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September 27, 2017

Ms. Eleanor Ryan
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Re: Second Consultations for the Review of the Federal Financial Sector Framework

Dear Ms. Ryan,

Thank you for the opportunity to participate in the second consultation for the Federal Financial Sector Framework review. Representing more than 90% of Canada's private property and casualty (P&C) insurance companies, Insurance Bureau of Canada (IBC) is pleased to provide the Department of Finance with our members' perspective on the government's second consultation paper, *Potential Policy Measures to Support a Strong and Growing Economy: Positioning Canada's Finance Sector for the Future*.

Our commentary focuses on the following six issues:

1. Earthquake insurance;
2. Cyber insurance;
3. The fintech business powers of financial institutions and fintech collaboration;
4. Climate risk disclosures;
5. Nuclear insurance; and
6. Corporate governance measures.

Earthquake Insurance – Safeguarding a Stable and Resilient Sector

As we have discussed previously, Canada's P&C insurance industry is capitalized well above international norms to withstand the financial consequences of a sizable earthquake. By 2022, Canadian insurers will have to have sufficient capital to survive two simultaneous events in British Columbia and Québec and provide for a 1-in-500 year event. However, there are limits to the capacity of an insurer and the industry to inoculate against such catastrophes. A catastrophic earthquake beyond a 1-in-500 year event would lead to institutional failure and would result in the Property and Casualty Insurance Compensation Corporation (PACICC) assessing surviving member insurers with the consequence of more failures. In order to prevent contagion within Canada's P&C insurance industry, the federal government can make straightforward amendments to the *Insurance Companies Act* (ICA).

This approach has the following benefits:

1. The requested changes are administrative in nature and relatively simple to implement.

2. The proposed approach to addressing contagion has been discussed with the most affected provinces and has the support of the provincial regulators.

3. The proposed changes have been designed to account for moral hazard within the industry as insurers will be allowed to fail. The proposed approach is designed to prevent contagion and to prevent the further failure of responsible actors.

4. Finally, to the best of our knowledge, the proposed approach does not have a fiscal effect on the government's financial position.

PACICC is designed to manage the occasional small to medium-sized insurer failure, and it has efficiently managed twelve such failures since it was established. However, PACICC was not designed to respond to an extreme catastrophic earthquake. If faced with such a catastrophic event, PACICC would not be able to fulfill its core consumer protection mandate at the time when it would be most needed. A solution that promotes the stability and resiliency of the financial sector is crucial as the frequency of catastrophic events continues to rise.

A catastrophic earthquake could cause widespread, systemic institutional failures with knock-on consequences throughout the financial services sector, creating significant uncertainty in financial markets. An event of this magnitude would leave Canadians financially exposed and unable to rebuild their homes, causing severe macroeconomic consequences across the national economy. Insurer failure as a result of an earthquake does not only put policyholders facing earthquake damages at risk, but all home, auto and commercial insurance policyholders across the country doing business with that insurer.

The issue requiring immediate resolution is that, under the current framework, a catastrophic earthquake in excess of the 1-in-500 year capitalization threshold could trigger systemic financial risk. In such a scenario, PACICC would not be able to raise sufficient liquidity from secondary stressed insurers to compensate the policyholders of failed insurers. Such catastrophic earthquakes are plausible and have occurred recently in New Zealand and Japan.

Policy Recommendation

To ensure that PACICC can fulfill its legal and financial obligations towards policyholders without triggering systemic financial risk, we recommend that the federal government enable PACICC to access a credit facility drawn on the Consolidated Revenue Fund (CRF) to provide emergency lending assistance (i.e., liquidity provision) for policyholder compensation in response to institutional failures.

This last resort, contingent funding commitment would ensure that, in the aftermath of a catastrophic earthquake, PACICC has immediate access to the liquidity it requires to compensate the policyholders of failed insurers in an orderly and timely manner.

A last resort, federal emergency arrangement for the industry's policyholder compensation scheme, PACICC, and the P&C insurance industry – or the *Policyholder Protection Facility* – would prevent the systemic financial impact associated with a catastrophic earthquake while reducing expected costs to the government in the form of higher debt and budgetary pressures.

In addition to providing liquidity to compensate policyholders for the claims liabilities of insurers that have already become insolvent, the credit facility would ensure that there is still an insurance market capable of meeting the continuing protection needs of Canadian consumers and businesses.

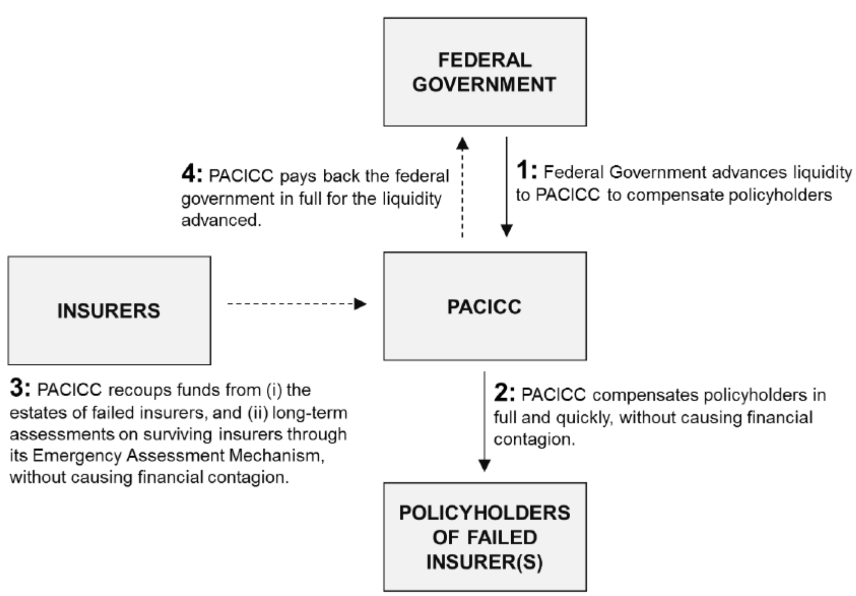
Why is emergency lending assistance for PACICC necessary?

PACICC's primary source of funding resides in its ability to assess insurers operating in Canada. Under the current framework, when an insurer fails, PACICC assesses all surviving insurers to raise the liquidity it requires to compensate the policyholder liabilities of the failed insurer.

However, in the aftermath of an extreme catastrophic earthquake, large-scale insurer failures would lead to a large cash call on surviving (solvent, but potentially at-risk) insurers. In such circumstances, PACICC's assessments would further stress the surviving insurers' already weakened balance sheets, triggering the likelihood of second-round insolvencies (i.e., financial contagion) and ultimately putting more policyholders at risk.

How would emergency lending assistance for PACICC work?

Emergency Lending Assistance for Policyholder Compensation



When the PACICC policyholder compensation mechanism is triggered following a catastrophic earthquake and following insurer failures, the PACICC board of directors would, in consultation with the Department of Finance and the Office of the Superintendent of Financial Institutions (OSFI), determine whether PACICC's existing assessment model is sufficient to raise liquidity quickly to compensate policyholders without triggering systemic risk to surviving insurers.

Should this consultation determine that PACICC's assessment model is not sufficient to raise the required liquidity without triggering systemic risk to surviving insurers, PACICC would access the credit facility to fund its immediate liquidity requirements and quickly compensate policyholders with claims resulting from the catastrophe itself and all other claims for a period of twelve months following the failure of an insurer.

Funds advanced by the government through this credit facility would be paid back in part through future assessments that PACICC would levy on surviving insurers, once insurers' balance sheets have returned to a viable state, and from the estates of insolvent insurers, once they become available. The repayment and assessments on insurers would take place over a long timeframe (to be determined through regulations) to minimize adverse market and consumer effects.

<u>Insurers that have failed following the catastrophic earthquake would still fail</u>. There would be no disruption to market dynamics or change to incentives for prudent capitalization and risk management. The only difference in terms of market outcomes is that the unintended chain of second-round failures that would otherwise occur due to PACICC's assessments on surviving insurers – that is, systemic financial contagion risk – would be avoided.

<u>How long would it take for the industry to pay back the federal government?</u>

PACICC has already designed an Extraordinary Assessment Mechanism (EAM) that would allow it to place such a cash call or assessment in a prospective and timely fashion. Using the EAM, PACICC would be able to assess insurers to recover any funds borrowed from the government, without causing detrimental capital/contagion impacts on insurers.

Every provincial insurance act includes a requirement, either in the legislation or in the supporting regulations, that insurers must be a *member of good standing* of a compensation fund when selling insurance. To be a *member of good standing*, the insurer must pay PACICC assessments as they come due. This means that, through its EAM, PACICC would be able to recover funds to pay back the government from all insurers operating in the country.

In the aftermath of a catastrophe, it would be prudent to focus on rebuilding the strength and stability of the insurance industry, while also ensuring that as many Canadians as possible are financially protected and not exposed to significant cost-inflation in insurance premiums. Therefore, we recommend that the liquidity loan has an initial grace period, with the full repayment schedule beginning at some 48 months or so after the event to ensure that insurers have rebuilt sound balance sheets and to protect consumers from immediate-term premium shocks. Longer payback schedules should also be considered as a tool to mitigate the impacts on consumer premiums. A $20 billion loan, under this scenario, could be paid back within a ten-year timeline.

This also works to enable surviving insurers to step into the markets of those failed insurers. Were 25% of Canada's property insurance market to be left without their insurer due to the failure of their insurer, it would be prudent to help find ways for those surviving insurers to meet those insurance needs.

<u>What would be required to implement emergency lending assistance for PACICC?</u>

To give PACICC the ability to borrow would require two minor amendments to the ICA. In addition, the Department of Finance would become a signatory to PACICC's Memorandum of Understanding and join the provinces on its board of directors.

1. *Legislative Change*

   The *Financial Administration Act* (FAA) has already been amended after the financial crisis to give the Minister of Finance the authority to enter into financial stability arrangements (Part IV.1) to promote the stability or maintain the efficiency of the financial system in Canada, including a contract to: "*make a loan to an entity*", "*provide a line of credit to an entity*", and "*guarantee any debt, obligation or financial asset of an entity*". Consequently, given that such a credit facility would be structured as a loan or guarantee, the FAA already authorizes payment out of the CRF under these systemic arrangements.

   The ICA can be amended to ensure that insurers belong to a P&C compensation association that is recognized by the Minister and that has the authority to levy assessments on industry members (i.e., PACICC). This would parallel the existing section of the ICA, section 449. Such a requirement in the ICA could be justified for systemic risk reasons, as it is desirable for all insurers to belong to the mechanism.

   In addition, under "Remedial Powers" in Part XV of the ICA, the following could be added after section 675.1.

   > *Agreements with Compensation Associations*
   >
   > *675.2 (1) The Minister may advance funds to a designated compensation association, in such amounts, in such circumstances, and on such conditions as are designated by regulation.*
   >
   > *(2) For the purpose of Subsection (1), the Governor in Council* [or Minister] *may make regulations designating the method for determining the amount of funds, the circumstances, and the conditions referred to in that subsection and designating the compensation associations referred to in that subsection.*

   Under this provision, a regulation would be created to designate PACICC as a compensation association and which prescribes, among other things, the terms of the agreement between the government and PACICC, including what PACICC is to do with the funds advanced (that is, compensate policyholders under its Memorandum of Operation) and the terms of the lending assistance agreement (i.e., rate of interest, if any, repayment period, etc.).

2. *Regulatory Change*

   This approach does not impact the current macroprudential regulatory framework managed by OSFI. No regulatory solvency changes would be required.

3. *Institutional/Governance Change*

   Through its Memorandum of Operation, bylaws and regulations, PACICC already has the necessary authority. Modest internal/operational changes might be required, which PACICC and its members are prepared to implement in short order.

   IBC, PACICC and the insurance industry realize that PACICC's current governance model may need to be amended in order to provide a suitable governance structure should PACICC have access to federal funds. This may include establishing a bilateral Memorandum of Understanding between PACICC and the government as well as including a representative of the Minister of Finance on PACICC's board of directors (which is currently comprised of both independent and industry directors as well as provincial and federal regulators, although the latter have non-voting rights). PACICC's existing governance is the result of agreements between the corporation and each provincial government. Any governance changes deemed necessary can be accommodated within the current framework and can be implemented in short order to meet the timing requirements of the Federal Financial Sector Framework review.

<u>What would the fiscal impact be to the federal government?</u>

According to Public Sector Accounting Standards, this contingent funding commitment would remain fiscally neutral – unless and until triggered. Because its likelihood of occurrence and impact cannot be reasonably estimated (since it is not possible to forecast what kind of earthquake might occur and the level of economic and insured losses), the government would be under no obligation to quantify and accrue any liabilities.

When triggered, the impact on government finances would be equivalent to that of any other loan – that is, it would depend on the terms and conditions of the credit/loan extended to PACICC, including any associated interest rate. These terms and conditions can be defined through regulations.

Most importantly, the fiscal impact should be assessed relative to its counterfactual. That is, if this credit facility is not in place, following a catastrophic earthquake, financial contagion would be triggered, causing large-scale second-round institutional failures, and government-sponsored financial assistance would still be needed. The government would still be faced with lending pressures in order to prevent systemic financial contagion. However, in the absence of a predetermined, coordinated approach, financial assistance would be chaotic, leading to higher transaction, legal and reputational costs, as demonstrated by past financial crises.

As reported in the Conference Board of Canada's 2016 study, *Canada's Earthquake Risk: Macroeconomic Impacts and Systemic Financial Risk*, the expected cost to the government, in the form of higher debt and budgetary pressures, could be halved from $120 billion to approximately $60 billion, if an emergency backstop arrangement such as the proposed *Policyholder Protection Facility* was in place to prevent systemic financial risk.

How would consumers be affected?

In the absence of emergency lending assistance, consumers with earthquake insurance would be left financially exposed, unable to rely on insurance compensation in the aftermath of a large earthquake. Insurer failure as a result of an earthquake does not only put policyholders facing earthquake damages at risk, but all home, auto and commercial insurance policyholders across the country at risk. Risk to consumers extends beyond earthquake insurance policyholders as PACICC would not be able to raise sufficient liquidity from secondary stressed insurers to compensate the policyholders of failed insurers. Consumers would also face increasingly limited and unaffordable earthquake insurance coverage options, given that the threat of systemic insolvency makes the provision of earthquake insurance economically and commercially challenging for insurers. Consumers may also not have access to an insurance market that can adequately meet their ongoing personal and commercial protection needs in the years following a major earthquake.

Emergency lending assistance ensures that policyholders of insolvent and solvent insurers are able to access the insurance compensation they are eligible for in the aftermath of a large earthquake. Critically, it also ensures that in the aftermath of a large earthquake, home, auto and commercial insurance policyholders across the country continue to be able to purchase coverage and, in the event of a loss, be compensated. Finally, it ensures that PACICC is able to fulfill its consumer protection mandate, properly managing any insolvencies that may occur due to a large earthquake.

Cyber Insurance – Safeguarding a Stable and Resilient Sector

We agree that cyber risk in all its forms is increasing in frequency and severity. Insurers are playing a meaningful role in cyber security by creating new products that provide financial protection against certain kinds of cyber risks. Consumer and business interest in cyber insurance is growing, with cyber insurance becoming one of the fastest growing insurance markets in Canada.

Today, there is an urgent need for greater collaboration among governments and the private sector, including insurers, to create a Canada-wide cyber security strategy. Last fall, IBC filed a submission with the government on Public Safety Canada's consultation on Canada's approach to cyber security. In the submission, we recommended the following:

- Government-industry partnerships should be formed to create cyber security programs that deepen individuals' and businesses' understanding of the threats and that reinforce the behaviours that reduce risk in cyberspace.

  Initiatives such as Public Safety Canada's Cyber Incident Response Centre (CCIRC) and Canadian Cyber Threat Exchange (CCTX) help prepare Canadian businesses by offering support to companies facing cyber threats and by providing insight on emerging threats. However, no amount of security can completely eliminate cyber threats. Instead, what is needed is a general shift in corporate and social culture to be vigilant against cyber risks by taking basic steps to protect digital infrastructure.

Public awareness of cyber has to be the foundation of any strategy. This approach has been successful for other risks. Government-industry partnerships have already been implemented successfully to shift societal understanding of issues with adverse effects, such as workplace violence, impaired driving, fire prevention and vehicle safety.

- Governments should collect information about cyber security incidents and share it with insurers and other stakeholders through a secure method on an anonymous basis.

  A secure, anonymous data repository would give insurers access to data on cyber risk. The data could then be used to overcome the challenge of assigning value to losses experienced from cyber incidents, which is common in insurance markets for new and evolving risks, particularly ones with the aggregation potential of cyber. Sharing the data this way would facilitate the development of new cyber insurance products and the expansion of the market, providing more coverage and risk management services to businesses and individuals.

Fintech – Supporting a Competitive and Innovating Sector

In general, there is a lack of clarity on whether fintech takes into account the concept of insurtech. If it does in the second consultation paper, collaboration between incumbent insurers and insurtech companies can be of mutual benefit by encouraging cross-pollination of ideas and contributing to an industry that is more responsive to the needs of Canadians.

For insurers to embrace innovation and meet consumer expectations, the federal and provincial regulatory frameworks have to reflect modern realities. Insurers are investing and partnering with insurtech companies and are early adopters and users of new technologies. We encourage additional regulatory flexibility, both provincially and federally, that would allow insurers to enhance their partnerships with insurtech companies and bring new products, services, rating practices and claims management approaches to the market.

Climate Risk Disclosures – Safeguarding a Stable and Resilient Sector

The widespread adoption of the voluntary climate-related disclosures recommended by the Financial Stability Board's (FSB) Climate-Related Financial Disclosures Task Force will benefit society by increasing the transparency associated with financial implications related to climate change. Specifically, climate-related disclosures will provide the metrics and the information needed to undertake robust, consistent analyses across industries and jurisdictions.

Insurers support climate change adaptation and mitigation efforts, such as land-use planning and investment in public infrastructure to protect communities from severe weather events, and have regular discussions with federal, provincial and municipal government officials on these efforts. As the federal government's work on climate-related disclosures continues, we would welcome the opportunity to discuss the insurance industry's perspective on the matter.

Nuclear Insurance – Modernizing the Framework

The Nuclear Insurance Association of Canada (NIAC) and its member insurers provide liability and property insurance for Canadian nuclear power generating stations, research reactors and nuclear suppliers and transporters. Repealing the nuclear insurance exemption in Part XIII of the ICA will affect NIAC and its members' ability to secure coverage for Canadian nuclear risks. We recommend that the government consult with NIAC and its members to inform any change to the nuclear insurance exemption.

Corporate Governance Measures – Modernizing the Framework and Safeguarding a Stable and Resilient Sector

Establishing Annual Elections

Changing the federal financial institution statutes from allowing director elections for one, two or three-year terms to establishing annual elections for directors with fixed one-year terms may result in instability of a company's board due to the potential for recurring turnover and disruption of the continuity of its board members and their knowledge and expertise. This change would not only introduce an element of risk for smaller insurers, but also impose significant director re-training requirements for management that would have to occur on an annual basis. This new requirement, taken together with other proposed corporate governance changes such as promoting diversity on boards, mandating individual director elections and majority voting, would consume a lot of management's time and could potentially be exceptionally onerous.

We recommend maintaining the ability of electing directors for terms of one, two or three years.

Information Publication Requirements

It is unclear from the consultation paper what the concern is regarding the amount and type of information that OSFI currently publishes. The example given in the consultation paper refers to OSFI publishing "basic information (e.g., legal name, chief agent)", which would appear to be very basic corporate information that is available from various sources.

Place of Records

In addition to obtaining the same benefits that banks currently have, allowing foreign insurers to hold records in Canada at a location other than the location of the chief agency of the foreign company would enable records to be managed more consistently across the organization, which has been an operational challenge for many insurers in the past. This ability should also apply to the records of insurers' foreign held subsidiaries.

Related-Party Regime

It is unclear whether expanding the scope of the definition of a related party would unintentionally capture certain forms of investments, for example, minority investments in the context of special relationship brokers or pooled funds in the context of a fidelity. Whether or not examples such as these may be considered to be a *non-controlling significant interest* or a *substantial investment* remains unclear based on the description in the consultation paper. We request further clarification to understand the government's intended outcome of this proposal.

We are not aware of a problem with the current exemption in the ICA for a company controlled by a foreign insurer which has a licensed Canadian branch. The proposal to expand the application of the related-party regime would not apply to the similar exemption in the ICA where the parent holding company is a Canadian-incorporated federally regulated financial institution. We request clarification on the concerns that the government is trying to address and the intended outcome for this proposal, which would allow us to consult with insurers on this matter and then provide the government with meaningful comments.

Conclusion

Risks of earthquakes, cyber and climate change as well as developing consumer expectations of insurers require changes to the federal and provincial legislative frameworks. The current federal review provides an opportunity to safeguard a stable and resilient financial services sector for all Canadians and businesses, to support competition and innovation to improve customer experience, and to modernize the federal legislation. As a best practice, when the government proceeds with legislative reform, we advise conducting cost-benefit analyses of any new measures.

Thank you for the opportunity to participate in the second consultation for the Federal Financial Sector Framework review. We look forward to working with the government in advancing these issues. In particular, we are interested in following up with the Department of Finance on the technical attributes of the earthquake credit facility proposal. Please do not hesitate to contact me if you have any questions or comments.

Sincerely,

David McGown
Senior Vice President, Strategic Initiatives

c.c.: Don Forgeron, President & CEO, IBC
Craig Stewart, Vice-President, Federal Affairs, IBC