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Analysis in Brief

Insights into the impact of extreme weather trends in Canada on homeowners insurance profitability and consumers

by Marisa McGillivray

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Insights into the impact of extreme weather trends in Canada on homeowners insurance profitability and consumers

by **Marisa McGillivray**

Canada's property and casualty (P&C) insurance companies have faced many challenges in the last decade, and more so in the past couple of years. The P&C insurance industry has been impacted by the COVID-19 pandemic, a workforce crunch, an increase in climate-related weather claims and higher reinsurance premiums, exacerbated by high replacement cost factors.

This analysis focuses on the impacts of extreme weather trends and catastrophic (CAT) claims on the P&C industry's financial performance. Specifically, this study focuses on the personal property insurance line of business, which is synonymous with homeowners' insurance. In 2022, there were 15 CAT events[1] in Canada, with claims ranging from $35 million to $1 billion, totalling $3.4 billion in insured CAT losses. These losses were mainly attributable to water-related damages. In 2023, CAT losses totalled $3.1 billion. Both 2022 and 2023 were record years, ranking in the historical[2] top 10. The claims (loss) ratio was negatively impacted during this time, and both insurers and consumers were affected through higher reinsurance and higher homeowners' insurance premiums, made worse by the pandemic.

This analysis uses data from the Quarterly Survey of Financial Statements (QSFS) starting from the first quarter of 2020 for the P&C insurance industry.[3] The QSFS program provides data used to measure the financial position and performance of incorporated businesses by industry aggregation. Financial statement information is used to explore several profitability metrics that are important within the P&C industry and compare them with various price indexes to gauge the aggregate impacts on the P&C industry, particularly homeowners insurance. Using the QSFS data, this analysis explores the claims ratio,[4,5] the combined ratio,[6] return on equity,[7] underwriting expenses, revenues, profits and policies in force.

Industry overview

P&C insurance is composed of property (personal and commercial), automobile (private passenger and commercial) and other (boiler and machinery, liability, and surety). According to Canadian Underwriter, Canada's P&C insurance booked total[8] underwriting income of $10.0 billion in 2022, and net income of $9.0 billion on $83.4 billion of direct written premiums.[9] From 1983 to 2008, insurers averaged CATs of $400 million yearly, and since 2009, the yearly average has risen to nearly $2 billion. Although CAT claims do affect automobile and commercial lines, the effects are concentrated within personal property.

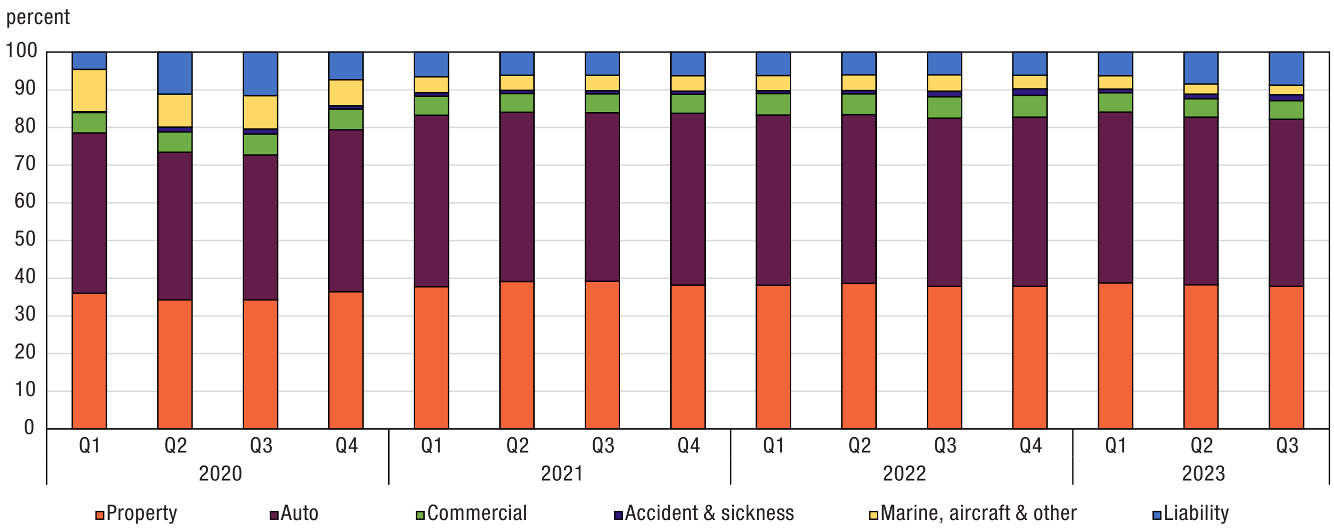
Including private,[10] government and mutual insurers, there are nearly 300 insurers[11] in Canada, with 195 publicly disclosing their financial results as of 2021.[12] More than 100 compete for auto and property insurance.[13] Despite the significant number of insurers, in 2022, the top 5 companies held roughly 50% of the market share, and the top 15 held approximately 80% of the market share. Given the concentration of the industry, this analysis will focus on the top 15[14] insurance companies at the Canada level for P&C insurance, inclusive of their subsidiaries. Over the

1. As of 2022, Catastrophe Indices and Quantification Inc. uses a threshold of $30 million for claims to be considered CATs.
2. "Historical" refers to data from 1983: Get up-to-date facts on the insurance industry (ibc.ca)
3. The insurance industry excludes life insurance companies, which are considered their own industry aggregate.
4. The claims ratio is the key performance indicator before International Financial Reporting Standards (IFRS) 17; after IFRS 17, it is the net insurance service ratio. For the purpose of this analysis, they are treated as equivalent. Other ratios may also be impacted by accounting changes.
5. Claims ratio = net claims incurred / net premiums earned. A lower ratio is better because it indicates an insurer's ability to pay claims costs. The claims ratio can be segmented to the line of business in the QSFS. All else equal, higher claims lead to a higher claims ratio.
6. Combined ratio = net claims incurred + expenses / net premiums earned. A lower ratio is better.
7. Return on equity (ROE) = net income attributable to equity shareholders / average total equity. Quarterly data are aggregated to a yearly ROE representation. ROE indicates how effectively the insurer generates profits, in which a higher ratio means the conversion of equity to profits happens more efficiently.
8. Government-run insurers are excluded. British Columbia automobile insurance is nearly 100% through the Insurance Council of British Columbia's provincially mandated basic coverage: Buying Car Insurance: What You Need to Know (insurancecouncilofbc.com).
9. Canadian Underwriter annual_statistical_guide_2023 - Canadian Underwriter 2023 Stats Guide.
10. This definition of private insurers includes public companies but excludes those that are government owned.
11. Canadian Underwriter Which insurers can expect to be consolidated. January 23, 2023 by Alyssa DiSabatino.
12. Canadian Underwriter COVID's impact on the Canadian P&C industry's capital base. March 22, 2021 by David Gambrill.
13. Insurance Bureau of Canada 2023-ibc-fact-book.pdf 2023 FACTS of the Canadian Property and Casualty Insurance Industry in Canada.
14. The top 15 excludes provincial carriers such as the Insurance Council of British Columbia and Saskatchewan Government Insurance that otherwise hold a significant market share.

past several years, there has been an uptick in merger and acquisition[15] activity, with many small companies being acquired, some by the top 15.

The property and automobile lines of business combined represent roughly 80% (Chart 1) of the total number of policies in force[16] within the top 15 companies.

Chart 1
Percentage share of number of policies in force



Source: Quarterly Survey of Financial Statements, author's calculations.

Navigating the complex landscape: Regulatory dynamics in the property and casualty insurance industry

The Office of the Superintendent of Financial Institutions (OSFI) provides federally registered financial institutions with supervisory and regulatory reviews to determine financial soundness, currently including 75 Canadian P&C companies and 70 foreign P&C companies, among many other financial institutions such as banks, trusts and life insurance companies.[17]

Although not regulatory bodies, the Insurance Bureau of Canada (IBC) and the Property and Casualty Insurance Compensation Corporation (PACICC) help to provide information, advocacy for insurers and consumers, and confidence within the insurance industry. IBC works to influence legislation, remove barriers, provide consumer education and advocate for affordable sustainable insurance.[18] PACICC protects consumers in the event of insurer insolvency to prevent undue financial losses.[19]

Insurance can also be provincially regulated—specifically auto insurance. It is mandatory to purchase minimum auto insurance coverage in all provinces, and in British Columbia, Manitoba and Saskatchewan, this coverage must be purchased through the government insurer. However, optional coverage can be purchased elsewhere.[20] Provincial bodies also regulate auto insurance rate increases where approval is required prior to rate changes. The province may also provide rate freezes or rate caps for a given period.

15. Canadian Underwriter By much how did M&A deals increase year over year? July 19, 2022 by Jason Contant.
16. The number of policies in force is used in addition to direct written premiums, as direct written premiums are no longer a required disclosure of International Financial Reporting Standards 17.
17. Office of the Superintendent of Financial Institutions Who we regulate, Updated 2022.
18. Insurance Bureau of Canada What we do Making a Difference.
19. PACICC Home | PACICC Our Purpose.
20. Insurance Bureau of Canada Mandatory auto insurance requirements.

Unlike auto insurance, homeowners insurance is neither regulated nor mandatory, and consumers are not legally required to purchase any minimum level of coverage; however, to meet the requirements for a mortgage, homeowners insurance is required.[21]

Additionally, new accounting standards are impacting insurers, the International Financial Reporting Standards (IFRS) 17 came into effect in January 2023. Although this analysis only scratches the surface of this impact, these changes will result in a break in series for many financial metrics used in the study (appendix).

Climate perils and coverage: Extreme weather impacts are a systemic issue

In OSFI's 2023/2024 Annual Risk Outlook,[22] climate risk is mentioned as one of several key financial system risks. Companies face not only physical risks from weather events, but additional risks as Canada transitions to a low-carbon economy, a shift that could worsen traditional risks such as credit, market, insurance and operations. One of the ways OSFI acted was to increase capital and liquidity requirements to ensure more stability during financial volatility, in addition to updating regulatory expectations in Guideline B-15, Climate Risk Management.[23] OSFI is also working in conjunction with the Bank of Canada to assess transition risk and single-peril physical risk (flooding). IBC and the federal government are collaborating to bring a low-cost national flood insurance program[24] to fruition, with millions of dollars pledged and a target rollout of mid-2025. Funding would go toward more robust flood mapping, disaster assistance and adaptation strategies, among others.

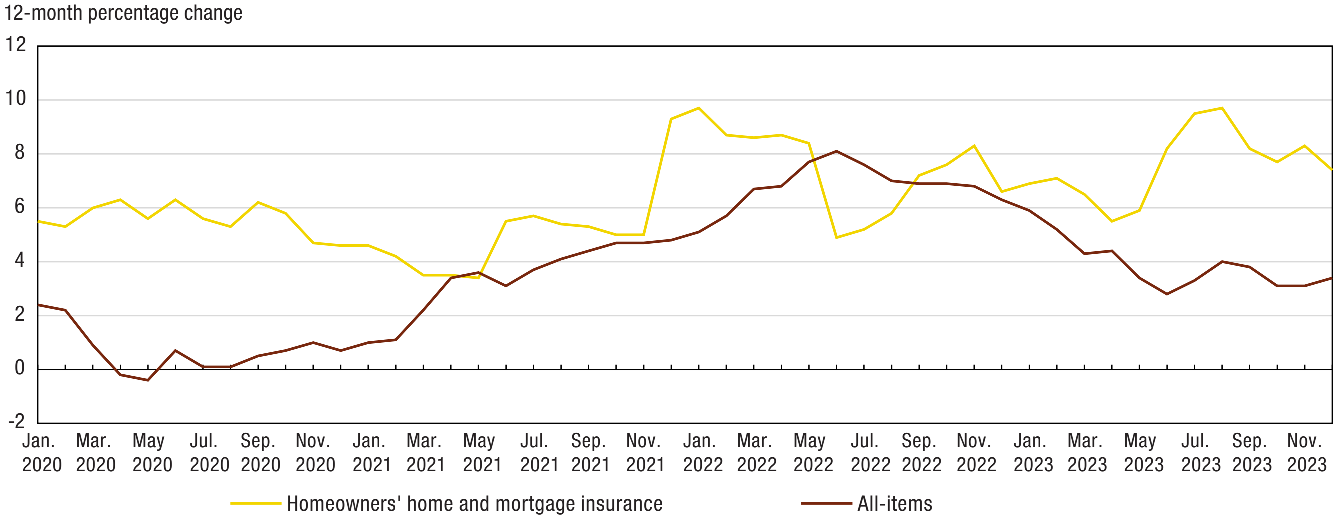
In 2024, OSFI highlighted the growing need for resilience against extreme tail weather events that could destabilize the industry.[25] A single event has the potential to cause tens of billions of dollars in damages and could result in insurer bankruptcy or withdrawal. This was experienced in 1992, when Hurricane Andrew hit the United States, resulting in the insolvency of 16 insurers.[26] Although risk modelling has become more robust, countries have experienced more frequent and severe catastrophic events since 1992, resulting in additional insolvencies throughout the years. Given the highly concentrated nature of insurers in Canada, risk management practices must be in place to ensure stability, which, according to OSFI, could include a backstop fund similar to the Canada Deposit Insurance Corporation that backs the banking sector.[27]

Extreme weather puts insurer profits at risk, impacting consumer affordability

Extreme weather events are increasing in frequency and severity across all regions in Canada. Regardless of location, Canadians have been significantly impacted by extreme weather in the past couple of years. From extreme cold weather to unusual warm weather, Canadians have experienced unprecedented weather events, costing billions of dollars each year. Unlike previous years, when one bad event caused a significant uptick in claims costs, recently several slightly smaller events that aggregate to billions of dollars are occurring. Ontario, Quebec and the Atlantic provinces experienced ice storms and a cold snap, while hot dry weather across Alberta, British Columbia and the territories caused significant forest fires in 2023. Despite the unprecedented fire damage, flooding caused by heavy rainfall, hail and hurricanes remains most detrimental to homeowners, most significantly impacting the coastal regions of Canada. Although extreme weather events have led to higher claims, the COVID-19 pandemic also influenced factors such as replacement cost and inflation, compounding the effect on insurance premiums and reinsurance premiums over the last four years.

21. Insurance Bureau of Canada How to Buy Home Insurance.
22. Office of the Superintendent of Financial Institutions Canada OSFI's Annual Risk Outlook – Fiscal Year 2023-2024.
23. Office of the Superintendent of Financial Institutions Canada Guideline B-15 - Climate Risk Management. March 2023.
24. Public Safety Canada Government of Canada releases report that will advance work on Canada's first national flood insurance program News release. August 2022.
25. Summary of remarks by Peter Routledge at the CatIQ Canadian Catastrophe Conference - Office of the Superintendent of Financial Institutions.
26. Remembering Hurricane Andrew's lessons, 30 years later.
27. Backstop on insurance needed from catastrophe risk: OSFI head.

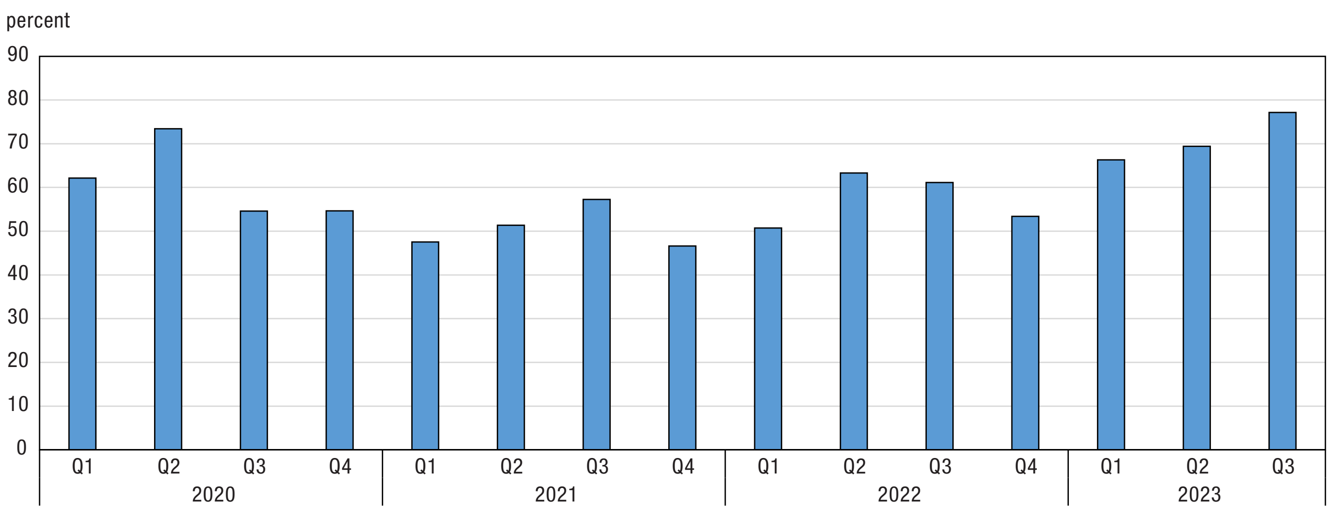
Chart 2
12-month change in the Consumer Price Index (CPI) and Homeowners' home and mortgage insurance, Canada



Source: Consumer Price Index.

For most of the period from 2020 to 2023, the Homeowners Insurance Consumer Price Index (HICPI) outpaced all items inflation (Chart 2), starting high in 2020 and rising by several percent to a peak in January 2022. The claims ratio (Chart 3) increased during the onset of the pandemic, reaching 73% in the second quarter of 2020. Since then, it has largely remained above 50%, with the highest peak of 77% occurring in the third quarter of 2023. Claims costs were lower in 2021, at $2.5 billion, leading to a lower claims ratio and a flattening of the HICPI. Claims rose steeply in 2022 and 2023, reaching $3.4 billion and $3.1 billion, respectively,[28] leading the HICPI to remain higher than 2020 levels. Overall, the HICPI[29] follows the trend of the claims ratio to a certain extent, though it seems to have a lag effect in some cases, keeping in mind that there are more factors to consider than claims.

Chart 3
Claims ratio, personal property, Quarterly Survey of Financial Statements

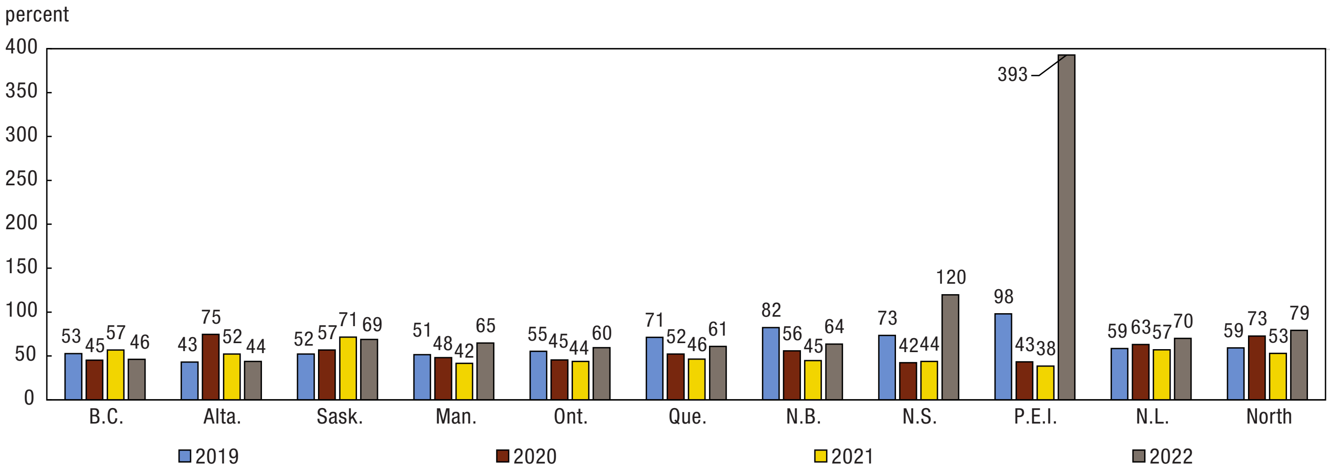


Source: Quarterly Survey of Financial Statements, author's calculations.

28. [Severe Weather in 2023 Caused Over $3.1 Billion in Insured Damage](#).
29. The HICPI is represented as a year-over-year value. The claims ratio is quarterly.

Despite the significant upward trend in claims from severe weather, the claims ratio at the Canada level did not surpass 80%, leaving room for expenses and potential profits. At the provincial level, the Atlantic provinces—particularly Prince Edward Island (Chart 4) and, to a lesser extent, Nova Scotia—were most significantly impacted in 2022. Prince Edward Island experienced a claims ratio of nearly 400% that year, translating to a loss of nearly 300%. This was mainly attributable to Hurricane Fiona, aggravated by a shortage of contractors and supply-chain issues.[30] Although there is some overall alignment with these weather events, claims ratios and the HICPI, the risk management strategy is unique to each company, and metrics may lag extreme weather events, making it difficult to pinpoint the exact effects.

Chart 4
Claims ratio, personal property, Canadian Underwriter



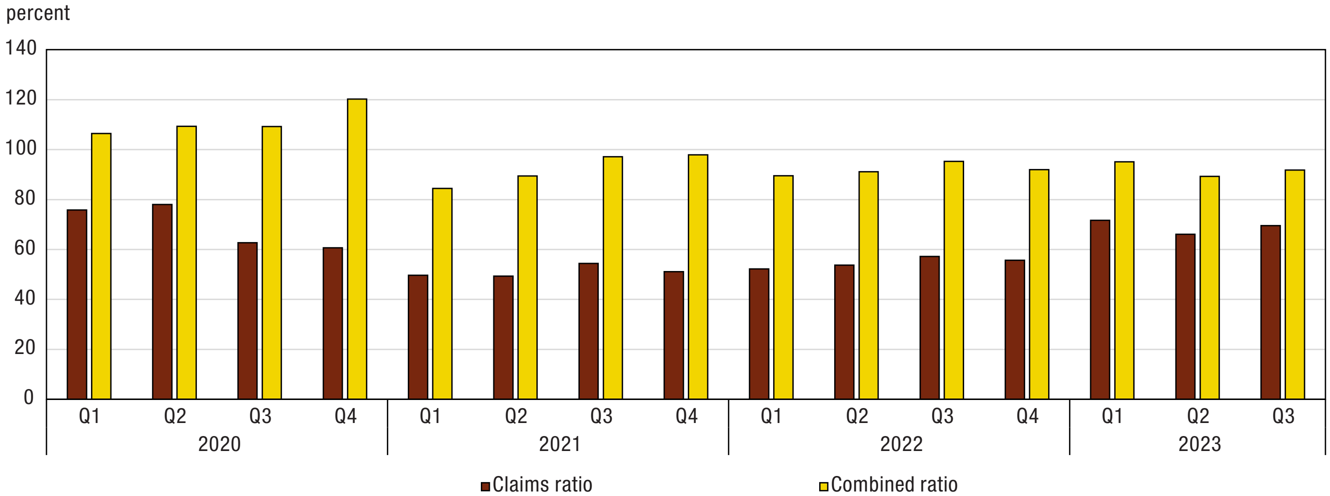
Source: Canadian Underwriter, author's compilation.

In 2022, Hurricane Fiona took second place, when the top three severe weather events were the derecho storm that impacted Ontario and Quebec ($1 billion, May), Hurricane Fiona that impacted the Atlantic provinces ($800 million, September), and the summer storms that impacted much of the Prairies ($300 million, July to August).[31] In 2023, the top three severe weather events were the Okanagan and Shuswap wildfires ($720 million, August to September), the summer storms in Ontario ($340 million, July to August), and the ice storm in Ontario and Quebec ($330 million, April), followed closely by the storms in the Prairies in fourth place ($300 million, June to July).[32] The average annual losses from water-related damage alone in the last decade amounted to roughly $800 million, nearly double the yearly CAT average for 1983 to 2008.

Higher claims costs related to extreme weather also contributed to a higher combined ratio, which incorporates the claims costs in addition to other expenses. Chart 5[33] encompasses all lines of business because other expenses are not broken down by line. In general, most companies target a combined ratio of less than 95%,[34] translating to a 5% profit margin. If this ratio is greater than 100%, the company is not profitable in terms of underwriting[35] (insurance) alone. The combined ratio was highest in 2020, likely an effect of higher expenses during the pandemic, but below 100% for the remaining three years. This means P&C insurance was not profitable in 2020 but has since been able to recover.

30. Canadian Underwriter annual_statistical_guide_2023 - Canadian Underwriter 2023 Stats Guide.
31. Canadian Underwriter annual_statistical_guide_2023 - Canadian Underwriter 2023 Stats Guide.
32. Severe Weather in 2023 Caused Over $3.1 Billion in Insured Damage.
33. Differences in charts 4 and 5 can be mainly attributed to the automobile insurance line of business.
34. LloydSadd Navacord Marketplace Insights - November 2022 | Lloyd Sadd.
35. “Underwriting” was replaced by “insurance” in January 2023 in IFRS 17.

Chart 5
Claims ratio and combined ratio, property and casualty insurance



Source: Quarterly Survey of Financial Statements, author's calculations.

Despite insurance losses, or losses from one line of business, a company may still record positive total profits if, for example, investment profits were to offset these losses. In several instances, claims contributed significantly to the combined ratio; however, other expenses[36] contributed, most significantly in the fourth quarter of 2020. For the most part, the claims ratio and the combined ratio follow the same trend.

Input factors put additional pressure on replacement costs

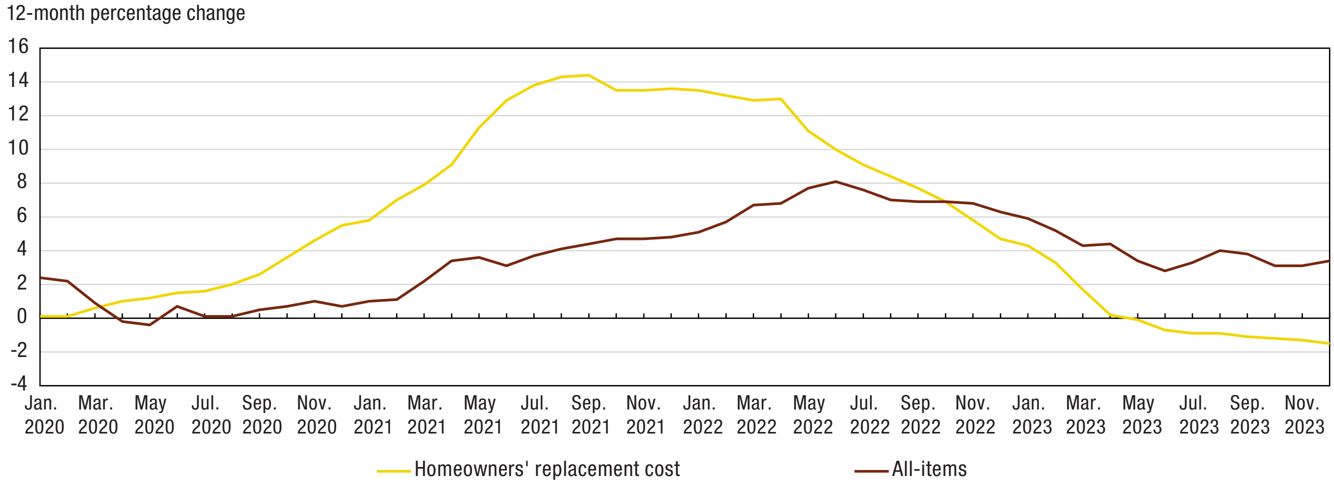
The pandemic had an impact not only on hiring, inflation and investment returns, but also on homeowners replacement cost, as building inputs and eventually wages rose. According to the Homeowners Replacement Cost Consumer Price Index (Chart 6), replacement cost peaked in September 2021, recording a year-over-year increase of 14.4%. This growth was mainly attributable to high lumber costs (see appendix), which had more than doubled at their highest level.

In the event of a claim, the insurance company would offer replacement cost or actual cash value. Replacement cost is an important consideration for insurers because they are responsible for rebuilding the house under current market conditions. Insurers consider a multitude of inputs, such as lumber, wire, concrete and construction wages, as well as furniture and electronics. The costlier it is to replace the structure and contents, the more coverage is likely required, and thus there is a higher cost for the consumer. The pandemic exacerbated such effects, and high input costs put additional pressure on replacement costs.

The uptick in renovations during the pandemic influenced input prices as well, potentially compounding the effects. If an owner adds value to their home through renovations, the cost to insure and replace the home will increase.

36. Other expenses are not disaggregated but may include other underwriting expenses and other related operating expenses such as, but not limited to, commissions, salaries and marketing.

Chart 6
12-month change in the Consumer Price Index (CPI) and Homeowners' replacement cost, Canada



Source: Consumer Price Index.

Reinsurance rates trend upward, significantly impacted by extreme weather claims

In a broad sense, reinsurance is effectively insurance for insurance companies. They reinsure a portion of their portfolios to offset or transfer risk to another party. Insurers are heavily reliant on the ability to transfer risk, especially for smaller insurers, and more so as extreme weather increases. In the event of a claim, insurers pay a deductible to the reinsurer and may need to reinstate the reinsurance policy for a premium. The process of reinsurance allows insurers to not absorb 100% of the risks and, in some cases, avoid insolvency. The new accounting standards have a profound impact on reinsurance metrics, and additional OSFI regulations will come into effect in January 2025, impacting how insurers manage their own risk, in addition to counterparty risks.

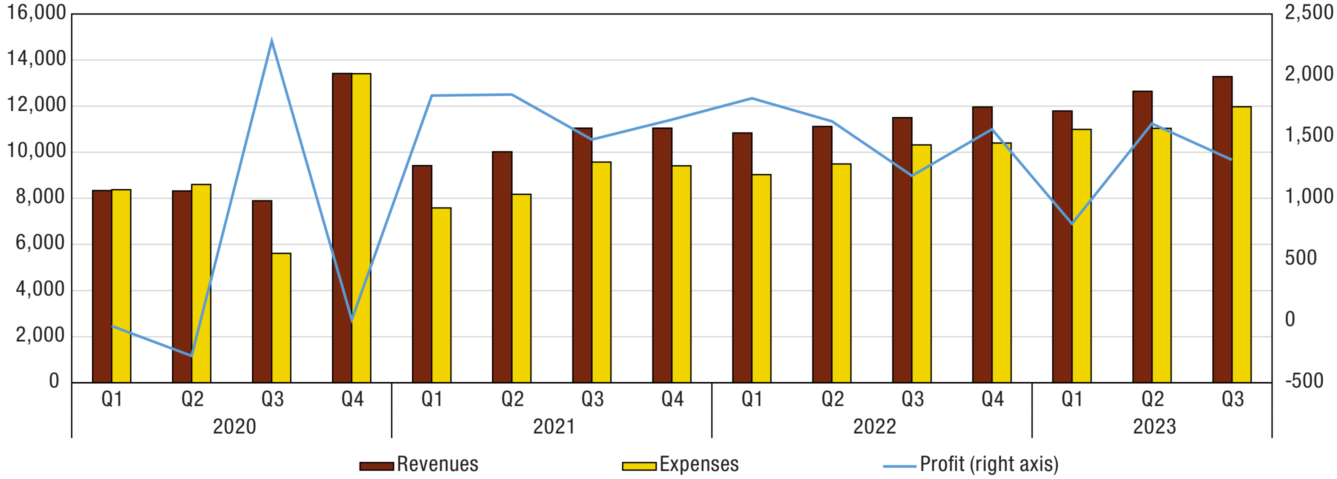
In 2023, reinsurance renewal rates were up significantly, in many cases as much as 25% to 70%,[37] largely because of the 15 CAT events in 2022. Reinsurance rates were also impacted by inflation and the overall rising input costs to rebuild. The insurance industry is reliant on protection from reinsurance companies to manage risks, and it is unlikely many companies would survive without the ability to transfer or offset their risks to another party. Despite such significant increases in reinsurance, consumers are unlikely to be significantly impacted by one bad year, unless such events become trends in which long-run profitability is at risk.

Extreme weather claims erode property and casualty insurance profitability, worsened by the pandemic

Underwriting revenue[38] (Chart 7) was low during the first three quarters of 2020, but it has been increasing overall since then. Expenses were lower than revenues in the third quarter of 2020, leading to an uptick in profits that was soon reversed in the following quarter. Despite the significant increase in revenues in the fourth quarter of 2020, expenses rose even faster, resulting in minimal profit for the quarter.

37. Canadian Underwriter What's driving Canadian insurers' reinsurance rates? (canadianunderwriter.ca) April 2023.
38. Before IFRS 17, this was known as underwriting revenues, expenses and profit; as of the first quarter of 2023, it is known as insurance revenue, expenses and net income operating result insurance service.

Chart 7
Revenues, expenses, and profits

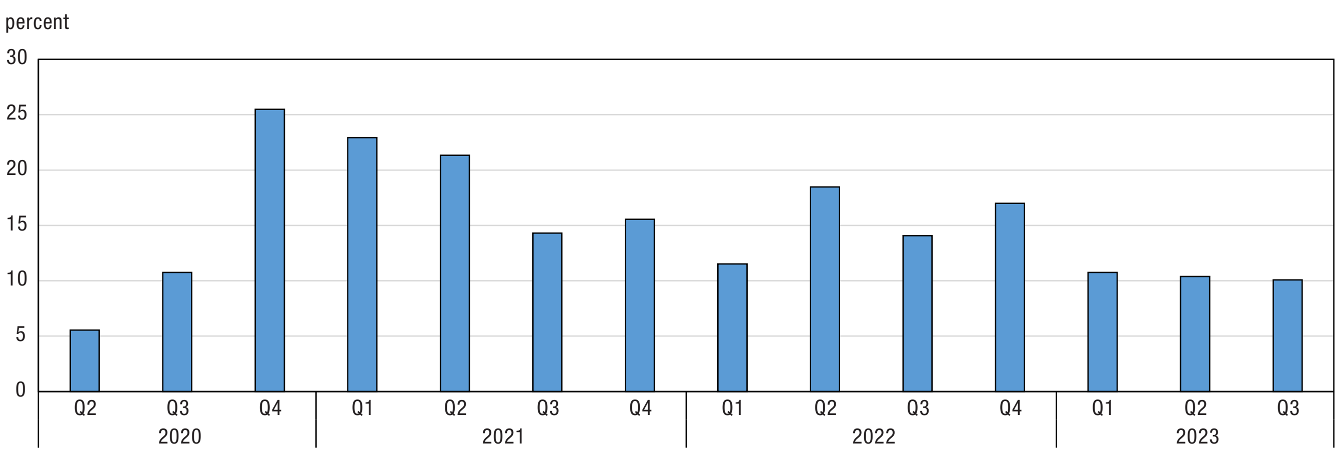


Source: Quarterly Survey of Financial Statements, author's calculations.

Both revenues and expenses trended upward after 2020, and profits were posted each quarter as revenues exceeded expenses. Profits dropped in the first quarter of 2023 on higher expenses, likely impacted by reinsurance premiums. According to an OSFI financial data for property and casualty companies,[39] insurers posted a $893-million underwriting loss in 2020 Q2, despite an increase of nearly $3.2 billion in underwriting revenues than 2019 Q2. Although insurers have experienced losses in previous years, underwriting revenues have climbed significantly over time, but so have claims and expenses, holding profits stable.

Despite the challenges, profitability has not wavered significantly and is consistent with historical trends. Return on equity (ROE) ranged from a low of 5.6% (Chart 8) in the second quarter of 2020 to its peak at 25.7% in the fourth quarter of 2020. This volatility is likely related to the pandemic, as net income attributable to shareholders suffered in early 2020, and tax advantages and deferrals could be used.

Chart 8
Quarterly return on equity, total property and casualty insurance



Source: Quarterly Survey of Financial Statements, author's calculations.

39. Financial data for property and casualty companies - Office of the Superintendent of Financial Institutions (osfi-bsif.gc.ca).

Although claims were high in 2022, ROE remained strong and ended the year at 17.0%. In 2023, ROE is trending downward and is likely reverting to its long-run sustainable rate. According to Canadian Underwriter, the long-run average is 10.1%, and it appears probable that there is further deterioration to come.[40] ROE in the third quarter of 2023 reached 10.1%, in line with the long-run average, impacted by high claims costs across 2022 and 2023, both years coming in 50% higher than the average yearly claims of $2 billion.

Catastrophic claims are taking their toll on insurers and consumers

Climate-related weather events are widespread across Canada and are shaping the homeowners insurance landscape. These "once in 100 years" events are happening more frequently, becoming more severe and more costly; 2020, 2021, 2022 and 2023 all rank in the top 10 worst years, surpassed only by the 2016 Fort McMurray fires, the 2013 flooding in Calgary and Toronto, and the 1998 Quebec ice storm.[41] Consumers and insurers must begin to adapt to create a resilient and sustainable future. Canadians may need to rethink how and where they rebuild,[42] given the risk assessment for some regions. Alberta wildfires contributed to nearly $1 billion of insured losses in 2023 alone, when 10 times more land burned than the five-year average.[43] Over and over again, unprecedented events are becoming the norm.

There may be some shifts and balancing in the next several years for insurers to remain profitable while providing affordable insurance to consumers. Consumers may also want to stay up to date with policy options because most insurers now offer overland water coverage, although most consumers do not opt in to the additional coverage.[44] This means they would not be covered in the event of overland flooding from a storm or water seepage into the home. As of 2020, only 6% of respondents knew they lived in a designated flood-risk area,[45] and it is estimated that more than 1.5 million households[46]—approximately 10% of all households in Canada[47]—are highly exposed to flooding. Flood risk is the most frequent extreme weather event in Canada.[48]

Given this volatility and uncertainty, it is possible that reinsurance and consumer premiums will continue to rise more than historical averages, as rising claims costs and expenses pose a threat to insurer profits. The temperature is rising[49] and will continue to cause more frequent and severe weather events, which are predicted not only to affect insurance, but also to have implications for agricultural production and human health, among others.[50] As many insurers have noted previously, "the hard market isn't going to soften anytime soon."[51] The insurance industry is adapting with the support of regulatory and government agencies to ensure resilience and profitability for insurers, alongside affordability and sufficient protection for consumers.

International Financial Reporting Standards 17 accounting changes: Impacts to key performance indicators

As of January 2023, with the International Financial Reporting Standards 17 accounting changes, the claims ratio can no longer be calculated in the same way. The net insurance service ratio, which is similar to the claims ratio, is the new key performance indicator (KPI); however, it could provide marginally higher results because of the inclusion of other expenses.[52] There are minimal material changes to the interpretation of such ratios, but they should be considered when making any comparisons with metrics earlier than 2023. The accounting changes will also have varying impacts on other ratios, such that pre-2023 metrics are not 100% comparable. This disproportionately affects some ratios and financial metrics more than others. For example, the claims ratio remains comparable, while reinsurance has virtually no comparability.

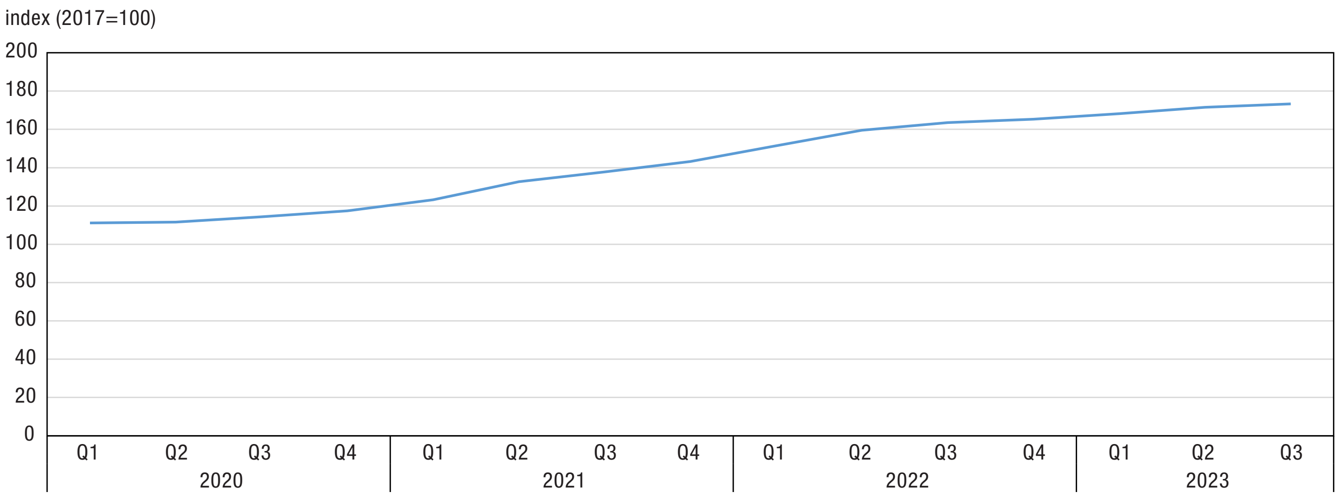
40. Canadian Underwriter annual_statistical_guide_2023 - Canadian Underwriter 2023 Stats Guide.
41. Severe Weather in 2023 Caused Over $3.1 Billion in Insured Damage.
42. Adapting to Rising Flood Risk - An Analysis of Insurance Solutions for Canada.
43. Canadian Underwriter Wildfires in Alberta burned 10 times more area in 2023 than the five-year average 2023. Among these wildfires, 35% were caused by lightning and 60% were caused by people.
44. Canadian Underwriter Flood policy education: What brokers are up against 2022.
45. Canadian Voices on Flood Risk 2020 | Partners for Action.
46. IBC welcomes the federal government's leadership on Canada's first National Flood Insurance Program.
47. Profile table, Census Profile, 2021 Census of Population - Canada [Country].
48. Government of Canada The risk of floods 2022.
49. CBC News Climate Dashboard | CBC News 2023.
50. Government of Ontario Ontario Provincial Climate Change Impact Assessment 2023.
51. Canadian Underwriter Will the P&C hard market stabilize or soften in 2023? 2023.
52. How Canada's P&C insurers are faring under IFRS 17.

Given the new specificity of claims costs and expenses, some expenses may no longer be classified as underwriting expenses.[53] In turn, this could have a favorable impact on the claims ratio and underwriting profitability, but result in a higher combined ratio. The Insurance Bureau of Canada is helping to start new KPIs for the industry. In aggregate, the new accounting standards aim to increase transparency and provide a common approach across insurance companies that applies to hundreds of insurers globally. Insurers are required to provide one year restated comparative information.

Appendix

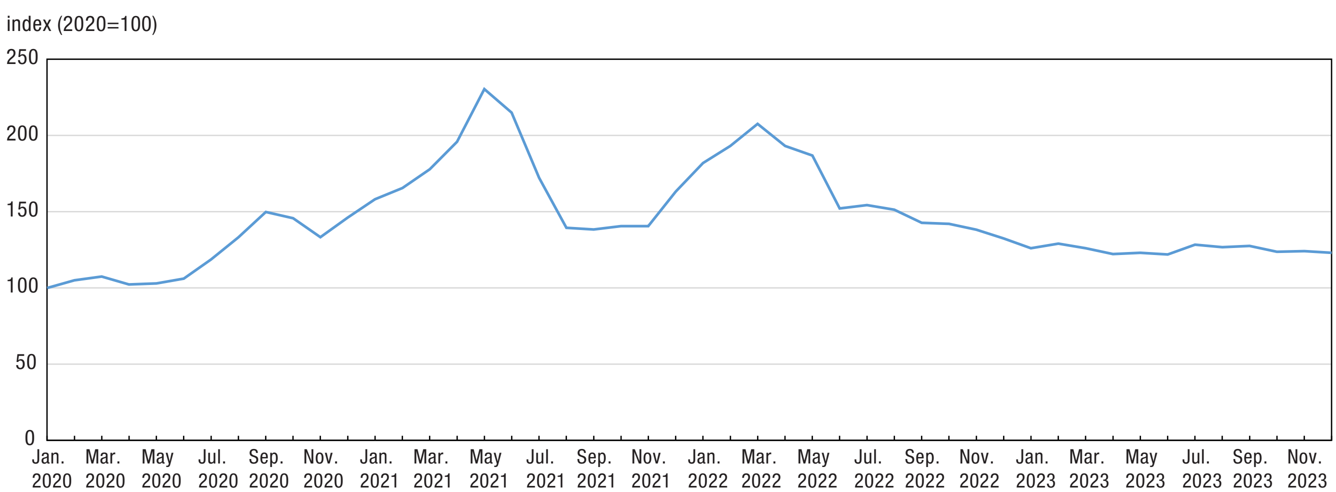
The Residential Building Construction Price Index has risen steadily since 2020 (Chart A.1), and the Industrial Product Price Index for lumber and other wood products peaked in May 2021, at more than double its January 2020 price (Chart A.2).

Chart A.1
Residential building construction price index



Source: Building construction price indexes. Table: 18-10-0276-01.

Chart A.2
Lumber and other wood products index, industrial product price index



Source: Industrial product price index. Table: 18-10-0265-01.

53. Insurance Bureau of Canada New global standard IFRS 17 changes how insurers report financials 2023.