Dodging a bullet

An Unforgettable Year in Review

Glenn McGillivray
Managing Director,
Institute for Catastrophic
Loss Reduction

In MSA Research Inc.'s Quarterly Outlook Report Q4-2016, president and chief executive office Joel Baker writes of the "Narrow Escape" experienced by the Canadian property and casualty (p&c) insurance industry in 2016. Says Baker: "The Canadian insurance industry was put through the wringer in 2016 with the Fort McMurray wildfire in May and higher than average other Cat losses throughout the year... It was relatively brutal, but the industry made it through in one piece."

This is one way in which the industry dodged a big bullet last year. The other is with industry results as a whole (which, themselves, were largely dictated by the losses in Fort McMurray).

If the fiscal year ended on September 30, 2016, the Canadian p&c sector would have had the third-worst result in 50 years as measured by return on equity (ROE). Although that's not an exactly accurate statement—Quebec-regulated insurers only report twice a year, so their decent results were not included in Q3 industry numbers—p&c insurers still had an acceptable fourth quarter, reinforced by Fort McMurray-related drawdowns and no severe weather-related losses. All in all, the October to December period helped prop up an otherwise lacklustre first nine months.

The international insurance market

In its *Global insurance review 2016 and outlook 2017/18*, Swiss Re reported that non-life (i.e. property and casualty) premium growth was slower in 2016 than in 2015, with premiums rising by 2.4% in real terms versus 3.0% the year before. In advanced industrialized economies, premium growth decelerated to 1.7% from 2.5% thanks to slower economic expan-

sion and a softer commercial insurance sector. Swiss Re included Canada, Japan and South Korea among the larger p&c markets that experienced accelerating premium growth last year.

Property and casualty premiums in the emerging markets grew an estimated 5.3% in 2016, up slightly from 2015, but lower than the 8% annual growth experienced between 2010 and 2014. The comparatively weaker increase was due to the continued economic slowdown in Latin America, with declines recorded in Brazil, Argentina and Venezuela, sluggish-to-negative growth in Sub-Saharan Africa, and premium growth slowdown in China (7% in 2016 versus 10% in 2015). This was partly offset by recovery in Central and Eastern Europe and strong growth of more than nine points in the Middle East and North Africa.

The U.S. p&c industry's combined ratio deteriorated by 2.2% to 99.8% in the first half of 2016, driven by higher catastrophe losses and lower reserve releases than in the same period a year earlier. Excluding the impact of reserve releases, the accident year combined ratio came in at 102.8% at the end of the first half of 2016, up from 101.1% a year earlier. Rate increases contributed to strong premium growth in personal lines, while softening rates contributed to a decline in commercial premiums.

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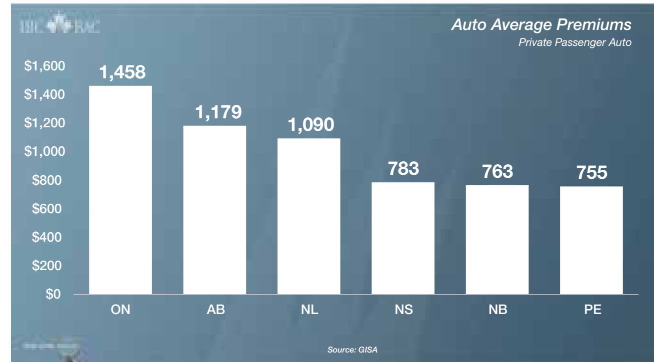

According to Swiss Re, underwriting profitability in Europe was about the same in the first two quarters of 2016 compared to full-year 2015, with the average combined ratio coming in at close to 95%.

Underwriting results in Japan and Australia, the biggest mature markets in Asia Pacific, have been mixed. In Japan, overall underwriting results deteriorated, reflecting mainly higher natural catastrophe (Cat) losses due to the Kumamoto earthquakes in April and higher losses in auto insurance. Underwriting performance in Australia, however, improved, with weakening liability and auto segments being offset by improvement in property (both commercial and personal).

Overall, Swiss Re reported that the pricing outlook in p&c lines remains challenging due to abundant capital and generally benign claims development. "Even so, an inflection point seems to have been reached and the momentum of rate softening has slowed recently," it noted in the review.

Swiss Re maintains that several factors could drive a turn in the low-price environment and set the scene for rate hardening. These include the following:

- reserve releases in places like the U.S., which "will eventually morph into a need to strengthen reserves, but it is difficult to forecast when that will happen;"
- stricter solvency regulations and higher capital requirements that will help turn the market; and
- volatile and significant capital market developments impacting insurers' capital bases; including impairments of invested assets, or a quick and strong rise in interest rates.

Canada: The numbers

"Circumstances left no way to sugar-coat 2016 results for the p&c insurance industry," said David McGown, Insurance Bureau of Canada (IBC) Senior Vice President of Strategic Initiatives, speaking at Swiss Re's 32nd Canadian Outlook Breakfast in Toronto on April 4, 2017.

MSA Research confirmed this in its report: "Year-end results for the industry came in with a slim underwriting profit, with an annual combined ratio of 99%, benefiting from a solid fourth quarter due to mild weather and strong reserve releases. Without the releases, the industry combined ratio would have been a much nastier 108.9%.

But grindingly low interest rates, the Cats and deteriorating auto results in Alberta, Atlantic Canada and, to a lesser degree, Ontario, took their toll, halving net income ($2.4 billion versus $5.2 billion in 2015) and the industry's ROE (4.9 versus 11.6 in 2015)."

According to MSA Research's Baker, the industry pulled through the year "thanks to large reserve releases at year-end, including some takedown of Fort McMurray-related reserves, in addition to relatively mild weather in the fourth quarter."

He underscored that the real story in 2016 was that the reinsurance/retro markets saved the day. McGown echoed that, noting reinsurance "likely prevented a challenging year from becoming a disastrous one for our industry" with "domestic and international reinsurers picking up an estimated 85% of the Fort McMurray losses."

Auto

According to Baker: "Auto results across the country are… keeping insurers awake at night."

He noted that, "while overall private passenger loss ratios in Ontario declined to 69.4%, that is only because of a drop-off in third-party liability (bodily injury or BI) claims. Accident benefit and physical damage loss ratios have spiked to 94.7% and 88.8%, respectively."

In Alberta, Baker asserted that private passenger auto results are "bad across the board," and he says it's the same for Atlantic Canada: "No good news there." But reforms made early last year could work to improve the product.

Ontario reforms

Ontario auto product reforms introduced in April and June 2016 were directed at lowering transaction costs, making the product more affordable for drivers and a more desirable line for insurers. According to Jim Cameron, President of Cameron & Associates, in *Canadian Underwriter* ("Ontario auto reforms should help cut transaction costs: Cameron," May 11, 2016), the transaction costs of determining entitlement to benefits—things like legal determinations, mediations, arbitrations and cost of medical examinations—have been a major problem in the system for years.

He noted that since about 1998 or 2000, transaction costs accounted for more than actual treatment costs and were "overwhelming the system,"

"I think this further attacks the transition costs piece of it, so that should be able to reduce the loss costs of the product and, therefore, reduce the premiums," he said.

According to Cameron, the reforms represent a big change and he wonders whether "people in the trenches" fully recognize the impact. "They are significant changes to the product that will impact all roles, including brokers, underwriters and claims adjusters" with, perhaps, the biggest impact being on producers. The reforms put the onus "on the broker to understand," he said.

"If an insurance company is deciding they want to exit Ontario auto, this may be something that could cause them to rethink that," Cameron suggested.

Auto and solvency

Looking at the auto line from a solvency perspective, the Property and Casualty Insurance Compensation Corporation (PACICC) has identified a few potential problem markets across the country in its 2016 Annual Report.

In Ontario—the country's largest auto insurance market, representing about a quarter of all p&c premiums written in the country—the product appears profitable for the time being. "The question facing consumers and the insurance industry is whether the latest round of reforms is sustainable and will affect industry solvency," the report said.

In Alberta, cost pressures—most prominently on the liability portion of the product—have increased markedly since a 2011 court decision that weakened the cap on minor injuries. "Under these conditions, PACICC considers insurers with a substantial book of Alberta auto business to have a higher risk of underwriting losses, which could impact their solvency."

In Atlantic Canada, "insurers focused on selling auto insurance… also face underwriting pressures over the next two to three years," PACICC noted. Stability enjoyed from years-old reforms in New Brunswick, Nova Scotia and Prince Edward Island that lowered claims costs, reduced prices for drivers and improved insurer profitability has since eroded. "In all three markets, there is evidence of increasing claims costs in the Bodily Injury portion of the auto insurance product, which will put upward pressure on rates in the near term. There will also be higher solvency risk if governments do not allow rates to offset these increased costs." PACICC believes that the system needs to be reformed in order to reduce long-term costs of auto insurance in these provinces.

In Newfoundland and Labrador, auto insurance is another source of concern. "Unlike the other Atlantic Canada markets, the province did not introduce the same reforms and, as a result, claims costs are rising faster than premiums. The Newfoundland and Labrador market is currently unprofitable and is eroding the capital base of insurers," PACICC said. "Solvency risk may, therefore, be elevated for insurers selling auto insurance in Newfoundland and Labrador."

The reinsurance side

In its *Global insurance review* 2016 *and outlook* 2017/18, Swiss Re noted the global p&c reinsurance industry is heading for a fifth year of strong, though lower, underwriting results. Near the end of 2016, after the November earthquake in New Zealand, the global p&c reinsurance sector was looking at an estimated year-end combined ratio of 93% to 94%.

This is marginally higher than prior years due to natural disaster losses that began trending back toward the 10-year average after a few quiet years (driven largely by benign North Atlantic hurricane seasons). ROE, according to Swiss Re, was projected to be around 9%. And while reinsurance prices continued to trend down in 2016, price decreases were less than in previous years.

Swiss Re noted that there is still an abundance of reinsurance capital (recently reported by Aon Benfeld at US$595 billion [all lines], up 5% over 2015), with strong supply in both traditional and alternative capacity. "However, the rapid expansion of alternative capacity which caused a sudden supply/demand imbalance in property catastrophe reinsurance in 2013–2014 has abated, as average returns for several alternative capital business models have fallen below their cost of capital," it reported. Alternative capital was estimated to be US$61 billion (excluding retrocession) by mid-2016, up slightly from year-end 2015. While it has maintained a roughly 18% share of global capacity in property catastrophe reinsurance, Swiss Re noted that in the broader context of all risks covered by the global non-life reinsurance market, market share for alternative capital is less than 2%.

Traditional capital in the international p&c reinsurance segment grew by 7% in the first half of 2016. The increase was almost entirely due to unrealized gains on investments, mainly associated with declines in interest rates during the period. According to Swiss Re, comparing capital and

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premium developments in reinsurance shows that capital has kept pace with premiums—"a proxy for insured exposures"—since 2009.

Underwriting results in non-life reinsurance were strong again in 2016, due to the absence of large natural catastrophe losses, said Swiss Re. It noted that based on six- and nine-month data, the reinsurance industry was expected to report a combined ratio of around 93% to 94% for the financial year 2016. However, the company warned that this does not properly reflect underlying underwriting profitability, because natural catastrophe losses (particularly North Atlantic basin events) have been lower than anticipated in recent years and the claims ratio has been reduced by positive reserve releases from redundant reserves for prior years' claims. "Excluding these two impacts, the underlying combined ratio will likely be close to 99% in 2016," it said.

In the low-yield investment environment, underwriting results remain the main profit driver for p&c reinsurers, said Swiss Re. The industry achieved what Swiss Re called a "meagre" averaged 3.5% annualized investment yield in the first half of 2016, up slightly from 2015. About 2.6% was from investment income and 0.9% was from capital gains. Based on a combined ratio of 93% to 94%, an ROE of around 9% is expected for full-year 2016, down three points from 2015.

Looking specifically at the Canadian segment, the 20 entities in the Reinsurance Research Council's (RRC) 2016 results reported assumed premiums of $2.54 billion in 2016, up from just over $2 billion in 2015 when 19 companies reported (Lloyd's Underwriters was not included in the council's posted member results for 2015). The 20 reported an underwriting loss of $533.7 million in 2016 (down significantly from a $343.1 million underwriting profit for 19 companies the year before). The huge difference largely owes, of course, to Fort McMurray and 12 other severe-weather events recorded in the country last year.

The group reported a total loss ratio of 82.2% in 2016 (up markedly from 47% in 2015) and an expense ratio of 29% (compared to 31.5% the year prior) for a combined ratio of 111% (up from 78.5% in 2015). The number should be no surprise given the disaster losses booked for the year.

Total investment income came in at $242.4 million (up from $186.9 million in 2015). A wholly unsurprising after-tax loss of $337.6 million was recorded, after 19 companies booked a $445 million profit the year before.

Natural catastrophes

According to Swiss Re's annual overview of natural catastrophes and man-made losses, totals for 2016 were the highest since 2012 and back in line with the 10-year, inflation-adjusted average. Internationally, the company reported 327 disaster events, 191 of which were natural catastrophes and

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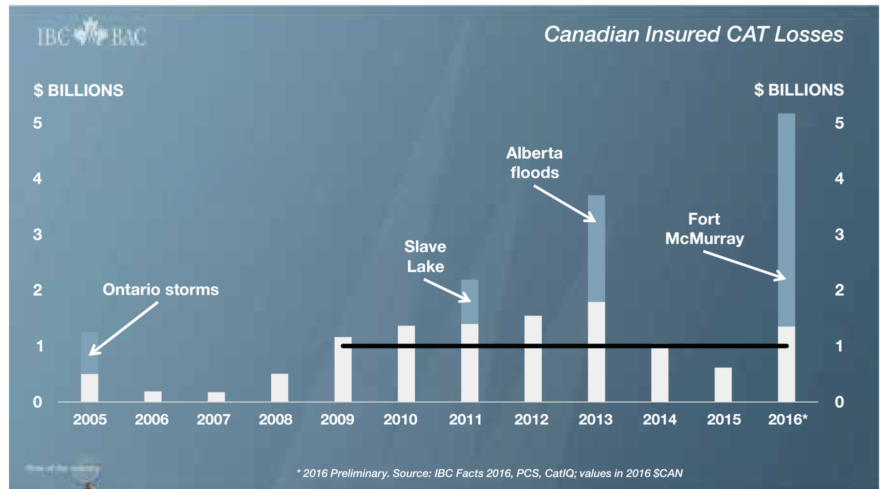
136 of which man-made disasters. In total, the events resulted in insured losses of US$54 billion: US$46 billion from natural catastrophes and US$8 billion from man-made disasters. The total is in line with the 10-year average of US$53 billion. Economic losses (i.e. the total of insured and uninsured losses) of US$175 billion came close to double the 2015 level.

Several large-scale disaster events occurred across all regions in 2016, including earthquakes in Japan, Ecuador, Tanzania, Italy and New Zealand. In Canada, the Fort McMurray wildfire came in as the country's biggest insurance loss event ever.

Worldwide, around 11,000 people lost their lives or went missing in disasters in 2016. According to Swiss Re, there were a number of severe flood events in the United States, Europe and Asia. Hurricane Matthew, the first Category 5 storm to form over the North Atlantic since 2007, was also a major humanitarian disaster, causing more than 700 deaths, mostly in Haiti.



Until 2016, these were some Canada's record-breaking disasters:

- the costliest wildfire in Canadian history (the 2011 Slave Lake event);
- the costliest flood and costliest disaster in Canadian history (the 2013 southern Alberta event);
- the (newest) costliest disaster loss in Ontario history (the 2013 Toronto rainstorm/flood); and
- the costliest hailstorm in Canadian history (2014 Airdrie, Alberta).

With 2016, we now have to update

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the list with the newest costliest wildfire event in Canadian history, doubling also as the costliest disaster in Canadian history by far: the May wildfire in Fort McMurray. The event comes in at just under $3.7 billion insured (not including lost adjustment expenses) over more than 45,000 claims filed.

The wildfire loss was unprecedented in size and scope, going down not only as the largest such loss in Canadian history, but also being included in the Top 50 largest insured catastrophe losses. It sits near the bottom of the list, which includes some of the costliest earthquakes, hurricanes and floods of all time.

The sense is that Fort McMurray, costlier than the 2013 floods in southern Alberta and Toronto together, and then some, will stay on top of the loss charts for years to come. That being said, many thought the same of the 2013 Canadian Cat year, so it is probably best not to prognosticate.

Along with the costs and the ongoing challenges associated with rebuilding Fort McMurray, three things are noteworthy when considering last year's roster of natural disaster losses.

First (and staying with the "dodging a bullet" theme), the ongoing misery experienced by residents of Fort McMurray and the costs being incurred by governments (read: taxpayers), insurers and reinsurers all emanate from the loss of 10% of the built city. The industry must really ask the question: What would it have had to deal with if one-quarter, one-half, three-quarters or all of the city was lost? Fort McMurray had the capacity to be a much, much larger loss than it was. As it stands now, it wiped out several years of profit from the Alberta property market.

It should have the industry thinking a lot more about what could have been, what could be elsewhere in Canada, and what other types of natural disaster scenarios could happen that have not been contemplated or modelled.

Second, somewhere around 200 or more residences have already been rebuilt in Fort McMurray and judging by photographs, many (perhaps all) have been constructed with vinyl siding. The industry is essentially putting Fort McMurray back the way it was (i.e. with the same level of risk).

One day, the city may be hit with another wildfire disaster (after all, it is in the middle of the Boreal forest and is surrounded by scars from many past wildfires) and the mistakes being made now will surely come back to haunt. The definition of insanity truly is doing the same thing over and over, and expecting a different result.

Third, 12 other catastrophes were recorded in Canada last year, for a total of 13 events. All in all, the baker's dozen

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cost Canadian insurers and reinsurers somewhere around $5.3 billion (not including claims adjustment expenses). It wasn't the busiest year for frequency since consistent records have been kept—2011 takes the crown with 14 events—but it was the costliest by far. Nine of the 13 events involved hail, and six took place, at least in part, in the province of Alberta. Fort McMurray excluded, there was still more than $500 million in insured losses in Alberta from severe weather last year.

Looking forward

In its *Global insurance review 2016 and outlook 2017/18*, Swiss Re projected overall moderate advancement for the global p&c sector, with emerging markets serving as the main driver of growth with overall premium increases forecast to improve to 6% to 7% in real terms in 2017 and 2018.

Counterbalancing that will be the industrialized markets, which are expected to grow only slightly in 2018 since macroeconomic conditions will improve only modestly and inflation is expected to increase.

Swiss Re projected that underwriting profitability in p&c will likely deteriorate in 2017 and 2018, assuming natural catastrophe losses at historical averages and an erosion of reserve releases. "Casualty claim trends are picking up momentum in markets like U.S. commercial auto and other liability lines, and this will reduce profitability and accelerate rate hardening in casualty," it said.

On the investment side, Swiss Re noted that insurers' investment income has been weak for some time due to the prolonged ultra-low interest rate environment, and this will not change soon. As interest rates gradually rise, investment income will grow only slowly, lagging rising rates.

Overall profitability in 2017 and 2018 is expected to remain at current lows, with ROE of around 6%.

The company noted that political instability could be a "significant headwind" for advanced market insurance sectors, with Brexit possibly leading to structural changes in insurance markets. "Conversely, rate dynamics are likely to add to growth in the following years. Global non-life premium growth is forecast at 2.2% in 2017 and 3.0% in 2018."

On the reinsurance side, global p&c premiums are expected to grow in 2017 in real terms, based on increasing cessions from emerging markets, noted Swiss Re. Premium growth in advanced industrialized markets "will reflect a moderation in rate pressures, slowing growth in the primary market and accelerating inflation."

Demand will likely also be supported by new solvency regulations, with p&c reinsurance becoming more attractive for European insurers under Solvency II, "since the new standards better reflect the risk mitigating effect of reinsurance."

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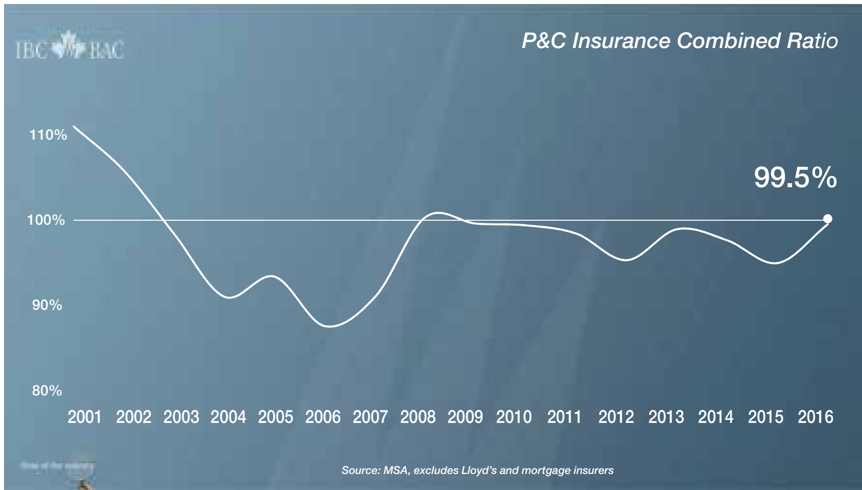

Swiss Re maintained that given the strong erosion of profit margins over the last two years, property catastrophe reinsurance rates are close to bottoming out. Indeed, the softening of average rates is expected to moderate across all lines of business. For casualty and specialty lines, significant differences in pricing developments by market and line of business are expected.

Under the assumption of average catastrophe losses, moderating rates and a less benign claims environment, the company estimates industry-wide combined ratios of around 94% to 96% in 2017 and 2018. And while it believes that underwriting profitability will likely remain below the average of recent years, investment returns will improve, though they will lag interest rate increases. Swiss Re is estimating moderate profitability of around 7%, again, assuming average natural catastrophes losses.

Here at home, as with much of the world, uncertainty appears to be the only thing that is certain. Indeed, according to IBC's McGown, "it's a no-brainer to say that we should expect more uncertainty," pointing to such upcoming events as the elections in France and Germany, the future of Brexit and the Trump Administration.

Of 2016, McGown noted that with interest rates unchanged and 1.4% overall growth in Canada (modestly better than in 2015) "yields on government bonds remained low for most of the year. For our industry, this is significant because government bonds make up almost 40% of our industry's investments."

He offered some hopeful signs for 2017, including a projected increase in global economic activity and Canada's economy exceeding expectations, now growing at an annualized rate of 2.3%.

McGown cautioned that there is much work to be done, including efforts to modernize out-of-date regulation on auto products, "which lags far behind today's technology and today's consumer expectations. I think we can agree that our customers are as frustrated as the industry. And the root of the frustration—ours and theirs—is, ultimately, cumbersome provincial regulatory systems," he said. "Work is also required with regard to property lines and soaring natural catastrophe losses."

McGown is correct and 2016 underscored the point with three bold lines.

All the natural catastrophe (i.e. events of $25 million insured or higher) losses from 2009 to 2016 inclusive, total more than $14.2 billion (not including claims adjustment expenses). This doesn't include what are often called "mini Cats" or small, day-to-day, one-off weather-related losses.

Last year, the industry dodged a big bullet, to be sure. But you never know when the next bullet will have the industry's name on it.

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