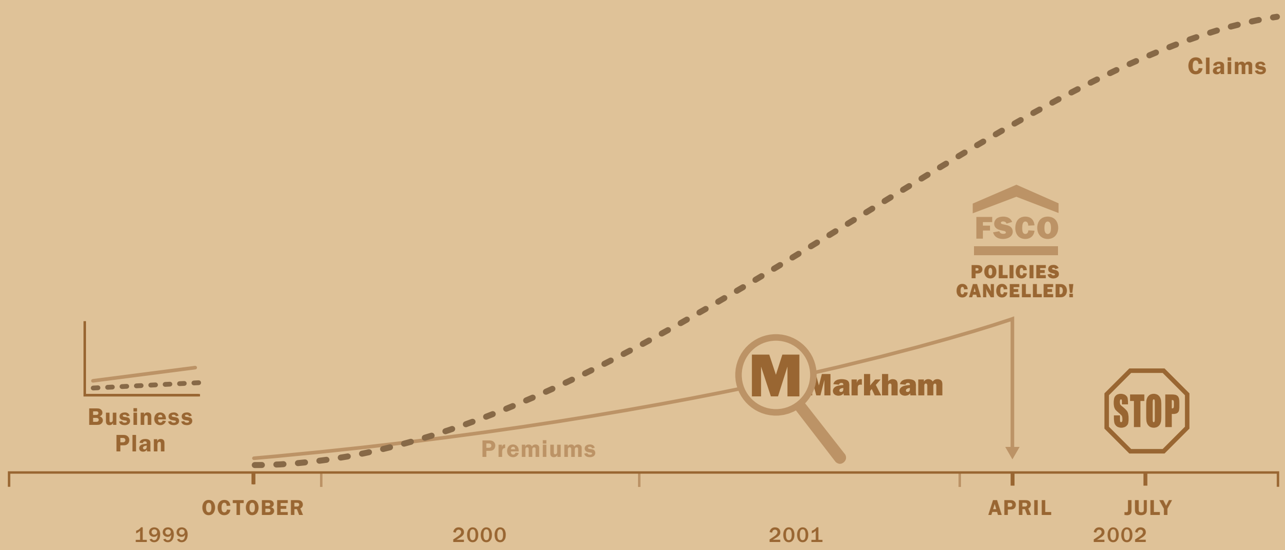
PACICC
Property and Casualty Insurance Compensation Corporation
Société d'indemnisation en matière d'assurances IARD

Why insurers fail

Lessons learned from the failure of Markham General Insurance Company



By
Jim Harries

2012

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PACICC's mission and principles

Mission Statement

The mission of the Property and Casualty Insurance Compensation Corporation is to protect eligible policyholders from undue financial loss in the event that a member insurer becomes insolvent. We work to minimize the costs of insurer insolvencies and seek to maintain a high level of consumer and business confidence in Canada's property and casualty insurance industry through the financial protection we provide to policyholders.

Principles

- In the unlikely event that an insurance company becomes insolvent, policyholders should be protected from undue financial loss through prompt payment of covered claims.
- Financial preparedness is fundamental to PACICC's successful management support of insurance company liquidations, requiring both adequate financial capacity and prudently managed compensation funds.
- Good corporate governance, well-informed stakeholders and cost-effective delivery of member services are foundations for success.
- Frequent and open consultations with members, regulators, liquidators and other stakeholders will strengthen PACICC's performance.
- In-depth P&C insurance industry knowledge – based on applied research and analysis – is essential for effective monitoring of insolvency risk.

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Acknowledgements
The author would like to acknowledge the information and assistance provided for this study by the Court-appointed Liquidator for Markham General Insurance Company, Deloitte & Touche, LLP, and by Amra Porobic, Manager, Library Services for the Insurance Bureau of Canada. Grant Kelly, PACICC's Vice President of Financial Analysis and Regulatory Affairs, provided valuable analytical assistance.

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

Introduction

Initial business planning

The plan to create Markham General Insurance Company (MGIC) took shape during the fall of 1997 and was principally developed by two property and casualty (P&C) insurance industry executives, Brian Johnston and John McGlynn (hereafter referred to as MGIC's management). MGIC was spawned by Millennium Financial Management Ltd., which was itself incorporated as a holding company on October 27, 1997 for the purpose of capitalizing MGIC as a new P&C insurance subsidiary.

Around the time that Millennium Financial was incorporated, Messrs. Johnston and McGlynn prepared and circulated an investment proposal to selected members of the insurance brokerage community primarily located in Ontario. The proposal called for the creation of MGIC as a new P&C insurance company whose key operating objectives included:

- Insurance brokers were to become significant investors in the holding company. This was intended to support exclusive relationships with broker-investors and to ensure a flow of high-quality business to MGIC
- Computerized, internet-based underwriting and business-processing tools would result in above average risk selection and help MGIC achieve one of the lowest expense ratios in the industry
- The focus of the Company was to be on *profit* growth rather than *volume* growth (emphasis added).

Actual outcomes

Millennium Financial's initial investment offering for MGIC raised $1.1 million – of which approximately 55% represented investments by some 20 brokers[1]. This was significantly less than the $23.5 million in capital required to launch the new company. Subsequently, Dailey Capital Ltd., a Connecticut-based venture capital firm, contributed $20 million to the start-up of MGIC. Despite a well-documented history showing that initial profitability is hard to achieve for start-up insurers[2], a press release issued by Dailey at the time of its investment in MGIC stated that "market values will increase from a consolidation trend in the insurance industry spurred by the efficiencies of scale and increasing momentum in the area of deregulation. Our objective is to exploit these trends for the benefit of our investors and by leveraging the valuation arbitrage in the middle market."[3] So, *the initial premise of having brokers become significant investors in MGIC – with accompanying incentives to flow quality business to the Company – was not met*.

In fact, brokers owned less than 3% of MGIC when the Company commenced operations in October 1999. And contrary to its stated business plan objectives, MGIC had as a majority shareholder a venture-capital firm intent on "leveraging the valuation arbitrage in the middle market" for the benefit of its investors. As the case study will demonstrate, it became apparent fairly quickly that the "valuation arbitrage" opportunity perceived by Dailey was an illusion.

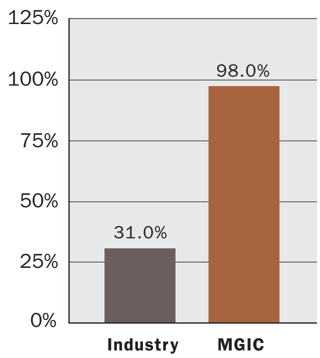
[1] From Company records held by Deloitte, the Court-appointed Liquidator for MGIC; and "Markham General set for Oct. 1 launch in Ontario," *Thompson's World Insurance News*, September 13, 1999.

[2] Darrell Leadbetter, *Why insurers fail – Determinants of survivability of new entrants to the P&C industry*, PACICC, 2011.

[3] Canada News-wire (CNW), August 18, 1999.

MGIC based much of its hope for a competitive advantage on being able to achieve a low expense ratio. The Company commenced operations in October 1999 and projected that its expense ratio would drop from 46.3% at start-up to 26.4% by 2003. As Brian Johnston commented when the Company was launched, "If all you're going to write is good average business, then my business is not going to outperform yours. But where I should be able to outperform is if I do a better job on the expense ratio."[4] Much of this advantage was to come from investing in and deploying emerging internet-based technology. Unfortunately, for reasons this case study will make clear, MGIC's plans to become an industry leader in lower expenses did not materialize. To the contrary, *MGIC incurred substantially higher expenses than projected. At the end of 2001, just months before the Company failed, its expense ratio was 98% – 3.5 times higher than called for in its initial business plan.*[5] (And, more than 3 times higher than the expense ratio of 31.0% recorded for the industry as a whole in 2001).

Exhibit 1
Expense ratio, 2001



Source: Insurance Bureau of Canada for industry data; 2001 P&C-1 filing for MGIC data.

Rather than focusing on profitable growth as stated in its initial business plan, MGIC in fact grew its business (primarily in Ontario auto insurance) so rapidly that the Company was unable to support or sustain it with adequate capital – or to ensure the quality of the new business it acquired. As Don Smith of Canadian Insurance Consultants commented at the time MGIC was authorized by the Financial Services Commission of Ontario (FSCO) to cancel its existing policies, and with respect to the Company's quadrupling of direct premiums from $20 million to $80 million in one year: "*You just don't grow that fast*"… "*anything beyond 10% growth per year was generally viewed as uncontrollable*." (Emphasis added).[6]

This introduction summarizes how MGIC's actual performance outcomes diverged substantially from the Company's stated objectives in its initial business plan. However, as the details of the case study will show, there were a number of other factors that contributed to the Company's demise – including the underpricing of its products as a strategy to attract business, as well as what would generally be viewed as management and corporate governance failings. MGIC was in business for only 2.5 years as a going concern (from October 1999 to April 2002). During this brief and turbulent period, the Company never earned a profit and had a shortfall of assets over liabilities of $4.9 million as of June 30, 2002 – just prior to being ordered into wind-up.[7] The shortfall of assets over liabilities would be much larger in liquidation – more than $20 million – as loss claims were incurred and funded in the liquidation process, primarily by insurance companies who are members of PACICC and the Facility Association. Considering the size of the deficit in relation to its brief time in business, MGIC ranks as one of Canada's costliest P&C insurance company failures.

[4] *Thompson's World Insurance News*, September 13, 1999.

[5] From records of the Court-appointed Liquidator, Deloitte.

[6] "Downfall leaves brokers scrambling to place policyholders," *Thompson's World Insurance News*, April 22, 2002.

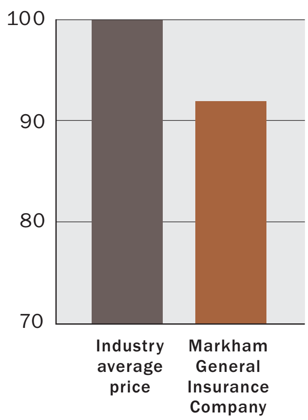
[7] Ontario Superior Court of Justice, Court File No. 02-CL-4612. Affidavit of Anita Sastri, Senior Manager of Compliance, FSCO, dated July 23, 2002.

Initial rate setting

When MGIC was launched, the stated intent was to "employ an operating strategy designed around the concept of an elite insurance 'co-op' and a unique scaleable internet-based technology platform that connects the insurance company (Markham) directly with its broker-partners on a real-time basis."[8] As noted in the Introduction, despite MGIC's plans for brokers to become significant investors in the Company, this did not occur, as brokers collectively never held more than 3% of MGIC's equity. So the concept of an "elite insurance co-op" never became a reality. Nonetheless, MGIC's initial rate setting unfolded as if its intended operating strategy was in place.

In October 1998, Towers-Perrin – who was engaged by Millenium Financial to assist with initial rate setting for the start-up that would eventually be licensed as MGIC – sent a letter to Millennium comparing MGIC's proposed rates to those charged by nine of the largest auto insurers operating in Ontario. The results of the comparison showed that MGIC's proposed rates were "close to the rates for these insurers."[9] Significantly, the letter from Towers-Perrin also estimated that industry auto insurance rates at the time in Ontario were underpriced by 5%.

Exhibit 2
Auto insurance pricing, 2001



Source: Published in PACICC, **Why insurers fail**, *"Inadequately pricing the promise of insurance", D. Leadbetter and P. Stodolak, 2009*

In February 1999, Millennium's management asked Towers-Perrin to compare MGIC's proposed rates to those charged by Belair Direct and CIBC Auto Insurance – two of the largest direct writers in the industry at that time. It is not clear why MGIC – which intended to distribute its products through insurance brokers – chose to compare its proposed rates to the leading direct writers. Nonetheless, despite the caution from Towers-Perrin regarding the inadequacy of then current rates, Millennium proceeded to use the Belair and CIBC rates as a basis for developing auto insurance pricing in its April 1999 rate filing and application to FSCO for MGIC's insurance license. This resulted in rates being filed for MGIC that were 24.2% lower than the rates first proposed by the Company eight months earlier. This was the beginning of what would become a pattern of auto insurance underpricing by MGIC. As a start-up insurer, MGIC was in effect placing a risky bet that it could deliver much lower expenses and/or superior risk selection compared to established insurers.

Ontario auto rate filing process

Auto insurance rate-filing guidelines in place at FSCO in 1999 suggested that insurance companies allow for and target a 12% return on equity after tax. Post-liquidation analysis, however, indicates that MGIC's initial rates were inadequate to produce a 12% ROE. In fact, they were approximately 25% *too low* in relation to FSCO's 12% ROE guideline. No explanation was given by MGIC in its initial rate filing as to why the low base rates of established direct writers had been selected and were considered appropriate for a start-up insurer.[10] And in approving the filing, at the time the conditional license was granted, FSCO appears not to have challenged or questioned the assumptions behind the low base rates.

MGIC's initial auto insurance rate filing to FSCO (and subsequent filings) included the following statements from the Company's valuation actuary:

> I have reviewed the data underlying this rate filing for reasonableness and consistency, and I believe the data are reliable and sufficient for the determination of the indicated rate (and)… the indicated rates have been calculated in accordance with Accepted Actuarial Practice.

The statements above were accompanied by a certificate signed by MGIC's Chief Operating Officer stating that:[11]

- (i) he had knowledge of the matters that were the subject of the certificate;
- (ii) the information and each document contained in the filing were complete and accurate;
- (iii) the proposed rates were just and reasonable, did not impair the solvency of the Company, and were not excessive relative to the financial circumstances of the Company.

"Take-all-comers" – and other complicating factors

Looking back on MGIC's aggressive auto insurance pricing practices, one wonders how well management understood the implications of the "take-all-comers" requirement in Ontario. This rule basically requires that coverage be provided to any driver who meets an insurer's underwriting rules at the rates approved for the company by FSCO. The take-all-comers requirement was not new when MGIC started in business – it had been in place since October 1992.[12] But with its auto insurance rates set below the industry average, MGIC was exposing itself to entire risk categories that were potentially underpriced. If MGIC's brokers then quoted the Company as the lowest premium, MGIC had to accept the risk. In doing so, the Company was taking on an underpriced product in an already deteriorating market – and at a time when established insurers in Ontario were filing requests for sizeable rate increases.

Two additional factors fueled the rapid growth of MGIC's auto insurance business in Ontario. First, in a departure from common industry practices, MGIC delegated much of the underwriting function to its brokers and paid commissions primarily on the volume of policies written (only a small portion of the commission paid was based on the loss ratio for a broker's portfolio of MGIC business). Second, of MGIC's total force of "broker-partners" (about 90 brokerages at peak) only 20 or so held any equity in MGIC and, as previously noted, that equity stake was less than 3% of the Company's total ownership. These factors, combined with the "take-all-comers" requirement for Ontario auto insurance, led to uncontrolled growth for MGIC.

[10] From records of the Court-appointed Liquidator, Deloitte.

[11] MGIC's valuation actuary at the time of the first rate filing and throughout the Company's operating history was Towers-Perrin (later KPMG).

[12] FSCO Bulletin No. A-14/92.

MGIC's losses mounted through 2001 – the Company's second and last full year in business. Its reported total loss ratio recorded in 2001 was 94.0% – *24 percentage points higher than projected in MGIC's business plan a year earlier*. Nonetheless, the Company continued to price its auto insurance business aggressively and well below the industry average.

The table below summarizes the average changes in Ontario auto insurance rates approved by FSCO between the 4th quarter of 1999 and the 1st quarter of 2002. It was not until the 3rd quarter of 2001 that MGIC filed for a rate change higher than the average figure approved by FSCO. MGIC also filed for higher-than-average rates increases in the 4th quarter of 2001 and the 1st quarter of 2002 – but by this time it was too late for these changes to have a positive impact on the Company's financial performance. MGIC's fate had been sealed by its earlier pattern of underpricing and its apparent unwillingness to seek rate increases in response to mounting losses.

Summary of Ontario auto insurance rate filings from 4Q 1999 to 1Q 2002

	Average rate change approved by FSCO	MGIC's rate filings	Effective new business date	Effective renewal date	Number of insurers that increased rates more then MGIC
1999.4Q	1.63%	No filing			11
2000.1Q	1.29%	No filing			9
2000.2Q	0.87%	Unchanged	15 May, 2000	1 June, 2000	14
2000.3Q	3.49%	No filing			20
2000.4Q	3.92%	No filing			22
2001.1Q	4.44%	2.10%	1 May, 2001	15 May, 2001	22
2001.2Q	2.56%	No filing			14
2001.3Q	4.92%	5.67%	1 October, 2001	15 October, 2001	11
2001.4Q	5.17%	7.00%	1 February, 2002	1 April, 2002	12
FSCO restricts MGIC's license – February 27, 2002					
2002.1Q	5.18%	9.20%	1 May, 2002	15 June, 2002	6
July 24, 2002 – MGIC ordered to be wound-up					

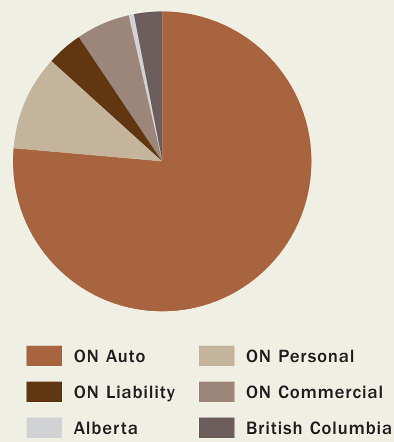
Source: **http://www.fsco.gov.on.ca/en/auto/rates/Pages/default.aspx**

MGIC at year-end 2001: on the eve of insolvency

At the end of 2001 – after only two full years in business – MGIC was in serious financial trouble. In particular, Markham General had failed to diversify its business in a way that could potentially have spread the risk it was facing: 97% of its direct premium written (DPW) was in the Ontario market, and the bulk of that premium (79.6%) came from Ontario auto insurance.

	2001 Industry	MGIC
Return on Equity	2.6%	–162.5%
Return on Investment	7.5%	9.1%
Investment Income as a percent of Net Premiums Earned (NPE)	13.7%	4.6%
Earned loss ratio	80.0%	94.0%
Operating expense ratio	31.0%	97.9%
Combined ratio	111.0%	191.9%
Growth in Direct Premiums Written (DPW)	10.6%	326.3%
Growth in Net Premiums Written	5.3%	167.3%
Growth in Net Premiums Earned	3.7%	597.7%
Underwriting Income as a percent of NPE	-10.7%	–91.4%
Change in Equity	-0.8%	–25.9%
Growth in NPE	5.3%	497.7%
Growth in Claims	9.3%	607.3%
Growth in Required Reserves	10.3%	3.6%

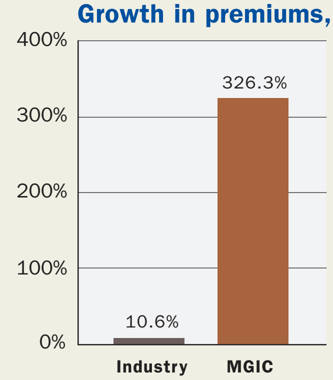
Exhibit 3
MGIC premiums, 2001



MGIC's markets as a percent of the Company's total premiums, before reinsurance

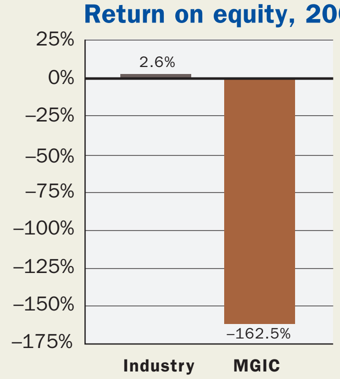
Ontario	DPW	Claims	Loss Ratios	Percent of total
ON Auto	38,548	32,212	83.6%	77.2%
ON Homeowners	5,168	4,139	80.1%	10.4%
ON Liability	2,003	857	42.8%	4.0%
ON Commercial Property	2,696	2,840	105.3%	5.4%
Alberta and BC				
Alberta Homeowners	17	0	0.0%	0.03%
Alberta Liability	12	0	0.0%	0.02%
BC Homeowners	1,471	1,241	84.4%	3.0%
Total	**49,915**	**41,289**	**82.7%**	**100%**

Exhibit 4
Growth in premiums, 2001



On the surface, MGIC's recorded Ontario auto loss ratio of 83.6% for 2001 doesn't seem disastrous. However, this loss ratio isn't representative of the true performance of the business because MGIC was significantly under-reserved. This is illustrated by how the Company's growth in claims and reserves during 2001 compared to the industry as a whole. MGIC's loss claims grew by 607.3% in 2001, but the Company increased its "required" reserves by only 3.6%. By comparison, the industry as a whole experienced claims growth of 9.3% in 2001 – but raised reserves by a more commensurate figure of 10.3%.

Exhibit 5
Return on equity, 2001



Among other signs of trouble for MGIC at year-end 2001:

- Return on Equity was -162.5, compared to 2.6% for the industry as a whole
- The combined ratio was 191.9%, compared to 111.0% for the industry
- The Company's year-over-year growth in DPW was rapid and unsustainable: 326.3% for MGIC compared to 10.6% for the industry
- Total equity dropped -25.9% from the previous year compared to -0.8% for the industry.

How did a new insurance company get so deeply in trouble in just two years time? The details presented in this case study show, in particular, how inadequate pricing and reserving, deficiencies in capitalization, management and corporate governance all contributed to MGIC's demise.

Source: Insurance Bureau of Canada for industry data; 2001 P&C-1 filing for MGIC data.

Technology

A key aspect of MGIC's operating strategy as an insurer was to be based on the innovative use of what was, in 1999, emerging internet technology. Indeed, this was the foundation intended to support the Company's hopes for a competitive advantage in achieving lower-than-average operating expenses.

To pursue this strategy, MGIC chose to invest in a computerized system called "Front-Tier" that was intended to automate certain functions including underwriting and policy administration, accounting and claims management. This system was supposed to allow MGIC to realize its vision of operating as a "virtual" (paperless) insurer with low expenses. Unfortunately, the Front-Tier system did not deliver the cost efficiencies and lower expenses that MGIC based much of its operating strategy upon. Among the key reasons:[13]

- MGIC spent a lot of money on the system – more than $5 million in total. (This was approximately 25% of the Company's initial capital)
- The Company was not developing a system that would be proprietary to – that is, owned by – MGIC. In fact, they had only purchased software licenses, which meant that the "base system" was still owned by the developer of Front-Tier (a Canadian company called "Concise Technologies" that was acquired in April 2001 by Sherwood International)
- Notwithstanding that MGIC's rights were only as a licensee, management considered the Company's technology to be a valuable asset which they hoped to market through a subsidiary company called "Insurance Data Network" (IDN). Indeed, during its first full year of operations, MGIC estimated the book value of its technology assets at $4.5 million (likely matching the dollars spent acquiring software licenses). However, the plan to market MGIC's technology through IDN never materialized. Moreover, when MGIC went into liquidation, its technology assets yielded little financial value
- MGIC encountered start-up problems with Front-Tier. Even at the time the Company was ordered to be wound up, there were still significant errors and shortcomings in the software that were noted by the Court-appointed Liquidator, including errors in the calculation of taxes and a still-undeveloped accounting/general ledger system.

MGIC's plan to utilize internet-based technology to be a leader in achieving low expenses and cost efficiencies largely failed. Indeed, by consuming more than $5 million in capital that MGIC could ill afford – and yielding no apparent substantive benefits – the strategy was ultimately a costly and unsuccessful experiment.

Broker commissions

MGIC paid its brokers above-average rates of commission. This was apparently done to provide brokers with an incentive either to transfer existing portfolios to MGIC, or to place business with the Company upon renewal. Paying over-ride commissions to brokers for portfolio transfers may

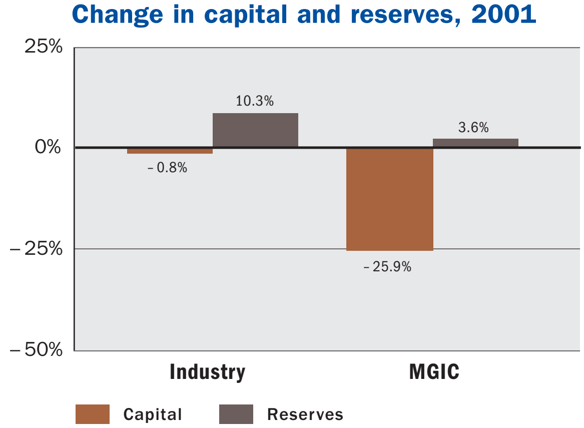
[13] Based on records of the Court-appointed Liquidator, Deloitte.

have been understandable, but it is less clear why MGIC decided to "incent" brokers in this way to place new business with the Company – especially when they were pricing aggressively. It appears the decision was made primarily to ensure the Company would grow rapidly once it commenced operations.

For example, according to Company records held by the Court-appointed Liquidator (Deloitte), MGIC agreed to pay commissions to its largest single broker, on gross premiums generated, at 10% and 5% above the base commission rate for the years 2000 and 2001, respectively. During those two years, this one agency generated gross premiums for MGIC of approximately $7 million and $13.3 million, respectively. Using the Insurance Bureau of Canada's Expense Allocation Program as a proxy for the industry, Ontario auto insurance broker commissions paid by 37 insurers included in the IBC survey averaged 11.6% in 2001.[14] Increasing that rate by 10% and 5% for the years 2000 and 2001 – with reference to the gross premiums generated by MGIC's largest broker for those two years – suggests that the Company paid an additional $160,000 (on top of industry base commissions) to this one agency during 2000 and 2001. Moreover, the Liquidator's records show that MGIC provided an advertising allowance of $500,000 per year to the same broker during the first two years of the contract. And the money was spent – as MGIC's 2001 P&C-1 filing shows advertising expenses of $931,000 attributable to that year alone. So it appears that MGIC spent an additional $1.1 million in 2000-2001 on "incentives" for its largest single broker. Those expenditures would perhaps have made sense had they resulted in profitable business.

However, this was not the case. By late 2001 and early 2002, MGIC had either terminated or restricted approximately 40 of its 90 brokers from writing new business due to poor loss results.[15] One of the underperforming brokers was the recipient of the additional commission and advertising monies. Despite that agency being a broker-partner (that is, an investor) in MGIC, and accounting for 16% of the Company's gross premiums in 2001, the resulting business appears not to have been any better than the unprofitable average in MGIC's total portfolio.

Exhibit 6
Change in capital and reserves, 2001



Source: IBC and MGIC 2001 P&C-1 filing

Claims handling

MGIC outsourced its claims handling and reserving functions to a third-party – the Underwriters Adjustment Bureau (UAB). This was part of management's strategy to operate MGIC as a "virtual" insurer with low expenses. But like many other aspects of MGIC's business, the strategy didn't work well in practice. Basically, MGIC failed to establish adequate controls in setting

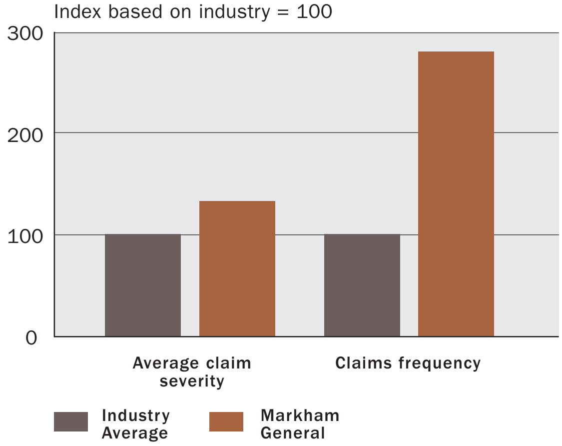
[14] IBC 2001 Expense Allocation Program, Exhibit IV.

[15] Based on records of the Court-appointed Liquidator, Deloitte.

reserves to meet its policy liabilities. The Company primarily used the case-reserving method for establishing its claims reserves (that is, it set a reserve for each reported claim), but used a "bulk-reserving" method to estimate "incurred but not reported" (IBNR) claims and allocated loss adjustment expenses.[16] The bulk of MGIC's reserves were case reserves – and these were largely underestimated. By underestimating its case reserves, MGIC underestimated reserves for IBNR claims. Average or bulk-reserving may be effective for certain types of claims, but claims professionals generally avoid it when reserving for accident-benefit and bodily-injury claims. And that caution would have applied even more to a fast-growing insurer like MGIC, which lacked a known and stable loss history.

Exhibit 7
Claims experience: auto insurance policies

Index based on industry = 100



Source: Published in PACICC, **Why insurers fail**, *"Inadequately pricing the promise of insurance", D. Leadbetter and P. Stodolak, 2009*

While UAB was responsible for "setting" the reserves, MGIC's management appears to have taken a high-level approach to reviewing reserve estimates and increasing them when necessary in response to adverse developments. To have been more vigilant with respect to reserving would have made MGIC's financial statements appear even weaker than they were already. But by underestimating its claims reserves, MGIC was only postponing recognition of the adverse financial impact. As actual claim losses developed and were greater than reserves, the difference had to come from the Company's current year capital. And, as the next section describes, MGIC's capital became seriously constrained through 2000 and 2001 – barely meeting the minimum asset test in 2000 and falling well short in 2001. Mounting losses and underestimated claims reserves were a big factor in MGIC's rapid "burn-through" of capital in 2000 and 2001.

How bad was the underestimation of reserves and ultimate losses by MGIC? As shown in the table below, MGIC's estimates of losses following policy years 2000 and 2001 ultimately turned out to be understated by about 30 percent.

MGIC Loss Ratios

Year	As estimated by MGIC *(in February 2001 and March 2002, respectively)*	As calculated by the Liquidator *(at December 31, 2006)*	Difference
2000	78.4%	100.9%	22.5 percentage points
2001	86.8%	114.8%	28.0 percentage points

Source: *Based on MGIC's Report on Policy Liabilities for the years 2000 and 2001, and the Court-appointed Liquidator's calculation of ultimate losses incurred for these two policy years.*

[16] Based on records of the Court-appointed Liquidator, Deloitte.

Capitalization

As noted in the Introduction, MGIC's initial business planning called for insurance brokers to become significant investor-partners in the new company. But by late 1997, total capital invested by brokers amounted to only $612,500. This was a small fraction of the $23.5 million the Company estimated as its total capital requirements during the first five years of planned operations. Accordingly, management needed to devise a different strategy to raise capital.

How MGIC's early funding strategy went awry

To help secure capital funding for the start-up of MGIC, the management of Millennium Financial engaged a Canadian firm named Orenda Corporate Finance Ltd. During 1998, Orenda prepared an information memorandum summarizing Millennium's corporate strategy and financial projections for the period 1999 to 2003, and circulated it to potential institutional investors. Despite numerous presentations to potential investors, only one venture-capital firm showed enough interest to submit a letter of intent: Dailey Capital Ltd., a U.S.-based company that described itself as a "private equity platform specializing in early to mid-stage leveraged buyouts."[17]

As part of its own due diligence before investing in Millennium/MGIC, Dailey commissioned PriceWaterhouseCoopers (PWC) to review the business plans of the proposed new company. In a report dated December 11, 1998, PWC made several cautionary observations. For example, the report noted that Millenium's model for calculating minimum asset requirements was both "lacking in sophistication" and "unreliable." The report also found the reinsurance commission assumptions in the business plan to be "unrealistic" (this likely suggested that Millennium/MGIC's loss ratio assumptions were considered to be low). In a comment that now looks prescient, PWC concluded that additional capital in the third to fifth years of the model would be "prudent." And the potential for capital to become deficient was reinforced by the following comment:[18]

> The Canadian industry has gone through a few good years, and a new cycle of declining premiums and increased loss ratios may sweep the market in the next five years. The level of capitalization of Millennium [and its planned subsidiary, MGIC] would make this passage difficult.

Despite these cautions, Dailey ultimately decided to proceed, in August 1999, with the equity investment in Millennium/MGIC. But how much did a venture-capital firm "specializing in early to mid-stage leveraged buy-outs" really understand about the realities of investing in a start-up P&C insurer, in a highly competitive marketplace, and at a challenging time in the insurance cycle – particularly a new insurer with an aggressive business plan? As subsequent experience demonstrated, Dailey was not an easy fit as the majority shareholder for MGIC. While not universally true, venture-capital investors are often interested in realizing a short-term profit from selling an equity position, rather than seeking to build a sustainable, valuable enterprise over a longer period. It appears that divergent investment objectives and operating realities contributed to MGIC's failure.

[17, 18] From records of the Court-appointed Liquidator, Deloitte.

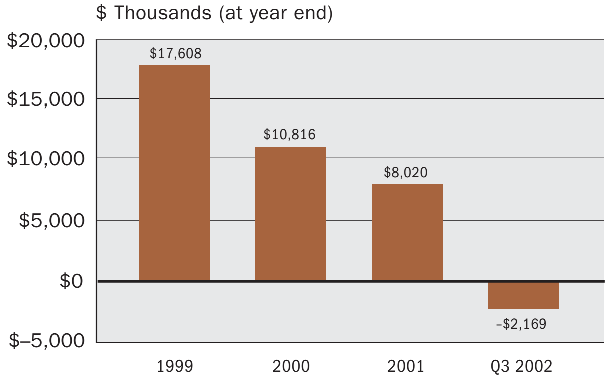
Why did MGIC's capital prove to be so inadequate?

A new P&C insurer that began operations with more than $20 million in capital should not prove so soon to be "undercapitalized." So what went wrong, and more specifically, why by March 2000 – after less than six months in business – was MGIC projecting it would need additional capital of $15 million in 2001, and $17 million in 2002? (This represented $32 million in capital above and beyond the initial $23.5 million that was supposed to meet MGIC's needs for the first five years of operations). Based on PACICC's analysis of information held by the Liquidator for MGIC, here are several reasons for the Company's failure to maintain adequate capital:[19]

- Errors in MGIC's capital modeling meant that estimates of required capital were understated (these errors were not identified by the Company until April-May 2001)
- MGIC burned through a portion of its capital for start-up and operating expenses (for example, more than $5 million was spent on software licenses alone, as noted in the section on expenses)

Exhibit 8 – MGIC capital

$ Thousands (at year end)



Source: MGIC 2001 and 2002 P&C-1 filings

- MGIC did not generate any premium income until October 1999 – three months after its license was granted by FSCO – but the Company was incurring expenses during this period
- MGIC was paying management fees to Dailey of more than $300,000 per year. The majority shareholder insisted on these payments – even though it appears that no commensurate services were received by MGIC. If such was the case, these payments were essentially a shareholder "dividend"
- Early losses also consumed capital. For example, MGIC's reported loss ratio for the year 2000 was 8 percentage points higher than projected – and instead of earning net income of $2.1 million as projected for 2000, the Company recorded a loss of $6.8 million. The Company's financial performance continued to worsen through 2001
- MGIC was never profitable during its 2.5 years in business – so the Company had no retained earnings to use as a means of building up its capital.

Some additional observations are in order regarding MGIC's lack of capital. First, the Company was not required to reserve or "vest" a portion of its starting capital as a cushion against losses or other adverse developments. The Company committed to FSCO, its solvency regulator, that it would maintain a Minimum Asset Test margin of at least 10%, and that it would maintain total capital and surplus at not less than 40% of its net premiums. These commitments were made by MGIC's parent company, Millennium Financial, to FSCO in March 1999 through two comfort

[19] Annual Return, P&C-1 for Markham General Insurance Company, 2001; and other records held by the Court-appointed Liquidator.

letters.[20] By 2001, MGIC was substantially off-side with respect to both commitments. In retrospect, the letters signed by Millennium's management when applying for MGIC's insurance license did not provide the regulator with the intended "comfort" or any real assurance of compliance.

Second, it is clear that Dailey Capital, as MGIC's majority shareholder, thought the business should have been able to be run on a "variable capital" basis. Dailey was uncomfortable with committing any more capital to MGIC than the minimum required by the regulator. And whether MGIC's management agreed with this view, they acquiesced in it. But it was a difficult strategy for a new insurance company – especially one attempting to grow as rapidly and aggressively as MGIC. The Minimum Asset Test was used at that time (much like the Minimum Capital Test today) as a guideline for monitoring the performance of insurers. Being right at the MAT margin of 10% (of assets available compared to assets required for test purposes) would not be viewed as a prudent operating strategy.

Third, MGIC's attempts to recapitalize through 2000-2001 were led by its major shareholder, Dailey Capital. In this respect – not wanting to dilute its existing equity position – Dailey's interests were in conflict MGIC's. Company records held by the Liquidator reveal that numerous potential investors were approached during 2000-2001, but they all declined to invest on the terms and conditions being offered by Dailey. Eventually, Dailey lost its entire equity stake when MGIC was ordered to be wound-up in July 2002.

[20] Ontario Superior Court of Justice, Court File No. 02-CL-4612. Affidavit of Anita Sastri, Senior Manager of Compliance, FSCO, dated July 23, 2002 (Section C, paragraph 12).

Corporate governance

MGIC's corporate governance fell short of what would generally be considered as effective. The Company's Board of Directors appears to have failed to use independent judgment in reviewing and approving MGIC's business plans and in overseeing the actions of management. As MGIC's financial performance deteriorated, the Board did not take or call for measures that could have improved the situation, at least by helping to stem the losses that were occurring.

MGIC's P&C-1 filing for the year 2001 lists seven corporate directors. Three of those individuals were senior management or corporate officers of MGIC. The other four Board members were affiliated with and appointed by Dailey Capital, MGIC's majority shareholder.

Of MGIC's many corporate governance shortcomings, the following appear to be the most noteworthy.

- The Board was composed almost entirely of management and related parties – there was little in the way of independent judgment that would normally be associated with effective governance and therefore expected of a Director.
- The roles of CEO and Board Chair were combined. This was an approach that was sometimes used a decade ago, but was increasingly criticized at the time. Consider, for example, the recommendations of two widely-publicized reports on corporate governance released before MGIC was conceptualized: first, the Cadbury Report on best governance practices argued that, "Given the important and particular nature of the Chairman's role, it should in principle be separate from that of the Chief Executive Officer;" and second, Canada's Senate Banking Committee, in a report on corporate governance, "strongly recommends that publicly traded CBCA (Canada Business Corporations Act) corporations separate the positions of chairman of the board and chief executive officer."[21]
- The Directors serving as Dailey Capital's representatives on the Board may have felt a tension between their allegiance to the majority shareholder and their duty to protect MGIC's corporate well-being. Two particular examples stand out. First, the insistence that Dailey be paid regular management fees by MGIC even though no commensurate services appear to have been provided (these fees totaled nearly $900,000 over MGIC's brief corporate history). Second, Dailey's contractual rights and involvement with MGIC allowed the majority shareholder to dictate terms and conditions for any additional capital that would have subordinated such capital to Dailey's original investment. Considering that MGIC was unprofitable and, indeed, recording sizeable losses, it would have been challenging enough to attract new capital on even terms, let alone subordinated terms.

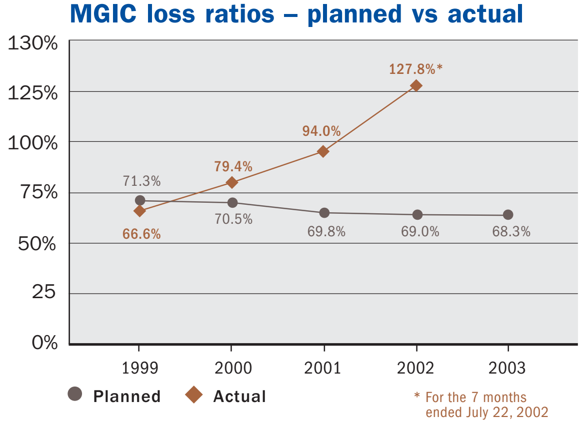
[21] Report of the Committee on The Financial Aspects of Corporate Governance (a.k.a., "The Cadbury Report"), December 1992; and Report on Corporate Governance, The Standing Senate Committee on Banking, Trade and Commerce, Senate of Canada, August 1996.

• With respect to the management fees paid to Dailey, these were challenged in September 1999, when first proposed, by a Board member named John Gwynn. Mr. Gwynn was a Managing Director of Dailey Capital, and although he had been appointed by the majority shareholder to the MGIC Board, he stated that "Markham General, as a start-up proposition, can ill afford expenses, charges and fees that are not closely related to positive bottom-line results."[22] Unfortunately for MGIC, soon after Mr. Gwynn expressed his opposition to the Dailey management fees, he was removed as a Director of the Company.

• MGIC's Board authorized a plan in February 2000 that awarded bonus compensation to senior management principally on the basis of achieving growth targets for gross written premiums. There was no reference to loss ratio targets or profitability in the compensation plan. Perhaps unintentionally, the Board had created incentives for MGIC to grow rapidly without due regard for profitability.

• MGIC's Board minutes reveal little in the way of discussion about the Company's financial performance. Business plans appear to have been approved as submitted with few questions asked – even though the assumptions (with respect to loss and expense ratios, for example) were unrealistic in relation to industry performance, especially for a new insurer. Similarly, no questions appear to have been raised by the Board when actual results were significantly worse than plan assumptions. This was particularly true during MGIC's critical and (as it would turn out) last full year of business in 2001. The Company's business plan for 2001, approved by the Board, called for a loss ratio of 76%. Near the end of the year, the measured loss ratio was 87.2%. And MGIC's reported loss ratio for 2001, as recorded in the Company's P&C-1 filing, was 94% – 18 percentage points worse than the business plan assumption. Moreover, adjusting for inadequate loss reserves, the Liquidator estimates that MGIC's true loss ratio was 114.8% – more than one and one-half times the expected value. Although MGIC's financial performance was deteriorating rapidly at this point, actions could still have been taken to save the Company. But the Board of Directors needed to be involved in identifying those actions and ensuring they were implemented. MGIC's Board appears to have done neither.

Exhibit 9
MGIC loss ratios – planned vs actual



Source: MGIC Business Plan, January 19, 1999: and MGIC 2001 and 2002 P&C-1 filings (Exhibit 10.60)

[22] Records of the Court-appointed Liquidator, Deloitte.

Reinsurance

MGIC's reinsurance program was changed significantly during its brief history – and the changes were not in the Company's favour. The initial business plan, prepared in December 1997, called for MGIC to cede approximately 10% to 15% of its premiums to reinsurers over the five-year planning period 1999-2003, and to retain the rest. When the Company began operations in late 1999, it had increased the premiums ceded to reinsurers to 45%. And by 2001 – MGIC's fateful last full year in business – the Company was ceding 70% of its direct premiums.[23] Without adequate capital and controlled growth, MGIC may have been forced into ceding more premiums than it originally intended. Otherwise, it would be difficult to explain why such a large shift in strategy would have occurred in such a short period.

MGIC's reinsurance program was a quota-share arrangement, brokered to include 20 registered reinsurers, the largest of which were Gen Re, Le Mans Re, Scor, and Folksamerica (these four reinsurers took on 75% of MGIC's total ceded premiums in 2001).[24] However, beyond the basic quota-share arrangement – which for the 2002 program entitled MGIC to a ceding commission of 23.5% only if the Company's loss ratio was 65.5% or lower – there was a "loss-participation clause" that required MGIC to cover all losses within the loss-ratio "corridor" of 77.5% and 87.5%. (Recall that MGIC's reported loss ratio for 2001 was 94.0%). This was not a common practice in reinsurance agreements at the time. In effect, the loss-participation clause was a relatively safe "bet" for MGIC's reinsurers. It limited their exposure to a risky new Company that was growing rapidly and deriving more than three-quarters of its total premiums from Ontario auto insurance. To some extent, it also reflected deteriorating conditions in the Canadian market for reinsurance at the time. But those conditions had been developing for at least two years prior and would have been known to MGIC's management and Board of Directors. So it is unclear why management and the Board continued to rely on unrealistic ceding commission assumptions in the face of poor loss experience.

Perhaps unintentionally, MGIC became over-reliant on reinsurance through 2001. Without additional capital available, and given MGIC's deteriorating loss experience, the reinsurance loss participation clause worked to accelerate (but not cause) the Company's insolvency.

[23] Records of the Court-appointed Liquidator, Deloitte.

[24] MGIC P&C-1 filing for 2001, Exhibit 70.20B.

The role of the insurance regulator

MGIC was licensed by the Financial Services Commission of Ontario (FSCO) – who also served as the Company's solvency regulator. During 1999, the timeline of developments – from application for an insurance license to the start of operations – was as follows:

- In January 1999, Millennium Financial submitted its proposed business plan for MGIC to FSCO as part of its application for incorporation and for an Ontario insurance license
- In March 1999, Millennium submitted two letters to FSCO agreeing to ensure that its "capital and surplus at any time will not be less than 40% of its net premiums written during the previous 12-month period," and "to maintain Markham General's assets at a level of at least 110% of the assets required for the Ontario test purposes under the Minimum Asset Test"[25]
- On June 18, 1999, FSCO granted MGIC a license to underwrite insurance in Ontario, but conditional on the Company obtaining capital funding to ensure its net surplus of assets over liabilities was at least $19.6 million. The closing of Dailey Capital's investment in MGIC took place on August 16, 1999
- MGIC commenced operations in early October 1999 – nearly four months after licensure and approval of its auto insurance rates; and two months after its capital was in place – in part because the Company's computer system wasn't operational.

FSCO made MGIC's license conditional on obtaining adequate initial capital, and on getting approval for its proposed auto insurance rates. With the benefit of hindsight, had the regulator also made the Company's license conditional on "the approval of rates judged to be adequate in relation to established industry experience" (or similar language), MGIC might have found it more difficult to pursue a strategy of aggressive pricing. Justification for such a condition could have been that MGIC's business plan – while "unique" in its intent to use emerging internet technology – was untested and not supported by any demonstrated loss experience. Moreover, where proposed rates differ significantly from the industry average, the regulator could request further substantiation or stress testing.

Once MGIC commenced operations, the Company was filing its financial data with FSCO on a quarterly basis. Two additional early signs of risk would have been evident to the regulator during 2000 (MGIC's first full year of operations): (1) the rapid erosion of available capital, and (2) rapid growth in premiums.

At the end of 2001 and early 2002, MGIC failed to comply with FSCO's MAT requirement. Intensive discussions then took place involving FSCO, MGIC's management and Dailey Capital as the Company's majority shareholder. According to the Liquidator's records, Dailey was seeking concessions and some type of forbearance from FSCO as a condition for contributing additional capital. When FSCO was unwilling to grant the concessions sought, Dailey advised it would not be adding capital. At FSCO's request, MGIC agreed on February 27, 2002 to restrictions on its

[25] Ontario Superior Court of Justice, Court File No. 02-CL-4612. Affidavit of Anita Sastri, Senior Manager of Compliance, FSCO, dated July 23, 2002 (Section C, paragraph 12).

ability to accept new business. Subsequently, Dailey agreed to deposit $3.5 million with an independent trustee – on the condition that MGIC be allowed to cancel existing policies to limit further loss claims. On April 15, 2002, FSCO's Superintendent authorized the termination of MGIC's auto insurance policies, and further noted in a letter to management that "Markham General's financial position is an appropriate ground for it to decline to issue, terminate or refuse to renew a contract, or refuse to provide or continue a coverage or endorsement."[26] In early May 2002, MGIC wrote to approximately 87,000 policyholders cancelling all in-force policies as of June 15, 2002. After some final attempts to keep the Company operational, MGIC's Directors decided to file for bankruptcy on July 19, 2002. FSCO then applied to the Ontario Superior Court for an order to wind-up MGIC, which was granted on July 24, 2002.

Looking back on how quickly MGIC grew its premiums, burned through its capital, and incurred much greater-than-projected expenses and loss costs, there are two elements of regulation that could have helped mitigate the risk of failure:

1. requiring new insurance companies to use conservative actuarial and reserving assumptions – at least until they mature enough to show stability in loss costs and profitability
2. requiring new insurers to maintain a higher capital margin in the early going – how much higher could depend on an assessment of risk relative to established insurers. While it could be argued that this would effectively be a "tax" on the capital of a start-up insurer, if such a requirement reduced the risk of another failure like MGIC, it would be a prudent policy.

[26] Ontario Superior Court of Justice, Court File No. 02-CL-4612, Notice of Motion (Returnable August 1, 2002).

The Ontario auto insurance market

Ontario introduced a series of changes to automobile insurance coverage in the 1990s that would directly affect insurers' operations and profitability. In June 1990, Bill 68 introduced a threshold no-fault plan (*Ontario Motorist Protection Plan*). It removed the right to sue in all cases except when the injury exceeded a verbal threshold. Motorists could not sue the at-fault third-party motorist unless the severity of their injuries met the threshold. On January 1, 1994, Bill 164 (*Insurance Statute Law Amendment Act*) created a Statutory Accident Benefits Schedule (SABS) which provided enhanced benefits. It modified the threshold for lawsuits and permitted legal action for pain and suffering under certain conditions. In June 1996, Bill 59 (*Automobile Insurance Rate Stability Act*) introduced a new SABS with reduced benefits and provided more opportunity for litigation.

These changes to Ontario's auto insurance framework in the 1990s drove up insurer costs significantly. Legal interpretation of the thresholds and the frequency of SABS claims were key issues. The changes would have serious adverse implications for MGIC, whose business was heavily concentrated in Ontario automobile insurance. By the end of the year 2000 – MGIC's first full year in business – overall auto insurance claims in Ontario were 50% higher than a year earlier.* A working group consisting of Ontario Government and auto insurance industry representatives began studying ways to stabilize auto insurance claims costs in 1998. This group reported to the Government of Ontario in 2001 – too late to be of help to MGIC.

While MGIC's original business plan proposed that personal automobile insurance would make up only 50% of the Company's gross premiums, Ontario auto insurance alone would come to account for more than three-quarters of its premium volume in 2001. The Insurance Bureau of Canada identified soaring accident claims as the main reason for 2001 being an all-time low for industry profitability – "the single worst year ever" according to IBC's then-chief economist Paul Kovacs.**

The foregoing shows that MGIC entered the Ontario auto insurance market as a start-up at a particularly challenging time. This certainly made it more difficult for the Company to achieve success. However, tough market conditions in Ontario auto insurance do not explain why MGIC failed – especially when one considers the Company's strategy of setting aggressively low prices that it couldn't support through underwriting expertise, expense control or capital strength.

* *Thompson's World Insurance News*, March 19, 2001.
** *Thompson's World Insurance News*, March 18, 2002.

Market dislocation for policyholders

MGIC's abrupt exit from the industry caused significant dislocation for some 87,000 policyholders and for the Company's network of 90 brokers. Many of MGIC's brokers sought to transfer their books of business to another insurer as of the cancellation date. They did their utmost to facilitate the transition of coverage in an attempt to minimize the impact on policyholders. An additional challenge for brokers was the return of unearned commissions on MGIC policies.

The insurance trade and general business press carried a good deal of commentary on the issues at the time. For example, Al Chamney, owner of Mississauga-based CMD Insurance Services, said "I'm regretting my decision of going to Markham General." He added, "They were killed by their own success."[27] Mr. Chamney was one of many brokers who had to find a home for MGIC policyholders within roughly one month. Many brokers were shopping around millions of dollars of coverage.

Given MGIC's artificially low rates, brokers were hard-pressed to sell policyholders on the significant rate increases that would come with the switch in insurers. Industry observers noted that MGIC's premiums were so low that many dislodged policyholders could see increase of 20% or more with another insurer.[28] Kingsway Insurance President and CEO Bill Star said FSCO's approval of MGIC's plan to cancel policies mid-term was essentially an acknowledgement that the Company's rates were too low. He noted, "If rates were adequate, this wouldn't be necessary."[29]

Don Smith of Canadian Insurance Consultants said the timing of MGIC's market exit could not have been worse, as there were very few companies looking to grow at that time. "A year ago or possibly even a year from now a buyer for the book wouldn't have been so hard to find," he said. It was noted that a hard market and several portfolio transfers (CGU/Pilot, ING/Zurich, Kemper/Royal & Sun Alliance) had already displaced a significant amount of business. Observers also noted that MGIC's business might be viewed as questionable, making it that much more difficult to place elsewere.[30]

MGIC's decision to close was supposed to conserve enough capital to pay all loss claims and leave enough money to pay refunds on policies terminated early. That did not happen. Approximately 1,000 refund cheques averaging $300 each bounced. A few thousand more refunds were left owing. (Post-insolvency, PACICC and Facility Association responded to all eligible loss claims and unearned premium refunds of MGIC policyholders – see the sidebar titled "PACICC: MGIC liquidation outcomes.")

[27] *Thompson's World Insurance News*, April 22, 2002.

[28] *Toronto Star*, August 20, 2002.

[29, 30] *Thompson's World Insurance News*, April 22, 2002.

The Toronto Star profiled one MGIC customer who was adversely affected by the insurer's failure. Gerry Almond, then a Mississauga-based computer consultant, learned early on that he could not count on Believer Plus Insurance Brokers of Hamilton, Ontario to find replacement coverage for his family's four vehicles. "They made it pretty clear that they weren't even close to getting anyone that they could represent," said Mr. Almond. He and his wife spent four eight-hour days searching for coverage at a price close to the $5,000 a year that they had been paying for their four policies. They were quoted annual prices ranging from about $8,000 to $15,000. They eventually found coverage with RBC Insurance Company for $8,000. The $3,000 differential represented a price hike of 60%.[31]

PACICC: MGIC liquidation outcomes

As of December 31, 2011, funding for the wind-up of MGIC came primarily from general assessments totaling $22.89 million levied on PACICC member companies. PACICC does not expect to levy any further general assessments for MGIC. At year-end 2011, PACICC had funded eligible claims payments to former MGIC policyholders totaling $20.84 million – and a further $1.1 million in unearned premium refunds. (A further $12 million of claims payments was funded by Facility Association). These payments were made by the Court-appointed Liquidator, Deloitte.

Also at year-end 2011, the Liquidator was projecting an eventual recovery of 55% for PACICC as a creditor to the MGIC estate. This can also be described as a dividend of 55 cents for every dollar expended on claims payments. It should be noted that the projected dividend figure is not adjusted for the time value of money.

The projected MGIC dividend of 55% is well below that for other PACICC-funded P&C insurance liquidations. In fact, liquidation dividends recovered by PACICC across nine member-funded wind-ups average 86.5% (including the projection for MGIC). The difference of 30 percentage points reflects the greater-than-average shortfall that existed in the MGIC estate at the time of insolvency.

A decision was made by the Liquidator for MGIC – in concurrence with PACICC and Facility Association in their capacity as estate inspectors – to commence legal action against certain third parties, including the Company's former officers, directors and actuarial advisors. This action ultimately resulted in a settlement in favour of the estate that was recovered in March 2009.

[31] *Toronto Star*, May 2, 2002.

Causes of insolvency

- **Inadequate pricing –** MGIC's auto insurance products, in particular – composing about three-quarters of the Company's business – were priced aggressively. MGIC's underpricing of its auto insurance products appears to have been a strategy to attract business.

- **Deficient claims reserving –** MGIC's loss claims increased by 607% in 2001, but its reserves increased only 3.6%. The disconnection greatly understated losses as reported in the Company's 2001 financial statements.

- **Poor risk selection and underwriting –** MGIC's business plan was to have strict underwriting rules and a focus on profitability. In practice, the Company delegated much of its underwriting to its brokers. Growth in premiums became the main priority – at the expense of profitability.

- **Inadequate capital –** MGIC commenced operations with adequate initial capital, but burned through it at a rapid pace. At the end of its first full year in business, the Company was barely in compliance with FSCO's MAT requirement.

- **High expenses –** MGIC incurred almost twice the level of expenses projected in its original business plan ($27.5 million vs. $14.5 million) to achieve the same level of gross premium (approximately $82 million). The Company's inability to control expenses was a significant factor in eroding its capital.

- **Inadequate corporate governance –** MGIC's Board of Directors would have benefitted from greater independence. As noted above, there were no independent or non-affiliated Directors on the Board.

- **Over-reliance on reinsurance –** MGIC's ceded premium ranged from a low of 15% (in its original business plan) to a high of 70% prior to insolvency. Assumptions regarding ceding commissions were consistently too optimistic, amplifying the impact of incurred losses on the Company's actual financial performance.

- **Failure to stick to original business planning –** MGIC's original business plan was premised on leveraging emerging internet technology to deliver low expenses and to create a competitive advantage; to favour profitability rather than growth; and to have broker-partners as its major investors. But once the Company commenced operations, none of these planned objectives were achieved.

Ten lessons learned from the failure of MGIC

- **Start-up insurance companies deserve special supervisory attention –** FSCO was actively supervising activities at MGIC throughout the brief life of the Company due to its inherent risks as a start-up insurer. Nonetheless, in MGIC's case, these inherent risks were heightened by a fatal combination of aggressive pricing, rapid growth, high expenses, rapid burn-through of capital, under-reserving, and poor management and corporate governance.

- **Outsourcing can be risky –** MGIC outsourced several of its key functions, including underwriting (to its brokers), claims handling (to UAB) and information technology. However, the Company failed to establish effective controls in each area, which is one reason why it had difficulty controlling expenses.

- **Effective governance is essential –** MGIC's Board of Directors was composed almost entirely of related parties. The Board would have benefitted from greater independence.

- **Patient, committed capital is important –** The short-term interests of Dailey Capital may have been an inappropriate investment horizon for a start-up insurance company.

- **Early loss data may be unreliable –** The combination of MGIC being a new and rapidly-growing insurer meant that its loss experience was immature and a poor predictor of future losses. Rapid growth in premiums also led to rapid growth in loss claims – which the Company continually underestimated. Perhaps management should have been required (by the Board of Directors) to use more conservative loss assumptions. (At least until it could demonstrate a more favourable and stable track record).

- **A new insurer pricing significantly below market sends a warning –** Boards, brokers, competitors and supervisors should be skeptical of any new insurance company that attempts to price its coverage at below-market rates. In MGIC's case, the ability to support below-market prices for auto insurance was never delivered.

- **Business planning is a necessary but insufficient condition for success –** A detailed business plan is a necessary but insufficient condition for the success of a start-up insurer. In MGIC's case, the immediate and sustained divergence between planned and actual outcomes was so wide that one has to question whether the Company's business plan was ever achievable.

- **Lack of diversification concentrates risk –** MGIC's business was heavily concentrated in Ontario (97% of premiums in 2001), and more than three-quarters of that premium came from a line of business with a long history of volatile underwriting results: Ontario automobile insurance.

- **Vested capital could reduce risk –** It would be reasonable for insurance supervisors to require a "deposit" of vested capital for a start-up – at least until a new insurer could demonstrate its ability to manage risk effectively and generate positive earnings. This would not only serve as a buffer against adverse loss developments, but could more specifically put a "brake" on the potential for high losses and expenses to deplete capital.

- **Under-pricing can intensify market dislocation for policyholders –** Market dislocation for policyholders can be a significant cost when an insurer becomes insolvent – in addition to the costs paid by the industry to bridge the shortfall of assets vs. liabilities. Because MGIC had priced aggressively, thousands of policyholders were hit with a double-whammy: having their policies cancelled with little notice, and then facing substantial price increases for replacement coverage in a hardening market.

MGIC had a short and turbulent history. The uniqueness of its business plan and the leading-edge tools intended to support the plan ultimately proved to be undeveloped and not commercially viable to achieve success as a P&C insurer. Management believed the underpinnings of the business plan were both achievable and commercially reasonable. However, achieving commercial success for MGIC ultimately proved to be beyond the scope of the management team and the investors assembled.

PACICC hopes that the lessons learned from the MGIC experience, as documented in this case study, may help to prevent another insurer failure such as this from occurring.

Timeline of key events

October 27, 1997	MGIC parent company Millennium Financial Management Ltd. (MFML) is incorporated
December 1997	KPMG is commissioned to prepare five-year financial projections for MGIC
August 31, 1998	Towers Perrin Inc. suggests rate levels for MGIC's entrance into the Ontario private passenger automobile insurance market
January 19, 1999	MFML submits proposed MGIC business plan to FSCO
June 18, 1999	FSCO grants MGIC a conditional license to undertake contracts for insurance in Ontario
October 4, 1999	MGIC commences operations
May 18, 2000	MGIC Board approves 2000 Business Plan; Targets $25M in gross premiums for 2000, $98.9M in 2001 and $171.8M in 2002
January 3, 2001	MGIC's capital requirements estimated to be $16M in 2001, $8.1M in 2002 and $12.4M in 2003
February 16, 2001	KPMG reports on MGIC liabilities as at December 31, 2000 and estimates 78.4% loss ratio
May 1, 2001	MGIC raises its rates by 2.1%
June 12, 2001	MGIC Board approves a revised business plan for 2001; Premiums ceded to reinsurers increase to 70%, and 2001 capital requirements are reduced from $17M to $12.7M
October 1, 2001	MGIC raises its rates by 5.67%
December 2001	MGIC files new Ontario private passenger rates – effective February 1, 2002 for new business and March 21, 2002 for renewals

December 14, 2001	MGIC loss ratio estimate for year-end 2001 is lowered to 72.3%. (Several months later the 2001 loss ratio is reported at 94.0%)
December 17, 2001	MGIC acknowledges losses of $6.7M as at October 31, 2001; Forecasted year-end loss ratio is 75.5%; Combined ratio is approximately 4% higher than plan; $11M in additional capital is required in 2002 to support target of $125M in gross premiums

January 15, 2002	MGIC is not compliant with required MAT margin of 110%
February 11, 2002	MGIC advises FSCO that it did not meet the MAT test as of the end of 2001; FSCO directs MGIC to be MAT compliant by February 28, 2002
February 14, 2002	MGIC advises brokers that it is suspending all new personal lines business effective immediately
February 27, 2002	FSCO restricts MGIC's ability to accept new business
April 15, 2002	MGIC is authorized by FSCO to cancel all in-force insurance policies and to refuse any new insurance contracts
May 4, 2002	MGIC notifies its policyholders that all in-force policies will be cancelled effective June 15, 2002 at 12:01 a.m.
July 19, 2002	MFML files for bankruptcy
July 24, 2002	MGIC is ordered to be wound-up pursuant to Canada's *Winding-up and Restructuring Act*

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