SOLVENCY MATTERS

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

PACICC

Issue 6 - June 2019

Insolvency protection for home, automobile and business insurance customers

PACICC Priorities

PACICC Benefits Review

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Emerging Issues (Nathalie Sirois – AMF)

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Insolvency risk is rising in Canada's P&C insurance industry (Grant Kelly)

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Risk Officer's Forum (Ian Campbell)

Upcoming Risk Officer's meetings and webinars

Next Forum Meeting – September 4

Keynote: Patrick Déry, Superintendent, Solvency, Autorité des marchés financiers and CCIR Chair

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From the Desk of the President (Alister Campbell)

A "Pair of Fresh eyes" perspective

I have now had the pleasure of serving in my new role as President and CEO of PACICC for a few months and have had a great opportunity to do a "deep dive" into all the core elements of its design.

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Industry Events

June 20-21
Canadian Institute of Actuaries Annual Conference

September 4
PACICC Risk Officer's Forum Meeting - Changes to the Business Environment in Canada, and ERM Survey Results

September 8-11
RIMS Canada Conference

September 10-11
KPMG's 31st Annual Insurance Industry Conference

September 15-18
CIAA Annual Conference

September 22-24
National Insurance Conference of Canada (NICC)

October 23
PACICC Emerging Risks Webinar - Climate Change

October 24-27
Insolvency Institute of Canada Annual Meeting

PACICC Priorities

Reducing systemic risk

The PACICC research papers, published in 2013 and 2016, regarding potential systemic pressures as a result of a large Cascadia event, were effective in putting this issue firmly on the public policy agenda. The bottom line was that the current PACICC Model would likely prove to be inadequate and could potentially contribute to systemic "contagion" in the face of a large-scale event. PACICC is now working closely with IBC in several areas including:

1. **Creating an Alternative Funding Model for PACICC:** PACICC proposes to work with the IBC Standing Finance Committee to develop an Alternative Funding Model for PACICC that is less likely to contribute to potential "contagion."
2. **Enhanced Resolution Toolkit:** PACICC currently has only one tool to deal with a failed insurer - liquidation. PACICC proposes to work with IBC and OSFI/AMF/FICOM to establish a broader range of viable alternatives to insolvency. This would include detailed thinking on: Which tools? When to use? How to fund? and, Under what criteria? The PACICC Board has established this as our 2020 Priority Issue. (See P.3 for more on this topic)
3. **Federal Quake Mechanism:** Canada is the only Quake-exposed developed nation without some form of government-backed Quake Program/Plan. We believe absence of a federal Quake/Catastrophe Funding Mechanism is a major shortfall in the public infrastructure of our nation. PACICC will continue to partner with IBC to help the Government of Canada design and implement a comprehensive Quake/Catastrophe Funding Mechanism.

PACICC Benefits Review

At its Fall 2018 meeting, PACICC's Board of Directors approved a review of coverage and benefit levels as the Corporation's Priority Issue for 2019. This decision recognized the fact that coverage limits must keep pace with changes in loss claims and unearned premium trends in the lines of coverage protected by PACICC. The $250,000 of PACICC coverage established in 1989 dollars now equates to approximately $450,000 in current dollars. Changing PACICC's coverage will have no financial impact on PACICC or its members unless and until there is an insolvency. Changes in PACICC's claim limits could have important financial impacts on members in the case of an insolvency however, depending on the options selected. It is important to also remember that when an estate is closed, PACICC issues dividends to member insurers reimbursing them for a portion of these costs.

Potential Recommendation #1: Updating benefit limits

a) Increasing PACICC claim limits (choose one):
   - i. Increase Personal Property (only) to $500,000
   - ii. Increase all limits to $500,000
   - iii. Increase all limits to $500,000 with cost of living adjustment
   - iv. Establish a target coverage protection percentage and survey periodically to reset to this percentage

b) Exploring options to purchase aggregate excess reinsurance to cover losses in excess of normal benefit limits in case of natural-catastrophe triggered default

Potential Recommendation #2: Enhancing the recovery of unearned premiums for insurance consumers

a) Increase Recovery Percentage: 100% recovery percentage up to $1,000 of premium (so maximum payout = $1,000)

b) Increase Principal: 70% recovery up to $2,000 of premium (so maximum payout = $1,400)

Potential Recommendation #3: Modernize Coverage and Exclusions in PACICC Memorandum of Operation to:

a) Adopt IBC Standard Definitions for all coverages and exclusions

b) Clarify that A&S and Credit Protection is covered only when sold by non-Assuris members

c) Broaden coverage for retail D&O (not-for-profit) and E&O (non-professional)

d) Make explicit the coverage for lines of business not excluded (e.g. Business Interruption, Cyber, New Home Warranty)

Potential Recommendation #4: No Change Regarding Commercial Risk Coverage Eligibility

PACICC was never intended to provide coverage for larger commercial risks (where polices were acquired by sophisticated buyers with the help of professional intermediaries). Increasing the benefits limit to $500, 000 (or higher) will ensure retail (e.g. Small Business) consumers continue to be protected. "Hardship cases" with losses above this limit can still be reviewed by the PACICC Board.

Proposed Review timing

PACICC will be engaging in a consultation process through the Summer and Fall of 2019 with our Expert Committee, member insurers, brokers, and consumers. After receiving feedback from member insurers, PACICC plans to initiate discussions with CCIR in September. The goal is to present a resolution regarding a recommended benefits reform package to the PACICC Board at their November 2019 meeting. If the PACICC Board approves the recommendations (and subject to subsequent unanimous provincial regulatory approval), the changes would become effective after the April 2020 PACICC Annual General Meeting.

Developing an Early Intervention Framework for PACICC

PACICC's Board-approved 2020 PACICC Priority Issue will be the development of an "Early Intervention Framework." To set the stage for this discussion, PACICC's 2019 *Why Insurers Fail* research paper explores three default scenarios and their potential impact on the Industry, including the scope and scale of any required PACICC Assessment. The Paper concludes that in the case of a default of a small carrier, the current PACICC Model works well. However, the traditional insolvency and liquidation model may not be optimal in the case of the default of a mid-size carrier, and is simply not the right option in the case of a large carrier default. In these latter two scenarios, traditional default could potentially expose the industry to significant public and regulatory backlash should it occur.

Proposed project timing

PACICC will examine Canadian (e.g. Assuris/CDIC) and international best practice (via PACICC's membership in the International Forum of Insurance Guarantee Schemes (IFIGS)) in this area. This will then inform work with OSFI/AMF and the IBC on alternatives to liquidation/insolvency and the criteria which might be used to determine if/when early intervention tools would be appropriate. In 2020, PACICC will engage with member insurers in a discussion of the governance/financial and ethical issues related to the possible use of early interventions tools.

Emerging Issues

L'Autorité des marchés financiers is active in the field of earthquakes - by Nathalie Sirois – AMF

AUTORITÉ DES MARCHÉS FINANCIERS

In our 2017-2020 Strategic Plan, L'Autorité des marchés financiers (AMF) announced our commitment to "Undertake a special project to analyze and determine how to mitigate the major financial risks – to the public and to the industry – of a moderate or major earthquake in Québec."

In March 2018, the AMF sent a questionnaire to property and casualty (P&C) insurers in order to develop a picture of the current state of the insurance market and to identify trends in insurers' practices related to earthquake risk. The questionnaire covered various topics such as the products offered, the take-up rate, underwriting, claim settlement and pricing as well as some prospective items for both personal and commercial property insurance.

In Canada, the highest earthquake risk exposure is primarily in British Columbia and Québec. The questionnaire covered these two provinces in order to compare insurers' practices and to understand their differences, if any.

For Québec, the insurers who responded represent nearly 97% of the market share in personal property insurance and 86% in commercial property insurance. Those same insurers represent, for British Columbia, 37% of market share in personal property insurance and 63% in commercial property insurance.

In Québec, the earthquake endorsement take-up rate among homeowners, which covers damage directly caused by an earthquake, including those caused by a fire following an earthquake, is approximately 3%. In comparison, the take-up rate among homeowners for insurers doing business in both provinces is over 40% in British Columbia. With respect to commercial property insurance, these proportions are respectively 44% in Quebec and 87% in British Columbia.

Thus, after getting an accurate picture of the current state of the insurance market and trends in insurers' practices with regard to earthquake risk in Quebec, the AMF plans to address and discuss the following things with various stakeholders, including the P&C insurance industry:

- the public does not seem to believe that earthquakes pose a risk in Québec;
- the offering appears less structured and less systematic in personal property insurance than in commercial property insurance; and
- the product could be revised to make it more attractive to insurers and their agents and brokers, and more attractive and understandable to consumers.

The analysis also highlighted challenges identified by some insurers if the earthquake endorsement take-up rates were to increase, such as the training of the various stakeholders involved in the product offering and claims settlement as well as the refinement of pricing and earthquake hazard zones.

Since the beginning of the initiative, several meetings have been held with different stakeholders and more are scheduled.

In addition, on May 31, AMF representatives were speakers at a meeting of the Association des actuaires IARD du Québec. More than 350 attendees had the opportunity to discuss the current state of the insurance market with regard to earthquake risk in Québec, as well as various options that could be considered to improve the resilience of the province in the event of a major earthquake.

The AMF has also made an inventory of the risk mitigation mechanisms in place elsewhere in the world dealing with this risk, which will be also discussed during meetings with various stakeholders.

Finally, let us recall that the AMF wishes by this initiative to be proactive in identifying the vulnerabilities and possible solutions to explore and act as a catalyst in bringing together the various stakeholders to discuss the implementation of possible solutions to improve Québec's resilience to a major earthquake.

Nathalie Sirois Directrice principale / Senior Director Direction principale de la surveillance des assureurs et du contrôle du droit d'exercice / Senior Direction for Insurers Supervision and Control of Right to Practise Autorité des marchés financiers

Insolvency risk is rising in Canada's P&C insurance industry

- by Grant Kelly

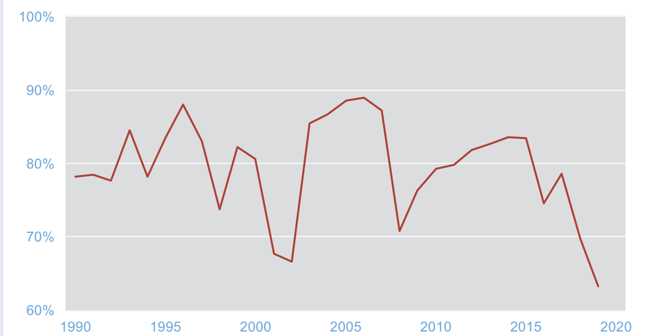
Insolvency risk – the risk that an insurer becomes insolvent – in Canada's property and casualty (P&C) insurance industry has been rising since 2015. One measure of insolvency risk is the percentage of companies within the industry that report losing money. In a competitive industry, there are always winners and losers. Some insurers try new distribution strategies. Others employ different tools to underwrite. Ideas that work are rewarded. In 2015, 83.4 percent of companies that competed in the marketplace reported profits. However, in the first quarter of 2019, just 63.2 percent of insurers that competed in the marketplace reported profits. This is the lowest level of insurer profitability since 1990.

Profitable insurers use their earnings to strengthen their financial health and support growth. Trends in earnings are the primary indicator of future capital adequacy. When firms employ unsuccessful strategies and are not profitable, some have to alter their decisions if their owners wish to continue to put their capital at risk by remaining in the market.

Sustained, healthy earnings reduce the risk of insolvency, while repeated losses increase the risk of failure. Often, in a competitive market, it is not unusual for any single insurer to have a rough year. PACICC examined the profitability of every insurer over the past 21 quarters (five years and the first quarter of 2019). 166 insurers in our sample reported profits over this period. Their capital bases grew by 61.7 percent. The remaining 34 companies actively competing in the Canadian P&C insurance market reported operating losses over this period. On average, these companies reported losses equal to 47 percent of their capital base.

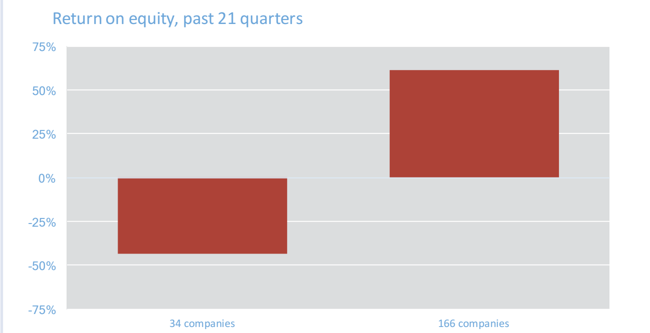
Thankfully, these losses have not yet translated into an insolvency. PACICC is in regular communication with Canada's solvency regulators, and the capital ratios of the companies competing in the market remain strong. In fact, overall, the capital base of Canada's insurance industry has never been larger. However, insolvencies don't happen on average. They happento individual insurers. Current trands are troubling and will need to be watched closely.

Insurers reporting profits



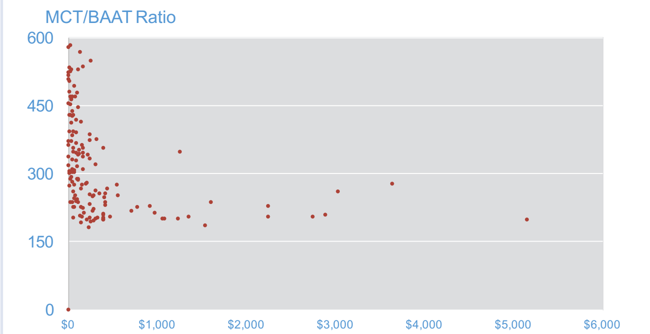
Source: PACICC based on data from MSA Research

Return on equity since 2014



Source: PACICC based on data from MSA Research

MCT to DPW, 2018



Source: PACICC based on data from MSA Research

Grant Kelly is Vice President - Financial Analysis & Regulatory Affairs

Solvency Analysis

- by Grant Kelly

Canada's P&C insurers reported a difficult first quarter of 2019, with total industry net income declining by 152.6% compared to the same period in 2018. Bad underwriting results were the key factor in the industry's poor performance, with the reported underwriting loss growing from -$119 million in the first quarter of 2018 to -$756 million in 2019 – a -535.3% change. The lone saving grace for financial results in the quarter was a surge in net investment income, which grew by 119.0% compared to the results from one year ago. However, strong investment income was not enough to overcome the decline in underwriting results.

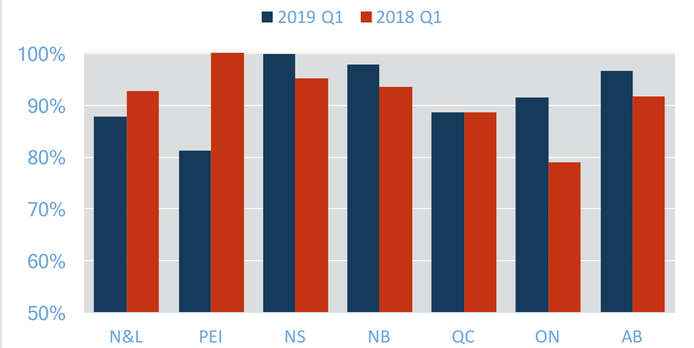
The worsening underwriting results were uniform across all of the industry's major lines of coverage. There was little good news in these numbers. Auto insurers reported private passenger loss ratios higher than 90% in four provinces – Alberta, Ontario, New Brunswick,and Nova Scotia. Three Personal Property markets – Quebec, New Brunswick and Prince Edward Island – reported loss ratios higher than 85%. Seven Commercial Property markets reported loss ratios in excess of 90% - Nunavut, Saskatchewan, Manitoba, Ontario, Quebec, New Brunswick and Newfoundland and Labrador. Loss ratios at these levels over time increase the risk of insolvency and are simply not sustainable. These lines of business in these territories are draining the capital base of the insurers who choose to compete in these markets.

Select Solvency Indicator Ratios

($ millions)	2019 Q1	2018 Q1
Average Equity	$48,438	$48,034
Return on Equity (ROE)	2.4%	4.3%
Return on Investment (ROI)	4.7%	2.1%
Comprehensive ROE	11.4%	0.8%
Comprehensive ROI	8.9%	0.5%
MCT Ratio (Capital Available/ Capital Required)	240.7%	240.8%

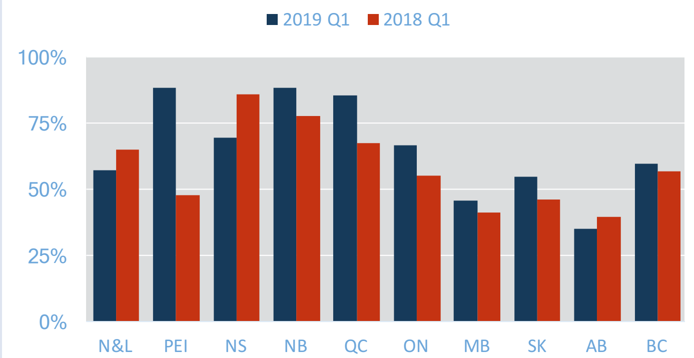
Source: MSA Research as of May 27, 2019

Personal Passenger Auto Loss Ratios



Source: PACICC based on data from MSA Research

Personal Property Loss Ratios



Source: PACICC based on data from MSA Research

1st Quarter 2019 Financial Year Results

($ millions)	Q1 2019	Q1 2018	
Direct Premiums Written (DPW)	$12,888	$11,798	9.2%
Net Pemiums Earned (NPE)	$10,553	$11,249	-6.1%
Net Claims Incurred	$7,531	$7,753	-2.9%
Operating Expenses	$3,836	$3,671	4.5%
Underwriting Income	-$756	-$119	-535.3%
Net Investment Income	$1,209	$552	119.0%
Net Income	-$103	$196	-152.6%
Comprehensive Income	$1,375	$98	1,303.0%
Combined Ratio	107.7%	101.5%	
Net Loss Ratio	71.4%	68.9%	
Expense Ratio	36.3%	33.6%	

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, September 4

Keynote:	**Patrick Déry** , Superintendent, Solvency, Autorité des marchés financiers and CCIR Chair
Topic:	*The Role of the Provincial Regulator*
Discussion:	**Nav Litt**, Partner, Consulting, Deloitte
Topic:	*Changes to the Business Environment in Canada*
Panel:	**Brandon Blant**, Vice President, Risk Management, Intact Financial Corporation **Ian Campbell**, Vice President, Operations, PACICC
Topic:	*2019 PACICC ERM Survey Results*

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, October 23

Speaker:	**Dr. Janis Sarra**, Presidential Distinguished Professor of Law Peter A. Allard School of Law University of British Columbia
Topic:	*Climate Change*

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.

From the Desk of the President

A “Pair of Fresh eyes” perspective - by Alister Campbell

I have now had the pleasure of serving in my new role as President and CEO of PACICC for a few months and have had a great opportunity to do a “deep dive” into all of the core elements of its design. Like a new homeowner, I have begun to inventory the structure - with all of its strengths and weaknesses - and started to make a “to-do” list of work to be done. I have now provided that list, along with some recommendations for short-term priorities, to our Board. By this Fall, I am confident we will have made great progress on those short-term priorities. But, I also hope that, on the same schedule, we will be able to craft a roadmap for the years ahead - that will chart a course for what I am thinking of as “PACICC 2.0.”

I started with a review of our Capacity. The good news is that we start with a fully functioning institution ready to do the job. And we start with a strong (if tiny) team performing great work in research, risk management and core administrative functions. However, there are areas of potential improvement to think about. On the review list could be items like; moving to a modern, risk-based model for our Administrative Assessment, ensuring we have signed “Intervention protocols” with all relevant provincial regulators, ensuring full financial data disclosure from all Members (amazingly we currently “insure” clients of companies that provide us with no “underwriting” information), potentially embedding PACICC in federal law and (finally) getting key amendments to the *Winding-up and Restructuring Act*.

I have also evaluated our Capabilities. We do have a strong team, but none of the current PACICC staff (including the new CEO) have any practical experience with the actual managing of an insolvency. Desktop simulations with regulators and liquidators will be a 2020 priority, as they will enable us to update our contingency plans. And there are some new elements of contingency planning that need to be built from scratch. “Social Media” didn’t exist last time PACICC was called upon to help manage an insolvency. So we have already initiated a process to review all contingency communications plans and update them to reflect modern digital best practice.

Looking at our core Mission/Mandate, there are also a handful of specific files that need attention. Ensuring our Coverage and Benefits are both adequate and responsible is a core obligation of the organization. A Review of both is the key Priority Issue in our 2019 Plan (discussed on P. 2 of this issue of *Solvency Matters*). We intend to engage broadly with the industry, regulators, brokers and consumers as we develop recommendations for any changes - to be considered by our Board in November and by our Membership in April of 2020.

In the next few weeks, our Chief Economist Grant Kelly will be publishing an important Research Paper regarding three potential default scenarios. The industry has changed in the 30 years since we were founded, with far fewer small players…and many more mid-sized and large insurers. If a natural catastrophe were to mortally wound one of these, the current PACICC model would be strained. The reality is that insolvency and liquidation is an extremely costly and inefficient way to manage larger insurer insolvencies. When PACICC was founded, we were given the broad authorities of a full “resolution authority.” These powers have never been used. It is time to explore whether or not we should develop a deeper toolkit and establish clear parameters with the industry about if, how and when we might employ new early intervention tools. This topic will be the key Priority Issue in our 2020 Plan.

Finally, there remains the outstanding issue of Quake. We are working closely with the IBC to develop options for consideration by the Federal Government. More on this to come in the next issue!

Alister Campbell is President and Chief Executive Officer at PACICC

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