» Insolvency
TRENDS
Spring 2015

National Conference of Insurance Guaranty Funds NCIGF

A biannual publication providing updates on recent property and casualty insolvencies and public policy developments

GUARANTY FUNDS WORK

in partnership with insurance regulators to protect policyholders.

A state court finds an insurance company insolvent and orders it liquidated.

Policyholder claim files are transferred to the guaranty funds for servicing.

Covered claims are paid from a pool of money drawn from three sources made available at the time of the insolvency: a) the insolvent insurance company's remaining assets, b) statutory deposits collected in certain states, and c) assessments on insurers licensed to write business in a state.

Payments are made promptly.

HOW THE GUARANTY FUND SYSTEM IS FUNDED

Recoveries

To the extent possible to fulfill guaranty fund statutory duties, monies are obtained from remaining estate assets.

- The insurance company's remaining assets (including reinsurance)
- Statutorily mandated deposits collected in certain states while the company is still writing business

Assessments from Insurers

Charged to insurance companies licensed to write business in a state

- Typical cap is 2% of "net direct written premium"
- Assessment is determined by the amount of money needed by the guaranty fund to supplement the funding pool described above
- Some guaranty funds have separate "assessment accounts" allowing them to segregate assessment billing and payments into various lines of business—a typical structure would be workers' compensation, auto, and all other property & casualty lines covered by the funds

Welcome to the 2015 spring issue of the National Conference of Insurance Guaranty Funds' (NCIGF) *Insolvency Trends*.

Authored by the legal and public policy staff of the NCIGF, the publication provides an update on recent events in insolvency law and practice and a look ahead at what is on the horizon.

See inside for…

- International developments
- Insurance insolvency developments; new liquidations and status of estates
- Developments in state insolvency laws
- Run-offs of troubled companies

PROPERTY AND CASUALTY GUARANTY FUNDS: CONTINUING TO EVOLVE TO PROTECT POLICYHOLDERS

The guaranty fund system was established in 1969 by the property and casualty insurance industry, insurance regulators, and states to provide a safety net that protects insurance consumers if an insurance company fails. The system is an innovative and common-sense mechanism that draws first on the assets of the failed insurance company before turning to assessments of healthy insurers in each state. Since its inception, the system has paid out more than $27 billion to policyholders, beneficiaries, and claimants related to more than 550 insolvencies.

Following liquidation, the statutorily created guaranty funds seamlessly step into the shoes of a defunct company and pay the covered claims of policyholders and claimants whose claims otherwise would go unpaid by an insolvent insurance company.

Today, the guaranty fund system remains true to its original intent: delivering protection to those least able to weather the impact of insurance company insolvencies.

THE INTERNATIONAL SCENE

INTERNATIONAL CAPITAL STANDARDS

Over the last 18 months, international insurance regulatory developments have taken center stage in discussions by regulators and industry. International capital standards have emerged as a prominent topic of those discussions. This is a big shift; almost no one was talking about international insurance regulatory matters a few years ago, much less international capital requirements. These matters have grown in importance since the 2008 financial meltdown and many players in the insurance insolvency system are paying close attention.

To summarize the action, the International Association of Insurance Supervisors (IAIS), of which the U.S. Federal Reserve and U.S. insurance regulators are active participants, is developing three group-wide capital requirements:

- Basic Capital Requirement (BCR): Intended to be simple and straightforward, the BCR will apply to all global systemically important insurers (G-SIIs). To date, the Financial Stability Board (FSB)[1], in consultation with the IAIS, has designated nine G-SIIs, including AIG, MetLife and Prudential. The BCR was finalized in October 2014; G-SIIs

[1] The FSB was established by the G20 to monitor and make recommendations about the global financial system. It aims to promote global financial stability by coordinating the work of national financial regulators and international standard-setting bodies.

will start reporting confidentially to their supervisors
in 2015.

- Higher Loss Absorbency (HLA): This requirement will apply only to G-SIIs, will build on the BCR, and will impose additional capital requirements in connection with those activities that make a G-SII systemically important. The initial proposal reportedly will be published this summer.

- Insurance Capital Standard (ICS): This will be a risk-based global capital standard that applies to G-SIIs *and* internationally active insurance groups (IAIGs)[2]. The ICS will be informed by, but will be much more sophisticated than, the BCR (and will eventually replace the BCR). The initial proposal was published December 17, 2014, and is due to be completed in 2016.

The reasons insolvency practitioners are paying attention to capital standard development are threefold:

- Trickle Down Application. For the time being, the capital standards outlined above would potentially apply only to companies that have been designated as a G-SII or an IAIG. (The IAIS anticipates that approximately 50 companies worldwide will be considered IAIGs.) Some state and federal officials believe, however, that over time, these capital standards (particularly the ICS) will apply to broader segments of the industry. As a result, many state guaranty fund member companies may eventually be impacted by these capital standards, and it's important for receivers and guaranty funds to have an appreciation for how they work and how they could impact insolvencies going forward. U.S. regulators may decide that higher capital levels constitute a best practice (as they did with ORSA, which began as an international initiative.) Rating agencies may decide to incorporate the international capital levels into their rating criteria. Companies that aren't G-SIIs or IAIGs may nevertheless feel competitive pressure to maintain capital at levels consistent with the international standards.

- Opposite Sides of the Same Coin. While the international community has been busy developing capital standards, it also spent much of 2014 working on resolution matters (and will continue to do so in 2015).[3] Capital standards and resolution standards are

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[2] An IAIG is a large internationally active group that includes at least one sizable insurance entity. A group would be an IAIG if:

(a) premiums are written in at least 3 jurisdictions;

(b) at least 10% of the group's total gross written premium is written outside of its home country; and

(c) the group has total assets of at least $50 billion or gross written premiums of at least $10 billion.

[3] Among other activities, the IAIS and FSB produced the following in 2014:

- Cross-Border Recognition of Resolution Action Consultation
- Key Attributes of Effective Resolution Regimes Final Version (including the Insurance Annex)

opposite sides of the same coin that are intended to work together to achieve financial stability. While capital standards are supposed to lessen the chances that an entity will fail, resolution standards help ensure that a failure won't destabilize the economy.

Because they are intended to work together, capital standards must be informed by resolution standards and strategies, and vice versa. For example, the Federal Deposit Insurance Corporation's (FDIC) single point of entry receivership strategy can succeed only if there is sufficient unsecured debt and capital at the holding company level. Thus, the FDIC's resolution strategy is informing (and dependent upon) the Federal Reserve Board's development of capital and debt requirements for SIFIs. The same story is playing out internationally, as regulators and standard-setting bodies consider the merits of the single point of entry strategy. The bottom line is that it's difficult (or maybe impossible) to accurately assess or understand the current activity involving resolution standards and strategies without some understanding of the capital requirements.

- Impact on Availability of Assets. The capital standards under development are group-wide requirements, and the IAIS has not yet determined where within a group the capital will need to reside. It is not necessarily the case that all of the capital will be permitted to be held at the insurance company level. (In fact, as discussed above, some of the proposed resolution strategies would require increased amounts of capital to be held at the holding company level.) Additionally, decision-makers are struggling with how to value qualifying assets and liabilities. As of now, assets will be valued on a fair value, rather than book value, basis. Liabilities will be valued using current estimates, excluding margins, using an IAIS-prescribed yield curve for discounting the liabilities. In a troubled company scenario, differences between local valuation methods and the international requirements could raise sticky questions, such as when a company is considered insolvent or what assets are available to meet policyholder obligations.

At a recent IAIS meeting in Los Angeles, U.S. industry representatives asserted that the ICS is unnecessary, given existing capital standards applicable to the legal entities. In the event the ICS goes forward, U.S. insurers made clear that the exclusive goal of the ICS should be policyholder protection. The IAIS supervisors responded that policyholder protection is only one of the goals and that the ICS must also bolster financial stability.

Industry advocated for more time and a slower phase-in, citing political challenges in getting standards adopted in local jurisdictions as proposed. Additionally, industry projects substantial

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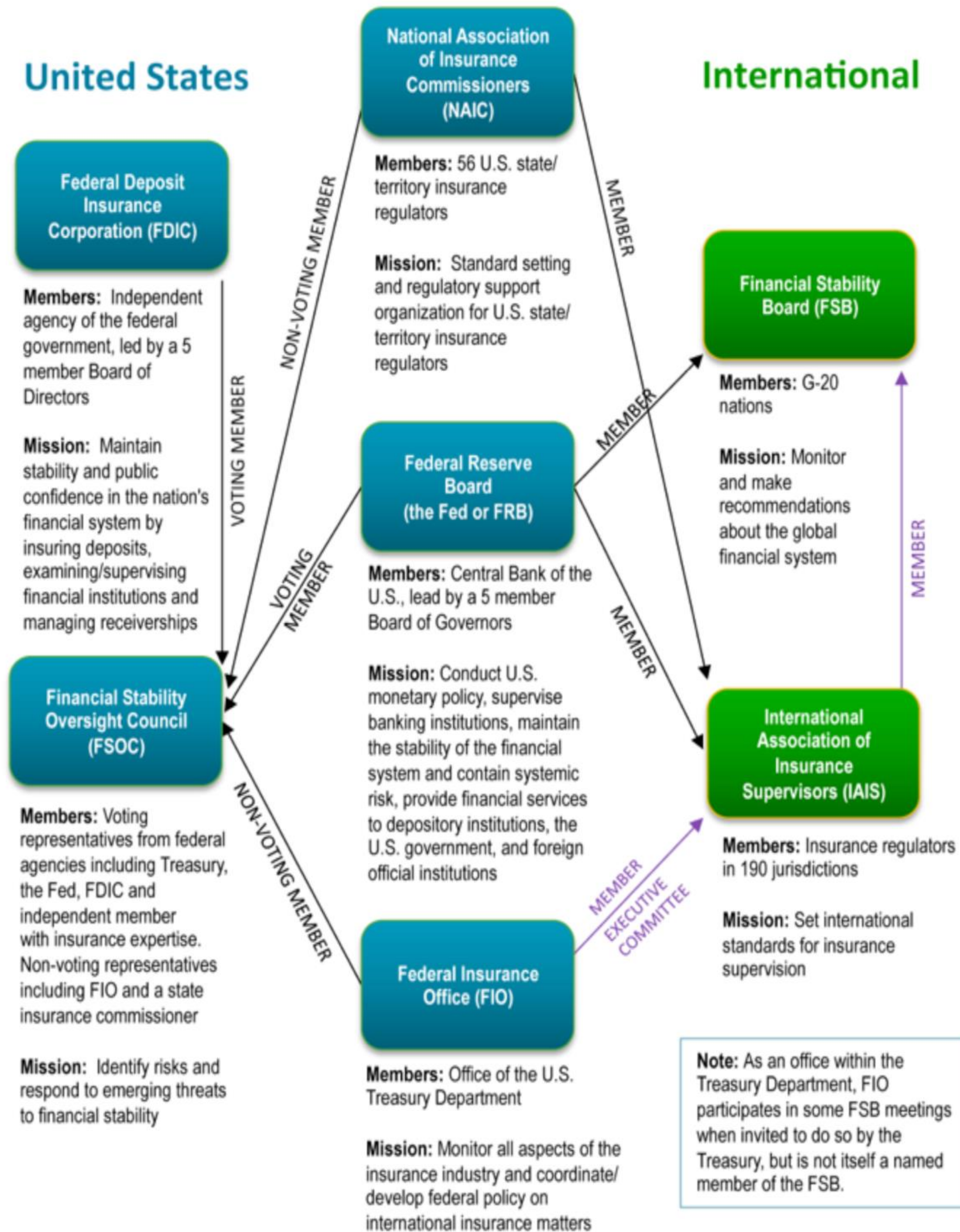
- Recovery and Resolution Planning for Systemically Important Insurers: Guidance on Identification of Critical Functions and Shared Services Consultation
- Guidance on Cooperation and Information Sharing with Host Jurisdictions Not Represented on CMG

The resolution element of ComFrame is expected to be published for comment in 2015.

additional costs, which will be passed on to policyholders and potentially dramatic changes in the way insurers invest and the products they offer.

Once finalized, these standards would have the force of law in the United States if adopted by a U.S. regulator. This outcome is likely; the Federal Reserve (Fed) has been directly involved in the IAIS discussions on capital standards and is already considering heightened capital standards for insurance SIFIs that they now regulate. Similarly, at least some states will adopt the international capital standards given that they, too, have been part of the international negotiations. Accordingly, the insolvency system will have to deal with international capital standards, directly or indirectly, through one or more of the avenues described above.

The chart on the following page shows the key groups impacting international insurance.


Key Players Impacting Insurance Regulation
A Complex Web of Interactions
United States
International
National Association of Insurance Commissioners (NAIC)
Members: 56 U.S. state/ territory insurance regulators
Mission: Standard setting and regulatory support organization for U.S. state/ territory insurance regulators
Federal Deposit Insurance Corporation (FDIC)
Members: Independent agency of the federal government, led by a 5 member Board of Directors
Mission: Maintain stability and public confidence in the nation's financial system by insuring deposits, examining/supervising financial institutions and managing receiverships
Financial Stability Board (FSB)
Members: G-20 nations
Mission: Monitor and make recommendations about the global financial system
Federal Reserve Board (the Fed or FRB)
Members: Central Bank of the U.S., lead by a 5 member Board of Governors
Mission: Conduct U.S. monetary policy, supervise banking institutions, maintain the stability of the financial system and contain systemic risk, provide financial services to depository institutions, the U.S. government, and foreign official institutions
Financial Stability Oversight Council (FSOC)
Members: Voting representatives from federal agencies including Treasury, the Fed, FDIC and independent member with insurance expertise. Non-voting representatives including FIO and a state insurance commissioner
Mission: Identify risks and respond to emerging threats to financial stability
International Association of Insurance Supervisors (IAIS)
Members: Insurance regulators in 190 jurisdictions
Mission: Set international standards for insurance supervision
Federal Insurance Office (FIO)
Members: Office of the U.S. Treasury Department
Mission: Monitor all aspects of the insurance industry and coordinate/ develop federal policy on international insurance matters
Note: As an office within the Treasury Department, FIO participates in some FSB meetings when invited to do so by the Treasury, but is not itself a named member of the FSB.
NON-VOTING MEMBER
VOTING MEMBER
MEMBER
MEMBER
VOTING MEMBER
MEMBER
MEMBER
NON-VOTING MEMBER
MEMBER EXECUTIVE COMMITTEE

NEW INSOLVENCIES THIS YEAR: THE PROPERTY CASUALTY GUARANTY FUNDS CONTINUE TO PROTECT CLAIMANTS

There have been no new insolvencies in 2015. Seven small insolvencies occurred in 2014: CAGC Insurance Company, a workers' compensation company, domiciled in North Carolina and licensed in North Carolina and South Carolina; Georgia Mutual Insurance, an automobile insurance company, domiciled in Georgia and licensed in Georgia, Tennessee and Alabama (claims in Georgia only); Professional Liability Insurance Company of America, a medical malpractice and workers' compensation insurance company, domiciled in New York and licensed in 31 states with claims in Illinois and Missouri only; National Guaranty Insurance Company, an automobile insurance company domiciled in Nevada and licensed in Indiana and Nevada (claims in Nevada only); Sunshine State Insurance Company, which wrote fire, allied, inland marine, homeowners multiperil and other liability, domiciled in Florida and licensed in Florida, Mississippi and South Carolina; Freestone Insurance Company, domiciled in Delaware, and licensed in 41 states; and Red Rock Insurance Company, domiciled in Oklahoma, and licensed in 48 states and Washington DC. The seven insolvencies that occurred in 2014 can be found in the table below.

Name of Company	Liquidation Date	State of Domicile	Direct Losses Unpaid	Type of Company	States Licensed
CAGC Insurance Company	1/17/14	NC	$17,993,440	Workers' compensation	NC, SC
Georgia Mutual Insurance, a Stock Company	2/7/14	GA	$2,623,725	Private passenger auto, auto physical damage	GA, TN, AL (claims in GA only)
Professional Liability Insurance Company of America	2/10/14	NY	$26,160,348	Medical malpractice, workers' compensation	31 states (claims in IL and MO only)
National Guaranty Insurance Company	5/6/14	NV	$6,278,278	Private passenger auto, auto physical damage	IN, NV (claims in NV only)
Sunshine State Insurance Company	6/3/14	FL	$9,103,518	Fire, allied, inland marine, homeowners multiperil, other liability	FL, MS, SC
Freestone Insurance Company	8/15/14	DE	$111,609,173	Workers' compensation, homeowners multi-peril, group accident and health, other liability, private passenger auto, auto physical damage	41 states
Red Rock Insurance Company	8/21/14	OK	$37,553,715	Workers' compensation, commercial multi-peril, other liability, commercial auto liability, auto physical damage, aircraft, surety, credit	All states except FL and NH

For comprehensive information on the companies the guaranty funds are handling with payout information, please see our assessment and financial history reports on our Web site by clicking here.

ESTATE DISTRIBUTION AND CLOSING EFFORTS

A important component of the guaranty funds' ability to pay claims of insolvent insurance companies in a timely manner is the distribution of remaining assets of the insolvent estates. Guaranty funds work together with estate liquidators to ensure that guaranty fund loss and expense payments are reported on a timely basis and legal documentation is in place to permit available funds to flow to the guaranty associations on an expedited basis.

In 2014, distributions were received by guaranty associations totaling more than $750 million.

In 2015, distributions of $36 million have so far been received; these are related to the Integrity Insurance Company estate.

ESTATES CLOSED OR NEARING CLOSURE

The Integrity liquidator is now making the final distribution to the claimants. This estate will be closing after 28 years.

Credit General Indemnity Company was closed in late 2013. In 2014 the Ohio Liquidator also closed the LMI and Credit General Insurance Company estates. These estates were large Ohio domiciled liquidations with significant workers compensation claims.

The American Mutual insolvencies are also moving toward closure, with $110 million distributed in 2011. The court approved an additional $50 million in the fall of 2012, which was distrbuted to the guaranty funds in October 2012. In these cases the receivers needed to determine values with the guaranty funds on remaining blocks of open claims: in particular, long-term workers' compensation cases. These estates represent cases in which the guaranty funds may be servicing claims for an extended period after the estate closes.

The Coronet Insurance Company, an Illinois domiciled insolvency, was closed at the end of 2013. Millers Insurance Company, a Texas domestic, was closed on December 9, 2013.

RUN-OFF PROPOSALS

In some cases a state regulator will attempt to resolve a troubled company's claims by means other than a statutory liquidation. In these cases the guaranty funds are not activated. Proponents of alternative approaches cite orderly claims processing, low cost, and greater flexibility to achieve commercially acceptable results. However, the efficiency and cost-effectiveness of a liquidation alternative – compared to a statutory liquidation – to our knowledge has never been established. In fact, there are many questions about how a prolonged run-off, versus a statutory liquidation, would impact the various stakeholders, including policy claimants. The status of active run-offs follow.

HIGHLANDS

Highlands was placed into receivership in Travis County, Texas, in November 2003. In 2007 the court approved the Second Amended Plan of Rehabilitation. Under the terms of the plan, the receiver was ordered to administer a monitoring plan to ensure the estate will continue to have sufficient funds to pay the company's claims as they come due. As of December 31, 2014, the estate held total assets of $163 million against total liabilities of $344 million. The company is expected to remain in run-off for the forseeable future. The receiver continues to provide the coordinating committee with periodic updates.

LINCOLN GENERAL

On February 9, 2009, Lincoln General discontinued the writing of new business and began a process that would result in a voluntary, solvent run-off of all business. The company continues to operate in run-off with a surplus of approximately $1.3 million as reported on its September 2014 Quarterly Statement. The acquisition of control by Tawa plc ("Tawa") of Lincoln General Insurance Company was approved by the Pennsylvania Insurance Department on October 5, 2011. Tawa is an entity that manages the run-off of non-life insurance companies and portfolios of policies.

NAIC ADOPTION OF NEW INSURANCE REGULATIONS

The financial crisis has brought about increased efforts to globalize regulation and accounting principles. Many changes have already occurred in major insurance markets, including those in the U.S. and Europe. These insurance regulatory and accounting changes could potentially impact guaranty funds and the ability to detect insolvencies. Some of the changes the NCIGF has been watching include the following:

NAIC'S Own Risk and Solvency Assessment (ORSA): The first significant new addition to U.S. insurance regulation is the U.S. Own Risk Solvency Assessment (ORSA). On September 12, 2012, the NAIC adopted the ORSA Model Act, which will be a regulator resource to assess and monitor insurers' and groups' risk management processes; it also will align regulatory requirements with business practices and the insurers' ability to withstand stresses. According

to the NAIC website, "the ORSA concept is now embedded in the International Association of Insurance Supervisors (IAIS) standards and is in various stages of implementation in the U.S., Europe and other jurisdictions."

The Model Act provides for an effective date of January 1, 2015.

An annual ORSA report will be required by large insurers (at least $500 million in annual premiums that are part of an insurance group with at least $1 billion in annual premiums). Under certain circumstances, the report could be requested by state regulators, federal agencies, or international insurance supervisors.

The NAIC adopted the ORSA Guidance Manual in March 2011. The manual provides general guidance to an insurer or insurance group for completing the annual ORSA report.

Corporate Governance Annual Disclosure Model Act: At the 2014 Fall National Meeting, the NAIC formally adopted the Corporate Governance Annual Disclosure Model and corresponding Model Regulations (CGAD). "Adoption of CGAD is the culmination of nearly five years of efforts by the NAIC to address concerns over the perceived lack of effective corporate governance practices and Board and senior management oversight of critical risk areas as part of the 'lessons learned' from the recent financial crisis. Beginning in 2016, the new requirement is intended to give U.S. regulators insight into the governance framework and practices of all U.S. insurers." [4]

The CGAD applies to <u>all insurers,</u> regardless of size.

The purpose and scope of the CGAD is to:

1. Provide the Insurance Commissioner a summary of an insurer's or insurance group's corporate governance structure, policies and practices to permit the Insurance Commissioner to gain and maintain an understanding of the insurer's corporate goverance framework.

2. Outline the requirements for completing a corporate governance annual disclosure with the Insurance Commissioner.

3. Provide for the confidential treatment of the corporate governance annual disclosure and related information that will contain confidential and sensitive information related to an insurer's or insurance group's internal operations and proprietary and trade secret information which, if made public, could potentially cause the insurer or insurance group competitive harm or disadvantage.

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[4] Roggenbaum, Frances R., Heinnickel, Jeremy F. *Insurance Practice Alert.* November 2014.

The model act provides the Insurance Commisser broad authority to dig deeper for additional information and retain third party consultants, at the insurers' expense, for assistance reviewing the CGAD and related information. There are confidentiality requirements throughout the Model for all parties receiving the information, but this may be difficult in practice to maintain. Industry pushed back with regulators over the last five years to get the appropriate amount of confidentiality included in this new requirement. The commissioner may, upon request, share documents with other state, federal and international financial regulatory agencies.

FUTURE OF GAAP AND STATUTORY ACCOUNTING: For a number of years the international and U.S. accounting board (IASB and FASB) have been working on a joint project that seeks to converge to a single set of global accounting standards. Because Statutory Accounting evaluates Generally Accepted Accounting Principles (GAAP) accounting and makes adjustments when called for, Statutory Accounting will be affected by whichever method (U.S. GAAP vs. International Financial Reporting Standards (IFRS) is adopted by the U.S. Some maintain it may be more difficult to assess solvency if the U.S. moves toward IFRS, because the framework is principles-based, and therefore more subjective than the U.S. rules-based method.

The NAIC will make policy decisions regarding IFRS after the Securities Exchange Commission's (SEC) decision. An SEC convergence decision is pending completion of priority projects: financial instruments, leases, revenue recognition, and insurance contracts. The SEC's final staff report released in 2012 was expected to make a recommendation regarding using IFRS. The report identified areas and factors relevant as to whether, when, and how the U.S. system is transitioned to IFRS. The report also noted that IFRS is not supported by the vast majority of participants in U.S. capital markets and is not consistent with methods employed by other major capital markets. [5]

INSURANCE CONTRACTS: Another item of interest is the U.S.-based Financial Accounting Standards Board (FASB) and London-based International Accounting Standards Board's (IASB) convergence project on insurance contracts. Despite pressures from the G20, convergence on insurance contracts will not occur. The IASB's initial exposure draft did not distinguish the differences in practices between life insurers and property and casualty insurers, especially in regard to short-term contracts. The IASB issued a revised exposure draft late June 2013 that built on previous consultations from 2007 and 2010. During the same week in June 2013, the FASB issued a proposed updated GAAP standard for insurance contracts. Both the IASB and FASB proposals were open for comment until October 25, 2013.

The FASB met on February 19, 2014 and determined it would scale back the scope of its insurance contracts project and focus on making targeted improvements to the current guidance for long-duration contracts and improve disclosures for short-duration contracts. The FASB also

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[5] Roggenbaum, Frances R., Heinnickel, Jeremy F. *Insurance Practice Alert.* November 2014.

indicated that the project would no longer focus on converging U.S. GAAP and IFRS. In deciding to focus on disclosures for short-duration contracts, the FASB noted that insurers and users of the financial statements said the current model provides reasonable measurement and recognition guidance. The IASB is moving ahead with its proposal.

IN THE STATES

CONNECTICUT (HB 6951) Legislation has been introduced in Connecticut to update the Insurers Rehabilitation and Liquidation Act to reflect provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act.

FLORIDA (HB 557) A bill revising the assessment process for the Florida Insurance Guaranty Association (FIGA) has been introduced.

ILLINOIS (SB 1805) Illinois is considering legislation to enhance collateral requirements for certain large deductible programs. The current proposal would revise the insurance code to strengthen collateral requirements, strengthen eligibility requirements for carriers authorized to write large deductible policies and strengthen requirements for policyholder eligibility to qualify to purchase large deductible policies.

MISSOURI (HB 609) has been introduced in the Missouri legislature to enact legislation to clarify the rights and responsibilities of the receivers and guaranty funds when insolvent companies are involved with large deductible insurance programs. The Missouri legislation calls for deductible collections and collateral drawdowns to inure 100 percent to the benefit of the guaranty associations to the extent of their claim payments.

OKLAHOMA Oklahoma may float legislation this year to address handling of large deductible programs for insolvent insurance companies. Recent Oklahoma domiciled insolvencies have included these arrangements. Any bill introduced would likely be similar to the Missouri proposal.

AT THE NAIC

NEW RECEIVERSHIP AND INSOLVENCY TASK FORCE (RITF) CHAIRMAN. Upon the departure of Jim Mumford (Iowa), California has been designated to chair the Receivership and Insolvency Task Force (RITF). We expect that John Finston will preside over most RITF meetings and activities.

TITLE INSURANCE GUARANTY FUND. A proposal was exposed to create a separate guaranty fund for title insurance claims. This proposal would not be an NAIC model, but rather a statute guideline that states could use.

MODEL ACTS WORKING GROUP. A list of provisions from the NAIC Insurer Receivership Model Act (IRMA), and the property casualty and life and health guaranty fund acts, was circulated for comments regarding which elements are necessary for uniformity and a smoothly functioning insolvency system. At this point the Working Group appears to be satisfied that coverage provisions in both the property casualty and life and health guaranty fund state laws are substantially uniform.

Future efforts will focus on IRMA. We expect interested parties to closely monitor this process, as several provisions in the IRMA model adopted by the NAIC may elicit controversy.

TO LEARN MORE…

More information about the property and casualty guaranty fund system is available on our Web site at http://www.ncigf.org

Look for a new issue of NCIGF's *Insolvency Trends* in July 2015.

The NCIGF is a nonprofit association incorporated in December 1989 and designed to provide national assistance and support to the property and casualty guaranty funds located in each of the fifty states and the District of Columbia.

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