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Mr. Glenn Campbell
Financial Institutions Division
Financial Sector Policy Branch
Department of Finance Canada
James Michael Flaherty Building
90 Elgin Street
Ottawa Ontario
K1A 0G5

Re: Consultations to Review the Federal Financial Sector Framework

Dear Mr. Campbell:

Thank you for the opportunity to participate in consultations regarding the Federal Financial Sector Framework. The Insurance Bureau of Canada (IBC), on behalf of Canada's private property and casualty (P&C) insurance companies, is pleased to share with the Department of Finance our industry's perspective regarding key trends and issues that should be considered and addressed as part of the review.

Established in 1964, IBC is the national industry association representing the Canadian private property and casualty (P&C) insurance industry. Our members account for over 90%, by premium volume, of private auto, home and commercial insurance sold in Canada.

The P&C insurance industry employs over 122,500 Canadians, pays more than $8.2 billion in taxes to the federal, provincial and municipal governments, has $114.6 billion in invested assets, and a total premium base of $51.9 billion, approximately one-third of which is derived from property insurance.

The following reflects IBC's views on the questions posed in the consultation document.

1. **What are your views on the trends and challenges identified in this paper? Are there other trends or challenges that you expect to significantly influence the financial sector going forward?**

   The paper notes that P&C insurers have been impacted by the increasing severity and frequency of catastrophic events over the past 20 years. This trend shows no signs of stopping. A catastrophic earthquake, in particular, poses a considerable challenge to Canada's P&C industry. This is not simply due to the heightened risk of a large earthquake itself – which Natural Resources Canada estimates at 30% over the next 50 years – but it is augmented given that high-value homes and businesses continue to cluster in earthquake-prone areas, most notably in the Vancouver region but also in the Quebec City-Montreal-Ottawa corridor. OSFI's regulations ensure that the industry is prepared for a 1-in-500 year

earthquake – one of the most rigorous prudential standards in the world. However, recent experience in similar jurisdictions showed that a larger event is possible. Stress tests and analysis by OSFI and the Property and Casualty Insurance Compensation Corporation (PACICC) showed that such an event would overwhelm the industry's capacity to meet its obligations and could cause widespread insolvencies amongst insurers, leaving Canadians without insurance protection precisely when it is most needed. Moreover, because of financial linkages between insurers, and between insurers and the wider financial sector, there is a real risk that the initial shock could trigger financial contagion impairing national economic growth for a decade or more. The Conference Board of Canada, for instance, estimates that a catastrophic earthquake generating financial contagion would reduce GDP by nearly $100 billion, halving GDP growth in the short term, and eliminate 437,000 jobs while raising the federal deficit by almost $90 billion.

There are institutional solutions that governments can relatively easily implement in advance to avoid this kind of scenario. Most advanced countries, including the US, UK and Japan, have created public-private solutions for the catastrophic risks they face, including earthquakes, floods, hurricanes and terrorism. And Canada's federal government has already established such programs for nuclear disasters, oil spills, and railway accidents. However, it has not acted on arguably the most well-recognized disaster risk facing the country. In a recent CD Howe Institute report, Canada's former chief financial regulator called on the federal government to act to stave off this preventable systemic risk by establishing a last-resort emergency backstop mechanism for P&C insurers, stating that "government needs to address gaps in the existing Canadian insurance scheme to ensure that a severe tail-risk earthquake does not become a systemic financial problem"[1]. We would ask that the Department of Finance review this important report and engage in a consultation with the insurance industry for implementing the recommended policy measures.

The paper also notes that P&C insurers have been adapting to advances in financial technology and evolving customer preferences. The use of analytics and insurance products for the sharing economy are recent examples of changes in the market. Insurers have also been adding to their offerings for cyber insurance and related risk-management services.

Traditionally, insurance has been an enabler of economic and entrepreneurial activity. Yet, the current regulatory requirements often prevent insurers and their customers from reaping all the benefits of new technologies and insurance products. Specifically, the various layers of complex and costly provincial regulations, which as a whole are unique to Canada, lessen competition and choice for consumers by forcing insurers to offer the same type of products using similar methods and technologies. For instance:

- The degree of product regulation for auto insurance has caused consumers to spend on insurance coverage that may not meet their particular needs;
- The degree of price regulation for auto insurance has limited insurers' ability to compete on price and charge an appropriate premium for a given vehicle's level of risk; and

[1] *Fault Lines: Earthquakes, Insurance, and Systemic Financial Risk*, C.D. Howe Institute, August 2016

- The degree of many transactional-based regulations has forced insurers and consumers to interact through registered mail when a more efficient manner would be communicating electronically.

As technology continues to advance, the sharing economy continues to grow and vehicles become more automated, consumers will be demanding even more changes and unique products and services that the regulatory framework will certainly not support. While these regulations are under provincial jurisdiction, the federal government's leadership could help bring about the necessary changes for consumers and the greater good of the economy.

2. **How well does the financial sector framework currently balance trade-offs between the three core policy objectives of stability, efficiency and utility?**

In the P&C insurance sector, the current regulatory regime largely strikes a successful balance between the core objectives of stability, efficiency, and utility. For instance, the requirement that insurers hold sufficient capital and reinsurance for a 1-in-500 year earthquake is one of the most stringent by international standards, but not so demanding as to sacrifice efficiency and utility in the name of stability. However, the lack of any solution for catastrophic events (where losses exceed insurers' capital requirements) poses a threat to financial stability, which in turn impedes the core objectives of efficiency and utility.

In the foreseeable event of a catastrophic earthquake, a pre-established solution would promote sectoral stability, by reducing the number and impact of insurer insolvencies on consumers, other insurers, and financial firms linked to affected companies.

It would also promote efficiency, by addressing the tail, or open-ended portion of earthquake risk, which cannot be absorbed by the private sector alone. This would stimulate product innovation and encourage insurers to enter (or, at a minimum, not leave or reduce exposure to) the earthquake insurance market, by making the availability and affordability of earthquake insurance sustainable over the long-term. It also has the potential to soften cost pressures on consumers. All this would clearly promote economic growth, by promoting the development of a critical risk-transfer service, eliminating a systemic risk to the financial system and improving post-disaster outcomes for consumers. Furthermore, the cost to implement a solution in advance is far less than the costs associated with trying to address contagion after the fact.

Finally, it would promote utility by creating a sound business climate and better product environment for businesses, individuals and families who need earthquake insurance. This is particularly important in British Columbia, where a major earthquake is inevitable, and where high insurance take-up is essential for post-quake recovery. It is also important in the Quebec City-Montreal-Ottawa corridor, where take-up is far too low, despite the degree of seismic risk.

3. **Are there lessons that could be learned from other jurisdictions to inform how to address emerging trends and challenges?**

As the scale and frequency of catastrophic events continues to increase, many other advanced countries have benefitted through pre-established institutional arrangements for managing catastrophic risks.

In Japan, for instance, earthquake risk is shared in layers between insurers and the federal government. For small and mid-sized events, insurers bear the brunt of losses; for rare but large-scale catastrophes that cannot be solely absorbed by the private market, government bears the lion's share. Importantly, the scheme includes incentives for risk reduction by all participants, minimizing moral hazard. By improving insurers' financial capacity and limiting insolvency risks, the arrangement has enabled insurers to absorb more small/frequent losses, and to provide lower/more affordable earthquake insurance premiums to consumers.

The US *Terrorism Risk Insurance Act* (TRIA) provides another example of a public-private scheme established to manage catastrophic risk. TRIA provides federal co-insurance for insurance losses due to an act of terrorism once aggregate losses exceed USD$100M. Insurers must also meet a deductible before accessing federal funds. By having insurers retain a degree of risk, this design mitigates moral hazard. Before TRIA, the private market for commercial terrorism risks in the US had all but disappeared as a result of the September 11th attacks. TRIA brought back the market. It has also softened product costs, facilitating a high degree of take-up among businesses. While terrorism and earthquake are clearly different perils, from a risk management perspective, they are both subject to the same constraints typical of open-ended, tail-risks.

Many more examples can be found in other jurisdictions. An extended survey of lessons learned from similar arrangements internationally was recently undertaken by IBC and is available online[2].

International experience is also instructive regarding the negative fiscal and economic consequences of low insurance take-up. A low rate of earthquake insurance take-up is an important concern for eastern Canada. Modelling suggests that a 7.1 magnitude quake in the St. Lawrence River Valley between Montreal and Quebec City would generate total economic damages in the $60 billion range. As the large majority of homeowners lack insurance coverage, most of the bill would likely have to be footed by the government.

From international experience, we know that if a meaningful number of homeowners purchase earthquake insurance, rebuilding efforts are facilitated. Government assets can be used to deal with disaster relief and rebuilding infrastructure rather than having to help homeowners rebuild their properties.

In Italy, where insurance take-up rate is very low, rebuilding efforts following recent earthquakes has been very slow as homeowners have to wait for government action. The

[2] A Primer on Financial Risk from Natural Disasters: The Case for Public-Private Collaboration, IBC, December 2015 - http://assets.ibc.ca/Documents/Resources/2015_PubPrivPart.pdf

Turkish market provides another example: following the large 1999 earthquake in Istanbul, where insurance take-up was very low – a pool arrangement (TCIP) to cover all earthquake exposures was put in place to better tackle the challenge of rebuilding in the future.

On the other hand, when protection is in place, resilience against major events is a huge benefit for those markets. High insurance penetration in New Zealand allowed homeowners to recover relatively quickly following major back-to-back earthquake events in 2011 without putting additional strain on governmental budgets or the economy. Insurance's role in facilitating economic recovery was similarly evident after the 2010 Chile earthquake and 2011 Japan earthquake and tsunami.

4. **What actions could be taken to strengthen the financial sector framework and promote economic growth, including with respect to the identified themes? How should those actions be prioritized?**

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 mechanism could be structured to kick-in beyond an industry-wide trigger for expected losses, for example somewhere above the regulatory 1-in-500-year level. The system would be designed so that insurers would continue to bear the lion's share of the risk, minimizing moral hazard. This type of federal backstop arrangement has been applied to risks in many other countries, such as Japan, US, France, Spain, and New Zealand.

In support of such a system, Canada's former chief financial regulator writes: "A federal emergency backstop arrangement for property and casualty insurers, properly designed, would minimize the systemic financial impact resulting from such a catastrophic and likely uninsurable event on those affected and on the economy at large. The moral-hazard implications appear small compared to the benefits of avoiding serious systemic risk"[3].

Another reform to the current financial framework that would benefit consumers is to strengthen the Property and Casualty Insurance Compensation Corporation (PACICC) to allow it to better manage insurer failures. The CD Howe Institute, for instance, recommends that PACICC be given the capability to borrow, from the federal government, in order to reduce its liquidity needs during a crisis. This is critical insofar as the systemic issues generated by a large earthquake would be greatly amplified given PACICC's current inadequate funding mechanism. These reforms would reduce the likelihood of any federal backstop arrangement being triggered, and, if triggered, would minimize the associated costs.

5. **What other actions should be taken to ensure the financial sector framework remains modern and technically sound?**

IBC recommends at least three other actions to strengthen the existing financial sector framework:

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[3] *Fault Lines: Earthquakes, Insurance, and Systemic Financial Risk*, C.D. Howe Institute, August 2016

1. Regulating bodies should consider broader, financial sector-wide stress testing, in order to better understand intra-sectorial and inter-sectorial linkages. Although progress has been made since the 2008 financial crisis to address systemic risks, much remains unknown or under-studied. For example, a major earthquake or flood could have ripple effects throughout not only the insurance sector, but also the broader financial sector as mortgage lenders are impacted by defaults on uninsured homes and investors in mortgage-backed securities face losses. Furthermore, recent housing finance changes are shifting mortgage risk back to banks and away from the mortgage insurance sector – yet the ensuing change in earthquake risk exposure for banks is not clearly understood.

2. The government should consider reforms to the federal *Competition Act* that would allow certain provisions of the Act to be temporarily suspended in the event of a major natural disaster. Certain restrictions on inter-provincial trade, for example, pose barriers to effective disaster recovery. For instance, specific tradespeople needed for claims assessment and reconstruction have, in the past, been prevented from entering an affected province, precisely when they are needed most.

3. Finally, the government should consider reforms to the *Winding Up and Restructuring Act* in order to facilitate insurer solvency management and reduce systemic risks in the event of a disaster. Under the current Act, 100 per cent of the assets of a failed insurer are immediately frozen by the courts and a majority remain unrecoverable. Based on past experience, it can take as long as 25 years to fully liquidate a failed company. This is a problem because, when an insurer fails, surviving insurers are assessed by PACICC to honor a portion of the claims of the failed insurer, and the inability to recognize the failed insurer's assets increases the size of this assessment on other insurers, ultimately increasing systemic risk. The problem is exacerbated by the industry's consolidation trend, as any given failure now tends to have a greater impact on surviving insurers. Although accounting rules demand a conservative interpretation of the insurer's frozen assets, the Act should be reformed to allow portion of frozen assets to be recognized in the immediate term for liquidation purposes.

We thank the Department of Finance for the opportunity to offer comment on the review of the Federal Financial Sector Framework. IBC would welcome an opportunity to work with the federal government in advancing these goals and recommendations.

Please do not hesitate to contact me if you have any questions or comments.

Sincerely,

David McGown
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Cc: Don Forgeron, President & CEO, IBC
Craig Stewart, Vice-President, Federal Affairs, IBC