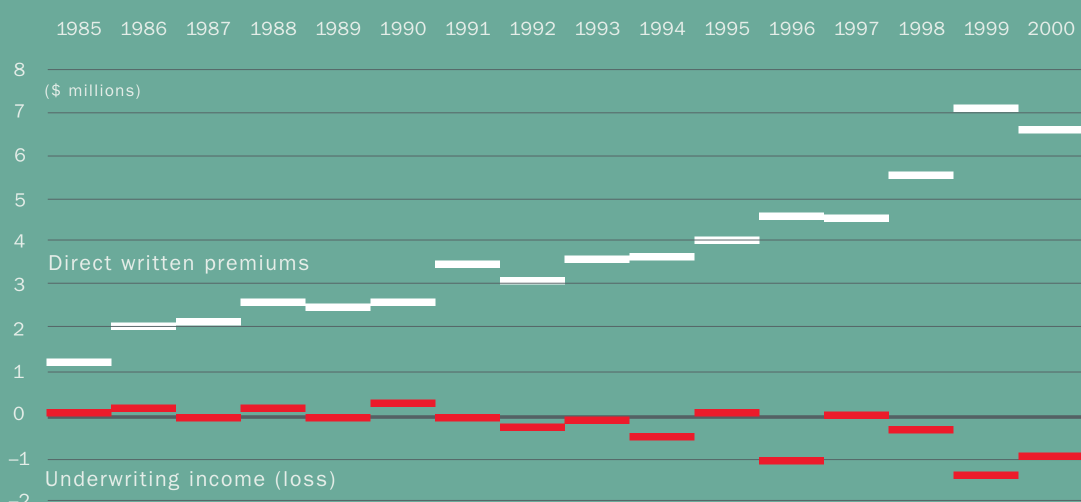
PACICC
Property and Casualty Insurance Compensation Corporation
Société d'indemnisation en matière d'assurances IARD

Why insurers fail

Lessons learned from the failure of Canadian Millers' Mutual Insurance Company

Canadian Millers' Mutual Insurance Company
SINCE 1878



By

Jim Harries

2014

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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 information provided to PACICC for this study by the Court-appointed Liquidator for Canadian Millers' Mutual Insurance Company, KPMG Inc. This information was provided to PACICC in its capacity as Inspector to the Canadian Millers' estate. Amra Porobic, Manager, Library Services for the Insurance Bureau of Canada, and Grant Kelly, PACICC's Vice President of Financial Analysis and Regulatory Affairs, also provided valuable assistance.

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

Introduction

Canadian Millers' was a small mutual insurance company, established in 1878, and based primarily in Ontario. After a series of large loss claims that began in the 1990's – coupled with increasing difficulties obtaining reinsurance coverage on favourable terms – the Company became insolvent and was ordered to be wound up by the Superior Court of Justice on the application of its regulator, the Financial Services Commission of Ontario, on December 7, 2001.

Canadian Millers' was primarily a commercial insurer – licensed to write commercial property and liability insurance. Its focus was on agri-business, insuring owners of feed mills and farming operations from medium size to large-scale. While the Company conducted some of its business through brokers, it was a direct writer in many of its markets until the mid-1990's. As a mutual insurer, Canadian Millers' policyholders were the "owners" of the Company. Canadian Millers' officers and directors were responsible for ensuring that the Company operated within the bounds of its available capital – and that the Company was profitable and able to increase its capital. Members of the Company's Board of Directors – generally six or seven members through the 1990's – were also policyholders, elected to their positions by the larger membership.

After 123 years in business, Canadian Millers' was hardly a start-up insurer. To stay in business that long, the Company had demonstrated that it could be successful as a niche insurer. So, what changed in Canadian Millers' last few years in business to render the Company insolvent? That will be our main focus in this case study. As we will see, a combination of factors led to Canadian Millers' demise, including:

- poor underwriting and risk selection
- large and volatile loss claims – and deficient loss reserves
- high expenses coupled with rapid growth – particularly in its last two years in business
- loss of business to competing insurers
- high reinsurance costs – and a tendency to use reinsurance as a substitute for capital
- insufficient capital.

Much of the source material for writing this case study comes from the Company's own records – minutes of Board of Directors' meetings, in particular – as well as public financial reports produced by TRAC and A.M. Best. Company records were used by permission of the Court-appointed Liquidator (KPMG). This information was supplemented by author interviews with a number of key stakeholders involved in or associated with the operations of the Company.

As with previous PACICC case studies of insolvent insurers, we identify a number of lessons to be learned from the failure of Canadian Millers'. These lessons are summarized below. (See also pages 23 and 24).

- **Deficient capital** – Canadian Millers' experience shows how this can be more of a problem for a mutual vs. a stock company. The primary source of capital growth for mutual insurers is through retained earnings – and if you are not a profitable insurer – where does the capital come from? Canadian Millers' became so desperate for capital by 1999-2000 that the Company was prepared to consider strategies that had nothing to do with its core business – like owning an insurance brokerage or entering the automobile insurance business.
- **Minimum capital** – While the minimum capitalization was $3 million for a P&C insurer incorporated and supervised in Ontario at the time Canadian Millers' failed, the Ontario Insurance Commission had told the Company in 1994 they needed $5 million in capital "to survive and compete." But the regulator had no way to compel Millers' – as a riskier-than-average insurer – to accumulate greater minimum capital. In retrospect, had those powers been available to the regulator, insolvency might have been avoided.
- **Governance** – At times, Canadian Millers' Board of Directors appeared to be in a near conflict-of-interest position. On the one hand, they were charged with maintaining the financial health of the Corporation. On the other hand, as policyholders themselves, they were reluctant to recommend the cancellation of clearly unprofitable business. As a Corporation, Canadian Millers' should have been clearer about the duties of its Directors.
- **Premium growth** – Canadian Millers' expanded its premiums rapidly in 1998-99 – at about 25 percent per year. This was not the kind of "controlled growth" the Company stated as its objective. Basically, Canadian Millers' went from a premiums-to-capital ratio of 1:1 before 1995, to a 2:1 ratio a few years later. This added "leverage" was risky – and it is not clear why the Board allowed it.
- **Claims** – The risks being insured by Canadian Millers' had a volatile loss experience. While some of this may have been inherent with large agri-business risks, we conclude that the Company could have done more to mitigate the losses incurred.
- **Expenses** – Canadian Millers' expense ratios were well above the industry average in the 1990's. Broker commissions were rising as a share of expenses after 1995, and reinsurance costs added to the Company's expenses after 1997. When Canadian Millers' needed to trim costs, their business model and operations gave them little room to maneuver.
- **Reinsurance** – It is unusual for a Company to change reinsurance programs as often (and as radically) as Canadian Millers' did after 1996. In retrospect, these frequent program changes – coupled with unrealistic budgeting for net reinsurance results – were a warning sign of financial instability. Canadian Millers' essentially ran out of options for reinsurance on competitive terms by 1997-98.

- **Underwriting authority** – Good risk selection is vital. When Canadian Millers' was primarily a direct writer of agri-business risks in the 1980's, and into the early 1990's, the Company had a better loss experience. Its performance deteriorated in the second half of the 1990's – as underwriting authority was delegated to brokers without adequate guidance and controls.
- **Strategy** – Departing from an established business strategy can be risky. The demonstrated expertise of Canadian Millers' was in agri-business, not in forest products or other supposedly "rural" risks the Company accepted in its desire for premium growth in its last few years in business. Had Canadian Millers' "stuck to the knitting" of covering only agri-business risks – and kept its premium volume in line with its capital – it is possible that the Company might still be in business.

Financial performance

In this section, we focus on Canadian Millers' financial performance in the 16-year period prior to the Company becoming insolvent – from 1985 to 2000. (Because Canadian Millers' was ordered into wind-up in 2001, full-year financials for its last year in business are not available).

Information on Canadian Millers' financial performance prior to 1985 is sparse. The Company did operate over long period of time, extending back to 1878, and survived through the Depression, two world wars and a number of other challenges. We understand that the Company's capitalization grew from $700,000 in 1973 to $3.6 million in 1992. This shows that the Company was able to increase its capital through profitable performance – by five-fold, in fact, over a period of 20 years.[1]

The seeds of Canadian Millers' insolvency were sown in the heavy loss years of 1996 and 1999. Looking back to the late 1990's, it is difficult to imagine what could have saved the Company from eventual failure.

We make the following observations: Prior to 1990 – Canadian Millers' Mutual was a stable and profitable niche player competing in Canada's insurance industry. When required, they sold investments to cover bad underwriting years.

The evidence:

- Between 1985 and 1989 Canadian Millers' average combined ratio was 94.1 percent. This compares to 108.5 percent for the industry. (For this section, please refer to the charts on pages 7 and 8)
- This was due to superior underwriting. Their loss ratio over this period was 61.6 percent. By comparison, the industry loss ratio was 77.5 percent
- Canadian Millers' return on equity (ROE) over this period was 15 percent. The industry ROE was 13 percent
- Canadian Millers' expenses and investment returns from 1985 to 1989 were in line with the industry average
- This period of profitability allowed the company to grow its capital base 11.6 percent annually. The industry's capital grew by 12.2 percent over this period.

In poor underwriting years, Canadian Millers' reduced invested assets to cover higher claims costs. This allowed the Company to "weather the storm" at least twice before they ultimately became insolvent.

- Canadian Millers' combined ratio in 1986 was 80.3 percent. In 1987, it jumped to 104.8 percent. Invested assets dropped by 1.3 percent.
- Canadian Millers' had a rough year in 1989. Their combined ratio rose more than 20 percentage points from the previous year, to 109.6 percent in 1989. It dropped again to 90.3 percent

[1] Information provided by Donald Cruickshank, an employee of Canadian Millers' from 1974 to early 1994. (Mr. Cruickshank served as Millers' General Manager during the last five years of this period).

in 1990. This was interesting because the Company's response was to sell one-third of its investment portfolio. Invested assets dropped by 34 percent in 1989. But Canadian Millers' had a good underwriting year in 1990, and invested assets rebounded by 44.2 percent.

Over the period 1985 to 1989 Canadian Millers' had more good years than bad. Invested assets grew by 18.4 percent.

Between 1990 and 1994, Canadian Millers' was an average performer by industry standards.

- Between 1990 and 1994, Canadian Millers' average combined ratio was 109.3 percent compared to 109.8 percent for the industry.
- They remained a superior underwriter in liability insurance. Their loss ratio over this period was 69.1 percent compared to 77.6 percent for the industry. (It is possible that some of this advantage was due to being under-reserved).
- But Canadian Millers' was a below-average underwriter in commercial property with a reported loss ratio of 77.3 percent compared to 67.1 percent for the industry.
- Expenses at Canadian Millers' were relatively high, averaging 40.2 percent from 1990 to 1994, compared to an industry average of 32.2 percent.
- Canadian Millers' return on equity (ROE) was 8.6 percent from 1990 to 1994, roughly equal to the industry's ROE of 8.8 percent.
- Canadian Millers' investment returns were in line with the industry average during this period.
- The Company grew its capital base 8.4 percent annually from 1990 to 1994, compared to 4.9 percent for the industry.

After 1995, Canadian Millers' had five bad years in a row, and the old strategy of selling investments to cover a bad claims year was not sustainable.

After 1995, Canadian Millers' had five bad years in a row, and the old strategy of selling investments to cover a bad claims year was not sustainable. While Canadian Millers' last five full years in business were difficult ones, two years stand out as particularly bad: 1996 and 1999. The Company had considerable difficulty trying to recover from the large losses incurred in 1996 and 1999.

- Between 1995 and 1999, Canadian Millers' combined ratio averaged 135.7 percent compared to 104.8 percent for the industry.
- Canadian Millers' loss ratio over this period averaged 85.4 percent compared to 73.0 percent for the industry.
- Canadian Millers' remained a below-average underwriter in commercial property with a reported loss ratio of 79.4 percent compared to 69.8 percent for the industry.
- The Company lost its advantage in commercial liability underwriting. Their loss ratio averaged 94.6 percent from 1995 to 1999 compared to 76.3 percent for the industry.

- Canadian Millers' expenses remained much higher than the industry average over this period. The average industry expense ratio was 31.8 percent. At Canadian Millers', the average expense ratio was 50.3 percent. (A deliberate expansion of broker-generated business during this period – in an attempt to grow premiums – contributed to the higher expenses incurred). Investment returns were in line with the industry average.
- Canadian Millers' capital base eroded by 7.4 percent annually from 1995 to 1999. It should be noted that the decline in capital was not smooth (See chart on page 8). The industry's capital grew 6.5 percent annually over this period. Of course as a mutual, no additional capital could be injected, as is the case with stock insurers.

Up to 1995, Canadian Millers' direct premiums were more or less aligned with its total capital – close to a 1:1 relationship. From 1996 on, this relationship diverged, peaking in 1999 when the Company's direct premiums were 2.3 times greater than its total capital.

Up to 1995, Canadian Millers' direct premiums were more or less aligned with its total capital – close to a 1:1 relationship. From 1996 on, this relationship diverged, peaking in 1999 when the Company's direct premiums were 2.3 times greater than its total capital. As Canadian Millers' premiums grew rapidly in this period – especially in 1998 and 1999 – capital failed to keep pace; in fact, the Company's capital declined in both years. In 1999, the Company had $7 million in direct premiums and only $3 million in capital. This was less than half the capital required to meet the Company's long-term performance of having a dollar of capital in place to support each dollar of premiums written.

Early-warning solvency tests

Between 1985 and 1989, Canadian Millers' passed at least seven of the eight "early-warning solvency tests" reported on by TRAC (later A.M. Best) in every year over this period. The only "warning sign" was premium growth in excess of 33 percent for two years: 1986 and 1988.

Canadian Millers' passed all eight solvency tests in 1990 and 1991. In 1992, the Company failed the two-year underwriting test; and in 1993, they failed both the two-year underwriting test and the change in premiums test.

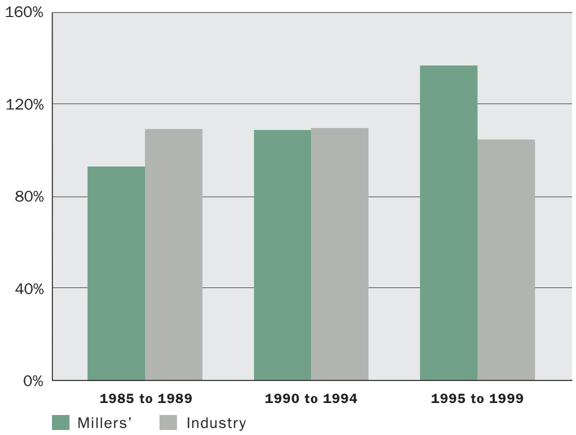
In 1995, there was a significant increase in the amount of information disclosed about the financial performance of all insurers, including Canadian Millers'. In particular, the results of the Minimum Asset Test (MAT)[2] were made available for the first time. In 1995 and 1996, though Canadian Millers' experienced poor financial results, the Company's MAT score remained between 80 and 90 percent. The regulatory minimum was 10 percent. Based on this increased information, Millers' appeared troubled, but remained solvent.

The first public warning sign that Canadian Millers' was experiencing serious financial issues occurred in 1997, when the Company failed to disclose its financial results for industry publication.[3] While the Company did file financial results with its regulator, these results were not made public. In 1998, the company resumed the normal practice of sharing its financial data, and reported a MAT score of 98.8 percent while posting a small loss. In 1999, as problems escalated, Canadian Millers' MAT score dropped more than 70 points to 21.2 percent, and the Company was never able to recover.

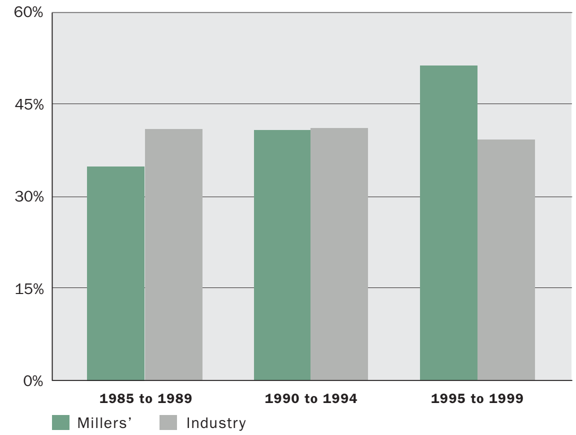
[2] This was the precursor to the current Minimum Capital Test. (The MAT score was calculated as the ratio of total assets to total liabilities).

[3] PACICC was able to generate some financial ratios for Canadian Millers' for 1997 by using the Company's audited financial statements – as provided to us by the Court-appointed Liquidator, KPMG Inc.

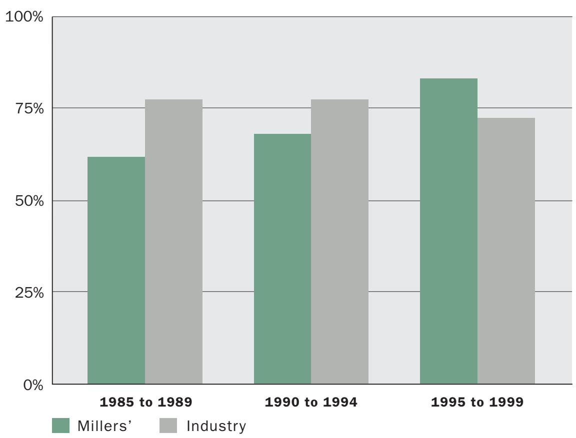
Combined ratios



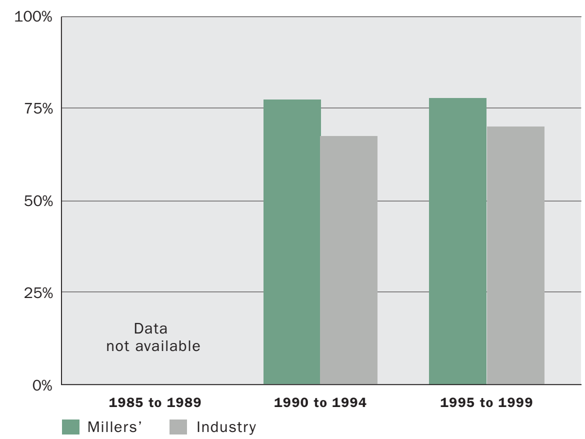
Expense ratios



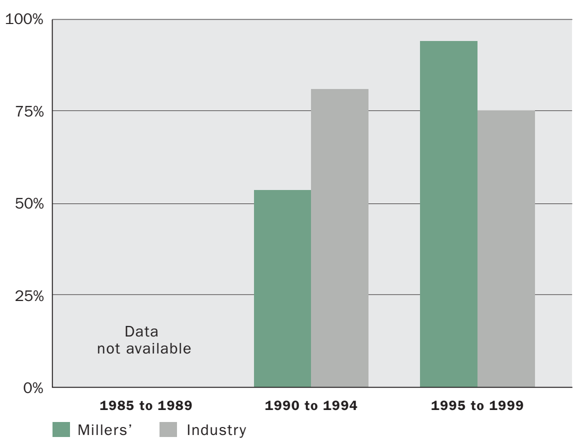
Loss ratios



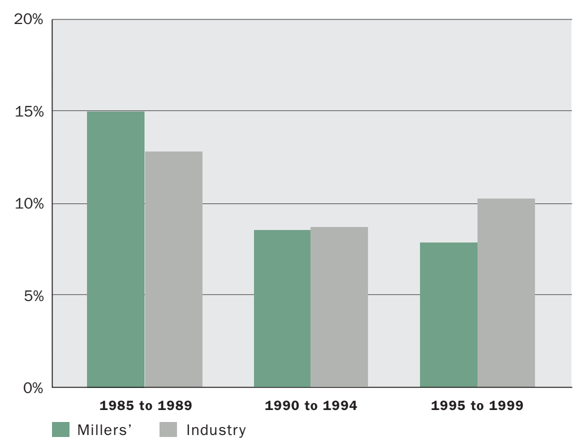
Commercial property loss ratios



Commercial liability loss ratios

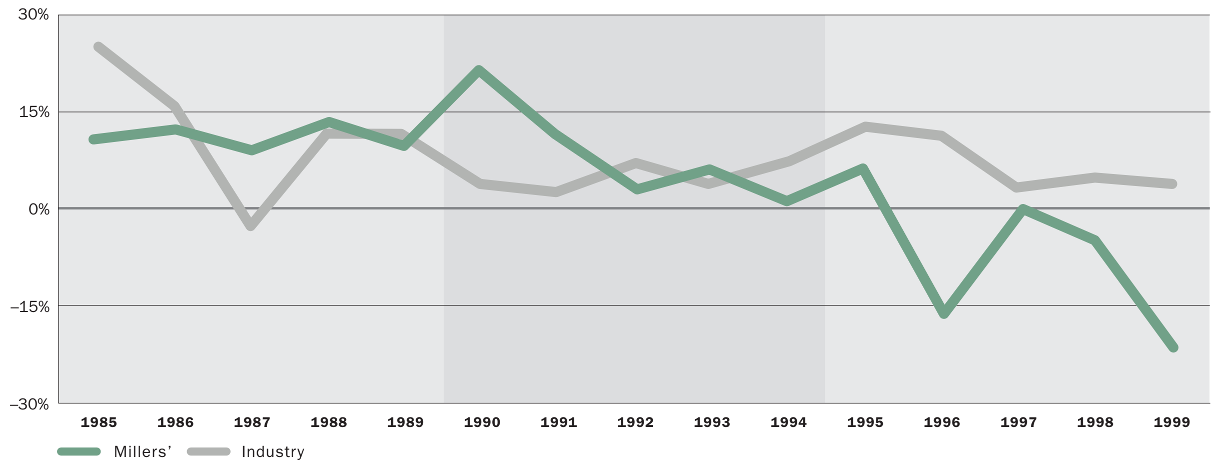


Return on equity

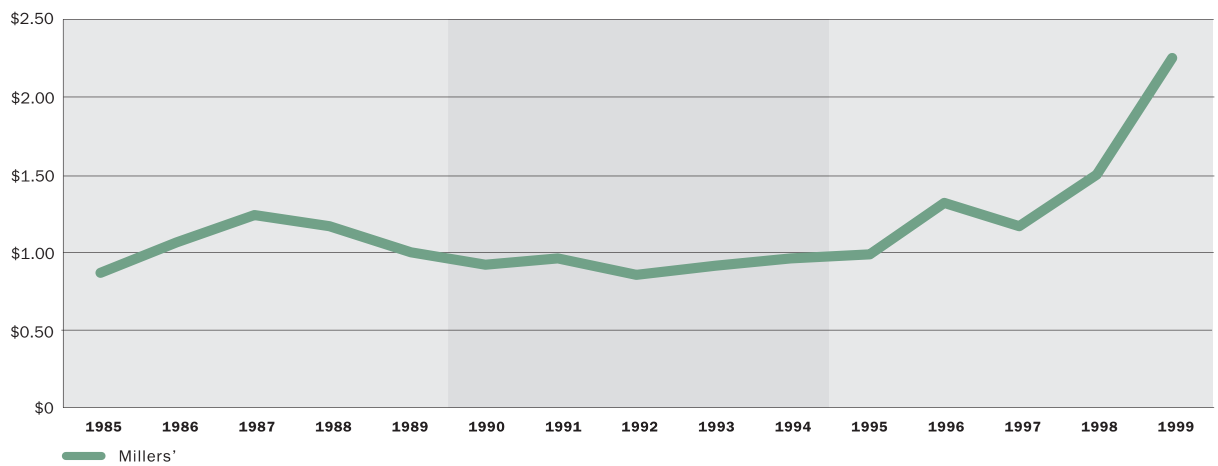


Source for all charts on this page: PACICC based on data from IBC and MSA Research

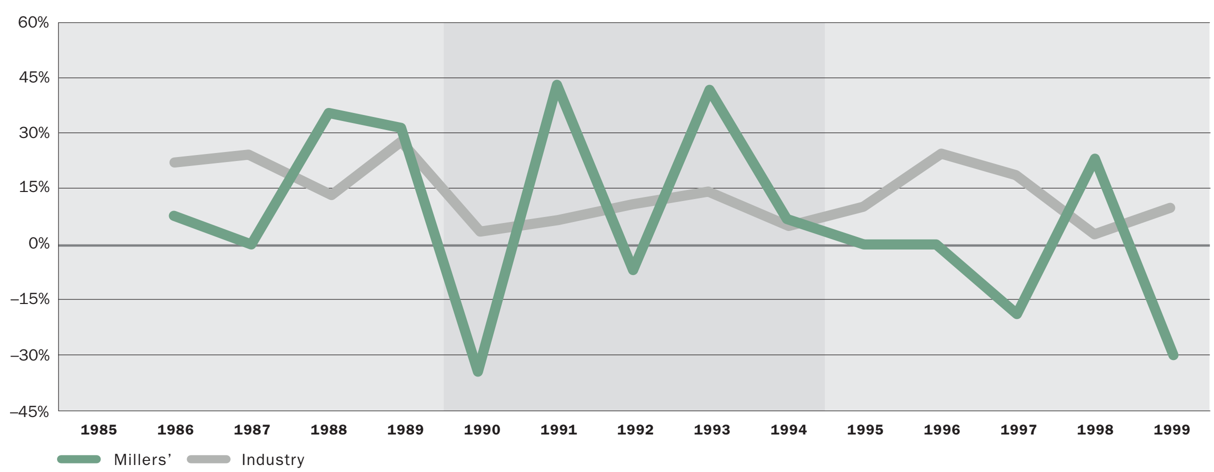
Growth in capital



DWP per dollar of capital



Growth in invested assets



Source for all charts on this page: PACICC based on data from IBC and MSA Research

Underwriting, risk selection and claims

In this section, based on an examination of the Company's own records, we are able to make several observations about the nature of the loss claims that ultimately dealt a fatal blow to Canadian Millers'. It is instructive to look back at how Canadian Millers' described its own strategic plan in 1996 (this being the first of several years of large losses that eventually rendered the Company insolvent). The strategic plan was presented to the Board by the General Manager.[4] Here are some excerpts from the 1996 strategic plan that address Canadian Millers' approach to underwriting:

- "We will continue to underwrite new and renewal business in a conservative manner, selecting only the better types of Agri-related risks."
- "Well-known and rural established brokers are being contacted on a selected basis to assist in our controlled growth."
- "No new products are anticipated at this time."
- "Our rates and policy forms continue to follow the majority of our competitors."
- "With the addition of Robert Brewitt, F.I.I.C., to our staff (as Assistant General Manager), we look forward to additional growth, particularly out of province." (Meaning, outside of Ontario – *author's note*).
- "Inspections of new and renewal risks continue to be a priority."
- "Premium volume increase for 1996 is budgeted at $675,000." (This would represent an increase of 16.6% from Millers' 1995 direct premium of $4.1 million – *author's note*).
- "We continue to strive for writing of $5 million [in premiums] without lowering our standards to do so."

"We look forward to additional growth, particularly out of province."

"We continue to strive for writing of $5 million [in premiums] without lowering our standards to do so."

We've referred to the 1996 strategic plan not only because this was a critical point in the Company's history, but also because we could find no other document that might have altered these stated objectives (save for a marketing plan prepared for the Company by a consultant in May 1999).

How well did Millers' adhere to these stated strategic goals? Consider the following points.

- Could 16 percent be regarded as "controlled" annual premium growth? If so, then 25 percent per year – which occurred in two successive years for Canadian Millers', in 1998 and 1999 – certainly was not.
- In January 1999, the General Manager's report to the Board of Directors contained the following statement: "Although our primary focus is agri-business, it does not mean that we cannot grow through other rural types of risks. As well, growing across Canada provides geographic diversification. Homeowners, farm-related business – tiling contractors, wood products

[4] Robert Lovell was appointed as Canadian Millers' General Manager in early 1994; he retired in October 1997 and was succeeded by Robert Brewitt.

manufacturing, penning and stabling contractors, building contractors, etc." *This represented a change in Canadian Millers' strategy compared to what was articulated three years earlier*. In effect, it said that the Company was prepared to move outside of its established niche – feed mills and hog/poultry producers – in order to grow its premiums.

- In 1995, Ontario accounted for 61 percent of Canadian Millers' premiums. By 1999, the Ontario share had dropped to 56.5 percent. The Company was under pressure from competitors – primarily North Waterloo Farmers' Mutual – and had lost a number of large accounts.[5] This lost business was largely replaced by rapid growth of premiums in New Brunswick and in the four Western provinces. Premium growth in these five provinces – between 1998 and 1999 – ranged from a low of 19 percent (Manitoba) to a high of 336 percent (British Columbia). How could Canadian Millers' maintain that it was "controlling" this growth?
- In May 1999, the Canadian Millers' Board received a Marketing Plan that strongly recommended a strategy of "appointing strong supporting brokers" with the goal of "increasing the volume of business written."[6] Since most of the Company's direct writing was done in Ontario, high rates of premium growth recorded in other provinces suggests that the use of brokers – and the delegation of underwriting authority to those brokers – was on the rise in Canadian Millers' last few years in business.
- On the matter of risk inspections, they appear to have been conducted periodically – partly by Canadian Millers' staff and partly outsourced. However, a former corporate officer at Canadian Millers'[7] told PACICC that many of the mill and commercial farm properties insured by the Company were older wood-frame structures, often without modern dust-collection systems. Regular reporting to the Board showed that fire losses were a frequent source of new claims. These were often large losses for an insurer with total capital of only $3 to $3.5 million. For example, a fire in 1996 resulted in a loss claim of $768,000 – and there were numerous other fire losses of a similar magnitude around this time. There is also some suggestion that risk inspections may have lapsed during 1999. In fact, the General Manager asked the Board to "revisit the issue of risk inspections." The Board minutes further state: "We have not budgeted for hiring a new Risk Inspector. [Our current risk inspector] is not interested in working full time. Perhaps we should consider having [our current risk inspector] train someone for us. After some discussion, the matter remained unsettled."[8]

Canadian Millers' had some good years, but its loss results often deteriorated sharply from one year to the next. When good results were achieved, was it due more to good luck than to good underwriting?

The foregoing points shed some light on Canadian Millers' approach to underwriting. It is clear that the Company was insuring volatile lines of business – not simply commercial property and liability, but the actual feed milling and farming risks they assumed. This can be seen in the loss ratio, which varied from as low as 25.0 percent to as high as 148.1

[5] During 1997, for example, Board reports show that Canadian Millers' lost large accounts worth $367,000, or 8.2 percent of its total premium income at the time. Also, Canadian Millers' Board minutes of August 27, 1998 make reference to "significant discounts" being given by the Company to "maintain business."

[6] The Marketing Plan was prepared by an external consultant and dated May 1999.

[7] Mr. Dean Bast, now Vice President National Distribution Management at The Guarantee Company of North America.

[8] Minutes from the Canadian Millers' Board of Directors meeting held on May 20, 1999. By December 1999, regular risk inspection reports started to be received by the Board.

percent between 1985 and 2000. Canadian Millers' had some good years, but its loss results often deteriorated sharply from one year to the next. When good results were achieved, was it due more to good luck than to good underwriting?

In the remainder of this section, we examine Canadian Millers' claims experience in greater detail. Around August 1997, a detailed loss report by client was prepared by staff for the Board of Directors. Over the previous four years, the report showed 105 policyholders with accumulated losses greater than the premiums they had paid – sometimes substantially so. Ranked by size of loss of the previous four years, the 163 largest "loss-producing" Millers' policyholders yielded these totals:

Number of losses in 4 years	**Total incurred loss in 4 years**	**Actual premiums paid over 4 years**	**Premiums paid minus losses incurred over 4 years**
579	$18,386,259	$8,611,525	($9,774,735)

From this same report, we list below the 10 largest "loss-producing" Canadian Millers' policyholders. These 10 policyholders accounted for 21 percent of Millers' large loss claims by volume between 1993 and 1997; and 50 percent measured by dollar amount over the same four-year period. Individual loss ratios for this group of policyholders ranged from a low of 127.4 percent to a high of 3,204.1 percent. The example shows how a relatively small number of Canadian Millers' policyholders produced very large losses – and were a significant drag on the Company's profitability. It also suggests that more could have been done on the

Policyholders	**Number of losses 4 years**	**Total incurred loss 4 years ($)**	**Actual premium paid 4 years ($)**	**Premium paid minus incurred loss 4 years ($)**	**4-year loss ratio**
A	8	2,059,146	434,711	(1,624,435)	473.7%
B	2	1,925,991	60,111	(1,865,880)	3,204.1%
C	22	1,165,975	588,514	(577,161)	198.0%
D	1	768,466	57,798	(710,668)	1,329.6%
E	6	694,783	545,509	(149,274)	127.4%
F	2	651,756	53,023	(598,733)	1,229.2%
G	2	574,500	100,769	(473,731)	570.1%
H	3	523,267	101,116	(422,151)	517.5%
I	65	496,785	374,450	(122,335)	132.7%
J	2	431,595	89,304	(342,291)	483.3%
Total	**113**	**$9,292,264**	**$2,405,305**	**($6,886,659)**	**386.3%**

underwriting side to mitigate these losses. At the time this four-year claims report was prepared, 8 of the 10 policyholders listed were still covered by Canadian Millers'; only two of the 10 policies were no longer in force (and it is not clear whether they simply lapsed or were cancelled).

After the heavy losses suffered by Canadian Millers' in 1996, the Company's performance briefly improved in 1997, and then went from bad to worse. This coincided with the rapid expansion of premiums in 1998 and 1999. It is interesting to note that Canadian Millers' management reports to the Board at this time frequently mention strong premium growth as a positive development – as if this growth was the solution to the Company's problems.[9] These reports seemed to overlook the fact that written premium doesn't fully become "earned" until the policy year concludes with a favourable loss experience. Unfortunately, "growing your way out of problems" is a frequently-adopted "strategy" of troubled financial institutions. (For example, the Canadian Commercial Bank and the Northland Bank – both of which failed in 1985 – advised Canada's Inspector General of Banks that this was their strategy for dealing with their issues).

Unfortunately, "growing your way out of problems" is a frequently-adopted "strategy" of troubled financial institutions.

The following comment, also made in the General Manager's report to the Board of Directors on October 28, 1999, sheds some light on Canadian Millers' approach to underwriting and its frequently volatile loss results:

> "Unfortunately, our luck ran out in the first two weeks of October. A house fire in Eastern Ontario, for about $300,000, a major theft in Vancouver for about $75,000, and a fire in Alberta for about $1,000,000 has made a major impact on our loss experience. Although three losses totaling close to $1.4 million is not significant to many insurers, our small volume takes quite a hit. This size of loss adds 20.0 basis points to our loss ratio… The loss in Alberta has, at this stage, possibly cost us our bonus commission on reinsurance. The reinsurance bonus was calculated using a 53.5% loss ratio as a break-even point.[10] The Alberta loss was about 82% reinsured on surplus treaty. As well, the excess treaty will also have to pay. So, this is the type of loss we pay heavy reinsurance dollars for."

Of course, an insurer's losses can be mitigated to some extent by a properly designed reinsurance program. We will have more to say about Canadian Millers' reinsurance arrangements and results in the next section.

Late in Canadian Millers' corporate lifespan, the Company underwrote a portion of a commercial property insurance policy for a New Brunswick-based forest products company. Canadian Millers' accepted 10 percent of a total insured value of $30 million on a subscription basis. Unfortunately,

[9] For example, the General Manager's report to the Board dated October 28, 1999 stated: "We fully anticipate that we are laying a solid foundation to achieve a volume of $10,000,000 within two years." Within two years, in fact, Millers' was on the eve of insolvency. The Company's Board and management were silent on how they planned to raise the additional $6 to $7 million of capital that would have been needed to support premium volume of $10 million.

[10] In fact, Canadian Millers' finished 1999 with a loss ratio of 106.6 percent – basically twice as high as the "break-even point" referred to by the General Manager.

this particular forest products company suffered a total loss due to fire in 2001, resulting in a claim of $3 million against Canadian Millers' (by far the largest claim experienced by the Company).[11] Remember that Canadian Millers' total capital at year-end 2000 – its last full year in business – was only $3.26 million. We conclude this section by observing that Canadian Millers' – a small insurer with limited capital resources and a history of specializing in agri-business risks in the rural Ontario market – had assumed substantial risks in different parts of the country and in a type of business with which the Company was not familiar.

How PACICC-covered Millers' claims compared to other liquidations

At the time of Canadian Millers' insolvency in December 2001, the Court-appointed Liquidator had about 194 outstanding claims to adjust. There were 32 casualty claims and 162 property insurance claims. PACICC paid a total of $5,239,432 to settle these claims – which averages to about $27,000 per claim. This is the highest average claim that PACICC has paid on any of the member insurer insolvencies it has handled. The only other commercial insurer insolvency to which we could compare Millers' would be Quebec-based GISCO, which failed in 2000. PACICC paid $4,416,580 to settle 659 claims in the GISCO estate – averaging $6,700 per claim. While we make no comparison regarding the types of commercial risks underwritten by both insurers, the average post-insolvency payout for Millers' was four times that of GISCO.

At the time of writing this case study, it appears that the final dividend received by PACICC, as the major creditor in the Millers' liquidation, will be approximately 70 cents on the dollar. So, notwithstanding the time value of money, there was approximately a 30 percent shortfall in the Millers' estate when all claims were settled. This shortfall was covered by PACICC member companies.

[11] Prior to being ordered into liquidation, Canadian Millers' management took the position that the broker did not have binding authority and that Canadian Millers' was not aware of the forest products company risk in question until the loss occurred. (In our opinion, this position illustrates how little control was actually being exercised by Canadian Millers' over its underwriting). Post-insolvency, the Court-appointed Liquidator for Millers' (KPMG Inc.) determined that this particular claim was indeed admissible. (PACICC paid up to its $250,000 limit, with additional monies coming from the estate).

Reinsurance: running out of options

As a small mutual insurer, writing larger accounts than common for a company of its size, Canadian Millers' was heavily dependent on reinsurance. But this dependence grew significantly after 1994 when Canadian Millers' decided to leave the Farm Mutual Reinsurance Plan (FMRP). Prior to 1973, we understand that Canadian Millers' did not use reinsurance in any form.[12] By the mid-1990s, however, the Company was, in effect, using reinsurance as a substitute for the capital needed to support rapid growth in premiums. The Ontario regulator advised Canadian Millers' in the mid-1990's that they needed minimum capital of $5 million "to survive and compete in the current market."[13] As a mutual, Canadian Millers' only practical option was to increase its capital through retained earnings. The largest amount of capital they managed to accumulate was $4.1 million at year-end 1995. Unfortunately, the Company's capital fell 16.7 percent in 1996 due to heavy losses. After a brief rise in 1997, Canadian Millers' capital trended back toward the $3 million regulatory minimum for their remaining years in business.

We pick up the story in 1996, when Canadian Millers' was on the verge of changing its reinsurance program for the second of five times in its last eight years in business. (See the accompanying timeline). Reinsurance arrangements can be complicated. For purposes of this case study, we will not attempt to analyze or compare the details of the reinsurance programs listed on the timeline.

Canadian Millers' Mutual Insurance Company: Reinsurance Timeline

1985 to 1994	1995	1996	1997	1998	1999	2000	2001
Direct with FMRP	Alexander Howden*	Alexander Howden	BEP*	BEP (extended to March 1, 1999)	Direct with ERC	PWS Canada (as of July 1, 2000)	PWS Canada

*Both Alexander Howden and BEP International were later acquired by AON Re

Suffice to say that Canadian Millers' general approach to reinsurance during this period was to cede premium to reinsurers on a quota share basis, supplemented by an excess of loss reinsurance treaty, and finally, to utilize facultative reinsurance for writing larger individual risks. In 1996, for example, Canadian Millers' ceded 25 percent of its direct premiums to reinsurers and received 25 percent of this amount back as a ceding commission.[14]

[12] Based on information provided by former Canadian Millers' General Manager Don Cruickshank.

[13] Letter dated October 6, 1994 addressed to Canadian Millers' then President (Board Chair), from Mr. Jai Persuad, Principal Examiner, Ontario Insurance Commission.

[14] The larger the ceding commission, the greater the benefit to the primary insurer. For the records examined in this case study, Canadian Millers' ceding commission was never greater than 25 percent, and was as low as 12 percent in the late 1990's. In 1996, Canadian Miller's expense ratio was 41.6 percent, so a 25 percent ceding commission covered only a small portion of expenses. In August 1997, OIC made the following comment: "The quota share treaty carries a flat commission rate of 25 percent, a figure that is low by industry standards and usually found at the minimum end of a sliding scale commission. We recommend that the company pursue a sliding scale commission similar to the one negotiated on the 1997 surplus treaty (minimum 24 percent at 70 percent loss ratio or more, to a maximum of 41 percent at 44 percent loss ratio)." *Exit meeting notes*, OIC, August 7, 1997, page 7.

Evidence suggests that this arrangement produced net benefits for Canadian Millers' – at least for a while. For example, a cost-benefit exhibit produced by Canadian Millers' reinsurance broker in mid-1996 contained the following figures:[15]

Cost-benefit analysis of Canadian Millers' 1996 reinsurance program (as of July 5, 1996)

	Cost ($)	Benefit ($)
Annual excess reinsurance premiums payable (@75%)	1,181,250	
Semi-annual premiums ceded to quota share (@25%)	341,527	
Excess reinsurance loss recoveries (@75%)		1,999,751
Reduction in excess premiums payable (from 100% to 75%)		393,750
Quota share loss recoveries		901,982
Commissions received from quota share reinsurers (@25%)		115,364
Totals	**$1,522,777**	**$3,410,847**
Net gain for Canadian Millers'	**$1,888,070**	

Because 1996 turned out to be a year of heavy losses for Canadian Millers', the Company's reinsurance arrangement, as outlined above, allowed it to remain in compliance with regulatory minimum capital. In effect, the 16.7 percent drop in the Company's capital in 1996 would have been worse in the absence of reinsurance. But how sustainable was this arrangement? As Canadian Millers' reinsurance broker Gordon Crutcher reminded the Board of Directors in late 1996: "The losses of 1996 would set the stage for the 1997 reinsurance program."[16] In other words, Canadian Millers' reinsurers would be seeking some adjustments to compensate for the losses they had borne. What would those adjustments look like for Canadian Millers'? We'll never know for sure, because the Company's Board and management decided to make another change to their reinsurance program – quite a radical change in this case.

... the 16.7 percent drop in the Company's capital in 1996 would have been worse in the absence of reinsurance.

The "radical" component of the BEP program was a high level of ceded premium (75 percent). In practice, however, the premium cession turned out to be much higher than 75 percent. This caused concern for Ontario's insurance regulator.

Late in 1996, Canadian Millers' began discussions with reinsurance broker BEP International (later acquired by AON Re) with the goal of creating a "better" reinsurance program for the Company – in particular, a program that would allow Canadian Millers' some breathing room to rebuild its capital. That was the theory, at least. The "radical" component of the BEP program was a high level

[15] Information supplied by Gordon Crutcher, then Senior VP with Alexander Howden.

[16] As recorded in the minutes of Canadian Millers' Board of Directors meeting on September 4, 1996.

of ceded premium (75 percent). In practice, however, the premium cession turned out to be much higher than 75 percent. This caused concern for Ontario's Insurance regulator (OIC), who commented:[17]

> "The net written premium to date in 1997 is less than 6% of direct premiums written. Our guideline on premium retention is a minimum of 25%. We were prepared to allow less retention in 1997 because of the company's need to smooth results and steadily rebuild surplus, but an excessive utilization of the surplus lines treaty has dropped the company's retained premiums to an unacceptably low level. Such low retention levels are inconsistent with sound underwriting practices. We recommend that management review the use of the surplus lines treaty."

Reinforcing the OIC's view, consider the following:[18]

> "It is recommended that [the] minimum retention level be set at 25% or higher. Regulators may choose to allow new companies to retain a smaller proportion in the first few years of operation but they should steadily raise the retention to the 25% level. If a company proposes to retain a lesser percentage, it is seeking to operate as a broker and not as an insurer."

Likely without intending to do so, Millers' became more of a broker than an insurer under the BEP program. So, why did Millers' Board and management accept the BEP reinsurance program without asking more questions about its possible implications? (Especially the initial high level of ceded premium – and with a view to "what could go wrong").

As it turned out, Canadian Millers' did not achieve the objective of strengthening its capital under the BEP program. Although they managed to generate net income of $287,000 in 1997, even this modest improvement wasn't sustainable. In 1998-99, net income was again negative.

We conclude the BEP "chapter" of Canadian Millers' reinsurance story with several observations.

- Board governance and management oversight of the 1997-98 changes to the reinsurance program was poor – and suggests a lack of understanding of reinsurance.[19]
- Simply changing programs didn't allow Canadian Millers' to escape its recent loss results. The following comment from BEP's early communications about the new program is revealing: "The main problem that we have encountered in obtaining more competitive terms for the program stems directly from the losses incurred this year, especially the large loss in July." (The reference is to "Policyholder D" in the table on page 11 – a fire loss of $768,000).[20]

[17] *Exit meeting notes*, OIC, August 7, 1997.

[18] Donald A. McIsaac & David F. Babbel, *The World Bank Primer on Reinsurance*, Policy Research Working Paper 1512, September 1995.

[19] Nonetheless, it was also the broker's job to explain the financial impact of changes in the reinsurance program – especially such a substantial change.

[20] Letter dated December 12, 1996 regarding "Your 1997 Treaty Reinsurance Program" addressed to Millers' President from its brokers at BEP International.

- It was unusual that Canadian Millers' appointed actuary at the time – Jim Christie of Ernst & Young – should have to write to the General Manager to request information about the new reinsurance program.[21]
- The BEP program added significantly to Canadian Millers' expenses. For 1997-98, the Company's expense ratio averaged 72.6 percent. So even though recorded losses from claims temporarily eased, Canadian Millers' was no better off in terms of its combined ratio.
- Millers' General Manager raised the possibility of seeking redress from BEP. In his opinion, the reinsurance program they had recommended "made it impossible to make money."[22] The Board disagreed with the General Manager on this point, concluding that "Canadian Millers' must accept responsibility for concurring with BEP's recommendations and therefore no action should be taken."[23]

The unfortunate outcome of the BEP program underlines the fact that reinsurance is a complex area. Even with the assistance of professional advisors, the program did not deliver the results that were anticipated.

By late 1998 – dissatisfied with the results of the BEP program – Millers' management and Board were again seeking a better deal for their reinsurance. The only problem was – based on its poor underwriting results – the Company was running out of options with respect to reinsurance.

Starting March 1, 1999, Canadian Millers' placed its reinsurance program with Employers' Reinsurance Corporation (ERC). (The BEP program had been extended for an extra two months). Because ERC was a direct writer of reinsurance, no broker was involved in arranging and administering the program. However, ERC's excess of loss coverage differed substantially from Canadian Millers' previous treaties with reinsurers – in this case, providing excess coverage of only $7 million *per occurrence*.[24] Canadian Millers' management and Board appear not to have understood this change, as they proceeded to write a large volume of new business for hog producers in and around the town of Morris, Manitoba. With only $7 million of excess coverage per occurrence, a tornado in the area could have caused significant losses. When ERC discovered this accumulation of risk, they immediately imposed a cap of $2.5 million on any single risk reinsured under their program. Canadian Millers' was then put in a position of needing to arrange facultative reinsurance to cover the gap. Unfortunately for Canadian Millers', ERC had exited the facultative market.[25] Not surprisingly, Canadian Millers' direct written premiums in Manitoba dropped 41 percent in the year 2000 compared to 1999.

The unfortunate outcome of the BEP program underlines the fact that reinsurance is a complex area. Even with the assistance of professional advisors, the program did not deliver the results that were anticipated.

[21] Letter dated April 17, 1997 from Jim Christie of Ernst & Young to Canadian Millers' General Manager states that "your reinsurance program has changed dramatically for 1997" and asks for details.

[22] General Manager's report to the Board dated February 25, 1999.

[23] Minutes from Millers' Board of Directors meeting dated February 25, 1999.

[24] This condition and limit was clearly outlined on page 2 of a revised proposal sent by ERC to Canadian Millers' General Manager, dated February 23, 1999.

[25] Based on notes provided by Gordon Crutcher, then of Towers Perrin Reinsurance, dated April 22, 2000.

Given these misunderstandings, Canadian Millers' was only reinsured with ERC for slightly more than one year. As of July 1, 2000, the Company returned to a more traditional reinsurance arrangement (similar to the program that expired at year-end 1996), brokered by PWS Canada, with participation from Munich Re, Lloyd's, Hannover Re, and Everest Re. After this program had run for about one year, Canadian Millers' management expressed their concern to PWS that the cost of the reinsurance was greater than anticipated. The dispute appears to have involved minimum premiums due to the reinsurers under the terms of the treaties. Payments were withheld by both parties (premiums owed by Canadian Millers' to the reinsurers, and claims payments owing to the Company from its reinsurers). As late as October 2001 – only two months prior to Canadian Millers' being ordered into wind-up – PWS wrote to the Company with the following message: "Underwriters suggest that an offset may be the best way to deal with these issues and if you are in agreement then we will prepare the necessary adjustments. If you are not able to deal with these issues at this time then I suggest that a meeting with FSCO may be in order to seek their support for a compromise position."[26]

By trying to grow its premiums faster than its capital base after 1995, Canadian Millers' had, perhaps unwittingly, greatly increased its dependence on reinsurance.

By now, it was clear that Canadian Millers' had few reinsurance options left – certainly fewer than at the start of its frequent changes in reinsurance programs starting in 1996-97. By trying to grow its premiums faster than its capital base after 1995, Canadian Millers' had, perhaps unwittingly, greatly increased its dependence on reinsurance. Unfortunately, along with this greater dependence came increased risk to the Company's solvency – especially considering its poor underwriting performance and lack of profitability. While Canadian Millers' management showed a tendency to "blame" reinsurers for its difficulties, based on the material we've reviewed for this case study, there is no credible evidence to support that view. That said, it seems clear to us that reinsurers, generally speaking, would have viewed Canadian Millers' as a sub-standard client.

[26] Letter from PWS Canada President to Canadian Millers' General Manager dated October 19, 2001; Subject: *Balances for Premium Owed and Claims Collectable*.

Regulatory scrutiny

Canadian Millers' principal regulator was the Ontario Insurance Commission (OIC), which had become the Financial Services Commission of Ontario (FSCO) by the time the Company was ordered into wind-up in December 2001. There is ample evidence to indicate that OIC (and later FSCO) was aware of the challenges facing Millers' and was actively monitoring the Company's performance and requesting corrective actions. We note, in particular, the points listed below as evidence of scrutiny by the regulator.

- Results of the annual examination of Millers' completed by OIC on September 27, 1994, which concluded with the following statement: "The results of the Minimum Asset Test indicates there is no immediate concern over the solvency of Canadian Millers'. However, the high expense and loss ratios, together with higher required reserves, increase the risk that the company will be unable to maintain the minimum surplus requirement of $3.0 million. I would like to receive your comments and an outline of your plans to address the items mentioned above, on or before November 30, 1994."[27]
- A number of action items were documented by OIC from an "exit meeting" with Canadian Millers' management in August 1997.[28] Three months later – starting in November 1997 – Canadian Millers' was required to report its financials to OIC on a monthly basis (quarterly was standard). The Company had effectively been put on "watch" by the regulator.
- Attendance at Canadian Millers' Board meeting of April 13, 2000 by two FSCO officials – Ms. Anita Sastri and Mr. Craig Walker. It is clear that FSCO's main concern was the "maintenance and growth of Canadian Millers' surplus" in order to protect policyholders. While the Company was still in compliance with minimum capital requirements, the minutes state FSCO's view that Canadian Millers' was "borderline" in this respect and "being watched very closely" by the regulator.[29]
- As of July 31, 2001, Canadian Millers' monthly reporting to FSCO showed that the Company's capitalization had declined to $2.3 million – well below the $3 million minimum requirement. Approximately one month later, FSCO moved to impose conditions and limitations on Canadian Millers' carrying on new or renewal business.[30] The regulator appears to have given Canadian Millers' a period of time to arrange for a possible acquisition by an interested party.[31] However, when the termination date for the proposed acquisition was reached (December 5, 2001), and no agreement was in place, FSCO obtained a Court order to wind-up Canadian Millers' two days later.

"… the high expense and loss ratios, together with higher required reserves, increase the risk that the company will be unable to maintain the minimum surplus requirement of $3.0 million."

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[27] Letter dated October 6, 1994 addressed to Canadian Millers' President, from Mr. Jai Persuad, Principal Examiner, Ontario Insurance Commission.

[28] Dated August 7, 1997 and prepared by OIC Examiner Doug Archibald – with management responses.

[29] Minutes of the meeting of Canadian Millers' Board of Directors held on April 13, 2000.

[30] *Notice of Intention to Impose Conditions or Limitations on the Licence of Canadian Millers' Mutual Insurance Company*, Referencing Section 55 of the Ontario Insurance Act, FSCO, dated September 6, 2001.

[31] Proposed Memorandum of Understanding between Canadian Millers' Mutual Insurance Company and EGI Investments Inc., dated September 10, 2001.

The above evidence shows active engagement and monitoring of Canadian Millers' solvency by OIC/FSCO from 1994 on. In particular, the evidence shows that the regulator focused its concern primarily on the adequacy of Canadian Millers' capital. The regulator did express concern about excessive reliance on reinsurance and other issues, but most interventions targeted action to strengthen the Company's capital base.

Desperate times, desperate measures?

To conclude our study of Canadian Millers' we make some brief observations about two "ideas" considered by the Company late in its lifespan, presumably with the goal of increasing capital.

- **Owning a brokerage** – In January 2000, Millers' Canadian General Manager proposed the idea of the Company owning an insurance brokerage business… "as a possible way to deal with all of the difficult issues before us."[32] This appears to have been viewed as a way of generating a steady income stream to help smooth Canadian Millers' financial results. While the Board asked for further information about the costs involved, the idea seems not to have been pursued.

- **Entering the automobile insurance business** – The first reference to this idea occurs in November 1999.[33] While the idea is discussed with the Canadian Millers' Board, it never seems to gain traction. At some point – likely during 2000, although undated – a report appended to the Company's Board minutes contains the following statement in an appendix: "A meeting was held with FSCO and their view was that it is not the appropriate time to enter the automobile market. There are financial, statistical and actuarial requirements needed to be addressed which, along with the appropriate rate filings, make it very costly and time consuming."[34]

…why would a Company with more than 120 years of experience insuring agri-business risks, suddenly think about entering the auto insurance business?

These two ideas had little to do with Canadian Millers' corporate strategy as articulated as late as 1996, and referenced earlier in this study. Both ideas – especially the proposed auto insurance market entry – are akin to "gambling for survival" when an insurer nears insolvency, as noted in PACICC's previous *Why insurers fail* studies. And it is interesting to note that the auto insurance discussion begins in 1999 – the second of two horrible loss years (1996 and 1999) experienced by Canadian Millers' on the road to insolvency. Echoing our earlier comments: why would a Company with more than 120 years of experience insuring agri-business risks, suddenly think about entering the auto insurance business?

[32] Report from the General Manager to the Board of Directors titled "Some Brief Advantages to Owning a Brokerage," dated January 16, 2000.

[33] Letter from the CEO of Focus Group Inc. (an advisor to Canadian Millers') addressed to Millers' General Manager and dated November 5, 1999; Subject: CMMIC Automobile Insurance Opportunity.

[34] Undated report titled *CMMIC's Proposed Entry into the Automobile Market*. (This was a time when Ontario auto insurers were generally experiencing poor results – author's note).

Causes of insolvency

Main causes:

- Poor underwriting and risk selection
- Inadequate capital (after 1995)
- Rapid premium growth, unsupported by capital growth (after 1995)
- Large losses in 1996 and 1999 – and failure to regain profitability
- Excessive dependence on reinsurance (used as a substitute for capital)
- High expenses (especially during the 1990’s).

Contributing factors:

- Poor management and corporate governance
- Delegation of underwriting authority to brokers without adequate controls
- Difficulty mitigating large loss claims
- Misuse and misunderstanding of reinsurance
- Departing from established agri-business strategy to pursue new sources of growth (for example, forest products).

- **Deficient capital** – Canadian Millers' experience shows how this can be more of a problem for a mutual vs. a stock company. The primary source of capital growth for mutual insurers is through retained earnings – and if you are not a profitable insurer – where does the capital come from? Canadian Millers' became so desperate for capital by 1999-2000 that the Company was prepared to consider strategies that had nothing to do with its core business – like owning an insurance brokerage or entering the automobile insurance business.
- **Minimum capital** – While the minimum capitalization was $3 million for a P&C insurer incorporated and supervised in Ontario at the time Canadian Millers' failed, the Ontario Insurance Commission had told the Company in 1994 they needed $5 million in capital "to survive and compete." But the regulator had no way to compel Millers' – as a riskier-than-average insurer – to accumulate greater minimum capital. In retrospect, had those powers been available to the regulator, insolvency might have been avoided.
- **Governance** – At times, Canadian Millers' Board of Directors appeared to be in a near conflict-of-interest position. On the one hand, they were charged with maintaining the financial health of the Corporation. On the other hand, as policyholders themselves, they were reluctant to recommend the cancellation of clearly unprofitable business. As a Corporation, Canadian Millers' should have been clearer about the duties of its Directors.
- **Premium growth** – Canadian Millers' expanded its premiums rapidly in 1998-99 – at about 25 percent per year. This was not the kind of "controlled growth" the Company stated as its objective. Basically, Canadian Millers' went from a premiums-to-capital ratio of 1:1 before 1995, to a 2:1 ratio a few years later. This added "leverage" was risky – and it is not clear why the Board allowed it.
- **Claims** – The risks being insured by Canadian Millers' had a volatile loss experience. While some of this may have been inherent with large agri-business risks, we conclude that the Company could have done more to mitigate the losses incurred.
- **Expenses** – Canadian Millers' expense ratios were well above the industry average in the 1990's. Broker commissions were rising as a share of expenses after 1995, and reinsurance costs added to the Company's expenses after 1997. When Canadian Millers' needed to trim costs, their business model and operations gave them little room to maneuver.
- **Reinsurance** – It is unusual for a Company to change reinsurance programs as often (and as radically) as Canadian Millers' did after 1996. In retrospect, these frequent program changes – coupled with unrealistic budgeting for net reinsurance results – were a warning sign of financial instability. Canadian Millers' essentially ran out of options for reinsurance on competitive terms by 1997-98.

- **Underwriting authority** – Good risk selection is vital. When Canadian Millers' was primarily a direct writer of agri-business risks in the 1980's, and into the early 1990's, the Company had a better loss experience. Its performance deteriorated in the second half of the 1990's – as underwriting authority was delegated to brokers without adequate guidance and controls.
- **Strategy** – Departing from an established business strategy can be risky. The demonstrated expertise of Canadian Millers' was in agri-business, not in forest products or other supposedly "rural" risks the Company accepted in its desire for premium growth in its last few years in business. Had Canadian Millers' "stuck to the knitting" of covering only agri-business risks – and kept its premium volume in line with its capital – it is possible that the Company might still be in business.

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Property and Casualty Insurance Compensation Corporation
20 Richmond Street East
Suite 210
Toronto, Ontario M5C 2R9
Phone (416) 364-8677
Fax (416) 364-5889
www.pacicc.ca