

LEGISLATIVE WHITE PAPER{PRIVATE }

The NCIGF Post-Assessment Property & Casualty Guaranty Association Model Act

I. EXECUTIVE SUMMARY.

Correction of Problems. In the decade since the last major overhaul of the guaranty fund Model Act numerous problems have been exposed and are addressed by the remedial provisions of this proposal.

Improvement of Inter-state Operations. This draft will greatly facilitate guaranty association operations between states in one of the most highly visible areas of insurance regulation, the consumer safety net.

Increased Capacity. The proposed Model creates a catastrophic borrowing option, and also makes several limitations on the benefits available for large commercial policy owners, thus increasing the capacity available for the individual consumers. The proposal's most important by-product is this systemic strengthening of the protection available for individual consumers.

Reduced Administrative Costs. It is anticipated that the administrative costs currently expended by receivers and guaranty associations will decline under this model. Part will be achieved by the disappearance of the unique variations from state to state, and part because of the elimination of a number of currently administratively-expensive provisions.

Major Changes. Some of the major changes in the draft are:

- Introduces an option for catastrophic borrowing capacity for the associations.
- Establishes a replenishment of capacity through a recoupment against insureds with a minimum net worth of \$25 Million and establishes minimum \$10 Million net worth provision for first party claims.
- Creates a \$10 Million aggregate claim limit.
- Establishes an 18 month claim filing deadline for claims against associations.
- Picks up the Life & Health Model's right to intervene.
- The duty to defend will cease upon tender of full association benefits.
- Sets a minimum claims cap at \$300,000.

II. CAPACITY BORROWING.

One of the highlights of the new proposal is the introduction of provisions enabling guaranty associations to borrow in the event of catastrophes, as a method of providing immediate recourse under instances of strained capacity. In major natural disasters there is an acute need to respond immediately to consumer losses. And frequently there is no time; in the immediate aftermath of Hurricane Andrew the Florida association spent virtually all of its annual capacity within a 30-day period. Of the options available to address this problem, the proposal's borrowing facility is the least costly and will quickly produce money for the benefit of the policy holders. The facility will be used in the event of natural disasters combined with a strain on capacity. It is also contemplated that the bonds issued would be tax-exempt. The draft's language has been drawn from the experience of the Florida association following Andrew, and also borrows from language previously enacted in California.

III. CAPACITY REALLOCATION.

As the guaranty association concept has evolved from its original focus on auto and homeowners protection many observers have become increasingly uncomfortable about the ability of large commercial insureds to take advantage of the present system and thereby absorb a disproportionate share of its capacity. This concern played a key factor in the introduction of § 11(2) in the 1987 NAIC Model, which gives associations recovery rights against policy owners whose net worth exceeds a given threshold level.

One of the intentions of the new proposed draft is to restore the balance between corporate beneficiaries and the individual consumers by placing reasonable limitations on large commercial policy owners in three major ways, the net worth provision, the aggregate claims limitation, and the claims bar date. Two of these three provisions already have been enacted in a

number of states; the proposal would extend these provisions throughout the country, thereby greatly easing capacity for the benefit of insurance consumers as a whole.

In 1994 the NCIGF conducted a study of industry assessments which indicated that under the statutes as enacted large commercial policy owners are continuing to account for a significant portion of the claims paid by guaranty associations. Specifically it showed that if the net worth provisions then in 18 jurisdictions had been in effect nationwide, along with two other provisions similarly designed to place limitations on the claims of large commercial policy owners, a reduction in assessments nationwide in the amount of 5% would have resulted. Related studies found that two large commercial insureds had consumed roughly seven and a half times the fund's worker's compensation annual assessment capacity in one insolvency in Maine. In Rhode Island, in another single insolvency, a large commercial insured had consumed almost four times the worker's compensation capacity.

Taken together the studies indicate that over the years there has been a shrinking of the percentage of capacity that is available to those who are least able to bear the prospect of the new strains in capacity, the individual insureds, to the advantage of the commercial sector which is most able to bear it. The proposed Model would arrest this development.

1) **The 1994 Study.** The study was designed with narrow focus so as to make available hard data which would serve as an illustrative example of the impact on capacity. It investigated five major liquidations (Ideal, Transit, Midland, Integrity and Mission) and the resulting guaranty fund payments in eight key states (California, Connecticut, Georgia, Michigan, New Jersey, Ohio, Pennsylvania and Wisconsin). It adjusted for duplication between provisions and also for association recoveries actually received from the estates (both early access and ultimate distributions and dividends). The study focused on just three provisions of the

proposed Model, net worth, aggregate claims limitation, and the bar date, and assumed that the other increases and decreases in assessments flowing from the Model would be statistically insignificant. It did not make adjustment for specific statutory differences then in effect in each state, and did not adjust for the later impact of statutory recoupment provisions. The ultimate finding of the study was that if the Model had been in place in these eight states, capacity would have been spared in the amount of approximately \$330 million. The study anticipates that if it were expanded to all states and all liquidations, the impact on capacity would have been markedly increased.

2) **Net Worth Portion of the Study.** The identity of claimants benefiting from the guaranty association safety net has been changing steadily over the years. A significant proportion of the claimants are large commercial policy owners, a partial listing of which is set forth on Exhibit A. One of the findings of the 1994 NCIGF study was that if merely three extant statutory provisions were extended nationwide — each of which places some limitation on the ability of those corporations to reap the benefits of the safety net — well over \$330 million of assessment capacity would have been released for general use. Whatever portion of that capacity that ultimately is not needed would in turn result in a welcome reduction in the ultimate burden on the insurance-buying public through recoupment.

To adjust for these developments the number of states enacting net worth provisions has grown in recent years, and now is in force in over 18 jurisdictions. In most of these states the provision follows the 1987 NAIC Model and provides simply that the guaranty association has the right to recover claims paid from large insureds whose net worth exceed the threshold amount. This approach is crucial from the viewpoint of the insurance-buying public, in that it guarantees that eligible claims will be paid in their normal course to the individuals who have suffered a loss;

net worth comes into play only later, and is in the nature of a recoupment provision designed to replace loss capacity for the associations after payouts to the claimants. The proposed Model extends this approach nationwide and adds a parallel first-party provision to complete the picture.

3) **Aggregate Limit Portion of the Study.** The proposed Model borrows the concept of the aggregate limit from the NAIC Model Life & Health Act. It places an intentionally high number on the dollar limitation, and it is anticipated that only rarely will a single commercial policy owner generate more than \$10 million in otherwise-eligible guaranty association claims. Based on discussions with guaranty fund managers and receivers involved in global settlements entered into by property and casualty guaranty funds, it can be surmised that over 99% of all claimants would not be affected by such a provision. Furthermore, it is likely that specifically with respect to individual consumer claimants virtually 100% will be unaffected.

Despite their rarity these instances do require legislative quarantine, because a single commercial policy owner has the potential to shatter capacity for the entire system. That instance could be a Bhopal or a Chernobyl, and protections need to be in place to preserve the solvency of the safety net itself for the benefit of all. Connecticut already has addressed this issue through enactment of a residents-only system. However, an aggregate limit is by far the more preferable solution.

4) **Bar Date Portion of the Study.** The concept of an independent bar date for guaranty associations already has been adopted in at least 9 states. These provisions arise out of the recognition that guaranty associations are different than all other liquidation claimants: the amount of their claims increase with time, and generally they constitute the single largest claimants in the estate. With a bar date independent of the liquidation estate, guaranty

associations will be better able to finalize and quantify their claims, a development which will be of great help to receivers trying to calculate the ultimate distribution, to cut administrative costs, and to facilitate closing mechanisms. Another major advantage of this provision would be to prevent large commercial insureds from filing late claims which may bloat the size of the guaranty association claims and exacerbate the capacity problem.

IV. ADDITIONAL FACTORS.

The proposal contains a number of other provisions which individually are expected to have impacts on guaranty association assessments and capacity, some increasing them and some decreasing them, but which taken together in the aggregate are anticipated to be statistically insignificant compared to the factors listed above.

Increases in Assessments. Following is a listing of the major provisions in the proposal which in isolation would tend to increase guaranty association assessments and thus increase costs to the general insurance-buying public; they also would benefit specific claimants by increasing benefits.

- **Claims cap increase.** Because the proposal sets a \$300,000 minimum in the claims cap, some 14 jurisdictions would see an increase in benefits paid to consumers.
- **Unearned premium coverage.** The proposal offers coverage for unearned premium claims with a minimum cap of \$10,000, which would result in increasing current coverages for unearned premium as they exist in legislative enactment in some seven jurisdictions.
- **Workers compensation.** The proposal's express coverage for the full amount of workers comp. would result in the elimination of caps on work comp. claims in three jurisdictions at last count.

Decreases. When considered in the aggregate, however, the above increases are not expected to increase pressure on capacity. This is because the increases are offset by certain

other provisions, the most important of which are listed below:

- Unearned premium limit. The proposal's \$10,000 per-policy limitation would result in reduced assessments since the cap would appear for the first time in some 21 jurisdictions.
- Duty to defend. The proposal's provision in § 6(1)(a) permits the association to satisfy its obligation to defend by tendering an amount equal to the lesser of its covered claim obligation limit or the applicable policy limit. Variations of this provision already have been enacted in Illinois. The problem came to the attention of Illinois authorities recently in that one large corporate manufacturer was projected to incur in excess of \$10 million in defense costs alone. This provision is seen as another necessary limitation on the ability of large commercial insureds to take a disproportionate share of the available assessment capacity in the system. It also is thought that the provision will encourage earlier settlements of litigation and therefore less administrative expenses, by promoting an early tender of limits by the associations.
- Covered lines. It is estimated that the proposal would result in the exclusions appearing for the first time in certain statutes: in seven jurisdictions (ocean marine), seven jurisdictions (credit), nine jurisdictions (surety), and 22 jurisdictions (financial guaranty).