2021’s key question was whether the insurance sector could sustain its remarkable results. Although 2022’s numbers look decent on the surface, a glance in the sideview mirror shows softer market conditions are gaining...
ast year, I began with the sunny news that “the year in review was the most generally favourable for Canadian insurers in a long while.” But I ended with the suggestion that those rosy numbers booked in 2021 could be short-lived and the industry may want to prepare for less favourable results sooner rather than later.

With preliminary 2022 numbers now in, it looks as though insurers can breathe a bit easier, at least for the time being. But breathing easier doesn’t mean resting on laurels, as the 2022 industry results came with both caveats and omens.
According to MSA Research’s Joel Baker, the 2022 year-end results reveal the market “more or less held its own and returned solid underwriting results with a combined ratio of 85.4%.” However, as he went on to observe in his MSA 2022 Q4 report, this was in great measure due to an ‘historically large’ reserve release of $7 billion, without which the industry’s combined ratio [COR] “would have been closer to 96%.”

Baker also identified a positive bump provided by the current high-interest-rate environment, since “loss reserves are discounted at higher rates.” Without considering the discounting, the industry’s COR would be closer to 91% “even with the reserve releases,” says Baker.

“Take out the reserve releases and the industry is running at over 100%.” The 100% number indicates the industry is, on average, breaking even.

So, “what looks good at first glance, looks worse when examined deeper,” Baker observes. “Industry results are slipping.”

Baker pulls down the rosy facade to reveal a bleaker picture, noting the ‘dramatic hit’ the industry took on the investment side because of escalating interest rates and volatile equity markets. “The impact on the Canadian P&C industry was dramatic, wiping out investment income and doing a number on OCI (other comprehensive income — which is marked-to-market). Net income, comprehensive income, and even capital, are down compared to year-end 2021 as a result.”

The direct written premium (DPW) growth of just 1.5% in 2022 barely kept up with inflation, causing him to wonder if this could be a harbinger of a softening cycle. “Yes, for personal lines, not yet for commercial lines and reinsurance,” he writes.

Overall, Canada’s property and casualty (P&C) insurance industry booked total underwriting income of $9.96 billion ($10.47 billion for 2021) in 2022 and net income of $9.02 billion ($10.6 billion for 2021) on $83.4 billion of DPW. Key industry ratios came in at just over 54% (loss ratio) and 85.5% COR, with an industry return on equity (ROE) of 13.63%.

Personal lines writers “appear to be slipping into soft market territory,” Baker cautions. Top line premium essentially matched inflation, but underwriting income dropped 32% compared to the same period the previous year. Importantly, Baker notes that when reserve releases are backed out, “the COR sat at an unprofitable 102.1 (even worse if you back out discounting).” And with “investment results on the ropes,” he adds, “the personal/muti-line sector is heading the wrong way.”

Canada’s P&C commercial lines sector (minus Lloyd’s) stayed ahead of inflation with DPW “up a healthy 12%, NPW [net premiums written] up 10.5%, against a 2% increase in claims offset by rising acquisition and general expenses,” Baker writes. Carriers operating in the market managed a COR of 76% and an ROE of 14.5%. The sector also benefitted by “generous year-end reserve releases,” Baker observes.

Grant Kelly, vice president and chief economist for the Property and Casualty Insurance Compensation Corporation (PACICC), said commercial “results were particularly strong in liability insurance, with a loss ratio of 33.6% in 2022,” as he observes in the April 2023 issue of Solvency Matters. “This is both remarkably low and highly unlikely to be sustainable over the long term.”

Regarding reinsurance, “strong growth coupled with lower losses yielded a COR of 74[%,] ten points better than a year-earlier,” Baker reports. Discounting, he added, led to a nearly 12-point boost to the COR, which would have been closer to 86% on an undiscounted basis. Despite a $3.1-billion NatCat year, improvement in the sector’s results is due in part to the one-two punch of higher NatCat retentions on the primary side and higher rates on the property NatCat side.

**Capital concerns**

I have written almost 300 articles about the insurance industry, severe weather and related topics over the years, and one of the most popular pieces I authored was titled, ‘Our own worst enemy,’ about the mechanics of the insurance cycle.

That July 2004 Canadian Underwriter piece explains that “cyclical rate peaks and valleys in (re)insurance [i.e., primary insurance and reinsurance] markets almost always come as a result of issues surrounding supply, rather than demand. In the risk transfer business, the supply in question is that of capital — essentially, capacity.

“In essence, the financial position of (re)insurers governs the cycle, as industry players tend to increase prices and pull back on capacity when growth of surplus is flat or negative, investment returns are sour and catastrophic losses high, and lower prices and increase capacity when surplus is growing, investment returns are high and claims costs are manageable.”

Years ago, (re)insurance capacity was provided strictly by (re)insurers. But in recent decades, as ‘outside’ capital viewed reinsurance as an attractive investment, other capital providers [like hedge funds and venture capital sources, often called ‘naïve capital’ because of the lack of expertise in (re)insurance] began to pump huge sums of capital into world (re)insurance markets. This may have started in the immediate aftermath of 1992’s Hurricane Andrew, when the Bermuda (re)insurance market popped up almost overnight, but it’s hard to say.

This massive and nearly unbroken influx of capital played havoc with international (re)insurance markets, and essentially ended the traditional insurance cycle as we knew it. The once inevitable pricing peaks and valleys of the past led to at least a decade-and-a-half-long valley, as the prior average seven-year insurance cycle gave way to a prolonged period of below-cost-of-capital pricing and less restrictive contract wordings due to competition.

So much capital existed in world markets that huge loss events like Hurricanes Harvey (August 2017) and Maria (September 2017) and some of the large fires across California hardly made a dent in available capital. In the past, such events would likely have driven an almost-overnight re-underwriting of NatCat risks.
“Severe weather in 2022 cost Canadian insurers and their reinsurance partners $3.1 billion. That’s among the Top 3 years for annual NatCat losses, including 2016 (the year of the Fort McMurray wildfire) and 2013 (the year of the Southern Alberta and Toronto floods). One common theme running through last year’s storm losses is the sheer size of the storms.”

But recent uncertainty and instability in international capital markets — possibly initiated by COVID-19 and exacerbated by supply chain disturbances; high inflation and resulting rapid interest rate increases; concerns about the international banking system; and the war in Ukraine among other things — led to a perfect storm. For the past while, investors have been sitting on capital, opting not to deploy it, even for investments that proved quite lucrative in recent years.

This has led to an unprecedented hard market in virtually all lines across property and liability. Companies underwriting the risks almost solely control the capital, which is generally no longer available from fly-by-night sources looking for a quick buck. And, oddly, as (re)insurers finally ‘get rate,’ sources of naïve capital are not able to take advantage of that by pouring capital into the market.

Historically, our industry would have seen that it was finally ‘getting rate’ and responded by increasing capacity, beginning the back-slide to a soft market. But not this time.

It’s quite possible that when we begin to see the general international investment markets open back up again — i.e., when we begin to see more businesses of all kinds issuing new stock shares and bond debt; see more initial public offerings and leveraged buyouts; and more share buybacks and so on — this could be a signal naïve capital is again poised to enter the (re)insurance realm.

But for (re)insurers, this means not knowing what kind of a NatCat year is going to be experienced. Will it be a $1-billion year? Or $2 billion? Maybe $4 billion or $5 billion? Or will we break entirely new ground with something higher?

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Catastrophe Indices and Quantification Inc. (CatIQ) declared 15 NatCat events last year. Such events cause a minimum of $30 million in insured damage (up from $25 million previously due to an occasional adjustment for inflation). Just two of these events amounted to two-thirds of the year’s total damage: the May derecho in Ontario and Quebec cost the industry $1 billion, while post-tropical storm Fiona in Atlantic Canada caused more than $800 million in insured damage.

One common theme running through last year’s storm losses is the sheer size of the storms.

From a spatial extent, the derecho (1,000 kilometres long at one point), Fiona, and a December ‘bomb cyclone’ affecting Ontario, Quebec and Atlantic Canada were huge storms, spanning large geographic areas. As I noted in a February 2023 Canadian Underwriter insBlog piece, ‘Far and wide,’ large storms such as these challenge individual insurers’ ability to manage their concentrations of business and place smaller regional players at great insolvency risk.

What’s ahead?

Canada’s P&C insurers reported an ROE of 18% in 2021, PACICC noted in its 2022 annual report. “These results were unsustainable for a highly competitive industry,” PACICC adds.

“2022 financial results posted by Canada’s P&C insurers represent the beginnings of an expected ‘reversion to the mean’ and a return to historically ‘normal’ levels of profitability. In the third quarter, the industry reported an ROE of 13.3%. This is still higher than the long-run average of 10.1%. So, based on historical patterns, it appears probable that there is further deterioration to come.”

The industry performed decently in 2022, but it must be underscored in no uncertain terms that results were significantly pushed along by a massive reserve release, high interest rates (which are actually a double-edged sword), lower losses and higher premiums. The numbers did not come purely from astute operational performance by all carriers across the board.

Indeed, PACICC notes, 14% of insurers still reported negative net income in 2021 despite it being the industry’s most profitable year on record. In 2022, the figure rose to 27.8%.

A reversion to the mean is afoot. It’s just a question of how long the process will take. ctu

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NatCat trends

One of the hallmarks of a warming world is that you never know what may come next. The reasonably stable climate of the last 100,000 years is being thrown into disarray as Earth’s systems are forced out of kilter.