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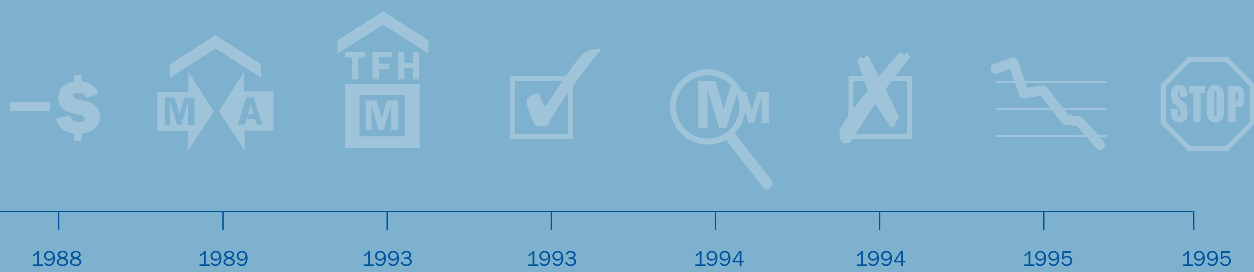
Why insurers fail

Lessons learned from the failure of Maplex General Insurance Company



By

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2008

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The authors would like to acknowledge the information and assistance provided for this study
by the Court-appointed Liquidator for Maplex, Deloitte & Touche LLP.

PACICC is responsible for the observations and conclusions of the study, and for any errors and omissions.

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Objectives

PACICC has four key objectives in undertaking this case study as part of its *Why Insurers Fail* series of research papers. The key objectives are to:

- identify the causes for the insolvency of Maplex General Insurance Company
- draw upon lessons learned and encourage dialogue on insurance solvency issues
- improve stakeholder understanding of the early warning signs of a troubled company
- enhance PACICC's preparedness for future insolvencies.

Executive summary

The primary causes of the failure of Maplex General Insurance Company documented in this case study are: deficient loss reserves, inadequate underwriting and pricing, rapid growth, and deficient management and corporate governance. These findings are broadly consistent with PACICC's 2007 research paper on *The dynamics of property and casualty insurance insolvency in Canada*. Management and corporate governance deficiencies, in particular, played a key role in the company's demise. Had Maplex's Chief Executive Officer been "fit and proper" for the job, and/or had the Board of Directors taken appropriate action when alleged financial improprieties emerged, it is possible that insolvency might have been averted.

When evidence of a serious breakdown in Maplex's internal controls provided an "early warning signal" to the Ontario Insurance Commission, an investigation was promptly launched. The investigation produced evidence of fraud in the form of deliberately-inflated claims payments and misappropriated funds – actions that were later successfully prosecuted. While fraud was found to be a "contributing" rather than a "primary" cause of Maplex's failure, it served to alert insurance regulators, about one year prior to the insolvency, that something was amiss in the way the company was being managed and governed. Approximately one year after the investigation was launched, the Commission declared Maplex to be insolvent and sought a winding-up order.

There are a number of important management and corporate governance lessons that can be learned from the failure of Maplex. (See page 18 for the complete list of "lessons learned"). These are:

- Insolvency risk is inversely related to the quality and experience of senior management
- Strong internal controls and transparency in financial reporting reduces the risk of insolvency
- Up to two years prior to a winding-up order being issued, it is common for the senior management of a troubled insurer to engage in aggressive market practices
- An experienced and professional management narrows the window of opportunity for engaging in fraudulent activities
- Implementing standards of sound business practices relating to the governance of insurance companies – for example, pertaining to the duties, qualifications and independence of directors – can help to reduce the risk of insurer insolvency
- In the case of Maplex, stronger laws relating to management and corporate governance could have mitigated, if not avoided, the primary causes of the company's insolvency.

Could the kind of management and corporate governance deficiencies that contributed so significantly to the failure of Maplex occur in today's environment? Certainly it is fair to say that corporate governance receives greater attention in 2008 than it did in the mid-1990s when Maplex failed. But much of this attention is focused on widely-held public companies and is intended, appropriately, to protect shareholders. Thirteen years after the insolvency of Maplex, the *Ontario Insurance Act* remains silent on specific requirements to ensure that the directors and senior management of a provincially-incorporated P&C insurance company are "fit and proper." In the absence of stronger standards for the qualifications and composition of company officers and directors, it is still possible that a closely-held P&C insurance company incorporated in Ontario and supervised for solvency purposes by the province could fail for much the same reasons that Maplex did in the mid-1990s.

Introduction

The Property and Casualty Insurance Compensation Corporation (PACICC) was founded in 1989. The Corporation's mission is to protect eligible policyholders from undue financial loss in the event that a member insurer becomes insolvent. Since it was established, PACICC has funded and participated in the winding-up and liquidation of 12 member P&C insurance companies doing business in Canada.

Fortunately, the solvency supervisory system for P&C insurance in Canada is sound and, among international jurisdictions, the risk of insolvency is moderate. Nevertheless, while P&C insurance insolvencies are relatively rare, they do occur.

For example, six insurance companies have failed in Canada since 2000, affecting more than 10,000 policyholders. Although the environment has improved, challenges remain and the potential for insolvency continues to exist.

A key part of PACICC's commitment to relevant research is to gain a better understanding of the financial health of its member companies. Another research priority for PACICC is to analyze and document why P&C insurers in Canada have failed. A thorough understanding of the circumstances of insurer failure helps to improve preparedness for future insolvencies.

Within this context, PACICC has compiled a case study of a member insurance company that was ordered to be wound-up, the Maplex General Insurance Company. The insurer's financial distress in late 1994 resulted in the issuance of a winding-up order by an Ontario court judge in March 1995.

PACICC has reviewed information available on the financial, corporate governance and regulatory history of Maplex in compiling this case study. The data for this analysis was obtained from court-related documents, news media, publicly available financial data and data available to PACICC in its role as an inspector in the liquidation.

Our findings and conclusions are summarized and presented as "Key lessons learned" from the failure of Maplex (see page 18). These lessons will influence PACICC's views of the likely "early warning signs" displayed by a potentially-troubled company. We expect that the lessons learned will also interest other stakeholders, including insurance regulators, brokers and PACICC member companies.

Background

Maplex General Insurance Company, an Ontario registered company, was incorporated on December 14, 1955. A year later, Maplex obtained an insurance license from the province of Ontario. It wrote business primarily in personal property, fire and automobile insurance. By the mid-1980s, Maplex was conducting business in a variety of insurance lines: personal and commercial property, automobile, boiler and machinery, and liability.

Profile of Maplex General Insurance Company

Nationality	Canadian
Jurisdiction of incorporation and licensing	Province of Ontario
Date incorporated	December 1955
Date of winding-up order	March 1995
Years of operation	40
Ownership structure	Not widely-held
Major lines of business	property, auto, liability, boiler and machinery
Group member	Subsidiary of Transit Financial Holdings Inc.

Up to the 1980s, Maplex grew steadily at an annual average rate of 15%. Maplex was initially concentrated in Ontario only, but later underwent rapid geographic expansion. By 1990, Maplex was licensed to write insurance in Ontario, Alberta, B.C., Saskatchewan, Yukon and N.W.T., and Newfoundland and Labrador.

In the late 1980s, Maplex was confronted by mounting claims liabilities. In 1988, Maplex's liabilities jumped by 52% and brought equity levels below the then minimum regulatory requirement of one million dollars. At that time, automobile insurance claims incurred skyrocketed, causing Maplex to report a net loss of $10M. Return on equity for Maplex plummeted, reaching -132.5%, the lowest value ever recorded by the company.

In 1989 Maplex merged with Abstainers', another Ontario registered-company that shared both officers and a head office location with Maplex. Abstainers' was mostly concentrated in personal lines insurance for a preferred customer base of alcohol and tobacco abstainers. At the time of the merger, Abstainers' appeared to be in a stronger financial position than Maplex.

In 1988 claims and costs also increased rapidly for Abstainers' and the company's return on equity dropped from 19% to -31%. Immediately after the merger in 1989, Maplex assumed Abstainers' business, although Abstainers' continued to exist as a legal entity until a winding-up order was issued for the insurer on the same date as Maplex, in March 1995.

In 1990 Maplex's financial statements showed substantial improvement in terms of equity levels, and the company's loss ratio was below the industry average. Equity and liabilities were growing at the same rate. Nevertheless, the growth in premiums showed signs of instability.

The merger with Abstainers' may have prevented Maplex from being placed into a restrictive mode in 1989 by regulators due to capital levels falling below minimum requirements. Although Maplex's situation may not qualify as a "near miss" (capital was injected into Maplex in 1989), there are reasonable grounds to believe that, had the merger not taken place, the insurer would have gone into run-off.

In the early 1990s, Maplex's financial state appeared stable and the insurance risk ratios showed no signs of distress. However, there were still signs of volatility evident in the growth rate of premiums and claims by line of business. In fact, in the period 1990 to 1993, claims incurred by Maplex grew faster than premiums written and capital.

Timetable of key events for Maplex General Insurance Company

December 1988	October 1989	May 1993	August 1993	May 1994	November 1994	February 1995	March 1995
Maplex incurred an adverse development of claims and a $10M net loss	Merged with Abstainers' Insurance Company	Aquired by Transit Financial Holdings	Mr. Platis was appointed CEO of Maplex	OIC initiated an investigation pertaining to improper claims handling	Mr. Platis resigned as the CEO of Maplex	Maplex failed to meet MAT requirement	Maplex ordered to be wound-up

See pages 21 and 22 for detailed timeline of events

Maplex General Insurance Company was owned by two brothers, Alfred Chan and Eduard Tan, who also controlled a public company called ETAC Sales. In 1993, the Ontario Insurance Commission (OIC) learned that the two brothers had been using shares from ETAC, a clothing company, to support Maplex. At the time ETAC Sales was experiencing financial problems.

In 1990 Maplex had bought ETAC shares from SEC Holdings Inc., a company owned 50% each by Mr. Chan and Mr. Tan. SEC Holdings also controlled Maplex at the time. In spring 1993, the Ontario Insurance Commission forced Maplex to liquidate an investment of $1.3 million ETAC common shares. Not long thereafter, ETAC went bankrupt. Maplex would have experienced a capital shortfall if its capital base had continued to include ETAC shares which had represented the bulk of Maplex's equity base.

After this development, the OIC was watching the company carefully and required an unusually-high deposit from Maplex. Due to concerns about the company's business, restrictions were also attached by the regulator to Maplex's insurance license.

In May 1993, Transit Financial Holdings (TFH) Inc., the holding company for York Fire & Casualty Insurance and Transit Insurance Company, acquired Maplex General Insurance. This acquisition was completed by acquiring from SEC Holdings Inc. certain non-voting preferred shares of Maplex, and by acquiring from M.E.R. Financial Corp. all of the shares of a holding company that owned the voting shares of Maplex.

The reorganization of the TFH Inc., including acquisition of Maplex, was approved by shareholders of the Corporation at the annual and special meeting held on May 28, 1993 in accordance with applicable regulatory requirements.

Prior to the purchase of Maplex, TFH Inc. was undergoing financial difficulties from its own operations. The acquisition was a strategic move to improve not only TFH's overall operations but also Maplex's performance, given that prior to the acquisition (1990-93) Maplex operated at a break-even level. For a number of years Maplex balanced out its underwriting losses with net gains on investment income.

Management and direction of Maplex

Three months after the acquisition of Maplex, on August 25, 1993, the president of TFH Inc., Mr. James Platis, was appointed as Chairman, President and CEO of Maplex and York Fire & Casualty Insurance Company. Mr. Platis was a chartered accountant, having obtained this designation in 1979. During the period 1985 to 1992, Mr. Platis had changed jobs four times, with his most recent job lasting approximately one year. Therse prevoius positions included work as the senior insurance partner with two of the largest international audit firms.

Mr. Platis's appointments had been made by the board of directors of the TFH Inc. and confirmed in the minutes of the board of directors. However, Mr. Platis did not have a formal contract of employment with either Maplex or York Fire & Casualty Insurance Company. The *Ontario Insurance Act* did not require the Ontario Insurance Commision to approve the appointments and indeed, OIC was notified of the appointments after the fact.

In late 1993, York Fire & Casualty, TFH's other subsidiary, was relocated to Maplex's head office. It was expected that both subsidiaries would benefit from common administration and management expertise within each of the two companies. Nonetheless, both insurance companies continued to operate as separate entities.

Business practices

Soon after York's relocation to Burlington, Ontario, Mr. James Platis entered an agreement with the owner of Phoenix Property Development Corporation Ltd. The agreement called for Phoenix to act as insurance adjuster and general contractor to York Fire & Casualty and Maplex, both subsidiaries of TFH. However, the OIC later found no evidence of a formal agreement between Maplex and Phoenix. Also, there was no record of any ownership interest between Phoenix and TFH or its affiliates. Nor was Phoenix ever licensed by OIC to act as an insurance adjuster.

Phoenix was incorporated on March 14, 1994 and was mandated by Maplex and York Fire to reduce the cost of settling claims. Phoenix had only two clients – Maplex and York Fire. As of March 1994, all claims from York Fire and Maplex were to be handled by Phoenix, which would receive anywhere from 2% to 5% of the cost to settle the claim as its fee.

Complaints and investigation

The claims staff at Maplex and York Fire, who normally handled the property claims, began questioning the exclusive use of Phoenix. Concerns about excessive payments to settle claims also came to the attention of the OIC.

The following statement, for example, appeared in the insurance trade press at the time Maplex was ordered to be wound up:

> *'If anyone was too vocal about what was happening, they were told to do their job and stop asking questions, the former employee said, noting that some workers decided to leave the insurer rather than continue to support the apparent fraud with their silence.'*
>
> *Thompson's World Insurance News, March 20, 1995*

Complaints from policyholders concerning the handling of various claims were brought to the attention of Ontario Insurance Commission. The complaints, plus the recent changes at Maplex, caused OIC examiners to begin a review of Maplex and York Fire on April 26, 1994. Prior to this, there had been few complaints about claims handling at Maplex. In retrospect, the surge in complaints was a clear warning signal of management problems.

Once the review was under way, the investigators observed that it appeared as though the company's loss reserves were also being manipulated with the use of "step reserving" practices[1]. On May 10, 1994, the Ontario Insurance Commission concluded its review of Maplex and York Fire. In reporting its concerns to the insurers, the OIC stated:

> *'Phoenix was mandated by Maplex and York to reduce the cost by utilizing their expertise in the construction field. Instead, bills paid to Phoenix were far in excess of the plan laid out by Maplex's CEO.'*
>
> *Ontario Insurance Commission Investigation, 1994*

Two months later, OIC examiners prepared a report for the Superintendent of Insurance that highlighted numerous concerns pertaining to claims handled by Phoenix. The report was provided to the investigators of OIC for review. After a detailed investigation of documents pertaining to payments to Phoenix for services rendered to Maplex, the OIC investigators concluded that payments to Phoenix were indeed excessive. As reported in the December 5, 1994 issue of *Thompson's World Insurance News*, "… the OIC investigated 77 claims filed by Phoenix to the insurers [Maplex and York Fire] and found only five had proper documentation according to normal industry practices… independent adjusters and contractors estimated the proper value of $447,000 in payments made to Phoenix by the insurers to just over $300,000." Moreover, the investigators found that some of the excess funds were being utilized for private expenses of Mr. Platis, including work done on both his home and cottage.

On August 31, 1994, the Superintendent of Insurance for Ontario sent a letter to the directors of Maplex outlining the substance of what appeared to be a scheme by which Phoenix was

[1] "Step reserving" is the process of incrementally increasing reserves as payments and losses become due/known rather than estimating the ultimate loss exposure. This practice consistently underestimates the required reserves, thereby making the company look like it has more capital than it actually does.

overcharging Maplex for services provided. The expectation of OIC was that the Board of Directors of Maplex would be forced to act, for example, by removing Mr. Platis from the company pending an investigation. However, the Board declined to take action. In retrospect, the failure of Maplex's directors to act reflects a serious deficiency in the company's governance. It seems unlikely that the directors of a federally-incorporated insurer, faced with similar circumstances, would have declined to act.

In September 1994, the Board of Directors of Transit Financial Holdings, the parent company of Maplex, reported a consolidated financial statement showing a net loss of $1.9M compared to net income of $1.2M in the previous year. TFH stated that the decrease in net income was primarily caused by the strengthening of claims reserves and higher reinsurance costs, along with reduced investment income.

Both subsidiaries, Maplex and York Fire, incurred net losses in 1994. The net loss reported by Maplex was $13.5M and the company's liabilities exceeded its assets by more than $1M. The OIC investigation stated that the extent of the loss during 1994 appeared to be related primarily to adjustments for quota share reinsurance commissions.

On December 31, 1994, Maplex was due for license renewal with the Ontario Insurance Commission. The outcome appeared to reflect problems uncovered by OIC's investigation and was reported at the time as follows:

> *'At the end of 1994 Maplex was placed in a restrictive license mode for being in violation of the Minimum Asset Test. Maplex went into run-off.'*
>
> *Canada NewsWire, March 1995*

In November 1994, James Platis resigned as the CEO of Maplex and York Fire for what was described at the time as "personal reasons." He was replaced by Dennis R. Starrit who was formerly Senior Vice-President of Trimark Financial Corporation.

In January 1995, the former CEO of Maplex, Mr. Jim Platis, was charged with fraud, theft and receiving secret commissions. Charges were also laid against the President of Phoenix Property Development Corp. Ltd. pertaining to excessive bills for services rendered to Maplex and York Fire.

Eve of insolvency

Immediately after Maplex's license was restricted, TFH Inc. announced it intended to transfer a portion of the business of its financially distressed subsidiary, Maplex General Insurance Company, to York Fire. It was estimated that Maplex would have required a cash injection of at least $3M to survive. The transfer never took place.

By late January 1995, independent actuarial reports based on Maplex's figures still indicated the insurer had enough assets to meet its run-off obligations. During February, it was learned that the situation had worsened. As the losses grew, so did Maplex's reinsurance commissions. Under the terms of its loss-sharing treaty, Maplex's commission due to the reinsurer went up $4 million between audits.

The appointed actuary for Maplex, Ms. Claudette Cantin of Tillinghast, stated that the new figures showed the company's position had deteriorated substantially between her first report for 1994 year-end (on February 24), and one she was required to revise less than two weeks later due to $2.5M in previously-unreported claims. Maplex had already exceeded its reinsurance quota, so the new-found $2.5M loss was a further direct hit to the company.

An article from *Thompson's* dated March 13, 1995 stated: "The latest revelations angered, but did not surprise Don Smith, chairman of TRAC[2]. Mr. Smith now believes the numbers given to TRAC were not entirely accurate. Based on those numbers TRAC passed Maplex on seven out of TRAC's eight rating tests. But it will only work for one year, before the true figures emerge. The test Maplex failed showed its reserves were less than half of the industry average." It is important to note that the OIC was constrained by at least two factors: first, by the time lag required to demonstrate that there was inaccurate financial reporting; and second, by the fact that the senior management of Maplex was actively thwarting the Superintendent's efforts to obtain accurate information – especially during the crucial year of 1994.

On February 28, 1995, the OIC requested that Maplex inject capital of $3M by March 7, 1995 to continue the orderly run-off of its insurance business. Maplex was unable to obtain the additional capital injection that was required by OIC. Subsequently, on March 9, 1995, the Superintendent of Insurance took possession and control of the assets of TFH's subsidiary, Maplex General Insurance Company.

On March 21, 1995 an Ontario court judge issued a winding-up order putting Maplex General Insurance Company into liquidation. At that time, the insurer had insufficient assets to cover its liabilities. The winding-up order was the trigger that allowed PACICC to begin making payments to Maplex policyholders with covered claims. The full extent of Maplex's problems emerged only after the company issued its financial results for the year ended December 31, 1994. Given the inaccuracies in Maplex's financial statements due to step reserving practices, its asset deficiencies were largely unknown to the supervisory authorities.

The downfall of Maplex, a 40-year-old Ontario licensed company, was the result of a series of events that occurred in just a few years prior to winding up. The following sections examine the internal corporate and external industry environment in which the insolvency occurred.

[2] TRAC (Tests-Ratios-Analyses-Charts) was a rating company. TRAC's reports contained financial and underwriting data on property and casualty insurance companies licensed in Canada. The information was compiled from annual filing statements completed by each company and maintained in a public data bank by the Federal Office of the Superintendent of Financial Institutions. Information on some provincially-supervised insurance companies was submitted to TRAC on a voluntary basis.

Internal Environment

Rarely is the failure of an insurer attributable to one cause or risk. Risks may originate from internal processes or the external environment or a combination of both. Looking beneath the observed effects of a risk, it is common to find a wide range of different interrelated causes

We have applied a causal chain approach to identify and categorize risks with a view to mapping the relationships among them. A European study used a similar approach to study insolvency cases that emerged from European Union countries.

Management and corporate governance

Research studies on why insurers fail have found that poor management is often at the root of insurance company problems. Although a well-managed firm can still fail, poor management makes a firm vulnerable. Similarly, poor management is often a symptom of shortcomings in corporate governance.

Corporate governance challenges may be increased when a company has gone through a series of acquisitions and mergers. In the six years prior to its winding up, Maplex experienced a merger in 1989 and an acquisition in 1993.

At the time, Maplex's Board had a large proportion of affiliated Directors. In the mid-1990s, when Maplex was ordered to be wound up, Ontario's Insurance Act contained no corporate governance requirements. The legislation still lacks specific requirements pertaining to the corporate governance of an insurer, such as a "fit and proper" test for the company's chief executive. By comparison, the Federal *Insurance Companies Act* had introduced a new corporate governance framework in 1992 – clearly establishing the Board as being responsible for directing the management of an insurance company, and for other responsibilities set out in law. Notwithstanding the shortcomings in the Ontario legislation, the new framework established by the Federal *Insurance Companies Act* created a reasonable expectation of effective corporate governance in the mid-1990s.

The CEO for Transit Financial Holdings Inc., who was also Maplex's chairman, president and CEO, was appointed at the discretion of the board of directors and no contract was ever drawn up or signed pertaining to the employment. The employment history of Maplex's CEO would have raised questions if it had been thoroughly checked.

The lack of proper management and corporate governance at Maplex unfortunately resulted in the breakdown of internal controls and procedures. Ultimately, this created a friendly environment for fraudulent activities within the corporation. The verbal agreement between Mr. Platis and the owner of Phoenix Property Development Corporation Ltd. is a case in point. This agreement was undertaken only a few months after Mr. Platis was appointed CEO in August 1993.

Subsequent to the agreement, the OIC began receiving complains from current and former Maplex employees pertaining to improper claims handling and excessive billing. Complaints from policyholders concerning claims handling were also brought to the OIC's attention. As a result, the OIC assigned a team of examiners to investigate the allegations.

The investigation of Maplex found evidence of fraud that was believed to be impairing the company's solvency. Maplex was found to be making exclusive use of an unlicensed adjusting company. Moreover, the investigators concluded that Maplex's claims and adjustment expenses had been built up based on excessive billing submitted to the insurer by the adjusting company.

The total amount directed to the benefit of Mr. Platis, as estimated by the OIC investigation of Maplex and York Fire in 1995, was $662,802. All the benefits came from the proceeds of the excess billing submitted by Phoenix to the two insurance companies, Maplex and York Fire.

In February 2006, a document titled "Agreed Statement of Facts" was filed with the Ontario Superior Court of Justice. The document indicated that Mr. Platis wrongfully diverted a total of $1,605,000 from Maplex.

Proper management and adequate corporate governance are fundamental to the accountability and operational efficiency of an insurance company. Internal controls and processes may break down for a number of reasons, but when they go unchecked or undiscovered for any period of time they may increase the risk of insolvency.

The losses associated solely with the breakdown in internal controls were not sufficient to render Maplex insolvent, but they were large enough to impair the company's capacity to respond effectively to an environment of rising costs.

Inadequate pricing and rapid growth

PACICC's analysis of Maplex's financial statements revealed vulnerabilities that likely originated from poor risk decisions, including uncontrolled rapid growth, or a lack of planned growth. In the two years prior to its liquidation, Maplex experienced adverse claims development associated with a rapid growth of written premium.

Usually the risk of claim deviation and rapid growth are closely related to past deficiencies in loss reserving and pricing. In fact, Maplex had been operating at a break-even level for an extended period of time, helped by its investment returns. During 1994, Maplex experienced unfavorable development of claims incurred in the previous year.

This was largely caused by suppressed reserve levels decided upon by the previous management at year-end 1993. Also, the cumulative effect of years of inadequate pricing and loss reserving emerged rapidly and finally caught up with the company's weak balance sheet.

In the early 1990s, Maplex's business mix also changed significantly. The company was concentrated mostly in auto, personal property and commercial property insurance, and the majority of the business was carried on in Ontario and British Columbia. After 1988, Maplex's commercial property business grew quite rapidly up to the end.

In June 1990, the Ontario Motorist Protection Plan (OMPP) was introduced in Ontario. This consisted of a threshold no-fault plan which incorporated increases in the level of accident benefits coverage with limitation on tort recoveries for automobile bodily injury claims. The OMPP, in addition to improvements in coverage, made automobile insurance a more labour-intensive coverage. In other words, the plan put pressure on the insurer's combined ratio by driving claims expenses up.

The OMPP and adverse claims development in automobile insurance forced Maplex's management to shift their mix of business. Maplex implemented a major purge of its Ontario personal automobile business in order to improve its results. Automobile direct premiums as a share of total premiums written declined sharply for Maplex. Meanwhile, the company placed emphasis on growing the personal and commercial property lines of business.

Toward the end of 1991, Maplex changed its guidelines for automobile insurance and started writing classes of risks that the company had previously stopped writing – such as personal automobile business. This contributed to a decrease in the underwriting loss, and improvement of the loss ratio.

Nevertheless, in 1991, Maplex experienced an adverse claims development in personal and commercial property lines. In 1991, Maplex's commercial property claims incurred almost doubled, while personal property claims incurred more than doubled.

As a result, at the end of 1992 and during 1993, the company went through a major purge of its property business and implemented significant rate increases. Personal property rates were increased by 10 to 15% in 1992 and 1993. For commercial lines, the increase varied from 5 to 15% depending on the region.

It is clear that Maplex's management lacked a well-developed strategy and plan for changes in its various lines of business. The lack of stability in premium growth and repeated changes of strategic direction suggest there were underwriting and leadership deficiencies in the organization. In fact, PACICC's research on why insurers fail in Canada shows that two-thirds of the distressed insurers that failed due to poor underwriting also displayed premium growth instability.

Reinsurance arrangements

Reinsurance arrangements are an integral part of a primary insurance company's business. Reinsurance allows an insurer to transfer risks that exceed its underwriting capacity, or to share risks which they choose not to bear alone.

Maplex had a quota share agreement with a reinsurance company starting in 1989, through which it ceded half of its written premiums. The quota share treaty is an obligatory ceding treaty under which the primary insurer is obliged to cede a fixed percentage of all business covered by the treaty, and the reinsurer is obliged to accept all cessions so made.

Maplex had also an inter-company arrangement with its sister company, York Fire, that was started in 1993. However, relatively few claims had been ceded to these covers and amounts had been set-off against each other.

In 1992, the structure of Maplex's reinsurance program changed from "by class" proportional and excess reinsurance only, to "omnibus" excess reinsurance. The reinsurance treaty under this new type of program grouped all the lines of business together instead of having individual treaties for each line of business.

Moreover, the total reinsurance protection available went up from $10 million to $15 million. A possible reason for the increase in the amount of protection may have been the switch from a "by class" reinsurance program exclusively to an "omnibus" excess program. Maplex's growth pattern at the time may have been an additional factor. In 1992, for example, premiums written by Maplex grew more than 30% annually.

The reinsurance Quota Share agreement was subject to a sliding scale provision. According to the treaty, Maplex bound itself to cede half of its premiums written. For 1992 and 1993, the provisional commission[3] was 32% at a combined ratio up to 100%. In 1994 the provisional commission was lowered to 27% at a combined ratio up to 95%. In case the combined ratio fell below 95%, Maplex received 27% of the premiums ceded to the reinsurer in the form of provisional commission.

At the end of each year the provisional commission is usually adjusted according to developments in the loss ratio. In 1993, the loss ratio (68.9%) improved from the previous year and hence was reflected in the reinsurance commission adjustment. Maplex received a higher reinsurance commission than had previously been provisioned. However, in 1994, the combined ratio ballooned to 115%. The reinsurance commission was adjusted as a result, and Maplex owed more than $4 million to its reinsurer.

[3] Provisional commission is paid by the reinsurance company to reimburse the direct insurer for the commission paid to its agents, plus taxes and its overhead. The amount of such allowance frequently determines profit or loss to the reinsurer.

At the end of 1994, Maplex's financial statements showed a net loss of $13 million. The investigation report compiled by the OIC stated that the extent of the loss was due primarily to adjustments for quota share reinsurance commissions. The $13 million loss in 1994 also reflected an increase of $3.3 million in loss reserves, as well as investment losses totaling $2.5 million.

Although the 1994 loss appeared to be caused by reinsurance commission adjustments, the fundamental origins of the loss were found in deficient loss reserving and inadequate pricing. Paired with rapid growth, these factors caused Maplex's claims and adjustment expenses to skyrocket.

Management turnover also appears to have contributed to the failure of Maplex. In 1994, the majority of Maplex employees, including managers, were replaced. A reinsurance-related claims audit conducted during January 1995 reported concerns regarding workloads, lack of supervision and lack of insurance experience. These circumstances were not conducive to appropriate underwriting strategies being adopted or implemented by Maplex.

PACICC's analysis of the internal environment of Maplex highlights various factors that made the insurer vulnerable and heightened insolvency risk. We conclude that poor management and deficient corporate governance were the main causes of inappropriate underwriting and investment risk decisions. (The risk map on page 23 helps to identify and categorize certain risks, mapping the causal relationships among them).

It would be fair to conclude that Maplex was also over-relying on its reinsurance arrangements as a substitute for capital. As the company's financial health deteriorated, its reinsurance capacity was rapidly exhausted and commission adjustment liabilities were incurred. While this situation in itself did not cause Maplex to become insolvent, it accelerated the company's demise.

External Environment

Insurance companies are often confronted with risks they cannot prevent, but they can generally mitigate consequences. However, a challenging operating environment may worsen financial problems in an already vulnerable insurance company – one that may otherwise have been able to survive in a more favourable environment.

Profitability and insurance cycle

Insurer insolvency is closely linked to industry profitability and insurance cycle. For some companies, periods of poor profitability increase the risk of insolvency, as already limited capital may be further eroded by claims development. PACICC's own research on insurer failures found a moderate negative correlation (40%) between Return on Equity (ROE) and insurer insolvency.

Maplex's financial distress, which persisted in the early 1990s, coincided with the softening of the insurance cycle which ended in 1994. During the period 1988 to 1994, the longest soft market in Canadian insurance history, 16 P&C insurance companies failed, including Maplex.

In 1994, return on equity, a key profitability indicator for the insurance industry, declined to 6.8% compared to 15.8% at the beginning of the cycle. Similarly, data for Maplex show that ROE declined from 28.5% in 1991 to 1.9% in 1993. Although the insurance cycle and weak industry profitability did not cause Maplex to fail, they certainly aggravated the company's vulnerable state.

Financial market risks

Financial market risk is also a significant potential contributor to insurer insolvency. Insurance companies hold large financial portfolios, mostly invested in government bonds, which increases exposure to interest rate risk. Recessionary periods associated with higher interest rate volatility increases insolvency risk, particularly for insurers operating close to the margin.

Maplex's investment portfolio underwent several changes in the two years prior to the insolvency, changes that adversely affected the company's investment performance. In 1993, almost 90% of Maplex's investment portfolio was invested in government bonds, with roughly equal exposure to short-term and long-term bonds (46% and 43% of the total portfolio respectively). The remaining 10% of the portfolio was held in common shares. The investment portfolio's annual return for 1993 had deteriorated slightly from the year before.

In 1994, Maplex committed to long-term bonds, and by the end of the year 86% of its portfolio was invested in long-term bonds and 4% in short-term bonds (common shares still accounted for 10% of the investment portfolio). During the same year, the return on investment portfolio plummeted, yielding negative rates of return.

For an extended period, Maplex had used returns on investments to offset net underwriting losses. Until 1994, Maplex had managed to stay afloat by showing small profits or breaking even. However, in the year prior to winding-up, deteriorating investment performance caught up with the insurer's poor underwriting.

PACICC research has found little correlation between levels of interest rates and financial impairment. The key risk associated with economic and financial market factors is not the *level* of interest rates, but their *volatility*.

In the early 1990s, there was an increase in interest rate volatility in Canada. PACICC research has found this to be partially correlated with insurer insolvency. Under-priced insurance policies – combined with interest rate fluctuations in the early 1990s – placed Maplex in a more vulnerable state. Investment losses incurred by Maplex in 1994 were also brought on in part by poor management and corporate governance.

PACICC research shows that decreases in equity prices exhibit only a weak relationship to P&C insurance insolvency. Like most P&C insurers, Maplex had only a small exposure to the stock market. Only 10% of the company's investment portfolio was held in common shares. But in 1994, equity prices experienced a sharp decline (11.8%), adding to Maplex's already vulnerable state.

While the external environment is unlikely to be a main cause of insolvency, it can aggravate vulnerabilities, reduce earnings and increase a company's exposure to insolvency risk. In the year prior to its insolvency, Maplex experienced a string of external shocks including the softening of the insurance cycle, elevated interest rate volatility, and a sharp decline in the equity prices – all of which contributed to the insurer's insolvency.

Causes of insolvency

Maplex's financial distress can be attributed to a series of main and contributing causes. After careful analysis of both the internal and external environment, PACICC was able to identify the main causes of insolvency for Maplex. Certain causes and risks were present for extended periods of time, while others emerged in the early 1990s prior to winding up. The causes of Maplex's insolvency fall in two categories: main causes and contributing causes.

Main causes of insolvency

1. Deficient loss reserving and inadequate underwriting
2. Management and corporate governance deficiencies
3. Rapid growth in particular lines of business

Contributing causes of insolvency

1. Fraud
2. Softening of the insurance cycle
3. Increased interest rate volatility

Costs of insolvency

At the time the winding-up order was issued, Maplex had an estimated 79,000 policyholders with some 4,200 claims outstanding that were being processed by OIC's agent. The agent subsequently received 500 additional new claims.

Bob Bethell, president of PACICC at the time of the Maplex failure, said the 1995 general assessment of members for Maplex would run $3 million "just to get started." In fact, the industry was assessed $20 million in total for the liquidation of Maplex. Mr. Bethell also mentioned that the fund expected to receive dividends from the assets of Maplex.

Excluding the time value of money, PACICC to date has recovered a 67% dividend and ultimately expects to recover 77 cents on the dollar. PACICC had paid $24.8 million in total claims and expenses to Maplex's policyholders. As of September 30, 2007, PACICC's records show that all loss claims have been settled.

Liquidation summary table for Maplex (at December 31, 2007)

Total PACICC member assessment	$20.0 million
Total PACICC claims and expenses	$24.8 million
Total liquidation dividend to date	$15.8 million
Number of claims outstanding	none

Given that Maplex's business was mostly in auto insurance, drivers ran the risk of never recovering any unearned premium since this was not covered by PACICC at the time of Maplex's insolvency. About half of the insurer's 56,000 auto insurance policyholders had prepaid their premiums, some as much as one year ahead. These policyholders had to purchase replacement auto insurance coverage from another insurer without the benefit of any refund.

A spokesman for the Ontario regulator said the Commission was concerned about the unearned premium situation and had started discussions with its federal counterpart and the insurance industry "to see what can be done."

Two years later, in 1997, PACICC introduced partial refunds of unearned premiums. Certainly the Maplex experience helped bring about that particular coverage enhancement to the benefit of policyholders affected by future insolvencies.

Key lessons learned from the failure of Maplex

Management and corporate governance

- Insolvency risk is inversely related to the quality and experience of senior management.
- Strong internal controls and financial reporting transparency reduces the risk of insolvency.
- Up to two years prior to a winding-up order, it is common for management of the troubled insurer to engage in aggressive market practices.
- An experienced and professional management narrows the window of opportunity for engaging in fraudulent activities.
- Implementing standards of sound business practices relating to the governance of insurance companies – for example, pertaining to the duties, qualifications and independence of directors – can help to reduce the risk of insurer insolvency.
- In the case of Maplex, stronger laws relating to management and governance could have mitigated, if not avoided, the problems of deficient reserving and rapid growth that (combined with deficient management and corporate governance) were the main causes of the company's insolvency.

Capital

- Research suggests that asset diversification reduces insurer insolvency risk.
- Insurer capital typically deteriorates rapidly in the final year leading up to insolvency.

Underwriting

- Adequate pricing and loss reserving are critical factors in reducing the risk of insolvency.
- Rapid growth fueled by under-pricing increases insurer vulnerability.

Internal processes

- Complicated internal accounting systems may create an environment conducive to fraud.
- Financial dealing between related parties may reflect a breakdown in internal controls, or the inadequacy or absence of appropriate documentation of such controls.

External environment

- Interest rate volatility increases the risk of insolvency.
- Softening of the insurance cycle contributes to insurer vulnerability.
- New insurance legislation and/or regulations – like the Ontario Motorist Protection Plan, introduced in 1990 – can bring additional financial challenges by increasing expenses associated with automobile claims handling.

Supervision

- Public data availability increases transparency and improves market discipline for insurance companies.
- Risk-based supervision should reduce insolvency risk. In particular, efforts should be made to step up on-site examinations when problems are detected.
- A “fit and proper” criterion for insurance company CEOs should be part of all federal and provincial insurance legislation in Canada.
- “Whistleblower” protection measures could be useful in the early identification of insurance company problems.

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Appendix

Detailed timeline of events

December 1955 Maplex General Insurance Company, an Ontario registered company, was incorporated. It was a stock company owned by Maplex Management & Holdings Ltd.

July 1956 Maplex was licensed in Ontario and by 1990 it was licensed in Alberta (1987), B.C. (1989), Saskatchewan (1989), Yukon and N.W.T. and Newfoundland (1990). Classes of insurance: Personal/Commercial Property and Automobile, Boiler & Machinery, Casualty and Liability.

October 1989 Maplex General Insurance Company merged with Abstainers' Insurance Company and the amalgamation continued under the name of Maplex General Insurance Company.

May 1993 Transit Financial Holdings Inc. acquired Maplex General Insurance Company. The acquisition was directly and indirectly completed by the acquisition from S.E.C. Holdings Inc. of certain non-voting preferred shares of Maplex and the acquisition from M.E.R. Financial Corp. of all of the shares of a holding company owning the voting shares of Maplex.

August 1993 Mr. James Platis, was appointed as Chairman, President and CEO of Maplex. Mr. Platis was a chartered accountant who had obtained this designation in 1979.

December 1993 Maplex's sister company, York Fire & Casualty Insurance Company was relocated to Burlington, Ontario, Maplex's head office. The rationale was to allow the operations of the two companies to benefit from common administration and management expertise.

March 1994 Maplex and its sister company, York Fire & Casualty, mandated Phoenix Property Development Corp. Ltd. to act as a general contractor in relation to all property claims of both insurance companies. Maplex and York Fire were the only clients of Phoenix.

March 1994 Complaints concerning the handling of various claims were brought to the attention of the Ontario Insurance Commission.

July 1994 The examiners of the Ontario Insurance Commission prepared a report to the Superintendent of Insurance listing their findings and concerns regarding Phoenix, the adjusting company for Maplex and York Fire.

August 1994 Acting on information received, the Ontario Insurance Commission Investigations Section executed a Criminal Code search warrant on the premises of Phoenix and seized business records.

August 1994 Based on its investigation, the Ontario Insurance Commission (the Superintendent) sent a letter dated August 31, 1994 to the Directors of Maplex outlining what appeared to be a scheme by which Maplex was being overcharged by Phoenix for claims adjusting expenses. The Directors declined to take action.

November 1994 James Platis resigned as the CEO of Maplex and was replaced by Dennis R. Starrit, formerly Senior Vice-President of Trimark Financial Corporation.

December 1994 TFH announces that Maplex may need a capital injection in order to meet its Minimum Asset Test at December 31, 1994 for license renewal with the Ontario Insurance Commission. TFH also announces that, as a result, Maplex was initiating a program of offering no new business and no policy renewals.

January 1995 The Niagara Regional Police charged the former Chief Executive Officer of Maplex and York Fire, Mr. James Platis, with fraud, theft and receiving secret commissions relating to the misappropriation of funds in excess of $500,000.

February 1995 Maplex goes into run-off. The Company engaged Tillinghast to perform an actuarial review of its policy liabilities for Maplex as at December 31, 1994, as required by regulatory authorities.

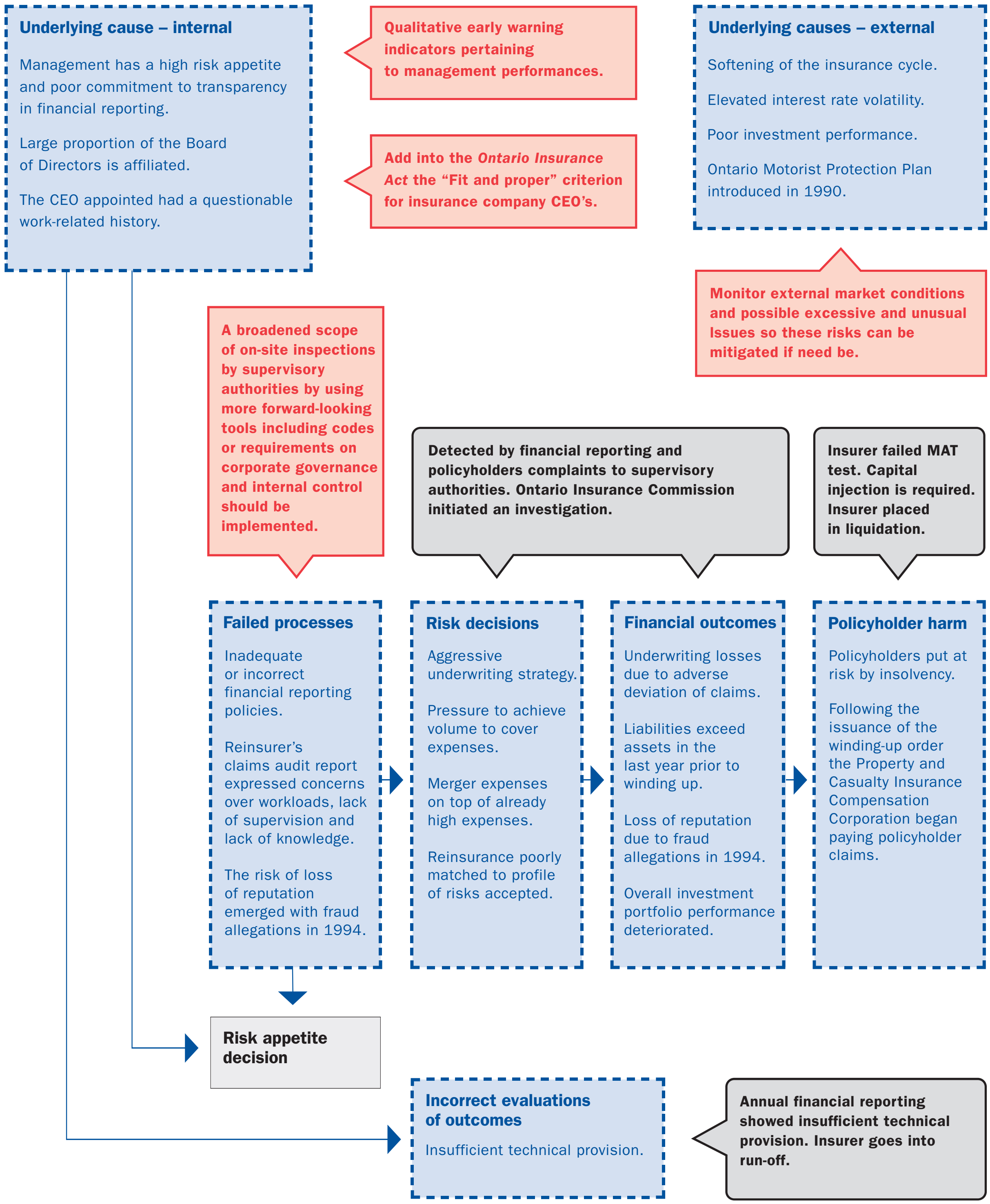
February 1995 Maplex was advised by the Ontario Insurance Commission that a capital injection of $3 million was required by March 1995 to continue the orderly run-off of its business. Maplex's operating license was amended to prohibit sale of new policies in order to protect funds to pay claims.

March 1995 An Ontario court judge issues a winding-up order putting Maplex General Insurance Company into liquidation. At that time, the insurer had insufficient assets to cover its liabilities. The winding-up order allowed PACICC to begin payments to Maplex's insurance policy claimants.

March 1995 At the time the winding-up order was issued, Maplex had an estimated 79,000 policyholders with some 4,200 claims outstanding that were being processed by OIC's agent. The agent subsequently received 500 additional new claims.

March 1995 Maplex policyholders were advised by the agent and by the Ontario Insurance Commission that they should seek alternative insurance coverage. Policyholders were covered for claims under existing policies until May 4, 1994.

Risk map



Key to risk map symbols