**NATIONAL CONFERENCE OF
INSURANCE GUARANTY FUNDS
Suite 1190, 10 W. Market Street
Indianapolis, Indiana**

NCIGF

CAPACITY OF THE NATIONAL NETWORK OF STATE GUARANTY ASSOCIATIONS TO PROTECT CONSUMERS OF NATIONALLY CHARTERED INSURANCE COMPANIES

The National Conference of Insurance Guaranty Funds (NCIGF) is an association of 55 member state property and casualty insurance guaranty funds. NCIGF was formally incorporated in 1989 to serve several purposes for its members. NCIGF provides national assistance to guaranty funds, assists in coordinating activities and communications between liquidators of insolvent insurance companies and guaranty funds, monitors litigation impacting guaranty funds, coordinates with the property and casualty insurance industry trade associations and members on legislative matters, conducts educational and training seminars for guaranty funds, provides financial information concerning the guaranty fund system, serves as a clearinghouse of relevant information and provides a national forum for discussion and liaison with the NAIC and other interested groups.

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I.

EXECUTIVE SUMMARY

Introduction

The NATIONAL CONFERENCE OF INSURANCE GUARANTY FUNDS (NCIGF) represents the Property and Casualty Insurance Guaranty Funds (the "Guaranty Funds") in the 50 states, the District of Columbia and Puerto Rico. Each state's Guaranty Fund protects the state's residents when a property and casualty insurance company doing business in its state becomes insolvent, can no longer pay claims as promised in its insurance contracts, and is liquidated. As soon as the insurer is ordered into liquidation, each state Guaranty Fund begins to pay covered claims[1] owed by the insolvent insurer to or on behalf of residents in the Guaranty Fund's state. Without the state Guaranty Funds, claimants would not be paid for many months or even years, and then only a fraction of the claim's actual value.

Over the past twenty-five years, this network of property and casualty state Guaranty Funds has paid over $9 billion to or on behalf of policyholders in more than four hundred insurance company insolvencies. The state Guaranty Funds have paid hundreds of thousands of claimants promptly and in full without waiting for payments from the insolvent insurance company's remaining assets. These payments have been funded through assessments on the insurance industry based on their market share, which makes up the membership of each of the state Guaranty Funds.

Optional Federal Chartering

Several insurance and banking trade associations are urging Congress to create an optional federal charter and regulatory system for insurance companies, all of which are now regulated by the states. Other groups, including the National Association of Insurance Commissioners, strongly assert that states should continue to be the exclusive regulators of the insurance industry, a tradition that has existed since the development of insurance regulation in the 19th century. NCIGF takes no position in this debate. The NCIGF does feel obligated to take a position, however, on the structure of any insurance consumer safety net that is a part of those proposals.

The insurance industry, through the Guaranty Funds, is the financial protector of the public in an insurance insolvency by providing the funds to pay the insurance obligations of fallen competitors. By using insurance principles, the individual financial burden of these insolvencies is spread throughout the insurance industry. Ultimately and over time, the cost of these insolvencies is borne by the insurance purchasing public as a portion of their premiums for insurance coverage. It is a system that for decades has worked well to protect insurance consumers. If legislation establishing an optional

[1] State Guaranty Fund laws uniformly provide that a "covered claim" means an unpaid claim which is within the coverage of an insurance policy issued by an insolvent insurer if the claimant or the insured is a resident of the state at the time of the insured event or the damaged property is permanently located in the state.

federal charter is enacted, the existing state Guaranty Fund System is able to adapt and continue to provide services.

Capacity

As part of their federal charter proposal, some groups have proposed a federal insurance guaranty program, perhaps like the FDIC, arguing that the financial strength of the federal government is necessary to protect the public. In fact, as indicated herein, such a new federal scheme is not needed. Since their inception in the late 1960's, state Guaranty Funds have capably provided the funds to pay the claims of every insolvent U.S.-domiciled property and casualty insurance company.

- Insolvencies have occurred in every year since the state Guaranty Funds were founded.
- State Guaranty Funds have handled multiple insolvencies in most of those years.
- In total, state Guaranty Funds have paid out more than $9 billion in claims and claims adjustment expenses.
- Today the network of state Guaranty Funds has a nationwide annual assessment capacity of over $4 billion combining all states and accounts.[1] This figure continues to grow as the annual premium volume written by all property and casualty insurance companies increases.
- Although annual assessment capacity is capped at 2% of premium (1% in some states) combined annual assessments have never exceeded 35% of actual capacity.
- State Guaranty Funds have in some years assessed hundreds of millions of dollars against member insurers, but rarely have states reached their annual assessment capacity.
- State Guaranty Funds facing temporary capacity limitations have been able, without exception, to meet their obligations through alternative funding solutions.

Advantages to Retaining the State Guaranty Fund System

Should dual chartering of insurance companies become law, the network of state Guaranty Funds should continue to be the operative safety net for insurance consumers

[2] Each State Guaranty Fund can assess all admitted insurers on the amount of insurance premium written in its state, which is included in the appropriate (auto, workers compensation or all other lines) Guaranty Fund assessment account. The accumulation of assessment capacity in every account for all states now equals more than $4 billion annually. Each state Guaranty Fund's capacity is limited by the amount of premium written in that state.

and claimants, regardless of whether the insolvent insurer is federal or state chartered, for these primary reasons:

1. The nationwide network of state Guaranty Funds has worked extremely well to protect insurance consumers and claimants of all property and casualty companies for more than twenty-five years. The state Guaranty Fund system has proven to be effective and has a track record of adaptability, flexibility, and innovation that has created an efficient safety net capable of performing its function and responsive to change. The state guaranty system could operate effectively even if a federal chartering proposal is enacted.

2. If a federal charter sets up a competing Federal Guaranty system, two guaranty fund systems could substantially weaken the strong consumer safety net protection now provided by the state Guaranty Fund system.

3. Insurance industry involvement in the guaranty fund system is a strength in state Guaranty Fund operation and would be diminished in a national system to the detriment of consumers.

4. State Guaranty Funds are responsive to local conditions, laws and legal/regulatory environment.

5. A dual guaranty fund system would create duplication and unnecessary expense.

6. A pre-funded assessment system operated by the federal government would significantly increase the cost of the insurance protection system to the national insurers involved, as well as create uncertainty about its adequacy.

7. State Guaranty Funds and state laws are more responsive to the state's consumers and allocate resources and assess insurers based on the impact on their states' residents. The system operates to balance costs and protections. Higher benefit limits cost consumers more and each state can best decide that balance for its insurance consumers. The uniformity that may be attractive under a federal charter is not as desirable in a claims, tort and Guaranty Fund system.

For decades, the property and casualty insurance industry, through the state Guaranty Funds, has successfully provided coverage for most insurance consumers affected by insurer insolvency. By using its collective financial strength and knowledge of the insurance business, and by employing experts in insurance and state tort law, the industry has successfully spread the risk and shared the burden efficiently and effectively to the benefit of all insurance consumers within the insurance lines covered by the state Guaranty Fund. These protections should not and need not be sacrificed in any effort to create optional federal regulation of insurance.

II.

THE GUARANTY FUND SYSTEM

All states have property and casualty insurance Guaranty Funds that safeguard their residents against the insolvency of a property and casualty insurer doing business in the state. This national safety network began in the late 1960's and has been operating on a nationwide basis for over twenty-five years. Since 1975 there have been over 400 property and casualty insurance companies placed into liquidation by state insurance commissioners. In each instance, state Guaranty Funds have effectively stepped in to adjust and pay the claims of policyholders affected by those insolvencies.

Rehabilitation/Liquidation Process

An explanation of an insurance company rehabilitation/liquidation will assist in understanding the purpose of state Guaranty Fund laws. An order of liquidation is sometimes preceded by an attempt to "rehabilitate" a troubled company. An order of rehabilitation is sought and obtained by the insurance commissioner and generally appoints the commissioner as the rehabilitator.

The order of rehabilitation authorizes him or her to take over the operation of the insurance company and to make the company's business decisions. If cash flow is insufficient to meet claims, then the rehabilitator will be given authority to place a moratorium on claim payments. If possible, claim payments are resumed after a plan of rehabilitation has been put in place. An order of rehabilitation can result from and is part of the Insurance Department's supervisory authority. It is part of the Commissioner's role to monitor insurers for solvency and seek, when necessary, rehabilitation.

Liquidation is ordered by a Court in the state of domicile of the insurance company when that state's insurance commissioner concludes that grounds requiring liquidation exist. The action is usually triggered by the insurance commissioner's finding that the insurance company is unable to pay its obligations. When a company's surplus is impaired or eliminated to such an extent that it is unlikely the company can continue to operate, the insurance commissioner must seek to rehabilitate or liquidate the company. In the event of a determination of insolvency, a court order will be issued directing the commissioner, as rehabilitator or liquidator, to marshal the assets of the insurance company and to determine its liabilities.

Once an order of liquidation is entered, in order to avoid any preferential treatment of claimants by an insurer, claims payments (and payment to defense counsel defending liability claims) are immediately stopped . All claim payments by the insurer cease until the liquidator can assess the extent of the difference between the value of the assets and the total amount of all claims owed by the insurer.

Typically, the liquidation order terminates all existing insurance contracts within 30 days after its entry. In addition, if the Company was still writing new business at the time of the liquidation order, the order prohibits the Company from issuing any new insurance contracts. Because an insurance company in liquidation ceases writing any new or renewal policies, its principal source of continuing funds derives from its remaining assets, which include investments and recoverables from reinsurance companies that agreed to reinsure some portion of the Company's insurance risks.

When all assets are liquidated and turned into cash and all allowed claims are valued by the liquidator, the liquidator then determines what percentage of each claim can be paid from the insurance company's remaining assets. This payment, typically called the "dividend," will be the only payment received by any creditor of the insolvent insurance company. Payments to creditors are made according to a priority scheme established by state statute which typically gives first priority to the liquidator's administrative expenses and gives policyholders' claims priority over general creditors' claims. The process of determining payments to creditors generally takes years to complete because of policy coverage issues and claims valuation, particularly those involving liability claims against the insolvent Company's insureds.

State Guaranty Fund Process

Before the state Guaranty Funds, insureds who had suffered property losses under property policies or incurred liabilities to third parties covered under liability policies issued by insolvent insurers received either no or a substantially reduced insurance payment. Injured employees eligible for reimbursement of medical expenses and worker's compensation benefits received either no or significantly reduced payments. Claim payments, if any, were substantially delayed.

Before 1969, a few states had attempted to address claimants' problems with some form of backup guaranty funds paid by insurance companies or funded by special taxes on insurance. New York enacted laws in the 1940's to deal with the unavailability of auto liability coverage when insurance companies insuring New York taxicabs were overwhelmed with claims and became insolvent. Connecticut enacted a law protecting its state's employees in the event of an insolvency affecting worker's compensation coverage. But increasing numbers of auto insurer insolvencies in the 1960's created the desire to provide a better and more encompassing safety net in the event of insurance company insolvency. Between 1960 and 1965, fifty-eight auto insurers became insolvent. In response, Senator Christopher Dodd of Connecticut introduced a bill that would have created a federal motor vehicle insurance guaranty corporation to pay the auto claims of insolvent insurers. An additional charge on all auto insurance premiums would have funded the guaranty corporation. In response to this federal initiative, the NAIC developed its Model Property and Casualty Post Assessment Guaranty Association Act and recommended its adoption by all states.[3] (See Appendix B.)

How State Guaranty Funds Operate

The NAIC Model Act's intent was to provide new levels of policyholder protection lacking under liquidation law. The primary purposes of the property and casualty state Guaranty Funds are to: (1) provide a mechanism for the timely adjustment

[3] Michael P. Duncan, *Property-Liability Post-Assessment Guaranty Funds*, ISSUES IN INSURANCE, Volume II, 4th edition, 1987.

and payment of covered claims under certain insurance policies issued by carriers which become insolvent; (2) minimize financial loss to policyholders and claimants due to the insolvency of an insurer; and (3) provide a mechanism to assess the cost of this protection among insurance companies doing business in the state. To accomplish this task each state has created its own Guaranty Fund that protects its citizens at the time of the insolvency of an insurer licensed to do business in the state.

State Guaranty Funds are created by state statutes as nonprofit legal entities whose members consist of the property and casualty insurers licensed to do business in the state and that write any of the lines of insurance to which the Act applies. In all but a few states, property and casualty Guaranty Funds are not considered to be state agencies. Instead, the state Guaranty Funds are governed by boards of directors elected by the member insurers. In some states, members of the board may also be appointed by the state insurance commissioner. Generally, the Funds function pursuant to a plan of operation. The plan establishes the procedures for the exercise of the Fund's powers and duties. Those powers and duties include procedures for handling assets, assessing member companies, disposition of dividends and other monies, filing claims and keeping records of all financial transactions. The state Guaranty Fund may contract with a servicing agent, hire employees, lawyers, actuaries, claims handlers and others necessary to carry out its responsibilities.[4]

By law, each state Guaranty Fund becomes obligated to begin paying covered claims to or on behalf of the residents in its state who were insured by the insolvent insurer immediately upon the entry of a liquidation order containing a finding of insolvency. Each state Guaranty Fund works with the liquidator to obtain the claim files of the company that relate to the residents of its state. The Guaranty Funds review these claims files to determine if and to what extent the claims constitute “covered claims” for state Guaranty Fund purposes.

To prevent duplication of coverage, state Guaranty Fund laws generally provide that an injured third party claimant must first seek coverage from the state Guaranty Fund in which the insured is a resident. For first party property damage claims, the claimant must first seek recovery from the Guaranty Fund in the state where the insured property is located. Worker’s compensation claims are first directed to the Guaranty Fund in the state of the claimant’s residence. Through this mechanism, claims are allocated among the state Guaranty Funds in a way designed to assign primary responsibility for handling and paying claims to a particular state Guaranty Fund.

After a state Guaranty Fund determines that a claim is one that its state should handle, it determines if the claim is a covered claim. This determination requires knowledge and experience with insurance policy provisions and state law. Interpretation of insurance policies and particular coverage rules are matters of state contract laws and vary on a state-by-state basis.

[4] NAIC MODEL LAWS, REGULATIONS AND GUIDELINES, Vol. III, P. 540.

A state Guaranty Fund will apply statutory exclusions and limitations to claims against the insolvent insurer.[5] State Guaranty Funds also will require that the claimant and/or insured exhaust any other insurance that may be available before proceeding against the state Guaranty Fund. Claim payments by state Guaranty Funds is almost uniformly limited to $300,000 per claim, however, most provide that the cap will not apply to worker's compensation claims. A few states provide a statutory coverage limit of less than $300,000, while three states (California, Michigan and New York) provide substantially greater caps on coverage. In a state system, individual states can develop the best cost/benefit safety net for their residents.

After a state Guaranty Fund determines that a claim is a covered claim and otherwise falls within the statutory provisions, it will adjust and attempt to settle the claim. This process requires knowledge of (1) state insurance laws with respect to adjustment of property claims, (2) state tort laws with respect to liability claims, (3) state worker's compensation laws and procedures, and (4) state and local courts and attorneys licensed and capable of providing a defense of liability claims where necessary because state Guaranty Funds fulfill insurance policy obligations to defend insureds against claims brought against them. Providing a defense to liability claims requires knowledge of and experience with local defense counsel and state court proceedings. (See Appendix D for a more detailed explanation of the claims adjustment process.)

As the state Guaranty Funds obtain claims data from the liquidator, each state Fund estimates its claims and claims adjustment expense obligations for that insolvency. Each state Guaranty Fund then assesses its respective member insurers to obtain funds sufficient to pay the Fund's obligations for that insolvency. Assessments typically are made on an "account" basis; *e.g.*, automobile insurance account, other than automobile insurance account, worker's compensation insurance account, etc. These accounts are prorated among member insurers based on the written premiums that each insurer wrote in that state during the previous calendar year for the line of insurance making up the account. Total annual assessments are limited to 1% or 2% of the insurer's total written premium for the lines of insurance specified in an account. In most states, member insurers are permitted to pass these assessments through to their policyholders in the cost of premiums. Other states permit insurers to surcharge policyholders or recoup (at least in part) assessments through an offset against premium taxes.

For more than twenty-five years and in over 400 property and casualty insurance company insolvencies, state Guaranty Funds have paid covered claims totaling more than $9.3 billion. Having paid billions of dollars in claims, state Guaranty Funds have sought to recover as much of their payments as possible from the assets of the insolvent insurer's estate. Estate recoveries usually occur many years after the state Guaranty Funds have paid claimants and often result in recovery representing only a fraction of what the Funds have paid to the consumers it has indemnified. To date, state Guaranty Funds have recovered from insolvent insurers' estates less than 30% of their payments.

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[5] Typically, mortgage insurance, ocean marine insurance, financial guaranty insurance, life insurance, health insurance, reinsurance, fidelity and surety bonds, title insurance and surplus lines insurance are not covered by property and casualty Guaranty Funds. Life insurance and health insurance are covered by a separate Guaranty Fund in each state which covers only life insurance, health insurance and annuities.

III.

HISTORY OF THE NATIONWIDE SYSTEM OF STATE GUARANTY FUNDS SYSTEM CAPACITY

Some commentators have speculated that the property and casualty Guaranty Fund system lacks the capacity to meet the claims payments of insolvent insurers. Actual experience over the past twenty-five years strongly suggests otherwise. Regardless of the level of activity, the State Guaranty Fund system has met its obligations and has had excess capacity in most years. While some state Guaranty Funds have hit annual assessment limits in some accounts on a temporary basis, their ability to make repeated assessments and to engage in short term borrowing or to use other financing mechanisms has allowed state Guaranty Funds to meet their obligations to insurance consumers when and where it has been necessary.

In the past fifteen years, Guaranty Fund total annual assessments have never exceeded 35% of annual nationwide capacity. The chart attached as "APPENDIX A" illustrates the assessment capacity and the actual assessments made for each year from 1985 through 1999. In 1987 an assessment equal to 34% of capacity was made and in 1989 an assessment equal to 25% of capacity was made. In all other years except 1986, assessments never exceeded 17% of capacity. Before 1985, assessments were even smaller.

The sufficiency of the protection provided by state Guaranty Funds is demonstrated when considering the number of new insolvencies that occurred from 1985 to 1993. According to A.M. Best analysis, 387 property and casualty insurance companies were placed in liquidation between 1985 and 1993.[6]

The Mission Insurance Group insolvency accounted for approximately $700 million in state Guaranty Fund payments, the largest amount for a single insurer thus far. Twenty-three of the largest insolvent insurers accounted for about one-half of the total claims paid by the Guaranty Funds from 1985 to date ($4.7 of a $9.3 billion total). During the same time period, state Guaranty Funds paid claims for many smaller insurers that failed, including the claims that arose from insurers felled by Hurricane Andrew.

In the past several years, insolvent insurer losses have been impacted by the expansion of toxic and environmental tort liabilities. In addition, the increase in the frequency and cost of medical malpractice claims has bankrupted some insurers, and the soft worker's compensation market has brought other insurers close to peril. The state Guaranty Fund system has withstood all these events and has continued to meet its obligations and pay claims without interruption.

As the insurance industry has grown, the assessment capability of state guaranty funds has increased with the increase in total written premium. The chart, attached as

[6] During the same period 1,414 banks failed. This figure does not include savings and loan institutions. "A brief History of Deposit Insurance in the United States", Appendix IA, page 66, Federal Deposit Insurance Corporation Report, 1998.

Appendix A Chart 1, was prepared from NCIGF records and documents the increase in annual assessment capacity. In 1985, state Guaranty Funds had the combined capacity of $1.95 billion in annual assessments. While some states make assessments on all written premium for a single guaranty fund account, many states assess the premium for certain coverages, such as worker's compensation written in the state. Consequently assessment capacity in each state will vary depending on the lines of insurance involved in the insolvencies. In total, however, the nationwide Guaranty Fund network had almost a $2 billion capacity in 1985, which grew to $3.8 billion in 1999, and which exceeds $4 billion annually today. More importantly, the capacity of each state Guaranty Fund has grown in relative proportion to the written premium of insurers in the individual state. Assessment capacity and risk are based on insurers' business in a state, which correlates to the approximate exposure of insurers in the state.

<u>Historic Highlights</u>
<u>Recent Insolvencies</u>

From 1985 through 1989, Transit Casualty Company, Ideal Mutual Insurance Company, Midland Insurance Company, Integrity Insurance Company, Mission Insurance Group and American Mutual Insurance Company were all placed in liquidation and state Guaranty Funds nationwide have paid out over $2.6 billion in claims for these six insolvencies alone. At the same time, other smaller insolvencies were occurring and their claims were being handled by the state Guaranty Funds. Contrary to the conjecture of the General Accounting Office Report[7], the state Guaranty Funds' assessment capacity was sufficient to provide adequate funds to timely pay the claims arising out of these major insolvencies.

In 1992, Hurricane Andrew struck Florida, Mississippi and Louisiana causing massive property destruction. Estimated insured losses from Andrew reached $15.5 billion. Several insurance companies that wrote business in Florida were immediately swamped with claims and became insolvent. The Florida Insurance Guaranty Association promptly stepped in and began paying covered claims. When claims reached the annual assessment capacity in Florida, the Guaranty Fund arranged loans against future assessments, worked with the City of Homestead to issue bonds, and continued paying covered claims to Florida residents who had suffered significant losses to their homes and business properties. The next year, a hurricane struck Hawaii with devastating results and the Hawaii Insurance Guaranty Association paid covered claims when local companies were declared insolvent after they were overwhelmed with losses estimated at $1.6 billion. More recently, a major medical malpractice insurer writing in Pennsylvania became insolvent. Its claims have resulted in the Pennsylvania Insurance Guaranty Association making maximum assessments in its "all other lines" account for consecutive years in order to pay covered claims.[8]

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[7] UNITED STATES GENERAL ACCOUNTING OFFICE, Insurance Failures Differences in Property/Casualty Guaranty Fund Protection and Funding Limitations, GAO Doc. No. GCD-92-55BTR (1992).

[8] Kevin D. Harris, A Review of the System of Property and Casualty Guaranty Associations: Achievements and Major Developments, American Bar Association Insurer Insolvency Revisited: 1999.

While some insolvencies have placed a strain on a few states' assessment capacities in one or more of their assessment accounts, the state's system as a whole has never been placed in jeopardy during the twenty-five years of its existence. Individual states have addressed capacity issues effectively by borrowing between accounts or through borrowing from the commercial lending markets or the capital markets in order to maintain cash flow, The state system's ability to make continuous assessments has offered the resources to repay short-term borrowing in all cases where it became necessary.

Recently the Pennsylvania Insurance Commissioner abandoned her effort to rehabilitate Reliance Insurance Company when its cash flow became inadequate to maintain claims payments and placed it in liquidation. The Reliance Insurance Group represents the largest single property and casualty insurer to be placed in liquidation in history. As of December 31, 1999, Reliance Insurance Group's Combined Annual Statement showed total liabilities of $7,064,946,704. No public annual statement has been filed for the year 2000. NCIGF personnel and committees began communicating with Pennsylvania's Insurance Department personnel as soon as Reliance was placed under supervision. When notified of the liquidation, the NCIGF, on behalf of state Guaranty Funds requested and received the most current financial information available from the Liquidator's Office. Based on historical payment patterns of the Reliance Insurance Group, the Liquidator projects that claim payments in the fourth quarter of 2001 will be $437 million, increasing to $1.325 billion in 2002 and less than $1 billion in 2003.

This large insurance company's expected cost for state Guaranty Funds is well within the nationwide assessment capacity of the state Guaranty Fund network. While a number of state Guaranty Funds will assess their full capacity in some accounts, based on past history, it is not anticipated that any Fund will lack the financial resources to pay covered claims as they are resolved. While other insurance company insolvencies may also occur as the result of September 11, 2001 disaster, state Guaranty Funds have a proven ability to withstand multiple insolvencies.

Funding Flexibility

To the extent the state system has been criticized based on perceived funding limitations in states using a line of business assessment approach, the NCIGF has proposed several approaches to address the issue. Recently the NCIGF suggested a change in state laws to permit borrowing between accounts and to authorize state Guaranty Funds to arrange for public borrowing against future assessments. The continuing assessment authority of state Guaranty Funds provides ample assurance of cash flow from premium assessments in future years to repay loans. The NCIGF has also urged adoption of limits on state Guaranty Fund coverage of large insureds for commercial insurance coverage. State Guaranty Funds were originally intended to protect the average person who could not afford to repay losses when its insurance company failed. Many large corporate insureds are financially able to absorb some liability losses and better assess the solvency of insurers; indeed, in the modern insurance marketplace, many businesses have adopted several forms of self-insurance.

IV.

LESSONS LEARNED FROM PAST EXPERIENCE

Uniformity is Not A State Guaranty Fund Problem

One of the criticisms often levied against the state insurance Guaranty Fund system is a lack of uniformity among the state Guaranty Fund laws. The Guaranty Funds' own experience is that while uniformity in some areas is critical, absolute uniformity is not required and may not be desirable. For example, the system needs uniformity on which state Guaranty Fund will take the primary role in handling a claim so that claimants and insureds are not bounced among Guaranty Funds. The state Guaranty Funds and the property and casualty insurance industry have recognized the areas where uniformity is vital, and have worked to provide that state Guaranty Fund laws contain the required uniformity. As a result, the state Guaranty Funds, through the urging of the NCIGF and the industry, have adopted more uniform Guaranty Fund provisions. However, just as the tort laws and worker's compensation benefit levels vary greatly among the fifty states and the District of Columbia, there is no need for absolute uniformity among the state Guaranty Fund coverages. For example, while most state Guaranty Funds have a $300,000 limit of coverage in claims (other than worker's compensation), the fact that the California legislature has chosen a higher limit for residents of its state does not adversely affect the residents of other states.

One area where some degree of uniformity is helpful is the manner in which state Guaranty Funds report claims information to liquidators. Liquidators need updated claims information from Guaranty Funds so that, among other reasons, the liquidator can bill reinsurers. Recognizing the need for an efficient process to permit liquidators to efficiently transmit claims data to state Guaranty Funds at the outset of a liquidation, and for state Guaranty Funds to transmit updated claims payment and reserve information to liquidators, in the early 1990's the state Guaranty Funds, through the NCIGF, worked with the NAIC to develop the Uniform Data Standards ("UDS"). UDS is a protocol for electronically transmitting claims information between state Guaranty Funds and liquidators. In those liquidations where UDS is utilized, it has greatly streamlined and enhanced the exchange of information and expedited the liquidator's recovery of reinsurance payments to the insolvent estate.

In the course of responding to hundreds of property and casualty insurer insolvencies during the past twenty-five years, the state Guaranty Funds have been able to identify which features of the state Guaranty Fund system have worked well and which have needed tinkering or improvement. The property and casualty insurance industry and state insurance departments have worked together when improvements were needed to solidify the safety net mechanism of state Guaranty Funds. Where legislative changes have been vital to effect positive change to preserve the strength of the state Guaranty Fund, individual state legislatures have been responsive with the necessary amendments. One of the strengths of the state Guaranty Fund system is its ability to be responsive to the needs of its citizens. Whereas, the Insurance Industry has discussed the need for uniformity in regulatory areas that effect licensing, product speed to market, etc., issues involving the state Guaranty Funds have not been part of the industry concern.

The concept of uniformity is illusory in the context of Guaranty Fund mechanisms because each state, each state's laws, risks, consumer wants, and insurers are unique. The individual Guaranty Fund needs of any particular state are best served by the state legislature's expression of policy through its state Guaranty Fund. The issues driving Federal Chartering do not apply equally to the consumer safety net mechanism of state Guaranty Funds.

Meeting Challenges

The need for better communication and coordination among state Guaranty Funds led to the formation of the National Conference of Insurance Guaranty Funds, the NCIGF, in 1990. Before 1990, there had been a National Committee on Insurance Guaranty Funds (the "Old NCIGF"). The Old NCIGF was an informal group of property and casualty company and trade association representatives and not a formal association of the state Guaranty Funds themselves. The old NCIGF focused its efforts primarily on legislative matters. The property and casualty insurance industry recognized that multi-state insurer insolvencies created a need for better coordination among the state Guaranty Funds, and that such coordination provides an opportunity for the state Guaranty Fund system to better and more efficiently serve claimants and insureds. As an association of state Guaranty Funds, the new NCIGF is a forum for state Guaranty Fund managers and property and casualty insurance industry representatives to discuss operational matters and challenges.

The NCIGF also serves as a point of communication with liquidators, which is particularly important in the planning and early stages of an insurance company insolvency. For many insolvencies, the NCIGF forms a coordinating committee made up of a handful of state Guaranty Fund representatives who interact with the liquidator and address issues arising out of the liquidation that are of interest to many state Guaranty Funds. Through these mechanisms, the NCIGF operates with a small but effective staff. In the past these coordinating committees have helped to negotiate global settlements between an insured (or group of multiple, related corporate insureds) and a large number of state Guaranty Funds, arising principally out of pollution, asbestos and other product liability and health hazard related claims.

As mentioned above, each state Guaranty Fund covers only claims by or against residents of its state. One early challenge for state Guaranty Funds was identifying the residency of corporate insureds that had offices, facilities and operations in multiple states. This led to occasional disagreements between state Guaranty Funds as to which Fund should pay a claim. In response to this problem, the state Guaranty Funds developed a system for resolving these residency disputes between them, leaving policyholders out of the disagreements. Many of the state Guaranty Funds have also signed a mediation agreement to help resolve any other legal issues between them in order to more efficiently serve involved claimants, insureds, and insurers.

The experience of a number of state Guaranty Funds, particularly in the late 1980's, of paying millions of dollars of claims under policies issued to large corporate insureds led guaranty associations to examine ways to better allocate their resources to those claimants and insureds who are most needy of protection. Insureds with substantial net worth, particularly large corporate insureds who are better able to analyze the financial strength and operational soundness of their insurer, and who are financially able to absorb the impact of the insolvency of their insurer, should not compete for claims payment resources with individual insureds. A few states initially adopted "net worth" provisions to exclude from guaranty fund protection claims against an insured whose insurer becomes insolvent when the insured's net worth exceeds a certain threshold. The net worth provision allows the guaranty funds to concentrate resources on protecting the average insurance buyer who is not as financially able to cope with an uninsured loss. As the positive impact of better allocating state Guaranty Fund resources to the most needy insureds became apparent more states adopted net worth provisions. Thirty-one states currently have some form of net worth provision in their state Guaranty Fund statutes.

Another lesson learned by the Guaranty Funds in the past thirty years is that the post-insolvency assessment mechanism has worked well and that there are potential problems with pre-funded assessment mechanisms. The post-insolvency funding mechanism has been proven to work very well. Post-insolvency funding is designed to minimize the financial burden of assessments, and therefore minimize the costs of insolvency protection passed on to policyholders. In this way, post insolvency assessment more accurately reflects the costs of insolvencies and the system on the premium paying consumer. Only one state, New York, has a pre-funded assessment mechanism. While the pre-funded amount by law should be used only for Guaranty Fund claims and expenses, the State of New York, due to budget constraints, has used the pre-funded Guaranty Fund monies for other governmental purposes. This experience is why other states shy away from pre-funding mechanisms. Any mechanism that does not assess based on a need of the Guaranty Fund in fulfilling its function becomes an indirect tax on insurance consumers who pay any assessment through their premiums.

V.

OPTIONAL FEDERAL REGULATION OF INSURANCE

Insolvency Protections for the Consumers of Federally Chartered Insurers

The enactment of the Graham-Leach-Bliley Act removing barriers between banks, insurers and stockbrokers signaled the introduction of new competitors for insurance companies – competitors that are not subject to the same multi-state regulatory system as insurance companies. As a result, some financial services and insurance industry groups are now advancing proposals for optional federal chartering of insurance companies.

Three insurance trade associations have publicly announced proposals for federal legislation that would allow insurance companies to be created, regulated and supervised by the federal government in place of current state regulation. The American Council of Life Insurers (ACLI), the American Insurance Association (AIA) and the American Bankers Insurance Association (ABIA) have each proposed federal legislation that would create a National Insurance Commissioner with the power to charter and regulate insurance companies who seek to do business in the United States. Very recently, Senator Charles Schumer of New York introduced the first modern bill providing for optional federal chartering and supervision of insurance companies, including life and health and property and casualty insurers. Even more recently, Representative John

LaFalce introduced House Bill 3766 entitled “The Insurance Industry Modernization and Consumer Protection Act” which would also create an optional federal chartering and regulation system for insurance companies.

Support for optional federal chartering of insurers is far from unanimous. The NAIC opposes federal regulation of insurance and publicly asserts that states should remain the exclusive regulators of the insurance business. Several insurance industry trade associations and others in the insurance industry support the same view provided there is greater uniformity adopted in the system of state regulation.

NCIGF takes no position on the question of optional federal chartering. It has no interest in either supporting or opposing the concept of optional federal regulation of companies who might choose that approach. However, NCIGF has a direct interest in the issues related to insurance company insolvencies and an effective consumer safety net. The Guaranty Funds in all states, the District of Columbia and U.S. territories indemnify their residents who have covered claims against insolvent insurers through the operation of their state Guaranty Fund’s assessment authority and claims paying responsibilities. Any regulator of the insurance industry must provide this vital consumer service and safety net when insurers fail. The NCIGF believes that any system of insurance regulation must also contain a strong solvency regulation component. The NCIGF’s purpose is to be a resource to all those considering a federal insurance regulatory system about the realities of Guaranty Fund protection.

All federal chartering proposals allow the federal regulator to place a nationally chartered insurer into liquidation, but the proposals differ regarding the method for protecting customers of an insolvent federal insurer. Senator Schumer’s bill, Representative LaFalce’s bill and the ACLI and the AIA propose the use of the national network of state Guaranty Funds by requiring each federally chartered insurer to become a member of the Guaranty Fund of every state in which it conducts business. The ACLI bill for life insurance and Senator Schumer’s bill for all types of insurance take the approach of establishing federal minimum standards for coverage and Guaranty Fund operations. Under this concept, federal insurers are required to be members of every “qualified” state Guaranty Fund in the states where they conduct business. State Guaranty Funds are "qualified" only if they meet the federal insurance standards. If any state does not qualify, federally chartered insurers must join a National Insurance Guaranty Corporation designed to protect the residents of such non-qualifying states. The qualification requirements of the Schumer bill and the LaFalce bill generally track the provisions of the NCIGF Post-Assessment Property and Liability Insurance Guaranty Association Model Act, with some significant exceptions[2].

The AIA approach relies entirely on the current state Guaranty Fund system by simply requiring that all national insurers join state Guaranty Funds in the states in which they do business. This approach leaves the current system entirely intact and leaves future national insurers where they are today with respect to the insurance consumers safety net. In most approaches, it seems generally accepted that the current system of

[9] Both bills would include surplus lines written insurance within the guaranty fund coverage. Neither the Model Acts nor the State Guaranty fund laws, except New Jersey, provide surplus lines coverage. The LaFalce bill contains no coverage caps although all current laws contain coverage caps.

state Guaranty Funds, perhaps with some adjustment, is the best mechanism for protecting insureds and claimants of federally chartered insurers.

Earlier proposals for optional federal chartering and the recently announced ABIA proposal offer a federal insurance guaranty corporation modeled, in some respects, after the Federal Deposit Insurance Corporation (FDIC) which would be administered by a federal agency, using a pre-assessment funding approach and expanding its responsibilities beyond claims payment on behalf of an insolvent national insurer to include examination and oversight functions of all federally licensed insurance companies. This proposal suggests a drastic change to the current system of insurance consumer safety net in an insolvency. (For more information regarding the FDIC, see Appendix C.)

Differences Between Banking and Insurance

Property and casualty insurance is entirely different from banking. An insurer provides customers with intangible services that are unlike the functions that a bank performs for its customers. A bank is a depository for a customer's money and it provides many services in connection with the depositors' funds. It allows the depositor to draw checks on his or her funds with the bank to pay other individuals and the bank provides accounts on which it agrees to pay interest on the funds deposited. A bank guarantees that the depositor's funds will be available when demanded by the depositor. Banks also make loans of funds to consumers for the purchase of homes, automobiles, and other tangible property.

A property and casualty insurance company does not take deposits and is not primarily in the business of making loans. Property and casualty insurance companies pool risks and make promises to indemnify customers against specific types of future losses, should they occur, in exchange for the payment of a premium.

These differences are important in the context of customers' reliance on a bank as compared to an insurance company. The bank holds a customer's money primarily used to pay his or her living expenses as well as some portion or perhaps all of the customer's life savings for the future. The consequences of a bank failure to its customers are immediate and dramatic. Consequently, modern society needs and demands that a bank failure be immediately cured for the average depositor so that he or she may continue to live his or her life without severe interruption. Hence, the FDIC system must be able to furnish immediate funds to pay for a bank's deposits when the bank is unable to do so.

A property and casualty insurer has made a promise to its customer to indemnify the customer or someone else in the event the customer's automobile, home, business or other property suffers a covered loss at some time in the future. It may also have made a promise to indemnify, on the customer's behalf, damages that the customer may owe to another person because the customer negligently caused injury to the person or damage to the person's property. The insurance customer does not expect the insurer to pay any money unless a loss covered by the insurance policy actually occurs. The customer does not rely on the insurer to supply money for his or her daily existence.

The FDIC today insures deposits in U.S. banks and savings and loans in the total amount of $3.05 trillion.[10] Conversely, the total insured liability reserves of all property and casualty companies writing direct business in the United States is $495 billion as of December 31, 2000, or less than 16% of the insured bank liabilities.[11] As described herein, these fundamental differences between banking and insurance play an important role in developing a safety net for customer protection when an insurer or a bank becomes insolvent and unable to pay its obligations.

Prefunding of Bank Failures versus Post Funding of Insurer Insolvencies

The immediate need for funds by the public in a bank failure led to the concept of pre-funding the FDIC insurance mechanism through premiums charged to banks. While the federal government initially funded the FDIC, and the full faith and credit of the United States was placed behind the insurance commitment of the FDIC, Congress did not intend that U.S. taxpayers should pay for bank insolvencies. Rather, Congress intended that the banking community and its depositors should ultimately pay the cost of bank failures. Currently, the FDIC maintains a combined fund balance of $42.4 billion previously assessed against banks and savings and loan associations to provide a reserve for potential bank failures.

On the other hand, state legislatures have not found it necessary to use a pre-funded approach to insolvency protection by state Guaranty Funds and generally have not done so. New York is the only state that has pre-funded its property and casualty Guaranty Fund since its inception. In addition, a few states have made up-front charges to provide funds for certain worker's compensation benefits. In all other states, state legislatures have enacted laws that fund property and casualty obligations post insolvency.

The difference in the nature of the demand on these guaranty mechanisms explains the reason why state Guaranty Funds can operate without advance reserves. As noted earlier, the size of the exposure to insurance insolvency is significantly less than that of banks, and, unlike banks, cash demands only arise as losses actually occur and are settled or adjudicated, which can be many years after the insurer's liquidation date. Further, the insurance company customer can immediately purchase other insurance for future losses. In addition to the differences in demand, the cost of pre-funding is very significant for the insurance industry and its customers. Property and casualty insurers rely upon investment earnings to assist in paying their policy claims and expenses. In today's world, the insurance industry's average cost for operating expenses, claims payments and necessary reserve liabilities exceeds 100% of premiums collected. The recent average is 106% with experience sometimes exceeding 110% of premium. The deficit is made up through insurers' earnings on investments. Pre-insolvency assessments not only reduce insurers' income but also reduce funds available for investment, and thereby reduce the funds available to pay claims and other expenses and result in increased cost to insurance consumers.

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[10] 3.05 Recommendations for Deposit Insurance Reform, p. 10, FDIC, April 2001.
[11] NAIC Reports, 2000.

Full Faith and Credit of the United States

The full faith and credit of the United States has never applied to insurance obligations but it has applied to bank deposits for almost seventy years. This federal "insurance" resulted in a substantial obligation to taxpayers because of the 1980s savings and loan crisis. The hole created by failed savings and loans was so large that no one believed the savings and loan industry could ever repay the losses. Consequently, American taxpayers paid the approximate $150 billion bill for this horrendous loss. The insurance industry has had no experience to equal the savings and loan debacle. However, the creation of a dual chartering approach where national insurers are afforded a federal guaranty system protection could divide the industry's financial strength and make necessary a federal government bail-out in the event that one or more of the largest insurers become insolvent. Creating such an exposure is questionable public policy.

VI.

ANALYSIS OF A FEDERAL INSURANCE GUARANTY SYSTEM AS COMPARED TO THE STATE INSURANCE GUARANTY FUND SYSTEM

Impact of Federal Chartering on State Guaranty Funds

Currently, over three thousand property and casualty insurance companies are licensed to do business in one or more states within the United States. Some consolidation has occurred in the past few years but there will remain many insurance companies in portions of the national marketplace for many years. For example, there were 1,100 groups of insurance companies in 1998, a group consisting of two or more insurance companies with common ownership. A high number of companies do business in a single state or in a region rather than nationally. Many farm bureaus operate their own property and casualty insurance companies within a single state. The National Association of Mutual Insurance Companies (NAMIC) has over thirteen hundred member companies, the vast majority of which are small insurers doing business in a regional area.

The property and casualty insurance industry is divided into lines of business. Commercial insurance consists of property and casualty insurance coverages written for businesses. Personal lines insurance consists of property and casualty insurance coverages written for individuals. Commercial lines insurance accounted for 48% of the $281.5 billion in U.S. net written premium during 1998. Personal lines, such as auto, homeowners and individual liability coverages, accounted for the remaining 52% of that year's premium.[12] However, division of premium volume is heavily weighted toward a small number of very large insurance companies as can be seen below. It is possible that only a small number of property and casualty insurance companies will seek a federal charter if such an opportunity becomes available. A substantial number of companies may choose to continue being regulated by the one or two states where they conduct the majority of their business. This reality raises an obvious concern about the viability of a federal insurance guaranty system for federally chartered insurers.

[12] The Fact Book 2000, Insurance Information Institute.

The ABIA and other federal insurance guaranty system proposals suggest creation of a federal guaranty system for national insurers with state licensed insurers continuing to belong to state Guaranty Funds. The most obvious problem with the proposal creating two separate guaranty systems is the negative impact on the capacity of both the federal and the state systems to meet insurance consumers' needs in an insolvency.

Obviously, the existence of separate guaranty fund systems will mean that each system will have fewer premium dollars for assessment purposes. For the past twenty-five years all property and casualty companies have been members of the various state Guaranty Funds and the combined premium writings of these companies has been available for assessments to pay Guaranty Fund claims. Chart 1 shows the latest 15-year history of the growth in state Guaranty Fund assessment capacity from approximately $1.9 billion in 1985 to $3.8 billion in 1999. Today capacity exceeds $4 billion annually. The same chart shows the actual total annual assessments of all state Guaranty Funds for each year. Actual assessment totals have ranged from $67 million to $903 million annually, but the total annual assessment has never exceeded 35% of that year's total capacity.[13] Average annual assessments were less than 20% of capacity.

It is instructive to examine how capacity would change under a federal guaranty system like the ABIA proposal if several of the larger property and casualty insurers chose to become federally chartered. As an example, take the year 1998 and assume that only the ten largest property and casualty insurers choose a federal charter. Appendix A, Chart #2 is a spreadsheet showing that the ten largest property and casualty insurers account for 43.5% of the total net written premium of the industry. State premium assessment percentages vary from 1% to 2%, with the average of all state premium assessments being 1.4555% of net written premium in the eligible coverage. Thus, the capacity of the state Guaranty Funds would drop dramatically, while the assessment capacity of the federal guaranty system would be about 25% of the nationwide capacity of a single system if those insurers were assessed at a 1% premium rate. From an actual capacity of $4 billion during 1998, the state Guaranty Funds' combined capacity would drop to $2.3 billion and the federal guaranty systems' capacity would be just $1.2 billion. This limited capacity in dual guaranty systems is one of the reasons the AIA chose to remain with the current state system in its federal chartering proposal.

<u>Proponents' Arguments for a Federal Guaranty System</u>

Proponents of a federal guaranty system advance several arguments in support. On close analysis, these arguments do not justify the disruption and cost that would occur with instituting a new federal system.

[13] National Conference of Insurance Guaranty Funds, Assessment Data.

1. *A federal system would be easier to coordinate with a federal regulator and a federal liquidator.* Under the ABIA proposal, the NIGC would be the receiver of an insolvent federal insurer. Since the NIGC is controlled by the National Insurance Commissioner and two other directors, close coordination should be realized. Further the NIGC Board would actually make the decision to liquidate and could act on its own volition without intervention or approval of any court. At the same time, coordination issues should be eliminated and the receipt of claims information should be simpler than under the current system because the NIGC is providing both liquidator and claims paying mechanisms for all insureds and claimants regardless of where they reside.

However, the roles of liquidator and claims payor for insolvent insurance companies are very different. State Guaranty Funds concentrate on prompt payment of the insolvent insurer's claims, many of which are complex and unique requiring specialized treatment. They are not distracted by the necessity to marshal the insurer's remaining assets for use in claim payments or the concern about making payments which are preferential to some claimants over other creditors. Moreover, the state Guaranty Funds have demonstrated the ability to effectively coordinate efforts with state insurance liquidators through the country. There is no reason to believe that state Guaranty Funds would not be able to similarly coordinate efforts with a federal liquidator.

2. *It would be unfair to subject national insurers to better regulation but require them to pay for the insolvencies in the alternative state-based system.* For example, under the ABIA proposal, (1) national insurers would be subject to an annual full-scope, on-site examination of their financial condition and market conduct and additional examinations whenever the NIGC believed necessary; (2) each national insurer's financial condition would be rated and analyzed for adequacy of capitalization and reserves and the commissioner would establish the insurer's capital requirement based on asset, credit, underwriting, actuarial and other risks determined by the commissioner (with a floor of $3 million), (3) any insurer that is found to be undercapitalized or under-reserved would be required to submit a restoration plan to the NIGC within 45 days of the examination, with the NIGC ordering corrective actions, restricting growth or requiring that prior approval of the NIGC be obtained for any new activities; and (4) annual independent accounting audits and actuarially certified reserve and asset cash flows would be required.

All of these concepts are taken from current state insurance regulation. Risk-based capital analysis was adopted by the NAIC a decade ago. Insurer's investment practices have always been regulated to assure sufficient liquidity to meet financial requirements and policy obligations. Periodic on-site examinations by insurance department examiners occur routinely, and insurance departments have the authority to perform on-site examinations as they deem necessary. All companies are required to file quarterly and annual financial reports in all states where they conduct business. Further, all companies are required to file an annual financial statement audited by an independent accounting firm, and have their claims reserves certified by an independent actuary.

The current state regulations which the ABIA proposes to transfer to the federal government will not prevent all insurer insolvencies, just as strong regulation of banks has not prevented bank insolvencies in the past. Insolvencies of state regulated insurers do occur for reasons that have not proven to be preventable by rigorous reporting and examination practices. Regulation cannot prevent natural catastrophes, changes in civil liability or tort laws, economic condition or market condition changes, or bad business decisions, which have led to insolvencies.

An examination of bank failures may be instructive since banks are subjected to regulatory oversight similar to insurance companies. Despite OCC and FDIC oversight, examination and supervision, national and state banks also fail. Most people remember the bank and savings and loan failures of the 1980's and early 1990's. But even more recently, sizeable national banks have been taken over by the FDIC because of economic conditions or loan practices which destroyed their financial strength. In many instances, the cause or causes of bank or insurer insolvencies has not been shown to be preventable by regulatory review, oversight or even affirmative regulatory control.

3. *Incorporate the benefits of the current system into a national system and avoid the duplication of more than 50 state Guaranty Fund administrations.* According to this line of reasoning, one national guaranty fund for national insurers using the NAIC Model Act as a model for coverage and limits would work more smoothly. All claims could be handled uniformly from one agency. This would save time and money in sorting and transmitting claim file information to numerous Guaranty Funds and eliminate the opportunities for mistakes and delays that occur before claims can be reviewed and resolved. Close control of the claims handling process would be possible and uniform claim treatment could be achieved.

This argument will not survive scrutiny for two reasons: (1) Uniformity cannot be accomplished because of the nature of state tort laws and compensation systems, and (2) the state Guaranty Fund system has proven to be cost-effective.

The various state tort laws and compensation systems does not permit uniform claims treatment. Property claims involve a loss sustained to real property that could be located anywhere in the United States. Liability claims involve a loss sustained as a result of a particular event or occurrence, e.g. auto accident, that could occur anywhere. Both of these types of claims must not only be investigated where they occur but must be adjudicated under the tort and insurance laws of the state where the loss or incident occurred or where one of the parties lives. Many national insurance companies locate claims offices throughout the United States because prompt and accurate claims adjudication can be best achieved closer to the location of the loss. The differences in state laws on determining fault and differences in economic, political and social standards of different localities result in the differences in the amounts of awards for similar injuries. Thus, uniformity of claims treatment is not possible because of the differences in social and political philosophies from state to state.

Further, given the volume and complexity of claims resolved by the state guaranty funds, the cost of operating the state Guaranty Fund system is less than one might imagine. Based on 2000 figures, the combined annual expense total for all Guaranty

Funds is $71 million.[14] The size of the state Guaranty Funds permits them to be very flexible. Many Funds reduce their staffs to a few employees when the number of insolvencies is small, and add to staff only during times of increased insolvency activity.

Contrast this cost with the operating costs of the FDIC today. It employs between six and seven thousand people, compared to approximately 312 total employees for all state Guaranty Funds. Further, the FDIC's operating budget for the year 2000 was $1.187 billion as compared to $71 million for all state property and casualty Guaranty Funds. Even taking into account the FDIC's additional bank examination duties, which state Guaranty Funds do not perform for insurance companies, there nevertheless exists a dramatic disparity in costs between the FDIC and the state Guaranty Fund system demonstrating that a federal solution is likely to be much more expensive than the current system.

4. *A national system would expand capacity by not limiting assessments to premiums written in a single state.* Each state's Guaranty Fund may assess insurance companies based only on the premium written by each company in the Guaranty Fund's state. In many instances, assessments are further limited to premiums written in a particular line of insurance because the state's Guaranty Fund law creates separate accounts for auto, worker's compensation and "all other" covered lines. Moreover, since property and casualty insurance is subject to catastrophic losses, there is not always a correlation between the volume of claims and the premium base upon which the state Guaranty Fund can base its assessment. This mismatch also may occur when an insurer with a large market share in a given state becomes insolvent, leaving numerous claims and a much depleted premium base for Guaranty Fund assessment purposes.

A good example of this situation occurred with Hurricane Andrew in 1992. Total insured losses reached $15 billion but the major property damage occurred in two states, Florida and Louisiana. When seven insurance companies doing business in Florida failed, there was insufficient premium capacity in the Florida Guaranty Fund to pay all claims from assessments of insurers' Florida-only premium. A few other examples have occurred with worker's compensation claims in small northeastern states.

The argument supposes that if assessments could be made against an insurer's premium written in all states, there is less likelihood of a "Florida type" disparity between the volume of claims against an insolvent insurer and the state Guaranty Fund's capacity to assess premiums written only in that state. These capacity issues, however, have been very rare and have never resulted in delayed payments to insureds or claimants. For example, the Florida capacity problem discussed above was resolved by arranging for borrowing through a bond issue paid through future years' assessments. In this way, funds were available as needed to pay all claims as presented. The "national" account simply is unnecessary to deal with capacity issues.

5. *A national insurance guaranty program would provide uniformity of coverage and protection in all states.* A federal law establishing uniform guaranty fund

[14] Does not include New York, whose funds are managed within the Liquidation Bureau of the New York Insurance Department.

coverages for all shareholder insurers of NIGC would apply equally to all insureds or claimants of an insolvent shareholder insurer no matter where they reside.[15] The dollar limits of coverage would be the same across the country, instead of varying depending on the state of residence of the insured.

The U.S. Constitution leaves it to the states to enact laws governing liability and the procedure that must be followed to establish liability. State laws, too, govern property ownership, disposition, and zoning, all of which have an impact on insurance coverage. Moreover, there are substantial differences in regional, state and local norms, economic conditions and politics. In addition, incomes, property costs and the cost of living vary significantly between the coastal states and the central and southern parts of the United States. Given these differences, uniformity in coverage limits may not be either desirable or possible.

6. *Congress may look favorably upon a system that is patterned after the banking model.* Congress is familiar with the FDIC which protects bank customers and operates on a national level in conjunction with the federal agencies, such as the OCC, OTS and the Federal Reserve that regulate the national banking industry. Congress may prefer that consumer protection from insolvency be provided by an agency over which it has control and which can, in time of possible crisis, be supported by the federal government. This argument presumes that Congress is willing to place the full faith and credit of the United States behind insurer insolvency, as it did with the savings and loan failures in the late 1980's. That commitment cost taxpayers approximately $150 billion.

Congress may not wish to undertake a program with the potential for taxpayer bailout which would arise from placing the full faith and credit of the United States behind a federal insurance guaranty fund. This may be particularly the case since the insurance industry already has in place a cost-effective and well-functioning system. Even though the insurance industry suffered the same economic conditions as banks during the late 1980's, the insurance guaranty fund system performed its function without any government bailouts. Given its experience with the savings and loan industry, Congress may have some reluctance to finance with limited tax dollars a system that is working well. In addition, the FDIC model would not work for property and casualty insurance companies. Even an insolvent bank has some ongoing business value which other banks are willing to assume for some consideration. In insolvent property and casualty insurance company has practically no ongoing business value because all insurance contracts are cancelled when the insurance company is placed in liquidation. Consequently, there is no continuing stream of income to support claims obligations. Only the assets are available for that purpose. Unlike a bank, an insurer's liabilities are neither fixed nor certain on the date of insolvency. Liabilities continue to arise and are reported for months and even years after the liquidation date. Unlike a bank, a property and casualty insurance company in liquidation has few buyers.

Further, the claims resolution process performed by state Guaranty Funds is entirely different than the FDIC's functions in bank liquidations. Investigation and

[15] Under the state guaranty fund system today, the coverage limit varies by state. State laws vary the limit from $100,000 to $1,000,000. Thus the state where the insured resides can determine the maximum limit paid by the state Guaranty Fund on a personal injury or property damage claim.

adjustment of property and casualty insurance claims is a complex process requiring several skills and special knowledge. Guaranty Fund claim adjusters must have an understanding of the law governing guaranty funds, as well as understand the insurance contract, its coverage, exclusions and limitations. The adjuster must also understand the tort and reparations laws of the applicable state. Depending on the type of claim, investigation of the incident may involve determination of fault, assessment of the injuries and damages to determine if they are covered under the policy, and if they are covered, determination of their monetary value.[16] Adjustment also requires negotiations to arrive at an agreed value for the claim. When there is either no liability or no coverage, the claims adjuster must resist the claim and defend any litigation initiated on the claim. Many of these issues involve nuances of local tort law, court procedures, jury awards and other methods of establishing either responsibility for or the value of such claims in that locality or state.

It has taken many years to develop the expertise in claims handling that the state Guaranty Funds now possess. Similar expertise will not be easily or quickly established by a federal agency whose personnel would begin where state Guaranty Funds were almost 30 years ago. In addition, Congress may not wish to involve the federal government in claims by constituents where the dispute resolution process necessarily will involve unfamiliar insurance concepts and the state civil court system.

7. *A pre-insolvency assessment system would provide that those companies that later become insolvent would contribute to the cost of their "bailouts."* In a post-insolvency assessment plan, an insolvent company does not contribute to the bailout of its own policyholders. But if all companies were required to make payments into a pre-insolvency assessment fund, then even the company that eventually becomes insolvent would pay some portion of the cost of its insolvency.

This argument ignores the fact that the insolvent company, before it became insolvent, contributed through Guaranty Fund assessments to the cost of other insurance insolvencies and so paid its "dues." Secondly, and more importantly, a pre-insolvency fund would incur a substantial cost to all insurers and insurance customers. A requirement to prefund insolvencies would permanently remove the investment income that would otherwise be attributable to the prefunded dollars.

Under the ABIA proposal, each insurer would pay into a government controlled fund a percentage of its total insured liabilities. The suggested figure ranges from .5 % to 1.25% and, for the 10 largest companies would equal $1.25 billion. Insurers include investment income in their ratemaking processes, which can reduce the cost of insurance to consumers. The transfer of $1.25 billion of insurance company assets to a government controlled pre-insolvency fund would remove those assets, and potential investment income connected to those assets, from insurers and increase the cost of doing business. The loss of income would be compounded each year because the usual annual income from those investment dollars would never reach the insurer. Furthermore, the presence of an account holding such pre-assessed funds has proven to be a tempting resource to

[16] Third party claims against insureds invoke the tort law of a particular state, an area where there is much uniqueness of rights, duties and remedies.

meet other governmental funding needs. Policyholders would ultimately pay increased premium costs because of the lost investment income.

VII.

STRENGTHS AND WEAKNESSES OF STATE GUARANTY FUNDS

The fundamental strength of the national network of state guaranty funds is clearly demonstrated by the actual experience of more than twenty-five years of efficient and effective operations. The original concept of guaranty funds has been achieved. Policyholders of an insolvent insurer receive protection from the state Guaranty Fund mechanism. Payment of policyholders' claims is made by the resident state Guaranty Fund within the policy and Guaranty Fund liability limits. In most states, policyholders also receive a refund of unearned premium. Payments have been made promptly and without unreasonable delay by state Guaranty Funds.

Potential participation in the loss encourages vigilance by more sophisticated insurance purchasers. Therefore, some part of a loss may be borne by the claimant or the insured in certain very large claims which exceed the Guaranty Fund limit and, in some states, where the insured's net worth is so large that a Guaranty Fund limitation is invoked. For the most part, however, other insurers and their customers bear the burden of an insurer insolvency, with the cost spread indirectly and over time among insureds or the government through an offset to the insurer's state tax liability.

There are also intangible strengths of the current system. It has not caused significant disruptions or strains on the insurance industry. It relies on insurance industry personnel to operate it efficiently and effectively. Over time a very experienced and knowledgeable network of fund managers has developed an effective and efficient method of working with liquidators and other state Guaranty Funds to serve insureds and claimants. Moreover, many of the legal questions inherent in any program established by state laws have been resolved through the courts and among the state insurance department regulators through the NAIC.

Weaknesses have also been discovered over the past twenty-five years of state Guaranty Fund operation. Most of these weaknesses have already been addressed through the NAIC, state legislatures and regulators, and by the Guaranty Funds themselves. The need for some form of coordination among the state Guaranty Funds was solved by the creation of the NCIGF. This organization serves many coordinating and clearinghouse functions for the state Guaranty Funds.

Questions sometimes arise as to which Guaranty Fund law applies to losses involving residents of different states. The solution developed and recommended to the states by the NAIC was a set of priority rules based upon the insured's residence, the claimant's residence or the location of the property controlled. Further, the NCIGF implemented a mediation process to be used by state Guaranty Funds when uncertainty of responsibility among Funds occurred.

The use of separate accounts for assessment purposes has sometimes created limitations on a particular state's short-term ability to raise sufficient funds within an account to meet its claims obligations for a particular insurance loss. For example, when a state Guaranty Fund can only assess worker's compensation premium written in the state to pay worker's compensation claims, claims may exceed the amount that can be raised from assessable worker's compensation premium. These problems have been addressed by allowing state Guaranty Funds to borrow between accounts.

Likewise, the overall limitation or cap on assessments, especially those at the 1% level in smaller states, has on a very few occasions created cash flow difficulties.[17] When faced with these problems, state Guaranty Funds have been able to increase the assessment caps.

During the Hurricane Andrew disaster of 1992, Florida's Guaranty Fund faced claims against several insolvent insurers and did not have sufficient assessment capacity in a single year, or even two years, to provide sufficient immediate cash for claims payments. Consequently, Florida's property and casualty Guaranty Fund sought and was able to arrange a bond issue to generate cash which it later repaid by assessments on insurers writing in Florida.

Some critics have pointed to the lack of uniformity of coverage limits and even types of coverage among state Guaranty Fund laws. There is a range of maximum payment limits across the states, with one state as low as $50,000 per claim and another state as high as $1,000,000[18]. The General Accounting Office has noted the differences[19] and commented that individuals residing in different states could receive lesser or greater payments for the same claim depending on the state's limits, however the General Accounting Office report made no real analysis of the reasons behind it.

It is advisable to understand why these differences exist. First, property and casualty insurance liability coverages provide coverage for liabilities determined by state tort laws, which are not uniform among the states. Second, property insurance protects against monetary loss from damage to property. A building in Los Angeles does not necessarily have the same market value as the same building located in Nebraska, or Alabama or many other locations. The economic value of a property or casualty loss varies from state to state based on geographic, economic, social and cultural differences in our society and differences in state Guaranty Fund coverage occur because of these value differences. Uniformity may not be as desired by society as some critics would suggest.

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[17] This problem arose recently in the California worker's compensation account.

[18] The average and the most frequently selected coverage limit chosen by the states is $300,000 for property and casualty claims and unlimited worker's compensation coverage

[19] UNITED STATES GENERAL ACCOUNTING OFFICE, Insurance Failures Differences in Property/Casualty Guaranty Fund Protection and Funding Limitations, GAO Doc. No. GCD-92-55BTR (1992).

Weaknesses recognized by the state Guaranty Fund system have been addressed by every state in which it was concluded that change was appropriate. There is no reason to conclude that any future problems cannot be similarly corrected.

VIII.

THE STATE GUARANTY FUND NETWORK SHOULD ALSO HANDLE FEDERALLY CHARTERED INSURERS

We fully recognize that our views are affected by our experience with the state Guaranty Fund system and pride in the quality of work done by the experienced Guaranty Fund managers in each state. Nevertheless, we believe that an objective analysis leads to the conclusion that, even if some form of optional federal chartering and regulation of insurance companies is enacted, change from a state Guaranty Fund system to a federal guaranty system is not essential or necessary. Optional federal chartering proposals are driven by objections to aspects of state regulation that have no relationship to the Guaranty Fund system. No perceived or real deficiencies with the state Guaranty Fund system have been identified in the current discussion of optional federal charters. There are many reasons why the current system could and should handle all insolvent insurers, whether state chartered or federally chartered, if a federal chartering law is enacted:

1. The state Guaranty Fund system has worked very well for over twenty-five years.

2. The property and casualty insurers which would obtain a federal charter are, in fact, members of the state Guaranty Fund network. Their customers have enjoyed the protection of the state Guaranty Fund system since its inception.

3. The state Guaranty Fund system is an efficient, proven and adaptable mechanism. For over twenty-five years it has paid consumer claims without the delay of awaiting distributions from the liquidation estate. Even on those very rare occasions when a state's annual assessment capacity has been reached, multiple assessments and borrowing when necessary have provided funds to promptly pay eligible claims. No commentators have identified serious problems and consumers have not complained about the system.[20]

4. *Two guaranty fund systems might act to substantially weaken the strong consumer safety net now provided by the state Guaranty Fund system.* A state-by-state post-insolvency assessment system has proven to be more than adequate to finance property and casualty insurance company insolvencies to date. Even though over 400 property and casualty insolvencies have occurred and more than $9 billion has been expended in the past twenty-five years, no single year has reached a combined nationwide cost of more than 35% of that year's total national assessment capacity.

[20] Kimball & Parrett, *Creation of the Guaranty Association System*, JOURNAL OF INSURANCE REGULATION, Winter, 2000, Vol. 19, Issue 2.

Proposals for a federal guaranty fund agency for national insurers in essence divide the insurance industry into two separate systems. These proposals seem likely to jeopardize the industry's ability under both the remaining state system and the newly created federal system to provide sufficient coverage for consumers in the event of insurer insolvencies. First, insurer insolvency is not easily predicted. Second, the capacity of each separate system would always be uncertain and subject to shifts and changes as some companies move from state to federal chartering.

5. *A national guaranty fund system would mean less involvement by the insurance industry in the guaranty fund system to the detriment of consumers.* There is intangible value to having insurers actively involved in Guaranty Fund operations rather than leaving the task solely to government officials. Insurers' vested interest in the state Guaranty Fund system leads them to provide company and trade association personnel to work without compensation, for Guaranty Fund boards and committees. This increases efficiency by allowing Guaranty Fund staffs to remain small. The federal guaranty fund proposals introduced to date do not provide the same opportunity for taking advantage of this expertise at no cost to the system.

6. *State Guaranty Funds are responsive to local conditions and legal environments*. Unlike the banking industry, property and casualty insurance protects against loss and liability based on the standards established by varying state laws, not by one national uniform law. State tort law, court rules and procedures, allowable damages and local social policy play important roles in adjudicating insurance claims. State Guaranty Funds have the expertise to deal with these local factors. Even if some insurers become federally chartered and exempt from some state insurance laws, the state legal systems will continue to be diverse. Just as important is the ability of consumers to affect state and local policy and the states' ability to respond with state-based innovations.

7. *A federal guaranty fund system would create duplication and unnecessary expense.* State governments and the insurance industry have a substantial investment in the state Guaranty Fund system. The bugs have been worked out of the laws and procedures for administering this system over its 25-year history. It has experienced personnel in every state and accounting and computer systems that are unique to its purpose. And it has twenty-five years of case law that has interpreted its laws and regulations. Duplication of this system at the federal level would be both time-consuming and costly. Just as important, creating another system would afford the opportunity to make mistakes on a national level that could be much more devastating than when tried only on a state-by-state basis.

8. *A pre-funded assessment system operated by the federal government may significantly increase the cost of the insurance protection system to the national insurers involved as well as generate uncertainty about its adequacy*. Today insurers provide funds only when the funds are actually needed. The funds benefit the general economy until they are needed to pay the claims of an insolvent insurer. Money paid into a pre-assessment fund will never again be available for investment and income return. The lost opportunity cost to insurers and to the general economy would be not only real, but also substantial and compounded annually. This removal of funds from the general economy

is a hidden tax levied to create a federal bureaucracy. The insurance consumer will pay this tax through higher premiums.

IX.

CONCLUSION

No good reason exists to disrupt the state Guaranty Fund system even if federal chartering legislation is enacted. This twenty-five year old network of state insurance Guaranty Funds has unstintingly paid the claims of insureds and claimants against insolvent insurers without failing in its mission. The state insurance Guaranty Fund system can continue its efficient and effective consumer safety net whether insurers are chartered under federal law, or under state law.

X.

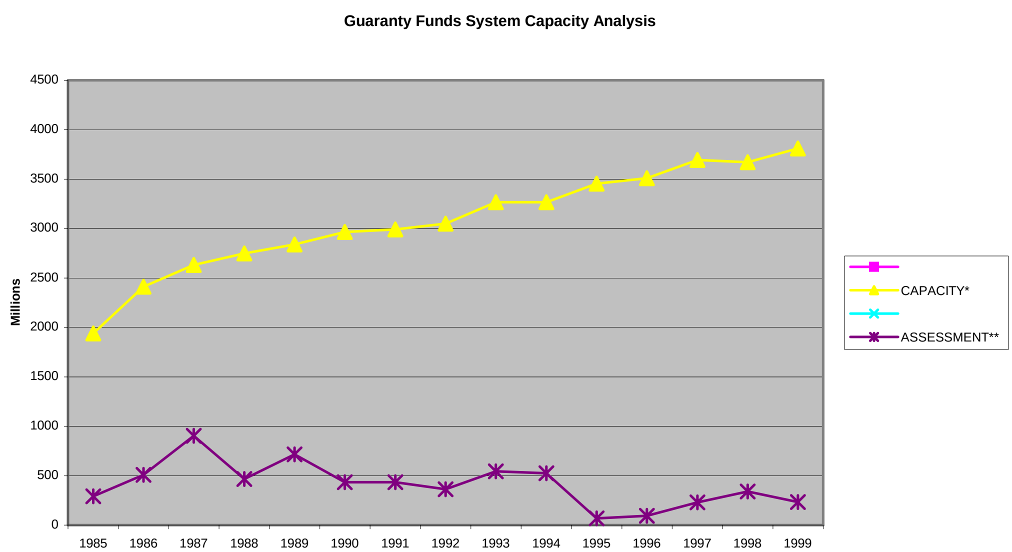
APPENDIX A
Chart 1

GUARANTY FUNDS SYSTEM CAPACITY ANALYSIS
(Millions of Dollars)

YEAR		CAPACITY*		ASSESSMENT**	% USED
1985	$	1,940	$	292	15%
1986	$	2,413	$	509	21%
1987	$	2,633	$	903	34%
1988	$	2,747	$	465	17%
1989	$	2,839	$	714	25%
1990	$	2,966	$	434	15%
1991	$	2,992	$	435	15%
1992	$	3,050	$	361	12%
1993	$	3,265	$	545	17%
1994	$	3,268	$	525	16%
1995	$	3,453	$	67	2%
1996	$	3,509	$	95	3%
1997	$	3,693	$	231	6%
1998	$	3,671	$	339	9%
1999	$	3,810	$	234	6%

*Represents % of total net written p&c premium eligible for assessment nationwide
**Actual total assessments made by state guaranty associations during the calendar year

CHART 1 GRAPH



APPENDIX A
CHART 2

DUAL SYSTEM CAPACITY ILLUSTRATION
(ooo omitted)

Total Net Premiums	$	281,508,998	%of total
FEDERAL CHARTER INSURERS PREMIUM BASE*			
Company	Direct Premiums Written		
State Farm	$	34,301,654	
Allstate Ins Group	$	19,446,097	
AIG	$	11,097,958	
Farmers Ins Group	$	10,525,841	
CNA Insurance Cos.	$	9,957,810	
Travelers PC Group	$	9,333,173	
Nationwide Group	$	8,530,339	
Liberty Mutual Group	$	7,739,968	
The Hartford Group	$	5,885,454	
St. Paul Companies	$	5,638,842	
Total	$	122,457,136	43.5%***
STATE CHARTER INSURERS PREMIUM BASE**			
State Charter Insurer NWP	$	159,051,862	56%
Assessment Capacity of State Guaranty System	$	2,315,000	

*1998 net written premium of 10 largest P&C insurers
** Remaining net written premium of rest of the P&C industry
*** Percent of total net written premium produced by 10 largest P&C insurers

Chart uses 1998 statistics as basis for presentation
NCIGF CHART JUNE, 2001

XI.

APPENDIX B

NAIC MODEL ACT

Borrowing the concepts developed by Professor Kimball in Wisconsin, the purposes of the NAIC Model Act were to: (1) solve the loss of risk protection for consumers; (2) provide funds to pay claims against the insolvent insurer; and (3) eliminate the delay in payment typical in an insurance company liquidation. This new state Guaranty Fund system eliminated the suffering endured by policyholders and claimants who otherwise would have to wait for years only to get paid cents on the dollar by a liquidator. Rather, the Guaranty Funds would step in and pay covered claims in a timely fashion and in full, subject to statutory caps, with the state Guaranty Fund assuming the policyholder's claim in the insolvency. That is, rather than the policyholder or claimant waiting years to get paid a few pennies on the dollar from the liquidator, the Guaranty Funds pay the claim and make a claim in the liquidation. As with many other "safety nets," including the FDIC protection for banking consumers, the NAIC Model Act followed the principle that the pain of insolvency should not be completely eradicated, only relieved, and then shared fairly,[21] hence the statutory limits on the state Guaranty Funds' obligations.

[21] Christopher J. Wilcox, *The U.S. Guaranty Association Concept at 25*, JOURNAL OF INSURANCE REGULATION, p. 371.

XII.

APPENDIX C

THE FDIC AND FSLIC PROGRAMS

The ABIA's proposed legislation uses the FDIC model for the establishment and operation of the NIGC. Understanding the FDIC and other bank guaranty mechanisms is important in analyzing whether it is a model that should be applied to the insurance industry. The FDIC system has evolved over 70 years to meet the problems that have arisen within the banking system.

From 1886 until 1933, various proposals for federal deposit insurance protections were advanced but defeated. As bank failures mounted year after year from 1921 until 1933, pressure increased for federal protection. Finally the banking system became so distressed that President Roosevelt declared a bank holiday to prevent catastrophic runs on the banks. After the Banking Act was enacted to reopen banks, members of Congress again proposed a program of federal deposit insurance. Although opposed by the Roosevelt Administration, segments of the banking industry and some members of Congress, the provision for creation of the Federal Deposit Insurance Corporation became a part of the Banking Bill of 1933 and was passed and signed into law on June 16, 1933.[22]

It is important to note that the FDIC was first funded by the U.S. Treasury and the 12 Federal Reserve banks. The Treasury provided $150 million of capital and Federal Reserve Banks purchased $139 million of capital stock. Further, the FDIC attempted to keep assessments of banks low so as not to further weaken the struggling banking industry.[23] In the 1940's, when Congress believed that the fund of $1 billion was sufficient, it ordered banks to repay the Treasury and the Federal Reserve banks for the amount of their original capitalization. Later, Congress also required the banks to pay almost $50 million in interest on the funds advanced by the Treasury.

Initially, coverage for insured deposits was limited to $2,500. From 1940 to 1969 coverage limits were periodically raised until the limit reached $20,000 in 1969. During this period, the banking climate was favorable, bank earnings grew and very few bank failures occurred. Bank coverage limits were raised in the 1970's to $100,000 per depositor and then in the mid 1980's Congress increased the FSLIC insurance coverage for savings and loans to $100,000 also to allow the savings and loan banks to attract more deposits as a solution to their growing financial problems with mounting loan losses.[24]

The economic environment for banks began to change in the 1970's and during the next twenty years a record number of insured bank failures and insured losses occurred. Payment of insured losses resulted in the FDIC being technically insolvent by

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[22] "A Brief History of Deposit Insurance in the United States" p. 27, FDIC Report 1998.
[23] Id. P. 28.
[24]. William Seidman, *Full Faith and Cedit*, (Random House, 1993), p. 178.

$7 billion dollars. During the same period, savings and loans failed in even greater numbers causing the FSLIC to be totally depleted and requiring the federal government to pay some $150 billion in insured deposits to customers of failed savings and loans.

When William Seidman took over as Chairman of the FDIC in October, 1985, the FDIC's list of banks with major problems had grown from 217 in 1980 to well over one thousand (1,000). Federal savings and loans failures occurred in abundance during the late 1980's, and Congress and the FSLIC now faced mounting costs as the problem grew beyond the capacity of the FSLIC to bail out banks and pay depositors. Eventually one-third of the savings and loan associations were closed, the FSLIC was destroyed and American taxpayers picked up the tab of $150 billion dollars. Insurance of savings and loan deposits was transferred to the FDIC and the Federal Home Loan Bank Board was dismantled.

In his book describing the savings and loan crisis, Chairman Seidman says:

> The S&L crisis was born in the economic climate of the times. It was nurtured, however, in the fertile ground of politics as usual and the political mentality of "not on my watch." The system may have given rise to the crisis, but human beings, with all their faults, ultimately determined the scope of the debacle. The S&L mistakes resulted in the closing down of one-third of the industry, destroying the agency charged with promoting and insuring it, and costing the American taxpayers around $200 billion, plus interest on that amount, probably forever! No larger financial error appears to be recorded in history. And all because of the use of the full faith and credit of the U.S. government was not treated with the respect and fear that must be accorded to it.[25]

Today the FDIC insures approximately 10,000 banks and savings and loan associations. It is a deposit insurer, supervisor and receiver.[26] Its five-member Board of Directors administers two funds, the Bank Insurance Fund (BIF) and the

[25] Seidman, Id. P. 196

[26] National banks are subject to regulation by more than one federal agency and state banks are subject to both state and federal regulation. National banks are chartered by and supervised by the Comptroller of the Currency; but they are also subject to regulation by the Federal Reserve System and the FDIC. Federally licensed savings and loan associations and savings banks are regulated by the Office of Thrift Supervision (OTS), and the National Credit Union Administration is both the regulator and insurer for the credit unions. State banks have a regulatory scheme under state law similar to the OCC and they are also subject to regulation by the Federal Reserve Board and the FDIC if they choose to join these programs. Id. p. 118.

According to Mr. Seidman, the potential overlapping jurisdiction of these agencies has led to many turf battles among the agencies. Mr. Seidman wrote:

> No activity is followed with greater interest in Washington, D.C. than the battle between various agencies for "turf". Turf is a euphemism for power, and particularly power achieved in gaining additional control and responsibility at the expense of rival agencies. In order to understand the U.S. Banking system, it is necessary to describe the various regulators' areas of responsibility, which represent a constant temptation for them to defend their respective turf. Id., p. 117.

Savings Association Insurance Fund (SAIF), which together equal $42.4 billion and insure $3.14 trillion of deposits, for a reserve ratio of 1.35%. The FDIC Improvement Act of 1991 introduced the concept of prompt corrective action by banks, established risk-based premiums for banks, set the reserve ratio, limited the scope of the safety net, mandated the use of a least-cost resolution to bank problems and restricted the FDIC's use of the "Too Big to Fail" concept. Despite a record period of prosperity and profit for the banking community and a restoration of the FDIC fund to the point where no assessments are being made on most banks, the FDIC believes that there are problems with the current system which require correction.

The FDIC's 2001 report contains recommendations to cure five problems with the current system. Those problems are:

1. There are two separate funds based on increasingly arbitrary distinctions;

2. Banks pay most during bad times;

3. Safe banks subsidize risky banks;

4. New deposits enter without paying for insurance protection, and;

5. The coverage level doesn't keep up with inflation.[27]

The FDIC currently has approximately seven thousand employees and its operating budget for 2000 was $1.186 billion dollars. It has been reducing both the number of its employees and its annual operating budget for the past few years from the levels existing during the bank crisis of the early 1990's. With BIF and SAIF fund levels restored, banks have not been paying insurance premiums since 1996. While there were practically no bank failures over the past seven years, three recent failures have begun to get public attention.

[27] Art Murton, Presentation to NCIGF Legal Seminar, Aug. 2001: Statement of Gaston L. Granni, Jr., Inspector General, Federal Deposit Insurance Corporation before Subcommittee on VA, HUD and Independent Agencies, Committee on Appropriations, U.S. House of Representatives.

XIII.

APPENDIX D

ADJUSTMENT OF PROPERTY AND CASUALTY INSURANCE CLAIMS

Guaranty Associations have the responsibility to investigate claims brought against them; to evaluate, adjust, compromise, settle and pay covered claims to the extent of the fund's obligations; and to deny and defend against all other claims. In their performance of these functions, Guaranty Associations stand in the shoes of insolvent insurance companies. The resolution of a property or casualty insurance claim is a complex process requiring technical skills and special knowledge. A claims adjuster first must recognize the type of claim and determine whether the insurance contract provides coverage for it, including a detailed investigation of the facts giving rise to the claim. Second, the limits of the insurance policy must be determined, assuming there is coverage for the claim. Additionally, the adjuster must determine how the law of the state, which governs the claim interprets the insurance contract's provisions. Third, in investigating the loss, a determination must be made as to whether, under the facts and applicable local law, the insured has legal responsibility, or liability for the claimant's loss. Fourth, and finally, damages must be evaluated. In other words, assuming coverage under the policy, and responsibility on the part of the insured, what is the value of the claim? It is customary to find adjusters who specialize in certain types of claims as seldom would it be possible for one adjuster to possess all of the requisite knowledge of the terms, provisions and exclusions governing all property and casualty insurance policies.

The rules of the applicable state tort and damage laws guide the fault determination and influence the determination of the value of a third person's injury or loss. Further, knowledge of current local court procedures, practices, similar claim settlement values and jury verdicts are required in the adjustment process. While first party claims, or those asserted by the insured, do not include all of the elements of third party claims, nevertheless coverage and valuation issues dictate that an adjuster must have specialized knowledge in order to assure that claims will be handled effectively.

When this adjustment work is accomplished, the claims adjuster must then know and apply the guaranty fund coverage guidelines and coverage limits as an overlay upon the results of the investigation. Adjustment then involves a process of negotiation with the claimant or the claimant's lawyer to reach agreement, if possible, on the value of the claim. When agreement is not reached, the parties often submit the claim to the courts for adjudication.

Worker's compensation claims are governed by the unique rules and coverages afforded by each state's separate worker's compensation program, and the rules which govern what benefits are determined and paid and what medical and hospital expenses are eligible for payment under the worker's compensation program. Almost every state's worker's compensation program differs materially from that of other states.

The property and casualty insurance claims adjustment process is more detailed than, often more complex than, and requiring of a greater level of expertise than the payment and satisfaction of a depositor bank balance or the payment of a life insurance death claim or policy cash surrender claim. Insurance claims adjustment requires personnel trained in the nuances of many highly technical factors, often influenced or governed by local laws, in order to make certain that just claims against the insolvent insurance company are paid and improper claims are resisted.

Two hundred years of statutory and case law precedent in fifty separate states govern the resolution of property and casualty insurance claims. That great body of law is taken into account by insurance companies in drafting their policy forms, pricing their products and determining when they elect to transact business. In addition, local regulators who are in touch with customers' needs, work closely with the Guaranty Associations to ensure as little disruption as possible, in the payment of claims, when the insurance company becomes insolvent.

XIV.

ADDENDUM 2005

NCIGF REPORT
RECENT ACTIVITIES OF
NATION'S
STATE PROPERTY & CASUALTY GUARANTY ASSOCIATIONS

In 2002, NCIGF published its report on the Capacity of the National Network of State Guaranty Associations to Protect Consumers of Nationally Chartered Insurance Companies. The report was prompted by serious proposals for a system allowing the federal chartering of insurance companies as an option to the current method of state chartering and regulation of insurance companies.

In the 2002 report we discussed, among other topics, the current State based Guaranty Fund System and its thirty plus year history, the strengths and weakness of the system and the lessons learned from past periods of increased insolvencies among property and casualty insurers. We demonstrated its ability too and the reasons why the current system should include any federally chartered property and casualty insurers which might be created under an optional federal chartering law. And we discussed the capacity of the assessment mechanisms to handle several large insurance company insolvencies at the same time.

BACKGROUND

Property & Casualty Guaranty Associations were created in all states following adoption in 1969 of a Model Post Assessment Property and Casualty Guaranty Association Act by the National Association of Insurance Commissioners. These laws were proposed to prevent the long delays experienced by consumers in receiving claim payments through the state liquidation process for insolvent insurance companies and to prevent the often drastic reduction in the amount of payments to compensate for policyholder losses which were the insurance obligations of the insolvent insurer. In the usual liquidation proceeding, distributions to creditors are made only after all assets have been marshaled and all claims against the insurer have been received and adjudicated by the Liquidator - a process which usually requires several years.

Guaranty Associations do not bail out weak insurers. What Guaranty Associations actually do is protect the average consumer who bought insurance to protect against his property loss or against his or her liability to others for injury or property damage. Guaranty Associations pay claims in full up to the policy limit or the Guaranty Fund claim cap established by the State Legislature for residents of the Guaranty Association's state. State Legislatures defined through the Guaranty Association laws, what claims are covered, what types of insurance or insureds are not covered and what limitation affect the claims of their resident state consumers. State Guaranty Associations are triggered by a finding of insolvency of a licensed insurer and usually, an order of liquidation. Thereafter, the Guaranty Association in the consumer's home state assumes responsibility for claims against the insurer covered by the guaranty association law and immediately begins processing and paying claims as promptly as data and needed claim information is received. Consumers do not have to wait long periods of time to have their claims processed, nor do they receive only a fractional payment of their claim. The full claim is paid up the Guaranty Fund cap or the policy limit depending on which amount is smaller.

Today, we report on the activities of the state guaranty associations during the past four years, beginning in 2001, when several new liquidations of major insurance companies occurred in rapid succession with the liquidation of the largest property and casualty insurance company insolvency in the U. S. history, namely Reliance Insurance Company.
This report will document how state guaranty associations met the challenge of 51 new insolvencies between 2001 and 2004.

RECENT INSOLVENCIES

In 2001, 18 property and casualty insurance companies were order liquidated, with Reliance being the largest of these companies. Reliance alone had over 100,000 open claim files and billions of dollars in claims liability. The year 2002 brought another 20 insurer insolvencies led in size by PHICO Insurance Companies. PHICO was a physician owned medical malpractice writer which had sold many policies throughout Midwestern states including its home state of Pennsylvania. Additionally the Legion Insurance Companies were placed in rehabilitation during 2002 and court proceedings in Pennsylvania caused some Guaranty Associations whose states were holding Legion deposits to begin paying claims in late 2002. In 2003, another 10 insurance companies including Legion were ordered liquidated. Fremont, Home and Reciprocal of America each generated thousands of new claims for Guaranty Associations in many states. Aggregated case reserves for claim and loss adjustment expenses of these insolvent insurers exceeded $13 Billion.

RECENT CLAIM PAYMENT HISTORY

Guaranty Associations have been expanding their annual claim payments since 2000 when combined Guaranty Association payments were slightly more than Seven Hundred Million Dollars. In 2001 claim payments increased by 68% to One Billion, One Hundred Ninety Million Dollars. Year 2002 saw another large increase in annual claim payments to One Billion Eight Hundred Seventy Million Dollars or a 57% increase. But 2003 topped all those figures with total claim payments reaching Two Billion Five Hundred Twenty Million Dollars or another 35% increase. In the past three years Guaranty Associations have paid a total of Five Billion Five Hundred Eighty Million Dollars in claim payments, including loss adjustment expenses. The attached chart gives the total number reported on the NCIGF website. Claim payment numbers of 2004 are not yet compiled and available. However, we fully expect the number to be in the same range as 2003.

The larger insolvencies of this decade have involved property and casualty insurers writing sizable volumes of commercial insurance; that is insurance for business enterprises. These companies write workers compensation insurance and general liability insurance, the former of which involve claims which continue for many years and are not subject to a dollar limit on the guaranty association's liability. The greatest dollar amount of claims has occurred in the workers compensation line of business and those guaranty associations which have experienced cash flow challenges found that they were created in the workers compensation accounts.

Commercial insurance has also presented new cash demands on guaranty associations because many employers desire to self-insure a major portion of their liability for workers compensation indemnity and medical payments as well as auto and general liability. Because qualification as in some states is difficult, larger business enterprises instead purchase workers compensation insurance from an insurance company with an endorsement providing that the insured will reimburse the insurer for the first x dollars of any claim under the policy. Often these deductibles are set at $100,000, $250,000 or even $1,000,000 per claim. In these arrangements, the insured takes almost all of the risk leaving only the exposure above the deductible amount for actual insurance protection. This means that the policyholder's insurance risk premium is dramatically less than it would be if the insurer were actually taking the entire risk. To satisfy state insurance laws, large deductible policies usually provide that the insurer will pay the claim and the insured will promptly reimburse the insurer for all claim payments up to the deductible. When an insolvency occurs, the guaranty association must pay the workers compensation claims within the deductible amount; however, reimbursement from the insured considerably less prompt and is usually collected by the insurance company receiver, instead of the guaranty association which paid the claims. The problem for guaranty associations is exacerbated because the reduction in premium paid for large deductible policies diminishes the amount of premium paid in the guaranty association's state upon which assessments can be made to provide funds for claim payments.

For commercial insurers, long running workers compensation claims stemming from permanent work injuries and long developing injury claims arising from asbestosis, mold and other environmental liabilities under general liability policies both extend the guaranty associations period of liability and increase the claim dollars needed to resolve claims against the insolvent insurer. Guaranty Associations continue paying claims of an insolvent commercial insurer for many years past the date of liquidation.

After considering the changed nature of business insurance coverages and the insurance product segmentation of many states assessment accounts (usually divided among, workers compensation coverage, auto coverage and all other coverage), the financial strength of the state based post assessment guaranty association network has been truly tested and proven during the past four years. A few guaranty associations have faced the potential of future cash shortages because of assessment limits usually in the workers compensation assessment account. California and Alaska are the most noted examples.

The California Insurance Guarantee Association recognized the problem and developed special provisions in California law to permit the issuance of bonds in the commercial market to fund claim payment over the next two or three years when workers compensation claim payments are expected to exceed the guaranty association assessment capacity. A secured bond repayment method through additional assessments on insurers in the future solved the California problem. No other state has the volume of claims which California has experienced. In Alaska, the cash shortfall in late 2004 was cured by a loan of $5 million from the California based Fremont Insurance Company liquidation. The loan can be repaid from future dividends which the Alaska Guaranty Association will receive from the Fremont Estate as it marshals assets and settles the Estate.

In Oklahoma, temporary legislation will allow loans from the auto account and the all other assessment account to the workers compensation account.

ASSESSMENT HISTORY

Year	**Claim Payments**	**Recoveries**	**Net Expenses**	**Assessments**	**Refunds**	**Net Assessments**
2000	$ 707,478,842	$ 372,745,783	$ 339,305,929	$389,698,765	$61,089,106	$ 328,609,659
2001	$1,190,420,680	$ 768,750,389	$ 426,510,697	$784,777,668	$50,104,919	$ 734,672,749
2002	$1,870,379,424	$ 420,133,156	$ 454,655,104	$240,604,222	$31,651,482	$1,208,952,740
2003	$2,520,524,786	$1,504,034,943	$1,038,893,184	$958,184,610	$56,536,200	$ 901,648,410

We reported in our 2002 paper that combined annual Guaranty Association capacity had grown to $3.8 Billion by 1999. In 2003, annual combined assessment capacity reached $6.3 Billion combining all accounts and all states. With increased claim payments assessments also increased dramatically to over three quarters of a Billion Dollars in 2001, and rising to One Billion Two Hundred and Nine Million in 2002. In all of these years actual assessments were much lower than the total annual assessment capacity and in 2003 assessment dropped below One Billion Dollars because of the effect of dividend distributions to Guaranty Associations from some existing insolvent insurers; again the attached charge will reflect the actual numbers.

However, assessments by state and by account within a state based solely on the premium written in the Guaranty Association's state does put some limit on available cash and isolated cash availability issues arose in 2004 in the workers compensation accounts of a few states because many of the new claims arose from workers compensation coverages sold by companies like Reliance, Legion, Home, Fremont and others. Despite these high levels of claims activity and even a few temporary cash questions, no claim payments were disrupted. Those Guaranty Associations affected by assessment limitations in workers compensation accounts used existing borrowing capability between accounts or, in California's case, a new bonding mechanism to continue paying all workers compensation claimants as payment became due.

The Guaranty Association network has been tested again during the past five years and it continues to work effectively to meet consumers' needs.