Consultation submission

SECOND CONSULTATIONS FOR THE REVIEW OF THE FEDERAL FINANCIAL SECTOR FRAMEWORK

PREPARED FOR:

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September 29, 2017

INTACT SUBMISSION TO THE SECOND CONSULTATIONS FOR THE REVIEW OF THE FEDERAL FINANCIAL SECTOR FRAMEWORK

Intact Financial Corporation is the largest provider of property and casualty (P&C) insurance in Canada and a leading provider of specialty insurance in North America, with close to $10 billion in total annual premiums. The Company has over 13,000 full- and part-time employees who serve more than five million personal, business, public sector and institutional clients through offices in Canada and the U.S. In Canada, Intact distributes insurance under the Intact Insurance brand through a wide network of brokers, including its wholly-owned subsidiary BrokerLink, and directly to consumers through belairdirect. In the U.S., OneBeacon Insurance Group, a wholly-owned subsidiary, provides specialty insurance products through independent agencies, brokers, wholesalers and managing general agencies.

While Intact applauds the initiative of federal authorities in consulting on various aspects of the changing landscape in the financial services sector in Canada, there are two specific issues raised by the Consultation Paper on which Intact wishes to offer its perspective: **(1)** earthquake insurance and, **(2)** corporate governance.

1. EARTHQUAKE INSURANCE

The Consultation Paper summarizes the existing regime in Canada with respect to earthquake insurance quite well.

As a federally regulated P&C insurer, we believe that Intact's insurance subsidiaries are able to manage the financial cost of any likely natural disaster. Canadian insurers are among the best prepared in the world for earthquake losses. Existing stringent prudential standards imposed by the Office of the Superintendent of Financial Institutions (OSFI) are appropriate and, in our case, complied with.

Based on these aspects of the current regime, Intact is not concerned about its ability to cope with low-probability earthquakes. Our focus is on avoiding the impact of possible financial contagion caused by the failure of an undercapitalized insurer. This submission serves to complement that made by the Insurance Bureau of Canada (IBC) which we, as an IBC member, fully support, including the suggestion to enhance consumer awareness of earthquake insurance products that are available. Intact is prepared to discuss more fully how such a program of raising consumer awareness could be accomplished on a collaborative basis between the industry and government.

Our focus is on ensuring stability of the insurance sector in the wake of a major earthquake. Given the profound human consequences of an extreme earthquake, this is a matter that Intact takes very seriously. Unlike disasters that stem from many small problems conspiring to cause one very large problem, earthquakes stem from one enormous problem that causes many other enormous problems.[1] Physically this means sliding and shaking that trigger fires, flooding, pipe failures, dam breaks, and hazardous-material spills—but this also means financial reverberations that affect an entire national economy.

In the following pages we propose sensible and proven policies that will, when adopted, prevent the systemic collapse of Canada's insurance industry. Our recommendations will not, however, prevent the failure of undercapitalized insurers or those providers who have not invested in adequate reinsurance. Nor will our recommendations suggest a bailout. This approach provides incentives for companies to be well managed and well capitalized.

1. Schulz, Katheryn. “The Really Big One: An earthquake will destroy a sizable portion of the coastal Northwest. The question is when”. *New Yorker*. July 20, 2015

A MAJOR EARTHQUAKE IN CANADA: A REAL AND PRESENT DANGER

It is not a matter of if, but when, a major earthquake will strike Canada and when it does it will likely be the largest natural disaster the country has faced.[2] Our jobs as insurers and policy makers is to ensure that P&C insurance can respond to the needs of the tens of thousands of Canadians that will be impacted by a major quake. Tools should be in place before a catastrophic earthquake occurs in order to avoid the risk of potential collapse of Canada's financial system.

Specifically, it is vitally important to proactively bolster the P&C Insurance Compensation Corporation (PACCIC) to reduce systemic impacts from severe catastrophes. Experience from extreme events in other countries tells us that having more tools available in advance to deal with catastrophic events has proven to reduce post-catastrophe disaster claims.

Our recommendations mirror those made previously by the IBC and other institutions such as the C.D. Howe Institute[3] to proactively bolster PACCIC:

First, we recommend that PACCIC be strengthened so it can intervene *before* insurance companies in financial difficulty become insolvent. A credit facility should be available to PACICC to provide emergency lending assistance for policy holder compensation in response to institutional failures and would ensure that there is still affordable insurance for Canadians and businesses following a catastrophe.

Second, to further protect Canadians and accelerate post-earthquake recovery, we recommend PACCIC have the capability to borrow funds to reduce its liquidity needs in a crisis. This could take the form of a loan from the federal government with a repayment period determined by the size of estimated PACCIC assessment (size of insured losses + number of insurers failing).

Finally, we agree that PACCIC should have the ability to isolate earthquakes to avoid a broader economic crisis that could leave thousands of Canadians unable to insure their vehicles, homes and businesses.

The above recommendations will bring greater stability to the sector and make it safe, sound and resilient in the face of stress. A properly designed federal backstop arrangement for uninsurable earthquake risks could compliment the industry risk-sharing already in place and would not materially pose moral-hazard concerns.

Adopting these recommendations now will ensure that when the crisis hits, the industry can focus on providing food, water, shelter and medical care for policyholders rather than having to simultaneously address a systemic collapse of Canada's insurance providers.

2. Le Pan, Nicholas." Fault Lines: Earthquakes, Insurance, and Systemic Financial Risk." C.D. Howe Institute Commentary. August 2016

3. Ibid.

PROVIDING CANADIANS WITH COMPETITIVE EARTHQUAKE INSURANCE COVERAGE

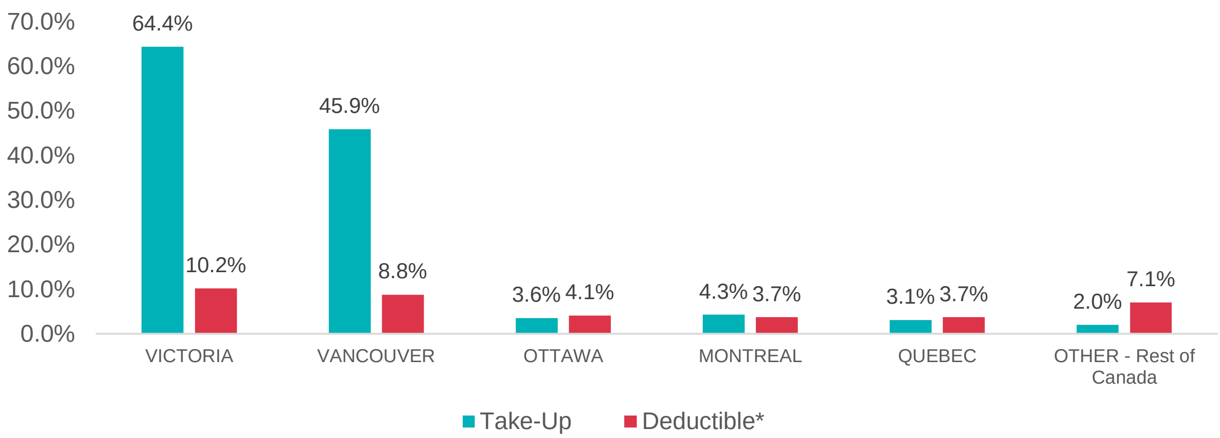
Earthquakes are not top of mind to most Canadians but the probability of a major (1 in 500 years) earthquake in the next 50 years is significant. While earthquakes in Canada are typically small and imperceptible to humans, we have had, over the past three centuries, at least 24 significant earthquakes. The latest science on this risk is that, given earthquake activity happens in cycles, there is a 30% chance in British Columbia and a 15% chance in Central Canada, of a major earthquake in the next 50 years.

Both of these regions have relatively high property values[4] and homeownership is highest among those most dependent on the equity of their home for financial security and who will require the most support to recover following an emergency, Baby Boomers aged 53-71.[5]

Intact is the P&C insurer of choice for about 12.7% of British Columbia's personal and commercial insurance market, 28.9% of Quebec's and 17% of the overall Canadian market. We process thousands of claims as well as issue new policies and process renewals every business day of the year as well as operate 24-hour emergency claims response centres across the country. We are often the first call that a policy holder makes after a loss.

Earthquake insurance take-up among Intact homeowner customers is highest in Victoria (64.4%) and Vancouver (45.9%) and, mirroring industry trends, drops off in the Ottawa-Montreal-Quebec corridor and in the rest of Canada.

INTACT'S EARTHQUAKE EXPOSURE
PERSONAL HOMEOWNER LINES EXCL. CDN DIRECT INSURANCE



Average deductibles calculated by taking the ground-up building and contents only

4. https://economics.td.com/canadian-regional-housing-outlook-aug-2017 Accessed September 19, 2017

5. Victoria is known for its disproportionately large retiree population. Some 6.4 percent of the population of Victoria and its surrounding area are more than 80 years of age—the highest proportion for any of Canada's metropolitan areas. The city also boasts the country's third-highest concentration of people 65 and older.
https://www.ctv.ca/servlet/ArticleNews/story/CTVNews/20070717/census_victoria_070717/20070717?hub=Canada

In part, this low uptake is due to both lack of awareness of risk and exposure and in part due to the reticence of P&C providers to promote earthquake endorsements to policyholders. Notably, only 3% of Quebecers have earthquake insurance, however, some 33% believe they are insured.

Simply put, the insurance industry is challenged to cover the earthquake reinsurance costs by collecting enough premium in a fair and equitable manner from our insureds, while maintaining a rate structure that is sound as well as easy to understand and explain. A backstop mechanism could encourage more P&C insurers to underwrite earthquake coverage which would create a larger risk pool and could reduce premiums for Canadians.

Our recommendations are intended to address this shortcoming by protecting policyholders while also insulating our economy from a systemic failure of our financial services sector following a major earthquake.

STABILITY IN THE FACE OF STRESS: THE ESSENTIAL ROLE INSURANCE PROVIDERS PLAY FOLLOWING A NATURAL DISASTER

While OSFI requires insurers to hold a given (and very strict, by global standards) level of reinsurance and solvency capital, the loss potential of earthquakes is unlimited – and ensuring the solvency and stability of the insurance industry in the face of a mega earthquake requires government to play a role and backstop losses.

Losses will be severe and long lasting. According to the Conference Board's macroeconomic forecast, the effects of a major earthquake will be profound:

THE RATE OF GDP GROWTH WILL BE HALVED
(and Canada has had flat or declining GDP growth for over a decade)

CUMULATIVE REAL GDP LOSSES WILL AMOUNT TO $100 BILLION

43,700 JOBS WILL BE LOST

LOWER EMPLOYMENT AND INCOME, IN TURN, WOULD REDUCE CONSUMER SPENDING BY SOME $133 BILLION

In addition to the **$42-BILLION** cost shouldered by insurers, federal taxpayers will have to absorb the costs of losses to both public assets and infrastructure, as well as uninsured private losses, an **$87-BILLION** hit to the federal treasury and a **$35-BILLION** hit to provincial finances, adding **$122 BILLION** in net new public debt to government coffers

$42-BILLION cost shouldered by insurers

$87-BILLION hit to the federal treasury

$35-BILLION hit to provincial finances

$122 BILLION in net new public debt

Direct taxpayer costs **($122 BILLION)** are nearly double the **$63 BILLION** in government borrowing that would be necessary if Canada had a mechanism in place to avoid financial contagion following the earthquake.[6]

6. Canada's Earthquake Risk: Macroeconomic Impacts and Systemic Financial Risk. The Conference Board of Canada. November 22, 2016.

For its part, Intact is doing everything that it can to prepare for a catastrophic earthquake so that it can capably respond when one occurs. But support for our policy holders and their communities demands that we be in a sound financial position and remain operational.

Intact has a best-in-class response to get people, businesses and communities back on track. We have full time resources dedicated exclusively to disasters. Our team has the expertise to rapidly deploy (often within hours) into affected areas to address the needs of our policy holders. These teams coordinate the deployment of more than 3,000 of our claims professionals either in person or through our customer care platform, which connects 35 sites and 12,000 phones from coast to coast. Such human and capital assets are critical for business continuity following an extreme disaster.

IT'S TIME TO MAKE INSURANCE A PRIORITY: PROTECTING BUSINESSES, INDIVIDUALS AND FAMILIES

Canada's P&C insurers are ready to serve their customers following a catastrophic earthquake. A major earthquake would affect all Canadians and have a domino effect on the national economy triggered by property damage, supply chain interruption, loss of services, infrastructure failure and business interruption.

While we cannot stop an earthquake from happening, we can prevent financial contagion with a government backstop to support the insurance industry and prevent systemic financial risk. There are institutional solutions that governments around the world have introduced to avoid a contagion scenario. Advanced countries, including the US, UK and Japan have created public-private solutions for the catastrophic risks they face from earthquakes.

EXTREME DISASTER EFFECTS ARE NEVER JUST LOCAL, THEY'RE NATIONAL

The March 2011 Tohoku Pacific earthquake was the strongest ever recorded in Japan and triggered the country's worst disaster of the post-war era affecting regions that account for 6 to 7% of Japan's population and economic output. The damage to tangible fixed assets and injury and loss of life dramatically reduced Japan's economic growth. The earthquake and tsunami seriously damaged nuclear power plants, with one-fifth of Japan's domestic nuclear capacity having been closed at least temporarily, resulting in electricity shortages.

Power shortages and the need to repair the damage caused by the earthquake and tsunami forced many factories to suspend production, including in the car and electric equipment sectors. The adverse effects in areas hit by the disaster may spread to other areas of the country and overseas due to shortages of parts.

Fortunately, Japanese insurers and government share earthquake risk by tapping into private (re)insurance for as much as the market can sustain, and then provide a backstop guarantee for uninsurable tail-risk. The Japanese government also encourages earthquake insurance take-up at the "front end" through tax relief on earthquake premiums. This insurance system was a key factor in the country's economic recovery after the 2011 earthquake and tsunami: insurers settled 90% of claims within the first three months, making insurance one of the first forms of relief to reach the disaster area.

Earthquake Risk Management in Other Jurisdictions: Select Examples. IBC

The current set-up of PACICC means that, in the aftermath of a catastrophic earthquake, PACICC would not be able to provide policy holder compensation without triggering a self-reinforcing chain of institutional failures across the country (i.e., contagion). This would affect policy holders directly affected by the catastrophe *as well as* trigger a crisis and limit other types of coverage that Canadians rely on.

Even in the absence of PACICC, earthquake risk poses an existential threat to the financial stability of P&C insurers, insofar as a large earthquake can overwhelm the already stringent regulatory capital regime to which insurers abide.

A federal last-resort emergency backstop mechanism for earthquake losses beyond the P&C industry's capacity would benefit consumers, the financial sector and the wider economy. The system should be designed so that insurers would continue to bear the major share of the risk, minimizing moral hazard. This type of federal backstop arrangement has been applied to risks in many countries, such as Japan, US, France, Spain and New Zealand.

Experiences from these other countries are that credit facilities and loan arrangements greatly reduce, or eliminate entirely, industry-wide solvency risk so that financial stress on the insurance industry does not amplify the impact of severe catastrophes in unaffected areas.

Recommendations to proactively bolster the P&C Insurance Compensation Corporation (PACCIC) to reduce systemic impacts from severe catastrophes:

1. PACCIC be strengthened so it can intervene before insurance companies in financial difficulty become insolvent. A credit facility should be available to PACICC to provide emergency lending assistance for policyholder compensation in response to institutional failures and would ensure that there is still affordable insurance for Canadians and businesses following a catastrophe.

2. PACCIC have the capability to borrow funds to reduce its liquidity needs in a crisis. This could take the form of a loan from the federal government with a repayment period determined by the size of estimated PACCICC assessment (size of insured losses + number of insurers failing).

3. PACCIC should have the ability to isolate earthquakes to avoid a broader economic crisis that could leave thousands of Canadians unable to insure their vehicles, homes and businesses.

2. CORPORATE GOVERNANCE

Intact fully supports a strong and modern corporate governance framework. However, formulating a rigid regime can lead to form over substance in particular instances. Intact Financial Corporation is incorporated under the Canada Business Corporations Act ("CBCA"), is a reporting issuer under provincial securities legislation and its shares are listed on the Toronto Stock Exchange. As a result, and consistent with its corporate values, Intact complies with all CBCA requirements, and will most certainly comply with any new requirements that emerge out of Bill C-25. In addition, Intact complies with all applicable corporate governance requirements contained in provincial securities laws and Toronto Stock Exchange Rules.

Furthermore, Intact has, in a number of instances, gone beyond simple compliance with applicable rules. For example, with respect to diversity, 5 out of 12 directors on our board are women, for a representation of 41.6%, which is in excess of current norm. We also have extensive gender diversity policies that are applicable to our directors and senior management, which are outlined in our public disclosure. In addition, we are a leader in shareholder democracy and, to this end, our board has adopted a majority voting policy and requires individual director election.

The foregoing background illustrates the extent of Intact's commitment to modern corporate governance practices. We submit that the appropriate level to impose such rules is at the parent company level. Replicating such measures also at the subsidiary level (in our case at the regulated insurance company level) would result in multiple regulatory frameworks that would create undue regulatory burden and inefficiencies for the federally regulated financial Institutions.

Existing corporate governance rules applicable to regulated insurance companies are more than sufficient if the parent public company (under existing and through CBCA amendments) is subject to such modernization. The focus of the updating for regulated financial institutions should be found at the parent public company. If proper and modern corporate governance procedures and requirements are satisfied at that level, then the enterprise as a whole will be operating properly in corporate governance terms. Since Intact will be subject to, and in compliance with, the current and amended CBCA, requiring the same at the subsidiary level is unnecessary. Exceptions for such situations should be built into any regime that is developed for regulated financial institutions.

Corporate Governance

1. Impose rules at the parent company level to avoid multiple regulatory frameworks.