Solvency Matters

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

Insolvency protection for home, automobile and business insurance customers

Issue 24 - January 2024

From the Desk of the President

Establishing a Solid Ground Game - by Alister Campbell

I had the pleasure of attending (another) nail-biter of a Grey Cup Final in Hamilton a few weeks ago – it was my third consecutive Grey Cup and the third in a row decided on the last play – and it got me thinking about (you guessed it) PACICC and systemic risk. Over the last 10 years, PACICC has worked hard to help key public policy leaders in Ottawa and Canada's quake-exposed provinces understand the need to establish some form of federal backstop mechanism to mitigate systemic risk after an event generating in excess of $35B in insured losses. This risk is all too real. And, thanks in part to our efforts, it has been fully taken on board in Ottawa. The Federal Budget in 2017 first identified this issue as one requiring action. The most recent Federal Budget reaffirmed this commitment and added the first potentially tangible measure – the creation of a reinsurance mechanism (potentially embedded within the Canada Mortgage and Housing Corporation (CHMC)) – to enable the formation of public-private partnerships to address flood risk, as well as other major natural catastrophe exposures that we face in Canada. This recent Budget announcement was welcome news. But it is quite clear that Ottawa proposes to tackle flood risk first. And it is also quite clear that the timeline for moving this mechanism from concept to actual existence will be measured in years, rather than quarters. So…what is PACICC to do (if anything) in the meantime…or should we just wait patiently on the sidelines?

> **"So…what is PACICC to do (if anything) in the meantime…or should we just wait patiently on the sidelines?"**

Fans of the CFL will know that our unique Canadian version of football relies heavily on passing and yields consistently higher average scores than the dull, four-down version played (on much smaller fields) by our neighbours to the south. But the last big game was a timely reminder that a prerequisite for successfully executing on big passing plays, is a solid ground game. Both Montreal and Winnipeg demonstrated their appreciation of this imperative in the Grey Cup Final. And our Board demonstrated its appreciation of the same logic in public policy formation when it approved our 2024-2026 Strategic Plan earlier in that same week.

I promise not to stretch the analogy any further (at least until the conclusion). But I do want to quickly talk to you about our plan for "incremental" mitigating initiatives to work through, during this "waiting period" before the Federal Government is seriously in a position to act on the quake backstop mechanism issue. We have identified four such measures and have begun work on all of them.

First, we have looked at ways to modernize our hard-coded Memorandum of Operation to create more flexibility in a crisis. In our history, all previous insurer failures have involved smaller Members. So our Board's mandate was to – as quickly as possible – ascertain "the maximum exposure" and send out a General Assessment notice to all remaining PACICC Members. This hard-coded mandate (to establish a "worst-case scenario") proved problematic during our desktop insolvency simulation exercise with OSFI in 2022, as it forced us to assess an amount equal to roughly double the anticipated, eventual required amount. An actuary on our Board posed a practical question…

Why wouldn't we use "best estimate" instead? In the end, the answer was simply…that would be better! This would be especially true in a circumstance involving the failure of a larger insurer…or perhaps in a situation where we witnessed multiple Member Insurers fail after a mega-quake. Quickly nicknamed "the Tullis Amendment," after Mark Tullis (the now retired Board Member who sensibly proposed it), our full Board approved this amendment to our MoO at its November meeting. It is now subject to our normal 90-day regulatory review period. Assuming no objections from the provinces and territories which together comprise the Canadian Council of Insurance Regulators (CCIR), this amendment will take effect in early March 2024.

Second, our Board approved a written request to the Minister of Finance regarding formal designation of PACICC as a "compensation association" under the federal *Insurance Companies Act*. Today, we remain exclusively a provincial/territorial construct. While the Board had approved this approach to Ottawa in principle back in 2021, we concluded that the timing is now appropriate to move forward with the request. There are several very good reasons for more fully exploring this step at this time – some technical, and relating to the *Winding-up and Restructuring Act*; some practical, including optimizing information exchange between OSFI and PACICC in discussions around potential insurer resolution (including when exploring potential use of our proposed new bridge insurer); and some simply logical, given the high percentage of PACICC Members (90%+) who are now under federal supervision. However, from a systemic risk management perspective, there is another compelling rationale. In any scenario where some, or all, of the federal liquidity backstop funding was to flow through PACICC, it would be easier to facilitate this legally if we actually "existed" under federal law. The proposed designation – already obtained some years ago by our peer organization Assuris on the life insurance side – is now in the hands of the Minister. Next steps and timing are thus clearly in Ottawa's court.

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Third, we have for some time argued that the structure of the industry's capital standard (MCT) itself could unnecessarily amplify systemic stress by incorporating "non-cash" elements of a very large PACICC General Assessment after a major quake. OSFI has established a formal calendar for a full review of MCT with a target date for implementation in 2025. We have flagged to OSFI our intention to propose a specific PACICC "line" in the new standard's formula, which would more easily facilitate the sensible application of "regulatory forbearance" by prudential supervisors in a time of systemic stress.

Finally, we are now engaged with our regulator colleagues at the British Columbia Financial Services Authority (BCFSA) in the planning for a desktop simulation exercise (involving a large quake) and exploring the possible impacts across the financial services sector of the region. The exercise is likely to be organized in several segments – designed to test different elements of the system – but one of the first is likely to be an exploration of the PACICC "circuit breaker." This term has become regulator shorthand for the section of PACICC's By-Law that authorizes our Board to simply declare – above some level of financial distress – that it cannot responsibly exercise its mandate to assess the industry to fund compensation for policyholders, without causing greater financial distress among other Member insurers. It is above this threshold that true systemic risk exists. Exploring the uncharted consequences – beyond this frontier – together with all of the other relevant financial services sector players, and both federal and provincial regulators, will help all of us to think more clearly about the challenges that we face and the measures that we could all take to better protect Canadians in this extreme tail-risk scenario.

Back to football to finish. I suspect many of us cherished the idea in our youth of being the one to toss the glorious touchdown pass to win a Grey Cup, or other "big game." As we mature, most of us learn that not everyone gets to do that. And that sometimes the best route to victory is by executing on less glamorous and more practical things…like a solid ground game. For now, the "long bomb" policy win of a full federal backstop mechanism to mitigate systemic risk will have to wait. In the meantime, we plan to get down to some practical running, blocking and tackling at PACICC in 2024.

Best wishes to all for a happy, healthy and profitable 2024!

Alister Campbell, President and Chief Executive Officer at PACICC

PACICC's New Year's Resolution – To be better prepared for a "resolution" - by Grant Kelly

At the beginning of the year, it is customary for many (including myself) to make resolutions regarding self-improvement. PACICC's focused mission requires us to make the same broad resolution each year. It must be to ready to perform its role to protect policyholders from the risk of undue loss in the unlikely event that their insurer fails. PACICC's specific resolution for 2023 was to be demonstrably more prepared to protect policyholders – and our Board illustrated this resolve by voting to modernize our benefit levels to better reflect the realities of inflation. But in the world of prudential oversight, the word "resolution" has a very different meaning.

The International Association of Insurance Supervisors (IAIS) defines resolution to be "an action taken by a resolution authority(ies) towards an insurer that is no longer viable, and has no reasonable prospect of returning to viability. Resolution actions include portfolio transfer, run-off, restructuring and liquidation." And OSFI has been challenging PACICC to demonstrate that we are "resolution ready" – both financially and organizationally. For PACICC to be financially "resolution ready," requires the Corporation to have access to liquid funds to quickly reimburse unearned premiums and pay eligible claims of policyholders, should a regulator lose confidence in a Member Insurer.

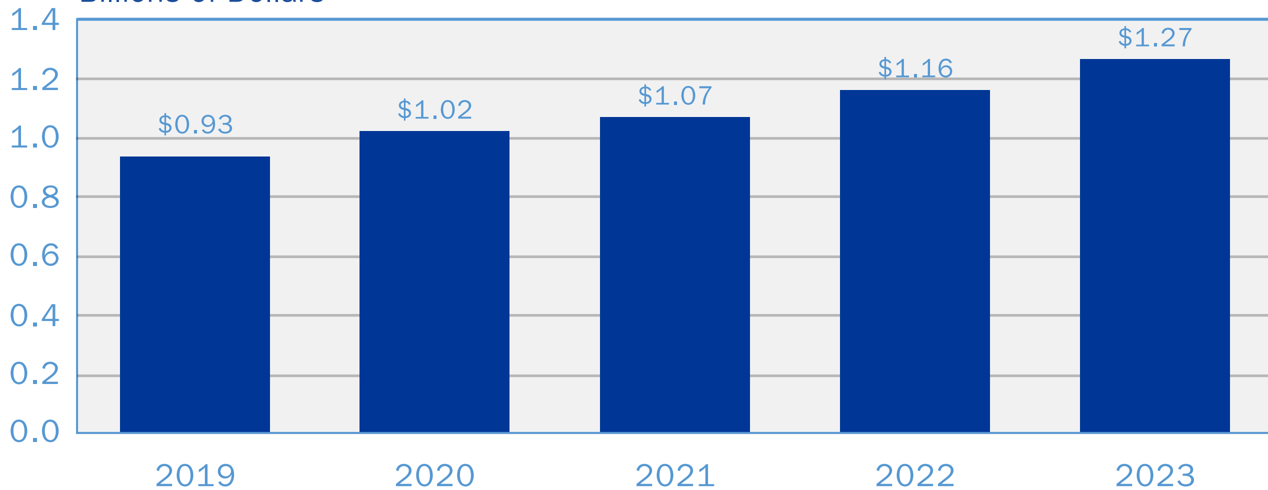
PACICC's most important financial tool is the power granted via our By-law, and embedded in our Memorandum of Operation, to levy an annual General Assessment of up to 1.5% of the direct written premiums of each Member Insurer, for as long as is required to address an insolvency. The Assessment process timeframe is partly determined by the circumstances of the failed insurer, but generally speaking, the process works like this:

a) The Court-appointed Liquidator provides the PACICC Board with a detailed analysis of the estate as a basis for determining the Total Liability and the available Assets

b) PACICC determines the expected shortfall in the estate, with a provision for adverse claims development and possible challenges in realizing asset values. The size of the Assessment is based on a determination of the cash flow and liquidity needed to ensure the timely payment of eligible claims.

c) PACICC then issues an Assessment to all Member Insurers based on their market share in the provincial jurisdiction where the failed insurer is domiciled. PACICC expects that once an invoice is issued, Members Insurers would be given up to 60 days to pay their Assessments.

As mentioned above, there is a legal limit on the amount that PACICC can assess Member insurers in a given calendar year. However, in 2024, that limit amounts to roughly $1.2 billion annually. And there is no limit on the number of years that the Member Insurer can be required to pay its share of this amount. The Member is responsible for paying the full Assessment over time, but is only required to pay the annually-limited portion in any 12-month period. If a Member is at this maximum and another insolvency occurs, the cost of that new insolvency would be added to future payments. It is critical to appreciate that under modern accounting rules, the full amount owed would be booked as a contingent liability of the books of each Member Insurer – with potentially devastating impact on their solvency status under the Minimum Capital Test (MCT) monitored by their prudential supervisor.



Source: PACICC based on data from MSA Research

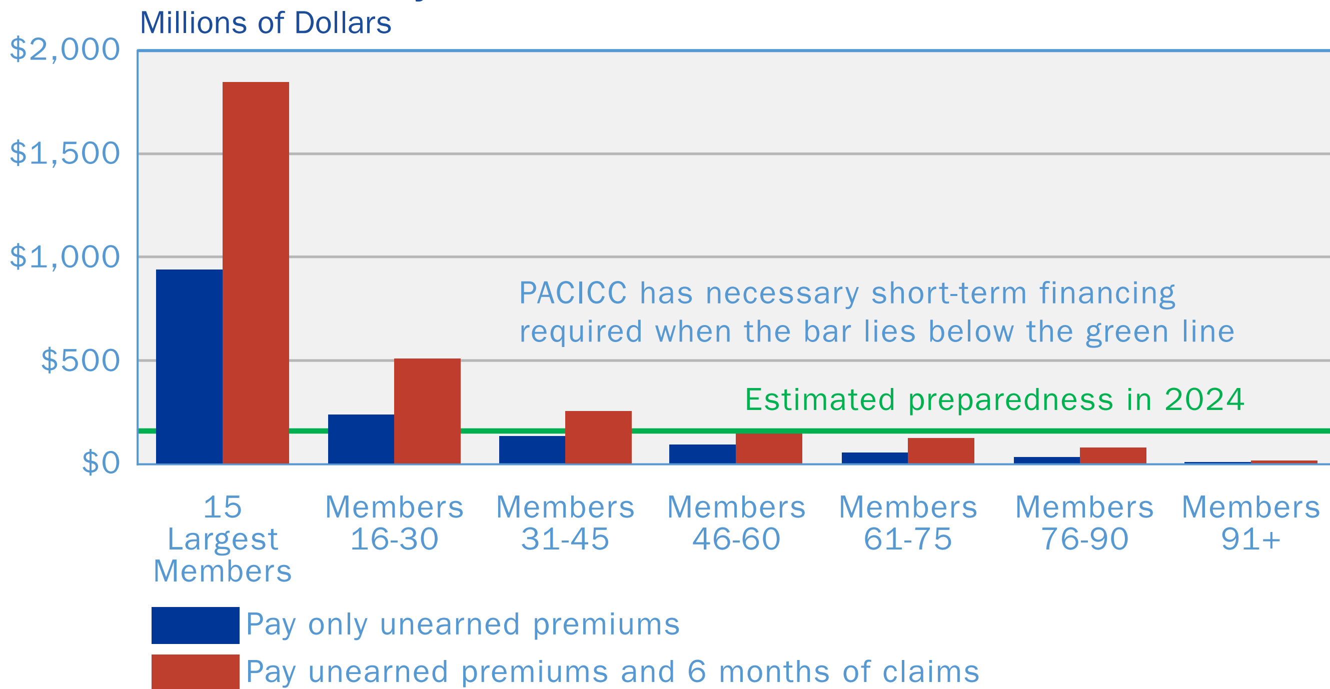
The Court-appointed Liquidator will take some time to determine the status of the estate of any failed insurer. And it will take additional time for PACICC to determine its best estimate of the required Assessment. And of course, it will take time to issue and collect such an Assessment. But policyholders must be protected and confidence in the system must be maintained throughout this period. To cover the critical short-term period between the announcement of an insolvency and the collection of an Assessment, PACICC has two available sources of liquidity. First is our Compensation Fund which as of December 2023 had $59.6 million in invested assets that the Corporation would be able to access within 48 hours. These funds are invested by CIBC Asset Management in fixed income securities with a priority placed on security and liquidity. If these funds are used, PACICC must assess Member Insurers to repay all funds, but there is some flexibility as to timing of this. Of note, PACICC has never used the Compensation Fund since it was established.

PACICC's experience is that quickly reimbursing premiums paid in advance can greatly reduce the adverse impact on policyholders and help to maintain confidence in Canada's insurance industry. The industry established the Fund (via capital levies in 1998, 1999 and 2000) to allow PACICC to quickly begin reimbursement of unearned premiums – in the 60-day period before Assessment funds are available. But is the Fund fit for purpose? Are we really "resolution ready"? In 2021, PACICC retained Eckler to estimate the liquidity required to rebate unearned premiums shortly after the failure.

The Eckler report demonstrated that the Compensation Fund would be adequate for the 100-smallest PACICC Member Insurers. However, it would not be adequate for the failure of any of the top-70 insurers in Canada – and our Board concluded that this was simply not good enough.

For this reason, in 2023, PACICC established a new "target level" for its short-term financing needs – a new quantum set at $300 million. But the PACICC Board also concluded that there was no compelling logic for generating the required increase in financial capacity via capital levies (an inefficient use of industry capital) or through the purchase of reinsurance (too much uncertainty regarding pricing and availability over time). Instead, PACICC increased its financial capacity via a $250 million standby line of credit (LOC) facility supported by a syndicate of Canada's big-six banks.

With the introduction of the LOC facility, PACICC can now rapidly access the funds required to reimburse unearned premiums in the unlikely event of a Member Insolvency…for all but the 17-largest PACICC Members. PACICC now also has the financial capacity to reimburse unearned premiums and pay up to six months of expected claims for 135 of PACICC's 169 Member Insurers.



Source: PACICC based on data from MSA Research

While the establishment of the LOC represents a material increase in the level of PACICC's preparedness, there is considerable work remaining for PACICC to be fully prepared for a crisis involving any of our larger Member Insurers. And this remains a crucial topic in our discussions with OSFI. Being ready to help to resolve a case of financial distress involving one of our top-17 Members is the reason that PACICC has actively pursued alternatives to liquidation over the past several years. Actions have included a Member consultation on potential resolution scenarios and the development of a *Resolution Protocol* that establishes the terms that must be met for PACICC to use industry funds for anything other than a liquidation.

But we are resolved to do more. This is because resolution of the largest PACICC Member Insurers would potentially require different tools, including portfolio transfer, reinsurance or the use of a bridge insurer. And it might also require more creative solutions to address medium-term financing needs above and beyond our current Assessment model. We will be exploring all of these options as part of our Resolution for 2024 — to be more "Resolution ready."

Grant Kelly, Chief Economist, Vice President, Financial Analysis and Regulatory Affairs

Reverting to the mean - by Grant Kelly

This is the third quarter for Canadian insurers reporting under International Financial Reporting Standards (IFRS) 17 (Insurance Contracts). As a result, PACICC is not able to compare all performance ratios to prior years. However, the P&C industry's third-quarter 2023 financial results do reveal three key trends.

One year ago, the investment results of Canada's P&C insurers hit an all-time low, as the industry's bond portfolios were negatively impacted by the increase in interest rates. This trend has since been reversed, and Canada's P&C insurers are back to reporting normal levels of positive net investment results. Over the first nine months of 2023, P&C insurers reported a return on investment of 2.7%. By contrast, over the same period in 2022, the industry's return on investment was -2.2%. This represents a $1.8 billion swing in industry profitability.

Second, the industry's overall insurance results were slightly worse in 2023. While Insurance Revenue grew by a healthy 8% compared to the same period in 2022, Insurance Service Expenses grew by 9.1%. This led to a small (1.6% or $94 million) decline in the industry's 2023 Insurance Service Result, compared to 2022 ("Insurance Service Result" is the new name for what was previously called Underwriting Income.)

Personal Property coverage should be the largest source of concern for underwriters. The overall Net Insurance Service Ratio (NISR) in this line of business was 111.6%, meaning that homeowner's insurance was an overall drain on the capital base of Canada's P&C insurers through the first nine months of 2023. This is, in large part, due to catastrophic losses, which have already exceeded $3 billion in 2023 (according to CatIQ.) (N.B. This new NISR measure is similar to the loss ratio under IFRS 4, but the new measure will generally produce higher numbers. It now includes acquisition expenses, factoring in commissions and reinsurance, as well as the impact of onerous contracts.)

Personal Property was clearly an outlier through the first nine months of 2023. By way of comparison, the Net Insurance Service Ratio was 92.6%for Auto insurance, 86.6% for Commercial Property, and 80.2% for Liability coverages. This means that, after including operating expenses, the Auto insurance line of business also likely drained the capital base of P&C insurers. However, Commercial Property and Liability insurance lines positively contributed to the capital base of P&C insurers thus far in 2023.

Thirdly, abnormally high industry returns have now – as we previously predicted – reverted to the mean. Through nine months, the annualized return on equity (ROE) has fallen to 11.5%. This result is very much in line with the industry's pre-IFRS 17 long-run average ROE. Between 1975 and 2022, Canada's P&C insurance industry reported an average ROE of 10.5%. Through nine months, 2023 is shaping up to be an "average" year (at best) for Canada's P&C insurers.

2023 Q3 - Summary of Financial Results

All values are from MSA as of November 27, 2023.
Values exclude mortgage insurers* and are in $millions, except where noted.

	2023 YTD	2022 YTD	Change
Total Insurance Revenue	60,657	56,146	8.0%
Insurance Services Expenses	-50,111	-45,923	9.1%
INSURANCE SERVICES RESULT	6,560	6,666	-1.6%
NET INVESTMENT RESULT	1,596	-247	646.5%
General and Operating Expenses	-2,173	-1,822	19.3%
Other Income and Expenses	549	239	129.7%
NET INCOME	5,249	3,649	43.8%
Other Comprehensive Income	-301	-3,092	-90.3%
TOTAL COMPREHENSIVE INCOME	4,928	556	790.0%

Select Profitability Indicators and Ratios

	2023 YTD	2022 YTD
Return on Investment (ROI)*	2.7%	-2.2%
Return on Equity (ROE)*	11.5%	8.1%
MCT Ratio (Capital Available / Capital Required)	340.1	
BAAT Ratio *(Applicable to Branches)* (Net Assets Available / Capital Required)	309.3	

Emerging Issues

Navigating the Canadian Bond Market: Opportunities Amid Economic Headwinds - by Michael Cook

In the Canadian bond market, the past year has been a testament to resilience amid volatility. According to OSFI data, approximately three quarters of P&C assets are invested in Canadian bonds. Drawdowns from rising rates in 2022 had a material and adverse impact on portfolio values, even if invested in shorter-duration bonds.

With indications that interest rates may have peaked due to the economy's heightened sensitivity to rate hikes and the substantial impact of rising mortgage costs, there is a shift in the investment landscape.

In 2023, the Bank of Canada (BoC) hiked its overnight policy rate 75 basis points to 5% and bond yields continued to rise. Expectations in the market on BoC policy rates have been volatile. As inflation and the economy continue to cool, expectations for rate cuts have increased, leading to lower rates and higher bond prices.

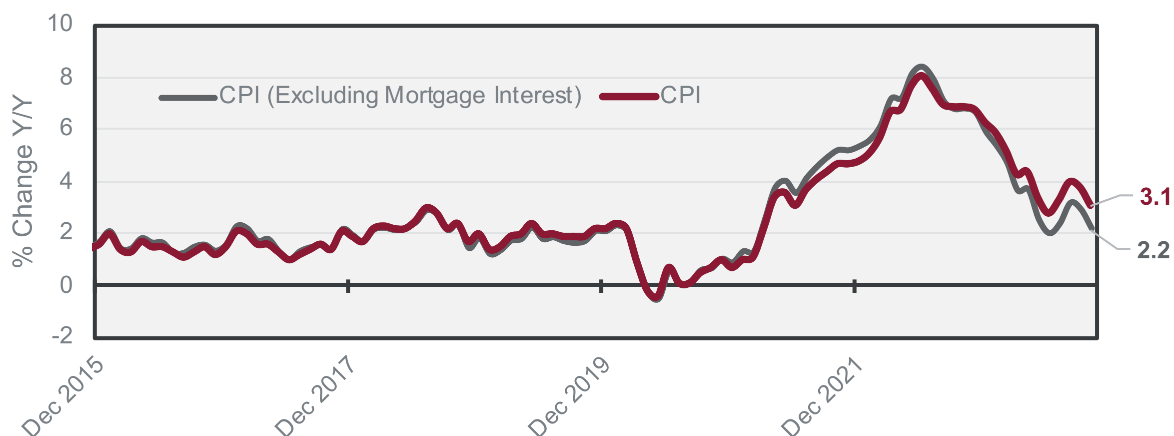
Developments in the Canadian Market

The BoC has tried to navigate a delicate balance of policy rate restrictiveness in the face of persistent inflation and a buoyant labour market. However, there is a growing consensus that the BoC may have already done enough to quell inflationary pressures.

Two themes that make Canada stand out from its global peers are the sensitivity of the economy to interest rates (in Canada mortgages renew faster than in the US) and population growth. A look at how these impact inflation and our economy shows supporting evidence that an end to high interest rates is coming.

Chart 1: Canadian CPI

Excluding mortage interest shows inflation near Bank of Canada's 2% target



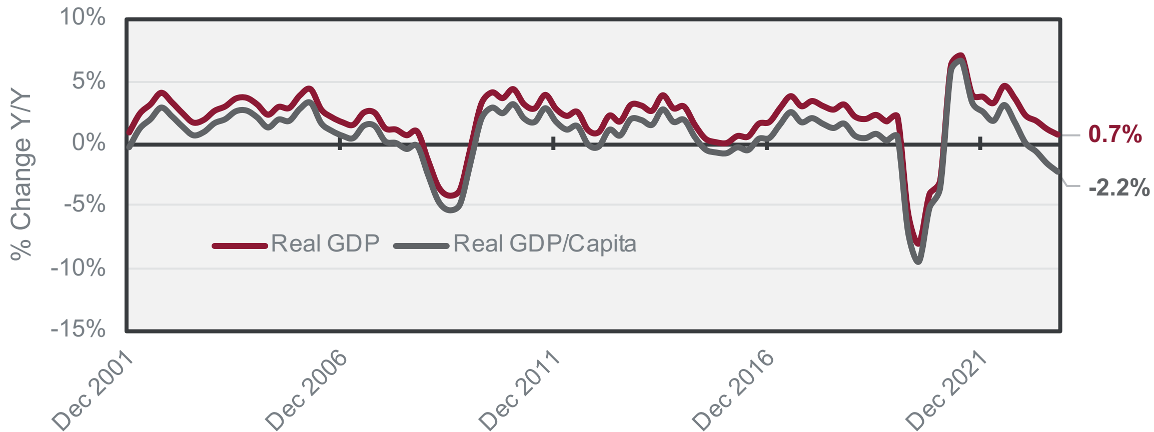
Source: Bloomberg, Stats Canada

Mortgage interest accounts for only 3.8% of the overall basket of CPI, but it increased 30.5% y/y in October, as more and more Canadians experienced mortgage renewals. If one excludes this impact on headline CPI, it drops annual inflation from 3.1% to 2.2% – much closer to the BoC's target.

The health of the economy is often measured by Real GDP growth. Although this growth rate has slowed to +0.7%, a worrying trend is that it gets worse when you remove the impact of population growth. Real GDP/Capita is already in recession territory at -2.2%.

Chart 2: Canadian Real GDP Growth

GDP has been slowing but population growth is masking true economic slowdown

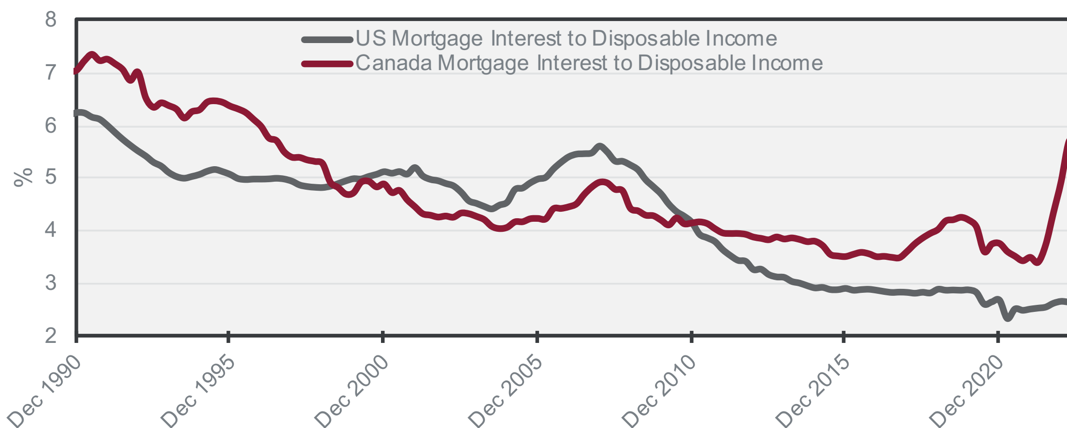


Source: Bloomberg, Stats Canada, as of September 2023

Canada's economic sensitivity to interest rate hikes, particularly in the housing sector, has been a significant concern. The impact of higher mortgage costs is starting to weigh more heavily on the Canadian economy than on others, contributing to a broader economic slowdown.

Chart 3: Rising Mortgage Costs

Canadian households are experiencing higher mortgage costs as renewals come due



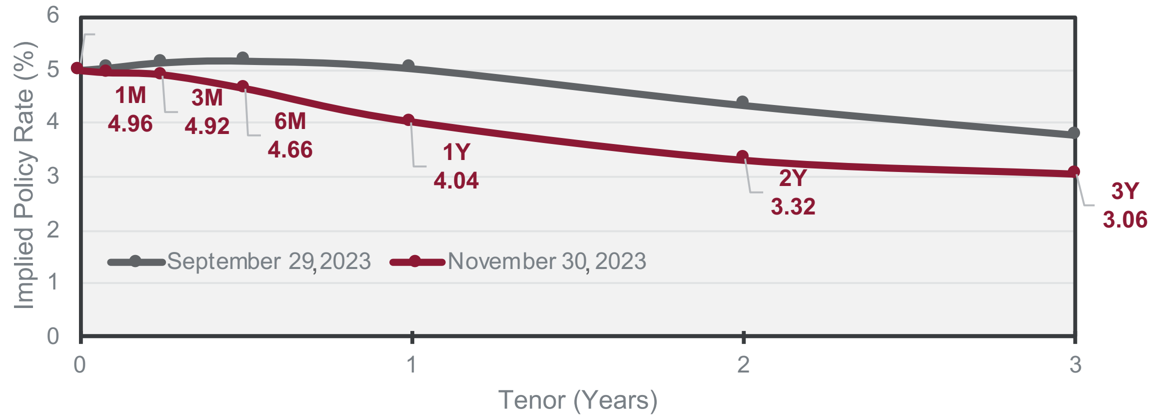
Source: The information was prepared by CIBC Asset Management Inc. based on the following third-party service providers' data: Bloomberg (as of June 2023)

Outlook for 2024

These headwinds mean the Canadian bond market is at a critical juncture. At the end of September, there were no rate cuts being priced into markets for the next 12 months. As of November 30, however, markets are expecting 100 bps in cuts over the next year. Canada's economic challenges suggest a cautious yet opportunistic approach for bond investors, as yield curves eventually normalize.

Chart 4: Market Implied Policy Rates

Markets have begun pricing in rate cuts in 2024

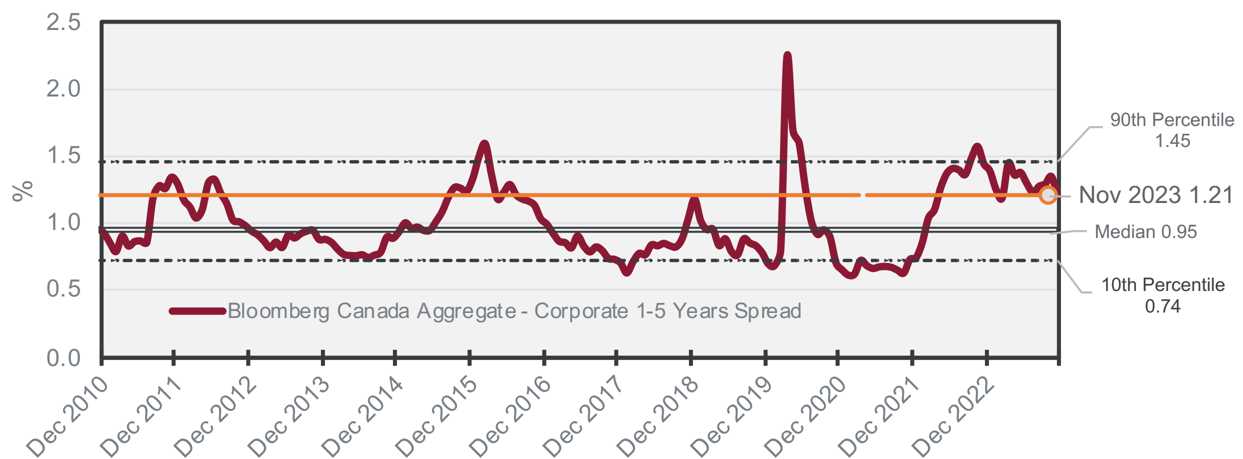


Source: Bloomberg

Corporate bonds were the star performer in 2023 as spreads in the Short-Term Universe narrowed 24 basis points, in addition to having more attractive yields than government bonds. Despite the tightening, spreads still remain well above their average, offering protection to investors as most of the widening happened in 2022.

Chart 5: Corporate Spreads

Spreads on short-term corporate bonds have narrowed but are still near non-crises wides



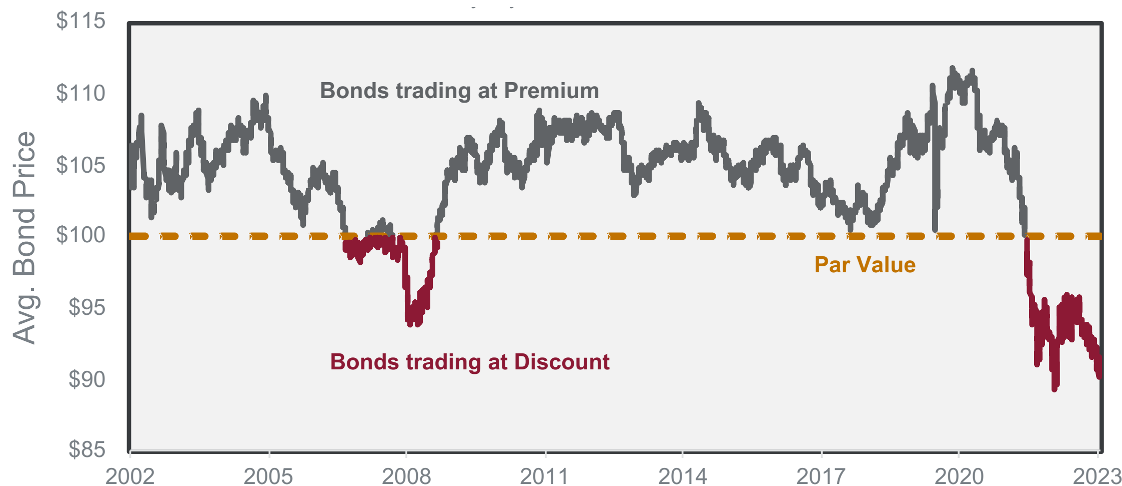
Source: Bloomberg, as of November 30, 2023

Considerations for Investors

For P&C insurers, the current bond market scenario in Canada offers a strategic opportunity. The potential peak in interest rates and the consequent stabilization in bond yields present a moment to reassess bond portfolios. The abundance of bonds trading at a discount, due to the past year's high yields offers attractive investment prospects, particularly considering their higher after-tax yields and the lower impact of capital gains.

Chart 6: Bonds Trading At Discount

For the first time in decades, a majority of bonds trade at a discount



Source: The information was prepared by CIBC Asset Management Inc. based on the following third-party service providers' data: Bloomberg (as of September 2023) - based on Bloomberg Canada Corporate Bond Index

With bonds trading below their face value, the income component – as a percentage of the total yield – is effectively reduced. This dynamic is particularly significant in the current market, where yields have risen sharply. Consequently, investors buying these discounted bonds can expect a higher portion of their total returns to come from capital gains rather than interest income, leading to a more tax-efficient investment outcome.

Investors should be mindful of the broader economic context, factoring in the likelihood of a slowdown. This environment necessitates a more nuanced approach to bond investments, with a focus on quality and valuation.

Conclusion

As 2023 draws to a close, the Canadian bond market presents a landscape of challenges intertwined with opportunities. For P&C insurers and other institutional investors, understanding the unique dynamics at play in the Canadian economy and bond market is crucial. The key lies in staying informed, agile, and responsive to the changing economic indicators and policy directions.

Michael Cook, Vice President, Client Relations & LDI Client Portfolio Manager
CIBC Asset Management, Inc.

Emerging Issues

Taming that tail risk - by Mary Kelly and Anne Kleffner

Financing losses from catastrophe perils is a major challenge for governments across the globe. Catastrophe perils, such as earthquakes, hurricanes and terrorist attacks, are challenging to insure. These perils can cause losses large enough to exceed insurers' capacity, are correlated across exposures, and are often difficult to price *ex ante* due to the relative infrequency of events. Private insurance markets alone are generally unable and unwilling to provide the insurance required to achieve broad levels of financial protection. The need for jurisdictions to be resilient to catastrophes—to be able to recover quickly from loss events and adapt to changes in the risk environment—is a key justification for government intervention into the market for catastrophe insurance. The policy objectives for government intervention and the role of the public sector varies across jurisdictions. In some jurisdictions, public sector interventions are aimed at creating affordable and available coverage for some or all insureds. Some interventions provide coverage for all losses arising from a specific catastrophic peril (or perils), while other interventions are aimed specifically at reducing tail risk to the private insurance industry. Some jurisdictions enact several interventions to enhance the insurability of catastrophic losses.

Catastrophe perils in Canada include earthquake, flood, hurricane, wildfire, and winter storms. These perils present different insurability challenges to private insurers. The recently proposed national flood insurance program is focused on providing affordable and available coverage to high-risk property owners. This addresses an important concern regarding the insurance protection gap. However, paying for insured damages from flood losses does not threaten the viability of the private property-casualty (p/c) insurance industry in Canada. As highlighted previously in *Solvency Matters* ("From the Desk of the President" – June 2023), only earthquake is capable of causing systemic collapse of the p/c insurance industry.

> **"Catastrophe perils in Canada include earthquake, flood, hurricane, wildfire, and winter storms. These perils present different insurability challenges to private insurers."**

Given the threat to the stability of the private insurance market and the consequential effects to the economy after a catastrophic loss, there is a compelling case for the federal government to participate in the management of tail risk. Unfortunately, industry efforts to have the federal government assume a portion of the tail risk arising from earthquake have not yet resulted in government action. While PACICC has undertaken several noteworthy initiatives to expand its financial capacity and enhance its resolution capabilities, the threat to private market stability remains.

An examination of government interventions globally provides many examples of interventions that would effectively support the policy objective of protecting the solvency of the Canadian p/c insurance industry, without crowding out primary insurers. By establishing a mechanism *ex ante* to provide funding *ex post*, insurers are assured that they will have access to financing for both liquidity and solvency purposes after a catastrophic loss. The three interventions that we explore here are a guaranty, a backstop, and a coinsurance agreement. Related to these three options are two key decisions. First, should the promise of ex post liquidity be free, or should insurers pay an upfront annual fee? Second, should the funding be finite (i.e., have an upper limit) or unlimited?

In many jurisdictions, insurers pay a fee for the government funding. Toka Tū Ake EQC in New Zealand pays 10 million NZD annually and in France, the unlimited government guaranty provided for Caisse centrale de réassurance (CCR) is funded by primary insurers who pay 10.8% of their premiums. The Australian Reinsurance Pool Corporation's (ARPC) limited government guaranty (currently 55 million AUD) is negotiated annually as the program is designed to have a net zero cost to the government in the long run.

With a guaranty, the government provides funds to insurers that do not need to be paid back. Public insurers in New Zealand (Toka Tū Ake EQC), Spain (Consorcio de Compensación de Seguros), and Iceland (National Catastrophe Insurance of Iceland) all have access to unlimited government guaranties. A finite guaranty is more common and can be found in many jurisdictions including Australia (ARPC), Japan (Japan Earthquake Reinsurance), the Netherlands (Nederlandse Herverzekeringsmaatschappij voor Terrorismeschaden) and Türkiye (Turkish Catastrophe Insurance Pool).

A second option is a backstop, either finite or unlimited, where government provides funds after a catastrophe and insurers pays back some or all the funds over time. In the U.K., Pool Re's retrocession agreement with the Treasury provides funding if losses exceed Pool Re's claims paying ability. Any amounts claimed by Pool Re must be subsequently repaid to the Treasury by Pool Re members from future premium income. In some jurisdictions, there is discretion in the amount to be paid back, allowing for only partial repayment if there is a very large event. This can also be achieved by a "forgiveness" mechanism that could be triggered later based on liquidity or other considerations.

A third example of government participation is a coinsurance agreement, whereby the government participates in the payment of catastrophic losses. Examples include the insuring of simple risks (property defined by usage and property value) in Belgium and the Terrorism Risk Insurance Program (TRIP) in the U.S. What makes these interventions particularly relevant for Canada is that in both these jurisdictions, these programs are based on an explicit loss-sharing agreement between private insurers and the government, with no public insurance or reinsurance entity.

In Belgium, to manage tail risk, the catastrophic losses payable by insurers are capped and the regional government assumes a finite layer of losses excess of what is paid by primary insurers. Specifically, the regional governments cover losses up to €280 million per insurer and event if the damage per insurer and event exceeds €3 million, plus 0.35 times the insurer's premium. If total losses exceed the combined amounts that the insurer and governments were obligated to pay, amounts payable by the government and insurer are pro-rated.

Similarly, TRIP does not cover terrorism losses directly, but reimburses insurers for a portion of their losses. For terrorist losses large enough to trigger the program ($200 million US in 2020), insurers are responsible for losses up to 20% of their direct earned premium for commercial insurance. Above that limit the government will pay 80% of losses with primary insurers covering the other 20%. Total losses annually are capped at $100 billion US, with losses above that amount uninsured. Although insurers do not pay for this coverage, the government can recoup some or all federal payments from insurers through a surcharge on insurance policies in the years following government coverage of insurer losses. Recoupment of losses by the U.S. Treasury depends on the size of the loss and is discretionary for large losses.

The cost and efficacy of government intervention (guaranty, backstop, or copay) depend on the level at which the intervention is triggered and, for limited interventions, the upper limit of the interventions. Programs that set the trigger above past large events or loss years are less likely to expose the government to significant financial risk, but also provide less protection for insurers.

When the government funding is unlimited, the government assumes all tail risk. With finite funding, tail risk still exists, and the key issue is who bears the tail risk. It may be that the insurance market must assume losses above the limit, but in most cases, claimants and policyholders assume the uninsured losses if a major event or series of events exceeds the limit. Programs address this issue in different ways. Some programs have defined pro-rata payment approaches to allocate claims payments if program ceilings are reached, others can place post-loss assessments on all policyholders, or losses are simply uninsurable.

TRIP provides a legislative authority for the government or legislature to consider making payments for uninsured losses if program ceilings are exceeded. A similar mechanism exists in Australia for ARPC's cyclone pool (but not the terrorism risk pool). Although the government guaranty for the pool is $10 billion AU, if the guaranty is likely to be exceeded within a single year, the government will increase the guaranty to help the cyclone pool meet its obligations. Providing the option for discretion in extraordinary circumstances reduces the need for *ad hoc* government intervention and can enhance the resiliency of the private insurance market by being able to adapt to the specific needs arising from an event.

Currently, earthquake insurance is not mandatory in Canada and even for those that have coverage, losses from secondary perils such as tsunami and snowslide are generally not covered. And as we noted in *Solvency Matters* (September), if the government chooses to take steps to reduce the protection gap, tail risk will be increased. In this case, it is particularly important for the government to commit to supporting the insurance industry by assuming the tail risk.

To summarize, there are many options for the federal government in Canada to help insurers manage tail risk. Doing nothing and planning on ex post ad hoc government spending is not likely to be the best one.

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PACICC Priority Issues: Updates

Managing Systemic Risk

PACICC's *Systemic Risk Model* has estimated the size of insured loss that would result in systemic collapse of Canada's P&C insurance industry. For more than a decade, PACICC has worked with the Insurance Bureau of Canada to encourage the Federal Government to introduce a backstop mechanism to protect policyholders. While this dialogue is ongoing, to the best of PACICC's knowledge, the Federal Government has not yet formulated a plan to introduce such a backstop. However, the most recent Federal Budget formally committed the Government to moving forward with a new reinsurance mechanism to address flood risk and has indicated that, "in parallel," work would continue on the quake risk file with the idea that the mechanism(s) designed to address flood risk could and would also be used to help to address the exposures Canada faces from a major earthquake. This process is underway, but realistically will take at least several years to move to implementation. In the interim, PACICC's Board has approved a series of "incremental" measures (see more comprehensive summary of this action plan in *From the Desk of the President* on Page 2).

PACICC is seeking changes to its Memorandum of Operation (MoO) to allow it to better protect Canadian policyholders in the unlikely event that their home, auto or business insurer becomes insolvent. Paragraph 14 of PACICC's MoO requires that, should a Member Insurer be closed by a regulator, the PACICC Board of Directors must estimate an amount which reflects "the maximum exposure of the Corporation anticipated by the Board." This approach was acceptable if/when PACICC was expected to deal primarily with the failure of smaller companies.

However, this model could introduce systemic contagion risk if a large insurer (i.e., any of the 17-largest PACICC Member Insurers) were to fail, or if multiple smaller Members were to fail at the same time (likely as a result of the same event). This is due, in large part, to the impact of International Accounting Standard 37 (*Provisions, Contingent Liabilities and Contingent Assets*). This Standard outlines the accounting treatment for provisions (liabilities of uncertain timing or amount) and requires PACICC Members to record a liability in their financial statements if:

- A present obligation (legal or constructive) has arisen as a result of a past event. (Insurers are required to pay PACICC Assessments to be "Members in good standing" under provincial legislation);
- Payment is probable (There will be claims following an insolvency); and
- The amount can be estimated reliably (PACICC will provide an invoice with a specific amount).

A PACICC General Assessment would meet all of these criteria. Each Member Insurer would be

required to recognize its share of the full liability on its balance sheet, based on the "maximum" exposure determined by the PACICC Board. This contingent liability would lower the Minimum Capital Test (MCT)/Branch Adequacy of Assets Test (BAAT) scores for each Member Insurer. PACICC research estimates that the failure of a top-17 Member Insurer could cause the MCT/BAAT of otherwise solvent Member Insurers to fall below the regulatory minimum of 150 percent. The larger the PACICC estimated maximum Assessment, the larger will be the impact on the solvency tests and the greater will be the risk of systemic contagion.

PACICC's Board approved a change to Paragraph 14 of the Corporation's MoO requiring that, should a Member Insurer be closed by a regulator, the PACICC Board of Directors must estimate an amount which reflects "the best estimate of the exposure of the Corporation anticipated by the Board." The Society of Actuaries defines Best Estimate to mean: An estimate (e.g. of an assumption or a liability) that is not intended to be either optimistic or conservative. It is based on the actuary's expectation of future experience for a risk factor given all available, relevant experience and information pertaining to the assumption being estimated and set in such a manner that there is an equal likelihood of the actual value being greater than or less than the expected value.

This change has no immediate financial impact on PACICC Member Insurers. If a top-17 Member Insurer were to fail, or multiple smaller Members were to fail at the same time, then this amendment could significantly reduce – but cannot eliminate – the threat of systemic contagion risk impacting the balance sheets of otherwise solvent Member Insurers.

This change does not fully or comprehensively address Canada's larger systemic risk. Canada is not ready for a large catastrophic earthquake and PACICC will continue to champion the need for a backstop mechanism to protect Canadian policyholders.

PACICC is working on three issues to reduce systemic risks:

a) PACICC requested that the federal Finance Minister formally designate it as a Compensation Association under Sections 449(1) and 591(1) of the *Insurance Companies Act*. PACICC currently has no formal legal standing with the Government of Canada. At the time that it was founded, a substantial portion of the Canadian P&C insurance industry was still provincially supervised for solvency. However, today, the vast majority of PACICC's Member Insurers are regulated by OSFI – a fact which contributes to the increasing logic for embedding PACICC more formally within the federal *Insurance Companies Act*.

Most importantly, Section 35.1 of the *Winding-up and Restructuring Act* allows liquidators to enter into an agreement with any compensation association designated by order of the Minister of Finance, pursuant to Sections 449 and 591 of the *Insurance Companies Act*, in order to facilitate the payment of claims to policyholders and the preservation of the value of the estate. Historically, PACICC has been forced to seek Court rulings that treat the Corporation as if it were so designated, to protect policyholders. The risk that a future Court might not agree to such an arrangement is always present. Such an obstacle to effective consumer protection in a crisis – particularly if it involved a larger, national insurer – would be untimely.

b) PACICC has argued that the structure of the industry's capital standard (MCT) itself could unnecessarily amplify systemic stress by incorporating "non-cash" elements of a very large PACICC Assessment after a major quake. OSFI has established a formal calendar for a full review of MCT with a target date for implementation in 2025. PACICC has flagged to OSFI our intention of proposing a specific PACICC "line" in the new standard's formula which would more easily facilitate the sensible application of "regulatory forbearance" by prudential supervisors in a time of systemic stress.

c) Finally, we are now engaged with our colleagues at the British Columbia Financial Services Authority (BCFSA) in the planning for a desktop insolvency simulation exercise to test how PACICC would employ the "circuit breaker" clause in its MoO. Specifically, this relates to Paragraph 34 of the MoO, which states:

If the making of Compensation Payments, either actual or anticipated, is at any time likely to cause financial difficulties for the property and casualty industry in a Participating Jurisdiction, or for the Corporation, to the detriment of the public, the Corporation shall participate in discussions with the Insurance Regulatory Authority of that Participating Jurisdiction or all Participating Jurisdictions, as the case may be, with a view to an appropriate modification of the Compensation Payment arrangements provided for herein, and while such discussions take place, the Corporation may defer the making of Compensation Payments as is appropriate in the circumstances.

Policymakers have requested that PACICC clarify what this paragraph means – how, when and with whom PACICC would engage in discussions.

Coverage and Benefits Review

In 2020, PACICC committed to CCIR that it would review its coverage and benefits at least once every five years, with the next review occurring within three years. Our work on this file began in 2022 with a review of more than 750,000 claims files from Member Insurers. Analysis showed that PACICC's current levels of coverage are excellent:

- 98.9% of all Personal Property claims would be fully covered by the current PACICC limit. The remaining 1.1% would be covered up to the current $500,000 claims limit. They would also retain a claim on the estate of the failed insurer above this amount, or could make a "hardship" claim to PACICC.
- 97.1% of all Auto claims would be fully covered by the current PACICC limit. The remaining 2.9% of claims would be protected up to the current Auto claims limit of $400,000. They would also

retain a claim on the estate of the failed insurer above this amount, or could make a “hardship” claim to PACICC.

- 95.9% of all Commercial Property claims would be fully covered by the current PACICC limit. The remaining 4.1% of claims would be protected up to the current Commercial Property claims limit of $400,000. They would also retain a claim on the estate of the failed insurer above this amount, or could make a “hardship” claim to PACICC.
- 94.1% of all Commercial Liability claims would be fully covered by the current PACICC limit. The remaining 5.9% of claims would be protected up to the current Commercial Liability claims limit of $400,000. They would also retain a claim on the estate of the failed insurer above this amount or could make a “hardship” claim to PACICC.

The 2023 PACICC claims survey also found that the level of protection provided by PACICC was consistent across provinces and territories in Canada.

The claims survey did note that there was some erosion of coverage since these limits were revised in 2020. PACICC reported this finding (and a preliminary recommendation to introduce annual inflation adjustments to Member Insurers) in a 2023 Consultation Paper. There was a strong consensus among Member Insurers to introduce an annual inflation adjustment for Auto and Personal Property claims limits.

In November, our Board unanimously agreed that the annual Consumer Price Index (CPI), which is published each January by the Government of Canada, is an appropriate inflator to utilize for adjusting PACICC’s Personal Property and Auto benefit limits. The expectation is that Personal Property and Auto claims limits would be adjusted annually by the annual change in the National CPI each July 1st – rounded to the nearest $5,000. Our Board also concluded that, as there is no single inflator that will work well for Commercial lines, these will continue to be reviewed every five years.

PACICC has formally submitted the proposed changes to its Memorandum of Operation (required to implement the annual inflation adjustment) to provincial regulators who, under PACICC’s General By-Law, have 90 days for review. If no Participating Jurisdiction objects, the proposed changes are deemed to be approved and would be implemented following PACICC’s Annual General Meeting in April 2024.

The Industry Consultation exercise provided PACICC with input on two additional elements of the Review, and both will be incorporated into our future PACICC Workplans:

- In 2024, PACICC will conduct a comprehensive review of the “hardship” claims provision in our model, including qualifying criteria as well as the process for adjudication. In particular, the review will address scenarios where the Board might be required to address significant volumes of such claims after a natural catastrophe-induced Member Insurer failure
- In 2025, PACICC will conduct a Member Survey on usage of payment plans by Personal and Commercial lines policyholders, to help inform new thinking on PACICC benefit levels for the refund of unearned premium.

Expanding Resolution Capabilities – PACICC General Insurance

In 2023, PACICC submitted an initial draft application to OSFI for the establishment of a federally-chartered “Bridge Insurer” for the Corporation, as part of its resolution “toolkit.” We will continue to engage with OSFI (and our Members) throughout 2024 as we seek to establish the appropriate governance model, the optimal approach to capitalization and the detailed approach to operationalization for PACICC General Insurance.

It is anticipated that this effort will be the largest single work effort for the PACICC team and our external legal counsel in the course of 2024 and, as such, we have designated it as our #1 Priority Issue. Our objective is to complete the approval process with OSFI by the end of 2024, and then initiate the formal mechanisms to establish the new Bridge Insurer entity in the course of 2025.

Enhancing our Financial Capacity – Exploring Medium-Term Capacity Options

With the successful establishment of its $250 million Standby Line of Credit facility, PACICC is now confident that it has the resources required to handle short-term (first 12 months) liquidity needs in the instance of financial distress of an average-sized PACICC Member. However, there are a growing range of scenarios which would see PACICC requiring larger sums, likely in a period of broader systemic stress for the industry (e.g. post major natural catastrophe). While PACICC does have full recourse to annual General Assessments of the Membership of up to 1.5 percent of Direct Written Premium (roughly $1.2B a year, and for as many years as are required), PACICC was also granted full authority to borrow funds in its founding By-Law.

Recently, we have seen interesting developments in the United States, where a state insurance guarantee fund was able to successfully access capital markets to source debt-financing in a circumstance where greater liquidity was required than was available via its General Assessment mechanism. The guarantee fund’s success was aided by an A1 rating (i.e., upper-medium grade, low credit risk, higher end of generic rating category) from one of the major U.S. rating agencies. We have since learned that at least one other U.S. state guarantee fund maintains such a rating as part of its financing contingency plan. We propose to comprehensively explore the possibility of securing such a rating for PACICC in the course of the coming year, to better understand whether such a rating would logically align with our “low-cost” optionality model and add yet another potential tool to our resolution “toolkit.”

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.

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.

2024 Emerging Risks Webinar Dates/Topics:

Thursday, February 22
Topic: Risk Identification and Risk Assessment

Thursday, May 16
Topic: Artificial Intelligence

Thursday, October 24
Topic: Per and Polyfluoroalkyl Substances (PFAS)

Risk Officer’s Forum Meetings

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

2024 Forum Meeting Dates/Topics:

Thursday, April 4
Keynote: **Jacqueline Friedland**
(Executive Director, Risk Assessment and Intervention Hub, OSFI)

Discussion 1 Topic: All OSFI Risks

Discussion 2 Topic: Peril Stacking / Model Risk

Thursday, September 19
Discussion 1 Topic: Third-Party Risk

Discussion 2 Topic: Fair Treatment

Thursday, November 28
Discussion 1 Topic: Reinsurance Update

Discussion 2 Topic: Climate Change

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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