

# **Property and Casualty Insurance Compensation Corporation**

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A proactive vision for PACICC  
in a challenging business environment

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### *Annex*

- A - Results of the March 2003 PACICC member consultations
- B - Comparison of Canadian financial services guarantee funds

## *Why does PACICC need to change?*

Insurers provide peace of mind. If drivers, homeowners or businesses experience an accidental loss then their insurer works with them to restore everything as much as possible to the state that existed before the unfortunate loss. Most Canadians would find it impossible to imagine life without insurance and the security it promises.

The Property and Casualty Insurance Compensation Corporation (PACICC) is a vital element of the modern insurance industry. The industry has united, through PACICC, to guarantee consumers a reasonable recovery of loss in the unlikely event that an insurer fails. In our competitive industry it is possible that an insurer may fail, but should this happen legitimate claims will still be paid because the industry will not fail consumers.

We have consulted widely over the past year about PACICC and its future. These consultations are summarized on the next page and identified three areas of clear agreement:

- *PACICC has been a success. In particular, public concern is virtually absent about the risk that insolvency may cause an insurance claim to fail to be paid.*
- *The mandate established when PACICC was founded 15 years ago remains valid today. PACICC should continue to be managed and governed by its member insurers, and work to ensure reasonable recovery of loss for consumers in the unlikely event that an insurer fails.*
- *Nevertheless, the approach that brought success for the past 15 years needs to be adjusted. Member expectations for the organization have changed, and this paper provides a vision of the specific reforms that we believe are essential.*

We have been invited to share our vision of appropriate reforms, a challenge that we enthusiastically embrace. We propose that:

- *PACICC needs to develop and implement a business strategy setting out its financial, operational, government relations and communications priorities that will guide the Corporation over the medium term.*
- *PACICC needs a small, professional staff with sufficient resources and a contingency plan that details how the Corporation will operate during periods of extraordinary need.*
- *PACICC needs proactive Board members who will establish a clear strategic direction for the Corporation to position it appropriately in a changed business environment.*

We thank the many people who have shared their thoughts and concerns. In particular, we thank Jane Voll, Randy Bundus and Darrell Leadbetter for their contribution to the preparation of this paper. Nevertheless, the views expressed in this paper are our own, and are offered to invite comment and discussion.

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## **Consultations affirm mandate and governance**

Two years ago there was widespread concern about overcapitalization in the Canadian insurance industry. Excess capital reduced the near-term risk of insolvency, but contributed to poor industry underwriting practices and an increased medium-term risk of insolvency. Over the past couple of years this situation changed significantly and led to an active member debate about the mandate and role of PACICC.

Poor financial results for many member insurers, deteriorating equity markets and the choice made by a number of insurers to operate with less capital contributed to a growing industry concern about capital adequacy. While there is a broad consensus that PACICC has been a success over the past 15 years, some have questioned its preparedness for the challenges now facing the industry.

In March, the PACICC Board of Directors circulated a paper to member insurers inviting comments on the Corporation, specifically requesting direction about mandate and governance. The Board was successful in formalizing the debate that has been taking place within the industry, and securing clear direction. Member participation was very strong. As summarized in Annex A, insurers responsible for almost 90 percent of the insurance sold in Canada provided a written response to the March paper.

### ***Members endorsed PACICC's current mandate***

All but two members responding to the March survey stated that PACICC should continue to pursue its current mandate. One member did not respond to this question because it has announced its intention to withdraw from the Canadian insurance market. One member indicated that PACICC should expand its mandate if OSFI reduces its regulatory or information gathering activities. Almost no members indicated that PACICC should change its mandate. One member stated they supported the current approach because "*PACICC's mandate should not overlap with that of regulators*". Several members indicated that "*risk-based assessments should be introduced*". All other written comments about mandate were similar in nature.

### ***Members endorsed PACICC's current governance model***

All but three members stated that PACICC's current governance model should continue. Two members indicated that the Corporation needed to ensure the appropriate balance between governance by members and by independent Board members. One member did not respond to this question because it has announced its intention to withdraw from the Canadian insurance market. No members expressed support for a fully independent Board. Many members indicated that "*industry should have a majority on the Board*". Also members indicated that "*P&C is distinct from life and health insurance*" so there is strong acceptance that the best approach for PACICC members can differ from the approach selected for the life insurance industry.

### ***IBC also endorsed PACICC's current mandate and governance***

The Insurance Bureau of Canada was the driving force that led to the creation of PACICC 15 years ago, so the PACICC Board formally requested IBC's input with respect to the current review of the Corporation's activities. The Bureau responded with a strong endorsement of PACICC's current mandate and approach to governance. IBC added that important changes are nevertheless required at PACICC. In particular, the Bureau believes that the industry should enhance the resourcing of PACICC. In addition, the Bureau urges the establishment of a proactive Board that will press to ensure the Corporation is prepared for an extraordinary challenge, such as multiple failures. IBC expressed its willingness to support this review of PACICC's operations.

## **The organization needs to become proactive**

The operating environment has recently become very challenging for PACICC and its members. This is the driving force for reform of the Corporation's operations, staffing and governance.

The Corporation was founded in 1988. This followed five years of discussion during a period of considerable turmoil for the industry. Several insurers failed, bringing disruption that was of concern for consumers and insurers. The federal insurance regulator merged with the regulators responsible for banks and other financial institutions. The liability crisis combined with high rates of inflation and record high underwriting losses produced rapid growth in industry claims costs and the price of insurance. Significantly, insurance rating agencies like TRAC identified more than two dozen insurers that were vulnerable to insolvency and likely on the confidential watch list maintained by regulators. PACICC was founded during a difficult period for the industry.

PACICC benefited from a strengthening in the financial health of the industry between 1988 and 2000. Capital growth consistently outpaced growth in premiums. Indeed, in 2000 there was widespread concern that the industry was overcapitalized. There was also an evident strengthening during this period of the capacity of regulators to supervise insurance practices. This included a project led by Insurance Bureau of Canada, OSFI and regulators in Quebec, British Columbia and Ontario that established the most progressive system in the world for regulating management of insurers' earthquake exposure. The number of insurers identified as vulnerable to failure on the watch list of rating agencies declined steadily over this period, with no companies on the list by the late 1990s.

The organization introduced a number of changes. Over the last five or six years, for example, PACICC established a pre-fund so payments can be made quickly following an insolvency. The Corporation worked with regulators to establish a model wind up order which provided benefits for claimants in that it has smoothed the transition of the insolvent company, provided quicker payment of claims, reduced paperwork and reduced the cost of winding up. PACICC worked with liquidators to develop a more efficient means of handling claims through outsourcing. The indemnity limit was increased from \$200,000 to \$250,000. The \$500 PACICC deductible was removed. The Corporation introduced coverage for unearned premium.... Nevertheless, fundamental reform was not identified as a priority when PACICC was operating in a favourable operating environment.

### ***However, the business environment has changed***

By the end of 2002, most Canadians (70 percent) were customers of companies with regulatory capital scores under 15. This was a dramatic increase from 25 percent in 1997. Several insurers are likely now on regulators' watch lists. Also, insolvency risk typically lags the insurance cycle, so the operating environment will remain difficult for PACICC for several years.

Insurers have made significant investments over the past decade to strengthen their governance practices. This includes improved management of liabilities, assets and risk. Simultaneously there has been improvement in regulatory solvency supervision. The Office of the Superintendent of Financial Institutions (OSFI), for example, has introduced a supervisory framework that increasingly directs supervisory attention towards risky behaviours. Regulatory capital requirements that are much higher than those in the United States, Europe and Japan, likely reduce the risk that an insurer will fail in Canada.

We suggest that member insurers, regulators and other interested parties have higher expectations about the management of organizations like PACICC than 15 years ago. There is an expectation, for example, that the organization can clearly demonstrate a professionalism and preparedness with respect to its operations, communications and government relations. Operating priorities, staffing decisions and governance practices that were previously accepted as appropriate now need to be revisited if PACICC is to maintain its record of success.

## *Focusing on what matters*

Is PACICC prepared for the issues that may arise over the next few years? We believe that there is scope for improvement. Below are some operational issues and opportunities that PACICC should urgently address:

- PACICC needs a financial strategy. The ability to quickly access funding from members is constrained by a maximum annual levy. The Corporation has a prefund of \$30 million, and arranged a \$10 million line of credit. This may not be sufficient for the financial demands that may present themselves over the next few years.
- PACICC needs an operational strategy detailing how it would manage the failure of a large insurer, or the failure of several insurers simultaneously. This should include a contingency plan where the Corporation secures additional temporary assistance during extraordinary periods.
- PACICC needs a government relations strategy. Insurance regulators are forming views on the capacity of PACICC to fulfill its mandate, and are revisiting their relationship with the Corporation. Supervisors are seeking evidence that insurers embrace the importance that the industry invests in needed reforms.
- PACICC needs a communications strategy. The Corporation should anticipate the need to speak with the public, regulators, liquidators, member insurers and others.
- PACICC needs a small, professional staff endowed with sufficient resources. (This is addressed in more detail below.)
- PACICC needs Board members chosen to create a proactive, strategic and forward looking corporation. (This is addressed in more detail below.)
- PACICC needs reliable, accurate and timely information about the financial health of its members, like CompCorp and CDIC, a need that has become urgent given OSFI's recent decision that it will not share company information, in confidence, with PACICC.
- PACICC should consider risk-based funding mechanisms, like those introduced by CompCorp and CDIC.
- PACICC needs a formal agreement with CompCorp, CDIC and other guarantee funds that will need to work with PACICC if a financial conglomerate fails.
- PACICC should explore reducing the size of its Board, and assess the potential role of standing committees, like the recent decision to establish an Executive Committee.
- PACICC should explore establishing an insurance company, similar to CompCorp Life, because it would provide the Corporation with alternatives to the use of multiple liquidators in the final stages of resolving insolvencies.
- PACICC should review its current coverages to determine if they should be limited to auto, homeowners and small business claims, following the lead of US P&C compensation corporations to limit or eliminate coverage for large commercial risks.
- PACICC should actively champion continuation of a national compensation corporation.

## **Resources necessary to do the job**

Dedicated and experienced people have managed PACICC successfully for fifteen years. Former industry and trade association executives working on a part time basis following retirement have managed the organization well. Presently the Corporation has four part-time contract personnel. Remarkably, PACICC has never had staff with a salary, benefits, a pension, professional development support and expectations of a career with the Corporation.

Several US P&C compensation funds have a staff of 50 or more people. The compensation corporation for Canadian banks (CDIC) has almost 100 employees, and for Canadian life insurers (CompCorp) has more than 16 employees. PACICC has four people working part time. PACICC members pay \$2,000 a year, on average, for administrative costs. In contrast, as set out in Annex B, life insurers pay \$27,000 a year, and banks pay \$270,000. This was sustained during the period when the Canadian P&C insurance industry was well capitalized, but this should not continue in the current market. The absence of sufficient resources has severely limited PACICC's ability to proactively address pressing issues like those set out previously. There have been no resources for planning and preparedness, circumstances that should urgently be addressed.

### ***PACICC needs a small team of professionals***

Lower risk of insolvency in the Canadian P&C insurance industry suggests that PACICC should not establish a large staff like the US P&C guarantee funds. Nevertheless, PACICC should hire a professional team seeking a career in serving the insurance industry and its consumers. A small team with appropriate resources could work with a proactive Board to resolve the critical issues presently facing PACICC. It is essential that the team have a proven track record to develop and implement a business strategy that sets out financial, operational, government relations and communications priorities for the organization.

### ***A knowledge base to support change***

CDIC and CompCorp have invested in information gathering, research and analysis. PACICC should also invest in information systems to support implementation of initiatives like risk-based assessments and development of a financial plan. This should include the capacity to collect confidential data from member insurers, perhaps with a requirement that members share regulatory filings in confidence. IBC has developed an information management system that is used to assess regulatory filings shared on a voluntary basis with the Bureau, a system that IBC is willing to donate to PACICC. The system is easy to maintain and its holds considerable potential to support improvements in planning and operations at PACICC. It also would provide PACICC management with information needed to sustain a healthy long-term relationship with regulators and other stakeholders. For confidentiality reasons the information must reside at PACICC, although analysis and research may be purchased as required.

### ***Linkages with other organizations are critical***

We envision strong, formal linkages between PACICC, its member insurers and organizations willing and able to help the Corporation. This will be very important during periods of extraordinary need, such as multiple failures or the insolvency of a large member. PACICC should have a formal contingency strategy to secure temporary assistance from member insurers, other compensation corporations and other partners willing to support PACICC during periods of unusually extreme need. It is also appropriate for PACICC to secure ongoing support for elements of its regular operations. This may include secretarial, communications, statistical and administrative support, like those that have been in place for many years.

## **Strengthening governance and strategic direction**

PACICC was founded in 1988 with the understanding that it would be governed and managed by its member insurers. This governance model was established based upon five years of extensive negotiations with provincial and federal superintendents, and reaffirmed earlier this year as the preferred approach of members. At its core is the understanding that company management and insurance regulators minimize the risk of insolvency, while the insurance industry manages its guarantee fund to address the needs of policyholders and claimants of a failed insurer.

### ***High expectations for industry Board members***

Forty-four of the fifty state funds in the U.S. are governed without provision for any independent board members. Senior executives of member insurance companies are seen as the most capable of governing the operations of a P&C compensation corporation.

At present, industry executives volunteer to serve on the PACICC Board. Their expenses are paid but Directors are given no compensation for their services to the Corporation. Industry executives have direct knowledge about industry trends and the operating environment for the Corporation. Industry executives also understand consumer expectations that they are striving to address at a company level, that are essential as PACICC serves a similar function at the industry level.

There have been periods when it has been difficult to recruit industry executives to serve on the PACICC Board. This reflects, we suggest, the absence of solvency problems for the industry, and a prolonged period of policy stability with the Corporation. Board meetings are infrequent, and typically held at the call of the Chairman. We urge strong industry leadership during the current challenging period. Managed well, PACICC can help its members maintain a strong positive relationship with consumers and it can minimize insolvency costs.

### ***Changing expectations for independent Board members***

Responding to demands from Canadian regulators, PACICC has modified its governance model to bring independent members onto its Board of Directors. The governance policy was revised to increase from one, to three and later five independent members on the Board. The 2003 PACICC Board includes 7 senior executives working with member insurers, the President, the Secretary and 6 others with knowledge of the industry who are not employees of any member company. PACICC has a lower proportion of industry Board members (7 of 15) than any P&C fund in the world today.

Most independent members of the PACICC Board have been retired insurance executives or insurance regulators with distinguished careers. These independent Board members often have had similar skills and experiences as industry members. The PACICC Board has yet to actively pursue the potential benefits of including independent members with experience in other financial industries, in government or with an understanding of broader political challenges that may affect the industry and its capacity to effectively serve consumers.

In brief, the approach that PACICC has traditionally used to establish its governing body was effective over an extended period when there was a small and declining risk of insolvency, but the current business environment likely requires a proactive board with skills in a variety of areas in addition to knowledge of insurance.

## *Conclusion and recommendations*

We believe that PACICC has served insurance consumers and the insurance industry very well since it was established 15 years ago. It now faces, however, a different operating environment that will likely persist over the next five years or longer. New approaches are needed to position PACICC to maintain its record of success. This paper sets out our vision of changes needed in operations, staffing and governance. In particular, we propose that:

- ✓ *PACICC needs to develop and implement a business strategy to set out its financial, operational, government relations and communications priorities that will guide the Corporation over the medium term.*
- ✓ *PACICC needs a small, professional staff with sufficient resources and a contingency plan that details how the Corporation will operate during periods of extraordinary need.*
- ✓ *PACICC needs proactive Board members that will provide a clear strategic direction for the Corporation to position it appropriately in our changed business environment.*

We are pleased to have been invited to share our views on actions to strengthen PACICC's capacity to serve member insurers and insurance consumers. The Corporation has been a success since it was founded, but changing circumstances and expectations now require reform. Best efforts and adjustments that have been put in place over the last five or six years serve to emphasize the need for fundamental operational changes if PACICC is to build confidence that it will continue its record of success.

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## **Annex A**

### **Results of the PACICC member consultation**

PACICC members were encouraged to review the PACICC White Paper and provide direction about how PACICC can best sustain its record of success. Included with the paper was a member survey on the closely related issues of governance and mandate. The survey questions are summarized below with the responses.

Overall PACICC members strongly endorsed PACICC's current mandate and very strong support was expressed for an industry governed guarantee fund.

#### ***Mandate:***

##### ***97.4 % of responses:***

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

*or*

##### ***1.3% of responses:***

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

***1.3% of respondents had no comment*** (withdrawing from the market)

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#### ***Governance:***

##### ***96.1% of responses:***

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

*or*

##### ***0% of responses:***

- B. Establish an independent Board where no one on the PACICC Board works with a member insurer

***3.9% of respondents indicated the need for a balanced approach between independent directors and industry representation.***

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### **Summary statistics**

Number of responses		76
Proportion of PACICC membership		86.4% of member premium volume
Regional analysis	Newfoundland	40.0 %*
	Quebec	74.6 %*
	Ontario	57.4 %*
	B.C.	70.7 %*

*\* Regional breakdown represents aggregate provincial market share of provincial companies who responded to the survey as a proportion of total premium written by provincial companies. Provincial companies from other provinces also responded but data limitations prevented similar analysis.*

### **Consultation with Insurance Bureau of Canada**

Recognizing that Insurance Bureau of Canada (IBC) was the driving force for the industry in establishing a compensation plan in 1988 and that these issues are industry issues, the PACICC Board requested that IBC participate in this consultation and invited feedback in this regard.

IBC has responded and reaffirmed the industry's confidence in PACICC's current mandate noting that Canada's insurance supervisors are responsible for minimizing the risk that an insurer fails. Further, IBC reaffirmed that P&C insurers should continue to govern and manage PACICC.

In addition, IBC recommended that PACICC:

- Evaluate and enhance the resourcing of PACICC;
- Review opportunities to enhance governance through the active participation of senior insurance executives on the Board to provide knowledge about the industry, and independent members chosen for expertise on other factors such as governance experience, consumer knowledge or regional links.

## *Annex B*

### *Comparison of the Canadian financial service guarantee funds*

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