SOLVENCY MATTERS

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

PACICC

Issue 10 - June 2020

Insolvency protection for home, automobile and business insurance customers

PACICC Priorities

Priority Issue for 2020

Expanding PACICC's Resolution "Toolkit"

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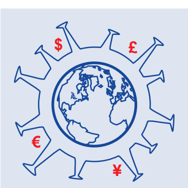

Emerging Issues (Donald P. Callahan)

COVID-19: One Observer's View of the Pandemic's Impact on Reinsurance

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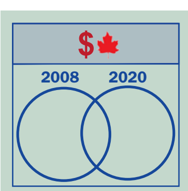

A rough start to a challenging year (Grant Kelly)

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Risk Officer's Forum (Ian Campbell)

Upcoming Risk Officer's Forum meetings and webinars

Next Forum Meeting – Thursday, September 17

Speakers are being confirmed and will be announced shortly. Following are the subject areas that will be on the Agenda: Government Regulation, Class Actions and their Funding...

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From the Desk of the President (Alister Campbell)

What Could Go Wrong?

A critical question underpinning any insurance underwriter's thought process is – "What could go wrong?" The question is not asked to lay the base for a negative decision. To the contrary…

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Industry Events
(subject to confirmation)

September 17
PACICC Risk Officer's Forum Meeting

September 20-23
CIAA Annual Conference

October 4-7
RIMS Canada Conference

October 19-20
Canadian Insurance Financial Forum (CIFF)

October 21
PACICC Emerging Risks Webinar - Government Regulation

November 9-10
InsureTech North

Priority Issues: 2020 to 2022

Priority Issue for 2019

Coverage and Benefits Review

At its April 2020 meeting, PACICC's Board of Directors gave final approval to the proposed changes to PACICC's claims limits and increased the amount of unpaid premiums that would be refunded to policyholders. The new benefits are:

- Claims limit for Personal Property claims is now $500,000 per policy
- Claims limits for all other types of covered policies are $400,000 per policy
- The maximum amount of unearned premiums rebate is 70% of $2,500 (maximum amount = $1,750)

The Board also directed PACICC staff to review these limits within three years (in 2023) and at least once every five years thereafter.

There are three items outstanding from the Board Resolution approved last November:

- The PACICC Board asked Management to present a documented policy for the processing of hardship claims, by November 2020
- PACICC issued a Request for Proposals to obtain reinsurance advice from multiple brokerages. PACICC has retained Guy Carpenter to act as its reinsurance broker
- PACICC prepared briefing materials for the Insurance Bureau of Canada to support their efforts to encourage provincial policymakers to move payment of auto accident benefit claims to the provincial Motor Vehicle Accident Claims Funds/Programs in Alberta, New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland and Labrador, consistent with the approach previously established in Ontario.

"Permanent Priority" Issue

Mitigating Systemic Risk from Quake

Despite sustained efforts from PACICC and IBC over recent years, we have not yet achieved a satisfactory resolution of the largest single risk facing PACICC and the Canadian P&C industry – systemic contagion driven by a large earthquake. The PACICC Board will consider a detailed Action Plan to guide the efforts of PACICC staff on this issue. The Plan will be revisited annually until a Federal backstop mechanism is in place. The Plan has two pillars:

1. Develop a national consensus on a Government mechanism to protect consumers from industry failure caused by a major earthquake.
2. Investigate incremental changes to the PACICC model to mitigate contagion risk.

In 2020, PACICC will work to address the following:

- Assist IBC in developing an industry-consensus proposal to Finance Canada
- Identify potential changes to the PACICC governance model that could make the industry proposal more palatable to Government
- Request that PACICC be formally recognized as a compensation association under the Federal *Insurance Companies Act*
- Establish an industry working group to investigate if the current assessment mechanism should be altered to reduce its adverse impact on Members
- Review the appropriate size of the PACICC Compensation Fund to reduce the impact of post-event assessments
- Develop materials to assist Insurance Bureau of Canada in an effort to change the treatment of auto accident benefit claims in Alberta and Atlantic Canada to align with Ontario model
- Expand PACICC's toolkit to include options in addition to liquidation.

Priority Issue for 2020
Expanding PACICC's Resolution "Toolkit"

PACICC could reduce systemic risk if it were able to develop options for Regulators to deal with distressed Member Insurers in addition to the cumbersome legal process of liquidation defined within the *Winding-up and Restructuring Act*. When it was first established, PACICC was granted many of the powers of a "resolution authority." However, we have rarely had the opportunity to use them. Evolving circumstances increase the likelihood that, in future, PACICC will be called upon to exercise these powers. However, prior to doing so, it would be vastly preferable if PACICC had established, in collaboration with Member Insurers and regulatory partners, the criteria which would be used by our Board to determine if, and how, to engage. It would also be wise for PACICC to develop a better understanding of how to operationalize these tools in practice, before ever being called upon to do so.

At its April 2020 meeting, the Board approved a Draft Resolution Protocol that outlines the conditions that need to be satisfied before PACICC would consider intervening to assist policyholders in circumstances where a Member Insurer is financially troubled, but has not yet been forced into wind-up by a Regulator. PACICC staff has been directed to receive feedback on the following Resolution Protocol:

1. **Recovery is unlikely** – In the words of the IAIS, the insurer "has no reasonable prospect of returning to viability."
2. **Market circumstances are "outside of the normal"** – Methods normally used to support an "orderly" market exit (such as voluntary run-off) are impractical or otherwise unavailable.
3. **Company must exit the market** – At the end of the resolution activity, the company would be closed.
4. **Must be less expensive than liquidation** – Alternatives to liquidation considered by PACICC must be less expensive than liquidating the insolvent insurer.
5. **Shareholders of the troubled insurer will not benefit** – The focus is on protecting policyholders. No industry funds should end up in the hands of shareholders of the insolvent insurer.
6. **Governance of the troubled insurer will be changed** – The prior Board of Directors and Senior Management are replaced or have governance authority transferred to secure oversight in which PACICC can have confidence.
7. **Advance notice** – Sufficient time exists for PACICC to take meaningful action.
8. **Reputation may be at risk** – A Member insolvency may harm confidence in the P&C insurance industry.

The COVID-19 pandemic has forced changes to PACICC's plans to consult Member Insurers through in-person workshops and group presentations. No changes will be made by the PACICC Board without feedback from Member Insurers and Regulators.

Priority Issue – 2021
Contingency Planning and Desktop Simulations

PACICC constantly works to upgrade its capabilities to respond to an insolvency. In 2019, the focus was on upgrading our internet and social media response capabilities. We have also begun to build out a modernized, step-by-step, Insolvency Contingency Plan, with an associated Communications Plan, including pre-prepared materials and back-up infrastructure. Other than live testing in a real-life case, the best method for testing Contingency Plans is via "desktop" simulations. The AMF has agreed to conduct a simulation with PACICC in 2021.

Priority Issue – 2022
Strategic Evaluation of PACICC Branding (Internal/External)

A core component of the PACICC three-part Mission is to "maintain consumer confidence in Canada's P&C industry." This obligation is also a consistent element in the objectives of all the other policyholder protection entities in Canada. Many of these schemes have consumer-facing, branding strategies as part of their effort to maintain and grow confidence in their sectors of financial services. In 2022, PACICC will evaluate if and how it might expand its branding footprint – drawing on best practices in Canada and internationally. Within the industry, there are also opportunities to materially enhance stakeholder awareness, particularly given the absence of any recent insolvency. Brokers and agents could be a significant target market for branding and increased awareness. The proposed Strategic Evaluation would examine ways in which PACICC could enhance industry understanding of the essential value that PACICC brings to the consumer trust equation.

Emerging Issues

COVID-19: One Observer's View of the Pandemic's Impact on Reinsurance - by Donald P. Callahan

Whether it be dollars, pounds, euros, yen, yuan or any other currency, the COVID-19 event will be the largest insured loss in history.

I begin this brief essay with that first sentence to inject a little shock and awe, but also because it demonstrates that COVID-19 is the first global loss across all currencies, affecting every nation on the planet. We've never witnessed a planet-pervasive loss and, remarkably, I don't think we ever anticipated one.

There have been theoretical papers (and great fiction) written about global pandemics and reinsurers have certainly developed models to quantify and parametrize these exposures. For some reason, however, we never fully envisioned a pandemic across all continents or, for that matter, an insured loss ranging from at least $50 billion to as much as $100 billion, without any physical damage to property. Compounding this disaster are industry investment erosions of an analogous magnitude. This direct correlation between insurance risk and investment risk is also unprecedented.

Much more tragically, who would have imagined a pandemic that would infect five million people and cause four hundred thousand fatalities midway through its scourge?

The early reinsurance loss estimates are inconsistent, lumpy and astounding.

Lloyd's, a market veteran of over three centuries, calls COVID-19 its largest single loss with a current estimate of $4 billion. Munich Re's early loss estimate is $1 billion. In contrast, SCOR reported on April 30th that it has "incidental and immaterial" exposure to many of the lines of business affected by COVID-19. The lines most heavily hit appear to be event cancellation, mortgage insurance, and contingency business.

Whether it be dollars, pounds, euros, yen, yuan or any other currency, the COVID-19 event will be the largest insured loss in history.

Exor's $9 billion sale of Partner Re to Covea collapsed under the weight of COVID-19. Everest Group posted a $150 million incurrence for its pandemic losses. Swiss Re has initially declared a $500 million loss estimate along with $300 million in investment losses.

COVID-19 losses and dwindling investments are not the sole influencers in the reinsurance arena. The ILS market is stumbling from its own new disease called "trapital" where the players are unable to re-invest capital trapped in COVID reserves. Furthermore, retro (reinsurance of reinsurance) costs are rising rapidly, such that the reinsurers who are able to report moderate net COVID losses this year will be suffering under the weight of heightened retro premiums next year.

Undoubtedly, the reinsurance market is hemorrhaging, but are any of the wounds mortal? Depending on whose estimate you choose and which classes of reinsurance capital are included, the global reinsurance market's capital is between $500 billion and $700 billion, with growth over the last decade of more than 50%.

A May 18th commentary from S&P Global Rating suggests a reinsurance loss of $30 billion (keeping in mind that insurers are the first line of fire and choose to retain a meaningful share of each catastrophe). Even if we inflate S&P's COVID-19 estimate to $50 billion, the reinsurance market appears fully able to bear the pain. Yes, it's more than an earnings loss but the market is indeed durable and capital remains plentiful.

With losses come northward vectors on pricing and conditions. May 1st renewals were a taste of what we ultimately expect. These contracts were negotiated in mid-April and many came down to the wire with reinsurers struggling to get a handle on the cost implications of COVID-19, on whether business interruption claims were in fact valid, on fears of retroactive legislation, and, most exasperatingly, on not being able to reach consensus on how to exclude future pandemic losses.

Donald P. Callahan, President and CEO, Guy Carpenter Canada

Next up are the July 1st renewals. This is a major renewal date in many markets. In Canada, there are only a handful of “July Ones” but they may well serve as a harbinger for January 1st. My sense is that the market will come to an agreement on pandemic exclusions and that most exposed contracts will contain a clause that looks a lot like the LMA 5394. This is the London Market Association’s Communicable Disease Exclusion, which is viewed as absolute.

Rates will be up, year-over-year at July 1st and at January 1st. The degree of increase will depend on local experience, but also the incidence of other Nat Cat events (particularly U.S. hurricane); the extent to which subject premiums have diminished; the rise and fall of COVID-19; a second wave; the efficacy of a potential vaccine; the anxiety over a COVID-21; and, all of the associated economic ramifications.

Not an easy year for observers...

A rough start to a challenging year - by Grant Kelly

The first quarter of 2020 will be long remembered by all Canadians for creating so many new worries. It is already hard to remember, but an oil price war between Saudi Arabia and Russia caused a fall in oil prices in early March and by the end of that month the TSX Index had dropped by 29.5%. These significant adverse economic events occurred before the full impact of the COVID-19 virus had been felt and introduced Canadians to the meaning of new terms such as “social distancing” and “flattening the curve.”

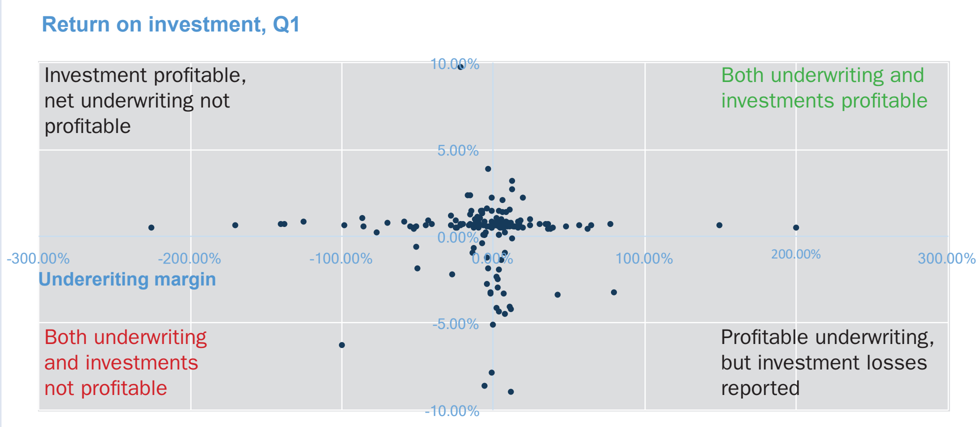
Canada’s P&C insurers were not immune in these stressful times. In the first quarter of 2020, 74 of PACICC’s 178 Member Insurers reported losses. In fact, more P&C insurers reported losses in Q1 2020 than in the 2008 financial crisis. To put this number in further perspective, it represents the largest number of unprofitable insurers reported since the early 2000s (a period in which insurers reported the largest losses in industry history). It is worth recalling that the poor financial results of the early 2000s were followed by double-digit price increases and significant availability problems for some consumers and businesses. Governments felt forced to introduce additional regulation on insurers. How things will play out through the remainder of this year is still uncertain. Suffice it to say, it has been a very rough start to the year for P&C insurers in Canada.

However, there is reason for hope that history will not repeat itself. PACICC has examined the source of earnings (or losses) for insurers in the first quarter of 2020. Generally speaking, insurers have two sources of income: underwriting (selling insurance) and investing. Each insurer has its own appetite for risk, but each is in the business of measuring and managing risk. A key objective of this focus on risk is to ensure that insurers are prepared for “unknown” risks, such as those experienced in the first quarter, without sacrificing the solvency of their company. So, it is worth noting that 59 PACICC Members reported profits from both underwriting and investments, notwithstanding the challenges they face in Q1. These insurers are well-positioned to manage risks associated with COVID-19-related economic uncertainty. Another 69 Member Insurers reported that negative underwriting income was offset by profits on their investments. More than half of PACICC’s Member Insurers reported positive investment income, despite a massive decline in the stock market – largely because a majority of insurers in Canada had zero stock market exposure going into 2020.

Of course, some PACICC Member Insurers did hold equities as part of their investment portfolio and were thus negatively impacted by the decline in the stock market. Of these, 19 PACICC Members Insurers reported that the positive underwriting income from their insurance operations offset their investment losses. This leaves only 19 PACICC Member Insurers which reported losses on both their insurance operations and their investments. So, there is increased solvency risk for this subset of Member Insurers.

It is clear that the COVID-19 crisis has negatively impacted insurer earnings in the first quarter of 2020. Fortunately, the overall solvency of our nation’s P&C insurers remains strong. PACICC’s Member Insurers were well-capitalized going into this crisis, and appear well-positioned to fulfil their commitments to policyholders. However, in the medium- and longer-term, our industry is simply a proxy for the growth and prosperity of our nation. As Canada’s economy suffers, so too will our industry. All the more reason for governments, industry and citizens to do all we can to tackle this virus and return our nation to full health, as soon as possible.

Sources of insurer profitability



Source: PACICC based on data from MSA Research

Solvency Analysis

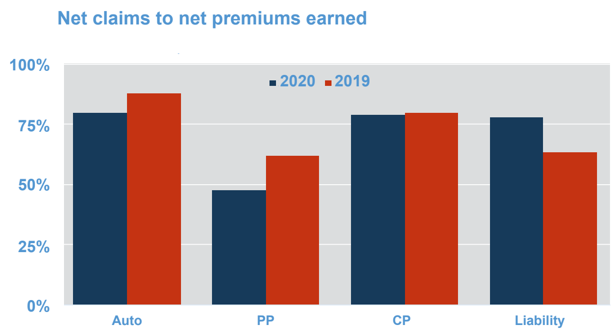
- by Grant Kelly

In the first quarter of 2020, the net income of Canada's P&C insurers was 30.7 percent lower than the year prior. The 30 percent decline in the stock market resulted in an industry-wide drop of $1.2 billion in the industry's Net Investment Income, compared to the same period a year earlier. Fortunately, improving insurance results mitigated the impact of declining investment losses for many insurers.

The improvement in first quarter underwriting results came from personal lines – Auto and Personal Property. These results include the first couple of weeks of stay-at-home orders, as Canada fought the COVID-19 pandemic. The national loss ratio for Auto insurance fell from 87.7 percent in the first quarter of 2019 to 79.7 percent in the first quarter of 2020. There was a similar improvement in the Personal Property loss ratio. It fell from 61.7 percent in 2019 to 47.6 percent in 2020.

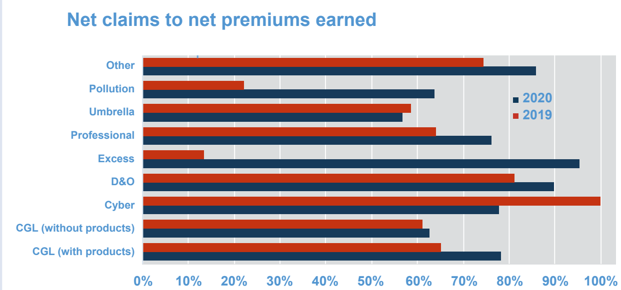
While most commercial policies clearly exclude coverage for pandemics, there are some bespoke policies that included coverage. The early negative impacts of COVID-19 are seen in liability loss ratios as insurers attempted to quantify their estimated losses. The loss ratio for Comprehensive General Liability rose from 65.2 percent in the first quarter of 2019 to 78.3 percent in the first quarter of 2020. Loss ratios also climbed in Directors and Officers Liability Coverage, Excess Liability and Pollution Liability policies.

Loss Ratios



Source: PACICC based on data from MSA Research

Liability Loss Ratios



Source: PACICC based on data from MSA Research

Select Solvency Indicator Ratios

($ millions)	Q1 2020	Q1 2019
Average Equity	$46,215	$45,144
Return on Equity (ROE)	1.3%	2.0%
Return on Investment (ROI)	-0.2%	4.8%
Comprehensive ROE	-9.7%	11.7%
Comprehensive ROI	-5.5%	9.5%
MCT Ratio (Capital Available/Capital Required)	231.3%	240.8%
BAAT Ratio (Net Assets/Capital Required)	359.5%	386.0%

1st Quarter 2020 Financial Year Results

($ millions)	Q1 2020	Q1 2019	Percentage Change
Direct Premiums Written (DPW)	$13,280	$11,779	12.7%
Net Pemiums Earned (NPE)	$12,708	$10,057	24.2%
Net Claims Incurred	$9,020	$7,263	24.2%
Operating Expenses	$3,863	$3,644	6.0%
Underwriting Income	-$113	-$789	-85.7%
Net Investment Income	-$60	$1,124	-105.3%
Net Income	$156	$225	-30.7%
Combined Ratio	101.4%	108.4%	
Net Loss Ratio	71.0%	72.2%	

Source: MSA Research as of June 3, 2020.

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 meetings (from 1:00-4:00 p.m.) 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.

N.B. Due to the pandemic our upcoming Forum Meeting will be held online

Next Forum Meeting – Thursday, September 17

Location:	As with the April 1 Forum Meeting, it is expected at this time that the next Forum Meeting will be an online event, using video conferencing. This was necessitated by the outbreak of COVID-19. The format for the meeting will be confirmed closer to the date of the event.
Speakers:	Speakers are being confirmed and will be announced shortly. Following are the subject areas that will be on the Agenda: • *Government Regulation* • *Class Actions and their Funding* • *Cyber Security – Learnings from the Frontline*

Emerging Risks Webinars

Three Emerging Issues Webinars are held each year, connecting 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 21

Speaker:	Regulator representative to be confirmed
Topic:	*Government Regulation*

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

What Could Go Wrong? - by Alister Campbell

A critical question underpinning any insurance underwriter's thought process is – "What could go wrong?" The question is not asked to lay the base for a negative decision. To the contrary, it is the essential basis for making any truly informed decision to say "Yes" – with appropriate terms, conditions and risk transfer price. Obviously, being people trained to see "half empty" when others only want to see "half full" can leave the unfair perception that risk professionals have a gloomier world view than others. Especially when the most "gloomy" often end up as Chief Risk Officers (or CEOs of industry insolvency compensation funds).

Over the last five years, as good risk management hygiene dictated regularly updated Business Continuity and Disaster Recovery Plans, I have no doubt that CROs across Canada had to nag to ensure that over-worked colleagues found the time to focus on this essential but "low-priority" task. But I suspect that our entire industry is deeply grateful now. In the midst of the extraordinary challenges of "lockdowns" and "stay-at-home" rules, our industry has performed above expectations in maintaining customer/broker service levels and ensuring the performance of core finance, policy administration and claims services. We all can be very proud of this fact.

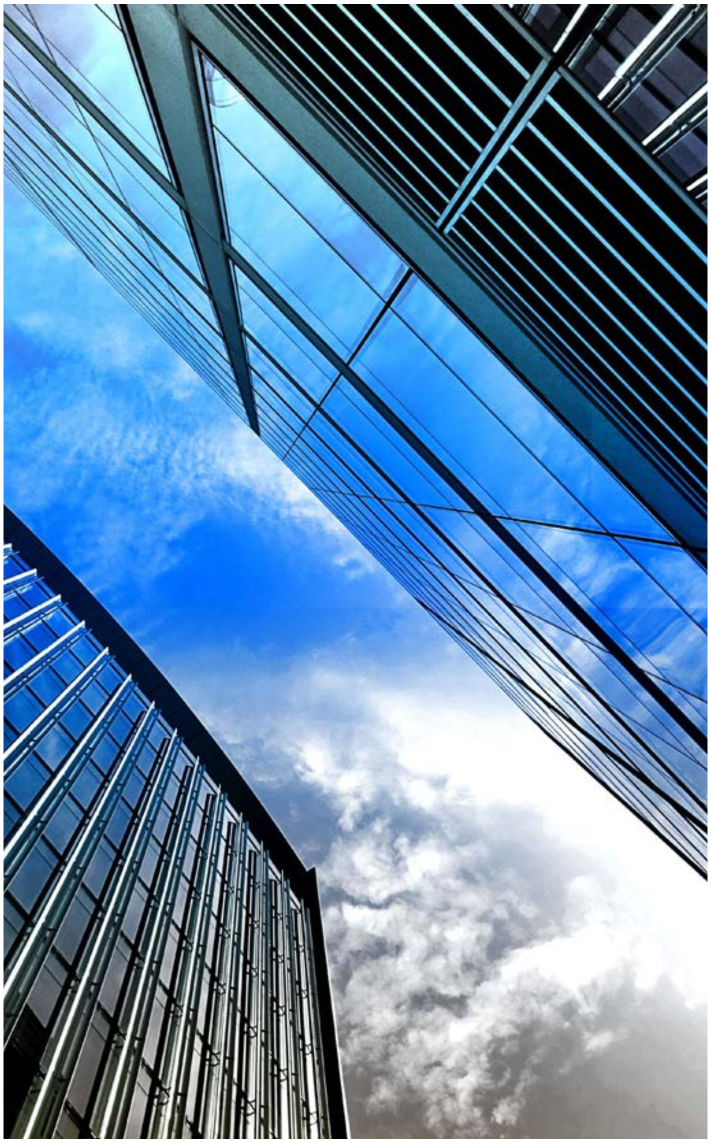
From a PACICC perspective, we have the obligation to keep asking that essential underwriter's question regarding the health of our industry and each of our Member Insurers. We are in regular dialogue with OSFI, Finance Canada, the AMF and other provincial regulators to ensure that we are aligned in understanding what this extraordinary period of uncertainty could yield in terms of insurer "distress."

The first source of potential distress is obviously any extraordinary losses triggered by the significant disruptions in the stock and bond markets, as the impact of COVID-19 caused major declines in equity values and unanticipated distortions in yield curves. As our Chief Economist Grant Kelly wrote in our last *Solvency Matters* newsletter, the Canadian industry entered this period well-capitalized. The industry was also prudently invested. In fact, 50 percent of PACICC Members held no equities at all in their investment portfolios. So, while we will need to see more financial reporting to be sure, it would appear highly unlikely that adverse investment outcomes triggered by COVID-19 will be a driver of any insurer "distress" in our country.

The second source of potential distress is underwriting losses due to obligations to honour policies written, and for which coverage is due. We would indeed expect PACICC Member Insurers with larger exposure to travel insurance, event cancellation insurance and/or trade credit insurance to have larger-than-normal losses. But they would likely be losses within the normal scope of a prudent underwriter's "What could go wrong?" checklist, and any insurers with exposure in these niche markets would likely have purchased appropriate reinsurance. Of course, there are certain segments where losses could prove substantial – liability policies for owners of private long-term care facilities come to mind. However, potential class-action losses in categories such as this may have a longer tail and allow some time to provide for adequate capital.

From a PACICC perspective, we have the obligation to keep asking that essential underwriter's question regarding the health of our industry and each of our Member Insurers.

It is the third source of potential distress which is uppermost in our minds in the short term. This is the risk of unanticipated losses driven by exposures not fully understood or intended. In this regard, the primary focus of all observers is on business interruption. Pandemic insurance was available in the market. Few purchased it. Contingent business interruption was available in the market – often as part of a logistics/supply-chain coverage – but purchased by only a few larger customers. Standard commercial policies generally had explicit exclusions (post-SARS) or relied on a clear requirement regarding physical damage to property. So…the "lockdown" business interruptions losses are generally and genuinely "not covered." However, there will be cases where manuscript wordings included more generous provisions. And there will also likely be cases where an individual insurer's wordings prove accidentally more generous than intended. And if this unanticipated (and unpriced) exposure produces material losses for certain insurers, it may accidentally test



catastrophe reinsurance treaties which were narrowly written to protect for Nat-Cat events only, rather than all perils.

There is one last source of potential distress which will require more monitoring over the medium term. And that is the potential for regulatory, judicial or legislated mandating of broader coverage than intended by insurers issuing policies in good faith. The events of this pandemic have placed great strains on our economy and our society. Such strains can have profound impacts on politics, and yield adverse public policy outcomes. By way of example, various U.S. state legislatures have seen alarming legislation tabled which could have significant adverse consequences for the insurance industry. The industry buys reinsurance for potential losses they intended to cover. And it holds capital for losses in excess of those anticipated. But no industry can withstand legislated mandates to retroactively cover exposures for which no coverage was offered or intended, no premium collected or reinsurance purchased. Bad public policy has a way of metastasizing across jurisdictions and borders. I take comfort in the strong public institutions which have performed so well in this crisis in Canada, and in the long history of our common law with its firm, negative view regarding retroactive legislation. But as an industry observer trained to ask “What could go wrong?”, it is this potential source of insurer distress which will definitely be a key area of focus for PACICC in the weeks and months to come.

Stay safe everyone!

Alister Campbell is President and Chief Executive Officer at PACICC