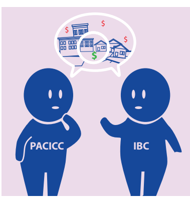
SOLVENCY MATTERS

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

PACICC

Issue 5 - March 2019

Insolvency protection for home, automobile and business insurance customers



PACICC Priorities

Reducing systemic risk/Catastrophic earchquake

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Emerging Issues (Janis Sarra)

Resolution of Insolvent Insurers

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PACICC's Benefit Survey (Grant Kelly)

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Risk Officer's Forum (Ian Campbell)

Upcoming Risk Officer's meetings and webinars

Next Forum Meeting – April 3

Keynote: Penny Lee, Senior Director, P&C Insurance Group, Insurance Supervision Sector, OSFI

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Beyond Tomorrow (Alister Campbell)

Honouring a Legacy… by Moving Forward

As I assume the role of President and CEO of PACICC this year, I am deeply conscious and appreciative of the legacy left behind by the leaders who held this title before me.

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Industry Events

April 2
Swiss RE
Annual Canadian Insurance Outlook Breakfast

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)

April 25
Insurance Bureau of Canada Annual General Meeting

April 28 to May 1
RIMS 2019

May 15
PACICC Emerging Risks Webinar - The Social Psychology of Cyber Security

PACICC Priorities

Reducing systemic risk/Catastrophic earthquake

At its November 2018 meeting, PACICC's Board reiterated the need to continue efforts to reduce systemic risk, in partnership with IBC. They also urged the re-engagement with member insurers in 2019 on the development of a possible Assessment Mechanism that would have a lower probability of fueling financial "contagion". PACICC's new CEO Alister Campbell has been consulting with a variety of industry stakeholders on a number of key PACICC files, including with IBC on the earthquake file.

PACICC is working in partnership with IBC on measures to support Finance Canada as it considers how to address systemic risks that a catastrophic earthquake could pose to P&C insurers.

While PACICC believes progress is being made – the magnitude of the risk involves significant cost and complexities. And solutions, once identified, will take time to implement. In the meantime, the residual risk remains with PACICC and the P&C insurance industry. The risk remains that PACICC could be unable to respond to the expected needs of insurance consumers following a catastrophic earthquake. In the interim, PACICC will continue to explore other means of mitigating risk including the development of new pre-liquidation resolution alternatives.

Refunding PACICC Liquidation Dividends

It was noted earlier that all member insurers that were put into wind-up by their regulator (requiring PACICC to assess insurers) have now been resolved. There are now no outstanding or unresolved claims. Given that PACICC has made a recovery in most of the insolvencies it supported, the Corporation was in a position to refund dividends from liquidation funds for the following insolvencies: Markham General, GISCO, Hiland, Canadian Millers', Canadian Universal, Ontario General and Beothic. PACICC distributed cheques to 132 member companies for their shares of the combined balance of these liquidation funds, which totaled some $21 million.

PACICC Benefits Review

PACICC's 2019 priority is to review its coverage and benefit levels and engage member insurers, supervisory authorities and other industry stakeholders in fulsome discussion, before any changes are made. PACICC's benefit levels and coverage limits are detailed in its Memorandum of Operation and any amendments require approval from Provincial Insurance Superintendents. It has always been PACICC's practice to consult with member insurers prior to putting forward any recommendations to provincial regulators. It is important to note that contracts signed by the insurance industry with each provincial government prohibit PACICC from lowering benefit levels.

As part of the review process, PACICC is seeking to answer three key questions:

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

PACICC claims limits were determined in 1989. Adjusting strictly for inflation, PACICC claim limits for eligible auto, commercial and homeowners' insurance policies have eroded sharply over time. A $250,000 claim limit in 1989 for auto, homeowners' and commercial insurance is equivalent to a limit of more than $429,000 in today's dollars. PACICC is reviewing its claim limits against international guarantee funds. In the United States, the National Association of Insurance Commissions has a model law that sets limits in the U.S. at USD $500,000 for auto, homeowners' and commercial policyholders. In addition, PACICC has surveyed member insurers to measure the percentage of claims currently on their books that would be covered by PACICC's current claim limits.

2. Are there types of insurance products that are not currently covered by PACICC that should be covered? Not covered?

Lines of coverage are defined in Part B of PACICC's Memorandum of Operation. Specific exclusions are detailed in Part C. Important examples of current exclusions include automobile insurance in Manitoba and Saskatchewan, and speciality lines of insurance such as surety, fidelity, marine and aviation. PACICC is consulting with member companies, insurance brokers and regulators to determine whether any changes are required to its defined coverages and, if so, what inclusions/exclusions would be appropriate.

3. Should large commercial risks be excluded from PACICC coverage eligibility?

PACICC protects all commercial insurance policyholders up to established claim limits. Some international guarantee funds have sought to focus their benefits on small business owners. PACICC has established a working group of members that write primarily commercial coverage to develop options to ensure that PACICC makes best use of its resources to address industry insolvencies.

Recommendations regarding possible changes to PACICC coverage and benefit levels will be presented to the PACICC Board at its April 11 meeting. If there is Board support for changes to current coverage, a consultation paper will be prepared to engage the industry in comprehensive discussion. Industry consultations would take place over the summer. Final recommendations would be presented to the PACICC Board at its Fall meeting (November 7). PACICC would seek sign-off from regulators following the PACICC Board meeting (90-day review). The Canadian Council of Insurance Regulators is aware that PACICC coverage limits are being examined. A number of provinces have explicity stated that they feel a review is timely and appropriate. If approved, revised benefit levels would be introduced in the spring of 2020.

Developing an early-intervention framework for PACICC

PACICC's priority for 2020 will be to address any gaps that exist between actual vs. recommended powers for P&C insurance resolution authorities in Canada. Changing circumstances (including the joint development of intervention guides 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 being issued. PACICC's existing Memorandum of Operation explicitly provides the Corporation with a number of tools to intervene prior to a wind-up order, including providing a loan to a distressed insurer, providing reinsurance or assisting in the sale of a book of business. In its 30 years of operation, PACICC has never exercised these powers.

Early intervention is the focus of PACICC's 2019 *Why insurers fail* study.

Emerging Issues

Resolution of Insolvent Insurers - by Janis Sarra

Canadian insurance companies provide important services that safeguard against loss of income or assets due to injury, illness or catastrophic events. Even well-managed insurers can face risk of insolvency, including from cybersecurity breaches, new technologies, and pricing new markets with changing customer demand. The federal and provincial governments share jurisdiction over P&C insurers, and federally, the Office of the Superintendent of Financial Institutions ('OSFI') has oversight of 153 P&C insurers. OSFI will intervene with insurers at early stages where solvency risks have been identified in respect of capital adequacy, liquidity and management of companies.

Previously, the insolvency of an insurance company meant liquidation in most cases. OSFI's practice was that, once it took control of an insurer, it would apply to the Minister for a winding-up order, often resulting in going-concern value being lost and disruption to policyholders. There has been a shift in recent years, with industry specialists looking to solvent resolution or other going-concern solutions to insurer financial distress. To "resolve" an insurer is to use a series of tools to address its financial distress in a manner that safeguards the public interest; ensuring, to the extent possible, continuity of the policies held by customers; restructuring of all or part of the company to allow it to continue operating where that option is viable; facilitating orderly merger with a solvent insurance company that may benefit from the assets, goodwill and customer lists of the insolvent business; or providing for an orderly winding up.

The Winding-up and Restructuring Act (WURA) is in need of overhaul to bring it into a modern insolvency framework. For example, it was not designed to address catastrophic events, such as a major earthquake, which could pose solvency risks for numerous P&C insurers. There have been suggestions for its reform over the years, but little will to enact change. The largest gap is with solvent resolution, in terms of who has authority and the transparency of the process. Improving resolvability of financially distressed insurers will enhance the system's overall objectives of a timely and effective resolution process, and will protect against unnecessary losses to policyholders and creditors.

Another needed reform is to make clear that an insolvency professional can be appointed under either the *Insurance Companies Act* or the *WURA* to facilitate going-concern or solvent recovery/resolution. Such provisions have been successfully deployed for corporations pursuant to the *Bankruptcy and Insolvency Act* and *Companies' Creditors Arrangement Act*, maximizing the value of the company. There is a highly-skilled professional community in Canada already, with accountancy, restructuring and liquidation skills. Timely resolution of insurer financial distress in turn minimizes negative impact on the industry and helps maintain confidence in the soundness and stability of insurers and the policyholder protection scheme. OSFI could issue clear guidance regarding the process of assessing and improving resolvability of insurers, including revising the intervention stages to facilitate solvent recovery; appointing a restructuring professional to monitor progress of a recovery plan or to co-ordinate an insolvent resolution or liquidation if a recovery plan fails. Parliament could also clarify which entity is the lead macroprudential authority when there is a conglomerate failure that includes corporate divisions or entities with activities in banking, insurance, financial services and other activities.

PACICC, as a major stakeholder providing policyholder protection, has considerable contingent liabilities on failure of an insurer, making it a significant contingent creditor in any P&C insurer insolvency. It has acquired considerable skill and expertise in monitoring the solvency of member insurer institutions. The Guide to Intervention that OSFI and PACICC agreed upon is a big step forward. The document promotes awareness and enhances transparency of the framework for intervening with companies. While co-operation with regulators during insolvency currently exists, it would be enhanced by clarifying PACICC's access to critically important information such as market value of assets and liabilities and material inter-company agreements; and its role in identifying financial distress and in advising on the best options for recovery, solvent resolution or winding-up. Insurers could be required to improve their recoverability or resolvability well in advance of being staged by OSFI for more aggressive intervention. One additional important reform would be to set criteria for cross-border co-operation where the insolvent insurer operates in more than one jurisdiction.

For a discussion of these issues, see: Janis Sarra, "Flotsam, Financing and Flotation: Is Canada "Resolution Ready" for Insurance Company Insolvency?", Annual Review of Insolvency Law 2018 (Toronto: Carswell, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3338035.

Janis Sarra is Presidential Distinguished Professor, University of British Columbia and Professor of Law, UBC Faculty of Law.

PACICC's Benefit Survey

- by Grant Kelly

In the summer of 2018, PACICC surveyed member insurers in order to determine the level of protection offered to policyholders. The goal of this survey was to allow PACICC's Board of Directors to make more informed decisions about potential changes to PACICC's policy limits. The purpose this summary is to share some of the findings from this survey of approximately 400,000 insurance claims.

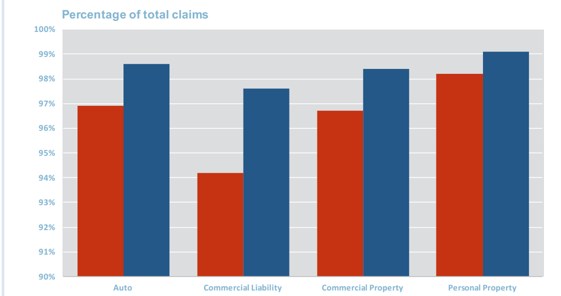
The percentage of claims that are covered by PACICC is high, but varies by line of business. If a PACICC member insurer was to fail in 2019, 96.9 percent of open auto claims would be covered by PACICC's claims limit of $250,000. 94.2 percent of open commercial liability claims and 96.7 percent of commercial property claims would be below PACICC's policy limits of $250,000. 98.2 percent of open personal property claims would be below PACICC's $300,000 policy limit. All of these figures are based on the number of files. The figures are lower if PACICC protection is measured by dollars reserved by member insurers.

While this is a very high level of protection, some claims are larger than PACICC's limits. According to the survey, if a medium-sized or larger PACICC member was to fail, more than 1,700 claims would exceed PACICC's limits. More than half of this number would be auto or homeowner claims. Having a large number of claims that receive only partial payment creates the potential for negative media attention and a possible reduction of consumer confidence in Canada's P&C industry. In past liquidations, there were very few claims (primarily commercial policyholders) that exceeded PACICC limits and these hardship claims were dealt with on a case-by-case basis. The 2019 review of PACICC benefits levels includes consideration on how to best manage policyholder claims above these limits.

The survey allows PACICC to estimate the change in assessment that would be required to fund a future insolvency. As a baseline, consider the following hypothetical PACICC member that sold equal amounts of auto, homeowners, and commercial coverage. Regulators have lost confidence in its financial viability. It has been determined that an assessment of $100 million was required to protect policyholders at current limits. If PACICC members were to raise all limits to $500,000 per policy, the industry assessment required would increase by 15 percent. If PACICC members raised limits to $1,000,000 per policy, the assessment required would increase by 28.6 percent. PACICC's assessment mechanism would share these costs equally across all members.

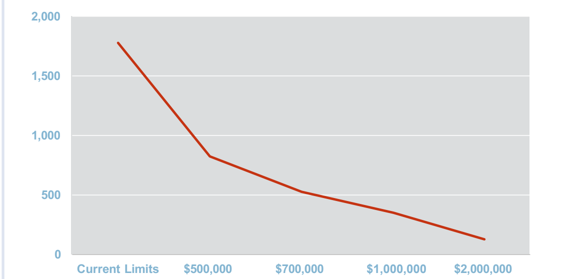
It is important to note that this increased assessment only occurs when a member insurer fails. If no PACICC member insurer fails, then the cost of protecting policyholders is zero. PACICC will be issuing a consultation paper to member insurers and other industry stakeholders in the summer of 2019.

Level of PACICC protection



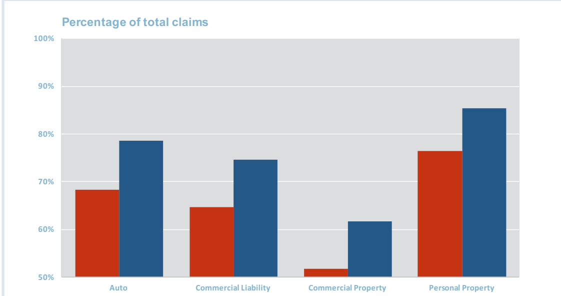
Source: PACICC

Number of claims exceeding PACICC limits



Source: PACICC

Claims dollars



Source: PACICC

Solvency Analysis

- by Grant Kelly

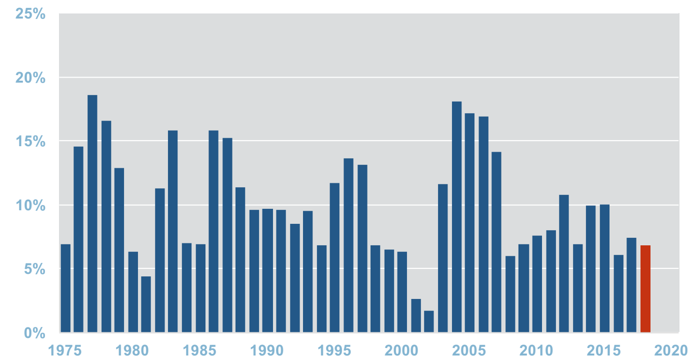
Canada's P&C insurers had a rough year in 2018. The industry's net income declined by 18.6 percent compared to the prior year. Overall, P&C return on equity (ROE) fell from 7.8 percent in 2017 to 6.4 percent in 2018. This is the fourth time in the past five years that the industry's ROE was below its long-run average return of 10 percent.

The decline in profitability was the result of a 15.2 percent increase in claims costs, coupled with a $1.1 billion decline in investment income. The increase in claims costs was most evident in commercial property markets where the industry loss ratio rose from 62.1 percent in 2017 to 74.8 percent in 2018. The commercial property loss ratio rose in eight of Canada's 10 provinces.

Importantly for insurers, Ontario's private passenger auto insurance market remained profitable with a loss ratio of 73.0 percent. Claims costs in Canada's other auto markets are increasing. Auto loss ratios in New Brunswick, Nova Scotia and Alberta are unsustainable.

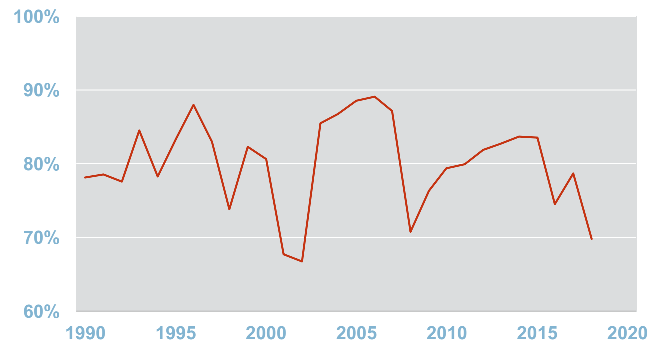
Profitability is not uniform across PACICC's member insurers. 70 percent of PACICC members reported profits in fiscal 2018. That means that 30 percent of PACICC members reported negative net income. This is the fewest number of profitable members since the hard markets of 2001 and 2002. Sustained profitability is a vital component in maintaining solvent insurers and having a significant share of PACICC membership reporting losses (even in the short term) increases the industry's solvency risk. PACICC will continue to monitor the profitability of its member insurers.

Return on equity



Source: PACICC based on data from MSA Research

Insurers reporting profit



Source: PACICC based on data from MSA Research

Select Solvency Indicator Ratios

($ millions)	2018	2017
Average Equity	$49,136	49,391
Return on Equity (ROE)	**6.4%**	**7.8%**
Return on Investment (ROI)	**2.1%**	**3.1%**
Comprehensive ROE	**3.9%**	**6.6%**
Comprehensive ROI	**0.9%**	**2.6%**
MCT Ratio		
(Capital Availiable/ Capital Required)	**237.2%**	**228.6%**

Source: MSA Research as of March 22, 2019

2018 Financial Year Results

($ millions)	2018	2017	
Direct Premiums Written (DPW)	$59,093	$54,899	7.6%
Net Pemiums Earned (NPE)	$51,334	$47,094	9.0%
Net Claims Incurred	$34,824	$30,242	15.2%
Operating Expenses	$15,954	$15,387	3.7%
Underwriting Income	$787	$1,716	-54.1%
Net Investment Income	$2,244	$3,361	-33.2%
Net Income	$3,134	$3,849	-18.5%
Comprehensive Income	$1,899	$3,272	-42.0%
Combined Ratio	98.9%	96.9%	
Net Loss Ratio	67.8%	64.2%	
Expense Ratio	31.1%	32.7%	

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;
- Discussing 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 – Wednesday, April 3

Keynote:	**Penny Lee**, Senior Director, P&C Insurance Group, Insurance Supervision Sector, OSFI
Topic:	*Update on Current P&C Insurance Industry Issues*
Discussion:	**Sanjeev Agarwal**, Chief Risk Officer, AIG Insurance Company of Canada **Brandon Blant**, Vice President, Risk Management, Intact Financial Corporation **Christopher Walton**, Chief Agent for Canada, General Reinsurance Corporation, General Re Life Corporation and National Liability & Fire Insurance Company
Topic:	*Current P&C Insurance Industry Issues (Group Discussion)*
Panel:	**Nick Milinkovich**, Senior Solution Leader & Associate Partner, McKinsey and Company **Erwann Michel-Kerjan**, Partner, Insurance Risk North America, McKinsey and Company
Topic:	*Artificial Intelligence and Machine Learning*

Emerging Risks Webinars

Three Emerging Issues Webinars are held each year (always from 1:00-2:30 p.m. Eastern Daylight Time). 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 – Wednesday, May 15

Speaker:	**Dr. John McAlaney**, Associate Professor and Head of Education Department of Psychology, Faculty of Science and Technology Bournemouth University, United Kingdom
Topic:	*The Social Psychology of Cyber Security*

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

Honouring a Legacy… by Moving Forward - by Alister Campbell

As I assume the role of President and CEO of PACICC this year, I am deeply conscious and appreciative of the legacy left behind by the leaders who held this title before me. PACICC is celebrating the 30th Anniversary of its founding this year and I am only the fifth person to serve as President. Each leader before me helped to shape the successful organization that we are today, but I would like to take a moment to celebrate the particular accomplishments of the recently retired Paul Kovacs.

Paul served as President of PACICC for 15 years and played a central role in building the solid platform we stand on now. In his time, PACICC successfully managed the liquidation of many failed insurers. In fact, earlier this year, we completed the winding-up of all outstanding resolution files and were in a position to refund more than $20M to the insurers who were initially assessed to provide the funds PACICC needed to protect imperilled policyholders.

Paul did much more than just manage insolvencies however. Under his leadership, PACICC developed a comprehensive and robust research capability and through the "*Why Insurers Fail*" series created an invaluable resource for insurers and regulators world-wide. Through that same research capability (as well as through his parallel role as Executive Director of the Institute for Catastrophic Loss Reduction), he helped to raise industry awareness around the risks for our industry and our policyholders from large natural catastrophe events - either climate change-driven or as a result of severe earthquake.

Understanding clearly that the best defense is a good offence, Paul and PACICC also developed the Risk Officer's Forum and, through this vehicle, we have contributed to material and ongoing enhancements in the identification and implementation of risk management best practices in the Canadian P&C industry.

Finally, over the last several years, Paul and PACICC were able to develop Intervention Protocols with both the federal Office of the Superintendent of Financial Institutions (OSFI) and the Authorité des marchés financiers (AMF) in Quebec to ensure that going forward, PACICC will now have early warning of cases of insurer distress and can actively participate in the identification of potential mitigating actions to address issues in such entities…before liquidation. We anticipate signing similar agreements with at least two more of the provincial regulating authorities in the course of this year.

I believe that the best way to honour a legacy is by moving forward. And there remains work to be done. PACICC is due to review its coverage and benefits levels in 2019 and we have already initiated the consultation process on this important topic. The core elements of coverage (including a list of excluded classes), benefits (what we pay to policyholders of insolvent insurers in the case of a claim), as well as the limits on return of unearned premium were all set when PACICC was established in 1989. The last change was in 2006, so this review is both important and timely.

We also have work to do as an industry, and as a country, to ensure that we have the financial capacity to protect our policyholders in the case of a major catastrophic event. In this context, it is clear that we need to develop a solution that includes our federal and provincial governments and, together, PACICC and IBC will be playing a central role in helping to make this happen.

I will provide further updates on these critical topics in the months ahead. In the meantime, I hope you will all take a moment to reflect on the fine legacy left to our industry and our country by a true leader – Paul Kovacs. Thank you, Paul.

Alister Campbell is President and Chief Executive Officer at PACICC

Denika Hall
Editor and graphic design

SOLVENCY MATTERS

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