Insolvency Trends – 2009
An Annual Publication of the National Conference of Insurance Guaranty Funds

Welcome to the 2009 edition of Insolvency Trends. Authored by the legal and public policy staff of the National Conference of Insurance Guaranty Funds (NCIGF), this paper provides an update on recent events in insolvency law and practice and a look ahead at what is on the horizon in 2009.

Overview: A crisis in search of a bottom

With the fall of 2008 came what now many regard as the worst financial crisis since the Great Depression. Although no property and casualty insurance companies failed in 2008, last year's dramatic developments fueled a widespread interest in the nationwide guaranty fund system – how it works, who it serves and the system's ability to handle a new wave of insolvency-related claims. For this reason, the NCIGF opens this issue of Trends with a primer on the property and casualty guaranty fund system. Readers may find it helpful in understanding how the 40 year-old system plays a role in the financial protection of insurance policyholders. (For more information on the guaranty fund system visit the NCIGF's Web site at www.ncigf.org.)

A Framework of Policyholder Protection: A Primer on the Nationwide Property and Casualty Guaranty Fund System

The guaranty fund system is rooted in public policy established by America's state legislatures almost 40 years ago; the system delivers financial protection for those least able to deal with an insolvency-related uninsured loss.

Insurance companies are different from other businesses in that they are liquidated under state law rather than the federal bankruptcy laws. The state-based nationwide guaranty fund system serves as a backstop that pays outstanding claims against insolvent insurers.

Property and casualty guaranty funds have been established in every state, the District of Columbia, Puerto Rico and the Virgin Islands. They are created by state law, most of which were enacted in the late 60s or early 70s. In most jurisdictions a guaranty fund is activated or "triggered" when a state court finds that an insurance company is insolvent and has issued a final order of liquidation.

Once an insurance company is insolvent and the liquidation process begins, the claim files are transferred to the state property and casualty guaranty funds. Guaranty fund staffs review and adjust "covered" claims in a similar fashion to claims adjusters in a solvent company; in essence, they "step into the shoes" of the insolvent company to pay outstanding claims.

The property and casualty guaranty funds cover a wide range of licensed business of property casualty companies. There are some exceptions and statutory parameters for coverage that in some cases may be different from policy limits; these are outlined on the NCIGF Web site at www.ncigf.org. (Claims for insolvent life and health insurance companies are covered by a separate guaranty fund mechanism. More information about this system is available from the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) www. nolhga.com.

While assessments to member insurance companies help fund the guaranty fund system, it is not the only source guaranty funds draw on to pay claims. In addition to assessments, state guaranty funds fulfill their statutory duties to policyholders and claimants via funding from several other sources, including:

- The remaining assets of the failed insurance company. Per state statutes, these funds can often be made available to the guaranty funds on an expedited basis, and
- Statutory deposits that may have been collected in some states to secure the insurance companies claim payment obligations.

The 1990s brought a growing number of large insolvencies among insurers writing significant amounts of commercial insurance. Some recent insolvencies have involved complex multi-state commercial insurance products, such as large deductible policies. In addition, many of these insolvencies, such as Reliance Insurance Company, Fremont Indemnity Company and Legion Insurance Company, were larger than any the system had previously handled.

The guaranty funds have a long record of providing financial protection to policyholders and claimants impacted by insurance insolvencies. Payouts through 2007 are more than $23 billion. A chart containing a by-year breakout is attached. More information related to the guaranty fund payouts, assessments and related data is available at the NCIGF Web site at http://www.ncigf.org/industry-assessment.asp.

The statutory framework of the fund system enables states to supplement its statutorily-defined assessment system with a variety of tools when necessary. These include bond issues, loans and legislatively authorized assessment increases, among them.

Current Trends

IRMA

The Insurer Receivership Model Act (IRMA,) the National Association of Insurance Commissioners' (NAIC) model liquidation act, was adopted in final form in December of 2005; and some modifications, including a large deductible statute, were added in 2007.

IRMA continues to be a matter of discussion and occasional debate in the states. However, no IRMA bills were introduced in the 2008 legislative sessions. Extensive dialog took place in Pennsylvania, but the Insurance Department did not introduce an IRMA bill. Whether the effort will be renewed in 2009 is unclear.

Some initial discussion about adopting IRMA took place in Tennessee – the Insurance Department hoped that the IRMA model would address many issues related to insolvency matters. However, after some initial meetings no comprehensive legislation was introduced.

Of keen interest last year was what the NAIC's Financial Regulation Standards and Accreditation (F) Committee (FRSAC) would do with suggested specific provisions of IRMA that were proposed for consideration as accreditation standards. Many groups weighed in, including the NCIGF and NOLHGA.

State legislators openly expressed opposition to an accreditation process that ties state certification to adoption of NAIC model laws and standards. This is because, they argued, it requires legislators to approve model laws that may not be suitable for their states.
Previously NCOIL had adopted a resolution opposed to specific accreditation standards for IRMA.[1]

Ultimately, the FRSAC voted to retain the insolvency standard in place now and substitute IRMA nomenclature. The new standard was exposed for a one-year comment period in January of 2008. When asked, the FRSAC chair opined that those states with “old” NAIC liquidation act language would ***not*** have to adopt the IRMA format to maintain accredited status.

Large Deductibles

A large deductible policy is an insurance contract in which the financial risk of the insurance is shared by agreement between the insurer and the policyholder through the use of deductible endorsements on insurance policies.

Normally, large deductibles are employed in certain workers’ compensation policies; however, large deductibles may also show up in automobile and general liability policies. The deductible amount for these programs typically exceeds $100,000.

Under terms of such a policy the policyholder agrees to reimburse the insurer, per claim, dollar for dollar up to the deductible amount. A standard large deductible policy and endorsement provide that the insurer will initially pay claims, and the policyholder will thereafter reimburse the insurer for amounts within the large deductible. The character of the large deductible asset in the context of an insurance liquidation has been a matter of lively and pointed discussion. So far, seven states have enacted large deductible legislation, all of it calling for assets to flow at 100 percent to the guaranty funds to the extent of their claim payments.[2]

The debate may be changed somewhat by the enactment of legislation in California which deals with deposit amounts collected on large deductible programs. For insurance companies domiciled in states that call for any part of the deductible reimbursement or draw downs on collateral post liquidation to be general assets of the insolvent estate, deposits would be collected without regard to the deductible amount and the collateral posted to secure the reimbursements. This would mean substantially higher deposits would be required from insurance companies domiciled in those states.[3]

Insurance Liquidation – Is There A Better Way?

A Task Force has been formed at the NAIC to study restructuring mechanisms for troubled companies. The charge of this task force is to:

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[1] NCOIL Resolution Regarding Efforts to Make Insurer Receivership Model Act (“IRMA”) Provisions Part of the NAIC Accreditation Standards adopted. July 22, 2006. This resolution reads in part “…BE IT RESOLVED that NCOIL opposes including post-solvency receivership standards in the solvency-based accreditation system…”

[2] California: Cal. Ins. Code § 1033.5; Illinois: ILCS 5/205.1; Michigan: MCL 500.8133a; Pennsylvania: 40 P.S. § 221.23(a) Texas: Tex. Ins. Code § 21A.213; Utah: UT § 31A-27a-612(6) Related legislation is also in place in New Jersey: NJC § 34:15-111.

[3] Cal. Ins. Code §11691.

Undertake a study of solvent schemes of arrangement (solvent run-offs) and Part VII portfolio transfers (a transfer leaving no recourse to original contractual obligor/insurer) and any other similar restructuring mechanisms to gain an understanding of (i) how these mechanisms are utilized and implemented; (ii) the potential affect on claims of domestic companies, including the consideration of preferential treatment within current laws; (iii) how alien insurers (including off-shore reinsurers) who have utilized these mechanisms might affect the solvency of domestic companies; and (iv) best practices for state insurance departments to consider if utilizing similar mechanisms in the United States and/or interacting with aliens who have implemented these mechanisms.

The subgroup is chaired by Kathryn Belfi, a regulator from Connecticut. The NCIGF expects a white paper to be finalized by the NAIC sometime in 2009.

The current system of liquidation statutes and guaranty fund statutes are based on a clear public policy objective of protecting consumers. The NCIGF suggests that the objective of protecting consumers should form the foundation of any alternative mechanism for dealing with any troubled insurers.

Other groups continue to be intrigued by this mechanism. We understand a run off statute draft has been developed by The Association of Insurance & Reinsurance Run-Off Companies (AIRROC.) To the best of our knowledge it has not been approved by the AIRROC board of directors.

Notably, only one state, Rhode Island, has enacted legislation to permit these alternative arrangements for troubled companies. To our knowledge it has never been used.

Run-Off in Real Life

Despite the existence of specific statutory guidance in most states, several "troubled" companies are being run off under existing law.

Frontier Insurance Company

Frontier Insurance Company was placed into rehabilitation in October 2001. Since that time, the rehabilitator has been paying claims and has stated its desire to see Frontier eventually returned to financial health. According to Frontier's 2007 annual statement, as of year end 2007, it had a negative surplus of $103 million. It is unclear how the rehabilitator's plan will be affected by the current financial downturn.

Kemper

The run-off continues to progress. As of the 2007 Annual Statement the companies had $752,502,924 in direct losses unpaid. This compares to $3,037,336,763 in 2002.

Early Access

Early Access is money released from the insolvent estate to the guaranty associations to assist with claim payments of the associations. These funds are subject to call-back by the liquidator if needed to pay higher priority claims.

Early access distributions for the property and casualty guaranty associations in 2008 topped out at about $489,500,000. In addition, about $166,000,000 in interim and final distributions were made on several California estates. Every dollar distributed from the insolvent estates reduces assessments against member carriers and the costs to consumers and taxpayers.

2008 Guaranty Fund Law Update

Developments in guaranty fund laws in 2008 include:

Alabama A bill to increase the assessment cap for the workers' compensation line of business was developed. The bill also included revisions to covered claim cap language to avoid claims stacking and revisions to the net worth statute already in place. The proposals were introduced in the Alabama legislature as two separate bills – one that included the increase in assessment cap and the other the additional guaranty fund act amendments. The bills failed to pass in the 2007 session. Similar bills were introduced in 2008. The assessment increase legislation was enacted. The bill containing an adjustment to net worth language and other changes failed; however, this is something we expect to see introduced in the 2009 session.

California California's Insurance Guarantee Association Act was amended in 2008 to open to the public all meetings of the association's board of governors and its investment and audit committee.[4] The new provisions apply to meetings conducted in person and via teleconference. Notice of meetings and an agenda of items to be discussed shall be provided at least 10 days in advance of the meeting via the association's Web site, and published in a newspaper of general circulation in the State of California, as well as via regular mail or by e-mail if such request is made in writing. Further provisions provide notice exceptions, and when meetings may be conducted in a closed meeting or session.

Georgia Association and industrial insured captive insurance companies issuing workers' compensation insurance contracts were permitted to join and receive benefits from the Georgia Insurers Insolvency Pool (Chapter 36) as to workers' compensation only on and after January 1, 2008. These captive insurance companies are also liable as to assessments and for all obligations under Chapter 36 for workers' compensation only. In addition, the Georgia Insurers Insolvency Pool shall not be liable for any claims incurred by any captive insurance company before January 1, 2008. [5]

Hawaii and Rhode Island These states considered guaranty fund legislation based on the NCOIL model. However, no action was taken in 2008.

Mississippi In 2009 we might see Mississippi on the move – possibly adding a net worth limitation and a bar date to its act.

West Virginia In July "the state's workers' compensation business opened up to any insurer that meets state requirements. Before, coverage was only available from the state-run mutual company." [6] As a result workers' compensation was added as a covered line of the West Virginia guaranty fund.

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[4] See Cal. Ins. Code §1063.17.
[5] GA ST. § 33-41-20
[6] III Issues Update November 2008.

The NAIC Model The NAIC continues to discuss the property and casualty model guaranty fund act. A draft was adopted by the Financial Condition ("E") Committee at its December meeting. It is likely to be adopted by Executive and Plenary Committees early in 2009. This new model would 1) raise the covered claim cap to $500,000, 2) drop language calling for the liquidator to be bound by the claims determinations of the guaranty associations, 3) afford broad coverage for claims on assumed business – whether or not the ceding entity was a guaranty fund covered insurer, and 4) retain a claims filing deadline tied to the date established by the liquidation court. The new model would also include an optional net worth limitation.

Reinsurance Collateral

For some time, the NAIC's Reinsurance Task Force has been debating a new approach for working with non-U.S. reinsurers doing business in the United States. The Task Force has been developing a Reinsurance Regulatory Modernization Framework Proposal. This proposal was adopted by the Task Force and the E Committee at the Washington D.C. meeting this September. According to NAIC staff prepared materials, components of the proposal include the following:

- Two classes of reinsurers are established: national reinsurers (U.S.) and port of entry (POE) reinsurers (non-U.S.) "In order to transact assumed reinsurance business in the U.S. national reinsurers would be licensed through a single 'home state' and POE reinsurers would be certified through a single 'POE state.'" [7]

- The NAIC Reinsurance Supervision Review Department (RSRD) is established. The RSRD would be responsible for evaluating which jurisdictions would be eligible to be recognized by a POE supervisor. "The RSRD would also be responsible for establishing uniform standards for a state to qualify as either a home state supervisor or a POE supervisor." [8]

- Home state and POE supervisors would be responsible for evaluating their respective national and POE reinsurers to establish an appropriate supervisory rating. A national or POE reinsurer's collateral requirements for contracts entered into or renewed under the framework would be determined by its assigned supervisory rating.

Still of much concern to interested parties are the collateral requirements embodied in the proposal. The proposal calls for reinsurers to be assigned one of five different rating classes with collateral requirements ranging from 0-100 percent.

NCIGF weighed in with comments expressing concern that reinsurance would likely be more difficult to collect in a liquidation context when collateral is non existent or less accessible.

We are advised that a modification to federal law would be needed to implement the new proposal. Many expect a proposal to be introduced early in the 2009 Congress; however, in the current economic climate it is hard to imagine such a bill would have much traction.

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[7] Reinsurance (E) Task Force, Meeting Summary and Action Items (September 22, 2008)
[8] ID

SSAP 35

Adopted in 2001, SSAP No. 35 (Guaranty Fund and Other Assessments) requires an insurer to record a liability for guaranty fund assessments resulting from an insolvency/liquidation of an insurer. The liability estimate to be recorded is the ultimate loss expected from known insolvent insurance estates. Property and casualty insurers have experienced great difficulty getting enough current information to calculate the ultimate expected assessment exposure. A survey performed by industry in 2006 indicated that property and casualty insurers did not appear to have any consistency in their estimates in applying the current SSAP 35 guidance.

The NAIC Statutory Accounting Principles Working Group formed a subgroup in 2006 to reconsider SSAP 35. A letter addressed to the Chairman of the SSAP 35 Subgroup from Interested Parties dated November 7, 2008 stated that adopting AICPA Statement of Position 97-3 (Accounting by Insurance and Other Insurance Related Assessments) with certain exceptions taken from SSAP 35 would bring consistency in reporting by property and casualty insurers in three ways: 1) proposed changes would result in a consistent methodology of estimating assessments that is based upon available information, ensuring more consistency and reliability in property and casualty insurers' estimates; 2) the proposed approach is more consistent with the manner in which property and casualty insurers are addressed under state guaranty fund assessment statutes; and 3) the proposed changes would improve the ability to audit property and casualty insurers' estimates.

SSAP 35 was briefly addressed by the Working Group at their December 2008 meeting. The Working Group stated that interested parties' proposed adoption of AICPA Statement of Position 97-3 with certain exceptions taken from SSAP 35 is being considered by the Subgroup.

The AICPA SOP 97-3 takes the approach that two events must occur to trigger liability for post-insolvency assessments: 1) the insolvency itself and 2) the writing of the premium in the base year for guaranty fund assessments. The liability to be recorded is what can be reasonably estimated and relates to premium writings for the year preceding the year of assessments. This estimate coincides with the way the majority of guaranty funds make assessments, which is also based on premiums for the year preceding the year of assessments.

Guaranty Fund Strategic Planning Readies System to Meet Future Challenges

A significant development within the guaranty fund system was ongoing work on the NCIGF's Strategic Plan.

Through this effort the property and casualty guaranty funds have undertaken a thoughtful, candid and broad-based self-examination of the culture and process of the state system through a strategic planning initiative created by the NCIGF board of directors.

The initiative, which began in January 2006, evolved into the most ambitious self-examination of the state guaranty fund system in its history. As part of the effort, the NCIGF sought and received the participation of all the guaranty funds' insolvency partners, including receivers. The goal was to assess how the guaranty fund system and the NCIGF perform on key fronts, and how the guaranty funds can improve in insolvency administration. The initiative is providing the foundation for the future of the property and casualty guaranty fund system, and helping chart the future of the system and the NCIGF.

Goals also include analyzing the challenges facing the property and casualty guaranty funds, the challenges the guaranty funds will face in the future, and offer direction on how the NCIGF could work more effectively and efficiently to help its members fulfill the core mission of "paying the claims of insolvent insurers."

The plan, *Putting Consumers First: The State Guaranty Funds Moving Forward Together*, voices a strategic and tactical vision for the guaranty fund system and the NCIGF, the system's support organization.

In 2009 and beyond, the plan will guide an ongoing assessment and evolution of the guaranty fund system and the role of the NCIGF. It will also drive many of the changes that will continually improve the system's ability to deliver on the mandate that was given to it by policymakers nearly 40 years ago – to protect policyholders and claimants.

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, Puerto Rico and the District of Columbia.

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