Property and Casualty Insurance Compensation Corporation

Options to ensure another fifteen successful years of service

March 4, 2003

Table of contents

Positioning for success

The Property and Casualty Insurance Compensation Corporation (PACICC) has served Canadians well since it was established in 1988. At this time, however, changing circumstances require a re-evaluation of the Corporation to ensure that it can be equally successful for the next decade and a half. This paper reviews PACICC's mandate, governance, coverage and capacity with the objective of engaging member insurers in discussion. What reforms would best position PACICC to sustain the success evident during its first fifteen years of operation?

When insurers fail PACICC provides consumers with reasonable recovery of claims for loss and unearned premiums. PACICC is the national guarantee association providing uniform benefits for policyholders and claimants everywhere in Canada. It is a system that for fifteen years has served Canadians well, providing protection to thousands of policyholders and claimants without undue strain on the industry.

Property and casualty insurance insolvencies are rare in Canada, but they do occur. Notwithstanding its history of success in protecting property and casualty insurance policyholders and claimants, the industry and PACICC are facing new responsibilities and challenges. Currently, more insurance customers are with insurers with weak regulatory capital scores than at any time since PACICC was established. This reflects the alarming growth in claims costs that insurers have faced over the past five or six years, and the sharp decline in investment markets over the past two years.

The current environment is one of the most challenging ever faced by the industry. Industry earnings declined to the lowest rate on record over the past two years. A few insurers have failed, and as stated earlier, many are reporting poor regulatory capital scores. The industry is vulnerable to a major shock. In view of this challenging environment facing the industry, it is important that PACICC and its members review its successes, and reflect on how it can best continue to provide reasonable recovery for consumers and cost-effectiveness for member insurers.

Insurance Bureau of Canada (IBC) was the driving force for the industry in establishing a compensation plan in 1988. Accordingly, IBC staff participated in the development of this paper. In particular, we thank Darrell Leadbetter, Randy Bundus and Jane Voll for their contribution to the preparation of this paper.

This paper briefly explores options for PACICC with respect to its mandate, governance, coverage and capacity. Members are encouraged to review the paper and provide direction about how their Corporation can best sustain its record of success. The paper includes a member survey (see Annex D) as one means for members to share their views. All comments are welcome, and we encourage members to forward their views by March 28 so they can be shared with the members of the PACICC Board of Directors. Our thanks to all those who participate in this important review.

Alex Kennedy *President & CEO* *PACICC*	*Paul Kovacs* *Senior Vice President* *IBC*

Mandate options

The Property and Casualty Insurance Compensation Corporation (PACICC) manages a compensation plan (the Plan) designed to provide a reasonable level of recovery for claims for loss and unearned premiums of policyholders under most policies issued by property and casualty insurance companies. It is a plan that has functioned very well during its first decade and a half. PACICC continues to develop effective and efficient mechanisms for working with liquidators to serve insureds and claimants, without disruption or undue strain on the industry.

It is a national plan. Equal treatment is provided to insurance consumers across Canada. We have been successful in avoiding the interjurisdictional problems that plague the fifty state P&C compensation corporations in the United States, so attention and scarce resources are directed to serving Canadian consumers, following insolvency. To best serve consumers it is essential to maintain PACICC's national mandate.

Representatives of PACICC consult with the court appointed liquidator immediately after a winding-up order is made to arrive at an appropriate working relationship. Preliminary consultations are held prior to the appointment, although PACICC is not called upon to make any payments until after the winding-up order has been made. The Corporation could, however, be directed to expand its mandate. This may include proactive work to help prevent the failure of member insurers and/or work with regulators to resolve the problems of troubled insurers.

Preventing insolvency

The federal and provincial insurance supervisors are responsible for the prudential regulation of Canadian insurers. The Office of the Superintendent of Financial Institutions (OSFI) is the prudential regulator for more than ninety percent (by premium volume) of the Canadian P&C insurance industry. The regulators have a professional staff dedicated to minimizing the risk of insolvency, and OSFI has been recognized internationally as a leader in effective solvency regulation. Rating agencies also play a role to reduce insolvency risk.

PACICC could be mandated to further reduce the risk that a member insurer fails. This could involve research into the factors that could contribute to failure, and identification of industry practices to best manage this risk. Staff could prepare confidential assessments of each member, including an analysis of measures of financial health and judgement of management performance. The compensation corporation for Canadian banks (CDIC) has such a mandate.

The Corporation could also be mandated to participate in intervention with regulators and troubled member insurers prior to a winding-up order being made. It is unclear what actions would be involved, but this approach has apparently been helpful in preventing insolvencies in other industries, like life insurance.

Current mandate

Continuance of the current mandate would clearly exclude interventions such as the development of funds to shore up weak companies or involvement with the management decision making processes of a failing company. Regulators would remain responsible for minimizing the risk of insolvency. So PACICC's mandate would continue to be to provide reasonable recovery to individual policyholders and claimants against loss resulting from a financial failure of a P&C company.

Governance options

PACICC was founded in 1988 with the understanding that it would be governed and managed by its member insurers. This governance model was established based upon five years of extensive negotiations with provincial and federal Superintendents of Insurance. It reflected the approach adopted by P&C guarantee funds around the world. At its core was the understanding that regulators work to minimize the risk of insolvency, while the insurance industry manages its guarantee fund to address the needs of policyholders and claimants of a failed insurer.

The National Association of Insurance Commissioners has established a model P&C guarantee fund and this model promotes industry governance. Indeed, forty-four of the fifty state funds in the U.S. are governed without provision for any independent board members, and none of the funds have a fully independent Board. Nevertheless, responding to demands from Canadian regulators, PACICC has modified its governance model to bring independent members onto its Board of Directors. PACICC's governance policy was revised to increase from one, to three and later five independent members on the Board. The 2003 PACICC Board includes 7 senior executives working with member insurers, 6 people with knowledge of the industry who are not employees or officers of any member company, the President and Secretary Treasurer. PACICC has a lower proportion of industry Board members (7 of 15) than any P&C fund in the world today.

In January 2003, the Office of the Superintendent of Financial Institutions (OSFI) indicated that it would prefer that PACICC establish a fully independent board of directors, similar to that of CompCorp, the guarantee fund for Canadian life and health insurers. OSFI has discontinued sharing staging information on the status of companies within the supervisory framework, but has offered to resume sharing this information if PACICC establishes a fully independent Board. PACICC will still be given some prior notice if OSFI intends that a company be wound up. OSFI also publishes on the Internet financial information about P&C insurers, including regulatory capital test results.

P&C is distinct

P&C insurance is very different from life insurance, and this is certainly evident in the management of solvency risk. When a P&C insurer fails, the objective is get consumers to secure coverage with another insurer. P&C insurance is a very competitive industry, so auto and property insurance consumers have many choices when they seek coverage. In contrast, when a life or accident and sickness (A&S) insurer fails, the objective is to find another insurer that will continue the coverage for policyholders. A complex dialogue takes place when a life or A&S insurer is in difficulty, including extensive sharing of confidential company information and plans with the members of the CompCorp Board of Directors. There would be limited utility in the sharing of this kind of information with the PACICC Board when a general P&C insurer is in difficulty.

Canadian and U.S. experience demonstrates that the information requirements of administering a property and casualty insurance compensation fund are different than those required for solvency monitoring and intervention. It is important that a compensation fund be aware of insolvency risk, however, it does not need detailed staging and intervention data in order to effectively and efficiently administer compensation to policyholders and claimants. Enhanced information and analysis by PACICC of public information could address the information requirements of a P&C compensation fund.

Coverage options

In the unlikely event of the collapse of a Canadian P&C insurer, the industry seeks to provide a reasonable level of recovery to policyholders under most policies issued by P&C insurance companies. The objective of the Plan is to provide policyholders with basic compensation, but it is not designed to provide full coverage in all cases. The maximum recovery from PACICC is $250,000 in respect of all claims arising from policies to an insured that arise from a single occurrence. Since 1996, the Plan also responds to claims for unearned premiums up to 70 percent of a maximum unearned premium of $1,000.

The industry compensation plan covers the majority of policies in force. Excluded from the Plan are policies written by life insurers because they manage a similar plan. Also excluded because of their distinctive characteristics are insurance for aircraft, credit, crop, directors' and officers', employer's liability, errors and omissions (medical malpractice is covered), fidelity, financial guarantee, marine, mortgage, surety, and title. Auto insurance is excluded in British Columbia, Manitoba and Saskatchewan where government-owned insurers provide coverage. Bodily injury auto claims are excluded in Quebec. Government-owned insurers otherwise participate in the Plan. Notwithstanding these exclusions, the Plan covers most P&C policies.

Current limits

It is important that PACICC regularly assess its recovery limits so they are reasonable for claimants. In particular, the maximum recovery for claims needs to reflect current claims trends.

Commercial property

PACICC protects individual policyholders and claimants against loss due to the financial failure of a P&C insurance company. Large commercial property owners and their brokers have the resources and capacity to analyze information published by OSFI, rating agencies and other sources on the financial soundness of their insurer. Such research and analysis should be done as part of a company's normal risk management plan. Large commercial entities also may be financially able to absorb the impact of the insolvency of their insurer and perhaps should not compete for claims payment resources with individual consumers and small enterprises.

Currently PACICC covers all property policies, with limits. In the event of insolvency, assessments on the industry are based on premiums, and as the cost of insolvencies are spread over the premium base, these costs are ultimately borne by policyholders. More than three-quarters of the industry's total premium comes from personal lines, so personal insureds ultimately bear the largest part of the cost of protection that PACICC provides for commercial coverage. To address this issue, guarantee funds in other jurisdictions have provisions that limit coverage for commercial property.

The experience of a number of state guarantee funds of paying large claims under policies issued to large corporate insureds led guarantee associations to examine ways to better allocate resources to those claimants and personal insureds. As a result, many states have instituted exclusion or subrogation net worth provisions. The exclusion stops the fund from paying claims to insureds whose net worth exceeds a threshold. The subrogation-type provision usually applies to third party claims and requires the fund to pay the claim but then recover the payment from insureds with net worth beyond some limit. Net worth provisions serve as reasonable limits on claims of large commercial insureds, in effect preserving guarantee association capacity for individuals and small businesses. Thirty-one states currently have some form of net worth provision in their state guarantee fund statutes. In addition, Japan and other international jurisdictions currently have similar provisions or are introducing them.

Coverage options (con't)

Auto cover in B.C., Manitoba and Saskatchewan

Fifteen years ago auto insurance coverage in British Columbia, Manitoba and Saskatchewan was excluded from PACICC. This is no longer consistent with current practices in these markets and the Plan.

In 1988, when PACICC was established, the statutory minimum limits for automobile liability insurance in all jurisdictions were $200,000. This was also the amount that public insurers provided in their basic auto liability coverage. PACICC limited its payments for direct loss to a maximum of $200,000. At that time PACICC did not provide for the partial refund of unearned premiums. And it was argued that the public insurers would not fail. So all auto coverage in these three provinces was excluded.

PACICC has increased its coverage limit to $250,000 while there has been no change in the basic coverage offered by the provincial insurers. Also PACICC now provides a partial repayment of unearned premiums. It can be argued that optional auto coverage in these provinces should now be included in the Fund.

Government supported insurers and private insurers jointly shape the market environment through their competitive practices. In a highly competitive environment, such as property and casualty insurance, public insurer practices may have a large influence on solvency risk. Government supported insurers participating in voluntary markets do not stand apart from contributing to the broader risks of insolvency. Further, as the cost of insolvency is ultimately borne by policyholders, a government supported insurer that competes with private insurers but does not participate in a guarantee fund possesses an unfair competitive advantage.

In markets where government-owned insurers compete with private insurers, such as the personal property insurance market in Saskatchewan, public insurers are required to participate in PACICC. In British Columbia, the Government is working to create a level playing field between the government owned insurer and private insurers, and this should involve inclusion of private insurers and ICBC's optional auto insurance business in PACICC.

Capacity options

Is PACICC appropriately prepared for the challenging period that lies ahead? This is a difficult question to answer. Experience demonstrates that P&C failures are very rare in Canada, and PACICC has successfully managed the failure of a number of smaller insurers. The Corporation has established a prefund of $30 million, and a small (1½ full time equivalents) but very knowledgeable staff. Nevertheless, there is a growing sense within the membership that additional capacity is needed, particularly in the current environment. The changing relationship with OSFI further reinforces the importance that the Corporation reviews its capacity.

Prefund adequacy

The optimal size of PACICC's prefund is difficult to determine. Insolvencies are rare and each event is unique, so history is a poor indicator of future need. Moreover, PACICC has established a maximum annual levy, and this limits the Corporation's ability to quickly access new funding. Accordingly, PACICC established a prefund of $30 million that will help the industry manage the failure of a member. In addition, PACICC has access to a $10 million line of credit. Some recent P&C failures suggest that this may not be sufficient if a larger member should fail, or if more than one mid-sized member fails. The Canadian life insurance industry has set up a prefund of $100 million. Research would help to better define the appropriate fund size and maximum annual levy formula for PACICC.

Resource adequacy

A further, but distinct, concern is the limited infrastructure and resources of PACICC. Several U.S. P&C compensation funds have a staff of 50 or more people, while PACICC has four people working part time. Appendix A shows that PACICC members pay $2,000 a year, on average, to support the administration of PACICC, compared to payments of $27,000 a year by Canadian life insurers to support CompCorp, and $270,000 a year by the Canadian banks to support CDIC. This was sustained during the period when the Canadian P&C industry was very well capitalized, but this should not continue in the current market. If PACICC increases its staffing by 3 or 4 people then it would have the capacity to address questions like those set out in Appendix C, such as how to introduce risk-based member assessments.

PACICC should also explore the idea of a contingent capacity plan, perhaps with formal arrangements in place so staff could be seconded to the Corporation from member insurers or other potential partners to ensure that PACICC is able to manage the failure of a large insurer.

Relationship with regulators

The relationship with regulators is an important factor in determining the capacity of PACICC. It is therefore important that the Corporation review the nature and scope of its relationship with Canadian insurance regulators. This will clarify responsibilities and expectations, and should strengthen communications. PACICC needs to maintain a healthy and mutually supportive relationship with all of the federal and provincial insurance regulators.

Conclusion

PACICC has served insurance consumers and the insurance industry very well since it was established 15 years ago. Changing circumstances, however, require a reassessment of the Corporation. This paper explores a number of the reform options that should be considered by member insurers. Members of the PACICC Board of Directors welcome comments from member insurers about possible reform ideas, and particularly invite comments about the Corporation's mandate and governance.

Board discussion about these issues is very supportive of sustaining the current mandate and governance practices, and we seek affirmation from member insurers that they share this perspective. In particular, we seek to determine if the members agree to:

- ✓ *Reaffirm the industry's confidence in PACICC's current mandate, as the industry's guarantee fund that provides reasonable recovery to individual policyholders and claimants against loss resulting from the financial failure of a P&C insurance company. PACICC should remain a national plan. Canada's insurance supervisors are responsible for minimizing the risk that an insurer fails, while PACICC's mandate should not be expanded to possibly overlap with the work of regulators.*

- ✓ *Canada's P&C insurers should continue to govern and manage PACICC. Current practices reflect the approach that has been proven effective in the management of other P&C guarantee funds internationally. PACICC already has the lowest proportion of industry representation on the Board of any P&C guarantee fund.*

Member insurers are encouraged to share their views about how to best strengthen PACICC's ability to sustain its track record of success. All views are welcome and should be directed, preferably by March 28, to Alex Kennedy, the Corporation's President and CEO. Member participation in this important review is greatly appreciated.

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Annex A

Comparison of the Canadian financial service guarantee funds

	PACICC	***CompCorp***	***CDIC***
Mandate	Protect policyholders and claimants against loss due to the financial failure of a P&C insurance company.	Provides policyholders with protection against loss of benefits from insolvency. Monitor the level of Financial failure risk in the industry and member companies. Work cooperatively on risk mitigation and interventions.	Protects depositors against loss. To be instrumental in the promotion of standards of sound business and financial practices. Pursue objectives for the benefit of depositors in such a manner as will minimize the exposure of loss.
Governance	Board of Directors elected by member companies.	Independent Board of Directors.	Half of the Board are ex officio (Finance, OSFI, Bank of Canada...)
Member institutions	214	110	89
Operating budget	$0.5 million	$3 million	$24 million
Expenses/member	$2,000	$27,000	$270,000
Staff	1.5	16.5	95

Annex B

Some pros and cons of an independent PACICC board

Some advantages

* PACICC will be a full participant when a member fails that is affiliated with a bank, trust or life insurer fails.
* A stronger relationship with regulators who have proposed a fully independent board.
* Advice from the board may reflect a broader range of experiences.
* Board members may have more time to support PACICC.

Some disadvantages

* Reduced board engagement with industry issues. Within approximately six months, even individuals who have spent a career in the industry are frequently out of touch with current issues and challenges.
* Member insurers may become increasingly detached from PACICC and less involved in the identification of emerging risks or support of organization.
* Weakened linkages in the higher level strategic and regulatory process between complimentary industry issues. (Such as guaranty fund assessments and industry capital requirements.)
* Higher levels of supporting infrastructure and data requirements are required to provide board members with information and background that industry members would already have.
* Enhanced board compensation and incentives may be required to align board member interests toward effective participation and monitoring of insolvency issues.
* Senior management would be required to spend more time communicating with Board members, reducing time available for managing insolvencies, relations with regulators and other responsibilities.
* Greater attention will be needed to regularly revisit the mandate of PACICC to ensure that the independent board members focus on the priority issues identified by the members of Corporation.
* Reduced board flexibility to respond to emerging issues in terms of member availability and increased formalization of processes.

Annex C

Examples of policy issues that could be addressed with a change in PACICC staffing

How should PACICC assess members/the role of risk-based assessments?
CompCorp, CDIC and other guarantee funds have introduced risk-based assessments and OSFI are now publishing regulatory capital test information so PACICC could introduce risk-based assessments.

How large should the PACICC pre-fund be?
PACICC has a fund of $30 million available to pay insolvency costs but is this adequate? CompCorp maintain a fund of $100 million. OSFI have asked if PACICC believes it has the resources available to respond to insolvencies.

What is the optimal size of a guarantee fund board of directors?
The consensus on the optimal size for a board of directors has changed since PACICC was established. A review of the corporate governance literature and best practices on the optimal size of the PACICC board may show that a smaller board is better than a larger board.

What are the appropriate practices governing director conflict of interest in the event of insolvency?
Review property and casualty guarantee fund practices and by-laws for addressing conflict of interest for companies at risk of insolvency and members of the guarantee fund board of directors.

What is the most efficient mechanism for funding the operating costs of a guarantee fund?
CompCorp and many P&C guarantee systems, fund their operating costs through an allocation of a portion of investment income, and do not assess members, and a similar approach may provide a more cost effective way to fund PACICC's operating budget.

Should PACICC establish an insurance company?
A review of organizational structures of guarantee funds will identify options to further improve PACICC's management of insolvencies. In particular, PACICC could establish a licensed insurer, similar to CompCorp Life, to manage insolvencies and smooth out the flow of funds between the Corporation and its members.

What are the major factors that could cause a PACICC member to fail?
Review past failures of P&C insurers and other information about the risk of future insolvencies. In particular, review the risk associated with new companies and also insurers operating in multiple jurisdictions.

What is the relationship between regulatory capital requirements and guarantee funds?
Regulatory capital requirements are higher in Canada than in the United States, Japan and Europe, and research could explore if this may have reduced the total net cost to the guarantee fund of resolving insolvencies.

How can the guarantee funds best manage financial conglomerates?
Review the legal and economic implications of the insolvency of a financial conglomerate. This should be done in co-operation with CompCorp and CDIC.

Annex D

PACICC member survey *Note: Please mark your preference with* "(X)"

Mandate (choose one):

Discussion of this issue is included on page 2. A summary can be found in the conclusion on page 7.

( ) Reaffirm the industry's confidence in PACICC's current mandate, as the industry's guarantee fund that provides reasonable recovery to individual policyholders and claimants against loss resulting from the financial failure of a P&C insurance company. Canada's insurance supervisors are responsible for minimizing the risk that an insurer fails, while PACICC's mandate should not be expanded to possibly overlap with the work of regulators. *(status quo)*

or

( ) Expand PACICC's mandate to intervene to prevent the failure of members, work directly with regulators to resolve the problems of troubled insurers while resolving claims and refunding unearned premium following an insolvency

Comments: ____

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Governance (choose one):

Discussion of this issue is included on page 3. A summary can be found in the conclusion on page 7.

( ) Canada's P&C insurers should continue to govern and manage PACICC as current practices reflect the approach that has been proven effective in the management of other P&C guarantee funds internationally *(status quo).*

or

( ) Establish an independent Board where no one on the PACICC Board works with a member insurer

Comments: ____

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Your name and address:

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Please complete and return by March 28 to:

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