A ONE-HIT WONDER?

Are the industry’s healthy 2021 results an indication of what’s in store for the next few years, or just a flash in the pan? History points to the latter.

By Glenn McGillivray

This past year was the most generally favourable for Canadian insurers in a while — since 2006 as a matter of fact — with the industry’s return on equity (ROE) coming in at a solid 17.2% (against 11.2% in 2020).

The Canadian P&C industry’s ROE has only surpassed 12% twice between 2006 and 2019, in 2006 and 2007, MSA Research president and CEO Joel Baker reminds us in his MSA Q4-2021 Quarterly Outlook Report.

But are these results a song for the ages, or merely a one-hit wonder?

There is no denying 2021’s financial results were very good for the Canadian P&C industry. Earned premiums grew by 8.4%, while claims “fell off a cliff by 10.7%, yielding over $10.6 billion in underwriting income,” according to MSA. The industry’s combined ratio came in at 83.7%.

“Despite over $5 billion of dividends or transfers to parents or home office, capital levels have increased by $7 billion to $65.2 billion, and the industry MCT [Minimum Capital Test] jumped by 30 points to 275.7,” Baker says.

On the commercial side, MSA notes direct premiums written grew by 15.2% and were up 13.4% on a net earned basis. This healthy premium growth, married with a 13% decrease in claims year-over-year, led to more than acceptable key ratios for the segment. The 15% ROE for commercial writers “is only lower than the industry’s because of the highly capitalized nature of commercial carriers which is a drag on the ratio,” Baker writes.

Regarding personal and multi-line carriers, while growth in net premiums earned (NPE) slowed to 5.7%, claims fell by 9.6% year-over-year “yielding a nearly eight-point improvement in their [combined operating ratio] COR,” according to MSA. Although much of that owes to decent returns on the auto side, Baker cautions that “physical damage loss ratios are rearing their head and BI, while tame, seems to be turning a corner. These could indicate increases in frequency.”

Meanwhile, “reinsurers held their own in 2021 with solid premium growth coupled with a drop-off in claims, despite the Cat losses...” MSA observes. “The single-digit ROE is due to the heavy capital denominator in the ratio.” According to Reinsurance Research Council data, 22 companies booked [net premiums written] NPW of $8.59 billion in 2021, a 19.1% hike over the year prior. The segment’s underwriting profit came in at $1.69 billion, with pre-tax income of $1.81 billion on a COR of 79%.

Overall, “there is obviously good news in these short-term returns with the promise of favourable impact on the
long-term, sustainable solvency of Canada’s insurance industry,” the Property and Casualty Insurance Compensation Corporation (PACICC) says in its 2021 annual report. Why? Because these profits have resulted in improving capital test scores for most insurers.

The average MCT figure increased from 234.2% in 2020 to 264.4% in 2021. The Branch Adequacy of Assets Test figure also rose slightly, from an average of 297.3% to 298.9%. PACICC board chair Glenn Gibson rests solid industry results on the shoulders of strong underwriting performance in auto and commercial lines. Additionally, Baker points to the hard market in both commercial and personal lines, lower auto losses owing to COVID-19, decent reserve releases and an absence of ‘large-scale’ catastrophes during the last two years.

But are these results here to stay? Gibson is skeptical. “The increasing loss ratio for personal property (62.7% in 2021, up from 55.9% in 2020) and lower net investment income in 2021 (down 25.9% from 2020) give clear indication that this period of profitability is likely to be short-lived,” he writes in his preamble to PACICC’s 2021 annual report.

Inflation, interest rates and the hard market

Virtually every major industrialized economy is now wrestling with record or near-record inflation, due largely to supply chain disruptions and surging demand as national economies rebound from COVID-19 and other issues. Much of the unpredictability, says RMS Canada, is “largely driven by volatile sectors like gasoline, food, shelter, utilities and transportation.”

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Some economists maintain Canada hit ‘peak inflation’ in March 2022, when the year-over-year number hit a 31-year high of 6.7%. But a May report indicated April inflation edged even higher to 6.8%.

“The key takeaway from April’s CPI release is that inflation is spreading much more broadly, and at clear risk of getting firmly entrenched,” writes Bank of Montreal chief economist Douglas Porter in a report. He predicts inflation of more than 6% will continue throughout 2022; other economists worldwide corroborate this view. Some estimates say high inflation will drive interest-rate hikes beyond the 50 basis-point increase announced by the Bank of Canada on Apr. 13. Some money markets are reportedly betting on a total of 250 basis points in increases for the year.

The one-two punch of inflation and the resulting interest-rate increases can have several impacts on Canada’s P&C sector, including on claims costs, expense ratios, investment returns and the continued viability of the current hard market. Rising costs of doing business, beyond claims costs, coupled with an already tight labour market that’s putting pressure on salaries, will also affect industry profitability. And it’s not yet clear whether the high price of gasoline and diesel will cause clients to drive less and positively impact claims costs for personal and commercial auto.

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**Cat trends**

Severe weather cost Canadian insurers $2.25 billion in 2021, placing the year in the Top 5 for losses according to Catastrophe Indices and Quantification Inc. (CatIQ). This is for events of $25 million in claims or higher. Fourteen such events were declared last year, a tie for second place for frequency, since CatIQ began tracking such losses in 2006.

Some years, it looks as if Alberta or Ontario are solely in the crosshairs of these events. But in 2021 British Columbia received a relentless barrage that pummeled the province almost unendingly from early summer through late fall.

First, large swaths of the province were hit by a major heatwave, precipitated by a heat-trapping high-pressure system that parked over the Pacific Northwest between Jun. 25 and Jul. 1, 2021. The heat dome that system generated pushed temperatures to 49.6°C in the Lytton, B.C. area, the hottest temperature ever recorded in Canada. And, on Jun. 27, temperature records were broken at 59 weather stations in a single day.

Those temperatures, in part, fed the third-worst wildfire season in the province for area burned.

According to B.C. data, 1,642 wildfires burned 869,279 hectares from Apr. 1, 2021 to Mar. 28, 2022 (the province’s fiscal year). But while there have been worse years for area burned (namely 2018 and 2017), 2021 was one of the worst years for fire affecting communities, resulting in 181 evacuation orders being issued and several communities experiencing structure losses, including Monte Lake, Bouleau Lake, Killiney Beach and Lytton. These fires cost insurers close to $200 million.

Then came the atmospheric rivers and ensuing floods and debris slides, all exacerbated by the earlier wildfire season.

While B.C. was hit by at least five atmospheric river events over the course of 2021, the most damaging occurred over a mid-November weekend with up to 200 millimetres of rain falling on places like Hope, Merritt and Princeton. Several smaller communities in southwestern B.C. experienced major flooding and, at press time, many people are still out of their homes.

Critical infrastructure, particularly related to transportation, experienced severe damage. Coquihalla Highway completely washed out in at least 10 places, long stretches of Highway 8 were wiped off the map, and washouts and mudslides damaged Highways 1, 3, 5, 99 and others. Damage ranged from buckled pavement to entire culverts, overpasses and bridges being lost. Water treatment plants and potable water and storm-sewer systems also saw severe damage.

Insured damage from the event exceeded $675 million but would have been substantially greater with higher market penetration of residential coverage for overland flood. While total damage is hard to pinpoint, some numbers range around $9 billion. By mid-December, the federal government provided the province with a preliminary $5 billion in disaster relief.

What’s next?

Despite turmoil from the ongoing COVID-19 pandemic that’s affected many facets of the insurance business — auto premium rebates, the handling of Cat claims, the availability and price of building materials and labour, and the need to work remotely — Canada’s P&C insurers still managed to produce solid returns.

Several not-so-subtle hints suggest those gains might be fleeting and the industry should relish them while they’re here.

“Whether these strong returns can be sustained into 2022 remains to be seen. Despite [work from home] trends, traffic activity is returning to pre-pandemic norms. Real rate increases (those that overtake inflation) will be harder to achieve, while claim costs are being driven up by supply chain and labour shortages. 2021 might be a high-water mark for years to come,” cautions Baker.

It’s important, when looking at such positive returns, to remember the Canadian P&C industry’s history, PACICC warns. “P&C insurance profitability has been widely cyclical,” it notes in its annual report, adding, “In the past, high levels of profitability have never proven to be sustainable for P&C insurers.”

Over the past 45 years, P&C insurers have reported returns on equity greater than 15% on 10 occasions. These years of high profitability generally appear in clusters (1977 to 1978; 1986 to 1987; and 2004 to 2006). The average return on equity in these years of peak profitability was 16.8%.

“Every single time that insurers have reported such above-average profits, competitive forces have quickly acted to cut the industry’s return on equity in half — to an average of 7.4% — within two years. The high returns on equity reported by insurers in 2020 and 2021 are likely to follow this same historical pattern,” adds PACICC’s annual report.

And yet, while 2021 may prove to be a one-hit wonder, at least the industry will be able to say it’s topped the charts at least once this decade. cu

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