September 27, 2017

Ms. Eleanor Ryan
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Financial Sector Policy Branch
Department of Finance Canada
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Re: Second Consultations for the Review of the Federal Financial Sector Framework

Dear Ms. Ryan,

Thank you for the opportunity to participate in the second consultation of the Federal Financial Sector Framework review. The Property and Casualty Insurance Compensation Corporation (PACICC) is pleased to provide input regarding the Department of Finance's consultation paper, *Potential Policy Measures to Support a Strong and Growing Economy: Positioning Canada's Finance Sector for the Future*. Our commentary focuses on the issues related to the solvency of Canada's property and casualty (P&C) insurance companies. In particular, we will focus on two issues identified by the Government:

1. Earthquake insurance; and
2. Resolution regime for Canadian insurers.

In developing this submission, PACICC has worked closely with the Insurance Bureau of Canada (IBC). Our submissions are complimentary and PACICC fully supports the recommendations from IBC on earthquake insurance.

Earthquake insurance

In February 2017, the Organisation for Economic Co-operation and Development (OECD) recommended that member states: "establish a strategy, under the leadership of Ministers of Finance or other relevant national authority, for managing the financial impacts of disasters." Many modern economies have developed programs to manage the risks of catastrophic natural disaster events. The purpose of these programs is not to protect insurance companies; rather, they serve to protect the competitiveness and *resiliency* of their economies. Examples of these programs include:

France**:** Created in 1982, the ***Caisse Centrale de Réassurance*** **(CCR)** is a public-private partnership providing government-guaranteed reinsurance.

New Zealand**:** The ***Earthquake Commission*** **(EQC)** provides automatic first-loss cover for valid claims for all policyholders of residential fire insurance. Premiums are collected through a compulsory levy added to all homeowner policies, and private insurers transfer the levy to the EQC for investment by the ***Natural Disaster Fund***. Owners of non-insured property can expect no help from government.

Spain**:** The ***Consorcio de Compensación de Seguros*** **(CCS)** was founded to indemnify Spanish insurance companies against claims arising from unpredictable events, including natural disasters. It became a permanent state-run, private-public partnership in 1954 providing nationwide, state-guaranteed cover for extraordinary risks.

United States**:** The ***California Earthquake Authority*** **(CEA)** was established in 1996 as a tax-exempt, not-for-profit, largely privately-funded pool to cover seismic damage in that State. Insurers had the option of paying an "exit tax" and offering cover, or transferring funds and participating in the pool; 70 percent agreed to transfer funds, which together with premiums and return on investments provides the total CEA income.

This list is not exhaustive. Many countries have developed programs to increase the resiliency of their economies to the risks posed by natural catastrophes. While the structures of each of these programs are unique to the countries that they protect, there is a common theme with these programs – a recognition by Governments that there are catastrophic events that are too large for private insurers and that there is a role for Government.

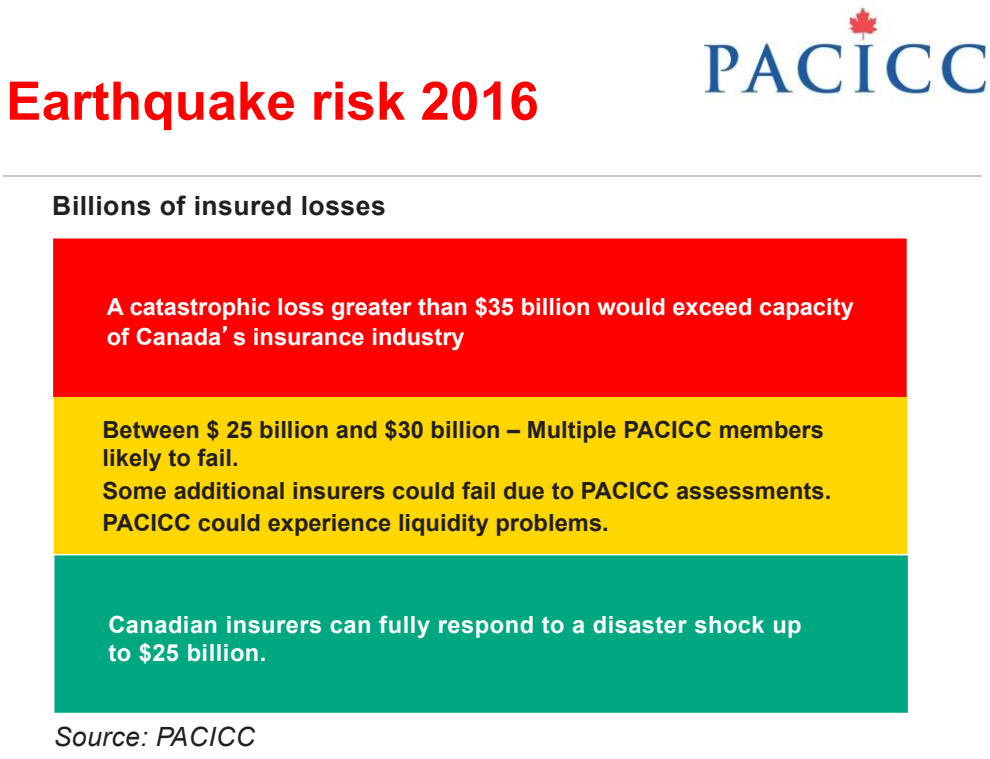
P&C insurers are financially prepared to pay earthquake claims up to $25 billion

A catastrophic earthquake will occur in Canada. However, we do not know when or where it will strike. In 2013, PACICC first identified the negative consequences of a catastrophic earthquake could have on Canada's insurance consumers and the insurance industry in the *Why Insurers Fail* research paper. This paper was updated in 2016.

Canada's insurance industry presently has a capital base of approximately $50 billion. PACICC estimates that Canadian insurers purchase an additional $24 billion in catastrophe reinsurance from global markets. This is the capital base used to underwrite all economic activity in Canada. Last year, insurers paid almost $40 billion to settle insurance claims across Canada, in addition to billions of dollars in salaries and taxes.

PACICC estimates that Canada's P&C insurers are prepared for a catastrophic earthquake resulting in insured losses up to $25 billion with little impact on their solvency. This would be an event much larger than the Fort McMurray wildfire – the largest catastrophic loss ever experienced in Canada. An earthquake of this size would leave thousands of Canadians homeless. It would cause widespread disruption across the economy. However, Canada's insurers are ready to play their part to provide billions

of dollars to assist the nation's recovery. In effect, the private insurance industry has pre-funded the money required to support the ongoing insurance needs of Canadians and a further $25 billion of earthquake damage claims, likely without any companies failing.



Source: PACICC

An earthquake resulting in claims exceeding $30 billion is too large for Canada's P&C insurance industry

A catastrophic resulting in claims greater than $30 billion is currently too large for Canada's insurance industry to manage. We believe that this is the outer-band of the industry's current ability to assist in Canada's recovery from a catastrophe. The PACICC model suggests that several P&C insurers would fail. The resulting costs of liquidating these insolvencies would be a significant additional burden for insurers that survive the earthquake. PACICC would experience significant problems raising the funds that it needs to protect consumers. A loss of this magnitude would create significant problems for the Canadian economy.

For example, our model shows that an earthquake resulting in $40 billion of insurance claims would have the following impact:

- One-third of the industry's capital base would immediately disappear.
- Approximately 50 P&C insurers would report a decline in their capital base of more than 25 percent. These insurers would not be in a position to growth their businesses.

- 40 of these insurers would be categorized as "financially distressed" meaning they would fail the Canadian Council of Insurance Regulators (CCIR) Minimum Capital Test.
- These insurers serve almost 60 percent of P&C Canada's insurance market. Following an earthquake of this size, many Canadians would be unable to find insurance coverage.

Research by PACICC finds that Canada's P&C insurers are prepared for a very large earthquake, meeting the highest regulatory standards in the world. There are, however, limits to the ability of insurers to support Canada's recovery following a catastrophic event.

PACICC and earthquake risk

PACICC has been operating for almost 30 years as Canada's consumer protection agency, designed to manage the occasional failure of small to medium-sized insurers. The Corporation has signed contracts with every provincial and territorial government in Canada – our participating jurisdictions. The *Insurance Act* in each participating jurisdiction requires, as a condition of their provincial licence to sell insurance, that the insurer belong to a compensation plan, PACICC. In return, provincial insurance regulators have the power to veto changes to our Memorandum of Operation. This system has worked well. PACICC has efficiently managed 12 failures since it was established.

PACICC's involvement in the national response following a catastrophic earthquake would begin with conversations with insurance regulators as documented in the regulatory Guideline for Intervention for P&C insurers. OSFI has indicated to PACICC that it plans to introduce a revised Guideline in 2017 that would involve sharing information with PACICC earlier in regulatory process. The regulator would be forced to decide which companies have lost their confidence and therefore need to be closed. Once an insurer is closed, PACICC provides cash necessary for the court-appointed liquidator to pay the claims of policyholders and reimburse premiums paid in advance.

PACICC has only one way to finance a liquidation. Currently, assessment mechanism determines the total amount required to fund the liquidation and invoices each company their share of these costs. The surviving insurers are required to recognize the full cost of the liquidation on their financial results in their financial statements. For a catastrophic earthquake, the size of these invoices become the transmission mechanism for contagion potentially causing a second round of insolvencies.

Should the PACICC-regulator consultations determine that PACICC's assessment model could adversely impact the insurance industry, PACICC's Board of Directors could decide that PACICC cannot fulfill its function to protect policyholders covered by the failed insurers. In this case, PACICC would initiate discussions with our participating jurisdictions or, failing to come to some agreement, not protect consumers. If this were

to occur, the policyholders would be forced to follow the legal process outlined by the *Winding Up and Restructuring Act (WURA).* This would mean waiting for several months, or years, to receive any payment. PACICC's experience with insurance liquidations indicates that it takes decades to liquidate a P&C insurer. It is unacceptable to expect consumers to wait decades for this legal process after a catastrophic earthquake has destroyed their homes and businesses.

Recommendation 1: Allow PACICC to borrow from the Consolidated Revenue Fund to finance liquidations following a catastrophic earthquake

To ensure that PACICC can protect policyholders without triggering systemic financial risk, we request that the Federal Government enable PACICC to access a credit facility drawn on the Consolidated Revenue Fund (CRF) to provide emergency lending assistance (i.e., liquidity provision) for policyholder compensation in response to institutional failures.

Under this proposal, insurance companies that mismanaged earthquake risk would still fail. Companies that prudently capitalized and appropriately managed this risk would not be subject to the secondary shock of having to finance the liquidation of their failed competitors. The unintended chain of second-round failures that would otherwise occur due to PACICC's assessments on surviving insurers – that is, systemic financial contagion risk – could be avoided.

PACICC proposes to repay the loan by introducing an Extraordinary Assessment Mechanism (EAM) that would allow it to place an assessment on future insurance underwritten by our members. For example, if the EAM was set at 2 percent, then PACICC member insurers would place a 2 percent surcharge on future insurance policies. Using the EAM, PACICC would be able to assess insurers to recover any funds borrowed from the government, without causing detrimental capital/contagion impacts on insurers. When the loan was repaid, the EAM surcharge would be eliminated.

Under PACICC's current governance structure, introducing the EAM would require approval from every provincial and territorial insurance superintendent. PACICC presented its proposal to the CCIR in 2016 and received positive feedback. The EAM proposal is ready and PACICC could quickly introduce it prior to receiving any loan from the Government.

Recommendation 2: Make two small changes to the Insurance Companies Act

PACICC fully supports the proposals made IBC to make two minor amendments to the *Insurance Companies Act*. In addition, the Government of Canada should sign an agreement to become a participating jurisdiction with PACICC.

1. *Required Legislative Change*

The *Financial Administration Act (FAA)* has already been amended after the financial crisis to give the Minister of Finance the authority to enter into financial stability arrangements (Part IV.1) to promote the stability or maintain the efficiency of the financial system in Canada, including a contract to: "*make a loan to an entity*", "*provide a line of credit to an entity*", and "*guarantee any debt, obligation or financial asset of an entity*". Consequently, given that such a credit facility would be structured as a loan or guarantee, the *FAA* already authorizes payment out of the CRF under these systemic arrangements.

The *ICA* can be amended to ensure that insurers belong to a P&C compensation association that is recognized by the Minister and that has the authority to levy assessments on industry members (i.e., PACICC). This would parallel the existing section of the *ICA*, section 449. Such a requirement in the ICA could be justified for systemic risk reasons, as it is desirable for all insurers to belong to the mechanism.

In addition, under "Remedial Powers" in Part XV of the *ICA*, the following could be added after section 675.1.

> *Agreements with Compensation Associations*
>
> *675.2 (1) The Minister may advance funds to a designated compensation association, in such amounts, in such circumstances, and on such conditions as are designated by regulation.*
>
> *(2) For the purpose of Subsection (1), the Governor in Council* [or Minister] *may make regulations designating the method for determining the amount of funds, the circumstances, and the conditions referred to in that subsection and designating the compensation associations referred to in that subsection.*

Under this provision, a regulation would be created to designate PACICC as a compensation association and which prescribes, among other things, the terms of the agreement between the government and PACICC, including what PACICC is to do with the funds advanced (that is, compensate policyholders under its Memorandum of Operation) and the terms of the lending assistance agreement (i.e., rate of interest, if any, repayment period, etc.).

To conclude the discussion on earthquake risk, PACICC strongly encourages the Government of Canada to develop a program, in partnership with the P&C insurance industry to protect our citizens from the risks arising from a catastrophic earthquake.

Resolution framework for Insurers

The second issue that PACICC would like to discuss is the proposal to review the resolution framework for life insurers. PACICC requests that the review include P&C insurers. The resolution framework for both Life and P&C insurers are defined by *WURA.* This Act needs to be modernized.

WURA is a key component of the legal framework underpinning the Canadian economy. It provides the framework that governs the affairs of most financial institutions experiencing financial distress and insolvency. Due to the size and influence of financial institutions, the statute can significantly affect large numbers of individuals and broad sections of the economy when an institution becomes distressed.

The *WURA* has many features that support effective resolution of a financial institution. In particular, it is a relatively flexible framework that generally permits guarantee funds and liquidators to adapt to the unique circumstances of each distress situation. This flexibility should be maintained.

Nonetheless, there are also elements of the statute that are detrimental to policyholders, reducing both the amount of assets that can be returned to consumers and unnecessarily increasing the length of time that consumers and other creditors must endure before gaining full access to their financial resources. The larger the distress event, the more evident these issues become.

PACICC's experience with these issues is practical rather than theoretical. With 32 failures over the past 35 years and five estates currently being supported by PACICC, the P&C insurance industry is a frequent user of the statute. While PACICC has worked to ensure that few of these deficiencies become apparent to consumers in the liquidations in which it participates, the global crisis highlighted that there are situations where the scale and complexity of the distress situation could make it challenging (if not impossible) to minimize the impact on consumers. As the primary user of the *WURA*, PACICC believes that the *WURA* can be amended to both maintain the statute's flexibility and improve outcomes for consumers in a distress situation.

PACICC recommends the following changes to Part III of the *Winding-up and Restructuring Act*:

Recommendation 3: allow provincial insurance regulators access to the Act

In Canada, P&C insurance companies operate as a federal or provincial corporation. Only a few of the provincial insurance regulators have the power to take possession and control of an insurer's assets and apply for an order to wind up an insurance company under the *WURA*. Some provincial acts clearly provide this power. The Ontario and Alberta legislation empowers the Minister of Finance take possession and control of an

insurance company and apply under the *WURA*. Further, in Saskatchewan, the Act explicitly states that the Superintendent can appoint a receiver pursuant to the *WURA* to wind-up an insurance company.

However, some provincial Acts are either unclear regarding the powers that they provide or do not provide these powers at all. For example, the British Columbia and Quebec Insurance Acts do not provide clear guidance on when the *WURA* may be invoked. This issue becomes exceedingly important following the catastrophic earthquake example detailed above. For a $40 billion earthquake, it is conceivable that a British Columbian-incorporated insurer, an Alberta-incorporated insurer, a Quebec-incorporated insurer, an Ontario-incorporated insurer and several federally-incorporated insurers could become financially distressed. Would *WURA* apply to all of these companies? Could there be multiple courts applying possibly conflicting pieces of legislation to resolve the estates of these insurers? It would quickly become a legal mess. Canada should have one legal framework to resolve the estate of Canadian insurance companies.

Recommendation 4: clarify that unearned premium trusts are assets of the estate

Insurance brokers may hold premiums as a trustee, but are not the owner of the beneficial title to the funds. Insurance brokers are required to treat all unearned premiums as trust funds and segregate them from their own funds until they are required to remit them to the insurer. In the normal course of business, it is acknowledged that unearned premiums in trust accounts belong to the insurer.

Confusion results when an insurance company is wound-up. In some cases, due to valuation and measurement issues of liabilities and assets, the determination of solvency status is a matter of actuarial assessment and public confidence. Therefore, a company may be wound-up when the solvency supervisor believes with some level of actuarial confidence that the company is insolvent. In this vein, the interaction of the language between the *WURA* and Quebec's Civil Code has generated confusion as to whether the unearned premiums belong to the estate, since it may not technically be bankrupt within the meaning of the Civil Code. Insurance company insolvencies are relatively infrequent, there are few precedents and information is scarce. This has generated confusion and led to legal action in some cases as various brokers interpreted the treatment of unearned premium trusts differently.

Clarifying that the unearned premium trusts were part of the assets of the estate would improve the refund process to policyholders by eliminating conflicting approaches. It will also help brokers by reducing their legal exposure, uncertainty and clarifying potential conflicts of interest.

Recommendation 5: a single claims process for insurance claims

The *WURA* contains two separate and inconsistent sets of rules related to claims – one for insurance companies (s. 166 – 169) and one for other companies (s. 74-77, 85 & 87-92). The relationship between the rules is not specified, and the *WURA* has been

interpreted to subject insurance companies to both sets of rules. In PACICC's experience, utilizing both claims processes has not identified additional claimants and has only served to delay the distribution of assets to consumers.

Further, the Insolvency Institute of Canada notes that some of the provisions are inconsistent, citing two separate disallowance provisions to which claimants are subject. Overall, the Insolvency Institute of Canada states "… some of the rules currently found in the WRA are unsatisfactory because they generate unnecessarily high administrative costs, which reduce the assets available to creditors."

PACICC recommends that insurance companies be subject to a single claims process and be excluded from also subjecting claimants to the general process.

Recommendation 6: in some situations, the liquidator should be permitted to rely on the financial institution's records

For the issuance of refunds of unearned premiums and other short-tailed claims, being able to rely on the records of the financial institution, where they are sufficiently complete and credible, would facilitate the liquidator being able to issue refunds.

Recommendation 7: harmonize the WURA approach to Crown priority with that of the BIA

Currently the *WURA* does not bind the Crown, allowing it to enforce its claim against the insolvent insurer, in some cases restricting the capacity of the liquidator to maximize the proceeds of the estate. Several reports and committees since the 1970s have concluded that Crown priority in bankruptcy is inappropriate, particularly where the claim results from a contractual arrangement. Even in the case of unpaid taxes, the government can distribute the burden across the taxpaying public rather than focusing it on relatively few policyholders and depositors.

This would be consistent with the structure of the solvency framework, ensuring the stability and confidence of the financial sector. For example, guarantee funds and solvency supervisors distribute the cost of the insolvency throughout the relevant financial sector, thereby protecting policyholders and depositors from undue losses. Eliminating Crown priority does not eliminate Crown claims but it does eliminate distortions in the liquidation process and more closely aligns the *WURA* with the framework under the *BIA/CCAA* and policies promoting financial sector stability.

In respect of Crown priorities, PACICC endorses the Insolvency Institute of Canada's recommendations that the *WURA* treat all Crown claims, except those arising from fines or penalties in the same way that they are treated under the *BIA*. Claims arising from fines and penalties, should in theory be borne by shareholders who had an opportunity to control an institution's conduct and therefore be subordinated to all other claims.

Recommendation 8: improved claims priority for employees

In 1886, Parliament added the preferred claim for salaries and wages to the *WURA*. The wording has remained virtually unchanged. That wording uses terms like "clerk" to describe employees. There are few cases that have focused on whether an individual falls within the meaning of clerk or other person in or having been in the employment of the company. In those cases, the courts have found that the word "clerk" is the principal term and have generally interpreted it fairly narrowly.

Within financial institutions, employees can be critical to the successful operation of a liquidation. It is important to treat the employees of a troubled financial institution equitably because they often play a critical role in the company due to the specialized nature of transactions. Further, while the societal importance of policyholder and depositors claims and savings may outweigh claims, which are preferred under the *BIA* (for example municipalities and landlords), for many employees the last paycheque may be just as important.

Recommendation 9: ensure consistency between WURA and Part XIII of the Insurance Companies Act

Over the past 25 years, there have been a number of branches in Canada placed into involuntary wind-up. It has emerged that claims on the estate of a branch in wind-up have included policyholders with risks located in Canada, who were policyholders with the foreign parent or another foreign affiliate of the company in wind-up. The *WURA* currently makes no distinction between claimants based upon the presence or absence of supervisory oversight, and in this respect is inconsistent with the vesting regime of the *ICA*.

In support of OSFI's appropriate efforts to align the two statutes through its regulatory framework, PACICC recommends that there be an amendment to the *WURA* to fully address the issue.

Recommendation 10: relevant guarantee funds should be entitled to be inspectors

The most serious deficiency of the *WURA* is the absence of provisions addressing the role of creditors and guarantee funds in the winding-up of a financial institution. In part, this reflects the origins of the statue in the 19th century where guarantee funds did not exist and information transmission was slow. However, the need to ensure stability and public confidence in the financial system is the primary justification for the involvement of guarantee funds and establishing a separate liquidation system for financial institutions.

The administrative framework of the *WURA* says little about the role of anyone other than the Court and the liquidator. Guarantee funds have a critical role in preserving confidence in the surviving institutions in the financial sector. Active participation by a guarantee fund in the early stages of a liquidation is necessary to reassure claimants of a

failed insurance company that they are protected and ensure the continued flow of claims payments.

For the liquidation of a particular institution, a large proportion of creditors tend to hold relatively small claims and generally be uninformed about the financial health or operations of the financial institution. For this reason, the approach used by the *BIA* to select inspectors is not suitable for the *WURA* due to the difficulty in those creditors collectively participating effectively in the selection and instruction of inspectors.

Further, most consumers of a financial institution are protected by a guarantee fund such as PACICC, which during the claims process takes over the role of representing the creditors claim with the estate. As a result, guarantee funds typically have a large stake and play an important role in the winding-up of a financial institution. Guarantee funds also accumulate a great deal of specialized expertise in the winding-up of financial institutions. The special role of guarantee funds should be recognized in the legislation and at a minimum there should be a formal mechanism for them to be appointed as inspectors. This would facilitate getting guarantee funds benefits to consumers and reduce court costs associated with unnecessary applications.

In addition, the role of inspectors should be clarified. Under the statutory powers of *WURA,* inspectors are limited to advising and assisting the liquidator. An early court ruling involving a non-financial institution established that the most important function of an inspector is to advise on the sale of assets.

Among the powers an inspector should have, the Insolvency Institute of Canada recommends that liquidators "should have an obligation to consult with inspectors prior to making decisions on material matters unless satisfied that urgency will not permit this in a given case." While this is in fact largely the practice of most liquidators, experience has shown that it is not always the case. Further, the Insolvency Institute of Canada notes that inspectors should have the power to make recommendations to the Court on matters such as fees, disbursements and restructuring of the financial institution.

PACICC endorses this recommendation and would add that an annual financial reporting process to inspectors should also be included. These recommendations clarify the role of inspectors, reducing the need for court applications while still preserving liquidator flexibility to respond to events.

Recommendation 11: liquidators should have powers to obtain property and records of an insolvent institution being held by third parties

In many cases, companies outsource critical functions such as claims adjustment, accounting and information technology. In such cases, it may require substantively longer periods of time to get enough information to estimate the claims liability sufficiently to initiate an assessment of PACICC's member insurers. Experience suggests

that in some cases it may take as long as a year. Conversely, on average, the time required to identify and initiate an assessment when there is ready access to information is 2.5 months

In other cases, where some functions are outsourced to a party that had a non-arm's length relationship with the insolvent institution and there was evidence of impropriety, there may be disincentives to share information and data. Having the power to obtain property and records could facilitate the process for the liquidators and shorten the time between the issuance of the winding-up order and the payment of claims.

Recommendation 12: protection for liquidators following discharge

For most insurance company insolvencies, more than 90 percent of consumer claims are fully resolved and paid within four years. While some lines of business take time to run-off, in many cases the liquidation process takes even longer. For example, no claims at all have been paid by PACICC to consumers during the final seven or eight years for five of the liquidations involving PACICC, but the process continues in each case.

In order to accelerate and simplify the completion of liquidations, the *WURA* should be amended to provide that a liquidator's discharge insulates it from post-discharge claims based on its acts or omissions in good faith during the liquidation. The application for discharge would require proper notice and disclosure to have been completed.

Recommendation 13: the restructuring process under WURA should clearly outline the process and judicial authority for the transfer of insurance policies to a solvent company

Part III under the *WURA* is entitled "Restructuring of Insurance Companies". However, it does not enact a comprehensive restructuring regime for insurance companies. Rather, it provides distribution priorities for competing claims against the insolvent company and enables the transfer or reinsurance of an insolvent insurance company's policies. There is a need for *WURA* to clearly outline the process and judicial authority for the prompt transfer of insurance policies to a solvent company. For life insurance and accident and sickness policyholders specifically, the continuity of benefits is an important aspect of their continued security.

Recommendation 14: a regular review process of the WURA, as part of the financial sector review cycle, should be introduced

A flexible, principles-based statute does not necessarily require frequent updates. However, in recent decades, the *WURA* has been a statute for winding-up financial institutions, and the financial sector is experiencing rapid change and innovation. Requiring a regular review would allow the insolvency framework to adapt, where necessary, to this changing environment.

PACICC is a consumer protection agency that protects Canadians if their P&C insurer becomes financially distressed. With this submission, PACICC makes 14

recommendations to the Federal Government to ensure that Canadians can count on this protection following a “normal” insolvency or a catastrophic earthquake. A catastrophic earthquake will present untold challenges and hardships to Canadians. By acting on PACICC’s recommendations now, the Government will not need to waste essential time, energy and resources negotiating with insurers after the earthquake when every available resource will be needed to assist in the rebuilding of homes and businesses. PACICC looks forward to working with the Government to development a program to protect Canada’s economy from a catastrophic earthquake.

Best regards,

Paul Kovacs
President and CEO

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