Expenses	$10,976	$10,602	3.5%
Underwriting Income	$283	$1,100	-74.3%
Net Investment Income	$1,739	$2,222	-21.7%
Net Income	$1,879	$2,509	-25.1%
Comprehensive Income	$1,259	$1,853	-32.1%
Combined Ratio	99.7%	97.2%	
Net Loss Ratio	68.2%	65.2%	
Expense Ratio	31.5%	32.0%	

Select Solvency Indicator Ratios

($ millions)	2018 YTD	2017 YTD
Average Equity	$48,131	$47,515
Return on Equity (ROE)	5.2%	7.0%
Return on Investment (ROI)	2.2%	2.7%
Comprehensive ROE	3.5%	5.2%
Comprehensive ROI	1.5%	1.9%
MCT Ratio (Capital Availiable/ Capital Required)	234.6%	229.1%

Source: MSA Research as of November 26, 2018.

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.

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 Year's Forum Meetings

Wednesday, April 3, 2019
Topic: Psychology of Cyber Security Protection

Wednesday, September 4, 2019
Topic: Climate Change; and the Business Environment

November (Date TBA)
Topic: CEO Perspective on ERM and Industry Feedback on OSFI Risk Management Seminar

Next Year's Emerging Risks Webinars

Wednesday, February 20, 2019
Topic: A Conversation with Insurers Regarding Risk Identification

Wednesday, May 15, 2019
Topic: A Brave New World - Where are We Headed?

Wednesday, October 16, 2019
Topic: Product Innovation

Forum Membership

Membership in the Forum is open to staff of any Canadian licensed insurer or reinsurer (Federal, Provincial and Territorial) with management responsibility for ERM in their respective organizations. This includes PACICC member insurers and risk officers with insurers and reinsurers that are not PACICC members. An insurer or group may have more than one member, as long as the member has ERM responsibilities. Chief Executive Officers, Chief Agents and Foreign Risk Officers can serve as members, if there is no other Canadian staff with ERM responsibilities.

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

Farewell and best wishes - by Paul Kovacs

I have chosen to retire as President of PACICC. As the organization approaches its 30th anniversary, it has been an honour and privilege to lead PACICC for the past 15+ years, a period of progress in the protection of Canadian insurance consumers.

36 insurance companies have been closed in Canada by insurance regulators since 1979, including 32 property and casualty insurers and 4 life insurers. 16 P&C insurers failed during the 1980s, contributing to a crisis in consumer confidence that led to the establishment of PACICC.

PACICC exists to protect consumers. All eligible claims have been paid. PACICC has no outstanding or unresolved claims. The resolution of a dozen member insurers was completed with no public concerns or complaints made by the hundreds of thousands customers affected.

PACICC assessed the insurance industry for a total of $68 million to support the payment of the claims over the past 30 years. $57 million was eventually recovered from the estates of failed insurers and returned to the industry. The industry cost of protecting consumers has been low.

An additional $30 million was assessed to create a liquidity fund to support immediate cash requirements for future industry failures. Presently, this fund is valued at $55 million.

The number of Canadian insurance consumers that report that they are confident or very confident in their insurers' ability to pay claims increased from an alarming low of 55 percent in the 1990s rising to about 80 percent over the past decade.

In brief, PACICC has been successful in protecting consumers, minimizing the cost to member insurance companies, and supporting confidence in the insurance industry.

PACICC assessed the industry $28 million (spread over 30 years) to finance a small office. Staff oversee the resolution of insolvent insurers, prepare for future failures, assess the risk of failure, and promote solvency risk reduction by member insurers and insurance regulators.

PACICC is available, if requested, to speak with regulatory authorities if a member insurer experiences extreme distress. If it becomes clear to the regulator that a company must be wound up, PACICC is prepared to take the lead to protect consumers and support the resolution.

We work with organizations responsible for insolvency risk and consumer protection programs in life insurance, banking and other financial industries. We are a founding member of the Canadian Financial Services Insolvency Protection Forum and the International Forum of Insurance Financial Guarantee Schemes.

A foundation for success has been a commitment to understand and actively confront solvency risk. This includes one of the world's leading programs for the analysis of solvency risk in the P&C insurance industry. PACICC also partnered with the Insurance Bureau of Canada to champion establishment of a government backstop to address systemic risk in the insurance industry from a catastrophic earthquake.

I am proud of my role in guiding PACICC's evolution into its current position as Canada's P&C insurance consumer insolvency protection program and resolution authority. I look forward as others will build on our successes to further enhance the protection provided to insurance consumers and thereby build confidence in the industry. I am proud of what we have accomplished and know that PACICC is now better positioned to protect insurance consumers and member insurers.

Paul Kovacs is the President and Chief Executive Officer of PACICC

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Editor and graphic design

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