Solvency Matters

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

PACICC

Insolvency protection for home, automobile and business insurance customers

Issue 21 - April 2023

NEXT

From the Desk of the President

The Price of Money - by Alister Campbell

I had the opportunity to attend the Annual General Meeting of the International Association of Insurance Supervisors late last Fall in Santiago, Chile. The opening remarks were delivered by the IAIS Chair – from the UK – and her remarks were disturbing and gloomy. Her high-level recounting of the deeply stressful sequence of events that had forced the Bank of England to suddenly reverse course, and flood the system with liquidity, despite double-digit inflation which urgently called for a tightened monetary policy, was simply fascinating. The cause – as we have all since learned – was a rapid and totally unexpected movement in the market for UK debt (or "gilts" as they are known), in reaction to the ill-fated effort by then new – now "ex" – British Prime Minister Liz Truss, to cut tax rates while already running big deficits. These sudden movements forced large UK pension funds – many of whom, it was discovered, were employing "liability-driven investment strategies", and with rather more leverage than previously understood – to rapidly sell bonds from their portfolios… prompting a spiral of further sales as asset values plummeted. A systemic crisis was averted due to prompt action by the British central bank, but prudential supervisors the world over, had another vivid lesson of just how rapidly systemic risk can surface, and in places you might least expect it.

Returning home, I spent December hearing insurance industry colleagues describing just how grim and challenging the Canadian and global reinsurance renewal season was turning out to be. Obviously, a portion of the stress in the system was directly correlated with adverse underwriting results for the reinsurers, attributable to the particularly challenging natural catastrophe environment experienced worldwide in the last few years. But there was also another deep-rooted driver of the sudden decline in available market capacity. Bond prices had fallen everywhere, as central banks around the world raised interest rates to levels not seen in twenty years. And insurers, diligently matching assets to liabilities and reinsurers in particular, with particularly large portfolios of longer-duration bond assets to match their longer-duration liabilities, have all had to report significant mark-to-market write-downs on the value of those assets. The Swiss Re Institute estimated that global reinsurance capital had shrunk 30%, in large part attributable to this dramatic shift in asset valuations.

Controversial American economist and investment strategist Elaine Garzarelli was once quoted as saying that "Bonds are like men. The longer the maturity, the less volatile they are." But recent events have reminded us that the exact opposite is true. The rapid rise in interest rates world-wide had the greatest adverse impact on medium and longer-duration bonds. Just the kind that insurers and (especially) reinsurers buy to match their longer-duration liabilities. While it is the life insurance sector that has the most exposure to long-duration bonds, the last twelve months have seen such a shift in valuations that bonds of all durations were adversely impacted. Which meant our P&C sector was hit hard too. In the last issue of *Solvency Matters*, our Chief Economist Grant Kelly reported that – through nine months of 2022 – the Canadian P&C insurance sector was reporting negative investment income – for the first time ever (at least as far back as the roughly 50 years in our data set). The cold comfort he offered was that the losses were only "paper losses" and that –

assuming bond assets were held to maturity – those accounting losses would be recovered. And, in normal circumstances, that assumption would be completely valid. But, as the UK pension sector discovered…if unanticipated volatility forces the timing of asset sales, then accounting losses can necessarily become very real…very fast!

I began work on this column before the failure of Silicon Valley Bank. But the extraordinarily rapid failure of that large and previously well-respected financial institution (second largest failure after only Washington Mutual in 2008), represents another powerful reminder of the impact of sudden volatility. In that case, substantial paper losses necessarily became capital-destroying real losses, as depositors rushed to secure their funds and SVB was compelled to liquidate portions of its asset portfolio on particularly disadvantageous terms. It was an old-fashioned "run" on the bank which proved fatal, but the roots of the disaster can be directly traced to the largely unanticipated movement in bond prices in the year prior.

I entered graduate business school many years ago, already a proud possessor of several Arts degrees (Medieval English Economic History if you must know). Going in, I believed that, if I just learned how to understand the stock market, I would be successful in my future business career. I graduated (amazingly with a Finance major), firmly aware that the only thing I really needed to understand was in fact…the bond market! Lessons learned on how to think about "movements in the yield curve" were the most important lessons I learned at that school. I confess I struggled early, but had an epiphany, when legendary Finance professor and author Jeremy Siegel (I recommend *Stocks for the Long Run*) explained it to me simply as "the price of money".

Why this personal digression? Because, wherever we live, work, run our businesses and raise our families, there is almost nothing that matters more than "the price of money". When the yield curve moves as dramatically as it has in the past year, unanticipated volatility across all asset classes and throughout all developed economies is a certainty. And unanticipated events can trigger urgent sales of assets – sales which force the crystallization of accounting losses into actual losses – which is exactly what happened…in the UK last year…and to SVB this quarter. And, given the scope and scale of the mark-to-market losses that our own industry had on the books as we closed 2022, it is a risk scenario we need to keep very much in mind.

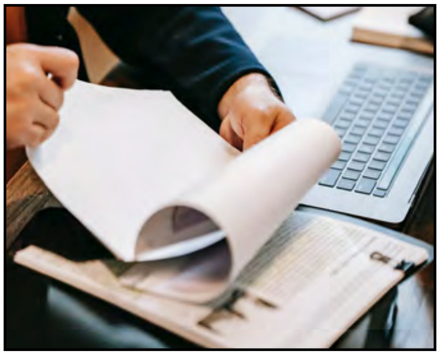
Of course, it is important to acknowledge that – as a general rule – you don't see "runs" on an insurer, the way you do when public confidence is lost in a banking institution. Rumours of a troubled insurer do not prompt policyholders to rush to crash their cars or burn down their homes. But a sudden, major, natural catastrophe, with huge numbers of urgent, short-tail property claims is just one example of the type of "capital event" that could trigger rapid, forced sales of the currently marked-down assets held by the insurers in our sector.

The Canadian P&C sector remains highly capitalized, properly reinsured, well managed and capably supervised. The risk of systemic instability thus remains very low. But, when the price of money moves dramatically, it is guaranteed that dramatic events will follow. As James Carville once said, "I used to think that if there was reincarnation, I wanted to come back as the president or the pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody." It is wise for all of us engaged in the sector to remain firmly aware that, when the mighty bond market moves, the consequences can almost certainly strike close to home.

Alister Campbell, President and Chief Executive Officer at PACICC

PACICC Priority Issues: Updates

"Permanent Priority" Issue



In 2021, we updated our Systemic Risk Model for the first time since 2016. Findings were published in a major research report (*"How Big is Too Big? The Tipping Point for Systemic Failure"*) which clearly demonstrated that there is a threshold – insured losses in excess of $35B – beyond which otherwise healthy insurers could fail due to contagion (because of their obligation to absorb the insolvency costs of any failed companies). This risk can and must be mitigated. We believe it is best addressed through some form of government backstop that is available to the industry – beyond the "tipping point" of a $35B loss event.

We continue to engage actively with all stakeholders in this ongoing policy dialogue. And in recent discussions with Finance Canada and the industry, options around possible "multi-peril" pools – which would help to manage a range of tail-risks faced by our country (including flood, fire, wind, as well as quake) – appear to have moved to the fore. We will continue to work closely with all related stakeholders to advance such discussions. But PACICC continues to remind those engaged in this important public policy work, that there is only one risk on this list which represents true systemic risk to the entire system. And that is earthquake. We very much hope that work on other important risk factors does not detract from the simple reality that Canada urgently needs a backstop mechanism against this extreme tail-risk event.

While we are disappointed at the slow pace of this process, we remain optimistic that, in the course of 2023, we will be able to move this critical file forward toward final resolution. But, it is incumbent on our Board to plan for scenarios where no material progress is made in these discussions with Ottawa. In the course of 2023, PACICC staff will begin to develop contingency plan options in this regard.

Priority Issue – 2023
Coverage and Benefits Review

In 2020, PACICC committed to the Canadian Council of Insurance Regulators (CCIR) that it would review coverage and benefits at least once every five years, with the next review occurring within three years. The regulators also asked that we specifically incorporate province-by-province analysis of the adequacy of PACICC benefit limits. At its November 3 meeting, the PACICC Board approved this as the Corporation's *Priority Issue* for 2023.

The new Coverage and Benefits review was launched last fall with an industry-wide data call which secured claims data from more than 75% of the Canadian insurance market. It will enable PACICC to properly evaluate the adequacy of current limits – including at the provincial level. The review will again rely on our three guiding principles – Fairness, Transparency/Clarity, and Modernization and will examine: extent of coverage, benefit limits by province, return of unearned premiums, the threshold for commercial coverage eligibility and the hardship claims appeal process.

Other Key Priority Issues

Last Fall, the PACICC Board endorsed two additional Priority Issues that will help to enhance our resolution infrastructure.

a) **Increased Financial Capacity**

After several years of research and industry consultation, in November 2022 the PACICC Board approved a new, higher target for the Corporation's short-term liquidity capacity. Earlier analysis had confirmed that PACICC's Compensation Fund was inadequate to enable the Corporation to respond effectively to the failure of any of the top-70 P&C insurers in Canada. With authorization from the Board and under the supervision of the Audit and Risk Committee, PACICC Management successfully negotiated terms of a $250M standby line of credit facility, which is now in place. Information on this important initiative was communicated to all PACICC Members in a year-end (November 21) letter from PACICC President and CEO Alister Campbell. The start-up and annual operational costs of the facility are being recovered through the Annual Administrative Assessment of PACICC Members. However, the minimum Administrative Assessment remains at $10,000 for most PACICC Members (unchanged for a fourth consecutive year).

This new facility means that PACICC now has in excess of $300 million in ready liquidity, to effectively respond to cases of Insurer Member distress – funds available to support policyholder compensation in liquidation scenarios…but also available to support PACICC's engagement in "resolution" scenarios where it is determined by the PACICC Board and regulators that liquidation is not in the public and/or industry interest.

b) **Expanded Resolution Capabilities**

In our review of defined best practice regarding "resolution infrastructure" from the Financial Stability Board (FSB) and from the International Association of Insurance Supervisors (IAIS), we confirmed that there was in fact one significant gap in the current operating model for the Canadian P&C sector – the absence of a "bridge insurer" mechanism. This gap appeared more significant when we compared ourselves with Canada's banking sector (CDIC has full "bridge bank" powers) and, more significantly, Assuris – PACICC's peer organization for life insurance has had an OSFI-chartered "bridge insurer" (CompCorp Life) in place for many years.

At the instruction of our Board, PACICC staff approached OSFI regarding its willingness to consider an application for the establishment of an OSFI-chartered and supervised "bridge insurer" for PACICC. OSFI has given an initial indication of their openness to such an application, and provided us with the outline for a streamlined application process. That process has now been initiated and will represent a major work initiative for PACICC staff in the months ahead. While timeline for this work effort is still in development, we are hoping to have a completed application in OSFI's hands before the end of 2023.

There will be a number of key issues – particularly regarding governance and capitalization – which will need to be addressed as this application process proceeds, and certainly before such a new insurer receives federal charter and provincial/territorial licenses. As the dialogue with OSFI expands and we gain more certainty as to the supervisory expectations for this new entity, we will be keeping all Members up-to-date. It is our intention to engage in broader consultation around key issues in the application process with all of our Members, prior to submission of our final application.

Solvency Analysis

2022 was a very strange year - by Grant Kelly

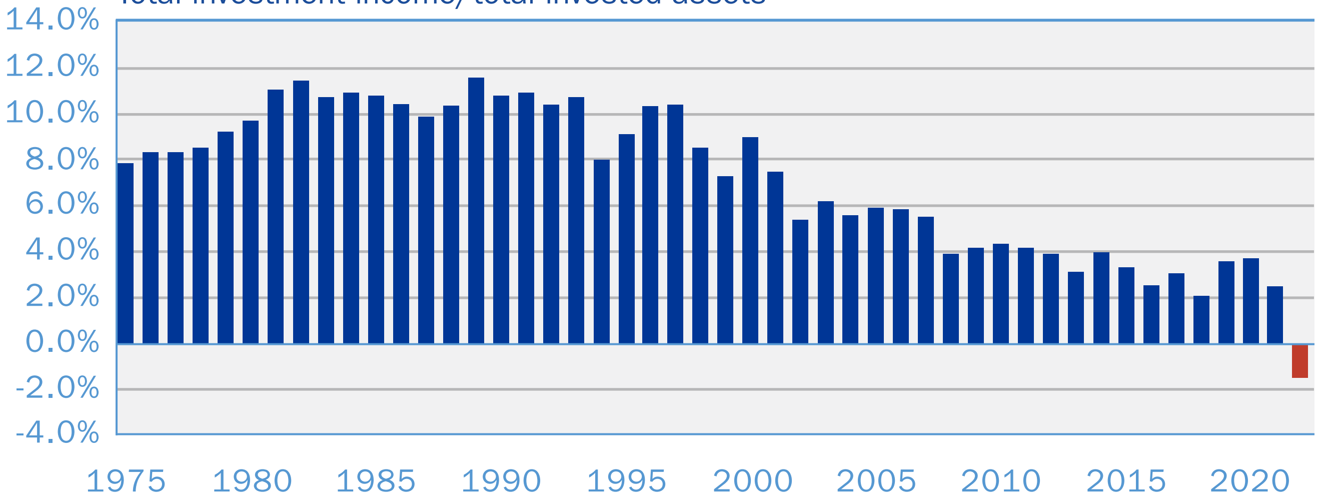
The annual financial results show that 2022 was a very challenging and unusual year for Canada's P&C insurance industry. For the first time ever, Canada's P&C insurers reported, at an industry level, a combined investment loss. This was the first time that this has occurred in the 47 years of PACICC's historical database.

Fortunately, for the solvency of Canada's insurers, the industry posted historically strong underwriting results, which served to partially offset the very poor investment results. The 86.5% industry combined ratio was the second lowest ratio reported in the PACICC database – only bested by the 85.5% reported last year. These strong underwriting results were evident in all major lines of insurance coverage. Results were particularly strong in Liability insurance, with a loss ratio of 33.6% in 2022. This is both remarkably low and highly unlikely to be sustainable over the long term.

The loss ratios in other lines of business rose slightly in 2022. The national loss ratio for Auto insurance was 62.2% in 2022 which was up from 58.4% in 2021. The national loss ratio for Personal Property also rose – from 50.7% in 2021 to 58.7% in 2022. The loss ratio for Commercial Property rose from 45.6%% in 2021 to 51.0% in 2022. While underwriting results were not as strong as the prior year, 2022 will long be remembered as a remarkably good year for the industry.

P&C insurers reported first negative investment income ever in 2023

Total investment income/total invested assets



Source: PACICC based on data from MSA Research

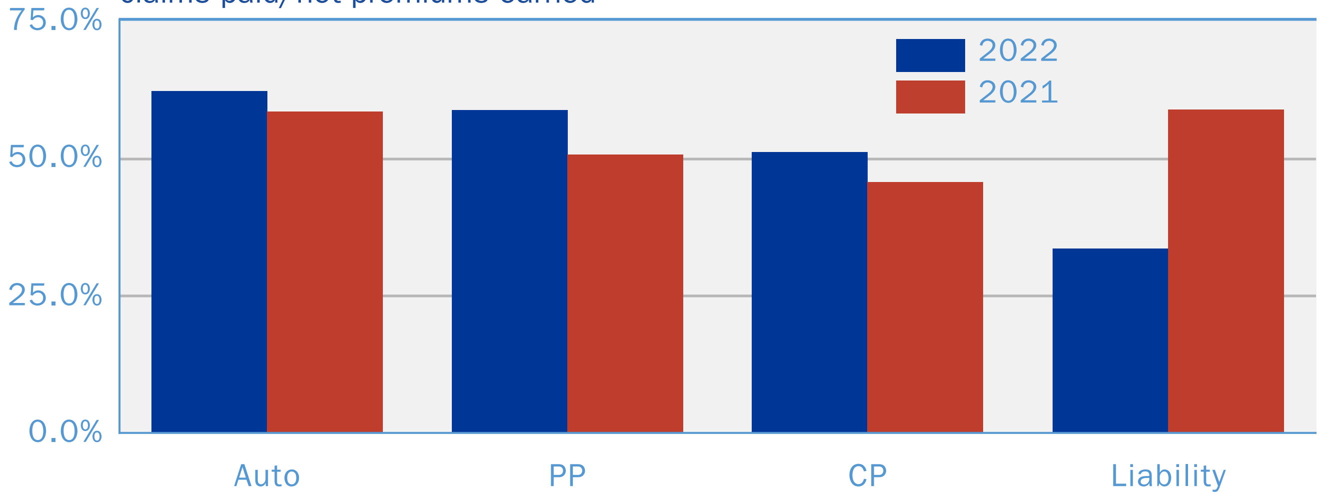
These strong underwriting results are good news for organizations like PACICC that focus on industry solvency. PACICC's *Why Insurers Fail* research series has consistently found that poor pricing decisions and inadequate reserving for insurance risk are the primary causes of insurer failure worldwide. In contrast, sustained underwriting profits consistently generate more capital and reduce solvency risk.

Overall Canada's insurance industry reported a return on equity (ROE) of 14.0%. This is materially lower than the 17.0% reported a year earlier, but still above the long-run average of 10.1%. Based on historical patterns, further "reversion to the mean" is still expected. Of course, the impact of these industry trends varies across PACICC's membership. Our industry remains highly competitive. In 2021, 14% of insurers reported negative net income, despite it being the industry's most profitable year on record. In 2022, this figure rose to 27.8%. The latter figure is more in line with the industry's long-run average, and is not yet a significant source of concern.

The question for those insurers reporting negative net income now, is how quickly can they return to profitability? Consistent profitability is a very important solvency metric for PACICC, and not all insurers have demonstrated the ability to achieve it. PACICC is actively monitoring a small number of Canadian insurers that have consistently reported negative net income.

Underwriting results saved the day

claims paid/net premiums earned



Strong underwriting results in every line of coverage and across Canada. Only line of coverage reporting unprofitable loss ratio, at the industry level, was Cyber.

Source: PACICC based on data from MSA Research

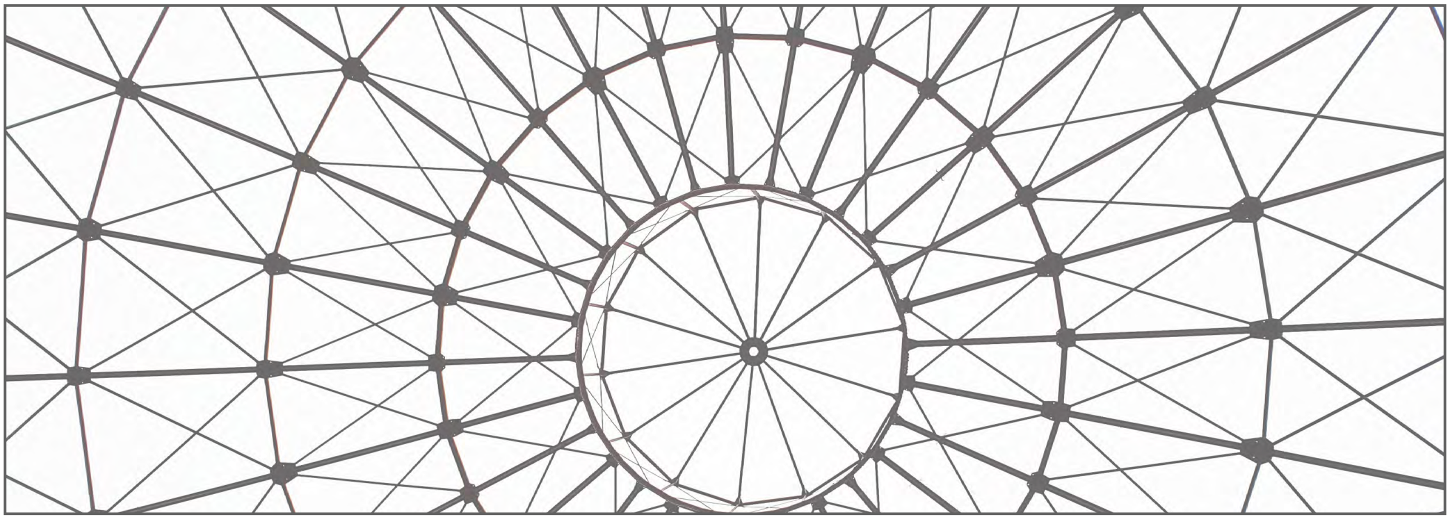
Full-year 2022 Financial Results

($ millions)	2022	2021	Percentage Change
Direct Premiums Written (DPW)	$81,661	$75,290	8.5%
Net Pemiums Earned (NPE)	$64,938	$63,031	3.0%
Net Claims Incurred	$35,232	$33,888	4.0%
Operating Expenses	$20,892	$19,845	5.3%
Underwriting Income	$9,139	$9,497	-3.8%
Net Investment Income	-$121	$2,812	-104.3%
Net Income	$8,334	$9,510	-12.4%
Combined Ratio	86.5%	85.2%	
Net Loss Ratio	54.3%	53.8%	

Select Solvency Indicator Ratios

($ millions)	2022	2021
Average Equity	$59,422	$55,961
Return on Equity (ROE)	14.0%	17.0%
Return on Investment (ROI)	-0.1%	2.7%
Comprehensive ROE	6.8%	17.8%
Comprehensive ROI	-4.0%	3.1%
MCT Ratio (Capital Available/Capital Required)	256.4%	266.3%
BAAT Ratio (Net Assets/Capital Required)	303.9%	305.4%

Source: MSA Research as of March 20, 2023.



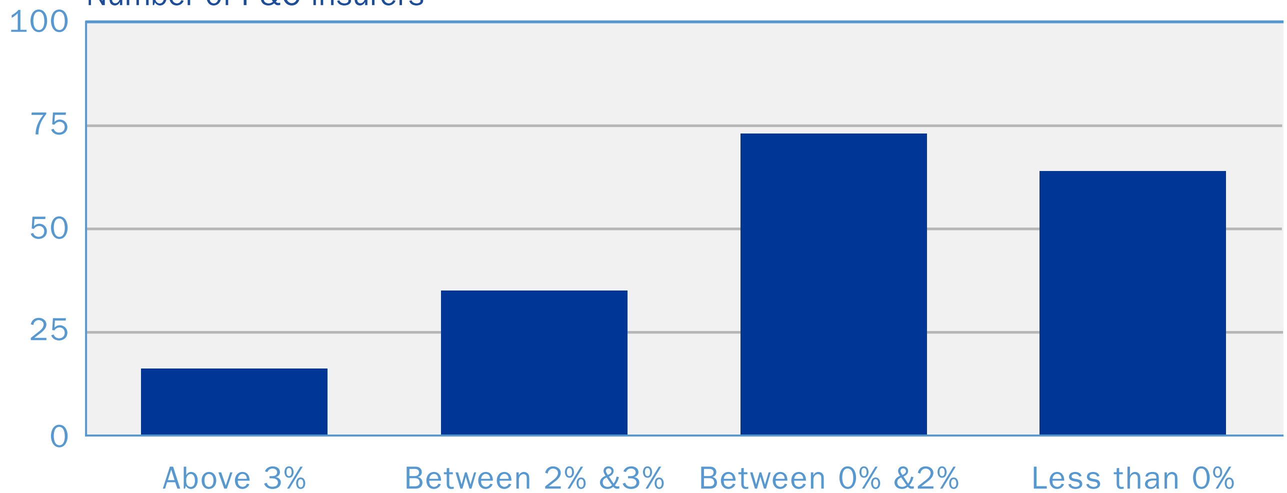
A first time for everything in P&C insurance
by Grant Kelly

PACICC's database of industry results traces back to 1975. Over this 47-year period, P&C insurers have NEVER reported annual investment losses – not once. That is, until 2022, when, for the first time, Canada's P&C insurers reported return on investment of -1.2 percent. This decline in investment returns is primarily the result of the dramatic rise in interest rates. Between March 2022 and January 2023, the Bank of Canada increased interest rates eight times – pushing its overnight rate from 0.5% to 4.5% – to combat inflation. An unintended consequence of this policy was that, as interest rates rose, the value of the industry's bond portfolio fell.

Why did this happen? Insurers based their investment decisions on the regulatory/legal "prudent person" concept. An insurer employing this prudent person approach tries to match the income generated by its investments to the cash outflow required to pay its insurance claims – the average duration of insurance liabilities varies by company and by line of business. The industry's average duration is between 3.5 years and 4.5 years. As a result, a 4 percent increase in interest rates resulted in a decline in the value of the bonds held by P&C insurers of between 14 percent and 18 percent in 2022. PACICC is not alone in hoping that the size and speed of the rise in interest rates will not be repeated in 2023.

Wide variation in investment returns

Number of P&C insurers

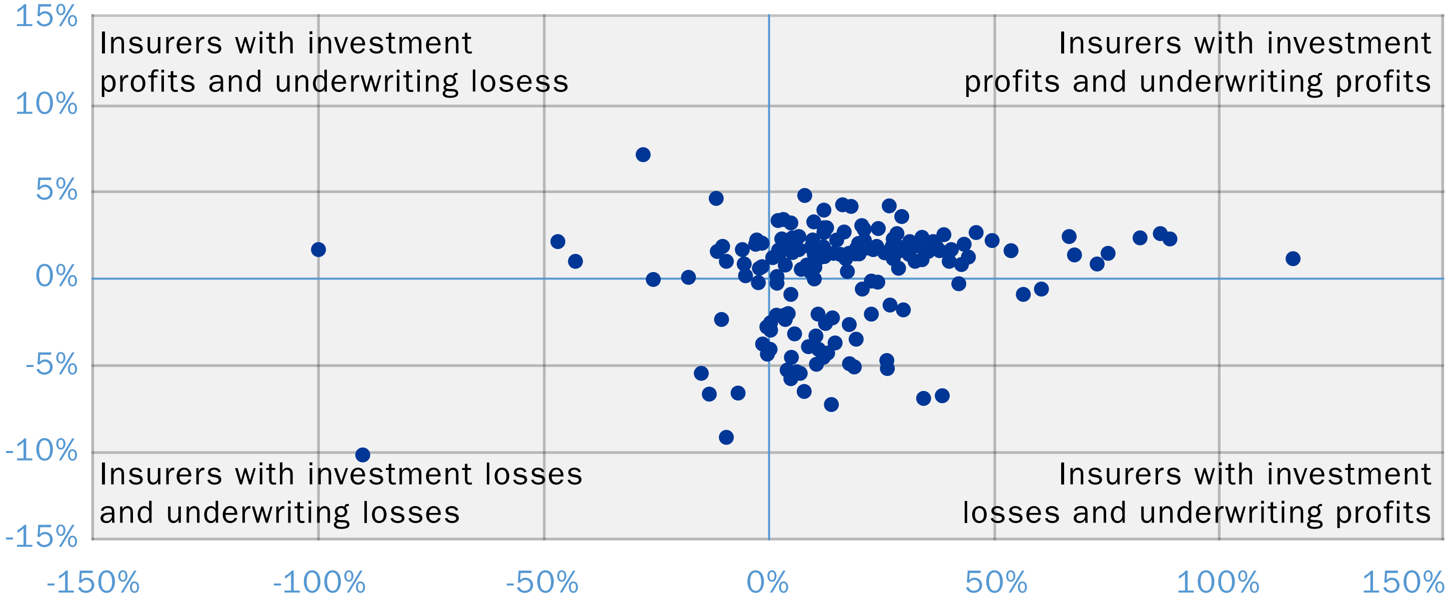


Source: PACICC based on data from MSA Research

Of course, the impact of rising interest rates was not felt equally across the individual companies that comprise Canada's P&C insurance industry. In 2022, just 64 P&C insurers reported investment losses, while another 73 insurers reported investment returns of between 0 percent (breaking even) and 2 percent, and 41 insurers reported investment earnings of greater than 2 percent. But the large losses of those 64 insurers more than outweighed the small gains of the others.

Some Insurers Are Reporting Tough Times

Investment returns



178 insurers reported financial results in 2022. 30 insurers reported underwriting losses. 64 reported investment losses. However, only 14 P&C insurers reported BOTH underwriting and investment losses in 2022.

Source: PACICC based on data from MSA Research

The poor investment returns in 2022 do not necessarily indicate problems with the solvency of any P&C insurer. Why not? Firstly because many P&C insurers do not actively trade their bond portfolio. This means that the decline in values will only matter if they ultimately sell these bonds (and crystalize their losses). There is always a risk, however, that a major catastrophic loss could require the insurer to change its plans and sell these bonds at a loss in order to pay its claims. Second, different insurers are required to report these losses on their 2022 income statements. In this case, the worst-case impact is already reflected in the 2022 statements. The bottom line here is that determining the impact of unrealized gains or losses on insurer solvency requires examining each company individually.

The primary business of a P&C insurer is to provide insurance coverage. Traditionally, insurers use investment income to supplement the profits from the provision of insurance coverage. 178 insurers reported financial results in 2022 and, of those, 30 reported underwriting losses and 64 reported investment losses. Thankfully, only 14 P&C insurers reported BOTH underwriting and investment losses in 2022. It is simply not sustainable for those insurers to report both negative net underwriting profits and investment losses for any extended period of time.

Consistent profitability is the most important solvency metric for PACICC. And not all insurers have shown the ability to achieve this. 2022 was a difficult year. PACICC will continue to closely monitor the small number of insurers that reported both underwriting losses and investments losses, and look to see that they quickly return to profitability.

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
- Providing resources and information to facilitate research of risk management and related governance topics.

Risk Officer's Forum Meetings

Forum Meeting include a keynote speaker on a topical industry issue, followed by industry/expert presentations on current Enterprise Risk Management (ERM) issues.

Next Forum Meeting:

Thursday, September 14

Discussion Topics:

- CEO Perspective on ERM
- Earthquake Update
- 2023 PACICC ERM Benchmark Survey Findings

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.

2023 Emerging Risks Webinar Dates and Discussion Topics:

Thursday, May 18

Craig Stewart – Vice President, Federal Affairs, Insurance Bureau of Canada

Topic: Climate Change and Adaptation

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 647/264-9709.

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