OFFSHORE GROUP OF INSURANCE SUPERVISORS

PRINCIPLES PAPER
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CEASE AND DESIST ORDERS, WITHDRAWAL OF LICENCES AND WINDING UP

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Introduction

1. 'Cease and desist' orders, withdrawals of licence and the ability to wind up an insurance undertaking are a necessary part of a supervisor's armoury which enable him to act when a serious situation in an insurance company[1] arises and is not capable of correction by normal supervisory means. Such measures are necessary when insurance companies fail to meet prudential requirements; when there are regulatory violations, or when the interests of policyholders are threatened. The ability to issue cease and desist orders, withdraw licences and wind up insurers are the most draconian of a supervisor's powers and need to be exercised with care. Except in emergencies, they are usually used as a last resort when other courses of regulatory action have failed to produce the desired results. The supervisor must consider whether the action he is taking is required for the benefit of policyholders and whether this benefit outweighs the likely loss to the insurer's shareholders and its employees of a means to a livelihood. In most cases, of course, the policyholders' interest will be paramount especially where there is a danger that their claims will not be paid, or that they will be defrauded in other ways.

Cease and desist orders

Grounds for action

2. For the purposes of this paper, 'cease and desist' orders are defined as orders issued by the regulatory authority which require the insurer to stop issuing new contracts of insurance, although it is recognised that the term may have slightly different meanings in different jurisdictions. The order will also require the insurer not to renew general insurance policies when they come up for renewal but it is not possible, nor desirable, for an order to interfere with the terms of an existing long – term insurance contract. The issue of a cease and desist order will be appropriate in a number of circumstances:

   - where the insurer has failed to meet its solvency margin, and has been unable or unwilling to restore itself to a sound financial position;

   - where the insurer is acting in a way which is not considered to be sound and prudent, e.g., its actions are likely to lead to future insolvency or will

[1] Reference in this paper to e.g. "insurance companies" or "insurers" includes reference also to "reinsurance companies" or "reinsurers"

be to the detriment of the public or of policyholders' interest, and has failed to take action;

- where a controller, director or manager of an insurer is found to be not fit and proper and the insurer, after due warning, has failed to remove him;

- where there has been a substantial and serious departure from any forecast which the insurer has provided to the supervisor, on the basis of which a licence has been issued;

- where the insurer has provided the supervisor with false or misleading information;

- where the insurer has been formally required by the supervisor to take a course of action (or to stop taking a course of action) but has failed to comply.

The above circumstances are sometimes referred to as the "grounds" on which the supervisor decides to take a particular course of action. These grounds may be evident only after an investigation has been carried out into the insurer's affairs.

Alternative courses of action

3. Before deciding whether to issue a cease and desist order, the supervisor will need to consider whether this is the most appropriate course of action. In many cases, where the events outlined in paragraph 2 have occurred, it will be appropriate for the supervisor to allow the insurer a chance to rectify the fault. For instance, most jurisdictions require insurers to maintain a margin of solvency above the assets needed to meet the insurer's technical provisions (i.e. its liabilities). In cases where the insurer's assets are adequate to meet its liabilities but not the extra amount which will provide the solvency margin, there is often no danger that a policyholders' claims will not be met. In such circumstances, it is often appropriate to allow the insurer an agreed space of time to restore itself to a sound financial position, or to request a recovery plan to do so within a given timescale. In most cases, the shareholders will be willing to inject more cash into the insurer to restore the solvency margin, but where they refuse, or are unable, to do so, the supervisor will have little choice but to require the insurer to stop issuing new contracts of insurance.

Representations by the insurer

4. In cases where the supervisor concludes that a cease and desist order is necessary because the insurer is unlikely, for whatever reason, to put right the faults referred to in paragraph 2 above, he must then decide whether immediate action is necessary, or whether the insurer should be allowed a chance to make representations before the order is issued. In most cases, natural justice will dictate (and the law will often require) that the insurer should be allowed to make representations and to be given notice of the supervisors intentions. The insurer will be given, typically, one month in which to make these

representations and there will be a further period of time in which the supervisor will consider whether the representations have merit before finally deciding whether to issue the order. Where the supervisor is taking action on the grounds that a controller, director or manager is not fit and proper, it will often be necessary to give that person an opportunity to make representations on his own behalf before serving notice on the insurer. Once issued, the order should have immediate effect and the insurer must cease forthwith to cover new risks. The order will require life insurers to restrict themselves to servicing and renewing the existing portfolio (i.e. take in regular premiums from existing policyholders or renew cover where the existing contract allows it to do so) but non-life insurers will be permitted normally only to service the existing portfolio (i.e. pay claims but not collect further premiums).

Urgent action in serious cases

5. There will also be occasions where the faults are considered so serious that action is necessary to require the insurer to stop writing new business immediately without being given a chance to make representations. This will always be a matter for the supervisor's judgement, but examples of where immediate service of a 'cease and desist' order may be necessary are where an insurer's financial position has deteriorated suddenly and unexpectedly to a point where claims may not be met; or where a controller, director or manager is suspected of some illegality which threatens policyholder interests. In these circumstances, it would be normal to allow the insurer to make representations after the order has been served that it should be allowed to recommence taking on new business. A typical timescale for hearing representations would be one month after the date of the order, plus a further appropriate time for the supervisor to reach a decision whether or not to withdraw the order. Alternatively, the legislation might make provisions for 'cease and desist' orders which are served without prior warning to be of a temporary nature and to lapse if the supervisor has not confirmed the order within an appropriate timescale (two or three months). In those circumstances, if the supervisor cannot decide finally within the timescale that the insurer should cease completely to take on new business, or be allowed to recommence underwriting, he will need to renew the temporary order for a further period of time. He may only be able to do that with the agreement of the insurer.

Withdrawal of licence

Circumstances where a licence should be withdrawn

6. Withdrawal of licence in this context goes wider than requiring the insurer to take on no new business. It is a final withdrawal of licence so that the insurer can no longer legally effect or carry on contracts of insurance. This will mean, for example, that the insurer can no longer legally pay claims, which is to the detriment of the policyholder, so the use of this power is probably only appropriate to circumstances where:

- the insurer has not made use of the licence within a legally determined period of time;

- the insurer has ceased its operations and the business that has been written has now fully run-off, i.e. there are no known outstanding claims liabilities and no reasonable prospects of such liabilities emerging in the future.

7. Checking to see whether the insurer is making use of its licence should be part of the normal supervisory procedure which will include ensuring that the insurer is not writing any class of business for which it is <u>not</u> authorised. When the licence (either the full licence, or a part licence for a particular class of business) has not been used for a statutorily defined period (typically 12 months), the supervisor should contact the insurer to determine whether there is any possibility that the licence (or part licence) will be used in the reasonably near future. Where there is no prospect that it will be, the licence should be withdrawn. The reason for this is that, where a licence has been unused for several years, the insurer would be able to commence writing new business without having to obtain the supervisor's approval. This may result in a change in the fundamental nature of the business which might go undetected for some time to the detriment of the solvency margin and of policyholders interests.

Withdrawal after a run-off of business

8. Before withdrawing a licence based upon a company having fully run-off its business in a class, it is important to get clear evidence that there are no remaining known liabilities and no reasonable prospect of such liabilities emerging. This evidence may not be sufficient unless it comprises:

   - the latest accounts and annual return which report (without qualification from the auditors) that there are no remaining gross liabilities; and

   - a statement by a person (who would be qualified to sign an annual return) writing on behalf of the company that no there is no reasonable prospect of any further gross liabilities emerging.

Claims made policies

9. Unless the insurance business is inherently short-tail in nature, it is unlikely the supervisor will be satisfied that the business has fully run-off until a considerable time after the last insurance policy was written. In particular, liability business (including treaty reinsurance with a liability component) may take many decades to run off fully. Two factors are of special relevance in considering whether business has fully run-off –

   - whether insurance was only written on a claims-made basis, and

   - the likelihood of latent damage.

   Claims-made insurance policies provide that a claim may only be made within the period of cover under the policy and (sometimes) for a specified period thereafter (often called "sunset clause"). An insurance company which has only

written claims-made policies, knows at the end of the last "sunset" period that it has received all the claims notifications that it is going to receive. However, that class is not fully run-off until all claims so notified are either settled, commuted or defeated in court or settled by arbitration.

"Latent damage"

10. Where not all policies were written on a claims-made basis, it becomes important to assess the likelihood of insured events giving rise to latent damage and to assess the maximum latent period reasonably possible. (Latent damage is damage which arises from an insured event but does not become apparent until some time later. The period between the event and the damage being notified as a possible claim is the latent period.) The class is not fully run-off until the end of the maximum latent period or, if later, the settlement, commutation, defeat in court or arbitration of all notified claims.

Speeding up a run-off

11. Of course, an insurance company may seek to advance the run-off of any class of business by –

    - a transfer of liabilities as provided by legislation;
    - a novation of liabilities, or
    - a commutation of liabilities.

    A legal transfer is the most effective method of completing a run-off.

    A novation of liabilities is the transfer, by non-statutory means, from the insurance company to another insurance company of its liability to policyholders. A commutation is the contractual discharge of liability to policyholders. Both require the agreement of every policyholder in respect of which they apply. They are, therefore, only relevant to bringing the run off to an end where –

    - the company only has a few policyholders, e.g. business derives from a few cedants, or the company is a captive etc.; or
    - the company is near the end of its run off and only a few potential claims remain.

    In recent years, there has been an increase in the number of specialist 'run-off companies' which take over the management of the assets and liabilities of companies closed to new business, but without acquiring legal title to these. In such cases, the issue for the supervisor is whether the run-off company has the resources and expertise to run off the portfolio in question.

Publicity

12. When a final withdrawal of a licence has taken place it is desirable to publish the fact, and most jurisdictions' legislation provides for this.

Winding up

13. Generally speaking, the winding up of an insurance company can only take place with the agreement of the courts and will depend crucially on company law which may differ widely from jurisdiction to jurisdiction. The following paragraphs can give, therefore, only a broad indication of the considerations involved.

14. A supervisor would normally commence winding up procedures by petitioning the courts. There will be a natural reluctance to take this step with a licensed insurer for a number of reasons. Firstly, it means that other supervisory measures have failed. Also, the cost of liquidation and winding up can be high and, therefore, use up assets of the company which would otherwise be used to support policyholders' benefits and pay their claims. Moreover, the liquidator's main responsibility is to raise as much money as possible for the creditors of the company whose interests mat be in conflict with those of the policyholders. Consequently, a supervisor will petition the court for a winding up only if there are very strong reasons to do so. These reasons would include:

    - that the insurer has failed to comply with a formal requirement imposed on it by the supervisor;
    - that the insurer has failed to keep proper records of its insurance business and the supervisor is unable to determine its financial position;
    - that the insurer is insolvent or unable to pay its debts;
    - that winding up would be in the public interest.

    The supervisor may also seek winding up when a company is carrying on insurance business without a licence. Moreover, in circumstances where the insurance licence has been withdrawn under procedures described in paragraphs 6 to 12 above and has no remaining insurance liabilities the company may seek its own winding up. The latter process need not involve the supervisor.

15. It may be in some jurisdictions that the supervisor himself would be appointed by the court to assume control over the assets and operations of the company. If so, the due process of law will govern the proceedings whereby the company is liquidated and wound up. If the insurer is insolvent, for example, the liquidation will be subject to the normal insolvency provisions unless the jurisdiction's insurance supervisory legislation makes special provisions, say, to confer preferential treatment for policyholders.