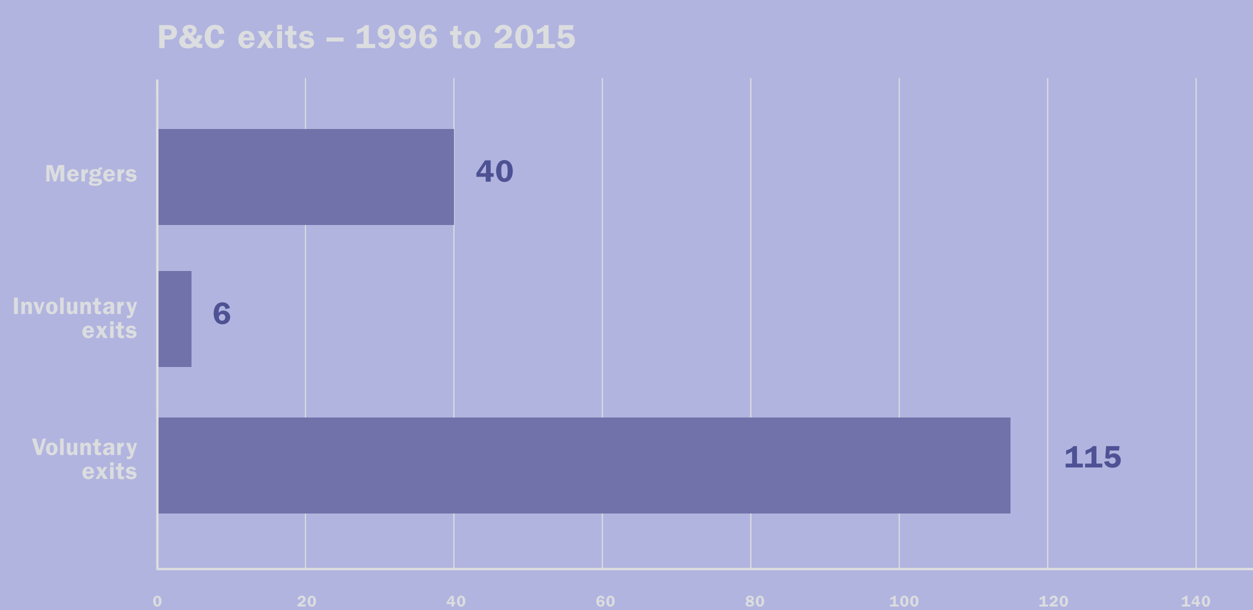
PACICC

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

Why insurers fail

Exit strategies of P&C insurers in Canada



By

Grant Kelly

2017

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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

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

Executive summary

OVER THE PAST 20 YEARS, PACICC has identified 161 different insurance companies that exited the Canadian P&C market. This is evidence that Canada's P&C insurance marketplace is competitive. When firms employ unsuccessful strategies and are not profitable, some decide to leave the market. Of the exiting firms, just six were involuntarily closed because the regulators lost confidence in their ability to pay future claims. This is less than four percent of firms that exited the market. PACICC played its role in protecting consumers by providing the estates of these failed insurers with the funds necessary to pay eligible claims. Between 2008 and 2012, the default rate within Canada's insurance industry (life and P&C) was approximately 0.0001 percent of industry liabilities. This is similar to the default rate in other modern, well-regulated insurance markets.

One hundred fifty-five (155) of the firms exited voluntarily. This is more than 96 percent of exiting firms. This is evidence of the high pace of change in the P&C Canadian insurance market. Consumers that bought policies from these companies were protected by the regulatory system throughout the company's lifespan. Insurers are using all of the options available under Canada's voluntary exit regime – Assumption Reinsurance agreements, Transfer of Liabilities, and run-offs.

On an individual firm level, insurers that exited via merger or exited voluntarily reported stronger underwriting results than firms that exited involuntarily. Insurers that exited by merging with another insurer, or those that left by other voluntary means, experienced better loss development than insurers that were forced to close by regulators. There were insignificant differences between the investment returns of insurers that exited the P&C insurance industry and the companies that remained in the market. The primary driver of the decision to exit is related to unacceptably poor underwriting results. Insurers that were closed by regulators appear to have been more dependent on reinsurance recoverables than firms that exited voluntarily.

PACICC's Risk Management process can identify a unique set of circumstances where there could be three key advantages to an earlier intervention by PACICC, in advance of an involuntary winding-up of the troubled company:

- First, the potential cost to the industry could be reduced (compared to a full winding-up);
- Second, policyholders could receive full compensation for losses (going beyond PACICC's current cap on claims); and
- Third, the P&C insurance industry's reputation with consumers and government would be maintained, if not strengthened.

PACICC should consider setting out the circumstances that could prompt the Corporation to intervene in advance of an involuntary wind-up.

Introduction

THIS IS THE 11TH EDITION of the Property and Casualty Insurance Compensation Corporation's (PACICC) *Why insurers fail* research series. While it is rare for P&C insurers to fail in Canada, this research program serves to remind stakeholders that insolvencies do occur and to profile the lessons learned from the past so that they are not repeated. The objectives of these papers are to:

- identify the causes of the company insolvencies;
- document key lessons learned and encourage dialogue on insurance solvency issues;
- improve stakeholder understanding of the early warning signs of a troubled company; and
- enhance PACICC's preparedness for future insolvencies.

PACICC's 2017 study examines insurers that exited the P&C insurance industry and identifies some of the factors that drove these companies to choose a particular exit strategy when leaving the market. A competitive market encourages companies to try different strategies and to introduce new products. The reality, however, is that many of these ideas fail to meet their expected level of success. Exit from the market is a normal feature of a healthy competitive market, as economist Joseph Schumpeter noted when he wrote that "Creative destruction is the essential fact about capitalism."

PACICC collected financial data on 401 of the insurance companies that actively competed in the Canadian P&C insurance marketplace between 1996 and 2015. Of these companies, 161 insurers exited the Canadian marketplace over this 20-year period, while 240 insurers remained in the market in 2016. Of the companies that remained in the market over the 20 years, 25 changed the name of their company.

The 240 insurers in the market in 2016 is not a complete census of the insurers competing in the Canadian P&C insurance market. In fact, PACICC identified more than 375 private and public insurance companies currently operating in Canada last year. Provincial governments in British Columbia, Saskatchewan and Manitoba, for example, operate government-owned auto insurance monopolies that are not included in the study of exit strategies. This is a point-in-time snapshot of the number of companies that have competed in the P&C insurance industry. Over the past 20 years, PACICC identified more than 550 public and private insurers that operated in the Canadian market. Of these, PACICC, collected financial data for 401 private companies for this study of exit strategies.

Table 1: Number of P&C insurers in Canada

Federally regulated P&C insurers	159
Provincially regulated P&C insurers	89
Ontario farm mutuals	46
Reciprocals	32
Captives	23
Provincially regulated reinsurers	3
Quebec multi-brand insurers	3
Government-run P&C auto insurers	4
Other government-run P&C insurers (workers compensation, export credit, home warranty, agriculture)	20+
Estimated number of P&C insurers in Canada	379+

How insurers exit

P&C INSURANCE IS A REGULATED INDUSTRY. The *Federal Insurance Companies Act* and provincial *Insurance Acts* set out the legal process to enter and exit the marketplace. To enter the industry, companies must secure approval from Canada's insurance regulators. They must convince regulators that they have the expertise and financial resources required (capital and reserves) to operate the company and to comply with our laws and regulations. It is a rigorous process to establish a P&C insurance company in Canada.

The legal framework that allows companies to exit the market is even tougher. Companies may voluntarily choose to leave the industry in the manner described below or regulators can step in and use the Canadian court system to force a company to leave involuntarily. In either case, the legal and regulatory system in Canada is designed so the insurer honours the promises made by the insurance contract.

The International Association of Insurance Supervisors' (IAIS) Insurance Core Principles (ICP) includes powers that supervisors should have to support the process of providing insurance companies with an orderly exit from the market. This is an important aspect of supervision since ICP 16 (Enterprise Risk Management for Solvency Purposes) along with ICP 6 (Licensing) and ICP 8 (Changes in Control) contribute to the powers that supervisors require to control who is allowed to own and operate an insurance company in the marketplace.

According to the IAIS Core Principles, the orderly exit of a company from a market should start before it fails the tests for capital adequacy. The exit process starts with the observations made and actions taken well before the imminent failure of a company.

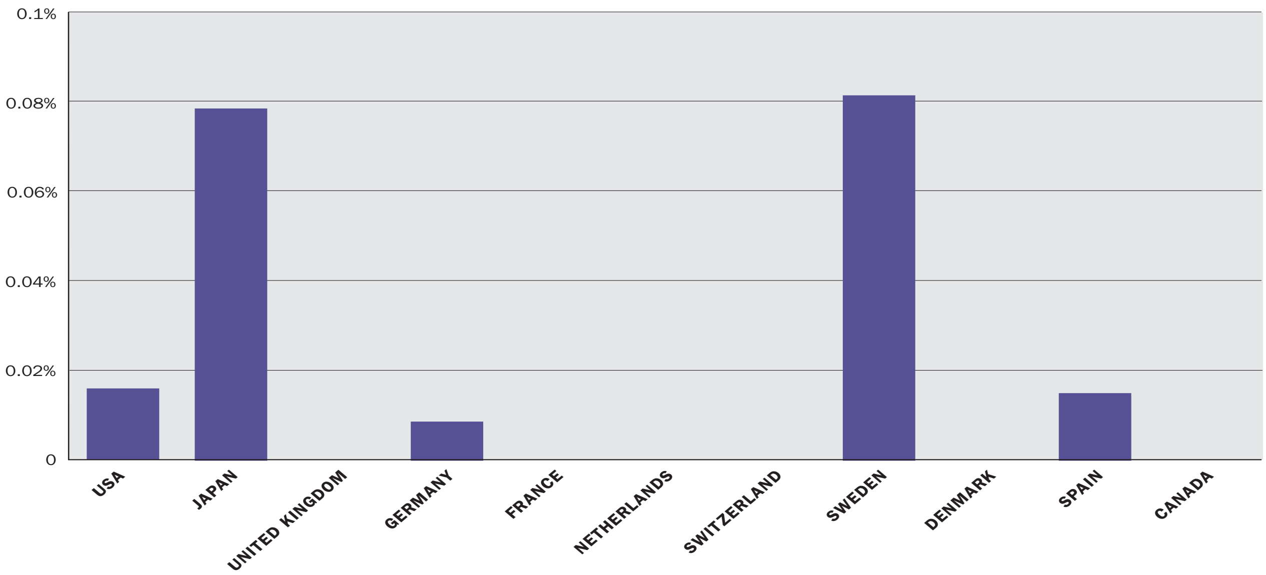
Involuntary exits: sometimes insurers fail

While most insurers exit the market voluntarily, a small number of insurers were closed by regulators involuntarily. An involuntary market exit occurs when an insurance regulator loses confidence that a company is viable or believes that it is behaving in an unacceptable manner. To protect policyholders' rights, the regulator has the authority to force an insurer out of the market. In this case, the regulator seeks a winding-up order from a court. Normally, the winding-up order replaces the insurer's management with a court-appointed liquidator. The court freezes the assets of the insurer to give the liquidator time to assesses the financial resources of the company compared to its liabilities. Consumers are directed to find a new insurance company within a reasonable time period (generally 45 days). At that time, their insurance contracts cease to protect them. The liquidator hires independent actuaries to review the adequacy of the insurer's claims reserves. The liquidator also reviews all reinsurance contracts.

Past experience in Canada demonstrates that liquidators generally need liquidity to pay claims and refund premiums paid in advance. They call upon PACICC to provide the estate with the necessary funds to pay eligible claims and to refund unearned premium. It can take 20 years or more for the liquidation process to be completed, especially if complex commercial claims are involved. PACICC's role is to ensure the timely resolution of the needs of consumers.

It has been more than a decade since the last P&C insurer failed in Canada. While this may seem like a long period of calm, it is not uncommon for a modern well-regulated insurance industry. The Geneva Association studied insurance insolvencies from 12 of the world's

Chart 1. International insurance default rates



Source: Geneva Association. Canada figure from PACICC.

largest insurance markets. They estimate that the size of insurance insolvencies globally between the beginning of the financial crisis in 2008 and 2012 was less than 0.04 per cent of total outstanding liabilities in any one year. Life insurers in Japan and Sweden were hit hard by the combination of historically low interest rates and the 2008 global financial crisis. Insurance insolvencies are rare in Canada and in most modern insurance industries around the globe. There was just one insolvency in Canada's life insurance industry during the period studied by the Geneva Association. PACICC estimates that the comparable default rate for Canada is 0.00001 percent of total life and P&C industry liabilities over this period. This rate of insolvency is very low, and it appears to be in line with other modern insurance markets. Indeed, six major insurance markets – the United Kingdom, France, the Netherlands and Denmark – report no involuntarily insurance exits between 2008 and 2012.

While involuntary insurance company exits are rare, recent history in the Canadian P&C insurance market shows that periods of calm can be punctuated by clusters of insurer insolvencies.

Table 2: Insolvencies come in clusters

	1980 to 1986	1990 to 1995	2000 to 2003
Number of insolvent P&C insurers	20	9	6
Number of policyholders affected	144,300	111,209	93,200

These clusters of insolvencies coincide with periods where the industry experienced poor underwriting results. A primary finding of PACICC's *Why insurers fail* research was that the most common cause of P&C insurer failures in Canada was poor underwriting results and claims reserving. For example, during the period 2001 and 2002, more firms than average exited the P&C market. This coincided with the two least-profitable years in the P&C industry's history. In 2001, the industry's return on equity (ROE) dropped from its long-run (50-year) average of 10 percent to 2.5 percent. In 2002, ROE remained below average at 1.9 percent. In 2002 and 2003, 18 insurers voluntarily exited the market and another five insurers were closed by regulators. Overall industry profitability is a significant factor in the decision to exit the Canadian P&C industry.

Long periods of stability create other risks. Because it has been more than a decade since a Canadian P&C insurer failed and was ordered into liquidation, there are a number of insurance regulators and bankruptcy professionals who have never managed the complexities involved in the liquidation of a P&C insurer.

Over the past 20 years, regulators have used the legal process to force insurers to exit involuntarily just six times. These include:

1) **GISCO** (Ceased 2000) – PACICC assessed members for $3.5 million. Total claims paid to policyholders from the estate totaled $5.3 million. This estate was closed in 2016.

2) **Alta Surety Company** (Ceased 2001) – OSFI took control of the company and the court granted a winding-up order. Alta Surety sold policies not covered by PACICC. The court appointed PricewaterhouseCoopers Inc. as liquidator. The winding-up of the estate continues.

3) **Canadian Millers' Mutual** (Ceased 2001): PACICC assessed member insurers for $3 million. Claims paid to policyholders totaled $3.7 million. This estate was closed

in 2016 – 15 years after the initial winding-up order was issued.

4) **Markham General** (Ceased 2002): PACICC assessed member insurers for more than $22 million. Claims paid to policyholders totaled more than $21 million. This insolvency took 13 years to work its way through the court system. The estate was closed in 2016.

5) **Reliance Insurance Company** (Ceased 2003): PACICC did not assess member insurers. This was a solvent Canadian branch of a troubled U.S. insurer. At the onset of the liquidation, the court froze the company's assets. Early in the liquidation, PACICC negotiated a loan and service agreement with the liquidator and pledged a portion of PACICC's assessment capacity to allow the liquidator to "thaw" these assets and begin to pay creditors. The liquidator of the estate determined that there was enough money in the estate to pay 100 percent of money owed to creditors.

6) **Home Insurance** (Ceased 2003): OSFI took control of the Canadian branch of The Home Insurance Company in June, 2003. The Ontario Superior Court of Justice subsequently appointed Deloitte and Touche Inc. as provisional liquidator of the company.

Involuntary exit was a last resort tool for insurers and regulators. Over the past 20 years, 155 other insurers have chosen to exit the Canadian market voluntarily.

Voluntary market exit: sometimes insurers just exit

A voluntary market exit is a withdrawal from the market that is managed by the owners of the company. The insurance company continues to be regulated throughout the process. Companies decide to leave a market because:

- Results are not meeting expectations of profitability;
- Difficulties in other markets may require selling assets to refinance the problem area; or
- Management has decided to focus on other markets.

Whatever the reason, the company must have support from the regulator before it is allowed to withdraw voluntarily. This is necessary because the regulator must be satisfied that the company has the financial and other resources necessary to meet its obligations to policyholders throughout the withdrawal process proposed by the company.

Companies in run-off are not normally allowed to write new business. They are limited to the administration of existing business until all obligations under those contracts are met. They continue to be regulated insurance companies and are subject to the same legislation that applies to going-concern insurers. For example, the company must remain a member of the policyholder protection plan – PACICC in the case of Canada. The goal of this regulatory process is to ensure that policyholder rights are not compromised as a result of decisions that might be made during the process of exiting the insurance market.

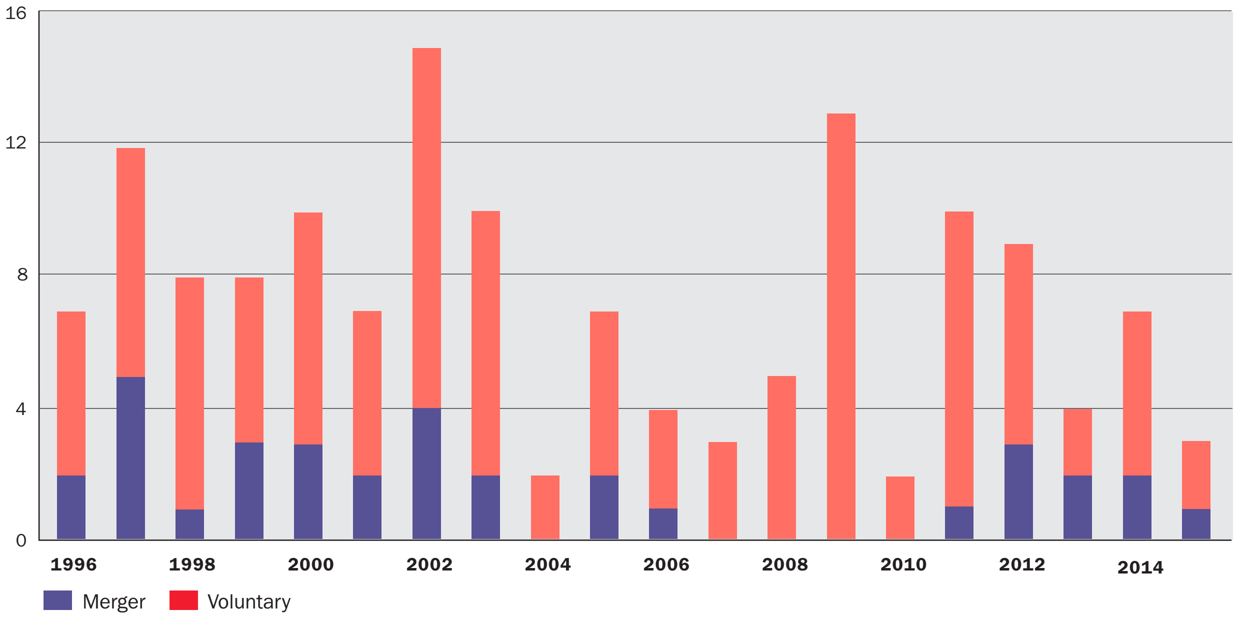
Regulatory standards are not reduced because a company wants to leave the market. At the end of the process, the company must apply to the regulator for permission to withdraw their final assets from Canada.

Voluntary market withdrawals can be completed through any combination of:

- Selling the company's assets and liabilities to another company or owner via merger;
- Selling portions of the company to different companies or owners; or
- Running off the business by ceasing to sell new policies and using the assets and investment income to pay claims as they fall due, and to meet operating expenses.

In a competitive industry, it is natural that some companies will exit the market each year. Over the 20 years examined in this paper, Canada's P&C insurance industry has averaged four or five insurers exiting the industry each year. This can be thought of as the normal or natural rate of voluntary exits. In addition, an average of two firms generally exit the market each year by merging with another insurer.

Chart 2. Number of P&C insurers that exited voluntarily



Source: PACICC based on data from MSA Research

Over the 20-year period from 1996 to 2015, data collected by PACICC show that 40 insurers exited the P&C insurance industry by merging with another insurer. PACICC identified another 115 insurers that exited the market voluntarily by other means in this 20-year period. In total, 155 insurers voluntarily left the Canadian P&C insurance market over this period.

Forty insurers exited by merging with another insurer

For an insurer that has chosen to exit the Canada's P&C insurance marketplace, a merger is often the most attractive option. The objective of the seller is to find a buyer that is willing, ideally, to pay a premium for the business. Under a merger, the shareholders of the insurer usually get their money back with a profit. Policyholders are transferred from one regulated insurer to another.

Forty (40) insurers exited the market in Canada between 1996 and 2015 by merging with another insurer. They found a willing buyer. On average, these insurers competed in the Canadian P&C insurance marketplace for 53 years before they decided to exit. Most of these firms (78 percent) were regulated OSFI. Some 22 percent of the firms that exited via merger were provincially-incorporated and supervised by provincial insurance regulators. About half (22) of these insurers were Canadian-owned. Nine of the merged insurers had U.S. ownership; another nine were owned by European shareholders.

Another 115 insurers exited voluntarily

One hundred fifteen (115) insurers did not find a partner with which to merge. They exited the P&C market voluntarily by other means. On average, these insurers competed in the Canadian P&C insurance marketplace for 43 years before deciding to leave. In fact, one company had competed in Canada for 117 years before exiting. The vast majority of the insurers that exited voluntarily were regulated by OSFI. Just six of these 115 insurers (5 percent) were provincially-incorporated and regulated insurers.

Voluntary exits that were not the result of merging with another insurer employed three main tools:

1) Assumption Reinsurance;

2) Transfer of liabilities; or

3) Run-off.

Assumption Reinsurance

Eight percent of the insurers that exited Canada's P&C insurance marketplace during 1996 to 2015 employed an Assumption Reinsurance agreement. Under these agreements, a reinsurer assumes – for a price – the obligations the exiting insurer may owe under its policies. The exiting insurer pays the reinsurer for the opportunity to exit. These reinsurance contracts normally include the discharge of the financial obligations and the policy administration functions. The reinsurer agrees to become liable to the policyholders. In June 2016, OSFI clarified its expectations with regard to Assumption Reinsurance.

Policyholders must be notified that they have a new insurer. Policyholders pay their premiums, if any are owing, directly to the reinsurer and look to the reinsurer for the payment of claims made under the policies.

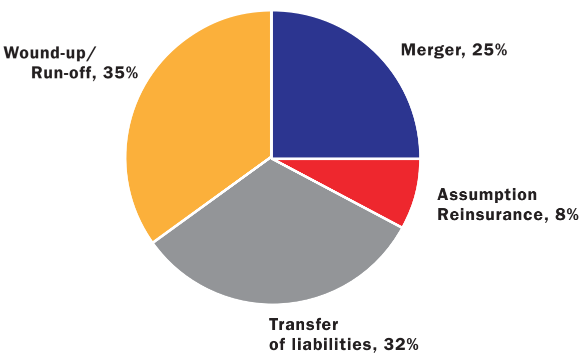
Assumption Reinsurance does not amount to a full legal transfer of policies. The ceding insurer retains ultimate liability regarding each policy that has been reinsured, until that liability ceases in accordance with the policy terms. There is no statute or common law precedent in Canada for a complete discharge other than a legal transfer.

Despite the lack of legal discharge, the benefit of Assumption Reinsurance is that it amounts to a transfer of policy risks for accounting and actuarial purposes, which relieves the ceding insurer of the capital and regulatory burden associated with the risks. It is most commonly used when it is not commercially reasonable to effect legal transfer of policies (for example, where there are too many policies to obtain individual consents). For eight percent of insurers exiting the marketplace, Assumption Reinsurance proved to be a practical way to apply to OSFI for a release of its assets.

Transfer of liabilities

Thirty-two (32) percent of the insurers that exited the P&C insurance market in the past 20 years legally transferred their policy obligations to another insurer. In this case, the exiting company pays another insurer to release them from their promises to Canadian policyholders. This is a legal contract between two insurance companies. Normally, the price of the transfer is based on the expected cost to the new insurer to settle these claims, plus a profit margin for the new insurer. Once the transfer is executed, the exiting insurer is free from their obligations. Unlike in some countries where there is a method of transferring legal liability with court and/or regulatory approval, in Canada, a legal transfer is possible only with the consent of the policyholder — of each individual policyholder.

Chart 3. Method of voluntarily exit



Source: PACICC based on data from MSA Research

Run-off

Thirty five percent of the insurers that exited the Canadian P&C insurance market over the past 20 years entered into “run-off”. Under a run-off, the insurer stops selling new insurance policies. They attempt to settle liabilities of existing policies as quickly and efficiently as possible. An insurer is still regulated in run-off. Insurers can run-off all of their policies to exit the market, or they can run-off one or more lines of insurance that are not meeting their profit expectations. There is a large profitable part of the insurance industry that focuses entirely on running-off exiting insurers. However, the run-off insurer is more profitable if it can settle claims for amounts lower than initially expected. The objective of a run-off is to release capital quickly as policy obligations are settled. This capital can then be redeployed to other opportunities that earn higher returns.

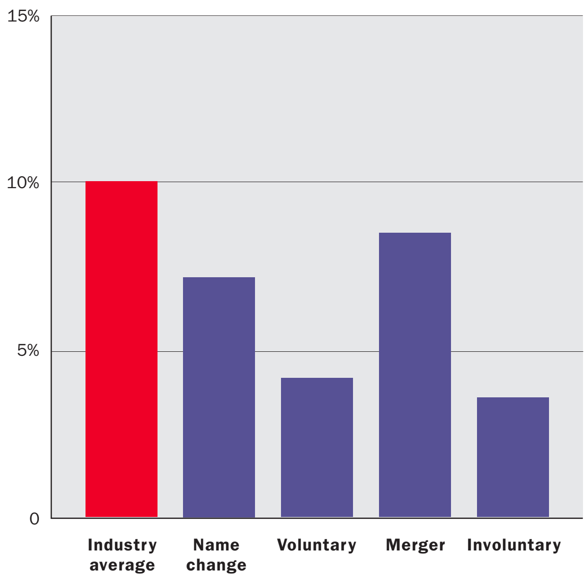
Firm-specific factors

FIRMS THAT DECIDED TO EXIT the industry also made a choice about the strategy they would employ to leave. The next section of this paper examines performance differences in the firms that exited by merger, by voluntarily running off their business, by changing their name, or through liquidation. The following charts compare key financial ratios for insurance companies that exited the marketplace in their final five years of operation. The financial performance measured here include return on equity, claim development, combined ratio, equity growth and reinsurance recoverables.

Return on equity (ROE)

Return on equity (ROE) measures an insurer's profitability. The higher the ratio, the greater the return to shareholders per dollar of capital that they invested. For long-run solvency, the sustainability of healthy earnings is more important than wide swings of occasionally high returns followed by periods of low returns. Between 1995 and 2015, ROE for Canada's P&C industry averaged 10.1 percent. Unsurprisingly, the companies that chose to exit the industry voluntarily, reported below-average profitability. Companies that exited by merger were closest to average profitability. Firms that exited voluntarily or were closed by regulators reported ROE of less than half of the industry average over this period. In an efficient capital market, it is reasonable to expect that an investor who is disappointed in the returns on their investment would seek to redeploy their capital to other, higher-yielding opportunities.

Chart 4. Average ROE



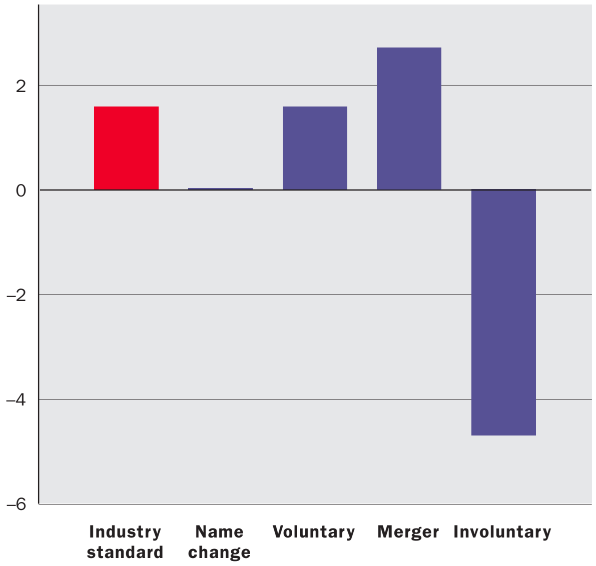
Source: Geneva Association

One-year claim development to equity

A consistent finding of PACICC's *Why insurers fail* research is that the most common cause of insurance company failure is inadequate pricing and reserving of insurance risk. This finding is again confirmed by examining the financial ratios of companies that exited the Canadian insurance market. The one-year development margin (or deficiency) on unpaid claims compared to equity measures how close the insurer was to accurately estimating the amount they needed to settle future claims. A negative ratio means that the insurance company underestimated the cost of settling claims in the previous year. This means that their solvency was overstated. It is normal for an insurance company to include a provision for adverse deviation when deciding how much money to set aside as a reserve.

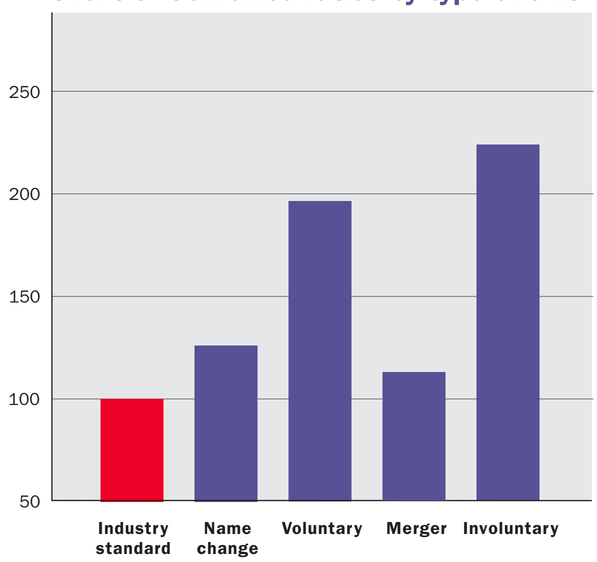
The insurers that were able to find a buyer and were an attractive merger candidate for buyers reported better reserve adequacy. Companies that were closed involuntarily consistently under-reserved by up to five percent in the final years of operation. Companies that voluntarily exited the market appeared to set adequate reserve levels.

Chart 5. Reserve adequacy by type of exit



Source: Geneva Association

Chart 6. Combined ratios by type of exit



Source: Geneva Association

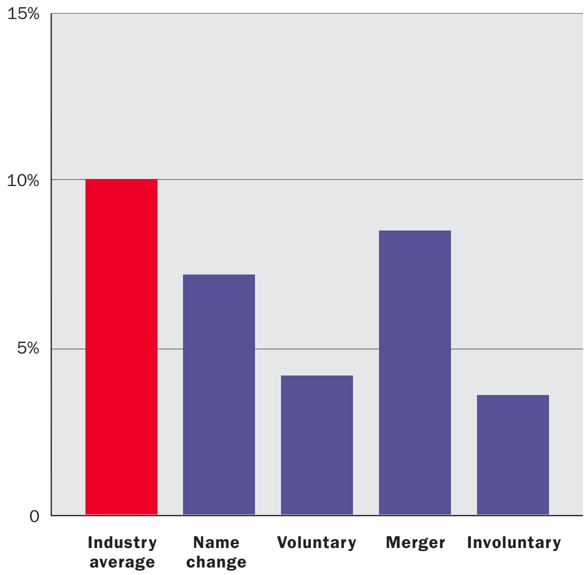
Two-year combined ratio

Another financial ratio that measures the underwriting performance of an insurer is the combined ratio. This ratio measures the insurer's cost of settling insurance claims compared to premiums that the insurance company charged for that coverage. Regulators smooth bad years by examining this ratio over a two-year period. A combined ratio greater than 100 indicates that the insurer lost money on the underwriting of insurance. A ratio less than 100 indicates that the insurer made money underwriting insurance. Over the time period of this study, the combined ratio for the P&C insurance industry was 100.1. Companies that exited the industry performed much worse than the industry average. Poor underwriting results appear to be a critical driving force behind a company's decision to exit the market. Again, those that exited via merger were closest to the average, indicating that buyers saw an attractive book of business they could merge with their own.

Growth in equity

Profitable insurance companies generate earnings they can retain as their primary source of capital to strengthen their financial health and support growth. Adequate capital fuels growth. Companies that chose to exit the Canadian P&C insurance market all reported growth in their capital base.

Chart 7. Growth in capital by type of exit



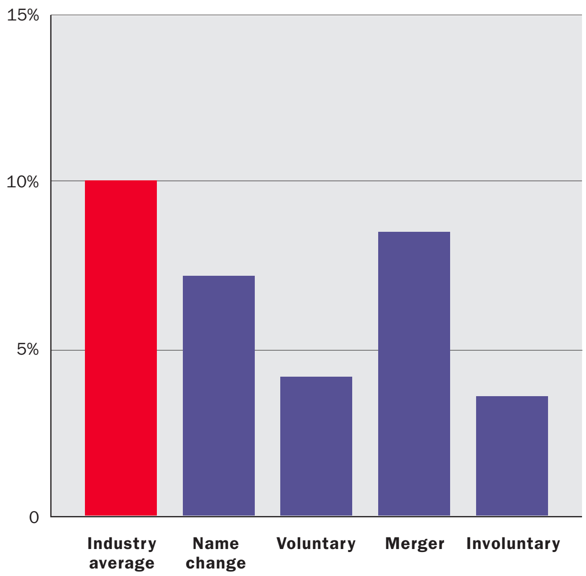
Source: Geneva Association

Previous *Why insurers fail* studies noted that the conditions that led to the failure of insurance companies in Canada often built up over a period of as many as 10 years before the regulator closed them down. Insurers that remained in the market with a new name were able to generate capital at a higher rate than companies that voluntarily exited the market.

Investment yield (ROI)

Another finding of PACICC's *Why insurers fail* research has been that large investment losses have not caused insolvencies in Canada. P&C insurers invest the money they collect in premiums according to the prudent-person rule. This is a legal maxim restricting the discretion in a client's account to investments that a prudent person seeking reasonable income and preservation of capital might buy for his or her own portfolio. Typically, P&C insurers invest more than 75 percent of their portfolios in bonds. They try to purchase bonds that provide the cash-flows necessary to pay claims – the average duration of an insurer's bond portfolio is approximately four years. P&C insurers in Canada are conservative investors.

Chart 8. Investment yield by type of exit



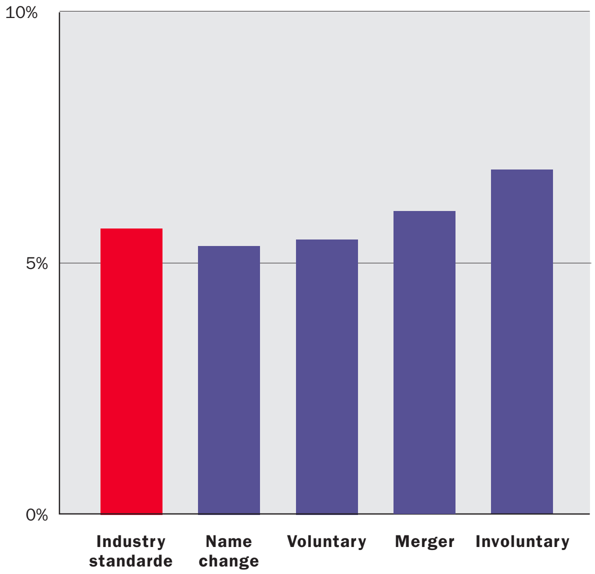
Source: Geneva Association

This finding is confirmed when we examine the investment returns of firms that exited the market. In fact, there is very little difference between the investment yields of insurers that exited the P&C insurance industry and those companies that remained in the market.

Reinsurance recoverables to equity

Reinsurance is an important tool that insurance companies use to manage insurance risk. Every insurer buys reinsurance from another insurance company. There are several different types, but the easiest to understand in the context of this report on exit strategies would be coverage for catastrophic risk. With this coverage, the reinsurer promises to step in with money to assist the insurer to pay claims resulting a natural hazard. Reinsurance is an important and effective tool to manage risk.

Chart 9. Reinsurance recoverables by type of exit



Source: Geneva Association

But reinsurance is also a potentially confusing tool that can be overly relied upon by an insurer. In several of PACICC's *Why insurers fail* case studies, the failed insurers did not fully understand their reinsurance arrangements. One measure of how important reinsurance is to the financial health of the insurer is the ratio of reinsurance recoverables to equity. A recoverable is the money that the insurer expects to receive from the reinsurer. The higher this ratio, the more dependent that the insurer is on its reinsurers. All of the companies that exited the Canadian P&C market between 1996 and 2015 were highly dependent on reinsurance. Expected recoverables represented about half of the total capital base, on average, supporting these companies. For companies that exited involuntarily, this ratio was highest with several failed insurers approaching 100%.

This examination of financial ratios suggests that the exit market for P&C insurers was active over the past 20 years. Companies with better underwriting results and those that were more conservatively reserved were able to find a buyer and exited via merger. Regulators have stepped in and forced insurers to close very few times in the past 20 years. The companies that were closed involuntarily reported worse underwriting results. Their reserves were smaller compared to their equity base. Regulators clearly had their reasons. Another 115 companies exited the market using a variety of tools that are allowed in Canada. These firms were able to exit the market with little to no impact on consumers.

Implications for PACICC

OVER THE PAST 20 YEARS, more than 161 P&C insurers have exited the Canadian insurance market. PACICC role was involved in assisting policyholders impacted by involuntary exits. PACICC was not involved in funding or otherwise facilitating a voluntary exit. The voluntary exit market appears to have worked well without PACICC's involvement.

The role of Policyholder Protection Plans, like PACICC, in the resolution of Systemically Important Insurers is still being discussed at both the international and national levels. According to the Financial Stability Board (FSB) report "Progress and Next Steps towards Ending – Too Big to Fail," the failure of Global Systemically Important Insurers should be prevented (or their failure managed by orderly recovery planning).

Policyholder protection plans in other countries play a more active role in assisting insurers to exit their markets voluntarily. PACICC's Memorandum of Operation provides powers to assist if regulators and PACICC's Board of Directors determine that policyholders are at risk. Specifically, Part XI of PACICC's Memorandum of Operation reads:

> XI. STEPS PRIOR TO CONTROL OR WINDING UP ORDER
> The Corporation may take reasonable steps with respect to a Member in financial distress, prior to such Member becoming a Controlled Insurer or an Insolvent Insurer, to facilitate the achievement of the Corporation's objects with respect to such Member, including, without limitation, the following:
>
> (a) assist in the sale, transfer or reinsurance of a book of business written by such Member which is covered by the Corporation on such terms and conditions as may be approved by the board of directors of the Corporation;
>
> (b) issue guarantees or otherwise provide financial support in respect of a book of business written by such Member which is covered by the Corporation on such terms and conditions as may be approved by the Board of Directors of the Corporation; and
>
> (c) monitor, discuss and gather information in respect of such Member, subject to the Corporation maintaining the confidentiality of all information relating to such Member obtained by it hereunder, provided, however, that this duty of confidentiality shall not apply to any information which (i) was lawfully in the public domain at the time of communication to the Corporation, (ii) lawfully enters the public domain through no fault of the Corporation subsequent to the time of communication to the Corporation, (iii) was lawfully in the Corporation's

possession free of any obligation of confidence at the time of communication to the Corporation, (iv) was lawfully communicated to the Corporation free of any obligation of confidence subsequent to the time of initial communication to the Corporation, or (v) was lawfully communicated to any person free from any obligation of confidence subsequent to the time of communication to the Corporation.

These powers are consistent with those granted to Policyholder Protection Plans in other countries. The functions that a protection plan performs differ between jurisdictions. In some cases, the plans have a narrower function of paying claims in respect of an insolvent insurer. In other jurisdictions, the plans may also have a role in insurer loss minimization, the rehabilitation of a distressed insurer, or in resolution mechanisms that seek to ensure the continuation of insurance contracts.

PACICC's risk management process has identified some scenarios where liquidation could result in adverse outcomes for policyholders, as well as, higher assessments for PACICC member insurers. The following example is entirely hypothetical and does not represent the financial status of any of PACICC's member insurers.

Consider a solvent insurer that writes two profitable books of insurance business. In this example, the insurer is regulated in a province that has not adopted OSFI Guideline B-9 and that does not require DCAT from provincial insurers. In PACICC's experience, such an insurer may not employ the full range of risk management tools available to them.
If a catastrophic event were to occur that impaired one of the insurer's books of business, they could be faced with inadequate reinsurance and face insolvency. The whole insurer may not be attractive to a buyer and merger may not be an available option, but half of their book of business may still be an attractive merger candidate.

Regulators, PACICC and the insurance industry would then be faced with circumstances that the Corporation has never faced before. Under these circumstances, the regulator may not approve a merger if that means there were no assets remaining to support the liabilities on the impaired half of the company. Regulators would be particularly worried if there was a potential that many claims exceeded PACICC's policy limits. The cost of liquidating the whole company, and the resulting PACICC assessment, could be many times higher than the cost of PACICC providing a cash injection. This specific set of circumstances represents the low probability event for which Policyholder Protection Plans were created.

Under some circumstances there are three key advantages to an earlier intervention by PACICC, in advance of an involuntary winding-up of a troubled company:

- First, the potential cost to the industry could be reduced (compared to a full winding-up);
- Second, policyholders could receive full compensation for losses (going beyond PACICC's cap on claims); and
- Third, the P&C insurance industry's reputation with consumers and government would be maintained, if not strengthened.

PACICC's Memorandum of Operation (Section XI, paragraph 40) permits the Board of Directors to take "reasonable steps" prior to a member being ordered into wind-up if such steps are consistent with the Corporation's objectives. The Memorandum of Operation further clarifies that "reasonable steps" include, "without limitation, assisting in the sale, transfer or reinsurance of a book of business written by a member company," and/or "issuing guarantees or otherwise providing financial support."

PACICC's objectives are captured in the Corporation's mission statement: "… 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." PACICC's rules are clear that the Corporation was created to protect consumers – not shareholders of insurance companies.

Lessons learned

SOME OF THE LESSONS LEARNED from this review of the insurers that have exited Canada's P&C insurance industry over the past 20 years are:

For insurance solvency regulators:

1. **Solvency regulation should focus on profitability as a key indicator of future capital adequacy and exit.** The firms that exited the P&C marketplace reported lower return on equity, worse underwriting results and were less conservatively reserved than firms that remained competitive in the marketplace. Sustained healthy earnings are a primary indicator that an insurer will remain in the marketplace.
2. **Companies exit the marketplace regularly.** Over the past 20 years, more than 161 firms have exited Canada's P&C insurance industry. This is strong evidence of a dynamic and competitive marketplace. Competitive forces impose discipline in underwriting and reserving.
3. **The default rate for Canada's insurance industry is comparable to other well-regulated insurance markets.**

For PACICC member insurers:

4. **Companies exit the Canadian P&C insurance market regularly.** Many companies that exit the Canadian P&C insurance market have a sound book of business, loss reserves, and capital base. These companies may present profitable and viable merger opportunities. White knights are often smart investors.
5. **There is a rigorous process involved in exiting the Canadian insurance market.** The exit process may move quickly if a company is insolvent, but the choice to exit the market voluntarily will be subject to extensive scrutiny by regulators. There are a number of options to support voluntary exit, and these have been used in the Canadian market. The critical element to successfully exiting from the Canadian insurance market is the fair treatment of policyholders.

For PACICC:

6. **PACICC will become involved if an insurance company fails and the regulator orders an involuntary wind-up.** PACICC is prepared to act if a member insurer fails, but it is rare for companies to fail in a well-functioning market in Canada. Sound business practices and appropriate solvency supervision have reduced the frequency of failure in Canada to a low rate similar to that found in other major insurance markets around the world.

7. **PACICC should examine the circumstances when it would consider intervening in advance of an involuntary wind-up.** For example, perhaps there are there circumstances when PACICC would support the sale of an insurer that is likely to soon be declared insolvent, because:

- The potential cost to the industry could be reduced (compared to a full winding-up)
- Policyholders could receive full compensation for losses (going beyond PACICC's current $300,000 cap on personal property claims) and
- The P&C insurance industry's reputation with consumers and government would be maintained, if not strengthened.

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