ICP 16: Winding-up and Exit from the Market

Basic-level Module
Contents

About the Core Curriculum ................................................................. v

Note to learner ................................................................. vii

Pretest ........................................................................... ix

A. Introduction ........................................................................ 1

B. Identifying weak companies ..................................................... 4

C. Need for sound supervisory processes ........................................ 8

D. Winding-up ...................................................................... 15

E. The core principle ................................................................. 20

F. Use of supervisory powers .......................................................... 22

G. Putting the principles into practice ........................................... 24

H. Dealing with branches of foreign companies .............................. 37

I. Policyholder protection schemes ............................................... 38
J. Supervision and inspection ................................................................. 41

K. Conclusion ...................................................................................... 42

L. References ....................................................................................... 45

Appendix I. ICP 16............................................................................... 46

Appendix II. Answer key......................................................................... 47

**Figures**

Figure 1. Structured supervisory process ................................................. 5
Figure 2. Supervisory authority as gatekeeper ........................................... 8
Figure 3. Balance sheet ........................................................................... 9
Figure 4. Structured rating system .......................................................... 12
Figure 5. Transparency and communication in a structured supervisory process ... 13
Figure 6. Orderly market exit ................................................................. 15

**Case studies**

Case study 1. Contingency Planning ......................................................... 28
About the Core Curriculum

A financially sound insurance sector contributes to economic growth and well-being by supporting the management of risk, allocation of resources, and mobilization of long-term savings. The insurance core principles (ICPs), developed by the International Association of Insurance Supervisors (IAIS), are key international standards relevant for sound financial systems.

Effective implementation of the ICPs requires skilled and knowledgeable insurance supervisors. Recognizing this need, the World Bank and the IAIS partnered in 2002 to develop a “core curriculum” for insurance supervisors. The Core Curriculum Project, funded and supported by various sources, accelerates the learning process of both new and experienced supervisors. The ICPs provide the structure for the core curriculum, which consists of a set of modules that summarize the most relevant aspects of each topic, focus on the practical application of supervisory concepts, and cross-reference existing literature.

The core curriculum is designed to help those studying it to:

- Recognize the risks that arise from insurance operations
- Know the techniques and tools used by private and public sector professionals
- Identify, measure, and manage these risks
- Operate effectively within a supervisory organization
- Understand the ICPs and other IAIS principles, standards, and guidance
- Recommend techniques and tools to help a particular jurisdiction observe the ICPs and other IAIS principles, standards, and guidance
- Identify the constraints and identify and prioritize supervisory techniques and tools to best manage the existing risks in light of these constraints.
Welcome to ICP 16: Winding-up and exit from the market module. This is a basic-level module on winding-up and exit from the market that does not require specific prior knowledge of this topic. The module should be useful to either new insurance supervisors or experienced supervisors who have not dealt extensively with the topic or are simply seeking to refresh and update their knowledge.

Start by reviewing the objectives, which will give you an idea of what a person will learn as a result of studying the module, and answer the questions in the pretest to help gauge your prior knowledge of the topic. Then proceed to study the module either on an independent, self-study basis or in the context of a seminar or workshop. The amount of time required to study the module on a self-study basis will vary, but it is best addressed over a short period of time, broken into sessions on sections if desired.

To help you engage and involve yourself in the topic, we have interspersed the module with a number of hands-on activities for you to complete. These exercises are intended to provide a checkpoint from time to time so that you can absorb and understand the material more readily and can apply the material to your local circumstances.

You are encouraged to complete each of these activities before proceeding with the next section of the module. If you are working with others on this module, develop the answers through discussion and cooperative work methods. An answer key in appendix II sets out some of the points that you might consider when tackling the exercises and suggests where you might look for the answers.

As a result of studying the material in this module, you will be able to do the following:
1. Describe the reasons that an insurer might voluntarily or involuntarily exit from the market and how that might be achieved.

2. Describe the conditions that might cause a supervisory authority to seek the winding-up of an insurer.

3. Understand the need for prompt decisive supervisory action and how this can be balanced with the need to let companies solve their own problems.

4. Illustrate situations in which it may be appropriate to seek the winding-up of an insurer whose assets exceed its liabilities.

5. Explain why a legal priority should be given to the protection of the rights of policyholders and other policy beneficiaries in the event of an insurer becoming insolvent and winding-up.

6. Enumerate the steps commonly involved in the winding-up of an insurer.

7. Describe various forms of policyholder protection funds and explain how they are financed.

8. Describe the types of coverage limitations commonly imposed by policyholder protection funds and the meaning of “moral hazard.”

9. Summarize the requirements of ICP 16.

10. Explain why the existence of a policyholder protection scheme is not an appropriate reason for a supervisory authority to reduce its capital adequacy requirements or to exercise forbearance in dealing with a serious solvency concern.
Pretest

Before studying this module on winding-up and exit from the market, answer the following questions. The questions are designed to help you gauge your existing knowledge of this topic. An answer key is presented in appendix II at the end of the module.

For each of the following questions, circle the responses that are correct or most relevant. There may be more than one correct response for each question.

1. **Winding-up a company refers to:**
   - a. The process set by the company to close down its operations
   - b. The process set by the company to sell its operations
   - c. The legal process managed by a court to force a company out of business
   - d. Any process that is managed by the supervisor to protect policyholders.

2. **Winding-up an insurance company could be initiated by:**
   - a. The board of directors of the insurance company
   - b. The insurance supervisor
   - c. The creditors of the company
   - d. Policyholders.
3. In winding-up a company voluntarily, it is important that the following parties be actively involved in the process:
   
a. Board of directors of the insurance company
b. Courts
c. Policyholders
d. Insurance supervisor.

4. When an insurer is forced to be wound-up, preferential treatment is given to:
   
a. Owners of the company
b. Financial interest that policyholders and claimants have against the company
c. Expenses incurred to wind-up the company
d. Creditors that are owed money by the company.

5. The goal of winding-up a company is to:
   
a. Allow companies to exit the market
b. Protect the interest of policyholders
c. Force badly run companies out of the market
d. Enhance public confidence in the insurance industry.

6. It is important that the winding-up process be set out in the law so that the:
   
a. Insurance supervisor is protected from legal action by the owners of the company
b. Process is established and understood so that each company that is forced out of the market knows that it has been treated fairly
c. Court knows what its duty is when it is asked to make a decision to place a company into liquidation
d. Supervisor and the regulated entities have a common understanding of how the process works.

7. If the board of directors appeals a decision by the supervisor to wind-up the company, it is a sign that the:
   
a. Supervisory process has failed
b. Board of directors does not understand its responsibility
c. Owners are upset by the supervisor’s decision
d. Owners want to be sure that they are being treated fairly.
ICP 16: Winding-up and Exit from the Market

Basic-level Module

A. Introduction

The International Association of Insurance Supervisors (IAIS) has included a core principle on the powers that supervisors should have to support the process of providing insurance companies with an orderly exit from the market. This is an important aspect of supervision since ICP 16, along with licensing (ICP 6) and changes in control (ICP 8), contributes to the powers that supervisors need to control who is allowed to own and operate an insurance company in the marketplace. Supervisors have a responsibility to protect the rights and interests of policyholders. This duty requires supervisors to establish rules and standards for the companies and adopt supervisory approaches that contribute to the public’s having confidence in the insurance sector.

In the same sense as it is important for supervisors to control when and how companies may enter the market, it is critical that supervisors have the power to ensure that companies are able to leave the market in an orderly way.

Market exit can occur because of decisions made by a company to withdraw from the market for whatever reason it has, or the exit can be involuntary because of concerns
that the supervisory authority may have about the ongoing viability of the company. Whether these exits are voluntary or forced, the need for order and control throughout the process is important.

This module considers how to identify a troubled company and the actions that the supervisory authority can take to deal with that possibility including, but not limited to, winding-up the company. Since this topic is discussed at the basic level, it assumes that the reader has a modest understanding of supervisory processes. We will consider the information and processes that support the supervisory responsibility that contribute to the effectiveness of supervisory decisionmaking.

Information on companies and the industry is an important part of the foundation on which informed supervision is built. The supervisory methodology and process provide the structure and the evidence needed to support the decisions needed to deal with troubled companies. The evidence and processes are the structure that supports the decision to apply sanctions or enforcement actions against a company.

This topic will be followed by a brief discussion of the ways in which companies can exit the market and why one option might be chosen over another. We then will consider the possible timing and coordination issues needed to carry out these options as well as the ways in which the options are usually implemented.

Finally, we will look at the liquidation process in an environment in which the winding-up takes place under legislation other than the insurance legislation. Intermingled with this will be a discussion of the role of policyholder protection schemes and the extent to which their presence might influence timing and other decisions needed to manage an orderly exit.

It is important to manage the process from the point at which a company is accepted as part of the insurance industry to the point at which the decision is made for it to exit the market. This module looks at the use of information, documentation, and supervisory methodologies to facilitate that transition. It will address the powers and processes that can be used and choices that might be available during this transition. The focus will be dealing with straightforward situations, although, from time to time, some of the complexities that arise in dealing with internationally active companies, conglomerates, and companies that are a part of influential groups will be identified.

Winding-up a branch can be more straightforward than winding-up a company, or it can be more complex. In the concluding section in this module, we will consider some of the issues affecting the involuntary wind-up of a branch.

**Commonly used terms**

This section defines any terms that may benefit from a definition. If these terms are in the IAIS Glossary, no attempt has been made to include a definition here. However, if

---

2. The IAIS Glossary of Terms was adopted by the IAIS membership in 2003 and is available at www.iaisweb.org.
a specialized or narrow meaning is intended and the term is used more than once, consideration will be given to clarifying its use by including a definition.

**Viable or viability.** In the view of the supervisory authority, the company is sufficiently able to operate the practical business affairs of the company to retain, or regain and maintain, sufficient financial strength that it does not place its policyholders at an unreasonably higher risk of loss than would apply for other companies operating in the market.

**Capital margin.** In this module, this term is used to refer to the excess of the amount of capital available within the company to meet the minimum capital test over the level of capital that the company is required to maintain.
B. Identifying weak companies

Defining and managing the process of dealing with weak or troubled companies is an important aspect of supervision. This topic is covered more comprehensively in the core curriculum modules that deal with ICP 14, Preventive and Corrective Actions, and ICP 15, Enforcement or Sanctions. However, the supervisory methodology and supervisory processes are important elements of the ability of the supervisory authority to deal with troubled companies. Therefore, this module outlines some of the aspects of these supervisory processes that could have an impact on the effectiveness with which a troubled company is supervised.

The job of supervision is a complex task that involves:

- Managing people
- Influencing others
- Reporting to key stakeholders
- Balancing the company’s need for time to bring itself into compliance with the need for immediate action to protect policyholders
- Understanding and applying consistently the powers available in the legislation and regulations
- Working with industry and professional associations.

Companies can become weak as a result of financial issues, including:

- Poor investment including nonperforming assets
- Poor underwriting risk selection
- Unsound pricing strategies
- Unrealistic reserving or provisioning
- Adverse claims experience
- Adverse expense levels
- Uncontrolled growth and associated strain
- Inadequate access to capital
- Poor liquidity management.

Companies can become weak or troubled for reasons other than issues that emerge initially on the balance sheet. These can include:

- Noncompliance with important legislative or regulatory requirements
- Poor reputation through improper market conduct activities
- Weak corporate governance
- Weak planning
- Weak risk management practices
- Poor internal controls
- Weak management
- Lack of understanding of the local market
- Weak parent or sister company that places demands on the insurance company to provide financial support to the weak company.

These areas of weakness can eventually lead to financial weakness, which is the reason that they often are of significant concern to supervisors. The sanction or supervisory enforcement action that the supervisory authority selects to deal with the violation or problem facing the company should be consistent with the severity of the problem and the manner in which similar problems have been handled with other companies.

Identifying a potentially weak company is always a challenge for the supervisory authority because this task most frequently involves investigating and drawing conclusions that are at odds with the conclusions that management and the board reached when looking at the same evidence. In other words, management and the board are unlikely to have drawn the same conclusions as to the severity of the challenge that the company is facing.

A supervisory authority adopts a structured supervisory process (figure 1)\(^3\) to ensure that the company understands how the issues that are of concern to the supervisory authority were identified. Structured supervision also improves the chance that management can accept the process used to identify problems and supports the process under which management must resolve the challenges that face the company. This process should identify the issues of major concern at an early stage and use the power available to the supervisory authority to ensure that the company resolves the challenges that it faces in a timely manner so that the rights of policyholders and claimants are protected.\(^4\)

---

\(^3\) In this module, a structured supervisory process is one that is documented, systematic, and sequential. It includes processes to ensure that staff are able to apply consistent standards and processes in analyzing companies and that each company understands these processes. The methodology also includes documentation of the remedial actions that would be applied for violations of the legislation and regulations.

\(^4\) For more information on this process, refer to the core curriculum module on IAIS ICP 14, Preventive and Corrective Measures.
A structured supervisory process overlays the powers and authorities available to the supervisory authority with the methodology that is adopted and, through a series of stages, supports early action by the company to resolve the challenge.

The supervisory authority has a number of sanctions and supervisory enforcement tools to deal with troubled companies. The most severe or powerful of these is the power that supervisors have to force a company out of the market. These could be called refusal to renew a license, delicensing, or winding-up.

These are very significant powers and supervisors should use them when they are convinced that these provide the best alternative among the powers available for the protection of the rights and interests of policyholders and claimants. In other words, the power to deprive a company of the right to continue in business should be a last resort and used only after other powers have been used and found ineffective.

In some jurisdictions, the power to withdraw the license or make an application to a court to have a company wound-up are limited to explicitly defined violations. In other jurisdictions, the supervisory authority must apply judgment to the circumstances and to the company itself to determine whether the company is viable. Only then might the supervisory authority decide that winding-up power is the appropriate sanction and that the timing is appropriate to protect policyholders’ interests.

---

3. “Delicensing” is often used in reference to the power or process associated with removing the license of a regulated insurance company. Delicensing could be a result of refusing to renew a required license or of forcing a company out of the market through a forced sale or wind-up of the insurer.
Exercises

For each of the following questions, which responses are correct? Circle your choices. More than one response may be valid.

1. An insurance company may exit the market voluntarily, by:
   a. Informing the supervisory authority that the license is no longer required
   b. Selling the company to another licensed insurer
   c. Ceasing to sell new policies and running off existing claims
   d. Hiring a liquidator and have them run off the business.

2. An insurance company may be forced out of the market involuntarily, because:
   a. The company does not have sufficient capital
   b. The company did not comply with a Direction of Compliance
   c. The company had a poor reputation among its policyholders
   d. The supervisory authority selected the weakest company as an example to improve market discipline.

3. In dealing with troubled companies, the supervisory authority should:
   a. Do an inspection, without giving the company notice, to be sure that management does not hide the evidence that the supervisory authority wants
   b. Have in place a well-defined and implemented inspection process
   c. Apply tough sanctions to encourage action by the company
   d. Be prepared to wind up the company.

Answer the following questions considering the legislation and practices in your jurisdiction. If you are working with others on this module, develop the answers through discussion and cooperative work methods.

4. What are the steps in the supervisory approach used by your supervisory authority to decide whether an insurance company is well managed and solvent?

5. Does the insurance legislation provide for a voluntary market exit? Has a company ever used this provision to manage its own market exit?

6. How frequently are on-site inspections carried out? Does the frequency vary among companies? If so, why?

7. Has an insurance company ever failed in your market and been wound-up involuntarily? What circumstances caused the failure?
C. Need for sound supervisory processes

Building on the information and using supervisory methodology

It is important for the supervisory authority to be involved and have a significant influence in determining which companies are able to operate in a market. In the same sense, supervisors must also be involved in determining which companies may no longer operate in that market. This function can be compared to controlling the gates in and out of a fenced field (figure 2). At one gate, the supervisory authority controls who is allowed into the field, and at the other gate, the supervisory authority controls the process for leaving the field. Meanwhile, the supervisory authority patrols the perimeter fence to make sure that unwanted market participants do not enter. These functions parallel the supervisory approvals processes for licensing, changing control of, and winding-up and exiting from the market. Each approval process is a significant contributor to the overall effort to control the market so that the insurance buying public is well served and has confidence in the system. In other words, the system is basically under the control of the supervisory authority.

A substantial part of the rules for many sports address who may enter the playing field, who may leave, and how exit is to be carried out. These rules are intended to ensure that neither team has an undue advantage or disadvantage over the other. The strategy that determines the outcome of the game is to take place on the field, not through the manipulation of how many players are involved. Insurance markets are more complex than athletic events, so the rules for entry and orderly exit are more complex. Nevertheless, they are an important part of the way that the market is controlled, maintained, and seen to be fair to everyone. Thus, it is important for both sports and insurance markets that rules are in place to control the participants so that the activity is fair and the rules are consistently applied.

Supervision requires that the authority understand the nature of the operation of each insurance company, the risks to which insurance companies are exposed, and the

Figure 2. Supervisory authority as gatekeeper

6. This analogy can be expanded. Consider the supervisor as the referee in the game. At any time, the referee must have the power and resolve to expel a player from the game if the player's behavior is no longer within bounds acceptable for the game. Second, one could consider the insurance market so complex that it is as though the game's spectators are on the playing field and the referee must manage and control the game while the spectators are among the players.
processes in place within each company to manage these risks. To understand the process and issues needed in dealing with a troubled company, one must first understand that there is a wide range of challenges that can place a company in a situation in which it is either nonviable, in violation of legislative and regulatory requirements, or insolvent.\footnote{IAIS Core Principle 23,\textit{Capital Adequacy and Solvency}, and the associated module in the Core Curriculum provide more detail on how solvency can be measured and assessed.}

This module will consider a company to be nonviable when, in the view of the supervisory authority, the company ceases to be sufficiently able to operate the practical business affairs of the company that it is unlikely to retain, regain, or maintain financial strength, thus potentially placing its policyholders at an unreasonably higher risk of loss than would apply for other companies operating in the market.

An important measure of viability is the level of capital maintained by the company. In its simplest form, capital maintained by the company is the amount by which the assets of the company exceed the policy and other liabilities (figure 3). However, the legal requirements for solvency should be defined to encourage companies to manage their affairs so that the capital and surplus that the company maintains meet the minimum legislative requirements.\footnote{The IAIS\textit{Glossary of Terms} describes solvency as the ability of an insurer to meet its obligations (liabilities) under all contracts at any time.} This surplus is the amount that remains after making all the necessary adjustments to reported assets and liabilities and establishing the values of all assets and liabilities in accordance with statutory reporting requirements. Capital comes from several sources but, in general terms, it includes retained earnings and investments in the company that are made by the owners and others that are subordinate to the rights of creditors and policyholders.

Defined in this way, the level of capital that is held by the company is a calculable number that is determined using defined standards and methods. The supervisory authority prescribes a calculation for each company to determine the level of capital that
all companies must maintain.⁹ These two calculated amounts are compared to determine the degree to which the company meets the level of required capital. Both of these amounts must be calculable so that companies are able to manage this potentially complex compliance requirement. Companies should maintain a margin in excess of the amount of required capital so that compliance is not a day-to-day challenge and supervisory issue. In this module, “capital margin” is used to refer to the excess of capital available within the company to meet the minimum capital test over the level of capital that the company is required to maintain.¹⁰

In some countries, the minimum capital that companies are required to hold is literally the minimum required capital.¹¹ Failure to meet that test can lead to:

- Significant supervisory concern or intervention that could result in the company’s operations being significantly reduced
- The company’s being given a short timeframe to regain the minimum level of capital
- Possible forced market exit.

In many countries, failure to maintain the minimum level of required capital will start a process of supervisory intervention directed at getting the company to restore the level of capital so that it meets the minimum required level.¹² Only after the capital level has deteriorated further would the supervisory authority take stronger enforcement action.

In other countries, companies must maintain a prescribed capital margin (in excess of the minimum capital requirement). Failure to do so could lead to demands from the supervisory authority to re-establish the capital margin within a short time. Failure to meet these demands and maintain the minimum could lead to a forced market exit of the company.

Whatever the formula that a country applies to determine the level of required and available capital, the supervisory methodology should provide early warning indicators and early notice to companies if they move close to failing the minimum tests. Early warning to the supervisory authority of declining trends in capital and notice to the company to maintain capital at or above the required minimum margin provide a good discipline in the system and establish a level of expectation on the part of regulated companies.

---

⁹. The formula for determining the amount of capital that each company must maintain can be defined in the legislation or regulations, and can follow a variety of approaches depending on the stage of development of the insurance market, local market practices, and the risks that are accepted by the industry.
¹⁰. The capital margin can be expressed, for example, as a percentage of required capital or in terms of actual assets as a percentage of required assets.
¹¹. Minimum capital could be a fixed and defined amount, an amount that varies by the size and complexity of the company, or an amount related to actual assets and liabilities of the company that recognizes the company’s risk tolerance, size, and operational complexity.
¹². Supervisory methodology of both Canada and the United States includes stages of supervisory concern that are preset and that attract structured remedial action when any company falls into the various stages. These stages are preset either in terms of capital levels and/or supervisory ratings.
To sum up, a company could be insolvent, and insolvency could lead to its failure. Alternatively, a company could fail to maintain a minimum amount of capital margin, and this failure could lead to its failure. Thus, it is possible for a company to fail for financial reasons even though its assets are greater than its liabilities.

The orderly exit of a company from a market should start before it fails the tests for capital adequacy. The exit process starts with the observations made and actions taken leading up to the failure of the company to comply with the legislations and regulations. To achieve this, the supervisory methodology must lead to the identification of companies that are in decline and companies that potentially are problems, as well as those that are at immediate risk of insolvency. The methodology must also link these identification processes with supervisory action and the use of appropriate sanctions. These actions should be coordinated with the policyholder protection scheme so that the amount of overlap and duplication of effort is kept at a minimum, while the supervisory authority and the policyholder protection scheme keep each other informed.

This structured approach to dealing with a troubled company makes it easier to deal with a failure when the company is unable to take effective remedial action.

In a similar manner, companies are required to comply with all of the rules and regulations that relate to the way they must operate and the actions that they are not allowed to take. The penalty for noncompliance can range from a simple request to bring the company into compliance to financial penalties (fines) or forced market exit. The severity of the sanction or supervisory tool used to deal with a violation should be closely linked to the significance of the violation.

Failure of companies is not restricted to failure to meet the required capital tests. It is important to note that companies can fail as a result of noncompliance with legislation. Forced market exit is the last possible action against a nonviable company, no matter how it got into that position.

Providing an orderly process by which nonviable companies can exit the market is an important part of supervision. This process must be managed in a fair manner but the process should recognize that delay in supervisory action can harm policyholders and claimants. On the other hand, prompt action can protect policyholders. It is important that supervisors use their powers as effectively as possible to meet their responsibility to protect the rights and interests of policyholders and claimants. Informed, timely, and decisive actions go a long way to achieve this goal. Unwarranted optimism, delay, and supervisory forbearance generally do not work in the best interest of policyholders. Supervisory inaction and delay destabilize the industry and

---

13. Not all companies that fail the capital test as an early warning actually will fail. Some companies manage to find additional capital, reverse the trends of their financial affairs, and correct any deficiencies in time to prevent the failures of the companies.

14. The manner in which the two agencies provide notice to each other about their concerns and coordinate the activities with the company can be part of the disclosed methodology so that the public can have confidence that overlap and duplication of effort is kept to a minimum. Efficiency of the supervisory methodologies is an important part of establishing and maintaining public confidence.

15. In this context, noncompliance is meant to extend beyond the capital requirements to illustrate that companies can be forced out of the market for market misconduct as well as for capital deficiency. The provision that the company violated would have to be a significant problem to trigger a forced market exit but could include fraud by management, a long history of intentional nonpayment of valid claims, or a refusal to respond to a Direction of Compliance.
can transform a problem within one, or a few companies, into an industry-wide problem or systemic crisis.\textsuperscript{16}

An orderly market requires that all participants know, and accept, their roles and the behavior that is expected of them. This is true for the companies that are regulated as well as for the supervisory authority. This understanding of the roles and expectations is achieved through communication and transparency.

For the supervisory authority, this means providing the public with sufficient information about its authorities, processes, and practices that companies and other interested parties can understand the supervisory methodology and how consistent risk assessment and even-handed enforcement decisions are made. One way of achieving this is to use a structured supervisory process that includes a rating system (figures 1 and 4). The rating system enables the supervisory authority to assess each company against a number of pre-established criteria and to rate the company by the degree of concern that the supervisory authority has for the company.

For companies, it is also important that they understand what is expected of them and what they can expect from the supervisory authority if they fail to meet that expectation. At a basic level, companies must comply with the rules and regulations, and companies should understand the range of regulation and the importance of compliance from the point that a license is granted.

At a higher level, there are a number of expectations that are not quite so clear. For example, companies are expected to have effective risk management processes in place that recognize the unique risks to which the company is exposed. This is a judgmental assessment and demands a clear understanding of the principles and standards against which the compliance assessment will be carried out. This expectation can also be achieved through communication and transparency of the supervisory methodology (figure 5) and having a structured process for assigning a rating that the supervisory authority could employ. This result would then be linked to a series of possible sanctions that the supervisory authority could employ.\textsuperscript{17}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure4}
\caption{Structured rating system}
\end{figure}

The supervisory methodology determines into which rating group each company falls.

\textsuperscript{16} Delay and inaction on the part of the supervisor can cause other companies to believe that they will receive similar treatment for a similar violation. Such assumptions could encourage, rather than discourage, companies to act in ways that weaken the market and the industry and, in turn, weaken public confidence.

\textsuperscript{17} For more information on this topic, refer to the core curriculum modules on ICP 13, On-Site Inspection, and ICP 14, Preventive and Corrective Measures.
This linkage of legislative requirements, supervisory processes, supervisory conclusions, powers, and sanctions helps to define the structured supervisory process.

**Exercises**

**For each of the following questions, which responses are correct? Circle your choices. More than one response may be valid.**

8. **Sound supervisory practices help the supervisor to:**
   a. Identify problem companies
   b. Accumulate the evidence needed to show the company that it has a problem
   c. Hire the best people to inspect insurers
   d. Promote the industry and develop public confidence.

9. **An insurance company is not viable if:**
   a. The company is unable to make claims payments when they are due
   b. The company does not meet the capital test
   c. Management does not understand the business
   d. It begins operation in the market before getting a license.
10. A supervisory sanction should only be as severe as the violation that triggered its use because:

   a. Supervisors need to be fair
   b. A stronger sanction may be required if the first one does not work
   c. The company would complain that the supervisor was unfair
   d. The image of the supervisor would be tarnished.

Answer the following questions considering the legislation and practices in your jurisdiction. If you are working with others on this module, develop the answers through discussion and cooperative work methods.

11. In your jurisdiction, are insurance companies rated by the level of concern that the supervisory authority has for the continued viability of the company? If so, explain how the rating system works.

12. How has the supervisory methodology been communicated to the industry? Based on that communication, do you feel that the industry should understand when different sanctions might be applied? Explain.

13. If your jurisdiction has a policyholder protection scheme, at what point does the insurance supervisor inform the scheme about companies that might be of concern? What information is shared with the policyholder protection scheme?
D. Winding-up

Voluntary market exit

A voluntary market exit is any withdrawal from the market that is managed by the company (figure 6). Companies may decide to leave a market because:

- It is not meeting their expectations for growth or profit.
- They are having difficulty in another market and want to sell an “asset” of the company to generate sufficient revenue to refinance the problem area of the company. Or,
- Management may have decided to focus on other markets.

No matter what the reason, the supervisory authority needs to support the idea before allowing the company to withdraw voluntarily. This is necessary because the supervisory authority must be satisfied that the company has the financial and other resources necessary to meet its obligations to policyholders throughout the process proposed by the company. If the supervisory authority is of the view that the company has inadequate capital or weak management, then a smooth voluntary market exit may not be possible.

---

18. In fact, a company could decide to exit a market in which it meets all of the local requirements and has been a good corporate citizen as far as the local supervisory authority is concerned. Even with this record, a company might elect to exit the market, and the supervisory authority may not be given the full details or a full explanation. The company may simply put the operation up for sale, and the supervisory authority may become aware of the desire to exit the market only when the request for supervisory approval of the change in ownership is made.

19. The supervisory authority should receive and review the plan that the company has for winding up its affairs. The plan should be reasonable and achievable while it maintains regulatory capital during the process. When the supervisory authority is not satisfied that the company has a reasonable chance of being successful, the authority must either force the wind-up to be involuntary or monitor the process closely so that, if and when the capital falls below acceptable levels, the wind-up is forced to be involuntary from that point forward.
not be practical. If the supervisory authority is of the view that capital could deteriorate and fall below the minimum level required during the process, then it may be necessary to wind up the company on an involuntary basis after the voluntary basis has been in place for a while.

For the process to be an orderly one, from the supervisory authority’s point of view, it should require the company to:

- Seek and obtain permission from the supervisory authority carry out a self-managed market exit
- Seek regulatory approval for transfers of significant blocks of business
- Seek regulatory approval for the sale of the company new owners, whether it is an existing company or new major shareholder
- Maintain adequate capital at all times
- Meet all financial and nonfinancial reporting requirements as may be required by the insurance supervisory authority
- Retain qualified and capable management operate the company at all times, and,
- Maintain an involved board of directors to oversee the process under which the company continues to meet, promptly and in full, its obligations and pay valid claims.

Voluntary market withdrawal should be seen as a formal process involving regulatory approvals and ongoing supervisory oversight. Companies in run-off, that is, companies that are not writing new business but are just administering existing business until all obligations under those contracts have been met, continue to be regulated in insurance companies and subject to the same insurance legislation that applies to going-concern companies. Thus, policyholder rights must not be compromised as a result of decisions that might be made during the process. The prudential and market conduct standards should not be reduced because a company wants to leave the market. Policyholders are entitled to be treated in a fair manner whether the company is seeking new policyholders or not; whether the company is happy with its operations or not; and whether the company is as profitable as its owners would like or not.

Within these constraints—meeting the needs of policyholders and the requirements of the regulatory authority—there should be flexibility for companies to manage the process for the benefit of the owners. Voluntary market withdrawals can be completed through any combination of:

- Selling all of the local operation to another company or owner
- Selling portions of the company to different companies or owners
- Running off the business by ceasing to sell new policies and using the assets and future premiums and investment income to pay claims as they fall due and to meet operating expenses.
During the period of self-managed wind-up, the supervisory authority must review the process, carry out such inspections as it feels necessary, and review the financial condition of the remaining parts of the company to ensure that it is still able to meet its obligations to policyholders and claimants as they fall due. If the supervisory authority ever forms the view that the company will not be able to meet its obligations, then the supervisory authority must act promptly to protect the interests of policyholders and claimants. This action could lead to withholding regulatory approval for any transaction that the supervisory authority feels would give preference to transferring policyholders at the expense of the remaining policyholders. However, if the remaining policyholders and claimants can be expected to receive what is due to them, the supervisory authority should continue to support the self-managed market exit process.

**Involuntary market exit**

An involuntary market exit (figure 6) occurs whenever the supervisory authority forms the view that a company is no longer viable or that it is behaving in an unacceptable manner and, to protect policyholders’ rights must be forced out of the market. This judgment can occur when the company:

- Is no longer able to meet the capital and/or solvency requirements
- Fails to make a payment to a claimant or a creditor when it is due
- Has committed a criminal act or
- Has not taken the corrective action that was demanded by the supervisory authority through a Direction of Compliance.

Supervisory powers that could be used to facilitate a forced market exit include:

- Taking control of the company and managing its affairs
- Replacing management with new management and a new board of directors
- Using moral suasion to convince a strong company in the market to take over the weak company
- Applying to a court to have the company wound up by a liquidator that reports to the court
- Taking control of the company’s assets, requiring the injection of money to re-capitalise the company, and then selling the company.

It is important that supervisory authorities act in an even-handed and fair manner when applying powerful supervisory tools. The authority to force a company out of the market and to initiate the winding-up process is a powerful tool. This is the reason that so much of this module has discussed the evidence, process, and documentation that
supervisory authorities must build into their methodologies to ensure that they can support their decisions and demonstrate that they have acted reasonably.

It is only in the case of a forced market exit that policyholders receive priority treatment. In a voluntary market exit, creditors are paid, and shareholders may receive shareholder dividends so long as, in making these payments, the company continues to meet the legal requirements. In a liquidation, it is unlikely that the assets of the company will be sufficient to pay all of its debts and obligations. In these circumstances, policyholders are sometimes given additional protection by receiving priority treatment over general creditors.

**Orderly market exit**

There are a few basic requirements that support an orderly market exit. They include the following features:

- A fair, even-handed, and transparent supervisory assessment process
- Clear and consistent statement to companies of remedies to be achieved
- Time to implement realistic remedies
- Effective supervisory intervention and sanctions that are consistent with the significance of the regulatory violation or supervisory concern
- Timely and prompt supervisory action to protect policyholders from undue loss.

Market exit, whether voluntary or involuntary, must be carried out in an orderly manner. The processes used to identify and deal with companies that are exiting the market must be fair and must be seen to be fair. These processes must be strong and decisive but they must also be even-handed. The more that companies and the public at large understand these processes and accept their fairness, the greater the confidence they can place in the supervisory authority and the insurance sector.
Exercises
For each of the following questions, which responses are correct? Circle your choices. More than one response may be valid.

14. If a company decided to exit the market voluntarily, the supervisor should:
   a. Withdraw the company’s license
   b. Require more frequent financial reporting from the company
   c. Immediately do an on-site inspection
   d. Interview senior management to find out why the company is leaving.

15. A company should be allowed to undertake a voluntary market exit when:
   a. The company found it difficult to meet the capital test at all times
   b. It refused to remedy a problem after receiving an order from the supervisor
   c. It is discovered that the company has been used to commit fraud
   d. The foreign company that owns the subsidiary will manage the process.

16. An orderly market exit is important because:
   a. It demonstrates that the market is under good control
   b. The rights and interests of creditors are protected
   c. It shows that the supervisor is effective
   d. An orderly market is one that provides an attractive environment in which to carry on business

Answer the following questions considering the legislation and practices in your jurisdiction. If you are working with others on this module, develop the answers through discussion and cooperative work methods.

17. Does the insurance supervisory authority in your jurisdiction have the power to force a company into wind-up? If so, what preconditions must be in place before this power can be used?

18. Identify a company that left your market in the past 10 years. Research and summarize the circumstance and how the process worked. What lessons were learned by the supervisory authority as a result of this experience?

19. What practices does your authority have in place to ensure that supervisory enforcement decisions are made even-handedly?
E. The core principle

ICP 16 describes the powers that supervisors should have to manage the orderly exit of insurance companies from the market. The principle applies to any company that is either voluntarily exiting the market or being forced to do so by the supervisory authority. The reason for one company to exit the market could be quite different from the reason that might apply to another company. The reason can affect the degree of urgency that the supervisory authority places on achieving a speedy resolution. As a result, the supervisory authority needs a range of tools to facilitate or force the resolution.

In addition to the powers and processes that supervisors need to be able to use to get companies out of the market in an orderly manner, the legislation under which the process operates should provide a priority treatment for policyholders and claimants benefits over the rights of investors.20

Paragraph 16.1 of the Explanatory note section of ICP 16 covers a wide range of issues in a very few words. It achieves this result by using words such as “may” and “should” and phrases such as “in such cases.” The terms “viable” and “insolvent” are not defined in the principle, but a definition of these terms is needed to apply the principle.21 The question left unanswered by this paragraph is whether there is a limit on who may make the assessments in question. That is, who should determine that an “insurer is no longer financially viable”? Essential criterion a does however shed some light on the issue since it says that the legal framework should provide for the determination of the point at which a company should no longer be permitted to operate.

Thus, the responsibility for that determination may not lie with the insurance supervisory authority, but the legislation should be clear as to who has that duty. This is an important issue and one that should be clear in any country before the supervisory authority has to deal with a troubled company. However, the supervisory authority may have the duty to provide a mechanism for an orderly exit from the market, independent of who determined that the company is no longer viable.

The range of powers available to the supervisory authority should not preclude his or her involvement in a facilitated merger or transfer of business.22

Paragraph 16.2 states that the “legislation should establish the priority that policyholders receive in winding-up an insurer.” The legislative priority given to policyholders is necessary because of the complex and long-term nature of the insurance business. In addition, many feel that compulsory lines of business such as motor vehicle (automobile) insurance can cause policyholders to purchase insurance without having done adequate due diligence in choosing the insurer. For these and other reasons, the insur-

20. “Priority” is intended to mean that policyholders and claimants with benefits due from, and arising under, policies with an insurance company that is being wound up should receive benefits in recognition of the value accrued as of the date of the winding-up proceedings. These two groups should receive the benefits due them in advance of the investors receiving value for the amounts that might be due them. In some countries, policyholders have priority over both the investors and creditors of the failed insurance company. In other countries, the policyholders’ priority is over the rights of investors.

21. “Solvency” is defined in the IAIS Glossary of Terms. In essence, solvency refers to the ability of the company to meets its obligations to policyholders under all contracts at any time.

22. The range of powers available to supervisors is discussed more completely in the core curriculum module on Core Principle 15, Enforcement or Sanctions.
ance supervisory authority is often charged with the task of protecting policyholders from undue loss, and the insurance legislation provides policyholders with a priority in claims against the estate of an insolvent insurer. This priority position means that policyholders and claimants are usually ranked above creditors and investors but after tax authorities and the cost of liquidation.

Paragraph 16.2 goes on to illustrate a range of ways in which different countries have set these priorities and provided a priority for policyholder rights. The statement does not require a particular set of priorities but does require that the issue be dealt with and that policyholders be among the most-favored group.

*Essential criterion a* requires there to be a structured supervisory framework in place to identify and deal with companies that should not be permitted to continue to operate in the market. This framework is needed to ensure that the supervisory authority is even-handed in dealing with weak companies and that companies understand what actions the supervisory authority is likely to take if the company reaches the point at which supervisory intervention becomes necessary.

*Essential criterion b* requires that procedures for taking regulatory action against nonviable companies be set in law. This legislation is required to provide the supervisory authority with the legal authority to take action, to set out the steps that must be taken, and to protect the supervisory authority from being accused of arbitrary and preferential treatment of companies. This legislation also provides guidance to the courts on the processes that should be followed in forcing a company out of the market.

*Essential criterion c* requires that policyholders and claimants of insurance policies have a high priority in the settlement process. Groups that have priority in the winding-up process would be first to see their claims against the company met.
F. Use of supervisory powers

It is important that the supervisory authority use the powers available to it in an even-handed and consistent manner. Even-handed means balancing the supervisory tools, or sanction, to the severity of the issue that the company needs to resolve. To do this, the supervisory authority must understand the role of each of the sanctions available to it as a tool and when it might be appropriate to use that tool. These tools include the full range of sanctions. The use of the tool should correlate to the stage of the supervisory concern and the success that the company has, or has not, had in dealing with its challenges.

These supervisory tools, described in the module for ICP 15, include:

- Moral suasion
- Recommending the strengthening of business practices
- Restricting business activities
- Withholding approval of new business initiatives
- Removing directors or members of senior management
- Directing the company to cease unsafe practices
- Forcing the disposition of a part of the business
- Revoking the company's license
- Placing the company under a conservator
- Making an application to wind up the company.

Note how, as the severity of the issues increases, the sanctions become more intrusive and powerful.
Exercises

For each of the following questions, which responses are correct? Circle your choices. More than one response may be valid.

20. ICP 16 identifies the basic principles that should be used by the supervisory authority to deal with weak companies, including:
   a. Having a structured supervisory framework
   b. Setting in legislation powers and processes for dealing with weak companies
   c. Having the power to set priorities in the winding-up process
   d. Having the skill to identify nonviable companies.

21. Policyholders are given a priority in the wind-up of an insurer because:
   a. They should get their money faster than others
   b. The purpose of insurance legislation is to protect policyholders
   c. Policyholders, in many cases, do not understand insurance
   d. Policyholders need the money more than others.

22. In an involuntary wind-up of an insurer, the term “priority” means:
   a. Having first call on the assets of the company
   b. Standing first in line
   c. Others get paid only after the priority claimants are paid
   d. Getting as much as one wants from the company.

Answer the following questions considering the legislation and practices in your jurisdiction. If you are working with others on this module, develop the answers through discussion and cooperative work methods.

23. Has your insurance supervisory authority ever done a self-assessment of compliance with ICP 16? If so, what was the conclusion?

24. Which of the powers mentioned in the section of the module entitled “The use of supervisory powers” does your supervisory authority enjoy? In what section of which piece of legislation is each mentioned? Can you identify any other powers that would be useful in dealing with troubled companies? If so, how would they be useful?
G. Putting the principles into practice

Companies in financial difficulty

As we have discussed, companies can find themselves in financial difficulty either as a direct effect of problems with assets, with liabilities, or indirectly as a result of poor management and control procedures.

Such companies often have early signals of these impending problems. Problems that affect a particular company, as opposed to the industry at large, often build up over years and are seldom created in a short time. Thus, early warning indicators can strengthen the supervisory system and facilitate early supervisory intervention to resolve problems before they grow so large that the company is not able to adequately address and resolve them.

Supervisory powers

In working through management to resolve the issue facing the company, the supervisory authority might apply any combination of the following powers:

- Power to replace management or members of the board
- Power to direct a company to take action to solve a problem
- Power to hire a consultant or advisor and charge the cost to the company
- Power to instruct the external auditor to do an expanded audit
- Power to force the sale of a line of business
- Power to instruct a company to exit a market or product line
- Power to change pricing.

There is no guarantee that a company will be successful in finding a satisfactory and effective way to handle its problem. Reasons include:

- Management has underestimated the significance of the situation, and a more powerful solution is needed than it has implemented.
- The rate of decline is faster than had been anticipated and, even though the action that was taken improved the situation, it did not solve the problem.
- The action taken was not effective because of changes in the market that took place before the change took full effect.
- The planned action could not be implemented.
- The action that management took was misdirected and was not appropriate for solving the problem.

\[^{23}\] Insurance supervisors use early warning indicators to identify trends that may be evidence of problems within companies or the industry generally. These indicators often include the proportion of assets invested in risky instruments, concentration of risks in the liabilities, rapid growth, and levels of customer complaints.
What this means is that, even with the best intentions of management and the board of a company, they may not be able to solve the problems they face. This is one very good reason that supervisors should challenge the board and management of an insurer to develop actions that they feel should solve their problems. The supervisory authority should avoid suggesting the solution that the company should adopt. As a result, the common approach for getting a company to take action is to clearly state the:

- Problem that needs to be addressed
- Timeframe in which action should be taken
- Deadline to provide a plan of action to the supervisory authority
- Measure of success that the supervisory authority will use to assess the plan's effectiveness.

If the supervisory authority suggests a specific action, the company implements the action, and the action proves to be ineffective, then the company could easily place the problem back with the supervisory authority and ask for more time for any solution to take effect. In other words, the supervisory authority could find that it, rather than management, “owns” the problem.

The above scenario argues that supervisory authorities need structured processes with clear communication so that they are understood by the board and senior management of the company. If supervisors are clear and support supervisory conclusions with evidence, companies are more likely to take remedial action when it is required. On the other, being clear and getting the desired results are separate issues. Even if the company understands what is required to be done, it may not get the desired results. It then may be necessary for the supervisory authority to take more drastic action and make stronger demands for remedial action. Ultimately, if the company is not able to correct the problem in a timely manner, the supervisory authority may have to initiate the winding-up process and force the company out of the market.

**Limits to supervisory powers**

The powers that supervisors have are directed at identifying and resolving issues that affect one or a few companies. If the problem grows and is allowed to affect all companies in the industry, the problem could be so large that supervisory powers cannot provide a solution. That is, if a problem is not addressed in a timely manner, other companies could interpret the lack of supervisory action as acceptance of the situation and might adopt similar strategies to the one that created the problem. The problem could become systemic in short order.

Therefore, supervisors should act early to get companies to address their problems in a timely manner before these problems get too large to resolve and before the problems become systemic and transcend the scope of normal supervisory powers.
**Underlying principles in dealing with troubled companies**

In dealing with a troubled company, supervisors should consider the following principles:

- Clearly state the problem that needs resolution
- Ask the company to develop a strategy for resolving the problem
- Set criteria for assessing success (to identify when the problem has been resolved)
- Set clear and realistic timeframes for plans, action, and resolution
- Monitor progress toward resolution
- Give management credit for finding a resolution when it works
- Be sure that it is clear that management, not the supervisory authority, “owns” the problem
- If actions that are taken are not effective, press for additional, more powerful action
- As the problem worsens, or as time drags on without resolution, use more powerful supervisory enforcement tools
- If a policyholder protection scheme is in place, keep senior staff informed of the progress in dealing with companies that are at risk of becoming nonviable.

In all of this, it is important to have full and honest discussions with management and the board of the company, to create mutual understanding of the severity of the problem to be resolved, the urgency with which action needs to be taken, and the consequences of the problem not being resolved satisfactorily. Consistent actions should be required of companies that are exposed to similar problems, with consistent expectations placed on their managements and boards. Effective resolution of problems requires fairness and consistency in treatment, and ensuring that due process is followed so that stakeholders will accept that the supervisory authority was fair. In addition, the process needs to ensure that the supervisory authority does not apply enforcement powers in a unilateral or prejudicial manner. The application of supervisory principles built on fairness, consistency, and due process improves the chances that the intervention will yield a successful result and that the decision will be supported in the event that the company appeals the supervisory authority's actions.

**Supervisory actions**

In many situations, supervisors must use judgment to determine the extent to which a company is not in compliance with insurance legislation and to decide on the timing of supervisory sanctions. These decisions must be supported with documentation and adequate evidence on which these judgments are made. The supervisory authority must
support any decisions made with the evidence and description of the processes used to collect and analyze the evidence. In most cases, the supervisor's judgment blends the facts that have been analyzed with the experience of the supervisory authority. The supervisor should expect the company to debate the validity of the facts used in forming the supervisor's opinion and the process used to analyze the facts.

The fact that judgment is involved raises the possibility that there can be a protracted period during which the issues are debated before the company takes the necessary remedial action. Nevertheless, to meet its mandate, the supervisory authority must take prompt and decisive corrective action to protect the interests of policyholders and claimants. To resolve the problem quickly, the supervisory authority needs to act promptly and decisively.

Ensuring that companies understand the supervisory mandate and methodology before action is required can shorten these delays. The need to minimize delays reinforces the value of a supervisory methodology that initiates the corrective action process before the problems get too difficult to solve. The supervisory methodology must recognize that these delays can occur and that they must be managed and provision must be made for them.

Making such a provision in the methodology is critical because the greatest delays often occur when the supervisory authority is dealing with the most significant problems and policyholders' and claimants' rights are at the highest level of risk. Planning for these contingencies, therefore, becomes an important part of the supervisory process.

**Contingency planning**

Supervisors should work toward a successful resolution by pressing the company to find a solution to its problems but plan for the event that the company is not able to resolve its problems satisfactorily. This contingency planning is built on the premise of working for success but being prepared for failure. A contingency plan should have the following elements:

- The indicator that the contingency plan should be implemented
- The human resources who will be mobilized to place the contingency plan into effect
- The financial resources needed and their source
- When and how the people who need to know about the plan's being put into effect should be told
- The steps in the process.
Consider an insurance company with its head office and all of its operations in the same country. Assume that this company has experienced very heavy claims in an important block of its business, and they have dramatically reduced its profitability and increased its provision for claims. These effects, in turn, cause the company to fail the required capital test that it is supposed to meet at all times. The supervisory authority has the power to require the company to increase its capital to meet the minimum test immediately. Failure to meet the test would be sufficient for the supervisory authority to withdraw the company’s license or apply to the court to obtain an order to wind up the company.

This problem is a relatively common one for many supervisors, but it is not one that many companies have to deal with or want to ever have to face. As a result of these diverse perspectives, the supervisory authority must be prepared to convince the company that it needs to resolve the problem. Having done this successfully, the supervisory authority asks for a plan of action to re-establish the capital position of the company to be filed with the supervisory authority in two weeks. Meanwhile, the supervisory authority reviews the powers that are available if the company does not prepare a suitable plan in time. The strategy that the supervisory authority adopts is to meet with the board of directors in two weeks to discuss the plan. In fact, the board is preparing to discuss the consequences of not having an effective plan, so the supervisory authority is getting prepared for either eventuality.

The company submits a plan within the two weeks that indicates that it will obtain the required capital from the current owners and that this money will be in the company within three months. The supervisory authority is satisfied that it has no reason to object to the plan.

The supervisory authority goes to the board meeting and indicates that it does not object to the plan as proposed but that the results must achieve the goal of re-establishing the company to financial strength and that capital planning should be a part of all future business plans for the company. The supervisory authority reminds the board that failure to successfully resolve the problem could lead the supervisory authority to terminate the company’s license and that this will lead to the termination of the company. The supervisory authority requests that another meeting of the board be held in two months to monitor progress in obtaining the new capital.

The supervisory authority decides that, if, at the upcoming meeting, it appears that the plan is being implemented effectively and the capital will be forthcoming, the authority will continue to press for quick resolution. Given this scenario, the supervisory authority also decides to indicate that the problem will be considered resolved if the capital test is met for each of three months following the injection of new capital. On the other hand, if the plan looks as though it may not bring in sufficient new capital, the supervisory authority will inform the full board that it will inform the Minister of Finance that the company is unlikely to successfully resolve
Case study 1 (continued)

its problems in a timely manner and action may be required to wind up the company. The supervisory authority will also hold a meeting with the independent board members, without management or connected board members present, to explain the severity of the problem. In the meantime, the supervisory authority asks its legal counsel to begin drafting the papers required to take an application to court to wind up the company.

At the meeting with the board in the second month, the supervisory authority learns that plans are progressing well. New subordinated capital instruments have been prepared, and the company is actively trying to find investors to take up the paper. This activity was reported to produce an approximately 75 percent “take-up rate”, so far; in other words, investors have expressed interest in acquiring 75 percent of the paper. Therefore, the outlook is that new capital will come in but not as much had been anticipated or required. The supervisory authority asks for another meeting in one month, once the capital instruments are issued, to see what has been achieved and discuss the next steps if success is not fully achieved. The supervisory authority notes that the disclosure documents that have been provided to prospective investors indicate that the new capital is required to meet capital requirements. The supervisory authority concludes, therefore, that the new securities either will be fully taken-up or the securities offering will be withdrawn. Therefore, the supervisory authority is aware that it will be dealing with either a resolved situation or one that is unchanged and not resolved.

A week before the final meeting, the chairman of the board asks the supervisory authority for a two-week extension to get in the required capital, because a new investor has been identified for the remaining securities and the deal has not been closed.

The supervisory authority agrees to the two-week extension and follows up with a letter to the company with a copy to each member of the board indicating that the extension is not to be taken as forbearance but that the problem must be resolved with all possible urgency. At the same time, the supervisory authority informs the Minister that it now appears unlikely that the company will successfully find the capital that is needed, and legal counsel is instructed to complete the papers required to apply to the courts to wind up the company. The supervisory authority begins the process of preparing for an appeal from the company of the potential decision to wind up the company. If such an appeal is made, the Minister will be required to hear the appeal and decide on the appropriateness of the supervisory decision. Thus, the Minister is informed that the process could result in an appeal by the company, and the staff in the supervisory authority begins to draft the documentation that could be needed for the appeal.

A week later the chairman of the board contacts the supervisory authority to inform it that the new investor has decided to take a major position as a shareholder in the company and work has begun to issue a new
In this “case,” a number of contingency plans were initiated and worked through to an advanced stage of development. These included the situation at the very first meeting with the board and the activity of preparing for various outcomes through to preparing for a winding-up application and a possible appeal of the supervisory decision. Each of these is a contingency plan that anticipated an adverse outcome of the work undertaken by the company.

**Documentation**

In the case just discussed, the supervisory authority asked for a number of initiatives to be started. Two in particular required a significant amount of documentation of the evidence, analysis, conclusions, and the supervisory actions taken that would be included in the reports. These initiatives include preparing for the possible appeal that could have emerged and preparing the application to the court for a winding-up order. Documentation is the key to being prepared for these situations. If the documentation is inadequate, it will be very difficult to reproduce the events and support the decisions made with confidence.

Documentation of troubled companies is a critical part of the supervisory process. This documentation is required because it enables the supervisory authority to:

- Learn lessons from the experience in using the legislation to deal with problems. These lessons can lead to requests for additional powers.
- Participate in public hearings after the fact. HIH of Australia is an example of a failure that led to a public hearing.24

---

24. HIH was a significant non-life insurance group in Australia, and the failure was subjected to a Royal Commission charged with the task of reviewing the role of the supervisory and regulatory authorities. The full report is available on the web-site of the Australian government at [www.hihroyalcom.gov.au/finalreport/](http://www.hihroyalcom.gov.au/finalreport/).
• Identify skills gaps among supervisory staff and work on ways to close the gaps.

Detailed documentation of the work done and decisions made is critical when preparing reports for the Minister or court papers. When this material is needed, it is required quickly and must be made available to the people in the supervisory authority who are charged with preparing these reports and who may not have been involved in the process of dealing with the company. Without the documentation, these people will be unable to draft these reports, or they will require a substantial amount of time of the senior people in the authority to recreate the history of evidence, events, and actions taken.

Documentation is also critical to any review process that might be initiated after a situation has been worked through. Whether the company resolves its problems or eventually fails, reviewing the activities, the powers used, the results, and problems that emerged to determine what lessons might be learned from the process is useful. The result could be a change in the methodology used for analysis, on-site inspection, risk-rating, or even in how the company was actually dealt with during the process. However, by reading the documentation, it is not unusual to discover that additional powers were identified that could have improved the outcome. In the absence of good documentation, these lessons are hard to reconstruct, and they can be useful at a time when the legislation or supervisory powers are under review. Having facts to demonstrate the lessons learned will support the legislative review process.

**Paying for the processes and procedures**

Therefore, how are the processes of dealing with companies and establishing contingency plans to be funded? All of these processes can require very special skills and scarce resources.

As a company becomes of more and more concern to the supervisory authority, the authority places more resources on the case. More reports are requested, and each must be reviewed and assessed. In some cases, the supervisory authority uses outside service providers to assist in dealing with the troubled company. Resources are applied to contingency planning, and senior people in the authority must spend an increasing proportion of their time on these cases. As a result, more financial and human resources are required to deal with troubled companies. Despite all of this activity, the day-to-day work of the authority must be done. Usually, readjusting priorities can absorb some of the stress of reassigning the resources to deal with one or two troubled companies at once. However, it is not unusual to find that additional resources are required to deal with the situation.

25. Documentation should be honest, complete, and frank. It should be an accurate record of events, what decisions were made, and why they were made. One important reason for keeping these records is to enable people to learn from experience and mistakes that were made.
Obtaining the human and financial resources to deal with these situations requires planning and, in some cases, special powers. Because it is not unusual to find that the resources are most needed in a depressed part of the economic cycle, just at the time when governments place pressure on departments and agencies to reduce costs, having funding arrangements that are independent of government is important. If the funding of the supervisory authority is provided by the industry it regulates, more independence of decision making to finance planning and dealing with troubled companies is possible.

Cost of wind-up

The assets of the company cover the costs involved in winding up a company, whether the wind-up is voluntary or involuntary. These costs have priority over the obligations to policyholders and claimants. This ranking is appropriate to ensure the willingness of persons with the necessary experience to participate in the winding-up process. However, the level and types of expenses incurred in the process can have a significant impact on the amount of assets that are available to meet policyholder and claimant expectations. In addition, during this period, it is not unusual to find that the company enters into contracts with related parties to perform services for the company in wind-up. These arrangements also could be prejudicial to the interests of policyholders. For these reasons, when a company decides to exit the market, it is important for supervisors to be involved in the process and provide some oversight of the winding-up of its operations.

In the case of a voluntary wind-up and a company under an administrator, the costs of wind-up are paid as they are incurred and the supervisory authority must be of the view that the remaining assets of the company are sufficient to meet the future expenses and policyholder benefit obligations. If the remaining assets are expected to be insufficient, policyholder benefits will have be reduced unless additional funds can be obtained from the company's shareholders. If the process works effectively and all policyholder obligations are met in full, then the residual value of the assets is used to meet obligations to creditors, and the remaining assets are available to investors and shareholders.

Appeals process

It is often fair and reasonable to expect that a party that is harmed by a decision made by an arm of government should have the right to appeal so that it can gain some comfort that its rights have been reasonably honored. Some owners, in finding out that the company they built is to be closed by the regulatory authority, feel that their “property” has
been expropriated without compensation. It is reasonable to expect that people who are of this opinion will want to appeal the decision made by a regulatory authority.

An appeal process is usually provided for in the legislation. The appeal may be through the courts, in front of an appeals panel, or to a senior government official. The appeal should be impartial, and the person or panel who presides over the process should be seen by all parties as fair, informed, and capable of dealing with the complex issues involved in winding up an insurance company. During the appeal, the supervisory authority and the aggrieved party both should be heard. The decision should be made based on the process and the facts that were available at the time decisions were made. That is the reason that the process that the supervisory authority uses in dealing with troubled companies is critical to the timing and success of resolution.

One issue that often emerges in cases that are subject to appeal is whether the company should be allowed to operate while an appeal is pending. In some jurisdictions, the company’s operations are placed in the hands of an administrator while the court process is underway. This action is taken to ensure that the assets of the company are preserved for the protection of policyholders. In other cases, the company is allowed to continue its operations until the court has made a decision. Protection of the assets during this period is important whether or not the company is fully operational.

**Appointing an administrator**

Insurance legislation often provides the supervisory authority with the power to appoint an administrator to take over the powers of the board and senior management of the company. The appointment may be temporary or permanent. The term used to describe the appointment could be administrator, conservator, provisional liquidator, or controller. The person who holds the appointment could be from within the supervisory authority, from another insurance company, or from a professional services firm with experience in this type of work. This power could be used to take a company out of the control of management and the board to protect the assets for the benefit of policyholders, or it could be used to prevent a run on the company by policyholders.

Independent of the variation, the company remains subject to the insurance legislation and is a supervised insurer during the process. The supervisory authority would use its power to request and receive frequent and regular reports of expenses, transactions, financial reports, trends in claims, and forecasts of future cash flows.

The administrator should manage the company to have the highest chance possible of meeting its obligations to policyholders and claimants. This management usually means stopping the writing of new business, selling off blocks of business whenever

---

26. The supervisor must make decisions based on the information and evidence available at the time and this should be made available during the appeal process. The decision will either be supported or denied through this process. If the decision is made to support the supervisor’s action, it is still possible that additional information will become available after the company is placed into involuntary wind-up that might have changed the decision and the outcome of the appeal. Because of this potential, it is not uncommon for aggrieved parties to be able to appeal the winding-up decision to the courts after the process has begun and there is little chance or desire to regain ownership in the company.
possible, and settling claims. If the motivation for putting an administrator in place is
to prevent a run on the company, special authority may be needed to delay the payment
of all claims until the company’s condition can be properly assessed to ensure that all
policyholders will be treated fairly and none will be given priority over the others.

**Placing a company in wind-up**

Placing a company in an involuntary wind-up presents its own challenges for the su-
pervisory authority. This process typically involves making an application to the appro-
priate court, submitting comprehensive court documents that outline the grounds for
making the application, setting a court date, placing an administrator in control of the
company to preserve its assets, and providing notice of the actions taken to interested
parties.

The company should be placed under an administrator so that its assets are pro-
tected and not inappropriately used to satisfy the interests of shareholders, bondhold-
ers, or general creditors of the company. One method commonly used to preserve the
assets for the benefit of policyholders is to place the company under an independent
administrator during the period between the decision to make an application to the
court and the court date.

The court would hear from any or all of the interested parties that are directly af-
fected by the decision and make a judgment based on the information presented. An
important input into the decision will be the process that the supervisory authority
used to develop its opinion, the evidence that it considered, and the time and options
that it gave to the company to resolve its problems on its own.

In many cases, it is academic whether the supervisory authority has or has not
drawn a correct conclusion from the evidence. Once the company has been subjected
to a court action, the company is likely to suffer reputation risk and unlikely to be viable
again under the old management and ownership group.

The court would appoint a liquidator to carry out winding up the company. The
supervisory authority may have the power to appoint the liquidator or to make a rec-
ommendation to the court for such an appointment. However, once the appointment
is made, the liquidator becomes a servant of the court and is not directly accountable
to the supervisory authority. In many cases, the supervisory authority is seen by the
court as representing the interests of policyholders and having technical expertise in
the matter of winding-up insurance companies. Thus, the court may grant standing to
the supervisory authority and seek its opinion from time to time as the winding-up pro-
cess progresses. The purpose of the supervisory authority’s involvement is to protect the
interest of policyholders and to influence the winding-up process so that it is efficient
and appropriate.
Winding up a company

Once a company is placed in wind-up under the court’s jurisdiction, it no longer is a regulated company and the supervisory authority is no longer responsible for applying the provisions of the insurance legislation. The winding-up process basically involves disposing of the assets of the company and meeting its obligations to policyholders and claimants as fairly as possible. The process that is followed for any particular liquidation could be quite different from one that works well for another. The reason is that the nature of the assets and liabilities of the company will have a significant impact on how the process should emerge.

For a non-life insurer, the process will probably focus on identifying and settling claims. Since claims under some forms of non-life insurance may be filed several years after the coverage period has expired, this process can take several years. In the meantime, since the actual value of the assets as compared to the value of the claims is not known for certain until the whole process is over, the liquidator cannot actually settle claims until close to the end of the process. However, the liquidator will establish a conservative estimate of the ultimate payout percentage and apply that percentage so that a partial settlement of claims can be made before the final distribution percentage is set by the court. This process can be a huge inconvenience to policyholders. A policyholder protection scheme can ease the burden that falls to policyholders in this eventuality.

For life insurers, the process can be similar or quite different depending on the regime in place in the country. In some countries, the focus on winding up a life insurer involves selling various blocks of the business to other insurers until all of the liabilities of the company have been dealt with. For this process to be effective, premiums must continue to be collected; investment transactions continue; and claims must continue to be registered and processed. (The exception is that claims are not paid, at least not in full, until the ultimate ratio of assets to liabilities is known for sure; or until the policies are transferred to another insurance company.) This process has the advantage of keeping insurance coverage in place for people who may no longer be able to get insurance, but it has the disadvantage of possible lengthy delays in receiving money. Waiting for claims settlement could be a significant financial inconvenience to claimants. A policyholder protection scheme could ease that burden.

In other countries, the assets are sold and the value is distributed to policyholders and claimants in a manner that the court determines to be fair and reasonable to all. This process may result in quicker settlements for the affected policyholders and claimants, but it has the disadvantage of canceling insurance coverage for people who no longer may be insurable.

In all cases involving the wind-up of an insurance company, the presence of a policyholder protection arrangement can ease the financial burden and reduce the time that claimants must wait to receive payment.

27. This may be referred to as a general insurance company, a property and casualty insurer or a short term insurer, depending on the jurisdiction.
H. Dealing with branches of foreign companies

This module has focused on the failure of insurance companies that are unable to remain viable. It has not focused on branches of foreign insurance companies. Foreign companies can fail, and branch operations of a foreign company can fail to meet local prudential and other requirements. However, a branch cannot become insolvent without the failure of the larger legal entity of which it is a part. In other words, branches are not separate legal entities; rather, they are a part of a company. Parts of companies can be sold, or a part of the business can be wound down, but the failure of the branch to be solvent means that the company must be insolvent.

Nevertheless, foreign companies can voluntarily exit a local market whether they operate as a branch in the local market or as a subsidiary. Thus, the elements of this module that relate to voluntary exit apply to branch operations of foreign companies and to the subsidiaries of foreign companies. In addition, a branch would be wound up if the company of which it is a part is wound up.

Branches of foreign companies can also fail to meet the local requirements to keep assets in the country. When this happens, the supervisory authority should have the power to insist that the company correct this situation. If the company fails to make the correction, the supervisory authority must have the power to force market exit in an orderly manner. This is not a winding-up in the sense of a liquidation of the branch. Instead, it is a demand that the branch cease doing business and run off its affairs in a way that meets its obligations to local policyholders at all times. Failure to do so could trigger the need to place the whole company into liquidation.

In a sense, dealing with branches is an extension of the issues and processes that must be in place to deal with problem companies. In addition, branches can bring their own set of challenges and legal issues in managing problems. For example, the company's home supervisory authority may restrict the transfer of assets from the home jurisdiction to the branch. Furthermore, the recovery of reinsurance with respect to claims on policies sold by the branch may be compromised by offsetting obligations of the company in other jurisdictions.

Dealing with internationally active companies can also bring its challenges and unique issues. However complex the company or financial group that finds itself in difficulty, the supervisor should not forget one basic principle: it is companies that fail, and the failure of each company must be dealt with individually. Supervisors therefore must work cooperatively to determine which companies in a financial group that includes a failed member are viable and which are not. The nonviable ones will receive the same treatment as any company that is nonviable, and viable ones can probably be sold as going concerns in the market.
Exercises

For each of the following questions, which responses are correct? Circle your choices. More than one response may be valid.

25. Contingency planning is necessary in dealing with troubled companies, because:
   a. Companies cannot be counted on to do the right thing
   b. One should be prepared for the worst outcome
   c. It speeds up the process
   d. The next step is known with certainty.

26. Documentation of actions taken and decisions made is necessary, because:
   a. Supervisory authorities are bureaucratic, and reports must be written
   b. In case of a public hearing, the supervisory authority has a written record of what transpired
   c. Documentation shows how hard everyone worked
   d. Documentation shows how wise the decisions were.

27. A contingency plan should be developed for:
   a. Dealing with catastrophic events
   b. Situations in which there is doubt that the right decision was made
   c. Any situation in which the outcome is not assured
   d. Any project that will be done by others on whom you are counting.
I. Policyholder protection schemes

The presence of a policyholder protection scheme can influence the decision to place a company in involuntary wind-up and it also can influence the way in which a court-managed process might work.\(^{28}\) Before considering some of these issues, this module will consider the role of these schemes, what they provide, and how they work.

**Purpose and coverage**

Policyholder protection schemes have been established in a number of jurisdictions. Their existence and design may reflect experience in dealing with insurer failures in these markets. As discussed earlier, the winding-up process can be long and result in policyholders’ experiencing significant delays in being paid their entitlements from a company. A scheme may be established to speed up the payment process for the majority of claimants, hence contributing to strengthened public confidence in the insurance sector.

For non-life insurers, protection schemes cover claimants; whereas for life insurers, these schemes focus on policyholders and claimants. This difference arises as a result of the different nature of the insurance and the degree to which the policyholder can obtain replacement coverage quickly and at a reasonable cost. The cost of life insurance increases with age and rating classification. An individual’s rating classification increases as his or her health deteriorates. Thus, should insurance be lost as a result of the failure of the insurer, an individual may not be able to purchase replacement life insurance at all, or may be able to purchase it only at a substantial increase in cost.

When an insurance company is in liquidation, policyholders and claimants can wait for years before they get what they are entitled to receive from the failed insurer. The reason is that often there is not enough money in the company’s estate to meet its obligations in full so all of the claims against its assets must be agreed. After that, each claim will receive a percentage of what it is entitled to until the assets of the company are fully distributed.

In addition, when an insurer fails and is wound up, policyholders can lose a great deal of money. Yet, not being insurance experts, they may not understand why this happened and how they might have protected themselves.

---

\(^{28}\) In many countries, these schemes are referred to as policyholder protection funds. This term usually applies when the scheme includes a pool of money that has been built up over time that could be used to meet some of its obligations. Even when there is prefunding of the costs of liquidation, the scheme may be called a policyholder protection scheme. However, not all schemes involve prefunding of this type, so no fund is established until an insurance company fails. In this case, a pool of money is set up after the winding-up process has begun and is in place until the wind-up is completed. This post-funding arrangement is referred to as a policyholder protection scheme or arrangement. For this discussion, the more general term, “scheme,” is used.
These issues have caused jurisdictions to establish policyholder protection schemes. These schemes can be owned and operated by the insurance industry or by agencies of government. Independent of ownership, normally, they are funded by the industry.\footnote{The cost to the policyholder protection scheme would be the amount of money required to bring policyholder and claimant benefits up to the coverage limits of the scheme after the amount that would be paid from the assets of the company have been taken into account.}

The coverage available to protect policyholder benefits generally is subject to several limitations. First, some schemes have preset maximum policy sizes that are covered, while others have coinsurance or percentage amounts of benefits that are covered. Some schemes cover only personal lines of business,\footnote{Personal lines most frequently covered include compulsory lines such as motor (or automobile) insurance, worker’s compensation, homeowner, and personal property fire coverage.} and others cover certain classes of commercial lines. The decision of how the coverage limits might be set in a jurisdiction can depend on public policy and regulatory principles particular to the jurisdiction.

**Funding**

Some schemes have a fund that is built up from assessments from the industry. Others cover the cost of dealing with the liquidation through the wind-up process, and companies are assessed to meet cash flow needs when the money is required. In either case, in cases in which the assets of the company are insufficient, it is common for the costs to meet the obligations to policyholders and claimants of a failed company to be paid by the industry. In other words, the cost resulting from the failure of a life insurance company would fall to the remaining life insurers, and the failure of a non-life company would fall to the non-life companies.

Monies are collected from the insurance companies through assessments linked to their size. The assessments may be subject to a maximum that can be collected in any one year. In this case, additional means for accumulating the money needed to manage the obligations of the scheme through the winding-up process must be put in place in advance, including borrowing powers, government guarantees, and prefunding.

**Policyholder protection schemes’ role in wind-up**

Policyholder protection schemes are in place to deal with potential losses to policyholders and claimants for companies that are under involuntary wind-up. The role of the scheme is to pay claimants up to the policy protection limits and then claim from the company’s estate the amount that it has paid. Thus, the policyholder protection scheme “stands in the shoes” of the claimant during the liquidation process. This arrangement gives the policyholder protection scheme a financial interest in the liquidation. It is common for these schemes to have standing in court when the court hears proposals from the liquidator on the management of the liquidation process.
This approach enables the claimant to receive payment of up to the amount of the policyholder protection scheme coverage limits at the time that the claim is settled and not have to wait until the winding-up process is finalized. However, any claim amount in excess of the policyholder protection scheme coverage limits would remain a liability of the estate of the company and would not be paid until the liquidator was confident about the ultimate percentage that could be paid to each policyholder and claimant.

The amounts paid by the policyholder protection scheme to claimants before the liquidation process is finalized would be a liability of the estate of the company in wind-up and ultimately would attract the same recovery percentage as policyholders otherwise would have received. In this way, claimants are paid faster and potentially receive more than they otherwise would receive.

The presence of a policyholder protection scheme in a jurisdiction may affect the behavior of the supervisory authority and of regulated insurers. However, supervisors should carry out their responsibilities so that they protect the rights and interests of all policyholders. Thus, supervisory decisions and enforcement actions should be made without looking to the potential “safety net” provided by the policyholder protection scheme. To delay action because the scheme is in place could increase the risks of policyholders’ not being covered in full or in part. Similarly, the presence of a policyholder protection scheme should not be used as a reason to reduce the capital adequacy requirements of insurers. To do so would defeat the fundamental purpose of capital, which is to ensure that a company is able to meet its obligations to policyholders and claimants at all times.

Some companies can interpret the existence of a policyholder protection scheme as an excuse for impudent behavior on the grounds that the scheme will protect their policyholders so they need not be as vigilant as they otherwise might need to be. This moral hazard risk is one that should be corrected whenever the supervisory authority becomes aware that a company is counting on the scheme to protect its policyholders. The company and its board of directors should understand that the scheme is in place to provide a second line of protection for policyholders, not a line of protection for companies or a justification for increasing their risk appetite.

Similarly, when a policyholder protection scheme is in place, consumers may be less inclined to do their own due diligence on their choice of insurer. Consumers may seek low-cost products and services in the belief that the scheme will look after their financial interests should the company fail. As a result, most policyholder protection schemes have limits on the amount of coverage provided. These limits can be expressed as either percentages (co-insurance limits) or as maximum policy or claim size. In this way, all policyholders have a vested interest in the continued viability of the insurance company, and it is incumbent on them to make informed and prudent decisions in selecting their insurance providers.

31. The winding-up process can vary from country to country. The details of which interest group receives what level of priority over the rights and interests of other groups can also vary. This variability is particularly true of the treatment of creditors, but it can also affect the priority that the policyholder protection scheme receives.
J. Supervision and inspection

The supervisory process that applies while companies are strong participants in the market requires significantly fewer supervisory resources than does dealing with weak companies. These demands on resources require supervisors to be flexible in how staff resources are applied to the various tasks of the authority. The tendency is to assign the best staff to deal with the weakest companies because these companies will be the most likely to challenge the work of the supervisory authority. In addition, these are the companies that are most likely to be the topics of discussion with the Minister and the directors and managers of policyholder protection schemes.

However, the work of supervising the other companies must continue because similar problems could affect other companies; compliance issues in one company can emerge in others; and with the staff focusing on the crisis, the supervisory authority may be vulnerable to missing emerging problems. Therefore, the supervisory authority should establish a contingency plan for dealing with problem companies that recognizes that staff resources will have to be reassigned to deal with the problem, yet keeps the normal supervisory functions running smoothly. This plan could include an outline of how resources will be assigned, who will act as lead in dealing with the company, who will coordinate the supervision of the rest of the industry, and who will deal with the Minister and the policyholder protection scheme. The contingency planning process should identify any training needs, skills deficiencies, and organizational weaknesses that could be addressed by the senior staff in the supervisory authority before these critical needs emerge.

Communication is an important part of effective supervision. As issues emerge from supervisory efforts that could affect either individual companies or the industry, these issues and trends should be discussed with the affected parties. However, in doing so, a particular company would usually not be identified to the industry or other companies. In addition to potentially violating confidentiality requirements, making this information public could trigger the effect that the supervisory authority and the company are working to avoid—failure of the company. However, the lessons learned through the process could be valuable to the industry.

Extending these lessons learned to other potentially vulnerable companies can be useful and beneficial. For example, this can be done by carrying out a cross-sector analysis to determine the extent to which other companies have similar problems or risk exposures and sharing the results of that work with the industry. Two things are achieved by this approach. First, the supervisory authority can see how pervasive the problem is within the industry. Second, companies can understand the issue and see how they stand in relation to the industry as a whole. Companies usually do not like being seen as outliers, and evidence from this type of study can be a powerful supervisory tool to get companies to take high-risk exposure issues seriously.
K. Conclusion

Insurance supervision includes the power to allow companies to operate in the market as well as the power to force companies to leave the market. The powers between these two extremes are numerous and varied. All of these powers, however, are intended to control the way the business is carried out and who is permitted to operate in the market. Any company that is no longer fit to operate in the market should be forced to leave the market.

Orderly exit is essential for both an orderly market and protection of policyholders’ interests. Order starts with the supervisory methodology and control procedures that ensure that supervisory staff applies the processes in an even-handed and fair manner. Documentation of the processes that are followed and evidence that was considered are important to demonstrate that the decisions have been fair and reasonable under the circumstances.

Companies can exit a market voluntarily or involuntarily. If they have the resources to manage the exit process, they should be permitted to exit voluntarily. However, if the supervisory authority feels that there is a significant risk that policyholders will not receive the amounts to which they are entitled, the authority may have to place a company into involuntary wind-up even though the company would prefer to manage the process itself.

As a result, legal and supervisory processes have to provide for orderly exits from the market whether they are voluntary or involuntary. The processes should work for domestic companies, subsidiaries of foreign companies, and branches of foreign companies. The processes should work for both the urgent and critical cases and for those that should be allowed to withdraw gradually and over a period of time.

The processes are there to protect the interests of policyholders and to contribute to the public’s confidence in the financial system. Thus, supervisory cooperation often is required to manage the processes when dealing with all companies.
Exercises

For each of the following questions, which responses are correct? Circle your choices. More than one response may be valid.

28. Policyholder protection schemes are established because:
   a. They save the government money.
   b. Policyholders and claimants get at least some of their money sooner.
   c. They prevent a run on weak insurance company.
   d. They save consumers having to think about the strength of their insurer.

29. Policyholder protection schemes are paid for by:
   a. The industry
   b. Government
   c. Policyholder premiums from people that are covered by the scheme
   d. The Central Bank.

30. The disadvantages of policyholder protections schemes, include:
   a. Policyholders do not feel that they need to assess the strength of their insurer.
   b. They are costly to set up and run.
   c. They represent a moral hazard because they make the strong pay for the errors of the weak.
   d. They encourage consumers to seek out the best rates from the weakest insurers.

Answer the following questions considering case study 1 that was presented in section G, along with the legislation and practices in your jurisdiction. If you are working with others on this module, develop the answers through discussion and cooperative work methods.

31. For this question, we are changing the flow of events that were listed in the case study. Assume that the case is unchanged up to the point at which the company is trying to gather the investors and has only a 75 percent take-up rate. Rather than there being a major new investor on the scene, assume that the company expresses concern that it will not be able to get 100 percent take-up. What action would you propose? Support your decision with reasons, and describe your contingency plan.
32. For this question, we are also changing the flow of events that were listed in the case study. Assume that the case is unchanged up to the point a week before the end of the period in which the company has committed to raising the capital. At this point, assume that the company informs the supervisory authority that it has been unable to raise additional capital and that the subordinated capital offering has been withdrawn. What action would you take? Support your decision with reasons, and describe your contingency plan.
L. References


Appendix I. ICP 16

ICP 16: Winding-up and exit from the market
The legal and regulatory framework defines a range of options for orderly exit of insurers from the marketplace. It defines insolvency and establishes the criteria and procedure for dealing with insolvency. In the event of winding-up proceedings, the legal framework gives priority to the protection of policyholders.

Explanatory notes

16.1 An insurer may no longer be financially viable or may be insolvent. In such cases, the supervisory authority can be involved in resolutions that require a take-over by, or merger with, a healthier institution. When all other measures fail, the supervisory authority should have the ability to close or assist in the closure of the troubled insurer.

16.2 The legislation should establish the priority that policyholders receive in winding-up an insurer. However, in many jurisdictions, it is also common that priority is given to other stakeholders, such as employees or the fiscal authorities. Some jurisdictions may decide that protection provided through a policyholder protection fund is not necessary for commercial policyholders.

Essential criteria

a. The legal and regulatory framework provides for the determination of the point at which it is no longer permissible for an insurer to continue its business.
b. The procedures for dealing with insolvency and winding up the insurer are clearly set forth in the law.
c. High legal priority is given to the protection of the rights and entitlements of policyholders and other beneficiaries in the event of an insurer becoming insolvent and winding-up. This priority ensures that, as far as practical, disruption to the provision of benefits to policyholders is limited.
Appendix II. Answer key

Pretest

1. Responses a, b, c, and d are valid.
2. Responses a and b are correct. In some markets, c also would be correct.
3. Responses a and d are correct.
4. Responses b and c are valid.
5. Responses a, b, c, and d are valid.
6. Responses a, b, c, and d are valid.
7. Responses c and d are valid.

Exercises

1. Responses b, c, and d are valid.
2. Responses a and b are valid.
3. Responses a, b, and d are valid.
4. A discussion with a staff member involved in analysis or on-site inspection will provide the information needed to answer this question.
5. Discuss this with a senior staff member or with legal counsel.
6. Staff involved in on-site inspection should have this information.
7. Discuss this with a senior person or one who has been around for several years. Legal counsel would have been involved, so they may also be of assistance.
8. Responses a and b are valid. However, c and d are possible outcomes of having sound practices and making them transparent to the public.
9. Responses a and b are valid.
10. Responses a and b are valid. Response c is a possible outcome, but the company’s reaction should not determine the sanction used.
11. The team that does on-site inspection will be able to help with this.
12. This information may be on the website of the supervisory authority or available from the staff responsible for communication to the companies and the public.
13. The existence of the scheme should be generally known in the office. Coordination of communications will be understood by the senior staff involved in analysis and inspection.
14. Responses b, c, and d are valid.
15. Response d is valid. However, if you were considering that the company has adequate capital, then response b is possible.
16. Responses a and d are valid.
17. Senior staff in the supervisory authority should be able to provide the information and the legal basis for your response. Legal counsel also would know this.
18. The supervisory authority may prepare a report from time to time on movement of companies. Senior staff also would be able to indicate where you should look for the answer.
19. Senior staff should be able to help on this.
20. Responses a, b and d are valid. The skills to perform the work are a precondition to making the processes effective.
21. Responses b and c are valid.
22. Responses a, b, and c are valid although policyholders are not the top priority. If you rejected a and b for that reason, you are correct.
23. A senior member of staff should be able to provide this information.
24. Legal counsel should be able to help provide the information about the powers and references. Senior supervisory staff should be able to assist in identifying additional powers.
25. Responses b, c, and d are valid. If you feel that companies in your jurisdiction behave consistently with response a, then you are not wrong to have checked it.
26. Response b is valid. However, the situations noted in c and d are possible outcomes.
27. Responses a, b, c, and d are valid.
28. Responses b and c are valid.
29. Response a is most often the correct one. However, response b may be correct.
30. Responses a, b, c, and d are all possible outcomes and have been the arguments given by jurisdictions that decided not to establish these schemes.
31. There is no single right answer to this question. However, the arguments and discussion in support of the position you are taking is important. Once you have decided on the action and reasons for your decision, you may want to discuss your response with a senior member of your supervisory authority.
32. There is no single right answer to this question. However, the arguments and discussion in support of the position you are taking is important. Once you have decided on the action and reasons for your decision, you may want to discuss your response with a senior member of your supervisory authority.