Solvency Matters

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

PACICC

Issue 7 - September 2019

Insolvency protection for home, automobile and business insurance customers

PACICC Priorities

Coverage and Benefits Review

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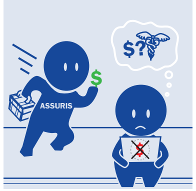

Emerging Issues (Stephanie Greer – Assuris)

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Assessing PACICC's Assessment System (Grant Kelly)

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Risk Officer's Forum (Ian Campbell)

Upcoming Risk Officer's meetings and webinars

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

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From the Desk of the President (Alister Campbell)

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Industry Events

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

October 28 (Morning)
OSFI Annual Risk Management Seminar

October 28 (Afternoon)
PACICC Risk Officer's Forum Meeting

October 29
IBC Regulatory Affairs Symposium

November 7
Toronto Insurance Council Annual Black Tie Dinner

November 26-27
Canadian Financial Services Insolvency Protection Forum

February 3-5, 2020
CatIQ Connect

PACICC Priorities

Coverage and Benefits Review

PACICC's Memorandum of Operation obligates the Corporation to review its coverage and benefits periodically to ensure that they remain relevant and appropriate. At its Fall 2018 meeting, PACICC's Board of Directors approved a review of coverage and benefits as the Corporation's Priority Issue for 2019. Work on this file has been ongoing since that time. The Board's decision recognized the fact that PACICC policyholder protection measures must reflect changes in the marketplace affecting lines of insurance covered by PACICC, as well as the cost of claims in those lines.

PACICC last undertook a comprehensive review of its coverage and benefits during the summer of 2006. Some 86 percent of PACICC Members participated in the consultation. Results of the review were presented to the PACICC Board in November 2006. PACICC Members strongly endorsed improvements to the system of coverage and a focus on increased loss claims protection for policyholders who did not have access to sophisticated risk management.

With the near-unanimous support of participating Members, the Board endorsed the following coverage and benefit changes in 2007:

- Harmonize PACICC coverages with the CCIR classes of insurance;
- Change from an all-risk set of coverages to a defined-benefit set of coverages;
- Increase the loss claim limit for personal property policies to $300,000 (from $250,000) per eligible policy;
- Maintain the current claim limit for all other policies at $250,000 per eligible policy; and
- Maintain the current unearned premium coverage.

We conducted the 2019 review using three guiding principles:

1. **Fairness** – PACICC has an obligation to ensure that all insurance consumers affected by an industry insolvency are treated in a fair and impartial manner;
2. **Transparency/Clarity** – It is important that any recovery options and benefit entitlements available to insurance consumers are appropriate, clearly defined and easily understood; and
3. **Modernization** – PACICC must ensure that its coverage and benefits are relevant and appropriate and reflect current market realities.

Over the past number of months, PACICC has consulted with a number of industry stakeholders, including an expert panel, IBC Board members and IBAC's Executive Committee. These discussions helped to shape a Consultation Paper that was recently distributed to all Member Insurers for their review and comment. Public consultations with insurance consumers have also been undertaken using focus group sessions as well as a national quantitative survey. The Consultation Paper lists 10 preliminary recommendations covering a broad range of issues, including: claim limits, recovery of unearned premiums, statutory accident benefits for automobile coverage, definitions of lines of coverage, coverage inclusions/exclusions, commercial risk coverage eligibility, Strata coverage, the process for hardship case review and the purchase of excess reinsurance.

PACICC is seeking to ensure that any actions taken are balanced, thoughtful and consistent with the Corporation's mandate. PACICC has a duty to protect eligible policyholders from undue financial loss, minimize the costs of insurer insolvencies and help to ensure a high level of consumer and business confidence in Canada's P&C insurance industry. Following the public and Member Insurer consultations, a final list of recommendations will be presented to the PACICC Board for consideration at its November meeting. Any Board-approved changes to PACICC coverage and benefits must then be approved unanimously by all provincial regulators in order to take effect. The earliest that this could happen is in the Spring of 2020.

Developing an Early Intervention Framework for PACICC

The most recent PACICC *Why Insurers Fail* Research Paper explores whether alternatives to liquidation could produce better outcomes for policyholders and member insurers in three default scenarios. The Paper concludes that in the case of a default of a small carrier, the current PACICC Model would continue to work well. However, the traditional insolvency and liquidation model might 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.

The paper also suggests the circumstances in which PACICC might choose to intervene prior to a Court-ordered wind-up. These could include:

a) Estimates showing that the cost to member insurers of early resolution would likely be materially less than the cost of full liquidation

b) The determination that the threat of serious reputational damage to the P&C industry could be minimized or avoided.

c) Discovery that market circumstances at the time of potential defalt were "outside the market" – meaning that often-used methods to support an orderly market exit were either unavailable or impractical for the troubled company; and

d) Confirmation that PACICC's financial interests could be adequately protected in the absence of a Court-ordered wind-up.

Proposed project timing

The purpose of this Paper was to provide the context for a discussion with all key stakeholders. PACICC will examine Canadian (e.g. Assuris/CDIC) and international best practices (via PACICC's membership in the International Forum of Insurance Guarantee Schemes (IFIGS)) in this area. This examination 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 such early interventions tools.

Reducing systemic risk

The PACICC research papers regarding potential systemic pressures as a result of a large Cascadia event (published in 2013 and 2016) were effective in putting this issue firmly on the public policy agenda. The bottom line of these studies 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.

Canada is the only Quake-exposed developed nation without some form of government-backed Quake Program/Plan. We believe the absence of a federal Quake/Catastrophe Funding Mechanism is a major shortfall in the public infrastructure of our nation. Finance Canada continues to study this issue in depth, however it is unlikely that any decisions will be made before the federal election in the fall of 2019. PACICC continues to partner with the IBC to help the Government of Canada design and implement a comprehensive Quake/Catastrophe Funding Mechanism.

Emerging Issues

Rapid Resolution - by Stephanie Greer – Assuris

Assuris requires better information from its member companies to ensure that it can act quickly when a company fails so that policyholders are protected, costs are kept to a minimum and the reputation and stability of the life insurance industry is retained.

Consumer Expectations

The age of delayed gratification is over. Consumers expect everything to be available now. They expect to be able to buy their electronics over the internet and have them delivered the same day. They expect to be able to access their bank accounts every minute of every day. And if their life insurance company fails, they will expect there to be an instant solution. Past life insurance failures were dealt with quickly, policyholders were notified within days, received updated statements in weeks and transferred to a new solvent company in months. But that was under the standards of the 1990s. By today's standards, that is glacially slow. Consumers now expect to be advised of the problem and the solution on the day their life insurance company fails.

A New Resolution Approach

This new consumer expectation drives us to a new approach to the resolution of a life insurance company – a Rapid Resolution. The keys to providing Rapid Resolution are:

- comprehensive information on the solvency position of the company;
- intervention by the supervisor when there is insufficient capital;
- well thought out generic resolution plans; and
- availability of company-specific resolution information.

While we have comprehensive information on the solvency position of companies, we have a wish list of improvements. The most important request is for better standardization of information to allow better cross-company comparisons to detect the companies taking above-average risks. Canadian supervisors are committed to closing a company when it has insufficient capital, rather than waiting for it to be technically insolvent. Assuris has well considered generic resolution plans covering the basic options of transfer or wind-down of the business. The plans also cover subtler options: use of guarantees, reinsurance and our bridge institution, CompCorp Life.

Much of the information needed for Rapid Resolution is the same as the information used for solvency assessment: Life returns, financial statements, Appointed Actuary's reports, Dynamic Capital Adequacy Test (DCAT) reports and Own Risk and Solvency Assessment (ORSA) reports. Additional resolution information is also contained in recovery plans prepared by a company. However, there is an information gap if we are to achieve Rapid Resolution.

Information needed for Rapid Resolution

To be ready for Rapid Resolution, we need specific company information on: realizable value; trapped capital; and complex financial contracts.

Realizable Value

- **Policyholder liabilities** – The value of the policyholder liabilities on the balance sheet may be significantly different than the value that a potential buyer would place on them. The value of the liabilities might also be different from the value if the resolution option was to run the business off over time. Cash flow projections from which the liabilities are calculated together with their present value under different interest rate assumptions would help Assuris estimate an exit value of the liabilities.
- **Assets** – The valuation of assets such as private placements, real estate and commercial mortgages can deteriorate quickly in a recession. Some assets may also not be available for resolution because they have been pledged as collateral. Assuris needs adequate information on the methods and assumptions used in determining asset default provisions and assets pledged as collateral.

Trapped Capital

- **Cross border** – While a company is solvent, there are few restrictions on the movement of assets across international borders. However, on entering resolution, supervisors in each country will prevent assets from leaving their jurisdiction until they are satisfied that all policyholders and creditors in their country have been paid in full. It is therefore essential that Assuris understands where the assets belonging to its member company are located before resolution action is taken.
- **Obligations to foreign branches and subsidiaries** – Policies held in a foreign branch of a Canadian company have a claim on the locally held assets and an additional claim on the Canadian assets of the company. In addition, the company may have given guarantees to support the claims of policyholders in foreign subsidiaries. Assuris needs to understand these obligations as they may reduce the assets available to protect Canadian policyholders. It also requires information on capital guarantees that have been given to foreign subsidiaries as these may result in assets leaving Canada when the company attempts a recovery from a financial crisis.
- **Legal entity** – Solvency regulation of a group of companies focuses on the overall solvency of the consolidated group. However, when a company fails, the resolution under insolvency law is by legal entity. Capital that may appear to be available at the consolidated level may be trapped in other legal entities such as foreign subsidiaries or other Canadian companies in the group. Before entering resolution, it is essential that Assuris understands the solvency and capital position of every legal entity in the group of companies.

Complex Financial Contracts

- **Derivatives** – Most derivative contracts will terminate on resolution. It is essential to understand the impact on the fair value of the company and the additional risks the company will be exposed to without these hedging instruments in place.
- **Reinsurance** – Reinsurance can be a source of strength or weakness when a company encounters financial difficulty. Assuris needs information to evaluate the impact in resolution of both external and inter-group reinsurance.

Rapid Resolution

With the right resolution information added to the existing sound Canadian system of supervision and resolution, it will be possible to meet policyholder expectations by announcing the solutions along with the problems when a life insurance company fails. A Rapid Resolution will allow Assuris to better protect Canadian policyholders.

Assessing PACICC's Assessment System

- by Grant Kelly

One of PACICC's key roles is to provide liquidity to the estate of a failed insurer. To collect the required funds, PACICC assesses Member Insurers. PACICC has used its assessment power 11 times since the Corporation was founded. The last time PACICC assessed Member Insurers was to protect the policyholders of Markham General in 2003 – $20 million was required.

PACICC assesses Member Insurers competing in the same province(s) as the failed insurer – based on their market shares. For instance, if a PACICC Member that only writes business in Ontario fails, PACICC would assess the 139 insurers that reported positive Direct Written Premiums (DWP) in Ontario in their 2018 financial filings, based on their share of the province's insurance market. If a New Brunswick-only insurer were to fail, the assessment cost would be shared across 112 PACICC Members.

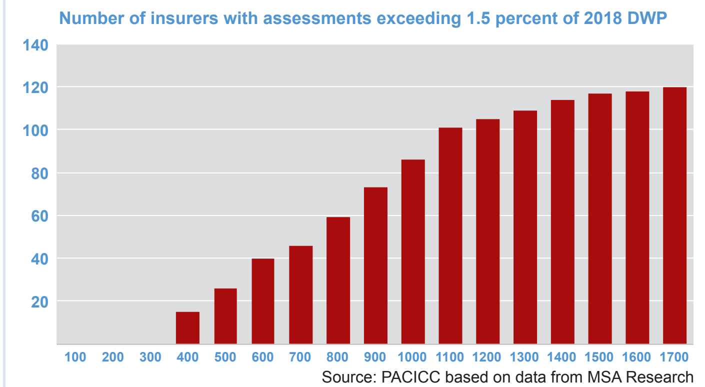
PACICC's Memorandum of Operation limits the annual amount that it can assess in any single year to 1.5 percent of covered DWP. Thus today, PACICC could assess more than $900 million annually to protect Canadian policyholders. There is no limit however, on the number of years for which PACICC can require this maximum amount.

Recently, PACICC modelled the impact of a large assessment if an Ontario-based insurer was to fail (See Figure 1). Up to a required assessment of $300 million, no member insurer reaches the 1.5 percent annual maximum requirement. However, at $400 million, 15 PACICC Members would reach this threshold and with a $1 billion assessment, 86 PACICC Members would take multiple years to pay their assessments. Above $1 billion, virtually all PACICC Members would require multiple years to pay their assessments.

Assessments have a direct impact on the capital position of the remaining insurers. PACICC estimates that an assessment of $100 million would only reduce the average MCT/BAAT of Member Insurers by 0.4 points (See Figure 2). However, the impact on a Member's Minimum Capital Test (MCT) or Branch Adequacy of Assets Test (BAAT) varies based on the size of the insurer's capital base. Naturally, the impact on MCT/BAAT scores grows with the size of the assessment required. At some point, the assessment would be large enough to reduce a Member's MCT/BAAT below their regulatory target (See Figure 3). An industry assessment of $1.7 billion or more would cause some solvent PACICC Members' test scores to fall below the regulatory minimum.

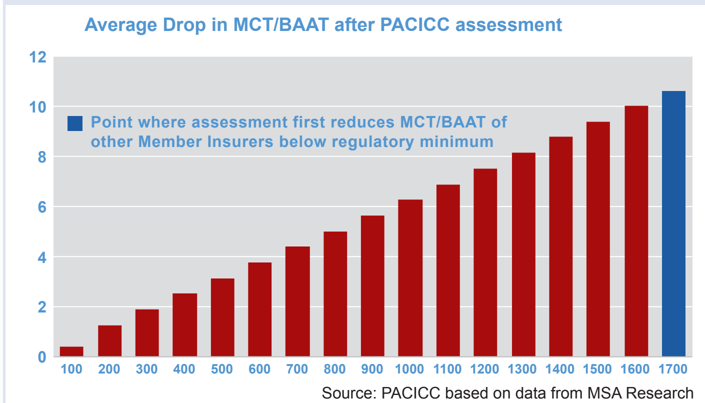
In 2016, PACICC's Board of Directors established a Risk Limit of two years of maximum assessments – currently $1.8 billion. If insolvencies were to occur requiring assessments larger than this amount, then the PACICC Board would need to discuss with stakeholders how to best handle the situation – balancing its obligations to policyholders with the viability of Canada's insurance system. While PACICC's assessment system has served policyholders and Member Insurers well for more than 30 years, PACICC and its stakeholders may wish to modernize the assessment mechanism in order to ensure we can maintain policyholder confidence in the future.

Number of Members requiring multiple years to pay



Source: PACICC based on data from MSA Research

Average impact on Member MCT/BAAT



Source: PACICC based on data from MSA Research

Grant Kelly is Vice President - Financial Analysis & Regulatory Affairs and Chief Economist

Solvency Analysis

- by Grant Kelly

Solvency risk remains high in 2nd quarter

In the second quarter of 2019, Canada's P&C insurers rebounded from a very poor first three months to post higher profits – 12.6 percent ($100 million) higher through the first six months of the year compared to the first six months of last year. This is positive because the most important indicator of long-run solvency of insurers and stability of the insurance marketplace is steady, sustainable earnings. PACICC's analysis of these results, however, raises concerns about the sustainability of these earnings.

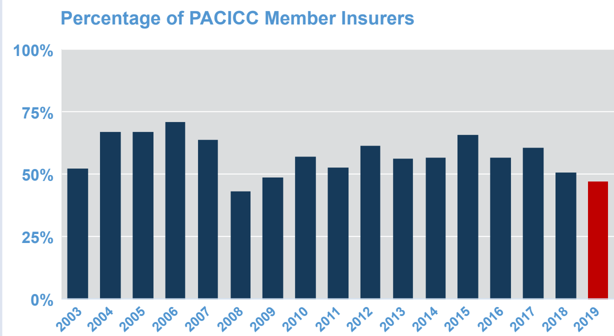
The rebound in profitability was due to investment income growing by $1.2 billion compared to the same period in 2018. $1 billion of this amount was unrealized gains on the investment portfolios that are required to be recognized as income for accounting purposes before the investment is sold – mark-to-market. This required accounting practice may make the second quarter look more profitable, but only temporarily, particularly if interest rates were to decline from current levels.

The industry's underwriting results were significantly worse than the prior year – by $400 million. Poor underwriting results are not uncommon for a portion of the market. However, through the first six months of 2019, fewer than half of PACICC's Member Insurers reported an underwriting profit. Just one time in the past 15 years – in the depth of the 2008 financial crisis – have underwriting losses been this widespread across the industry.

These poor underwriting results can lead to solvency risk particularly because they are in auto lines where prices are regulated – Ontario, Alberta, Nova Scotia and New Brunswick. In these markets, it will take legislative and regulatory change to improve results. There was little comfort in the property lines either, as commercial property markets were also unprofitable in six provinces – Newfoundland and Labrador, New Brunswick, Quebec, Ontario, Manitoba and Saskatchewan. Personal property markets were unprofitable through the first six months of 2019 in three markets – Prince Edward Island, New Brunswick and Quebec.

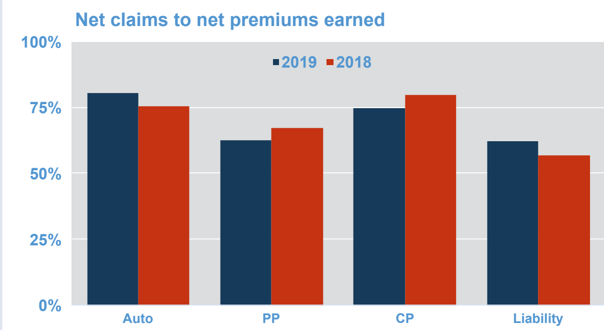
The final six months will need to show significant improvement if overall results are to materially alter this troubling picture.

PACICC Members with underwriting profits



Source: PACICC based on data from MSA Research

Loss Ratios



Source: PACICC based on data from MSA Research

Select Solvency Indicator Ratios

($ millions)	2019	2018
Average Equity	$51,002	$49,967
Return on Equity (ROE)	4.6%	4.1%
Return on Investment (ROI)	4.3%	2.2%
Comprehensive ROE	9.2%	2.7%
Comprehensive ROI	6.5%	1.5%
MCT Ratio (Capital Available/ Capital Required)	236.9%	237.0%

1st Six months of 2019 Financial Year Results

($ millions)	2019	2018	
Direct Premiums Written (DPW)	$31,693	$29,016	9.2%
Net Pemiums Earned (NPE)	$24,886	$24,793	0.4%
Net Claims Incurred	$17,364	$17,290	0.4%
Operating Expenses	$8,322	$7,858	5.9%
Underwriting Income	-$668	-$236	83.1%
Net Investment Income	$2,335	$1,176	98.6%
Net Income	$1,165	$1,035	12.6%
Comprehensive Income	$2,340	$674	247.2%
Combined Ratio	103.2%	101.4%	
Net Loss Ratio	69.8%	69.7%	
Expense Ratio	34.4%	31.7%	

Source: MSA Research as of August 26, 2019

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 downtown Toronto. 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 stakeholders 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 – Monday, October 28

Location:	**Royal York Hotel**, Toronto, Territories Room, Conference Floor
Keynote:	**Andrew Cartmell**, President & CEO, Saskatchewan Government Insurance
Topic:	*CEO Perspective on ERM*
Panel:	**Paul Field**, President, CEO & CFO, Old Republic Canada/Old Republic Insurance Group **Matt Moore**, Senior Vice President, Highway Loss Data Institute, IIHS **Pete Walker**, Chief Technical Underwriter, Aviva Canada Inc.
Topic:	*Cannabis Review – One Year In*
Panel:	**Michele Falkins**, Vice President and Chief Financial Officer, Heartland Farm Mutual Inc. **Kathryn Hyland**, Senior Vice President, Group Risk Management, Swiss Re **Sonia Kundi**, Vice President, Global Risk Innovation, Avivalc.
Topic:	*Review of OSFI Annual Risk Management Seminar Discussion*

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, University of British Columbia 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

- by Alister Campbell

Earlier this year, we published the 13th edition in our *Why insurers fail* research series. In that paper, entitled *Alternatives to Liquidation – Exploring the case for expanding Canada's P&C Resolution Toolkit*, our Chief Economist Grant Kelly walks through three carefully constructed scenarios and tests how effectively the traditional PACICC model for managing liquidation and insolvency would respond. There's good news and some not so good news.

The good news is that the thoughtfully conceived design of PACICC, as it was established by the industry 30 years ago, still holds up very well. In fact, in the first Scenario tested – the case of a traditional default of a small, poorly managed insurer – the mechanisms that PACICC has used in the past to manage such cases would still prove very effective. Even better, the standard PACICC model would be an acceptable method of handling the second Scenario – the default of a mid-size insurer, triggered by a natural catastrophe. However, with the default of an insurer of this size, the consequences for the industry (and for certain members of the industry) could be more significant, in terms of the capital impacts from the required PACICC Assessment. And the number of adversely affected policyholders having their claims capped by PACICC settlement limits would be larger, with all the associated negative reputational impacts for our industry – exactly the negative impacts PACICC was originally intended to mitigate.

The bad news is that the case of our 3rd Scenario – the default of a large carrier triggered by external shock or dramatically adverse underwriting outcomes – could stretch our traditional model to the breaking point. Capital impacts from our Assessment would be material for many and place a multi-year and substantial burden on a smaller but still significant number. Which is why it is so timely to begin the industry conversation around "Alternatives to Liquidation".

When PACICC was first designed in a partnership between industry and regulators, we were given all the powers of a "resolution authority" – **able to engage prior to liquidation** to:

- inject capital;
- issue a guarantee on a book of business;
- assist in sales of books, assets or companies; and
- offer guarantees (including use of reinsurance).

In fact, back in our history, we have twice engaged in activities from this list (these two instances will be detailed in a *Why insurers fail* paper to be published in the Spring of 2020). These instances are rare, because historically, PACICC has had limited advance warning of looming insolvency. However, we now have much greater line of sight into evolving problem cases, as a result of the signed Intervention Protocols now established with AMF, OSFI and soon with the other provinces.

As Grant Kelly's paper demonstrates, having a richer toolkit of options is in the interests of both our industry and Canadian consumers. But establishing defined criteria for the possible use of such tools in future will be important – to ensure we have not just the legal authority to act – but have earned the "social license" from our industry Members – that will allow us to act swiftly and effectively to address the next insurer solvency crisis. We will also need to collaborate with our key regulatory stakeholders to ensure that when they are forced to seek our help, we stand ready to creatively and effectively respond.

This topic has been established by our Board as our Priority Issue for 2020. I am looking forward to the conversation!

Alister Campbell is President and Chief Executive Officer at PACICC

Denika Hall
Editor and graphic design

SOLVENCY MATTERS

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

PACICC

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