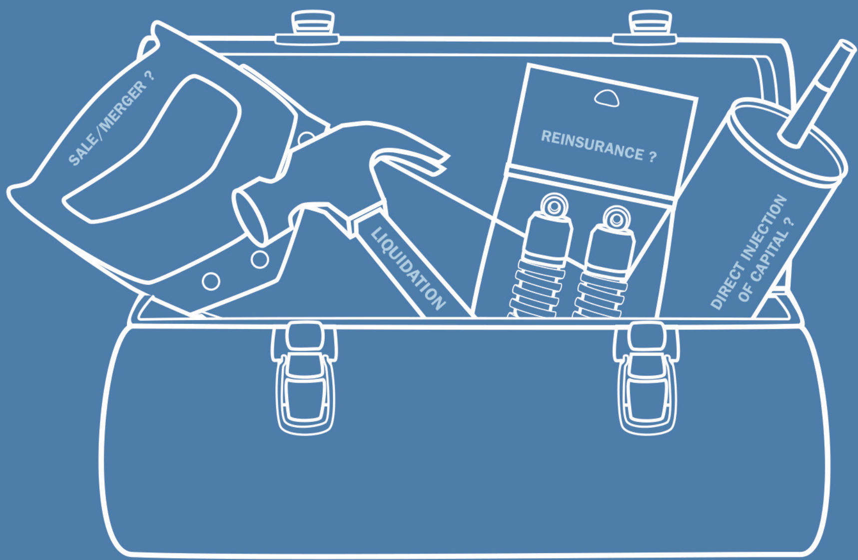
PACICC

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

Alternatives to Liquidation?

Exploring the case for expanding Canada's P&C resolution toolkit



By

Grant Kelly

The latest instalment in the PACICC Why insurers fail series.

2019

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PACICC's mission and principles

Mission Statement

The mission of the Property and Casualty Insurance Compensation Corporation (PACICC) 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 (P&C) 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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PACICC is responsible for the observations and conclusions of this study, and any errors and omissions.

Executive Summary

Property and Casualty Insurance Compensation Corporation (PACICC) exists to protect consumers if their insurer fails; maintain confidence in the property and casualty (P&C) insurance industry; and minimize the cost of resolution. Some insurance companies experience distress but then voluntarily exit the market without any need for PACICC. In these cases, management and regulators ensure that consumer interests are protected. However, a few insurers do experience extreme distress and fail. It is very rare that we are needed, but in these situations our role is critical.

For more than 30 years, PACICC has used one tool – liquidation – to resolve a failed insurer. Liquidation is a formal legal process in which all of the assets of the failed insurer are sold or otherwise monetized, with the proceeds used to pay its policyholders, claimants and creditors. A common problem in such cases, is that there is not enough money left to pay everyone in full. PACICC's specific role is to provide the Liquidator with the funds required to reimburse a portion of the premiums paid in advance by policyholders and to make sure that policyholders with a claim receive money owing to them – up to defined limits. These funds are provided by the solvent member insurers of PACICC via an assessment.

In the Corporation's establishing documents, PACICC's founders envisaged that the Corporation could need a broad range of tools to protect consumers. Paragraph 40 of PACICC's Memorandum of Operation gives PACICC the ability to:

- inject capital or issue a guarantee to a book of business of a distressed insurer;
- assist in the sale of an insurer or book of business; and
- offer guarantees (including procuring reinsurance).

In fact, the Corporation's powers to assist prior to the issuance of an actual wind-up order are quite broad. However, because PACICC has rarely had advance notice of extreme distress, the Corporation has never previously used such tools to resolve a distressed P&C insurer. Compensation funds in other financial industries, such as banking, have a more developed tool kit, to allow resolution of distressed institutions before liquidation. They have successfully employed a wider variety of tools than have ever been employed to protect Canadian consumers in cases of P&C insurer distress.

This paper explores whether the resolution tools available in other parts of the financial services sector could, if used in the P&C insurance industry, produce better outcomes for policyholders and for PACICC member insurers. It presents three scenarios and identifies two where the type of resolution tools available in these other sectors could potentially better protect consumers, be less costly for member insurers and strengthen confidence in Canada's insurance system. The paper concludes by highlighting potential changes required within PACICC, if industry stakeholders determine that the Corporation should indeed be better prepared to employ a broader range of tools in future cases of insurer distress.

Introduction

This is the 13th edition of PACICC's *Why insurers fail* research series. While it is rare for P&C insurers to fail in Canada, this research program has served 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 have been to:

- identify the causes of 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.

Historically, PACICC's involvement in protecting consumers of distressed P&C insurers has been limited to assisting in the liquidation of the insurer. This 2019 edition of *Why insurers fail* presents three scenarios where options beyond liquidation could potentially both benefit insurance consumers and reduce costs for PACICC member insurers. It also discusses the applicability of the resolution tools available to resolution authorities in other financial industries and outlines some of the changes that would be required both within PACICC and within Canada's policy framework to enable PACICC to better protect consumers in such situations.

The rubric used to evaluate these tools is based on recommendations by the Financial Stability Board (FSB) and the International Association of Insurance Supervisors (IAIS).[1] We also compare the actual powers in place for P&C insurance resolution in Canada with these international best practices, in order to identify and better understand any gaps that exist between actual versus recommended powers.

[1] "Key Attributes of Effective Resolution Regimes for Financial Institutions," Financial Stability Board, October 15, 2014.

Part 1: Background Information

What is resolution?

According to the IAIS Insurance Core Principle 12 (ICP 12):

> "**Resolution** refers to an action taken by a resolution authority towards an insurer that is no longer viable, and has no reasonable prospect of returning to viability. Resolution actions include portfolio transfer, run-off, restructuring and liquidation."
>
> "**Resolution Authority** refers to authorities that are responsible for exercising resolution powers over insurers. Depending on the jurisdiction, this term may include supervisors, other governmental entities or private persons (including administrators, receivers, trustees, conservators, liquidators, or other officers), or courts authorised by law to exercise resolution powers."

It is clear from the above that "resolution authority" can refer to multiple entities (including financial guarantee funds), working in concert to ensure that troubled insurance companies can be closed without disrupting financial market confidence and without imposing large losses on consumers.

In Canada, the Canadian Deposit Insurance Corporation (CDIC) is the resolution authority for banks. Assuris is the resolution authority for the life insurance industry and PACICC performs this role for the P&C insurance industry.

In the case of banking, there are clearly defined roles for regulators and the CDIC, and there is a defined point when authority transfers from the regulator to the compensation fund. This clarity does not exist in P&C insurance. The resolution authorities for the P&C insurance industry are a combination of the relevant insurance regulators (federal and provincial) and PACICC.

The IAIS also defines what powers a resolution authority needs to have. In Canada, these powers are shared by regulators (e.g. the Office of the Superintendent of Financial Institutions (OSFI), the Autorité des marchés financiers (AMF)) as well as compensation associations. The significant role of provincial solvency supervision complicates the resolution regime because each provincial insurance regulator has different legislative authority and it is not clear that all of Canada's provincial insurance regulators have the full range of resolution powers recommended by international best practice.

P&C consumers have been well served by the system that sees the solvency regulator responsible for going-concern companies and single-purpose consumer protection programs like PACICC accountable for managing resolution.

Resolution Authority Characteristics

In October 2018, the Financial Stability Board (FSB) conducted a status report on the implementation of resolution regimes across the world for insurance companies. The following table details how Canada fared in this assessment:

FSB: Status of implementation of aspects of insurance resolution regimes by FSB jurisdictions as of October 2018

	Existence of administrative resolution authority	Powers to undertake a transfer (including a portfolio transfer)	Powers to establish a temporary bridge institution	Powers to administer existing insurance contracts and fulfil obligations (including run-off)	Powers to impose temporary stay on early termination rights	Powers to restructure, limit or write down insurance and reinsurance and other liabilities	Existence of privately-financed policyholder protection schemes or resolution funds
Canada							

Current status of implementation

- Implemented
- Partially implemented (all elements in the Key Attributes provision are satisfied but powers/requirements can be exercised only in limited circumstances)
- Not implemented (some or all of the elements in the Key Attributes provision are not satisfied)

Source: Financial Stability Board

According to the FSB, Canada has clearly described processes and the required legislative clarity in just three of the seven aspects of an insurance resolution framework. The scenarios explored in this paper highlight why it is worthwhile to explore how to address at least some of the gaps in order to enhance our resolution framework.

Canada's *Winding-Up and Restructuring Act*

The *Winding-Up and Restructuring Act* (*WURA*) is the law that governs the liquidation or orderly exit of an insurance company and the resulting distribution of its assets in Canada. This piece of legislation is critical when considering Canada's resolution regime. Under *WURA*, a basic test of any resolution option is that it does not make any creditor worse off relative to the alternative of liquidating the company and using assets to pay creditors. This is a very important test when considering alternatives to liquidation.

Section 161 of *WURA* sets out the priority that different types of creditors may claim on the assets of the distressed insurer. The order of priority is:

1) Expenses of the liquidator in carrying out the liquidation;
2) Claims of employees for wages;
3) Policyholders with a claim; and
4) Policyholders with a claim for unearned premiums.

Under *WURA*, all or a portion of the policies may be transferred or reinsured, if the transaction is determined to be fair and equitable to all policyholders and the estate of the company as a whole.

PACICC's resolution powers

Part XI of PACICC's Memorandum of Operation[2] outlines PACICC's powers to act prior to control or winding-up order. The full text is included below. This section of the Memorandum of Operation has never been used by PACICC. It is not currently clear how or when PACICC would use these powers, however, it is very clear that the Corporation's founders saw the need for PACICC to act as a resolution authority. They established the Corporation with the authority to employ several potentially useful tools to assist in the successful resolution of a P&C insurer in Canada.

[2] http://www.pacicc.ca/wp-content/uploads/2017/11/Memo-of-Operation.pdf.

PACICC's Powers Prior to Control or Winding-Up Order

The Corporation has substantial power to act prior to a winding-up order.

PACICC Memorandum of Operation:

40. 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.

Resolution tools available in other Canadian financial sectors

Canada's other financial services sectors have more clearly defined the tools that they might use to resolve a distressed financial institution and have more clearly articulated circumstances in which such tools could be helpful. This section of the paper will discuss whether these tools might be appropriate for PACICC. The resolution tools available in the life and banking industries include:

1) Assisting with or forcing a sale;
2) Bridge bank/insurer;
3) Providing direct financial injections;
4) Requiring built-in shock absorbers; and
5) Liquidation.

1) Assisting with or forcing a sale

When the resolution authority can identify a potential buyer, it can assist or sometimes force a sale to another company. This sale could be of a large asset and range all the way up to a sale/merger of the entire company.

In banking, for instance, CDIC can take control of a failing bank in Canada for a short period of time in order to complete its sale, merger or restructuring. The sale would ensure that insured deposits are protected. With the approval of the government, a forced sale would be used when shareholder consent for the transaction is not expected or the time to obtain consent would be too lengthy.

CDIC identifies two types of forced sales:

1. All shares are transferred to CDIC and it becomes the sole shareholder to facilitate the sale; and
2. CDIC is appointed receiver to sell all or some of the failing bank's assets and liabilities to the buyer.[3]

PACICC cannot currently force a member insurance company to sell an asset. However, both OSFI and the AMF have the power to assume control of an insurer to potentially force its sale. It is not currently clear that Canada's other provincial regulators have this power.

[3] http://www.cdic.ca/en/about-cdic/resolution/Pages/tools.aspx.

Under OSFI's Guide to Intervention, a P&C insurer reaches "Stage 4" when; the regulator determines it is experiencing severe financial difficulties, the company has failed to meet regulatory capital requirements and has not immediately rectified the situation, or the insurer has not presented an acceptable business plan. In such a case, OSFI will determine the company to be non-viable. When these statutory conditions for taking control exist, OSFI may assume temporary control of the assets of the insurer and place these assets under its administration. PACICC's By-Law gives authority for the Corporation to assist with the sale of a troubled insurer (in whole or in part). However, PACICC does not currently have a defined set of criteria that must be met before it becomes involved. It is also not currently clear how PACICC would finance or receive support of member insurers to become involved in such a transaction.

2) Bridge bank/insurer

A "bridge bank/insurer" is a tool that is available when an institution fails and there is no buyer or private-sector solution on the horizon. It can be useful to employ such a bridge institution when the problems facing the institution can be isolated and there are other assets of value within the distressed company. These may include a profitable line of business, or a secure stream of cashflows. A bridge entity serves exactly the purpose its name suggests – it is meant to bridge the gap between when an institution fails and when a buyer or private-sector solution can be found.

CDIC is authorized to use such a tool to transfer all or part of a failing bank's business to a "bridge bank", which is temporarily owned by CDIC. Similar to a forced sale, the transfer ensures that insured deposits are protected. As owner, CDIC would likely appoint to the bridge bank a board of directors and chief executive officer to handle the restructuring and to stabilize the bank. Once stable, the bridge bank would then be sold to the private sector.

PACICC does not have such a P&C bridge insurer at the ready. PACICC's By-Law gives the Corporation the power to assist with the sale of a book of business that could potentially have a similar impact by separating profitable and unprofitable books of insurance business. However, PACICC has not yet developed any criteria that would be used to determine if/when to employ this resolution tool.

3) Direct financial assistance

CDIC and PACICC both have the authority to provide financial assistance to their member institutions, including loans, guarantees, deposits, or loss-sharing agreements or by acquiring shares. Both organizations can provide this assistance on a stand-alone basis, to assist in a private transaction, or in combination with any of its other resolution tools.

Direct financial assistance provided by PACICC could include a loan, an injection of capital or a purchase of a reinsurance contract. Again, it is important to note that today, PACICC has not yet defined the criteria for determining if such tools would be appropriate nor the conditions under which such assistance might be advanced.

4) Requiring built-in shock absorbers (Bail-in bonds and reinsurance)

The idea behind "shock absorbers" is to require an individual financial institution to plan in advance and to in fact provide its own resolution tools. The primary advantage of this is that there is less likely to be a cost to a compensation fund or to government. The "shock" is absorbed and the bank or the insurer continues in the market as before.

In 2016, Parliament introduced an amendment to the *Canada Deposit Insurance Corporation Act* to add the "bail-in power" to that Corporation's resolution tools. The Act required Canadian banks to issue bonds that would convert into regulatory capital should the bank become distressed.This tool is only for use in respect of Canada's six largest banks, known as Domestic Systemically Important Banks (D-SIBs), and acts as a shock absorber for the banking sector. These types of bail-in bonds do not currently exist for insurers in Canada.

Reinsurance is a comparable tool, as it is often employed to provide a capital buffer in the event of losses beyond those anticipated. Under such a reinsurance contract, an insurer (primary insurer) buys insurance from a second insurer (called a reinsurer). While reinsurance contracts are often complex legal documents, in essence, the contract says that in the case of a defined trigger event, the primary insurer can receive capital from the reinsurer. Reinsurance is widely used by both P&C and life insurers and acts as the shock absorber for Canada's insurance industry.

5) Liquidation

Liquidation is the final tool available to resolve a Canadian financial institution. It is the last resort tool that is used when all other options have been discarded. The regulator goes to court and winds-up the company under *WURA*. In such a liquidation, all assets are sold (liquidated) and the proceeds are used to compensate those that are owed money (creditors). The court appoints a liquidator to oversee the liquidation. In the case of the P&C sector, PACICC works with the liquidator to provide the cash necessary to protect policyholders.

Liquidation is the tool with which PACICC has the most experience. In fact, in reviewing each historical case, PACICC would argue that liquidation was the correct approach to take in order to fulfill its mandate. Generally speaking, in these cases, the insurers were closed by regulators because the failed insurers could not find buyers and there were no profitable lines of business left to sell.

Under conditions such as these, PACICC expects that liquidation will continue to be an important tool to protect P&C policyholders, should their insurer fail.

Financial Stability Board Guidance

FSB has issued Guidance on *Insurance Resolution Strategies*[4] that discusses when these tools should be employed. The FSB suggests that when there is "sufficient substitutability" (meaning that policyholders can easily move to another insurer on similar terms), it may be necessary to provide for continuity of cover only for a limited period, to enable existing policyholders to find replacement cover in the open market.

The Guidance also suggests that alternatives to liquidation should be considered if:

1. There are structural factors that lead to limited substitutability which may need to be addressed by policy action in other domains (e.g., competition);
2. Where insurers provide insurance functions of particular economic importance that have limited substitutability, authorities may consider this factor when developing resolution plans; and
3. Distressed insurers are of a significant size or importance and could be a channel for contagion, either within the group or to third parties.

[4] http://www.fsb.org/wp-content/uploads/Final-guidance-on-insurance-resolution-strategies.pdf.

In the case of the Canadian P&C sector and the defined list of general insurance products for which PACICC provides policyholder protection, substitutability is unlikely to be an issue. In fact, it is only in the last of these three circumstances where PACICC's lack of alternatives could prove to be problematic.

Canada's P&C Insurance Sector: Some Important Context

The Guidance of the FSB is in line with PACICC's experience. PACICC has not yet been required to utilize the full range of resolution powers at its disposal.

1) P&C contracts are short-term

Most P&C insurance policies are annual policies. The consumer agrees to pay his/her premium and the insurer promises that they will indemnify for any covered losses for an annual policy period. At the end of the year, the policy coverage is concluded and the consumer can decide to renew the policy with the same insurer, switch to a different insurer or, with the exception of mandatory coverages, choose not to buy insurance. This makes P&C insurance different from most other financial products that involve financial intermediation and long-term relationships. When a P&C insurer fails, the message to Canadian P&C policyholders of that insurer has been to:

- stop paying their premiums; and
- find a new insurer (within 45 days).

Funds stop flowing into the failed P&C insurer at that point. The assets available to the estate of a failed P&C insurer consist of an investment portfolio and potentially some reinsurance contracts. Generally, all of this money is required to pay the large volume of claims that the failed insurer left behind. If there are not enough assets, then PACICC, subject to coverage limits, provides what is needed to protect policyholders.

This is in direct contrast to most life insurance policies. Life insurance contracts are multi-year or multi-decade financial commitments. When a life insurer fails, the message to its policyholders has been to keep paying their premiums. As a result, a stream of cash continues to flow into the estate of the failed life insurer. When there is such a continuing cash flow, it has been possible for compensation associations in other financial sectors to sell this stream of cashflows to another insurer. These sales can result in better outcomes for policyholders (i.e. who may not necessarily be able to find similar coverage so many years after their initial purchase) and result in less costly resolutions.

Brief history of P&C insurer insolvencies in Canada

Since PACICC was established in 1989, the Corporation has had to respond to a total of 13 insurer insolvencies in Canada. Two of these insurers were well-capitalized branches that were ordered to be wound-up because their U.S. parent company had become insolvent. In every case, PACICC worked with court-appointed liquidators to wind-up or liquidate the company. The lone exception was **Home Insurance Company**. In this case, the liquidator was able to find a buyer to purchase the company and avoid liquidation.

- **Ontario General Insurance Company:** wound-up in 1989. An Ontario multi-line company that failed as it grew too rapidly and proved to have deficient loss reserves.
- **Canadian Universal Insurance Company:** wound-up in 1991. A Newfoundland and Labrador company writing commercial business primarily in the United States. Its parent company failed as a result of alleged fraud.
- **Beothic General Insurance Company:** wound-up in 1993. A Newfoundland and Labrador company writing primarily personal lines that failed due to deficient loss reserves.
- **Hiland Insurance Company:** wound-up in 1994. A Newfoundland and Labrador company writing primarily personal lines that failed as a result of weak internal controls and alleged fraud.
- **Abstainers' Insurance Company:** wound-up in 1995. An Ontario company writing primarily commercial business that failed when its parent company (Maplex) failed.
- **Maplex Insurance Company:** wound-up in 1995. A multi-line Ontario company that experienced rapid growth and deficient loss reserves. It also had weak internal controls.
- **GISCO la compagnie d'assurance:** wound-up in 2000. A Quebec company writing commercial business that experienced rapid growth and proved to have deficient loss reserves.
- **Canadian Millers' Mutual Insurance Company:** wound-up in 2001. An Ontario company writing commercial business that expanded into unrelated areas and experienced challenges in asset valuation.

- **Markham General Insurance Company:** wound-up in 2002. An Ontario auto insurance writer that grew too rapidly, had inadequate pricing and ultimately proved to have had deficient loss reserves.
- **Reliance Insurance Company:** wound-up in 2004. A profitable Canadian branch was closed due to an insolvent U.S. parent. This was a "solvent liquidation."

The final accounting of these estates shows that PACICC collected $68 million in assessments from member insurers to provide liquidity. Liquidators paid more than $121 million to reimburse premiums and to settle outstanding claims. When all of these were settled, PACICC refunded more than $57 million to member insurers.

2) A healthy and competitive exit market exists for P&C insurers

There is a healthy and competitive exit market in Canada. On average, seven or eight insurers leave the market each year. The 2017 edition in PACICC's *Why insurers fail* series identified 161 different insurance companies that exited the Canadian P&C market between 1996 and 2015. Some 155 of these firms exited voluntarily, which was more than 96 percent of exiting firms. PACICC had no role in these exits. Consumers that bought policies from these companies were adequately protected by the regulatory system throughout the company's lifespan. Exiting insurers have numerous options available under Canada's voluntary exit regime – including assumption reinsurance agreements, transfer of liabilities, and run-offs.

3) There are fewer small insurers in the market

When PACICC began operations in 1989, Canada's largest P&C insurer held just 4.8 percent of the market. In 2019, Canada's largest P&C insurer writes more than 17 percent of the market. In PACICC's history, the majority of insolvencies have been small, provincially regulated companies. In 1990, there were more than 200 insurers with a market share of less than one percent. In 2018, there were just 125 PACICC members with less than one percent market share.

Why other resolution tools could become more important: A Changing Industry

As PACICC enters its fourth decade of protecting Canadian insurance consumers, there are some important changes to its operating environment that might make the use of options prior to liquidation more likely.

1) Regulatory standards have improved

Over the past 15 years, Canada's system of solvency regulation has been strengthened. Significant regulatory initiatives include:

a) the introduction of a risk-based Minimum Capital Test/Branch Adequacy of Assets Test;

b) a requirement that actuarial liabilities of insurers now be peer reviewed by an independent actuary;

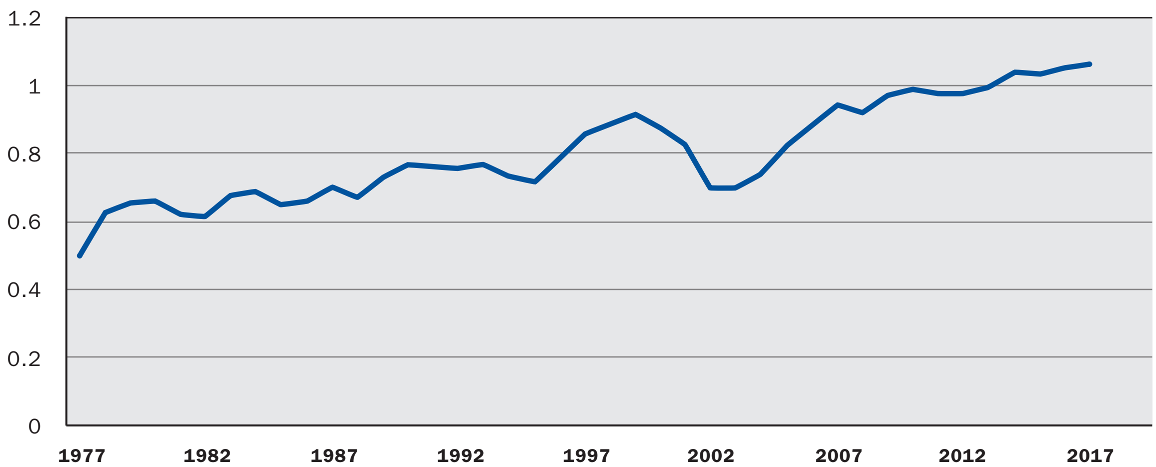
c) guidelines that require insurers to file reports on preparedness for earthquakes;

d) strengthened corporate governance; and

e) risk management reports on their reinsurance program.

The net result of these enhanced regulatory standards has been an increase in capital held by insurers. In 2018, every dollar of insurance underwritten in Canada was supported by $1 of capital. When PACICC was originally established in 1989, member insurers held only 70 cents of capital for each dollar of insurance they underwrote. This means that insurers today are better capitalized and much better prepared to manage shocks such as unanticipated events or deterioration in performance of a line of business.

Chart 1 – Capital to net premiums earned



Source: PACICC based on data from MSA Research

2) Development of new Regulatory Intervention Guides

The 2015 edition in PACICC's *Why insurers fail* series looked at the final 10 years of the insurers that failed in Canada over the past 40 years. Concepts such as "a run on the bank" mean that some financial institutions fail suddenly, but this has not been the historical experience in the Canadian P&C insurance industry. Some warnings of financial distress were generally evident years before each failure. In fact, most companies experienced a shock five or six years before failure, when their claims increased significantly.

Some insurers responded to this unanticipated spike in claims by selling assets and lowering prices in order to increase sales revenues. Assets sold in a rush may be undervalued. Revenues that result from lowering prices below adequate levels or the failure to set aside sufficient loss reserves because income is low, are actions that set the stage for the next underwriting crisis. In fact, for any capital injection to make a difference, it must be coupled with improved loss reserving practices and a review that ensures prices are adequate.

Most insurers that failed over the past 40 years were successful in securing some external funds to support their troubled company – nevertheless, these companies all eventually became insolvent. These injections were not generally used to address the primary weakness found in all insurance companies that failed – poor underwriting.

History suggests that there have been relatively few "surprise" failures in the Canadian P&C industry. In each case, the management of the insurer was given opportunities by regulators to solve their difficulties before they were ultimately shut down. The salient point however, is that these failures were generally a "surprise" to PACICC in that the Corporation had not previously been engaged in dialogue with the regulator and was not in fact brought into the equation until liquidation had become the sole remaining option. This is now changing.

In 2016, PACICC's Board of Directors established the Pre-Insolvency Regulatory Liaison Committee (PIRL), consisting of PACICC's non-industry Directors. The mandate of this committee is to provide a forum for confidential discussions with regulators, should the need arise.

The AMF released its new *Intervention Guide* in 2016. In 2018, OSFI released its new *Guide to Intervention for Federally Regulated Property and Casualty Insurance Companies*. The most important difference between the new P&C Intervention Guides and the older versions is that, when a PACICC member insurer first becomes distressed, the Corporation will now be engaged with these regulators at a much earlier point in the process and will have materially greater access to regulatory information than was available in previous insolvencies.

This is an important evolution for PACICC and the industry. This earlier engagement presents a significant opportunity for PACICC to potentially employ alternative resolution tools that could both better protect policyholders and reduce the cost of resolution to insurers.

3) Changes in regulatory expectations

The global financial crisis of 2008 profoundly changed the expectations of financial sector policymakers. Over the past 10 years, policymakers have focused on resolution planning for major banks and life insurers as a means of mitigating market disruptions caused by failed financial institutions. While much of the discussion has focused on the other sectors, some P&C insurance companies have also come under scrutiny – particularly those larger firms considered by policymakers to be potentially "systemically important." And for such institutions, regulators are increasingly looking for "Resolution Plans" or "living wills."

As the policy discussion on resolution planning continues to advance, PACICC has made changes to its corporate governance and to its working relationships with insurance regulators. As a result, PACICC is better positioned as a compensation fund to play a broader and more constructive role in enhanced resolution planning for Canada's P&C insurance industry.

Nonetheless, experience with resolution planning is still relatively new and evolving. While PACICC's Memorandum of Operation authorizes the Board of Directors to intervene in advance of a Court-ordered winding-up, that authority has never been exercised. In an evolving world of enhanced resolution planning and new intervention protocols with regulators, the likelihood has increased that PACICC will be called upon to protect policyholders of a troubled member insurer at an earlier stage, and in the absence of a Court-ordered liquidation.

Part 2: The Scenarios

The premise of each of these scenarios begins with a Canadian insurance regulator placing a P&C insurer in “Stage 3” of the regulatory process. OSFI’s Guide to Intervention defines “Stage 3” to be:

Stage 3 – Future financial viability in serious doubt – If a company is categorized as Stage 3, OSFI has identified that the company has failed to remedy the problems that were identified at Stage 2 and the situation is worsening. The company has severe safety and soundness concerns and is experiencing problems that pose a material threat to its future financial viability or solvency, unless effective corrective measures are promptly undertaken. One or more of the following conditions are present:

- The combination of the company’s overall net risk and its capital and earnings makes it vulnerable to adverse business and economic conditions, which poses a serious threat to its financial viability or solvency unless effective correction action is immediately implemented.
- Its performance is poor, with most key indicators well below industry norms.
- The company has significant issues in risk management or control deficiencies which present a serious threat to its financial viability or solvency unless effective correction action is promptly implemented.[5]

At Stage 3, under the Guide of Intervention, PACICC’s responsibilities are:

1. Estimating its coverage exposure.
2. PACICC’s PIRL Committee analyzing the pros and cons of each intervention option and comparing them against those that may arise from winding-up the company, including the costs that may be absorbed by PACICC.
3. Planning, as needed, the funding of its commitments.

[5] http://www.osfi-bsif.gc.ca/Eng/fi-if/rai-eri/sp-ps/Pages/gip.aspx.

This paper presents three scenarios where a hypothetical PACICC member insurer fails. **These examples are completely fictitious**. They are produced to illustrate the costs involved for Canada's P&C insurers and the potential impact on Canadian insurance consumers.

The scenarios are:

1. After more than a decade of poor underwriting results, a small regional insurer is closed by regulators.
2. A medium-sized member fails. The insurer has two distinct books of business – one that is profitable and one that is not profitable.
3. Failure of an insurer with more than a billion dollars in annual premiums.

The Corporation's performance in the following scenarios will be evaluated based on its effectiveness in delivering against this three-part Mission.

PACICC's Mission:

1. To protect consumers from financial loss in the unlikely event that their insurer fails.
2. To minimize the cost of liquidation for member insurers.
3. To maintain consumer confidence in Canada's P&C insurance industry.

In order to best consider performance against the "cost of liquidation" element of PACICC's mission, it is also important to appreciate the critical calculations PACICC must make and the key determinations to be made:

1) Coverage exposure and size of Required Assessment
    a) Rebating Unearned Premiums
    b) Cost of Unpaid Claims
2) Potential impact of the Assessment on solvent member insurers
3) Potential impact of the Assessment on PACICC's total capacity.

Scenario #1 – Member insurer A – Small regional insurer

The first example is a small regional insurer that is closed by its solvency supervisor. It does not matter for this example if this insurer is federally or provincially regulated. The legal treatment of the estate and the protection that PACICC offers consumers would not vary. The company offers auto and homeowners' insurance in one province. Total annual premiums are $75 million. The company has experienced financial problems over the past decade. They reported losses in six of the past 10 years. Their MCT has declined from 250% three years ago to 170%. This is below their regulatory target MCT. The company's owners have injected additional capital twice over this period.

1) Determining coverage exposure:

a) Rebating Unearned Premiums

The timely return of unearned premiums is a critical element in mitigating consumer concerns in the wake of an insurer insolvency. So, historically, an immediate priority for PACICC has been to work with the Liquidator to identify the affected policyholders and return to them their unearned premiums (up to defined PACICC limits). PACICC seeks to complete these payments to all policyholders within two or three weeks. To quickly return unearned premiums, PACICC can first draw from its Compensation Fund. This fund is approximately $55 million (at year-end 2018). At PACICC's current policy limits (70% of Unearned Premium up to $700), the Compensation Fund's capacity would allow the Corporation to quickly provide rebates for up to 78,500 policyholders.

In **Scenario 1**, an insurer of this size would be expected to have **a maximum of 30,000 policies in force**. Thus, PACICC's Compensation Fund would be adequate to enable maximum rebates required to protect all exposed policyholders. Since PACICC would be able to quickly rebate unearned premiums to policyholders, a failure of this size is unlikely to significantly impact consumer confidence in Canada's P&C insurance industry.

It is important to note that our founding By-Law requires that all payments made using the Compensation Fund be recovered from PACICC members by way of an assessment. Any funds required in excess of the Compensation Fund will also be collected from PACICC's members via an assessment.

b) Unpaid Claims

The second part of PACICC's coverage exposure calculation requires an estimation of the amount of claims that would be payable if the estate was liquidated. There is no standard method of estimation that would hold in every case. The core finding of PACICC's *Why insurers fail* research series has been that insurers that fail typically make two key mistakes. First, they consistently set the price of their insurance coverage too low and, second, they consistently under-reserve for claims that arise. As a result, it is a legitimate expectation that in **Scenario 1**, the insurance reserves on the book likely significantly understate the ultimate cost of settling all outstanding claims.

The Memorandum of Operation requires that PACICC calculate the Corporation's exposure as quickly as possible and clearly communicate this exposure to members. In PACICC's history of liquidations, generating a reliable estimate has often taken months. Generally, the Regulator, the Liquidator and PACICC would commission an independent actuarial review of the reserve adequacy of the failed insurer. This should entail a claim-by-claim review of case reserving at the failed company and a review of the company's estimated future claims. Using history as a guide, the company's book reserves can be expected to be **between 20 percent to 75 percent too low**.

The estimate of Unpaid Claims would then be compared to the assets available within the company. Canadian P&C insurers hold primarily Government of Canada bonds. While these assets may be frozen by the Regulatory Authority or the Court (meaning that they cannot be sold without permission of the Regulator or Court), these assets do become part of the estate and any cash gained by selling them would be used to pay costs, policyholders and creditors. The available assets are assumed to eventually become available to pay policyholders and other creditors.

In **Scenario 1**:

Available Assets	$CDN 150,000,000
Claims payable and unearned premium rebate required	$CDN 250,000,000
Estimated PACICC required assessment	**$CDN 100,000,000**

Another important factor in the review of claims files would be the number of policyholders with claims that exceed PACICC's policy limits. Historically, virtually all of the claims on the books of the failed insurers that have involved PACICC have fallen within the defined benefit limits. A small number of personal property claims have exceeded the policy limits. In 2018, PACICC surveyed member insurers on the percentage of claims that would exceed PACICC's current claim limits. Members reported that 98.5 percent of claims were currently protected by PACICC. That means that in **Scenario 1** only 5-10 claims would exceed the PACICC limit. In the past, such cases have been considered individually by PACICC's Board of Directors and resolved to the customer's satisfaction. There are also generally a small number of commercial claims that exceed the benefit limits. Historically, PACICC has not paid commercial claims above its limits.

2) Estimate of the impact of this assessment on PACICC member insurers

PACICC's Memorandum of Operation carefully defines the Corporation's process for the allocation of the required Assessment among solvent members:

Paragraph 14(2) (Estimate by Board of Directors) of PACICC's Memorandum of Operation states:

> *"The allocation of General Assessments shall be made in the proportion that the board of directors' estimate of Covered Claims and Unearned Premiums arising pursuant to Covered Policies made, or under applicable insurance legislation deemed to be made, in a particular Contributing Participating Jurisdiction is to the Total Assessment."*

The Memorandum includes considerable detail about how the cost of supporting an insolvency will be allocated among member insurers. When PACICC was established, it was understood that a fair allocation would focus on the jurisdiction of the failed insurer. In **Scenario 1**, the insurer operated exclusively in one jurisdiction. The cost of the insolvency would be allocated entirely to other solvent PACICC member insurers competing in that jurisdiction based on market share in the previous year.

The Memorandum also requires PACICC to determine if an assessment of this size would cause financial difficulties for other PACICC members:

Paragraph 36 of the Memorandum (Financial Difficulties):

> *If the making of Compensation Payments, either actual or anticipated, is at any time likely to cause financial difficulties for the property and casualty industry in a Participating Jurisdiction, or for the Corporation, to the detriment of the public, the Corporation shall participate in discussions with the Insurance Regulatory Authority of that Participating Jurisdiction or all Participating Jurisdictions, as the case may be, with a view to an appropriate modification of the Compensation Payment arrangements provided for herein, and while such discussions take place, the Corporation may defer the making of Compensation Payments as is appropriate in the circumstances.*

In **Scenario 1**, the cash shortfall in this estate would require an assessment of $100 million. The impact of PACICC's assessment varies by province:

	100% Ontario	100% Quebec	100% Alberta	100% B.C.
# of insurers assessed	131	101	110	106
Largest impact on MCT of	2.4 points	4.5 points	4.8 points	9.0 points
Average reduction in the MCT of members	0.003 points	0.003 points	0.003 points	0.05 points

If the insolvent insurer was based in Ontario, PACICC would assess 131 member insurers. The PACICC Assessment would cause, all other things being equal, an immaterial decline of 0.003 percentage points in their MCT score. This means that an insurer with an MCT of 250 percent prior to the insolvency would report an MCT of 249.99 percent after paying the resulting PACICC Assessment. An Assessment of this size is unlikely to be the cause of a subsequent insolvency of a member insurer. The impact varies by province, but is also not material.

It should be noted that a PACICC Assessment does not impact the MCT of each company equally. The maximum impact on a single member insurer in this Scenario, in the province with the fewest insurers, would be a reduction of 4.5 percent. This reduction, while certainly unwelcome to the Board and shareholders of the member insurer, is not likely to be material and extremely unlikely, on its own, to cause solvency problems for that single PACICC member insurer.

3) Impact of required assessment on PACICC's total assessment capacity

PACICC's Memorandum of Operation requires the Board to carefully weigh the impact of any proposed assessment on the total capacity of the Corporation:

Paragraph 21 (1) (Draws) of the Memorandum states:

> *The Corporation may levy draws from time to time in respect of each Contributing Member's Assessment as is deemed necessary by the board of directors. However, the aggregate of the draws levied in respect of each Contributing Member's Assessment in any fiscal year of the Contributing Member shall not, subject to sub-paragraph 21(2), exceed 1.5% of the Contributing Member's Total Direct Written Premiums in respect of the relevant Contributing Participating Jurisdiction for that Contributing Member's preceding fiscal year. Any draws made against and paid by a Contributing Member shall reduce its Contributing Member's Assessment by the amount paid; the balance of the Contributing Member's Assessment shall be carried forward so that draws may be made thereon in subsequent years; provided that the balance carried forward shall not be applied to any other Contributing Member so as to increase that other's Contributing Member's Assessment.*

The Memorandum of Operation does set the maximum amount payable by a PACICC member in a single year. However, it will be important to note that it does not limit the total amount that PACICC can assess member insurers over multiple years. A Canada-wide Assessment for 1.5 percent of covered premiums would equate to just over $900 million (as stated in Note 9 to PACICC's audited financial statements for the year ended December 31, 2018).

In **Scenario 1**, the required assessment would have the following impact:

PACICC Assessment Capacity	100% Ontario	100% Quebec	100% Alberta	100% B.C.
Average impact as a % of DPW	0.10%	0.10%	0.10%	0.10%
Largest impact as a % of DPW	0.16%	0.42%	0.42%	0.84%
# of PACICC members that reach 1.5% annual maximum	0	0	0	0

It is reasonable to conclude that an insolvency of this size would not reach the Assessment capacity limit of any member insurer. The average Assessment on a PACICC member insurer would be 0.1% of its direct premium assessment. No PACICC member reaches the maximum Assessment limit. The closest that any PACICC member comes to reaching this limit occurs only if the failed insurer solely did business in British Columbia. In this case, the Assessment of one PACICC member would represent 0.84 percent of its premiums.

It is also an obligation of PACICC to determine if the assessment for any insolvency would inhibit PACICC's ability to protect policyholders if a second member insurer were also to fail within the same time period. Beyond the limits established in the Memorandum of Operation, PACICC's Board of Directors has defined a Risk Limit-Risk Appetite. The Corporation measures its Risk Limit-Risk Appetite in relation to its ability to collect funds from members over a two-year period to pay for the eligible claims of insolvent members. Currently that limit is defined as 2X the Total Annual Assessment Capacity (roughly $1.8 billion as of 2018).

Certainly, in **Scenario 1**, the costs of the required Assessment come nowhere near breaching this defined limit.

Exploring alternatives to liquidation

1) Assisting with a sale

In **Scenario 1**, once the Regulator takes control of the insurer and if a "white knight" expressed interest, that would be in all likelihood preferable to liquidation from a financial cost perspective. Liquidations are costly…and slow. A sale could mean that PACICC would not have to assess member insurers. Policies would be transferred to the acquiring institution and policyholders would be both fully protected and not exposed to any losses as a result of PACICC's defined coverage limits. However, if a "normal" price for an insurer is at least one times the equity of the company being purchased, in our first Scenario, the distressed insurer has -$100 million in equity. A sale is unlikely in this case.

2) Utilizing reinsurance

PACICC could explore reinsurance options that might make the distressed insurer more attractive to an acquirer. For example, PACICC could suggest, with conditions, that the distressed insurer purchase "retroactive reinsurance coverage", such as an "adverse development cover", that provides capital relief by reducing required capital. Reinsurers might in fact be willing to provide the required amount for an appropriate price. If PACICC and the Regulator believed that the distressed insurer could be made more attractive utilizing such a mechanism, then this indeed could prove less costly to member insurers.

Again, a facilitated transaction might produce better outcomes for consumers, since the insurance contracts that they purchased would continue and their claims would be paid without being subject to PACICC coverage limits. But if we are to assume that the distressed insurer needs $100 million and the cost of such retroactive reinsurance is $120 million, then there is only a cost savings if the additional $20 million cost of the reinsurance is paid back when the distressed insurer is sold. In **Scenario 1**, it is unclear that the added costs associated with the reinsurer's required profit margin would make this option attractive.

In addition to the adverse development cover, another reinsurance alternative that could make the company more attractive to an acquirer could be for PACICC to guarantee that go-forward losses would not be larger than a fixed cost via some form of "stop loss." This could be attractive to an acquirer that believed the pricing to be inadequate and the underwriting discipline lacking in the existing company. This would allow an acquiring company time to re-underwrite and recalibrate pricing of the portfolio. However, given what we know about the risks associated with under-reserving in cases such as this, such mechanisms are unlikely to be affordable or even attractive to reinsurers in the scenario presented here.

3) Using a bridge insurer

As stated previously, a bridge insurer is useful to protect policyholders if assets can be separated into profitable business and unprofitable business. In this scenario, all lines of insurance are unprofitable and a bridge insurer is unlikely to resolve the issues facing this insurer.

4) Providing direct financial injections

PACICC could provide direct cash to keep the distressed insurer in business. PACICC's Board of Directors has never agreed to this in the past because it is considered likely to create a "moral hazard" problem. The risk is that other insurers might loosen their underwriting practices knowing that such "bail-outs" were accessible, thus making future insolvencies more likely.

The 2015 edition in PACICC's *Why insurers fail* series looked at the final 10 financial years of 18 Canadian insurers. Twelve of the 18 insurers examined were able convince investors or their parent companies to provide additional capital in an attempt to save them from insolvency. These include:

- **Advocate General Insurance Company** – Owners invested an additional $3.5 million in 1985.
- **American Mutual Liability Insurance** – Owners invested an additional $627,000 in 1984.
- **Eaton Bay Insurance Company** – Owners invested an additional $5.75 million.
- **Maplex General Insurance** – Merged with Abstainers' Insurance Company in 1989.
- **Midland Insurance Company** – Head Office Account and General & Contingency Reserves doubled in 1984 and again in 1985.
- **Kansa General International Insurance Co. Ltd.** – Head Office Account increased by 2,415% in 1985.
- **Northumberland Insurance Company** – Income from subsidiaries doubled.
- **Orion Insurance Company PLC** – Head Office Account increased by 1,119% in 1980.
- **Phoenix Assurance Company of Canada** – Head Office Account increased by 41% in three years.
- **Reliance Insurance Company** – Head Office Account doubled in 1984.

None of these investments proved to be profitable for the owners of these companies. The common thread in these investments is that the insurers continued to underwrite poorly after receiving these cash injections.[6] The money was not used to improve risk selection or to improve the insurer's ability to set prices. Clearly, an injection of capital in and of itself does not necessarily guarantee remediation of a company.

Given the long-term history of poor underwriting and the assessment by regulators that reserves are understated in **Scenario 1**, it is doubtful that injecting cash into this insurer would help it to survive. It is also worthwhile noting that before ever considering injecting additional capital, PACICC would need to develop criteria, similar to those employed by other resolution authorities, that make sale or eventual closure of the business a condition of financing.

[6] http://www.pacicc.ca/wp-content/uploads/2017/11/WIF-2015-The-Role-of-Capital-in-Weathering-Crisis.pdf.

5) Liquidation

In **Scenario 1**, PACICC would almost certainly recommend that the appropriate resolution mechanism would indeed be liquidation because:

- The Compensation Fund would allow the timely payment of all unearned premium rebates.
- The resulting member assessment would not negatively impact the solvency of the remaining PACICC members.
- The vast majority of outstanding claims are expected to fall within PACICC's policy limits.
- Closing a small PACICC member is unlikely to impact public confidence in Canada's P&C industry.

An important takeaway from **Scenario 1** is that liquidation of a PACICC member will continue to be a viable tool to resolve the involuntary exit of P&C insurers in Canada.

Scenario #2 – Member insurer B
– Medium-sized insurer with two distinct books of business

A profitable, medium-sized insurer has two equal books of business – auto insurance ($125 million in Net Premiums Earned (NPE)) and personal property ($125 million in NPE). The insurer is licensed to write insurance only in Ontario. At the end of its last fiscal year (2018), the company reported a combined ratio of 99.8 percent, a return on equity of 5.0 percent and a Minimum Capital Test score of 210.0 percent. The loss ratio on its book of auto business is 77.0 percent. The loss ratio on its personal lines business is 72.0 percent. The company's total reserves are estimated to be $160 million at the end of fiscal 2018.

The company has filed its reinsurance risk management plan with its Regulator. In this report, the company estimates that the probable maximum loss (PML) from its biggest risk is $50 million. It has purchased reinsurance coverage for this amount. The company's total capital base is $50 million. The company has never been staged by any Regulator. It reports few consumer complaints about its market conduct. It is not on PACICC's watch list.

In early 2019, there is a catastrophic wildfire that results in $2 billion in total claims for the insurance industry. Unfortunately for Member Insurer B, the fire impacts a community where their most successful broker was located. While they have less than 2 percent of the total provincial marketplace, Member Insurer B policyholders suffer 10 percent of the fire claims. The company's initial claims estimate forecasts are valued at $200 million. This is more than the total reinsurance and capital available to the company which faces a total deficit of approximately $100 million. Unfortunately, the company has no source of ready capital from a parent or related company. The insurer immediately reports this problem to regulators.

OSFI's Guide to Intervention (the Guide) for P&C insurers states that a company will be staged when OSFI identifies that the company has severe safety and soundness concerns and is experiencing problems that pose a material threat to its future financial viability or solvency unless effective corrective measures are promptly undertaken. In **Scenario 2**, Member Insurer B certainly meets this definition and we assume that their regulator would determine that their "future financial viability" is in serious doubt.

PACICC would begin by conducting the estimation process already described in **Scenario 1**.

1) Determining coverage exposure:

a) Rebating Unearned Premiums

In its last regulatory filing, the insurer reported 150,000 total policies in force. This means that repayment of the current maximum limit of $700 per policy would exceed the capacity of PACICC's Compensation Fund. However, PACICC would seek additional information from regulators about the proportion of policyholders of the insurer that utilize payment options that reduce total unearned premium exposure (e.g. monthly payment). Assuming that the unearned premium reserve is 50 percent of direct written premiums ($125 million), this is likely the top end of PACICC's exposure and therefore the Compensation Fund would not be sufficient to handle all of the liquidity requirements in **Scenario 2**. Nevertheless, PACICC would use the Fund to start the liquidation proceedings. The resulting industry Assessment would include repaying the Compensation Fund.

In past insolvencies, PACICC has sought to use its assessment capacity as collateral to thaw assets frozen by regulators to facilitate the immediate reimbursement of unearned premiums. If this is not allowed by the Court or the Liquidator, then PACICC would seek to immediately assess members to provide funds necessary to rebate eligible policyholders for their unearned premium.

b) Unpaid Claims

For total unpaid claims prior to the catastrophic event, PACICC would work with OSFI to determine if any of the reserved claims exceed PACICC's policy limits. For the purpose of this example, it is assumed that all or almost all of the company's current reserves represent claims that would be below PACICC's policy limits and would be fully protected. This was a well-run, profitable insurer prior to the catastrophic loss and both PACICC and the regulator have confidence that the unpaid claims reported in the firm's financial statements ($160 million) adequately reflect the claims of the insurer.

However, the new claims resulting from the wildfire total $200 million. In **Scenario 2**, 200 to 300 policyholders will report that their homes were completely destroyed in the fire. All of these claims are likely to exceed PACICC's policy limits. This quantum of total loss claims is something that PACICC has never faced before. The estimated exposure of PACICC in this case would be $100 million, if PACICC was to strictly apply existing policy limits and $200 million if PACICC paid all claims in full.

In **Scenario 2**, PACICC's Board of Directors would face a decision on the extent of coverage offered to these policyholders. PACICC's Board has the power to adjust and change the treatment of claims for any specific circumstance, however, stakeholders would expect the Board to justify why there would be a deviation from the approved limits and practices. Paragraph 45 (Amendment of By-Laws) states:

> *"Without limiting the generality of paragraph 44, the board of directors shall be entitled to include in the Memorandum of Operation or any amendment thereto, provisions*
>
> *(i) defining the types of insurance policies to which the Corporation is to be responsive;*
>
> *(ii) defining the types of claims to which the Corporation is to be responsive and their method of calculation; …*
>
> *(v) establishing criteria for the making of voluntary compensation payments to or on behalf of policyholders and establishing conditions precedent thereto."*

The vast majority of policyholder claims paid over many years by PACICC have been successfully resolved to the satisfaction of policyholders and other stakeholders. The established exceptions process has also worked very well in maintaining confidence in the insurance system. There have always been a small number cases that have required PACICC's Board to consider the payment of claims beyond the documented limits. Some policyholders have petitioned the Board to settle above defined limits based on their individual circumstances and arguing "hardship". Historically, all personal insurance appeals have been resolved to the satisfaction of the consumer. The quantum and total cost, however, suggest that this approach might be problematic in **Scenario 2**.

In this example, 200 homeowners could be left unable to rebuild their homes by a strict adherence to PACICC's established $300,000 per-policy claim limit. A large majority of the claim limit would be spent on living expenses and clean-up costs. PACICC has never dealt with hundreds of "hardship" claims and has no formal process to manage a large volume of claims.

If the message delivered by PACICC and the Liquidator to several hundred claimants is that they cannot expect to have their homes rebuilt because their insurer is bankrupt, this will be widely reported on social media. Negative newspaper and television media coverage will follow. Consumer confidence is very likely to be impacted and all insurers are likely to feel the impact of the ultimate political and regulatory reaction. This is a risk to PACICC's mission to protect policyholders from undue financial loss and a risk that the Corporation may fail to maintain confidence in Canada's P&C insurance industry.

In the current PACICC Strategic Plan, the Corporation's Board has indicated that current policy limits are under review and, as a result, if a member insurer was to fail before the review is complete, it is possible that the Board would consider settling within higher benefit limits. Each failure is unique and the insurance industry would face considerable public and political pressure to assist these homeowners in the unusual circumstances associated with mass evacuation and additional living expenses. In this example, it is assumed that PACICC's Board would, after consultation with member insurers and regulators, decide to pay all consumer claims.

Proper quantification of the potential required assessment includes determining potential company assets that would be realized by a Liquidator during a liquidation. Member Insurer B has a portfolio of invested assets of primarily Government of Canada bonds with a book value of $45 million. It also invested in common stock. The Liquidator estimates the realized value of these investments to be between $40 million to $50 million depending on the speed in which they are liquidated. When calculating the maximum exposure, PACICC would assume that the portfolio may need to be quickly liquidated.

In **Scenario 2**, the review yields the following:

Available Assets	$CDN 110,000,000
Reinsurance receivable	$CDN 40,000,000
Claims payable and unearned premium rebate required	$CDN 450,000,000
Estimated PACICC required assessment	**$CDN 300,000,000**

2) Estimate of the impact of this assessment on PACICC member insurers

# of insurers assessed	140
Largest impact on MCT of	22.3%
Average reduction in the MCT of members	1.9%

As Member Insurer B was based in Ontario, PACICC would assess the 140 member insurers licensed in that province. On average, the Minimum Capital Test (MCT) of these insurers would decline 1.9 percentage points. This means that an insurer with an MCT of 250 percent prior to the insolvency would report an MCT of 248.1 percent after paying the resulting PACICC assessment. An assessment of this size is unlikely to cause an insolvency of a member insurer. The largest impact on a single member insurer would be 22.3 percent. This is a significant hit but would not render the member insurer insolvent.

3) Impact of required assessment on PACICC's total assessment capacity

PACICC Assessment Capacity	
Average impact as a % of DPW	0.4%
Largest impact as a % of DPW	1.4%
# of PACICC members that reach 1.5% annual maximum	0

An insolvency of this size would not reach the assessment capacity limit for any member insurer. On average, the assessment on a PACICC member insurer would be 0.4 percent of direct written premiums. No PACICC member reaches the maximum assessment limit. However, one member does come close to reaching its maximum annual PACICC assessment limit in this scenario.

Liquidation of this insurer would be a viable option - financially. However, the catastrophic loss is projected to result in a large number of claims exceeding the PACICC policy limit. This would likely result in significant negative media coverage and could undermine confidence in Canada's P&C insurance industry. This negative media coverage and social media outcry would likely occur even if insurers paid, especially if there was uncertainty or perhaps a delay before money began to flow to claimants.

Exploring alternatives to liquidation

1) Assisting with or forcing a sale

It is possible that a competitor may find this insurer a desirable candidate to acquire. However, the major losses on the homeowners' book will significantly impact the price that they are willing to pay. The Regulator could compel the sale. However, a normal merger/acquisition involves months of due diligence and in the interim period policyholders would need to receive cash payments totalling well in excess of the PACICC Compensation Fund amount.

2) Bridge bank/insurer

A sale of the profitable auto insurance book of business may be possible. Selling this asset could reduce the assessment required by PACICC. Auto consumers would not need to have their premiums rebated. All past and future policies could be settled without the impact of the PACICC policy limits.

The end result of the sale of the auto book of business would be to isolate the unprofitable homeowners claims in a separate company. Both lines of the business in **Scenario 2** are profitable on a go-forward basis. There is no issue with underwriting or rates. Instead, if the sale was challenged in a Court, the Court could determine that the reinsurance limit was inadequate and accumulations should have been more actively monitored and managed. The proceeds of the sale could be used to offset the required assessment and, hopefully, increase the amount within the estate to pay homeowners' claims. Selling the auto book could reduce the assessment required by PACICC.

A potential legal concern is that, under the *WURA,* any transaction must not make the policyholder left behind at the "bridge insurer" worse off than if the company was simply liquidated. So PACICC would need to use the proceeds of the sale to pay claims in excess of the policy limits up to proportionate levels among auto claimants.

3) Providing direct financial injections

PACICC could inject capital into the troubled insurer to increase its MCT to temporarily keep the company viable. This would be much less expensive for PACICC members. In this example, $150 million would allow the insurer to pay all claims in full.

The conditions that PACICC would place on the troubled insurer in such a circumstance need to be determined. The most important condition to clarify will be, if the insurer accepts such a loan, then can that entity continue to compete in the marketplace? In other sectors, if industry assessments are required to fund resolution in this manner, the company must close its doors after the resolution or be sold.

4) Reinsurance

In this case, "retroactive reinsurance" could also be a viable option for PACICC to consider. The company, after collecting from its reinsurers, faces a deficit of $150 million. The resulting PACICC assessment to pay all of the existing and new fire claims is estimated to be $300 million. Buying retroactive reinsurance coverage for $150 million to $180 million would be less expensive for PACICC member insurers than the potential assessment and could also include adverse development protection in the event that more claims are reported, or rebuilding or liability costs are higher than anticipated. Such a transaction would allow the Regulator to choose not to immediately close the insurer. Avoiding liquidation means that the PACICC limits do not apply and policyholders would be better off because claims would be paid in full and their existing policies would be honoured. The existing assets within the company could be used to pay claims.

Again, the conditions under which PACICC's Board would be ready to fund such a mechanism would need to be determined. Presumably, when all claims are settled, at a minimum, the company would repay the full cost of the reinsurance, but more likely the company would be required to sell or run-off its operations. This solution would be similar to providing direct financial injections, but would have a dual added advantage of (1) insulating the company from reserve deterioration, and (2) under the MCT Guideline, reinsurance can provide capital relief by reducing required capital, rather than increasing required capital. This results in a strengthening of the company's MCT. However, there would be no direct payback from reinsurers in the form of refunded assessments to PACICC members. Refunding would have to wait until after ultimate sale of the company.

5) Liquidation

As discussed above, liquidation is a credible alternative. However, there are a large number of policyholders with a total loss claim who could suffer "undue loss" if the PACICC limits are strictly applied. Historically, these claims have been dealt with on a case-by-case basis. PACICC's mission statement is to protect policyholders from undue loss in the unlikely event that their insurer fails. Mismanagement of these total loss claims would likely cause significant negative press coverage for the P&C industry and result in a loss of consumer confidence in Canada's P&C insurance industry and potentially result in actions by Governments and regulators.

In **Scenario 2**, PACICC would want to explore alternatives to liquidation in order to ensure that policyholders with a total loss claim receive full payment and in order to minimize the cost of insolvency for member insurers and maintain to confidence in the P&C industry.

Scenario #3 – Member insurer C – Failure of a very large insurer

In this case, a national insurer - one of PACICC's largest member insurers - with annual premiums written exceeding $3.5 billion has failed. This company offered both personal and commercial lines of coverage and was licensed and active in every province and territory in Canada. On average, Canada's 10 largest insurers report unpaid claims of $3.9 billion. In the case of Member Insurer C, the regulator has expressed concerns that the company's loss reserves are inadequate.

In Scenario 3, the reason for the failure would have important implications in determining the optimal approach for PACICC and regulators to take in order to protect consumers.

Why could an alternative to liquidation be attractive in this case?

There are several reasons why PACICC may consider alternatives to liquidation for a large member:

- The large assessment required to fund a liquidation of one of PACICC's largest members could cause other PACICC members financial distress.
- The size of the necessary assessment would exceed the 1.5% maximum annual assessment for many PACICC members. This could create liquidity problems with the estate.
- Consumers with legitimate claims might be forced to wait a year or more for their claims to be paid up to full benefit limits.
- PACICC currently has only one mechanism to finance resolution of a member.
- A liquidation of this size, coupled with actual short-term liquidity problems, may undermine consumer confidence in Canada's P&C industry.

1) Determining coverage exposure:
a) Rebating Unearned Premiums

Canada's largest insurers report that, on average, the number of policies in force in any given year exceeds 2.5 million. As discussed previously, PACICC protection of consumers includes 70 percent of premiums paid in advance (up to $700). If PACICC rebated to its limit for each of these policies, the assessment required on members would be $1.75 billion.

This is of course an estimate of PACICC's maximum exposure from the reimbursing of unearned premiums.

The ultimate cost to PACICC would be much less than this amount for two reasons. First, there is a helpful trend of policyholders paying for their insurance policies via payment plans. Unfortunately, PACICC currently has no data on the payment patterns of policyholders. This paper assumes that 60 to 75 percent of P&C policyholders pay monthly. Second, policies are renewed throughout the year. This is important because if consumers purchased insurance on January 1st and paid the full amount at that date and the insurer failed on July 1st, then the company will have fulfilled one-half of its obligation. So on average, PACICC would likely only need to refund half a year's worth of the premiums.

It is important to appreciate that the $700 limit was set in 1991[7] and has not been increased since, while inflation has seen premiums increase for both personal and commercial line coverages. It is likely that even if PACICC paid up to 70 percent of the uncapped unearned premium for all policyholders, there would remain significant risk of loss of confidence among Canadians, given the likelihood that a large number of policyholders would be out of pocket in the wake of the default.

While it is likely that a large percentage of consumers pay monthly for their insurance coverage, it is clear that PACICC's Compensation Fund would not be adequate to reimburse unearned premiums for this scale of insurer default. An assessment or a loan arrangement with the estate, requiring the approval of the Court, Liquidator and Regulator, would be required to reimburse unearned premiums within 45 to 60 days in this liquidation scenario.

b) Unpaid Claims

In **Scenario 3**, PACICC would need to assess member insurers between $3 billion to $5 billion to successfully liquidate this distressed insurer. This scenario also assumes the Liquidator would be able to access a large portion of the invested assets held by the failed insurer to pay claims.

2) Estimate of the impact of this assessment on PACICC member insurers

PACICC would assess all PACICC member insurers, regardless of provincial domicile, because the distressed insurer reported premiums in every Canadian province and territory. A $3 billion assessment would cause the MCT of an average member insurer to decline 22.9 points on average. One member would see a decline in its MCT of 212.5 points. A $5 billion assessment would cause the average member's MCT to decline by 38.2 points.

[7] When PACICC was established in 1989, the Corporation did not refund any unearned premiums. Return of unearned premiums protection for consumers was added in 1991.

	$3 billion	$5 billion
# of insurers assessed	198	198
Average impact on MCT of members	22.9%	38.2%
Largest impact on MCT of	212.5%	354.2%

As discussed on page 23, the PACICC Board is required to determine if an assessment of this size would cause financial difficulties for other PACICC members. In **Scenario 3** it would. As the full assessment would cause financial difficulties for a number of other PACICC members, PACICC estimates that the resulting assessment of $3 billion would cause the MCT of four insurers to fall below the regulatory minimum of 150 percent. On average, these four members would experience a decline of 130.5 points in their test scores. An assessment of this size would also materially and negatively impact the financial viability of other PACICC members.

PACICC estimates that an assessment of $5 billion would cause the MCT of 13 insurers to fall below the regulatory minimum of 150 percent. On average, these 13 members would experience a decline of 143.3 points in their test scores. An assessment of this size would also materially and negatively impact the financial viability of other PACICC members.

Even in the $3 billion version of this scenario, the scope of negative impacts would likely cause PACICC to recommend against immediate liquidation of this insurer.

Potential for contagion	$3 billion	$5 billion
# of insurers with MCT below 150% after assessment	4	13
Assessment impact on MCT at these insurers	130.5%	143.3%

3) Impact of required assessment on PACICC's total assessment capacity

The maximum amount payable by a PACICC member in a single year is 1.5 percent of its prior year's premiums. However, there is no upper limit to the amount that PACICC can assess member insurers over time so the 1.5 percent maximum can actually be thought of as PACICC's payment terms. So, if a member insurer owes more than the annual maximum, they would be assessed again in subsequent years. Based on the most recent annual industry results, 1.5 percent of covered premiums equates to $904 million (as stated in Note 9 to PACICC's audited financial statements for the year ended December 31, 2018).

PACICC Assessment Capacity	$3 billion	$5 billion
Assessment as a % of member DPW	4.9%	8.1%
Largest impact as a % of DPW	14.7%	24.47%

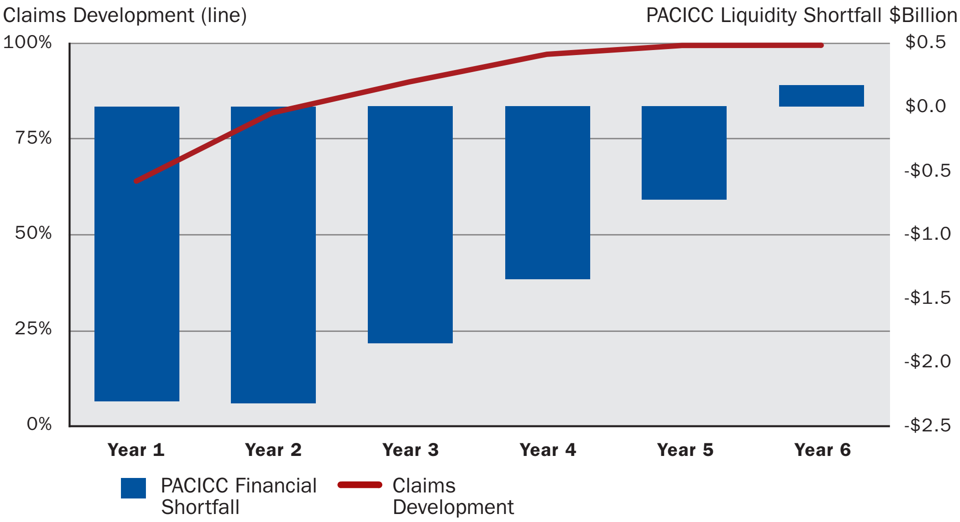
A $3 billion assessment represents 4.9 percent of assessable premiums as of 2018. In the case of a $3 billion assessment, more than 150 PACICC members would be assessed an amount larger than their annual maximum assessment. So these member insurers would therefore pay annually (on January 1st) the maximum assessment for roughly three years. The impact would not be equal on all PACICC members. In this scenario, one member insurer would pay the maximum assessment for nine years.

The financial impact is even more pronounced with a $5 billion assessment. The average PACICC member would pay the maximum assessment for five years. In **Scenario 3** however, one insurer would pay its maximum assessment for approximately 15-17 years.

4) Impact on PACICC liquidity

In past liquidations, PACICC and the Liquidator have come to an arrangement that pledged a portion of PACICC's future assessment capacity as collateral, allowing the Court to release some of the frozen assets of the distressed insurer. In each of these past cases, the numbers were a small percentage of PACICC's total assessment capacity. It is not clear that such an agreement could be reached in such a large insolvency. While it is not impossible that it could occur, the negotiation of such an agreement would be difficult in a liquidation of this size. PACICC, PACICC's membership, the Liquidator, and the Regulator would need to come to an agreement. The Court would need to approve it.

Chart 2 – PACICC liquidity shortfall



Source: PACICC with data from MSA Research

Chart 2 shows that a $5 billion assessment could result in significant liquidity issues if such an agreement is not reached. PACICC's annual assessment limit of 1.5 percent of the prior year premiums would create liquidity concerns within the estate. This scenario assumes that claims requirements within the estate follow a "normal" pattern. By the end of year one, we anticipate that two-thirds of the claims would be payable. Once PACICC collected its maximum assessment of $904 million and used this money to pay eligible claims, the estate would still have $2.3 billion of year-one eligible claims waiting to be paid. It is not clear how the Liquidator would determine which claimants are paid and which claimants would wait. It is also likely that these claims would become more expensive during this period.

PACICC would collect an additional $904 million from members in year two. Throughout year two, additional claims would also become payable. As illustrated by the bar in Chart 2, the net deficit in the estate would remain approximately $2.3 billion. In year three, the liquidity shortfall begins to close, but $1.7 billion worth of claims would remain payable. The liquidity gap does not close until year six of the insolvency.

In **Scenario 3**, it is very likely that consumer confidence in PACICC and its member insurers' capability to provide timely payment of consumer claims would be severely compromised.

Exploring alternatives to liquidation

The attractiveness of each alternative to liquidation would depend on what precipitated the failure of this company.

1) Assisting with a sale (including reinsurance)

A large multi-line insurer will have some part of its operations that would be considered a desirable and saleable asset. Where a buyer(s) exists, the Regulator could take control of a failing insurer for a short period of time to complete its sale, merger or restructuring. The sale would ensure that policyholders are protected. With the approval of the government, a forced sale could be used when shareholder consent of the transaction is not expected or the time to obtain consent would be too lengthy.

To assist with a sale of the insurer, PACICC could issue a guarantee similar to reinsurance or procure reinsurance (reinsurance options are discussed below).

2) Using a bridge insurer

A bridge insurer would also be a viable option for PACICC and regulators to consider if the Regulator could isolate money-losing lines of business from profitable ones. The proceeds of the sale of profitable lines of business could be used to offset the required assessment and, hopefully, increase the amount within the estate to pay claims.

3) Providing direct financial injections

PACICC has the authority to provide direct financial assistance to its members, including loans, guarantees, or loss-sharing agreements or by procuring reinsurance. PACICC can provide this assistance on a stand-alone basis, to assist in a private transaction, or in combination with any of its other resolution tools. It is clear that, in **Scenario 3**, direct financial assistance could be less expensive for member insurers relative to liquidation.

It is not clear, however, how PACICC would receive the approval of members to raise the money needed to provide assistance. There would be significant concerns about "moral hazard." It is also not clear what interest rate or repayment terms PACICC would require. However, these issues could likely be worked out through discussions with the PACICC Board and stakeholders. It would be prudent, however, for clear conditions for such financing intervention to be defined and agreed upon with all PACICC members long before such a scenario actually unfolds.

4) Reinsurance

Creative reinsurance professionals could identify a variety of options. The key considerations for PACICC and other stakeholders would be that these options would almost certainly be less expensive than liquidation and could ensure that policyholders remain fully protected to the original limits of their insurance policies.

Solutions could be structured in many different ways. Some examples might include:

a) **Adverse development guarantee –** the acquiring "white knight" sets the price it is willing to pay based on some expected outstanding claims figure. PACICC could guarantee that total actual claims payments do not exceed this amount. The terms of this agreement would have to be negotiated to the satisfaction of the purchaser. There is no clear mechanism for PACICC to recover this cost.

b) **Quota share guarantee or partial portfolio transfer –** Same as above, but the PACICC guarantee would take the form of a fixed percentage of claims payable. This could be purchased by PACICC or the acquiring company. There is potential for PACICC to assist in such a transaction to help ensure the stability of the market moving forward.

Suffice to say, there are potential reinsurance options that could protect policyholders and reduce the financial difficulties facing PACICC member insurers from such a large potential assessment.

5) Liquidation

A liquidation of one of PACICC's largest members would be expensive and difficult. A multi-billion dollar liquidation would threaten the solvency of some member insurers. PACICC would not be able to assess members quickly enough to pay all the resulting claims in a timely fashion. Consumers would be required to wait potentially years for claims payments. Not only would this result in significant negative media attention for insurers, it would also raise significant concerns with policymakers.

Part 3: Key Questions

In two of the three scenarios presented in this paper, intervention prior to a Winding-Up Order by PACICC and regulators could well produce better outcomes than liquidation both for policyholders and for PACICC member insurers.

While work needs to be done to develop a comprehensive list of questions needing to be answered, and to develop better answers to these and other questions, the outcomes of the scenarios in this paper suggest that it is timely for PACICC, its Board of Directors, its member insurers and its regulatory stakeholders to begin this work. This will help to ensure the Corporation's ability to continue to successfully achieve its three-part mission of protecting policyholders, minimizing the costs of insolvency and maintaining consumer confidence in the P&C industry that has served Canadians so well in the past.

Before PACICC can effectively implement the full range of powers it has been granted in its founding Memorandum of Operation, it will need to answer the following questions:

1. Under what circumstances should PACICC consider intervening in the absence of a Court-ordered wind-up?

Intervention would only be contemplated when the likelihood of insolvency was judged to be high, or as stated by the IAIS, the insurer "has no reasonable prospect of returning to viability." In these circumstances, the Board would need to be satisfied that:

a) the cost of early resolution to the industry would be materially less than the cost of full liquidation;

b) serious reputation damage to the P&C industry could be minimized or avoided by early resolution;

c) the market circumstances were "outside of the normal" – meaning that often-used methods to support an "orderly" market exit (such as voluntary run-off) were either impractical or unavailable to the troubled company; and

d) PACICC's financial interests could be adequately protected in the absence of a Court-ordered wind-up.

2. What conditions should PACICC place on its involvement in early resolution?

Good risk management suggests that PACICC should clarify, in advance, the criteria its Board of Directors would use to decide whether early, pre-insolvency resolution serves the interests of policyholders and members.

A first step is to set out the essential pre-conditions and core principles PACICC would want to satisfy before intervening to assist policyholders in circumstances where a member insurer is financially troubled, but has not yet been forced into wind-up by a regulator.

Possible pre-conditions could include:

- **Policyholders are at risk** – Because the safety and soundness of a member company is at risk. (This would likely correspond to "Stage 3" as identified in the PACICC-AMF and PACICC-OSFI Intervention Guides).
- **Recovery is unlikely** – In the words of the IAIS, the insurer "has no reasonable prospect of returning to viability."
- **Market circumstances are "outside of the normal"** – Methods normally used to support an "orderly" market exit (such as voluntary run-off) are impractical or otherwise unavailable.
- **Company cannot continue in the market** – At the end of the resolution activity the company would be closed.
- **Shareholders of the troubled insurer should not benefit** – The focus is on protecting policyholders.
- **Advance notice** – Sufficient time exists for PACICC to take meaningful action.
- **Reputation may be at risk** – A member insolvency may harm confidence in the P&C insurance industry.
- **Board approval** – PACICC will not act without approval from its Board of Directors including a quorum of Industry Directors.

3. How would PACICC fund the cost of early resolution?

PACICC has two main sources of funding – general assessments levied on members, and the Compensation Fund. These were designed to support the liquidation of a small or mid-sized insurer, and have proven to be effective for this purpose. Use of either of these tools would not be straightforward for an early resolution, because they were not initially established for that purpose. PACICC does have the authority to borrow funds, but would need to provide collateral (which could tie up its main assets, the Compensation Fund and its assessment capacity).

4. What protections would PACICC seek in supporting an early resolution – in the absence of a winding-up order? What legal processes would be followed?

These are questions that will need to be answered by PACICC's legal advisors. A key issue is how to ensure that PACICC is adequately protected, as a creditor, if the Corporation advances funds to the policyholders of a troubled insurer, but in the absence of the protections afforded by a Court-ordered liquidation. For example, would the usual requirement that policyholders assign their claim to PACICC in return for compensation (a process normally managed by the Liquidator) be sound and reliable in the absence of Court protection?

5. How would PACICC deal with a legal challenge to its resolution authority in the absence of a Court-ordered winding-up?

This could be similar, for example, to the legal challenge mounted against OSFI by Advocate General in 1989, when the Regulator took control of the company (and appointed Deloitte as its agent) before securing a winding-up order. While OSFI prevailed in this case and Advocate General was ultimately ordered to be wound-up, we simply note that PACICC does not have the same legal protection as an Insurance Superintendent.

6. How would PACICC communicate with key stakeholders – with policyholders, insurance regulators and member companies?

The task will be more complex than in a standard liquidation, for several reasons. First, much of the initial conversation will be subject to strict confidentiality conditions as the troubled insurer continues in the market. Second, in a winding-up, PACICC has traditionally relied on the Court-appointed Liquidator to handle a good deal of the communication with policyholders and reinsurers. Finally, because an early intervention by PACICC would be "non-traditional," the communications challenges – particularly with member insurers – could be greater than usual.

7. What additional resources would PACICC need to support an early resolution?

While it would depend on the scale and scope of the resolution, it seems likely that PACICC would need to engage additional professional resources, beyond its current staffing levels. Costs would need to be carefully managed and key potential suppliers pre-identified and pre-qualified.

8. ***What would the process look like for recovering funds, post-resolution?*** *(e.g. dividends paid to members who were assessed; to replenish a draw made on the Compensation Fund; or to repay a loan).*

PACICC might need to consider some limits on the time period for which funds would be made available, terms of repayment, etc. – otherwise it could find itself in the position of being a "long-term investor" with no clear prospect of repayment.

PACICC will need to define the conditions prior to provision of financing (including requirements for sale or winding-up of assets). The forced sale of the assets of the distressed insurer would likely provide the primary source for recovery of industry funds invested in pre-liquidation resolution.

Conclusion

This paper has explored whether the resolution tools available in other parts of the financial sector could, if used in the P&C insurance industry, produce better outcomes for policyholders and for PACICC member insurers. In two of the three scenarios presented in this paper, it would appear that alternatives to liquidation could indeed better protect consumers, be less costly for member insurers and strengthen confidence in Canada's insurance system.

Compensation funds in other financial industries, such as banking, have a more developed toolkit to assist in resolution of distressed institutions before liquidation. PACICC should take steps to expand its toolkit and develop its resolution powers to ensure it can continue to fulfill its mission to protect P&C policyholders.

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