» Insolvency

TRENDS

Summer 2014

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 2014 mid-year 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…

- FIO Report update
- International developments
- Federal developments, including the Dodd-Frank implementation
- Insurance insolvency developments; new liquidations this year 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.

Continuing Seamless Protection in the Era of Electronic Claims Records

Electronic communication and maintenance of records for any individual or business organization in electronic format is now standard practice – including for the insurance industry. When an insurance company liquidates and the guaranty funds step in to pay covered claims, all or many claims records may be electronic. This requires those involved in the insolvency process to be able to complete the claims transition process in this new envioronment.

Receivers and guaranty funds now must factor in download time to move imaged claim records. In addition,several recent insolvencies have involved claims handling data distributed among several third-party administrators that may have differing electronic infrastrustures. We expect receivers and guaranty funds to continue to develop tools and processes to deal with electronic records to ensure seamless policy protection in this challenging new world. One thing is clear: advance insolvency planning and an ever-ready guaranty fund system are essential to future insolvency administration.

THE INTERNATIONAL SCENE: INSOLVENCY IN A WORLD ECONOMY

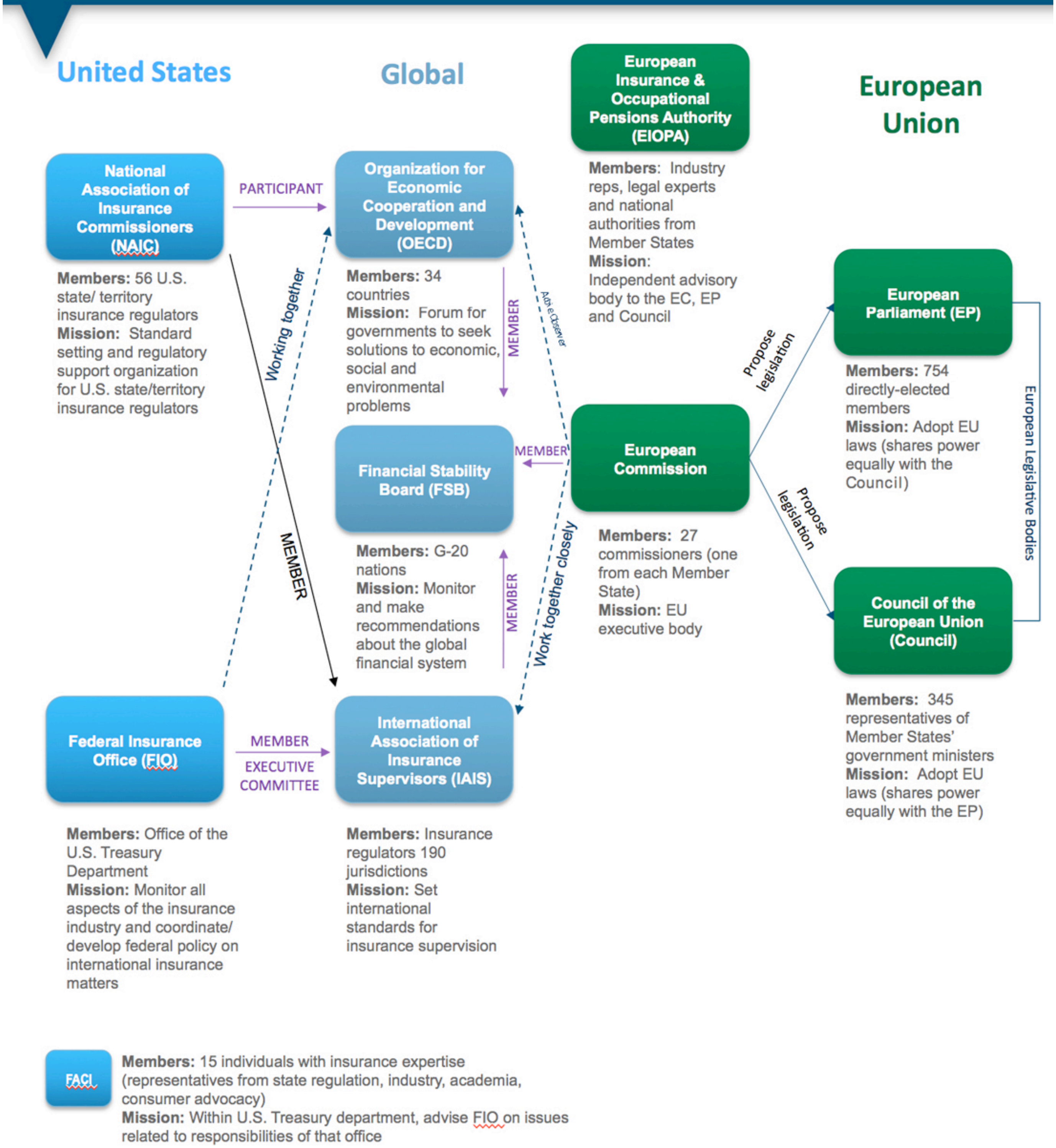
International issues have been at the forefront recently, both for banking and non-banking financial institutions such as insurance companies. Recently, a Federal Reserve Board representative observed: “[I]n many ways Title II has become a model resolution regime for the international community.” Recent commentary opines that the Fed’s global influence is increasingly relevant for insurers. When the Financial Stability Oversight Council (FSOC) designated AIG and Prudential as systemically important in the latter half of 2013[1], the Fed officially became an insurance regulator. After that, the Fed quickly sought membership in the International Association of Insurance Supervisors (IAIS) and is now a provisional member. The Fed now has the opportunity to influence international insurance regulation through the Financial Stability Board (FSB) and the IAIS.[2]

The chart on the following page depicts the various key groups impacting international insurance regulation.

[1] The FSOC voted in June 2013 to identify Systemically Important Financial Institutions (SIFIs). American International Group, GE Capital and Prudential were among those designated. Prudential had appealed the proposed decision to the FSOC in July 2013 but has since been notified it lost the appeal. Prudential has chosen not to pursue continued appeals in federal court.

[2] Kosnoff and Powell, “Learning from the Financial Crisis: How Federal and International Responses are Shaping the Future of Insurance Regulation and Receiverships.” FORC Quarterly Journal of Insurance Law and Regulation, Volume XXIV, Edition 4, Winter 2013.

Key Bodies Impacting International Insurance Regulation



DODD-FRANK: RESOLUTION OF SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

Enacted in 2010, 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 economy.

The law calls for large, interconnected financial companies that are systemically important to be identified by the Financial Stability Oversight Council (FSOC). Systemically important financial institutions might include insurance companies and insurance holding companies, although most observers contend that few, if any, insurers are systemically significant. Once identified, these companies will be subject to stringent regulation by the Federal Reserve Board.

The legislation also creates a new mechanism for liquidating systemically important financial institutions whose failure could destabilize the economy. **While the Federal Deposit Insurance Corporation (FDIC) will be appointed receiver of – and will liquidate – most types of financial companies, insolvent insurers (including any deemed systemically important) will remain subject to state receivership and guaranty association processes.**

INSURANCE CAPITAL AND ACCOUNTING STANDARDS ACT OF 2013 AND THE COLLINS AMENDMENT

On June 3, 2014 the United States Senate passed S. 1369 to give the Federal Reserve flexibility in setting capital standards for insurance companies. The so-called Collins Amendment of Dodd-Frank seeks to apply the FDIC's capital requirements for its insured banks as a floor for other capital requirements that would be established under Dodd-Frank.

The language of the Collins Amendment, which would amend Sec. 171 of Dodd-Frank, addresses the lack of flexibility of the Federal Reserve Board in applying these standards. This results in insurance companies being subject to bank-like capital requirements. At a hearing last year, then-Federal Reserve Board Chairman Ben Bernanke acknowledged that there was little flexibility in writing implementation rules and that legislation would likely be needed to deal with it.

The legislation is similar to H.R. 2140, the Insurance Capital and Accounting Standards Act of 2013 introduced in May by Representative Gary Miller (R-CA) and Representative Carolyn McCarthy (D-NY). Both bills seek to reserve the setting of capital standards to state regulatory bodies. The House bill goes a little further, however, by also removing the Fed's ability to regulate accounting standards for insurance companies.

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

There have been five insolvencies so far 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); and 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. The NCIGF staff assisted in various capacities in these new liquidations. New insolvencies that occurred in 2014 can be found in the following table.

Name of Company	Rehab Date	Liquidation Date	Direct Losses Unpaid	State of Domicile	Type of Company	States Licensed
CAGC Insurance Company	1/26/12	1/17/2014	$18 M 12/31/11	NC	Workers' compensation	NC, SC
Georgia Mutual Insurance, a Stock Company	N/A	2/7/2014	$2.6 M 12/31/12	GA	Private passenger auto, auto physical damage	GA, TN, AL (claims in GA only)
Professional Liability Insurance Company of America	4/30/10	2/10/2014	$26.1 M 12/31/09	NY	Medical Malpractice	31 states (claims in IL and MO only)
National Guaranty Insurance Company	N/A	5/6/14	$6.3 M 9/30/13	NV	Private passenger auto, auto physical damage	IN, NV (claims in NV only)
Sunshine State Insurance Company	N/A	6/3/2014	$9.1 M 12/31/13	FL	Fire, allied, inland marine, homeowners multiperil, other liability	FL, MS, SC

For comprehensive information on the companies the guaranty funds are handling with payout information, please see our Web site at http://www.ncigf.org.

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.

To date, in 2014 distributions have been recieved or proposed for distribution to guaranty associations totaling more than $25,426,592.

ESTATES NEARING CLOSURE

Estate closings continue in several jurisdictions. Credit General Indemnity Company was closed in late 2013. Credit General Insurance Company is making final preparations for closure. 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. Indicators also suggest one Illinois insolvency, the Coronet Insurance Company, is moving toward closure.

RECIPROCAL OF AMERICA

Reciprocal of America (ROA) was placed into liquidation in June 2003 in Virginia. The company wrote workers' compensation, professional liability, and general commercial liability policies. As of 2012, the estate has made distributions of 95 percent to policyholder-level claimants, with an additional 5 percent to the guaranty associations as early access. In 2012 the receiver announced its intention to sell the estate's entire block of workers' compensation insurance to an outside insurer in an effort to accelerate closure of the estate. In August 2013 the ROA liquidator filed a petition seeking the approval of the Loss Portfolio Transfer. The guaranty associations are working with the liquidator to develop file transfer protocols to facilitate the transfer of files to the purchaser when the transaction is approved by the court. Non-guaranty fund claimants have filed objections, although we anticipate the objections will be addressed and the court will approve the the Loss Portfolio Transfer sometime in 2014.

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 August 31, 2013, the estate held total assets of $187 million against total liabilities of $344 million. In June the guaranty funds' coordinating committee met with the Special Deputy Receiver and received an update on the runoff; the company is expected to remain in run-off for the forseeable future. The receiver will continue 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 $1,648,413 as reported on its 2013 Annual 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'S SOLVENCY MODERNIZATION INITIATIVE (SMI)

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 potentially impact the ability to detect insolvencies.

The NAIC consolidated its regulatory improvement and update efforts under its Solvency Modernization Initiative (SMI). According to the NAIC Web site: "SMI is a critical self-examination to update the United States' insurance solvency regulation framework and includes a review of international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in U.S. regulation." SMI has been described as the NAIC looking at all the "tools in its tool box" with a view toward deciding what stays, what goes, and what needs to be changed. The SMI (E) Task Force adopted an SMI White Paper, "The U.S. National State-Based System of Insurance Financial Regulation and the Solvency Modernization Initiative," on August 25, 2013. The white paper states its purpose is "to explain the U.S. solvency regulatory framework and how and why it works successfully," and also to "discuss the SMI self-evaluation and highlight the strengths of the national state-based system of insurance regulation and the improvements made over the last several years in the SMI." To view the SMI white paper, click here.

There are three topics the NAIC's Solvency Modernization Initiative is studying that could potentially have an impact on the property and casualty guaranty associations:

1) NAIC'S ORSA: The first is the NAIC'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. The NAIC's ORSA is expected to increase the chances that the U.S. insurance regulatory system will be viewed as "equivalent" to Europe's regulatory system under Solvency II. As encouraged by the industry, the ORSA will be less burdensome than Europe's to complete.

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.

2) FUTURE OF GAAP AND STATUTORY ACCOUNTING: The second item of interest is the international and U.S. accounting board (IASB and FASB) 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 whatever 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.

3) INSURANCE CONTRACTS: The third 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 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.

NAIC Receivership and Insolvency Task Force Considers Resolution Plans for Large Insurance Groups

At a conference call meeting on July 25 the National Association of Insurance Commissioners' (NAIC) Receivership and Insolvency Task Force (RITF) considered a charge to:

> Evaluate the benefits and costs associated with requiring resolution plans for large insurance groups. Develop guidance on resolution plans for states with

large insurance groups and address related issues developing in the federal and international standards.[3]

At this meeting little support was received for such resolution plans at the state level. Commenters noted that regulatory monitoring tools already existed in the states and implementation of such additional requirements would be costly. They also noted that property and casualty insurance companies rarely, if at all, create systemic risk; any companies that potentially would possibly pose risk under the terms established by Dodd-Frank, however, would be designated as SIFIs at the federal level.

At this meeting some discussion focused on the possibility of requiring companies in a financially troubled situation, where there was regulatory involvement, to prepare living wills. This could enhance the ability of regulators to plan for the possible transition of a company into statutory liquidation and facilitate the transition of claims handling to guaranty associations.

IN THE STATES…

ARIZONA SB 1013 – TRANSFER OF "SPECIAL FUND" TO PROPERTY AND CASUALTY GUARANTY FUND. Legislation has been enacted to transfer responsibility for the payment of workers' compensation claims from the Arizona Industrial Commission to the property and casualty guaranty fund. The new law calls for approximately $200 million to be transferred to the guaranty association to address current liabilities. The legislation is effective June 30, 2015.

DE SB 154 – FEDERAL HOME LOAN BANKS. Legislation has been enacted in Delaware to modify the insurance liquidation act to exempt home loan banks from stay and voidable preference provisions.

GUARANTY FUND FOR TITLE INSURANCE. Two drafts have been exposed by the NAIC to create a mechanism to provide guaranty association coverage for title insurance claims. One option is a standalone fund; the other proposes adding the coverage to the Property and Casualty Guaranty Fund Act and creating a separate assessment account for title insurance. The NCIGF

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[3] To view the charge and interested party comments see agenda materials for the RITF conference call on July 25. Available on the NAIC website at http://naic.org/committees_e_receivership.htm

filed comments suggesting that the separate guaranty fund was the appropriate approach if a title insurance guaranty mechanism was deemed to be necessary. Technical comments on the draft were also offered. NCIGF comments may be viewed by clicking here. The NAIC is continuing to deliberate on this matter.

RECEIVERSHIP REINSURANCE RECOVERABLES (E) WORKING GROUP
RECEIVERSHIP AND INSOLVENCY (E) TASK FORCE. This National Association of Insurance Commissioners' (NAIC) working group, which is charged to study and provide a recommendation for the issue of requiring interest on overdue reinsurance payments in receivership, circulated a draft guideline for comment. It calls for interest to be paid on overdue accounts that are considered accounts for which the receiver has made valid claims. Valid claim is defined as "a claim that has been allowed by the liquidator, rehabilitator, receiver or conservator." The group released a new exposure draft. Comments are available on the NAIC website.

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 January 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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