Insolvency Trends 2010 – Mid Year Report
A Publication of the National Conference of Insurance Guaranty Funds

Welcome to the 2010 mid-year issue of the NCIGF's 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 the coming year.

Property and Casualty Guaranty Funds: Built to Work – and delivering for 40 Years

The guaranty fund system was established in 1968 by the property and casualty insurance industry, insurance regulators and states to fulfill a public policy imperative: to provide a safety net that protects insurance consumers if an insurance company fails.

The guaranty fund system is an innovative and common-sense mechanism. The system draws first on the assets of the failed insurance company before turning to assessments on healthy insurers in each state. Since inception the system has paid out more than $24 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.

2010 has proven to be an eventful year in the insurance insolvency world

Developments on Capitol Hill related to Financial Services Regulation have been front-and-center throughout 2010.

GUARANTY FUNDS WORK

in partnership with insurance regulators to protect policyholders.

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

Policyholder claims 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) cash already on deposit with state regulators 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)
- Funds deposited with state regulators 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

The Dodd-Frank Wall Street Reform and Consumer Protection Act creates a new system for regulating large, interconnected bank holding companies and nonbank financial companies whose distress or failure could threaten the financial stability of the United States.

Oversight and Resolution Authority

Large, interconnected financial companies that are systemically significant will be identified by a Financial Stability Oversight Council chaired by the Treasury Secretary Timothy Geithner. (This could include insurance companies and insurance holding companies, although most observers contend that few – if any – insurers are systemically significant.) Once identified, these large financial companies will be subject to stringent regulation by the Federal Reserve Board.

The legislation also creates a new mechanism for liquidating systemically significant financial companies whose failure could destabilize the economy. **While the FDIC will be appointed receiver of – and liquidate – most types of financial companies, insolvent insurers (including any that are systemically significant) will <u>remain</u> subject to state receivership and guaranty association processes.**

The only exception would be if a department of insurance in a state where a troubled company is domiciled fails to act sufficiently quickly; this would lead to a triggering of the FDIC's "backup authority." The state would have 60 days to act. Resolution of systemically significant financial companies will be funded by a post-liquidation resolution fund. If any insurers are tapped to contribute to such a fund, they will get a credit for guaranty fund assessments already paid. Even though insurer insolvencies will be conducted under state law, the FDIC could be appointed receiver of certain subsidiaries of an insurance company if they are in default or in danger of default, their failure would have a significant adverse effect on the U.S. economy, and certain other criteria are met. However, it is unlikely the FDIC would step in because few, if any, subsidiaries would be systemically significant.

Federal Insurance Office

The legislation requires the Federal Insurance Office Director to conduct a study on how to improve and modernize insurance regulation, the results of which will be reported to Congress no later than January 2012. As part of the study, the FIO is charged with examining the potential consequences of subjecting insurance companies to a federal resolution authority, including the effects of any federal resolution authority on:

- The operation of state insurance guaranty fund systems, including the loss of guaranty fund coverage if an insurance company is subject to a federal resolution authority; and
- Policyholder protection, including the loss of the priority status of policyholder claims over other unsecured general creditor claims.

When it comes to insurance company receiverships, the financial reform legislation maintains the status quo, but opens the door for a discussion of significant future changes in the guaranty fund system.

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The Guaranty System

Under terms of the legislation, large, interconnected financial companies that are systemically significant will be subject to oversight by the Federal Reserve Board. This could include insurance companies and insurance holding companies, although most observers contend that few (if any) insurers are systemically significant. The FDIC will resolve systemically significant financial companies other than insurance companies.

In addition:

- All insurance companies (including any that are systemically significant) will remain subject to state insurance insolvency laws.

- The guaranty fund system's existing role in protecting policyholders will remain intact.

- Newly created Federal Insurance Office will study the possibility of subjecting insolvent insurance companies to a federal resolution authority, including its impact on the guaranty system. [1]

In the States…

The state legislatures were active this year in reviewing new proposals for the guaranty funds and the insurance liquidation acts. With the encouragement of the National Association of Insurance Commissioners, (NAIC) several states discussed, and many floated bills, to institute provisions of the NAIC model property casualty guaranty fund act adopted by the NAIC last spring. Notably, Oklahoma enacted the model into a new law. A bill is on the governor's desk in Louisiana which would up the covered claim cap to $500,000 and revise the act's net worth provisions as seen in the NAIC model. In Rhode Island new law would add the assumed business coverage provisions from the NAIC model along with other NAIC-styled changes.

More targeted efforts were afoot in Iowa and Illinois – both of which had legislation introduced to increase the guaranty association covered claim cap to $500,000, which is consistent with the new NAIC model. The bill is enacted in Iowa and has passed both houses in the Illinois legislature. Florida merged two separate auto assessment accounts in the property casualty guaranty fund.

While it's been some time since anyone has attempted to propose a comprehensive liquidation act bill based on the IRMA Model (Insurer Receivership Model Act), we have seen IRMA language regarding treatment of swaps and derivatives, investment vehicles used by insurance companies, being proposed in several states. Notably Illinois, Minnesota and Missouri have floated such proposals.

More New Insolvency Activity

On May 12, 2010, Imperial Casualty and Indemnity was placed into liquidation by order of the District Court of Oklahoma County, Oklahoma. Imperial had been in receivership since March 18, 2010.

The company was licensed to write property and casualty insurance in forty six states plus the District of Columbia. Its only line of business written was large deductible workers' compensation insurance. Like sister

[1] For the foregoing, the NCIGF thanks Charles Richardson, Baker and Daniels, LLC.

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company Park Avenue, which was liquidated in November 2009, coverage was written primarily to Professional Employer Organizations (PEOs). As of the date of liquidation there were approximately 476 open claim files. The liquidation order terminates all policies issued by Imperial as of June 11, 2010.

Another Oklahoma company, Pegasus Insurance Company, was recently ordered into rehabilitation. If the company liquidates, several guaranty funds will be triggered and begin handling the company's claims.

While none of these companies have near the magnitude of policyholder claims that the guaranty fund system handled in the early 2000s such as those in the Reliance and Fremont insolvencies, both the Park Avenue and Imperial matters were short-fused, complex, and include claims of injured workers and other claimants whose claims payments would be jeopardized were it not for the guaranty funds. That these insolvencies continue to occur again demonstrates the continued need for a guaranty fund system that is prepared to handle covered claims of insurance consumers.

The Florida guaranty funds continue to be busy handling claim operations. Recent insolvencies for which the Florida guaranty funds are handling claims include First Commercial Insurance Company (workers' comp, auto, property), First Commercial Transportation and Property Insurance Company (commercial auto), American Keystone Insurance Company (property), Park Avenue Property & Casualty Insurance Co. (workers' comp), Northern Capital Insurance Company (auto, property) and Magnolia Insurance Company (property).

Closing efforts – estate distributions

Closing efforts continue in several jurisdictions.

American Mutual Liability Insurance Company anticipates a distribution of approximately $110 million dollars this summer. This estate is in the process of resolving remaining open claims with the guaranty funds on long tail workers' compensation liabilities with a view towards closing in the near future.

On April 26, the liquidator of PHICO, a Pennsylvania medical malpractice company, filed a petition to distribute an additional $163 million to the guaranty funds. PHICO has shut down its standalone operation and takes care of the estate's remaining business out of the Harrisburg, PA Department of Insurance offices.

The liquidator of Credit General Insurance Company and Credit General Indemnity Company, via pleadings filed May 25 of this year, sought and obtained approval for a petition to distribute $12 million as a partial administrative expense distribution to the funds. Checks were mailed on July 1. The Credit General Companies, Ohio domiciled insurance carriers, were liquidated in December of 2000 and January of 2001.

Reliance made a distribution of almost $400 million this spring. This large estate, which was liquidated in October of 2001, has distributed $1.7 billion dollars relating to $3.7 billion in incurred loss payments since the guaranty funds were triggered.

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SSAP 35 and now 35R – new issues at the NAIC

The NAIC continues to grapple with statutory accounting rules regarding reporting of guaranty association and other assessments. While a fix, in the form of SSAP 35R, was developed that appeared to be acceptable to all relating to property casualty reporting, it poses new issues that impact life and health insurers.

Under SSAP 35R, life companies would continue to record assessments for future expected charges. However, any premium tax offsets would be non-admitted assets until the assessments have been paid. An "interested parties" March 11, 2010 letter to the subgroup recommends that life companies "admit guaranty fund assets related to future premium assessments based on prior histories of premiums written on in-force policies, considering appropriate persistency rates."

After additional discussion the working group agreed to expose for comments Issue Paper 143, Prospective-Based Guaranty Fund Assessments, and proposed substantive revisions to SSAP No. 35 (now as SSAP No. 35R) to the full Working Group and Interested Parties. An interim conference call to discuss comments is anticipated prior to the August NAIC meeting.

To learn more…

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

Look for a new issue of NCIGF's Insolvency Trends early in 2011.

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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