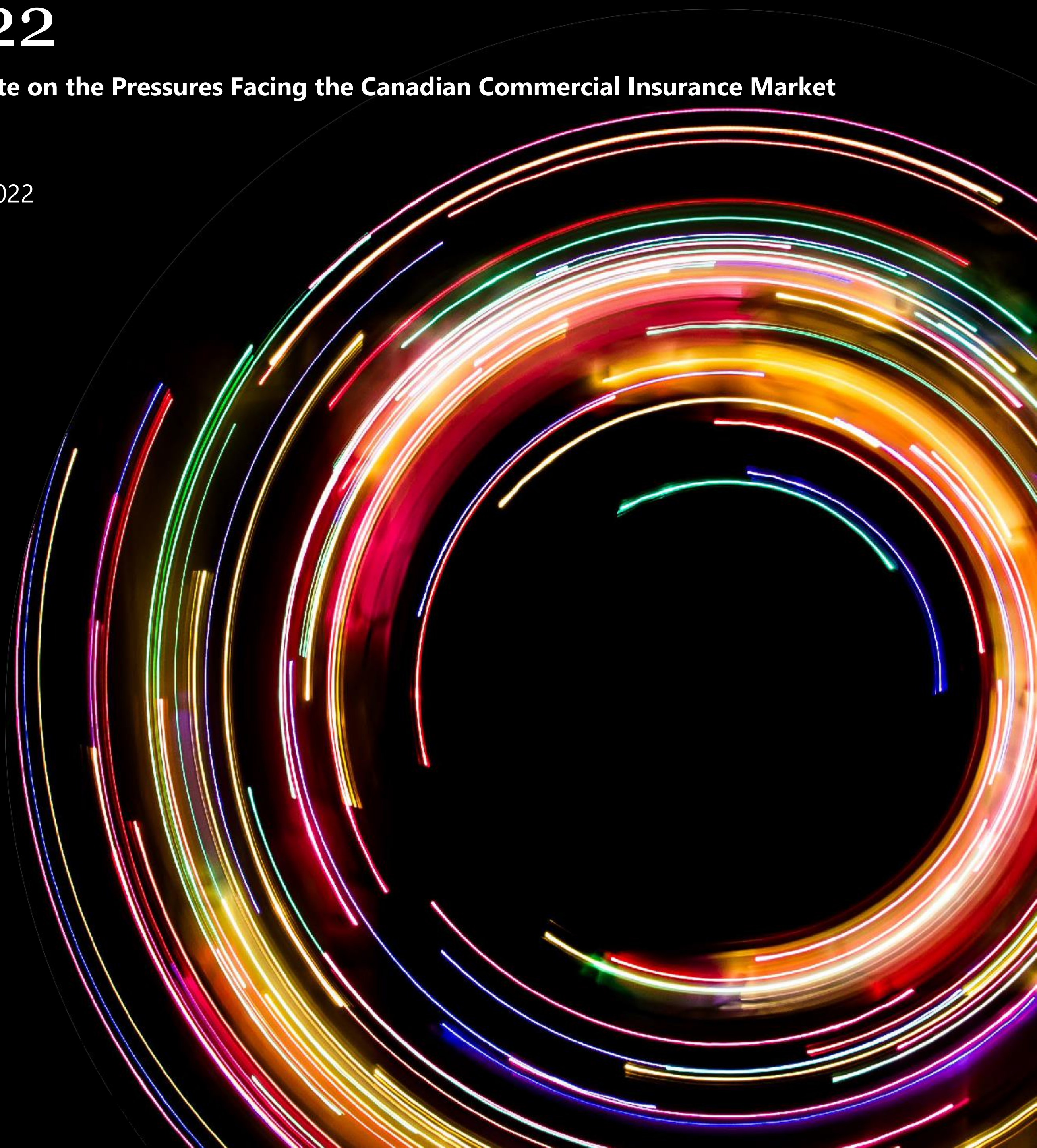
State of the Canadian Commercial Property & Casualty Insurance Market 2022

An Update on the Pressures Facing the Canadian Commercial Insurance Market

August 2022



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Executive Summary

This paper is an update to one we wrote in early 2020. That was a challenging time for the property and casualty (P&C) insurance industry. A decade of low interest rates and increasing competitive intensity had left the industry performing at an unsustainable level. In response, in 2019 the market began to "harden" – capacity left the market and rates began to rise.

Over the following three years, the market saw average rate increases of ~9% per year. This average includes both good and challenged risks. Risks with challenged claims history, and risks in high-claim industry sectors, like hospitality, real estate, and transportation, often saw much higher increases, and at times had difficulty getting coverage.

Starting in 2020, the COVID-19 pandemic also contributed to the challenges of the insurance market. It created financial strain and uncertainty across the economy. Businesses failed at record numbers and overall economic activity was down. In response, the insurance industry stepped up and supported their customers with over $3.7 billion in COVID-19 consumer relief measures.

Today, with the pandemic restrictions winding down, economic activity returning to pre-pandemic levels and three years of rate increases, the insurance industry's financial performance and sustainability has improved significantly.

There are signs that the hard market is moderating, at least in well-performing lines and for good risks, and the rate of increase of premium has slowed.

At the same time, new challenges have arisen that will require prudent management.

- Catastrophic weather losses continue to rise, and $2 billion in annual natural catastrophe losses appear to now be the norm, rather than an exception.
- Inflation is at a 40-year high, which will have a direct and material impact on claims costs.
- Hiring and retaining talent is a challenge across the industry, and the need to invest to retain staff will contribute to increased operating costs for the industry.
- The digitization of the economy has created new risks and increased exposure across all industry sectors. Cyber insurance is emerging to address these risks, but to date, performance in that line of business has been challenging.

Because of these factors, insurers are likely to remain cautious despite their improved results. Underwriting has become more rigorous over the last three years, and that discipline, and a conservatism in the face of market uncertainty is unlikely to lessen any time soon. So even as the industry turns to growth, the focus on risk quality will likely keep rates stable for the next several years. Whether that will be enough to maintain insurer's return on equity (ROE) is anybody's guess.

For policyholders, the lesson of the last few years is that risk mitigation does matter. Insureds can take actions to better manage their risks, and those actions in turn make it easier to access insurance at better rates.

1. Introduction

This paper is an update to one we wrote in early 2020[1], during the first pandemic lockdown. That was a challenging time for the property and casualty (P&C) insurance industry. A decade of low interest rates and increasing competitive intensity had left the industry performing at an unsustainable level.

In response, in 2019 the market began to "harden" – capacity left the market and rates began to rise. And then, in early 2020, the pandemic hit, creating a global health crisis and severe economic disruption. At the time, the scale of the crisis, and its impact on the insurance industry were unclear. Our previous report reflects these uncertainties and the concerns of the time it was written.

Two years later, the world is very different. Pandemic restrictions have been wound down and economic activity is returning to its pre-pandemic levels. And after three years of a 'hard market' the performance of P&C insurers has improved significantly.

To understand the impact of these changes on the current state and future prospects of the industry, we have compiled this update. For this report, in addition to research on key trends and analysis of industry performance, we spoke with a panel of industry experts – senior leaders of insurance companies, brokers and risk management consultants – to get their perspectives on the challenges and opportunities facing the industry. They spoke to us 'off the record', and their anonymized comments are described as industry expert perspectives throughout the report.

2. State of the Canadian Property & Casualty Insurance Market

The Canadian commercial insurance market is in a period of flux. After a decade of declining returns, the market began to harden in 2019, and has seen a significant improvement in performance across most lines[i] in the last two years. That improvement was driven by a broad-based increase in commercial insurance rates, and complicated by the effects of the COVID-19 pandemic.

Today, while performance has improved, insurers continue to face both ongoing and new challenges. Trends in claims severity, and increasing natural catastrophe events are likely to continue. Claims volume is likely to rebound as the economy returns to pre-pandemic activity levels. And new challenges – increasing inflation and geopolitical turmoil will put additional pressure on insurers.

2.1. Historic market conditions: 2019 – 2021

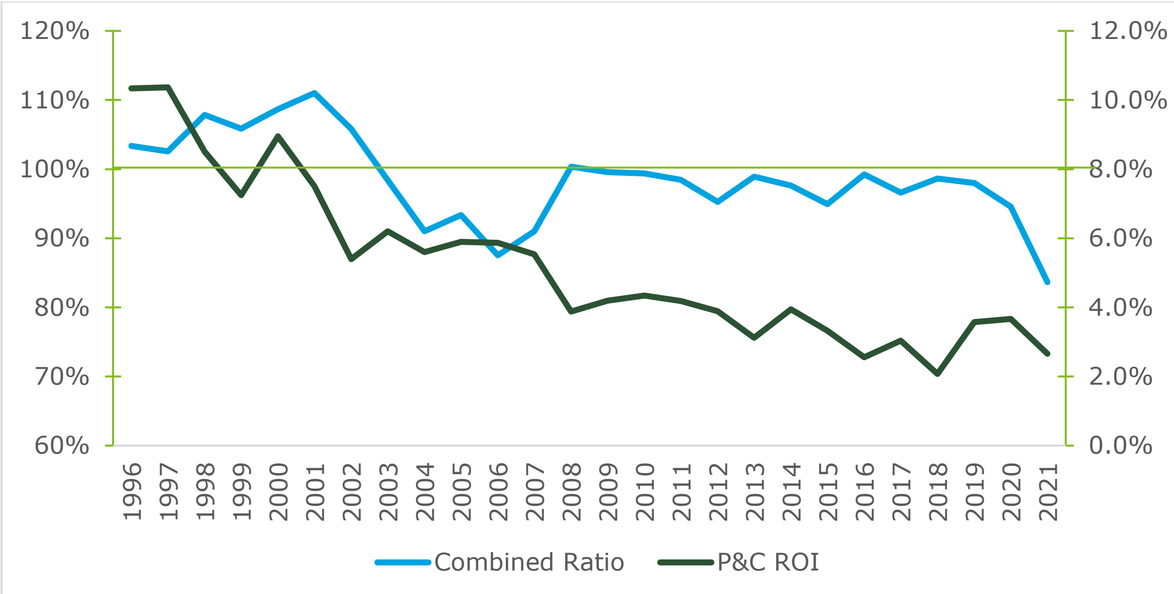
In 2019, the period covered by our last report, the P&C industry was in a challenging position.

Between 2015 and 2019, the P&C five-year industry average combined ratio (across all lines) was 97.5%, up from a low of 92.3% between 2003 and 2007[2]. In commercial property and liability insurance, loss ratios had climbed steadily, from a five-year industry average of 57.3% over 2006 to 2010, up to a high of 65.2% for 2015 to 2019.[3] Meanwhile, the premium rate had not risen proportionally.

Many factors led to this decline in financial performance. Capacity in the market increased, as several global insurers entered the Canadian market, and many Canadian insurers expanded their risk appetites to grow premium. These competitive dynamics impacted the ability to increase rates, putting initial pressure on insurers' underwriting profitability. Additionally, the low interest rate environment created a significant reduction in return on investment (ROI) from 6.2% in 2003 to 3.6% by 2019[4].

Exhibit 1: Canadian P&C ROI & Combined Ratio, 1996 - 2021

[i] Cyber and professional liability insurance were still unprofitable in 2021.



Sources: IBC, MSA, SCOR, AMF, BOC[ii]

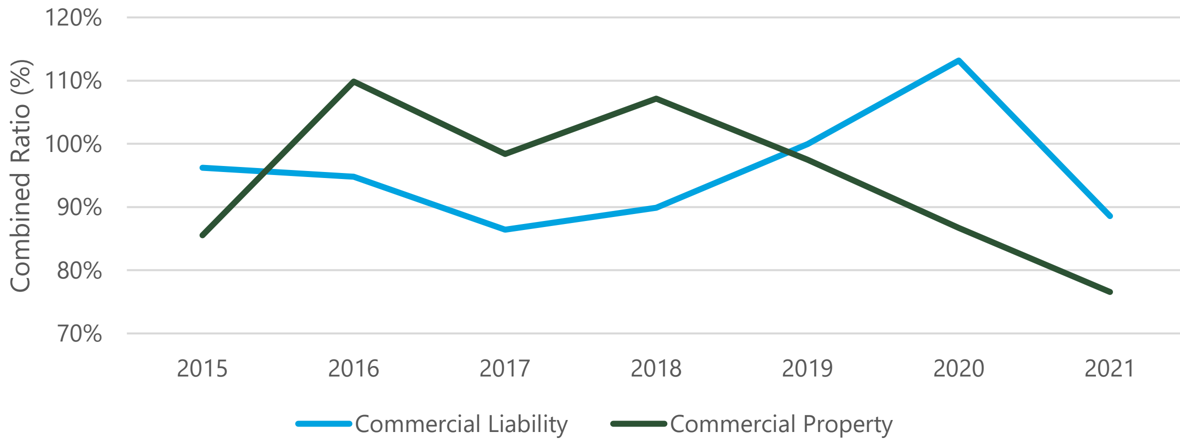
2019 – 2021

Ultimately, with both underwriting profitability down and lower investment returns, insurers took action to maintain their financial security and secure their future ability to pay claims. The result was a decline in commercial insurance availability and a corresponding rise in clients' premium rates.

Many insurers reduced the risk they took on and, in some cases, exited product lines entirely. Lloyd's of London, for example, closed eight syndicates which globally wrote a combined £1.5 billion in gross written premiums. Lloyd's also exited or significantly reduced capacity in more than 70 lines globally[5]. The reduction of capacity from Lloyd's and other insurers had a sizable impact on managing general agencies (MGAs) in Canada. MGAs lost a key source of capital in Lloyd's. As a result, MGA capacity declined significantly and where capacity was available, rates were up significantly.

Exhibit 2: Canadian Commercial P&C Direct Combined Ratios, 2015 - 2021

[ii] 2021 data is drawn from an Insurance Bureau of Canada (IBC) calculation from MSA Research (MSA), which uses a smaller group of companies than in previous years

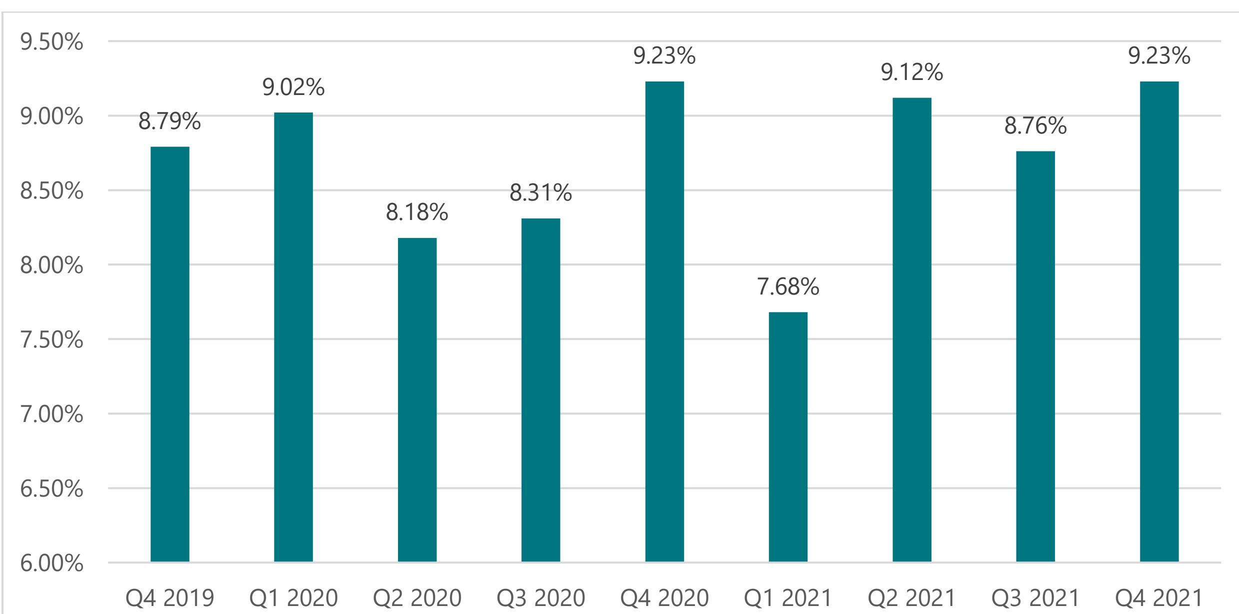


Source: IBC estimates with data from MSA, all private companies

In the primary market, rates increased as well. By the end of 2019, renewals were seeing an average rate increase of nearly 9%. Rate increases continued at a similar level through 2020 and 2021. Exhibit 3 summarizes the average commercial lines rate increase from 2019 to 2022. Over the period, the cumulative increase on Q4 renewals was 29.8% over the 2018 premium.

It is important to note that this figure is an average that includes both good and challenged risks. Risks with challenged claims history, and risks in high-claim industry sectors, saw much higher increases, and often had difficulty getting coverage.

Exhibit 3: Canadian Commercial Average Renewal Rate Changes, 19Q4 – 21Q4



Source: Applied Systems Commercial Rate Index Report, 2021Q4

COVID-19 Measures

Beginning in 2020, the pandemic's widespread impact on the health care system, lockdowns and closures of large sectors of the service economy, and supply chain disruption, created unprecedented challenges for Canadian businesses, and brought more stress and uncertainty to the insurance market.

At the onset of COVID-19, it was believed that the pandemic would have a compounding effect on hardening market conditions. The reality turned out to be more complex, with the pandemic impacting the commercial insurance market in a variety of ways.

Business closures – One concern was that the pandemic would cause a wave of bankruptcies and business closures, disproportionately impacting small businesses and the service sector businesses most effected by lockdowns. And to some extent, this did occur. For instance, 13,000 restaurants across Canada have closed since the pandemic began[6]. But, as the pandemic progressed, policy measures and government support helped businesses manage cash flow pressures and prevented many from closing. The insurance market saw a modest reduction in policy count from business closures, but the premium impact of the rate increases during the period more than compensated for any lost business. Indeed, commercial property and liability premium increased approximately 35% during the period 2019-2021.

Reduced business activity – In addition to business closures, overall business activity declined during the pandemic. Large pieces of the service economy were at times shuttered or operating at reduced capacity. Business travel essentially stopped. Workers and consumers operated out of their homes, rather than going to a business site. As a result, GDP declined 5.2% in 2020.

This broad-based reduction in activity appears to be reflected in the volume of claims in the period. Property claims were down 6% during the pandemic, and while liability claims rose in 2019 and 2020, they declined 16% in 2021 as well.

Supply chain disruption – The global disruption to manufacturing and logistics caused by waves of lockdowns, staff shortages, and restrictions on cross-border travel created supply shortages that drove up the cost of some property and auto claims. Prices for construction materials went up significantly, as were the costs for rental and replacement vehicles. While this effect was not large enough to counteract the drop in claims volume discussed above, it does suggest that as business activity returns to pre-pandemic levels, claims costs may be higher because of these price increases.

Slowed and deferred litigation – In a number of our expert interviews, the idea was raised that one factor contributing to the decline in liability claim costs was a slowdown in the litigation process. Court closures during the pandemic, challenges in taking depositions and other disruptions may have created a bottleneck to resolving some liability claims. This idea is difficult to prove, but if true, would suggest that a rebound in liability claims will occur once the bottleneck clears.

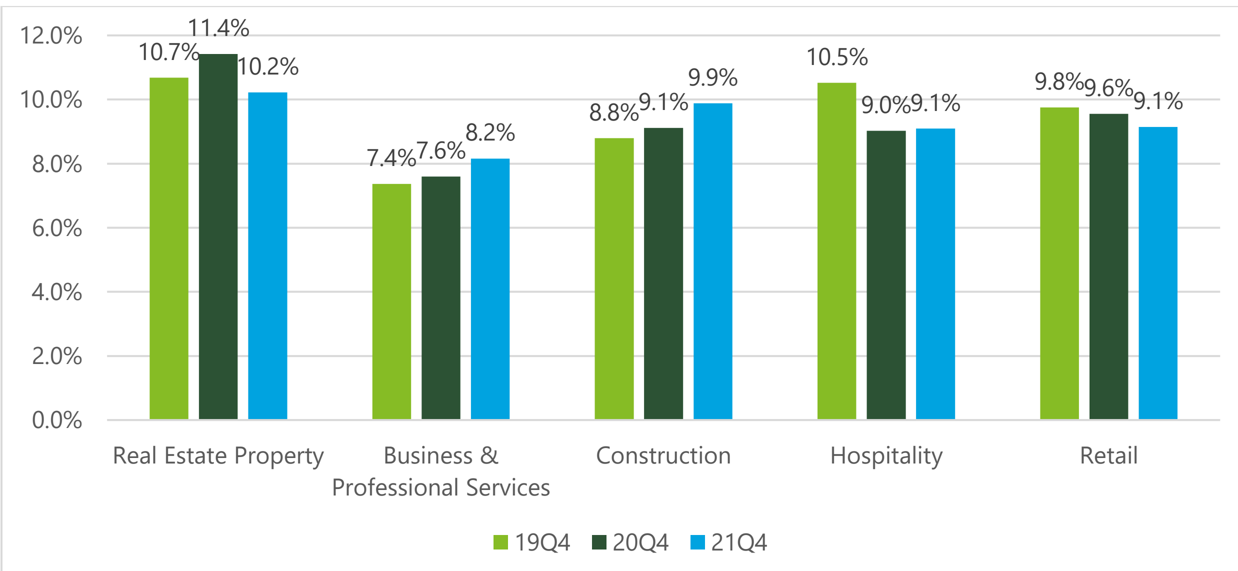
Industry relief efforts – Insurers responded to the increased financial strain from the pandemic on their customers with a series of programs to reduce or defer premium payments. IBC estimates that from March 2020 until the end of 2021, the P&C industry provided over $3.7 billion in COVID-19 consumer relief measures. This relief was provided on all lines of business – property, auto and commercial, with at least $930 million in relief provided to commercial insurance customers.

Industry Sectors

The impacts of the pandemic, and of the hard market were not uniform across the economy. Certain industry sectors had seen challenges with claims costs prior to the pandemic, and were more strongly impacted by the hardening market. Additionally, the pandemic had a greater impact on some service industries, and the challenges to business viability created by the pandemic increased the risk of those businesses.

Exhibit 4 compares renewal rate changes for a number of sectors impacted by the pandemic and the hard market. Real estate, hospitality and retail have all seen rate increases greater than the market as a whole, while business and professional services have seen less of an increase.

Exhibit 4: Average Renewal Rate Changes, 19Q4 – 21Q4 – Select Sectors



Source: Applied Systems Commercial Rate Index Report, Q4 2021

Construction – During the pandemic, the sector experienced increased risk exposures as an outcome of the shortage in skilled trade workers, reduced foreign suppliers, and the complexities of adhering to COVID-19 safety measures. This triggered a spate of claims for defective work in high rise construction.

Insurers and brokers have identified the increasing exposure and have been working with clients to establish risk mitigation plans where, if the plans are not followed, deductibles could be increased.

Real Estate – Real estate has been a habitually challenged segment, with increasing numbers of large fire and water damage losses from this segment. While some of this increase has been related to the increase in temperature and severe weather events, experts interviewed believe that issues with construction quality, and inadequate maintenance have contributed significantly as well.

Some carriers have provided more risk mitigation support to real estate clients, but with mixed success. Nonetheless, because of the size and growth of the sector, insurance capacity has returned, and is believed to be stable and potentially increasing.

Transportation – Transportation is a sector which has seen a material shift in business mix. In recent years, driven by the increase in online shopping, there has been greater emphasis on last-mile delivery which is heavily weighted with independent contractors. Additionally, new risks and regulatory issues have emerged including transportation-related licensing, permitting and interprovincial protocols. COVID-19 further compounded the pressures on this sector, as it resulted in driver shortage and safety issues.

These factors have created a driver pool that is less experienced and less-well trained, operating in a more challenging environment, which has led to increased risk exposure for the industry.

The industry experts who we spoke to believe that the amount of insurance available to clients in this industry sector decreased during the hard market, causing premiums to rise and making it challenging for some clients to get coverage. That said, clients, insurers, and brokers have been making substantial investments in technology and risk management services (i.e., dash cams to improve driver safety) to address and improve the exposure and profitability of the industry.

Hospitality – Hospitality was the sector hardest hit by the pandemic, with revenue shrinking by 15.2% between 2019 and 2021. Declines were largely driven by government regulated shutdowns and the operational complexity of adhering to the COVID-19 protocols that negatively impacted both revenue and expenses.

Industry experts indicated that prior to the hard market and the pandemic, this industry sector was already challenged to access capacity and, if capacity was available, prices were remarkably high. This was a particular issue for firms with exposure to liquor liability, which had seen an increase in large liability claims.

Over the course of 2019 to 2021, the access to capacity and rates worsened for the hospitality sector, specifically for the micro or small sized businesses (i.e., 99 or fewer employees). In response to the lack of capacity, it was noted that the mid to large-sized businesses (i.e., 100 to 500+ employees) have explored establishing captives and other alternative risk financing models.

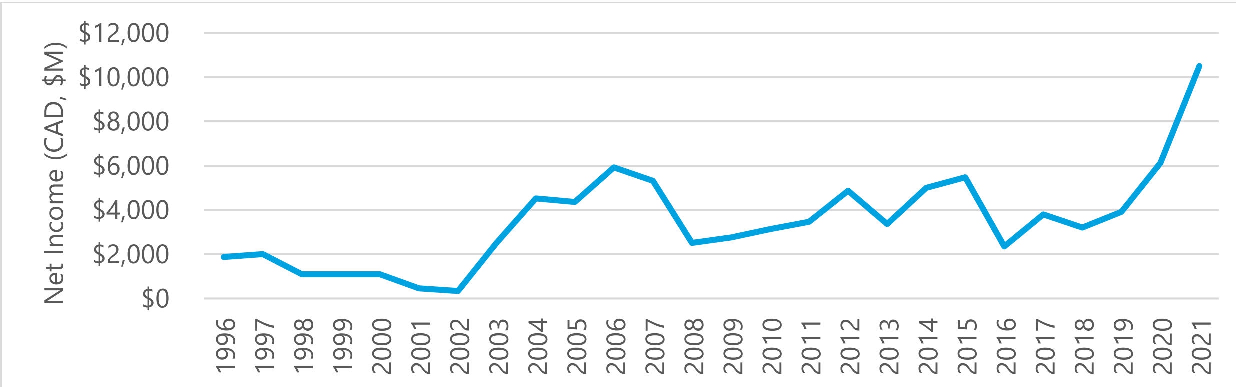
During the pandemic, risk management emerged as one of the leading differentiators for businesses and their sustainability. Businesses that adopted governance and risk reduction best practices in coordination with their broker and insurer saw improvements in their risk profile that helped mitigate their insurance costs. The insurers and the brokers play an important role in educating the businesses on factors contributing to the availability and affordability challenges with commercial insurance.

2.2 Industry Financial Performance

By any measure, 2021 was a good year for Canadian P&C insurers.

Prior to the pandemic, the Canadian P&C insurance industry's profitability had been on a steady decline. Between 2015 and 2019, net income had decreased at an annual rate of 8.1%, from $5.5 billion to $3.2 billion. While the industry did not lose money, both underwriting income and investment income declined over the period. As a result, ROE for the industry in 2018 was 6.4%, a level that had not been seen in sixteen years.

Exhibit 5: Canadian P&C Insurance Industry Net Income, 1996 - 2021



Sources: IBC[iii], MSA, SCOR, AMF

Starting in 2019, driven by the market-wide rate increases, performance in the industry began to improve. 2019 was a marginally better year than 2018, with a 1-point improvement in overall loss ratio. This led to an ROE of 7.6%, which, while better, was still below the 20-year average of 9.2%.

Performance continued to improve in 2020 and 2021, with 2021 being the industry's best year since 2005 – the end of the last hard market. Exhibit 12 summarizes the magnitude of the shift from 2018 to 2021. Over the period, direct premium written (DPW) increased 30.4% while growth in claims expenses were essentially flat, creating a 15-point decrease in the loss ratio. As a result, net income over the period increased from $3.2 billion (2018) to $10.5 billion (2021), and ROE grew from 6.4% to 17.1%.

More than half of this improvement occurred in 2021, driven by the interaction between the rate increases of the hardening market and the pandemic. Claims expenses decreased 10.4%, or $4.2 billion, year-on-year, translating to a drop of 11.3 points in the loss ratio. This decrease was driven in large part by the reduction in activity caused by the pandemic. Industry experts pointed to less auto travel, less business activity and earlier detection of personal property claims from staying at home as key drivers of the reduction. Despite this reduction in activity and the resulting rebates, premium was up 8.7% over 2020. The result was a $4.4 billion increase in net income in a single year – the largest annual increase on record.

Exhibit 6: Canadian P&C Insurance Summary of Financial Results, 2019 - 2021

	2021	2020	2019	2018	2021 vs. 2018
Direct Premium Written	$77,242	$71,043	$65,285	$59,215	30.4%
Net Premium Earned	$64,353	$59,559	$53,581	$51,797	24.2%
Total Underwriting Expenses	$53,783	$56,127	$52,341	$50,778	5.9%
Net Claim Expenses	$33,776	$37,926	$35,513	$34,824	-3.0%

[iii] 2021 data is IBC calculation from MSA, which has a slightly smaller sample group of companies than previous years.

Operating Expenses	$20,007	$18,200	$16,828	$15,954	25.4%
Underwriting Income	$10,570	$3,843	$1,344	$928	1038.9%
Net Investment Income	$3,014	$4,727	$4,299	$2,399	25.6%
Net Income	$10,503	$6,126	$3,918	$3,211	227.1%
Net Loss Ratio	52.6%	63.9%	66.6%	67.7%	15.0 pts
Combined Ratio	83.8%	94.7%	98.3%	98.9%	15.1 pts
ROI	2.7%	3.7%	3.6%	2.1%	-0.6 pts
ROE	17.1%	10.9%	7.6%	6.4%	10.7 pts

Sources: IBC and MSA, all private companies

Within commercial lines, the patterns were similar. Between 2018 and 2021, premium in commercial property increased 48.7%, from $8.4 billion to $12.5 billion. Claims expenses were down 11.2%, from $6.4 billion to $5.7 billion, leading to a loss ratio of 45.4%, the lowest it has been since 2006.

In commercial liability the turn in the market came later. From 2018 to 2020 liability premium grew 23.8%, from $6.3 billion to $7.8 billion. But, in the same period, claims grew 73.7%, from $3.7 billion to $6.4 billion – far outpacing premium growth. The loss ratio peaked at 82.5% for liability in 2020, a level that would create a significant underwriting loss.

2021 saw a significant improvement, with premium growing 20.3% to $9.4 billion, while claims decreased 16.3% to $5.4 billion. This brought the loss ratio back to 57.4%, slightly below its level in 2018, and at a level that would generate an underwriting profit.

Taken together, the combined 2021 commercial property and liability net loss ratio had fallen to 51.1%, the lowest it had been in 25 years.

This improvement, while broad based, was not universal. Most notably, both professional liability and cyber continued to experience challenging losses, with 2021 loss ratios of 88% and 115% respectively.

The magnitude of the decrease in claims 2019 – 2022 is a key feature of this hard market. While some of this reduction is from more careful underwriting, lower limits, greater self-retention, and improved risk management – the usual levers insurers and policy-holders use to manage claims – much of the reduction in 2020 and 2021 must be from the impact of the pandemic. How quickly and to what extent claims will rebound as the economy returns to pre-pandemic levels remains to be seen.

Exhibit 7: Commercial Property & Liability Insurance Financial Performance, 2019 - 2021

	2021	2020	2019	2018	2021 vs. 2018
Commercial Property					
Direct Premium Written	$12,521,943	$10,782,349	$9,138,055	$8,415,988	48.8%
Claims Expenses	$5,681,997	$6,034,918	$6,020,629	$6,404,115	-11.3%

Direct Loss Ratio	45.4%	56.0%	65.9%	76.1%	30.7 pts
Commercial Liability					
Direct Premium Written	$9,400,278	$7,812,979	$6,896,056	$6,311,135	48.9%
Claims Expenses	$5,391,851	$6,442,410	$4,714,329	$3,709,941	45.3%
Direct Loss Ratio	57.4%	82.5%	68.4%	58.8%	1.4 pts

Sources: IBC with data from MSA, all companies

2.3. Future Outlook

The natural question, after three years of an insurance market correction and record-setting performance in 2021, is when will the hard market soften? Will rates to continue to rise in 2022 and beyond? Will the industry continue to see above-average returns? Or will new capacity and renewed interest in growth increase competition and cause the market to soften?

In short, will this market cycle follow the pattern of previous cycles, or are things different this time?

Market Dynamics

The insurance cycle is driven by the interaction between underwriting discipline and the desire for growth. There is evidence that, after three years of exclusive focus on underwriting discipline, Canadian insurers are pivoting back to growth. In their 2022 Q1 review, Aon describes a broadly stable market and an interest by insurers in targeted growth in both property and liability, leading to increased capacity and some underwriting flexibility in both lines[7]. Additionally, since late 2021 Lloyd's has begun adding capacity again in the Canadian market.

However, the industry experts we interviewed believe that this additional capacity and shift in focus to growth is unlikely to soften the market materially in the near term. While rates may broadly stabilize, troubled industry sectors, like hospitality and real estate, are expected to continue experiencing rate pressure and issues with capacity. While there may be products where the market becomes more competitive on new business with good claims experience,[8] the experts we interviewed observed that underwriters are continuing to scrutinize submission quality, risk characteristics, and ask for underwriting data with a level of rigor that was not present prior to the hard market.

This tension between discipline and growth, therefore, is likely to stabilize the market for the next few years. In prior hard markets, above average performance only lasted two to three years before price competition intensified and rates softened.[9] This time, the industry faces headwinds in the form of climate change, inflation, and emerging risks that may slow the onset of a softening market.

Climate change

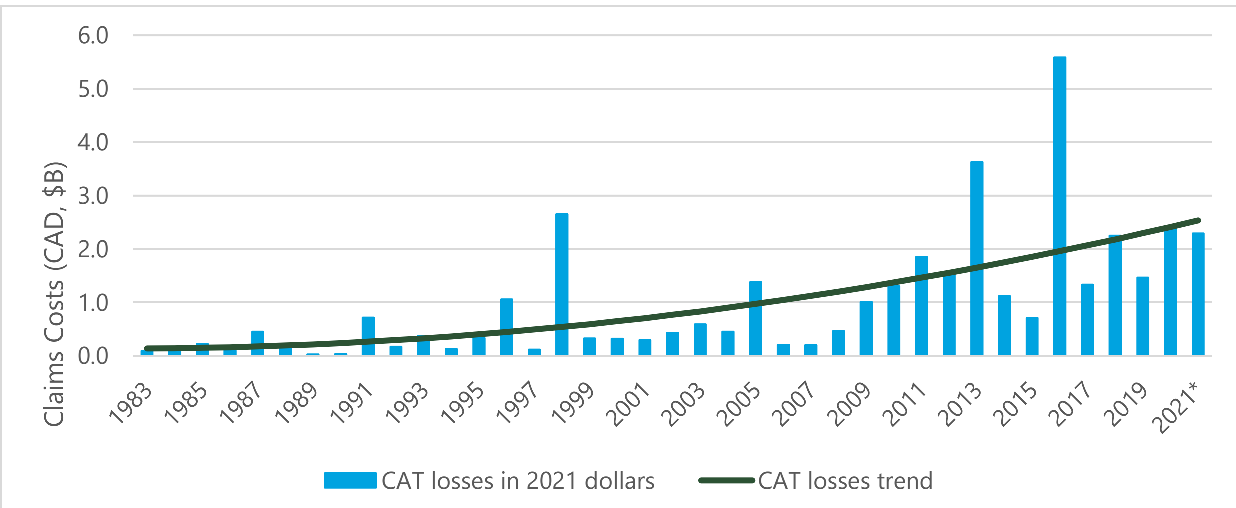
The increase in frequency and severity of extreme weather events is one of the most complex factors affecting the commercial insurance market. While the rise in severe weather events may lead to increased demand in high-risk regions and for certain insurance products, the pricing of such policies is challenging.

Competitive pressures and significant risk volatility, due to the wide fluctuations in weather patterns, reduce the ability of insurers to raise premiums to address the growing risks of extreme weather events.

In the past ten years, Canada has experienced its most costly wildfire, flood, and hailstorm events. Canada had routinely paid out over $1 billion a year in losses relating to extreme weather events, with the record annual natural catastrophe[iv] loss in 2016, at the cost of $5.4 billion. This has had a significant capital impact on the P&C insurance industry, accounting for up to 10% of Canadian P&C insurers' $52 billion in equity. The rise in losses from extreme weather was a key contributor to insurers' underwriting profit pressures and the shift into a hard market in 2019.[10]

Over the course of the pandemic, extreme weather events continued to occur across the country resulting in historic losses. In 2020, total losses were $2.3 billion, driven by floods across Fort McMurray and hailstorms in Calgary, Alberta. While in 2021, total losses were $2.1 billion driven by both hailstorms in Calgary, and floods in British Columbia.

Exhibit 8: Insured Catastrophic Losses in Canada, 1983 - 2021



Sources: IBC Facts Book, PCS, CatIQ, Swiss Re, Munich Re & Deloitte

Insurers expect the frequency and severity of extreme weather events to continue to rise, further increasing the strain on the market. A common expectation is that catastrophic losses in an average year are now likely to be above $2 billion. As one expert put it, "For catastrophic losses, two billion [dollars] is the new one billion [dollars]".

As a result, Canadian commercial insurers are expected to become more dependent on accessing reinsurance to reduce the financial impact of these catastrophic losses. The availability and pricing of reinsurance in the Canadian commercial market will be a key question over the coming years and will impact insurers' risk tolerance in providing commercial insurance coverage.

[iv] According to Catastrophe Indices and Quantification Inc. (CatIQ), a catastrophic event is an event that affects multiple policies and causes more than $25 million in insured damage.

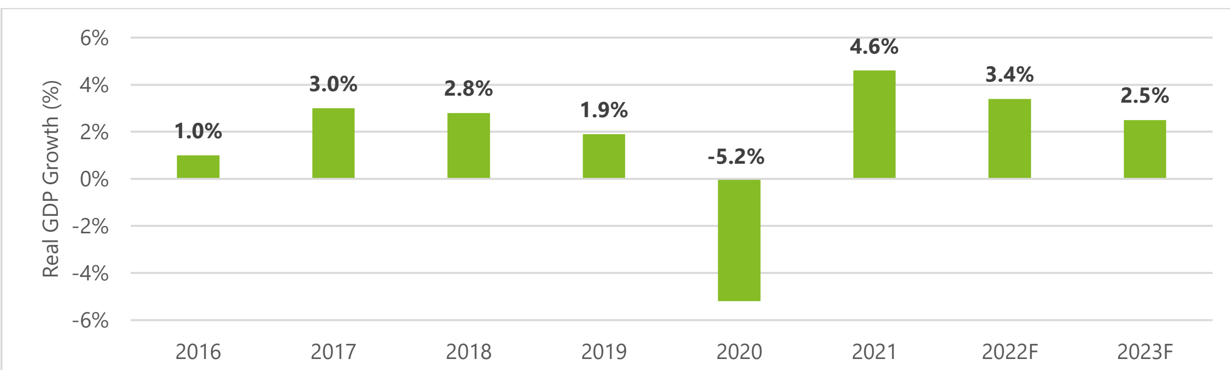
Economic growth and inflation

After a decade of sustained GDP growth (averaging 2.1% annually), in 2020 the pandemic caused the deepest recession in Canadian post-war history, with the GDP declining 5.2%, and unemployment rising to 8.8%.[11] But the recession was short-lived. In 2021, the economy bounced back with GDP improving by 4.6%.[12], and returning in 2022 to pre-pandemic levels. From a business perspective, economists believe the rebound will continue as businesses investments that were once postponed continue to ramp back up, with notable projects across energy, transportation and warehousing, and accommodation and food services.[13] This underlying economic growth should bring commercial policy growth back to pre-pandemic levels.

However, the recovery has not been uniform across the economy. Business bankruptcies rose sharply in the last quarter of 2021, driven by closures in the food services, accommodation and construction sectors, and experts say this trend will continue in 2022. Canadian business insolvencies jumped 36.8% in the fourth quarter of 2021, likely driven by the end of the federal wage subsidy, which preceded the arrival of the COVID-19 Omicron variant and new restrictions. Accommodation and food services saw a 75% jump in insolvencies between the third and fourth quarters of 2021.[14]

Issues with business viability in these sectors creates additional risk for insurers, and will continue to put pressure on rates and drive more intensive underwriting for these clients.

Exhibit 9: Real GDP growth, 2016 – 2023 Forecast



Sources: StatsCan, Forecast by Deloitte Economic Advisory as of March 14, 2022[v]

More concerning than the rate of growth is the rate of inflation. In June 2022, consumer prices were up 8.1% over the prior year, the highest rate of increase in 40 years. More relevant to insurance claims costs, the April home replacement costs index was 10%, the price of private passenger vehicles was up 8.2%, and the cost of a rental car was up 28.5%. Prices increased against the backdrop of sustained price pressure in Canadian housing markets, substantial supply constraints and geopolitical conflict, which has affected energy, commodity, and agriculture markets. Further, employment continued to strengthen in April, as the unemployment rate fell to a record low.[15] Ongoing labor actions by construction workers in Ontario will likely also contribute to increases in property repair costs.[16]

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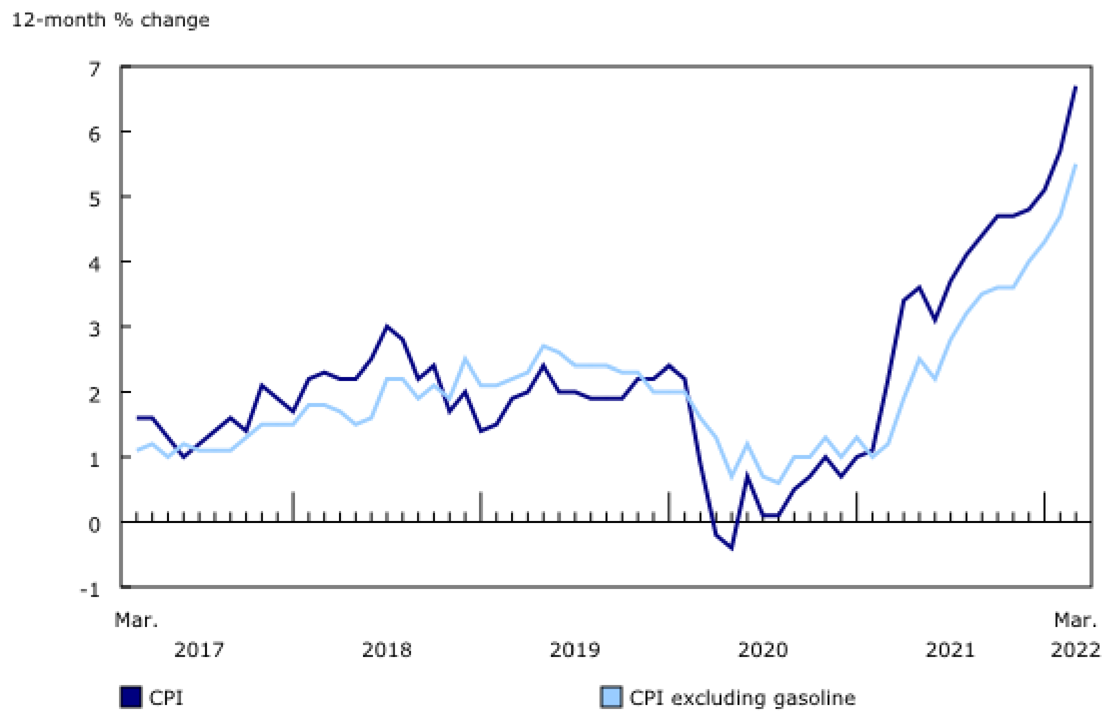
[v] Canada, "Economic rebound shaken by crisis in Ukraine, Economic Outlook", March 2022, https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/finance/ca-eo-march-2022-report-en.pdf?icid=eo-report-march-2022-aoda-en-banner-En

It is unlikely that this inflation was fully anticipated by the actuarial models used to price commercial policies. As a result, claims costs will be higher than expected. This will put upward pressure on rates, particularly in the property and fleet lines, and likely delay any softening of the market.

Exhibit 10: Canadian Inflation Rate, 2017 – March 2022



Sources: IBC and StatsCan, as of March 2022

Cyber and digitization

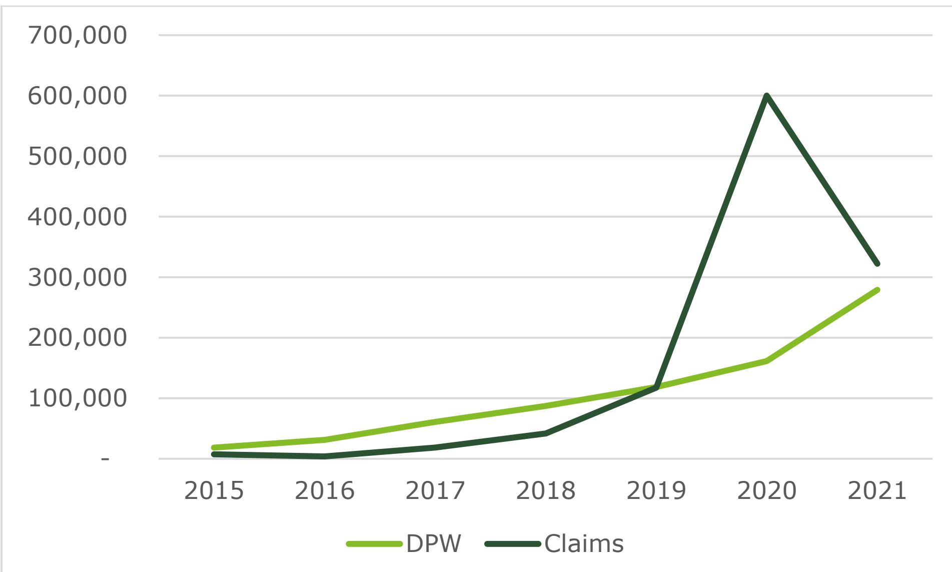
The digitization of the economy continues to create new risks and exposures for commercial clients. It remains the case that few clients have sufficiently protected against these exposures, creating a substantial need for new product development and innovation to address these emerging risks. Claim rates, particularly in cyber, have been much higher than expected. This will drive continued rate and capacity issues in these products, as insurers struggle to provide profitable cyber products.

Key changes in client exposure have been driven by the following forces:

- ***Growing technological complexity of operations and large-scale transformations*** – As operations become more technologically sophisticated and interconnected, the potential costs associated with loss events will rise.
- ***Rise of the sharing and gig economies*** – The growth of the Canadian sharing economy (i.e., sharing access to individuals' property, such as home-sharing) and gig economy (i.e., independent contractors working as part-time or temporary labor) have been sizable. While government mandated restrictions due to the COVID-19 pandemic temporarily slowed sharing economies, the increased demand for talent caused the need for gig economies to remain strong.

Increased risk of data breaches and cyber-attacks – The large share of interactions that occur online with sensitive data increasingly being stored digitally or in a cloud computing system. Prior to the pandemic, the Canadian economy already saw cyber risks rapidly rising. For example, in 2017 the Canadian economy faced the third most cyber breaches of any country, resulting in a loss of around $3 billion in GDP.[17] COVID-19 accelerated digital transformations for many companies. Additionally, industry experts have indicated that bad actors increased in numbers and in sophistication. These factors resulted in a higher frequency and severity of data breaches and cyber-attacks. In 2020, cyber claims soared to $600 million, which was +410% versus the prior year. By 2021, claims had decreased to $322 million, possibly as a result of businesses implementing stronger and more mature controls and cybersecurity measures. In both years the total cost of cyber liability (claims paid plus operating expenses) exceeded the premium collected and created an operating loss. Claims cost in those years were so high, in fact, that they alone were more than premium collected, a clearly unsustainable condition.

Exhibit 11 (ALT): Cyber Liability – Direct Premium Written and Claims Incurred, 2015 - 2021



Source: IBC with data from MSA, all companies

Initially, due to a lack of claims data and limited expertise, insurers did not have the actuarial models to accurately price cyber products. As cyber claims increased, insurers have strengthened their actuarial models, causing pricing to materially increase to respond to higher expected claims. To further limit exposure, insurers have made underwriting for cyber more stringent and robust, and coverage more restricted.[18] As insurers continue to navigate the uncertainty, and rising risk exposure of cyber losses, it is expected that capacity will continue to be constrained and contract further. For businesses to find coverage for their cyber risks, it is anticipated that many may be required to accept policies with lower limits and/or higher deductibles. Further emphasizing the importance of risk mitigation practices in the form of governance, controls, and cybersecurity.[19]

Insights from other markets

Another interesting feature of the 2019 hard market was its global nature. The market turned in a similar way in the US and UK at roughly the same time. This speaks to the growing interconnectedness of global insurance capacity, at both the reinsurance/London market level and at the primary insurer level.

Industry monitoring by Aon, summarized below in Exhibit 12, suggests that these markets continue to move at a similar pace and direction. Arguably, the US is slightly farther into the cycle, with somewhat better access to capacity. In terms of pricing, all three markets had pricing in the +1-10% range by Q4 2021. Like Canada, the US and UK reported that a more competitive market was emerging for only the in-appetite risks and placement types.[20] Australia, on the other hand, is arguably slightly behind the other markets in the cycle, with particularly severe results in pricing and deductibles that were both increasing at a faster rate than Canada. The increasing prices were driven by cyber, property, directors and officers (D&O) and casualty/liability where insurers had a contracting risk appetite.[21]

Exhibit 12: Status of Market Conditions across Canada, US, UK, and Australia

	CAN	US	UK	AUS
Overall Market	Challenging	Moderate	Challenging	Challenging
Pricing	+1-10%	+1-10%	+1-10%	+11-30%
Capacity	Constrained	Ample	Ample	Constrained
Underwriting	Prudent	Prudent	Prudent	Prudent
Limits	Flat	Flat	Flat	Flat
Deductibles	Flat	Flat	Flat	Increasing
Coverages	Stable	Stable	Stable	Stable

Source: AON, "Q4 2021 Global Market Insights Report"

2.4 The Talent Challenge

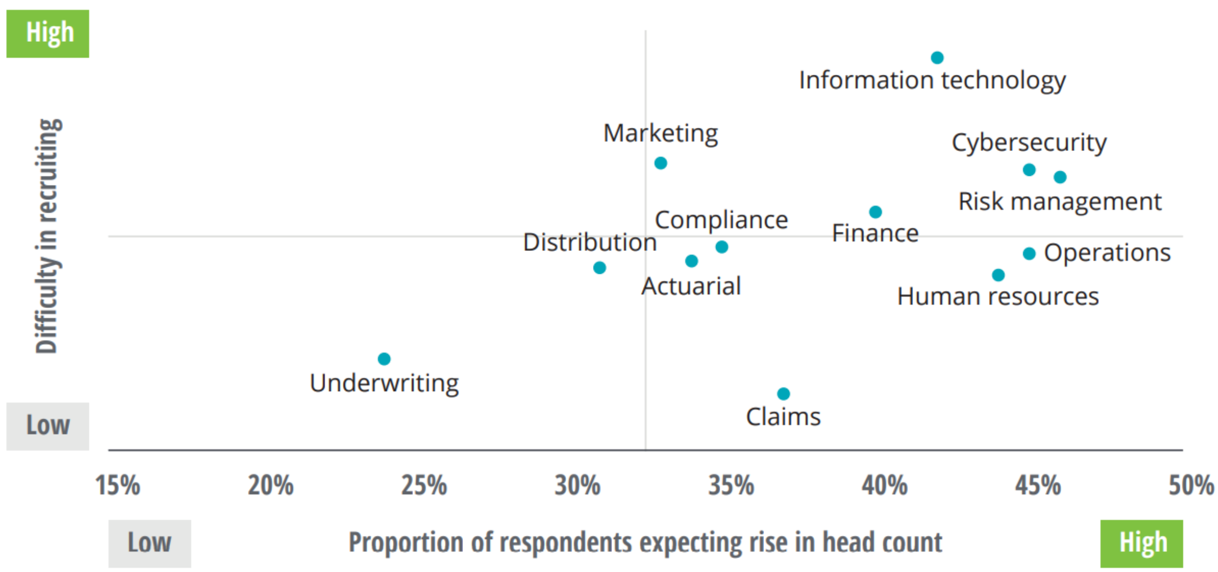
We interviewed a dozen industry experts for this report – a mix of insurance and distribution leaders, and professionals who serve the insurance industry. We ended each interview by asking what the greatest challenge for the industry was. All but one of our interviewees answered that question the same way; talent.

The demand for sufficient talent who have the appropriate skillset and expertise has been a growing challenge for insurers. The evolving market dynamics of COVID-19 has only caused this challenge to worsen, and it is expected to continue in the years to come.

While capacity will be constrained to cope with rising exposures, overall the industry still expects that the greater economic recovery will continue to boost business volumes and there will be a need to increase headcount across most functional areas. Further compounding the issue of lack of sufficient talent is that during the pandemic, many insurers made staff reductions to cut costs.

When it comes to skillset, in a global survey of 400+ senior insurance executives across multiple functions, 43% of talent respondents indicated that it is becoming more difficult to find skilled candidates, naming IT as the area of greatest difficulty. This is largely because when it comes to IT expertise, insurers are competing with both their industry peers and global tech giants. Insurers are also faced with the challenge of identifying talent with the appropriate skillsets to address the changing insurance landscape. For example, to sufficiently address the demand for cyber, insurers need talent who understand the nature of cyber risks, the range of mitigation services, etc. However, given that it is a recent phenomenon (as demonstrated by the spike in claims), the talent pool is limited.[22]

Exhibit 13: Recruitment challenges in Insurance, 2022



Source: The Deloitte Center for Financial Services 2022 Insurance Outlook Survey

To address talent gaps, insurers have been increasingly making investments to improve recruitment and retention of the key talent with the requisite skillset. These investments have had a negative impact to efficiency ratios in the short term:

- ***Supplementary training for new talent:*** Insurers will expand their traditional talent pool by exploring candidates from other geographies and/or professional backgrounds. The key will be looking for candidates with 'adaptable' skills. We heard this specifically in terms of underwriters, where insurers have been looking for candidates with industry specific experience with the intention to provide the necessary training to develop the underwriting toolkit.
- ***Upskilling existing talent:*** Insurers will look to strategically upskill their existing talent pool. This will be a long term and ongoing process that will require meaningful investment into training development (that would include the developing and executing training modules). Additionally, they will develop tools and resources (i.e., a center of excellence) that can ensure standardized industry expertise that is easily accessible across the organization.
- ***Automating processes****:* Insurers will automate capabilities, specifically in underwriting and claims processing. Using data and analytics, they will also look to enhance the accuracy and insights around sales and distribution, pricing and loss control. This provides more capacity for functions where

human-led support is necessary and highly valued by clients and partners and has potential to create meaningful cost efficiencies.

Insurers will be faced with the pressure to maintain profitability and operational efficiencies while ensuring that they can afford these extensive and necessary investments into talent.

3. Concluding Remarks

The Canadian commercial insurance market has had to cope with difficult conditions in recent years, which makes its financial performance in 2021 a welcome change. Past hard markets suggest that this level of financial performance will be short-lived, as increased capacity and a desire for growth puts downward pressure on rate and return.

This time, the potential for that historical pattern to repeat is complicated by a number of factors that are likely to drive higher claims costs and place sustained pressure on insurance costs. Climate change, inflation, increased cyber exposure will all drive increased costs for insurers. And the current geopolitical and macroeconomic environment is creating significant uncertainty, and that uncertainty will cause insurance executives to continue to be cautious with respect to both the risks they are prepared to underwrite and the cost for the assumption of these risks. Under these conditions, it would not be a surprise for modest rate increases to continue for the next two to three years, even as insurer margins return closer to historical levels.

4. Glossary

Combined Ratio: The combined ratio is one of the measures that is used to determine the profitability of an insurance company. It is calculated by adding the incurred losses and expenses and dividing that by the total earned premiums. A combined ratio above 100% indicates that it costs an insurer more to run the business than it collects in premium.

Loss Ratio: Loss ratio is calculated by dividing the total incurred losses by the total collected premiums. It speaks to the financial health of the insurance company.

Lloyd's of London: Lloyd's is an insurance marketplace formed by an association of members (or names) grouped into syndicates. The Lloyd's syndicates are made up of members who have been approved by Lloyd's to participate in the market. The Lloyd's market does not deal with its clients directly but rather, through a global network of insurance brokers and coverholders (an individual or company that has the authority to bind coverage for a specific line of business as outlined in a contract with an insurer). Lloyd's has a reputation for being the market of choice for specialist insurance and reinsurance risk.

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