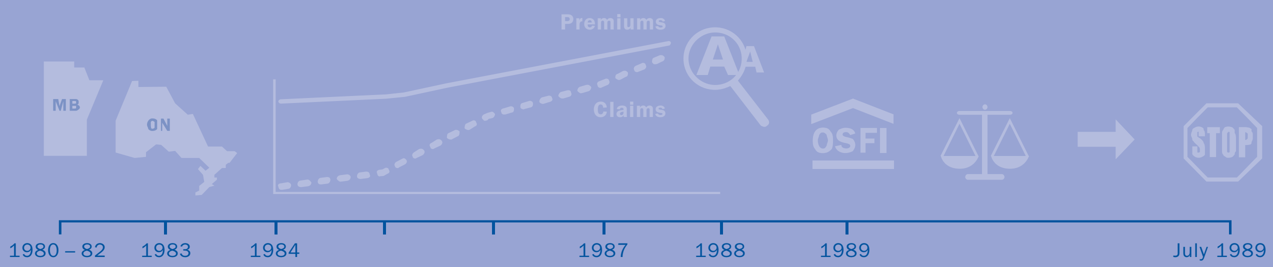
PACICC

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

Why insurers fail

Lessons learned from the failure of Advocate General Insurance Company



By

Jim Harries

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The author is Vice President, Operations for PACICC. He would like to acknowledge the information and assistance provided for this study by Robert W. Paul and Theresa Breckon of Deloitte (the Court-appointed Liquidator for Advocate General), and by Amra Porobic, Manager, Library Services at the Insurance Bureau of Canada. Suela Dibra also provided research assistance to PACICC on this project.

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

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A note about PACICC and this publication

As part of its "Why insurers fail" series of publications, The Property and Casualty Insurance Compensation Corporation (PACICC) has produced this case study on the failure of Advocate General Insurance Company with four main objectives in mind, namely to:

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

PACICC was founded in 1988. The Corporation's mission is to protect eligible policyholders from undue financial loss in the event that a member insurer becomes insolvent. Since it was established, PACICC has funded and participated in the winding-up and liquidation of 12 member P&C insurance companies doing business in Canada.

Fortunately, the risk of an insurance company failing in Canada is moderate. Nevertheless, while P&C insurance insolvencies are rare, they do occur. For example, 32 P&C insurance companies failed in Canada over the past 30 years.

A key part of PACICC's commitment is to conduct relevant research to gain a better understanding of the financial health of its member companies. Another research priority is to analyze and document why P&C insurers in Canada have failed. A thorough understanding of the circumstances of insurer failure helps PACICC improve its preparedness for future insolvencies.

Advocate General was the first member-company liquidation to be handled by PACICC. The insurer's financial distress in 1987-88 resulted in a winding-up order being issued by The Queen's Bench of Manitoba on July 5, 1989.

PACICC has reviewed extensive information on the financial, corporate governance and regulatory history of Advocate General in compiling this case study. The data for this analysis was obtained from court-related documents, news media, publicly available financial data and information available to PACICC in its role as an inspector of the Court-supervised liquidation.

Our main findings and conclusions are presented as "Key lessons learned" from the failure of Advocate General (see page 15). We expect that our findings will be of interest to a broad range of stakeholders, including insurance regulators and PACICC member companies.

Executive summary

Advocate General had been in the insurance business for nine years when it was ordered to be wound up in July 1989. The Company was established in Manitoba. Initially, Advocate had a balance of automobile and property policyholders, and its revenue came almost equally from Manitoba, Alberta and Ontario. The Company grew rapidly, with most of its expansion taking place in the highly competitive Ontario automobile insurance market.

PACICC had just been established as the P&C insurance industry's Compensation Corporation in the year prior to Advocate General's failure. Advocate became the first PACICC member company to be wound up. Ultimately, PACICC was responsible for more than $45 million in claims paid to Advocate General policyholders. PACICC member insurers later made a full recovery of the assessments they paid.

This case study documents the reasons for Advocate General's failure. Four key lessons to be learned from the Company's insolvency are:

- The shareholders and senior management of new P&C insurance companies need to be aware of the critical importance of getting their pricing and claims reserving "right" in relation to insured risks – as their survival often depends on it. Across all lines of business, Advocate General reported chronic reserve deficiencies relative to its peers and it ultimately failed
- Start-up insurance companies deserve special supervisory attention. Indeed, like Advocate General, roughly one-third of the P&C insurance companies that failed in North America over the past 30 years did so in their first 10 years of operation
- Inadequate pricing and deficient loss reserves tend to go hand-in-hand for failed insurers. Solvency and market conduct regulators need to be aware of the potential financial impairment that pricing below market rates can have, in particular, freezing or restricting premiums in relation to claims costs
- A key objective of insurance regulators should be to minimize the time period between taking control of a troubled insurer and winding-up the company's operations. This requires contingency planning to support decisive action when needed.

A more complete list of insolvency causes and lessons learned can be found on pages 14 and 15.

Advocate General failed because of deficient loss reserves. Inadequate pricing appears to have fuelled unsustainable growth and deficient reserves. Advocate's high concentration in Ontario auto insurance, and the freezing of auto insurance rates in that province in 1987, adversely affected the operating environment.

Introduction

Advocate General Insurance Company was incorporated in Manitoba on April 9, 1980, with an initial capitalization of $4 million. On November 14, 1980, the company was granted a Certificate of Registry authorizing it to transact several classes of property and casualty insurance, including but not limited to automobile and property insurance. The Company was federally-supervised – initially by the Federal Department of Insurance and subsequently by its successor, the Office of the Superintendent of Financial Institutions (OSFI).

Advocate was wholly-owned through a holding company, Advest Capital Inc. The principal shareholders of Advest were several Canadian businessmen residing in Winnipeg and Toronto. The principal shareholders were also directors of Advocate.

Advocate General was licensed to operate in eight provinces. Initially, its revenue came almost equally from Ontario, Manitoba and Alberta. In its early years, Advocate had a balanced portfolio of automobile and property insurance coverage. By the mid-1980s, Advocate General was generating about three-quarters of its total business from automobile insurance in Ontario. Coincident with the strong shift in its mix of business, the Company moved its executive office from Winnipeg to Toronto in 1985, while retaining its head office in Winnipeg.

Throughout its entire nine years in the insurance business, Advocate General showed uneven growth patterns. In 1982, for example, the Company's net written premiums grew by 78 percent, while in the following year premiums increased only 9 percent. Similarly, premiums grew by 61 percent and 39 percent, respectively, in 1985 and 1987, with little or no growth recorded in other years.

Profile of Advocate General Insurance Company

Nationality	Canadian
Type of licensing	Federal
Date incorporated	April, 9, 1980
Date of regulatory control	April 24, 1989
Date of winding-up order	July 5, 1989
Years of operation	9
Ownership structure	Privately held (several stockholders)
Lines of business	Auto, Property, Liability
Group member	Subsidiary of Advest Capital Inc.

While Advocate General was expanding its business into Ontario, the automobile insurance product in that province was generally considered by insurance companies to be under-priced. This situation was made worse by an auto insurance rate freeze put in effect in 1987 by the Government of Ontario. Moreover, Advocate's auto insurance policies were priced approximately 7 percent lower than the industry average. While this helped the Company attract new customers, it would ultimately prove inadequate to cover costs.

Timeline of key events for Advocate General Insurance Company*

Advocate General is licensed to underwrite property, automobile, fidelity and liability insurance	Advocate General opens a branch in Toronto	Advocate General moves its Executive Office to Ontario	OSFI completes on-site investigation and review of the Company's 1987 actuarial report	Advocate General fails the capital adequacy test	Advocate General stops writing new business and renewing existing policies	Regulators take control of the Company's assets	Advocate General ordered to be wound-up
November 14, 1980	January 1983	1985	June 1988	January 12, 1989	April 1, 1989	April 24, 1989	July 5, 1989
$(396)	**$108**	**$(2,194)**	**$(11,528)**				
245.1%	**99.1%**	**109.5%**	**128.4%**				

*The numbers below the timeline show Advocate General's underwriting income (loss) in $000's and the Company's loss ratio for the years 1980, 1983, 1985 and 1988. *Source: TRAC Insurance reports for various years.*

See page 17 for a detailed timeline of events.

Business strategy and performance

At the time that Advocate General was founded in 1980, Manitoba Public Insurance Corporation (MPIC) – which wrote mostly auto insurance and some personal and commercial property insurance – was reportedly interested in selling its property insurance line of business to another company. It appears that one of the factors that led to the establishment of Advocate was the idea of acquiring MPIC's property insurance book of business. In fact, some of Advocate's executives were former employees of MPIC, including the Company's President Joseph Pereira, who was formerly Assistant General Manager (second-in-command) at MPIC between 1976 and 1979. In addition, one of Advocate's directors and a Company shareholder, Allan Chisvin, had been a member of MPIC's Board of Directors during the period 1976-79.

However, for reasons that remain unclear, MPIC did not sell its property insurance business for another decade. In September 1990, one year after Advocate General failed, MPIC decided to sell its non-automobile insurance business to General Accident Assurance (one of the insurers that later amalgamated to become Aviva Insurance Company of Canada). As of October 1, 1990, MPIC ceased writing personal and commercial property insurance. By the time this transaction took place, Advocate was in liquidation – having pursued mainly an Ontario-based growth strategy that focused on automobile insurance. As a new insurance company with no experience or broker support in Ontario, this would prove to be a risky undertaking.

The chart on the following page illustrates how significant the shift in Advocate General's business was between the years 1981 and 1988 – by province and by line of business. (These two years were chosen because they represent the *first and the last* full calendar years that Advocate was in business). Toward the end of the decade, the swing to Ontario auto insurance was pronounced.

It is unclear if Advocate General's Ontario-based strategy simply "evolved" as an opportunity to write new policies and generate premium growth. What is clear, in retrospect, is that high concentration in Ontario auto insurance, combined with the poor underwriting results generated, contributed significantly to the Company's failure.

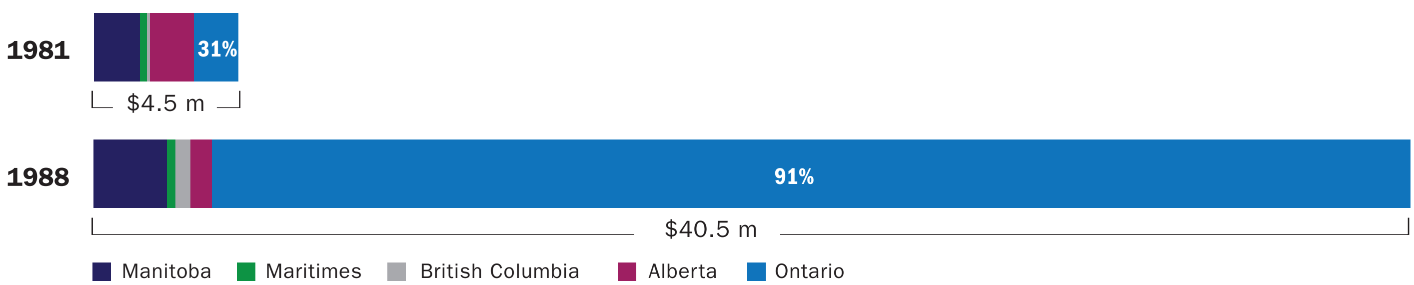
A review of key performance indicators during the 1980s shows why. The period 1984 to 1988 proved to be critical for Advocate General. During this period, the Company's underwriting ratio deteriorated from 109.6 to 128.4 (and the ratio hit a high of 131.1 in 1987). Advocate's total underwriting loss increased from $1.39 million to $11.53 million. Between 1984 and 1988, the Company's total assets (excluding deferred policy acquisition expenses) went from $17.9 million to $50.2 million – an increase of 180 percent – but total liabilities went from $13.4 million to $47.4 million, an increase of 253 percent. Premiums were growing quickly during this period – up 112 percent from 1984 to 1988 – but claims liabilities were increasing at a much faster pace. In particular, the Company's unpaid claims and expenses increased more than seven-fold between 1984 and 1988. Advocate was unable to generate any retained earnings during this period – its earned surplus deteriorating from $(0.2) million in 1984 to $(20.4) million in 1988. Faced with this situation, Advocate's shareholders had to inject more capital on several occasions to sustain the Company. The record shows that a total of $16.9 million in new capital was injected between 1984 and 1986.

Data show that Advocate General was significantly under-reserved in all of its lines of business. Between 1982 and 1987, for example, Advocate's reserves were below the industry average by the following percentage amounts: automobile insurance (- 70); property insurance (- 44); and liability insurance (- 81). Anecdotal evidence also suggests that Advocate's initial reserves for auto bodily injury claims were low compared to other insurers.

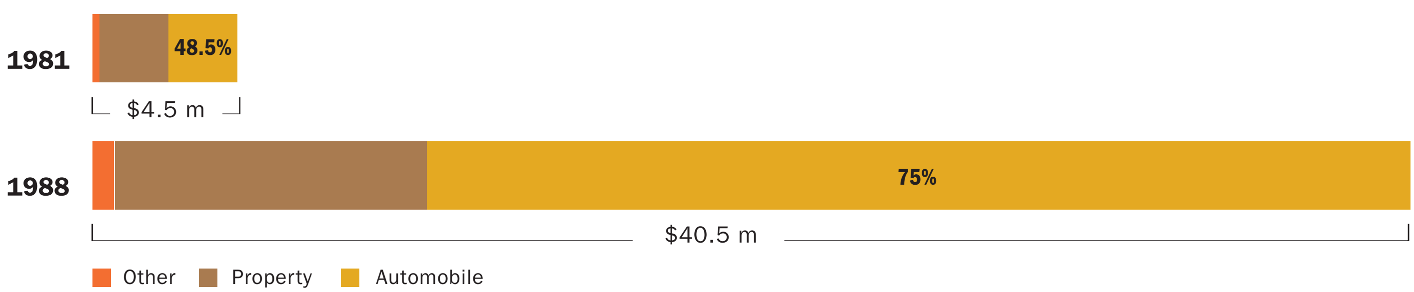
An independent source of information on the financial health of P&C insurance companies during the 1980s was a company known as TRAC Insurance Services (the acronym stood for "Tests-Ratios-Analysis-Charts"). Based on a total of 8 "early-warning solvency tests" published by TRAC, Advocate General was showing increased vulnerability during the years 1986 to 1988.

Advocate General Insurance Company: Net earned premiums

By province



By line of business



Source: TRAC Insurance reports for various years.

In fact, the Company went from passing 6 of 8 of TRAC's early-warning solvency tests in 1986, to passing only 1 of the 8 tests in 1988. TRAC's tests, as applied to Advocate General, provided an important warning of the difficulties facing the Company. The early-warning solvency tests show that Advocate's financial health came under steadily increasing pressure after 1986.

As Advocate General expanded its business in Ontario in the mid-1980s, anecdotal evidence suggests that the Company faced challenges with respect to its staffing and operations. Advocate initially chose a suburban location for its new office in Toronto. The Company reportedly had difficulty attracting and retaining qualified staff – despite having a salary expense ratio that was above the industry average. Staff turnover was reportedly high and individual workloads in some cases were heavy.

In addition, prior to 1985 Advocate General depended on manual processes for its underwriting and claims management operations, which led to delays in updating loss reserves. Interestingly, as a share of premiums, the Company spent only half of the industry average on data collection and analysis. On the other hand, broker commissions paid by Advocate (as a percent of earned premiums) were approximately 15 percent higher than the industry average.

Looking back, it is instructive to note some of the comments made by industry experts and observers around the time of Advocate General's failure.

Art Despard, a Vice-President at Reed Stenhouse Ltd. said that: "Freezes in Ontario motor vehicle insurance rates had come at a bad time for companies that had lowered rates to be more competitive." He added, "There was no way to correct the situation." (Advocate General's auto insurance rates, as noted earlier, were below the industry average).

Alex Kennedy, Vice-President and General Counsel for the Insurance Bureau of Canada, noted that: "Everyone will concede that the automobile business in Ontario is under-priced, particularly since the rate freeze was put into effect."

Donald Blenkarn, who chaired the House of Commons Finance Committee, said: "This whole problem with the P&C companies has been going on for 10 years now. What we really need in the business is some consolidation. You've got too many small companies without enough capital behind them."

And John Kruger, Chair of the newly-established Ontario Automobile Insurance Board (which was later merged with the Ontario Insurance Commission) had this to say: "Several insurance companies have already approached the Board for a [rate] deviation hearing. In some cases, they wanted a hefty premium increase to comply with federal solvency tests. I told them to increase their capital base because they were under-capitalized in the first place. Insurers with these kinds of troubles will either pull out of the car insurance market or withdraw from the entire property-casualty insurance field."

These comments highlight how Ontario's auto insurance rate freeze in 1987, and subsequent restrictions on rate increases, made conditions tougher for companies in that business – especially if they lacked capital strength. There does not appear to have been appropriate consideration of the implications that imposing a rate freeze and subsequent rate restrictions would have on the solvency of vulnerable insurers like Advocate. As PACICC concluded in its 2009 *Why insurers fail* study ("Inadequately pricing the promise of insurance"), "Setting adequate prices is a challenge for inexperienced insurers, including new companies and established companies that enter new markets." As a new company growing rapidly in the Ontario auto insurance market, Advocate was challenged by inexperience in attempting to set adequate prices. An already tough challenge was thus made more difficult by Ontario's decision to freeze auto insurance rates.

Nonetheless, freezing and then restricting Ontario auto insurance rates did not cause Advocate General to fail. Rather, the rate freeze exacerbated the challenges that the Company was already facing. These problems were not the result of rate inadequacy alone – as the following section clarifies.

Eve of insolvency: the Supervisor's perspective

Advocate General was supervised for solvency purposes by the Office of the Superintendent of Financial Institutions (OSFI). The Company had been closely monitored by OSFI as a start-up because of its small capital base. As Advocate's operating results deteriorated in 1987 and 1988, scrutiny by the Supervisor was correspondingly increased. In fact, discussions were held with Advocate and its shareholders in late 1988, focusing on the Company's non-compliance with capital requirements and whether more capital would be provided to address the deficiency.

At this time, Advocate General's major shareholders had engaged consultants Price Waterhouse to conduct an operational review of the Company and to advise on the relative merits of three possible actions: to invest more capital; to try to sell the Company; or to stop issuing new policies and wind down operations. When Price Waterhouse advised against investing more capital – concluding that more profitable alternatives were available to the shareholders – Advocate's prospects as a going concern were significantly diminished. Wood Gundy was briefly engaged to try to sell the Company, but nothing came of those efforts. The only alternative available to Advocate was to exit the P&C insurance business – and the question to be answered, essentially by the regulator, was whether that exit would be a voluntary run-off, or an involuntary liquidation.

The question was answered by OSFI in February of 1989, in a letter from then Deputy Superintendent Robert Hammond to Advocate General's President, Joseph Pereira. The letter specifically stated that the Superintendent had recommended to the Minister of Finance the following actions:

- prevent Advocate General from issuing new or renewal policies
- direct the Superintendent to take control of the Company, and
- seek Court approval to wind up the Company under the federal *Winding-up and Restructuring Act*.

Advocate General was given time to make representations before these recommended actions would be taken. For a period of several weeks, discussions continued between OSFI and Advocate regarding the Company's solvency. Advocate General believed that its assets were sufficient, and OSFI did not. The Company's view appears to have been based on the opinion of its auditor, even though its own actuary, Mr. William Weiland, had "indicated agreement with OSFI's view toward the end of 1988 that the reserve [of Advocate General] was inadequate by at least $3 million." (Statement from the affidavit of Richard Mabee, then Director General of OSFI's P&C Insurance Division, dated May 24, 1989).

To resolve the dispute regarding Advocate General's solvency, OSFI engaged Coopers & Lybrand to value and appraise the Company's assets and liabilities. Coopers & Lybrand submitted its report to OSFI on April 10, 1989. The report concluded that Advocate's provision for unpaid losses (as reflected in the Company's audited financial statements) was deficient by approximately $13 million. On April 24, 1989, OSFI took control of Advocate General and appointed Deloitte (formerly Deloitte, Haskins & Sells Ltd.) as its agent to assist in the day-to-day management of the Company.

In retrospect, the controversy involved more than just differing professional opinions on valuing assets and liabilities. In its February 1989 letter to Mr. Pereira, OSFI concluded "that there is very considerable doubt that the Company's assets are sufficient to enable it to meet its obligations on a run-off basis." Risks related to the run-off scenario – which was the Company's preferred market exit strategy – were central to the regulator's conclusion. Why? Because assets would have to be liquidated in run-off, and Advocate General's position was weakened in OSFI's view by three factors:

- the total actual market value of the Company's invested assets was approximately $1.4 million below reported book value;
- total assets included approximately $4 million of pre-paid expenses, mainly in the form of deferred acquisition costs, that were unlikely to be realized; and
- a receivable of $1.3 million from Advocate's parent company (Advest Capital) had been disallowed by OSFI. With respect to this particular receivable, the regulator's view proved to be correct when Advest later (in November 1989) filed a voluntary assignment in bankruptcy in the Province of Manitoba. The receivable thus became unavailable to the estate of Advocate in liquidation.

In addition to these key asset-related matters, the regulator had to consider the significant difference between its own and Advocate's estimates of total policyholder liabilities – a gap that approximated $8 million at the time OSFI took control.

Advocate General disagreed with OSFI's decision to take control, and while the regulatory action could not be immediately rescinded, the Company directed its lawyers to apply to the Court to have the take-control order set aside. As part of the process, Advocate's management sought permission to cross-examine Coopers & Lybrand regarding its report findings, but the request was denied by OSFI. The Court would thus become the final arbiter as to whether Advocate would be allowed to run off its business voluntarily, or be forced into liquidation.

One consequence of this dispute was that some of Advocate General's policyholders would have to wait almost *three months* until any decision could be made on the payment of claims. Other than payments approved prior to the take-control order, OSFI ruled that no further claims would be paid until the Court issued a decision on how the Company would be wound up. The resulting short-term uncertainty faced by Advocate's policyholders was unfortunate.

In PACICC's view, it is important that solvency regulators across Canada establish contingency plans so they can move decisively if an insurance company needs to be wound up. Advocate General ultimately failed because of inadequate loss reserves. Deficient reserves for a federally-supervised insurance company would be less likely to occur today. For one thing, federally-supervised insurance companies are now subject to peer-review requirements in estimating claims reserves and valuing assets. Peer-review can identify chronic under-reserving problems at an earlier stage.

In addition, risk-based supervision and capital requirements that are now in place would have moved a company like Advocate General higher on the risk scale at an earlier stage. (This is not to deny that OSFI was giving Advocate greater scrutiny – in fact, by the mid-1980s the Company was being closely examined due to its rapid growth and high concentration in Ontario auto insurance).

But for jurisdictions without recent experience liquidating insolvent insurance companies, there are valuable lessons to be learned from reviewing the case of Advocate General. More specifically, should a liquidation become necessary, jurisdictions with active risk-based supervisory practices and peer-review requirements are more likely to have identified emerging solvency problems at an earlier stage. By doing so, insurance regulators stand a better chance of avoiding solvency-related disputes and keeping to a minimum the time period between taking control of a troubled insurer's assets and securing a court order for a wind-up.

The winding-up order: the Court's view

The main question put before the Court in the case of Advocate General was: should the Company be wound up involuntarily (as recommended by the Superintendent), or allowed to run off its business voluntarily (as preferred by its management and shareholders)? The Court hearing the case was The Queen's Bench of Manitoba (Winnipeg Centre), and the decision would be rendered by Associate Chief Justice R. J. Scott. Prior to delivering his decision, Justice Scott had received petitions from the Attorney-General of Canada, and had read the affidavits of Richard Mabee (OSFI), and of Messrs. Jack Chisvin and Joseph Pereira (a Director of Advocate and the Company's President, respectively).

Many of the important facts relating to the dispute were summarized in the previous section of this case study. In addition to those facts, it was alleged by Advocate General (in particular, in the affidavit of Mr. Jack Chisvin, dated June 15, 1989) that the Superintendent had displayed bad faith in failing to pay claims and other commitments after taking control, in effect automatically rendering the Company insolvent by virtue of such inaction. In support of OSFI's position, the Attorney-General's petition cited the July 30, 1982 case of *Attorney-General of Canada v. Cardinal Insurance Co.*, which involved circumstances similar to those of Advocate (that is, an order by the Superintendent taking control of Cardinal that was opposed by the Company; and the subsequent granting of a winding-up order by the Court).

Justice Scott delivered his decision on July 5, 1989 in a 12-page document ("Reasons for judgment delivered"). Readers will find it instructive to review the reasons for Justice Scott's decision – which was to order that Advocate be wound up under the provisions of the Federal *Winding-up and Restructuring Act*. Reproduced below are what PACICC believes to be the key reasons cited by Justice Scott in reaching his decision to grant a winding-up order for Advocate General.

> This court does not have the jurisdiction to question or supervise the actions of the superintendent… On the other hand, the winding-up process is not an automatic *pro forma* one, but an opportunity to determine, on the criteria set forth in s. 10 of the Act, whether the company is insolvent, or if there are other criteria rendering it "just and equitable that the company should be wound up" [s. 10(e)].
>
> I do not regard the *Cardinal* decision as standing for the proposition that the Minister can automatically mandate a winding-up order from a provincial superior court by simply making the business decision (in good faith) that claims and other requests for payment not be honoured. In order to determine whether the company is insolvent, all the surrounding circumstances must be looked at.

In my opinion, there is certainly a triable issue as to whether the company is or is not insolvent and, but for the unique and urgent circumstances of this case, an order directing trial of such an issue would go forward. However, to do so would result in intolerable delay to the claimants, policyholders who are entitled to a return of unearned premiums, and others with claims against the company.

In the circumstances of this case, I believe it just and equitable and in the best interests of all those affected, in particular claimants and policyholders, that a winding-up order be made at this time. The interests of policyholders and claimants must, in the context of this case, be given greater weight than those of the managing shareholder. In addition, if the company is wrong, and it is, in fact, insolvent, there may well not be sufficient funds to pay all claims. The deputy superintendent, in his recommendation to the Minister dated March 20, 1989 indicated that some claimants might be paid in full, while others might receive only partial payment, or perhaps no payment at all. Further delay will be intolerable.

In my opinion, the creditors, policyholders and claimants of the company simply cannot wait to determine, by the trial of an issue, whether it is technically insolvent – other factors make it just and equitable that it is wound up now, and I so order.

In so doing, I want to make it clear that the controlling shareholders of the company may have resort to their ordinary civil remedies, should they wish, with respect to their allegations that the superintendent and his officials acted in bad faith, and that the company was and is not insolvent.

The civil remedies referred to by Justice Scott were not pursued by Advocate General's shareholders subsequent to the winding-up order. As noted earlier, Advocate's parent company, Advest Capital, filed a voluntary assignment in bankruptcy in Manitoba in November 1989. And while it is not definitive proof of insolvency, it is interesting to note that a report made three months after the winding-up date by Deloitte showed that Advocate General's total estimated liabilities in liquidation exceeded its assets by $12.6 million.

The role of PACICC

PACICC was established in 1988 as the P&C insurance industry's financial guarantee fund, with a mandate to pay covered policyholder claims resulting from the insolvency of a member insurance company. When Advocate General was ordered to be wound up on July 5, 1989, it became the first member-company liquidation to be handled by PACICC.

PACICC's Board of Directors met on April 27, 1989 – three days after OSFI had taken control of Advocate General. The Board discussed the Company's situation, and the minutes indicate "agreement that there was nothing that could be done by the Compensation Corporation as no winding-up order was in effect." PACICC's Board met again on August 10, 1989 – after the Court had approved a winding-up order for Advocate – and the decision was taken to make an initial general assessment levy of $10 million on PACICC member companies to fund payment of the covered claims of Advocate policyholders. The $10 million levy, in fact, was the only assessment of PACICC members required, as the Court approved a dividend of 60 cents on the dollar effective July 25, 1990. At that point, the Compensation Corporation became eligible to recover 60% of any amounts paid by the Liquidator to settle covered Advocate claims using PACICC funds.

Because Advocate General was the first member-company liquidation handled by PACICC, procedures had to be established, consistent with the new Compensation Corporation's Memorandum of Operation. For example, early on in the wind-up, PACICC and the Liquidator needed to agree on how claims settlement authority would be provided, and who would issue cheques to policyholders and other claimants. By mid-October of 1989, a formal agreement was in place that called for PACICC to review all proposed claims settlements for amounts greater than $25,000, and for the Liquidator, as PACICC's agent, to issue PACICC cheques on behalf of the Compensation Corporation. These basic arrangements proved both durable and practical – they have been used in most of the subsequent insurance-company wind-ups backed by PACICC, and are still in place today.

Policyholders needed to know about the role of the new Compensation Corporation. At the time Advocate General was ordered to be wound up in July 1989, the Company had about 45,000 policyholders and there were approximately 4,900 claims outstanding. Advocate General's policyholders also needed to be informed about several important matters, including: the importance of making prompt arrangements for replacement insurance coverage (PACICC would respond to claims that arose prior to or within 45 days of the winding-up order); the procedure for submitting a claim to the Liquidator; and the option now available to assign their claim to PACICC and to receive payment sooner than would otherwise be the case (and much sooner than was the case, in fact, in pre-PACICC P&C insurance company liquidations in Canada). All of this information was conveyed in a letter sent to Advocate's policyholders by Deloitte, in its capacity as agent to PACICC, on July 21, 1989 – two weeks after the Company was ordered into wind-up.

The liquidation of Advocate General required PACICC to pay out on eligible claims and expenses that eventually totaled $45.2 million. When the wind-up was complete, there was a full recovery of 100 cents on the dollar for PACICC as the principal creditor in the liquidation. (That recovery, however, does not account for the time-value of money). Two factors were noted by the Liquidator (Deloitte) as aiding a full recovery by PACICC: first, all reinsurance monies owing were recovered by the estate; and second, capital gains were earned on portions of Advocate's fixed-income assets, which remained invested until needed in the liquidation.

Because PACICC did not cover the refund of unearned premiums at the time Advocate General was ordered to be wound up (that coverage was added in 1997), premium refunds could only be paid to policyholders by the Liquidator after all loss claims had been fully settled. Ultimately, Advocate General's policyholders were reimbursed for 25 cents on the dollar for unearned premium claims.

Causes of insolvency

Advocate General's failure can be attributed to several factors.

Causes of insolvency

- ***Deficient loss reserves*** ($13 million in total estimated unpaid losses when OSFI took control in April 1989).
- ***Inadequate pricing*** (Advocate's auto insurance rates were 7 percent below the industry average).
- ***Rapid and unsustainable growth*** (Especially in the Ontario auto insurance market).

Adverse environmental influences

- ***Rate regulation*** (The freeze and subsequent restrictions on auto insurance rates put in effect by the Ontario Government in 1987).
- ***Soft insurance market*** (Two insurance cycle downturns occurred in the Canadian P&C insurance market during Advocate's nine-year corporate history).

Management issues

- ***Management's insufficient response to sustained losses*** (The Company lost money every year from 1984 to 1988, with large losses just before it failed).

Key lessons learned from the failure of Advocate General

- The shareholders and senior management of new P&C insurance companies need to be aware of the critical importance getting their pricing and claims reserving "right" in relation to insured risks – as their survival often depends on it. Across all lines of business, Advocate General reported chronic reserve deficiencies relative to its peers and it ultimately failed.
- Start-up insurance companies deserve special supervisory attention. Indeed, like Advocate General, roughly one-third of the P&C insurance companies that failed in North America over the past 30 years did so during their first 10 years of operation.
- Pricing significantly below market rates is a risky strategy, particularly for a new insurer that does not have the backing of a parent company with "deep pockets."
- Inadequate pricing and deficient loss reserves tend to go hand-in-hand for failed insurers – as demonstrated by PACICC's 2007 "Why insurers fail" study (*The dynamics of property and casualty insurance insolvency in Canada*). Solvency and market conduct regulators need to be aware of the potential financial impairment that pricing below market rates can have, in particular, freezing or restricting premiums in relation to claims costs.
- Early-warning solvency tests can be good indicators of developing financial stresses – signaling a need for further investigation and possible mitigation. (But such tests should not be viewed as a substitute for peer-review requirements of reserve estimates and asset valuations).
- Regulatory capital requirements are intended to help an insurance company absorb losses as a going concern, and to protect policyholders and creditors in the event of insolvency. Sustained compliance is needed to ensure that these two key purposes of regulatory capital can be satisfied.
- High concentration in a single line of business and in one region presents a different enterprise risk profile than a diversified strategy. Accordingly, it is important for management and Boards of Directors to evaluate business plans when insurance companies expand into new markets.
- A key objective of insurance regulators should be to minimize the time period between taking control of a troubled insurer and winding-up the company's operations. This requires contingency planning to support decisive action when needed.
- Ultimately, Advocate General failed because of inadequate loss reserves. Peer review, Dynamic Capital Adequacy Testing and other actuarial practices are now available to manage this important and persistent risk more effectively.

References

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Appendix

Timeline of events

April 9, 1980, Advocate General Insurance Company of Canada, a Manitoba-based federally regulated company, was incorporated.

November 13, 1980, Advocate General was granted a Certificate of Registry authorizing the company to transact several classes of property and casualty insurance.

January 1983, Advocate General opened an office in Ontario.

1985, Advocate General moved its executive office to Toronto, while the head office remained in Winnipeg.

1985, Advocate General opened a new office in Vancouver.

March 14, 1987, Advest Capital Inc., the parent company of Advocate General, becomes a reporting issuer in Ontario.

June 1988, OSFI completes an on-site examination of Advocate General and reviews the 1987 report of the Company's actuary.

December 13, 1988, the major shareholders of Advocate General engage Price Waterhouse to carry out a viability review of the company.

January 9, 1989, the President and the Chairman of the Board of Advocate General, advise that a decision regarding the recapitalization of the company will be made by January 31, 1989.

January 12, 1989, the Deputy Superintendent of Financial Institutions reports to the Minister of Finance that Advocate General is not in compliance with the capital adequacy rules.

January 30, 1989, Advocate General submits a revised financial statement for November 1988 reporting that the Company's assets exceeded liabilities by about $12 million, but were $2.4 million less than the minimum required.

February 7, 1989, Advocate General's actuary reports to OSFI that the Company's reserve for unpaid claims reflected in the November 1988 statement was understated by approximately $3 million.

February 8, 1989, a meeting was held between representatives of OSFI and the President and some shareholders of Advocate General. The shareholders advised that they had decided not to invest more capital in the Company.

February 13, 1989, the Deputy Superintendent reports that Advocate General's assets are not sufficient to meet liabilities and recommends that a limitation be placed on the Company's Certificate of Registry preventing it from issuing any new or renewal policies.

Timeline of events (continued)

March 3, 1989, OSFI receives Advocate General's preliminary financial statements for the period ended December 31, 1988.

March 6, 1989, Advocate General's actuary agreed that assets did not meet solvency requirements, but disagreed with OSFI on the extent of the deficiency.

March 20, 1989, OSFI engages Coopers & Lybrand to value and appraise Advocate General's assets and liabilities.

March, 1989, Advest Capital Inc., fails to disclose its quarterly financial statements to the Ontario Securities Commission.

April 10, 1989, Coopers & Lybrand submits its report to OSFI, finding that Advocate General's provision for unpaid losses was deficient by approximately $13 million.

April 24, 1989, OSFI's Superintendent took control of Advocate General Insurance Company and applied to the court for an order to wind-up the Company.

Late April 1989, Advocate General applied to the Federal Court of Appeal to have OSFI's take-control order set aside.

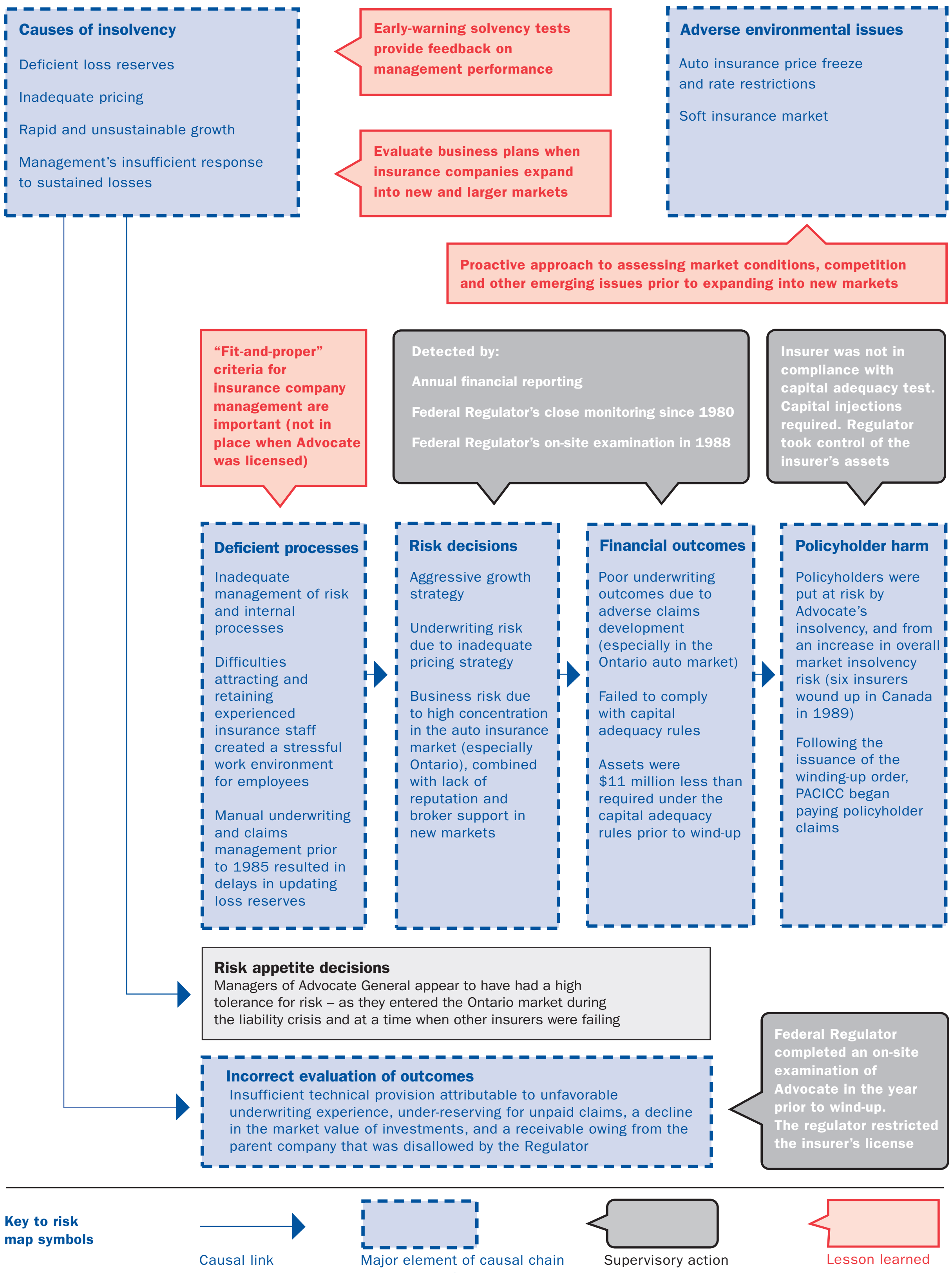
May 1989, Advocate General shareholders attempt to sell the company, but regulators indicate they will not approve any proposed sale unless the owners deposit an additional $5 million to address a deficiency in claims incurred but not reported.

July 5, 1989, The Queen's Bench of Manitoba dismisses Advocate General's motion to have OSFI's take-control order set aside and issues an order to wind-up the Company.

July 13, 1989, the Ontario Securities Commission issues a Cease Trading Order against Advocate's parent company, Advest Capital Inc.

November 29, 1989, Advest Capital Inc. files a voluntary assignment in bankruptcy in Manitoba.

Risk map


Causes of insolvency
Deficient loss reserves
Inadequate pricing
Rapid and unsustainable growth
Management's insufficient response to sustained losses
Early-warning solvency tests provide feedback on management performance
Evaluate business plans when insurance companies expand into new and larger markets
Adverse environmental issues
Auto insurance price freeze and rate restrictions
Soft insurance market
Proactive approach to assessing market conditions, competition and other emerging issues prior to expanding into new markets
"Fit-and-proper" criteria for insurance company management are important (not in place when Advocate was licensed)
Detected by:
Annual financial reporting
Federal Regulator's close monitoring since 1980
Federal Regulator's on-site examination in 1988
Insurer was not in compliance with capital adequacy test. Capital injections required. Regulator took control of the insurer's assets
Deficient processes
Inadequate management of risk and internal processes
Difficulties attracting and retaining experienced insurance staff created a stressful work environment for employees
Manual underwriting and claims management prior to 1985 resulted in delays in updating loss reserves
Risk decisions
Aggressive growth strategy
Underwriting risk due to inadequate pricing strategy
Business risk due to high concentration in the auto insurance market (especially Ontario), combined with lack of reputation and broker support in new markets
Financial outcomes
Poor underwriting outcomes due to adverse claims development (especially in the Ontario auto market)
Failed to comply with capital adequacy rules
Assets were $11 million less than required under the capital adequacy rules prior to wind-up
Policyholder harm
Policyholders were put at risk by Advocate's insolvency, and from an increase in overall market insolvency risk (six insurers wound up in Canada in 1989)
Following the issuance of the winding-up order, PACICC began paying policyholder claims
Risk appetite decisions
Managers of Advocate General appear to have had a high tolerance for risk – as they entered the Ontario market during the liability crisis and at a time when other insurers were failing
Incorrect evaluation of outcomes
Insufficient technical provision attributable to unfavorable underwriting experience, under-reserving for unpaid claims, a decline in the market value of investments, and a receivable owing from the parent company that was disallowed by the Regulator
Federal Regulator completed an on-site examination of Advocate in the year prior to wind-up. The regulator restricted the insurer's license
Key to risk map symbols
Causal link
Major element of causal chain with details of risk
Supervisory action
Lesson learned