A PUBLICATION OF THE NATIONAL CONFERENCE OF INSURANCE GUARANTY FUNDS

Welcome to the winter issue of the National Conference of Insurance Guaranty Funds' (NCIGF) Insolvency Trends 2011. Authored by the legal and public policy staff of the NCIGF, this paper provides an update on recent events in insolvency law and practice and a look ahead at what is on the horizon in 2011.

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

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

The guaranty fund system is an innovative and common-sense mechanism. The system draws first on the assets of the failed insurance company before turning to assessments on healthy insurers in each state. Since inception the system has paid out more than $26.2 billion to policyholders, beneficiaries and claimants related to more than 550 insolvencies.

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

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

On Capitol Hill

The insurance industry has always operated in a dynamic political environment at the state and federal level. In 2010, insolvency practitioners closely monitored the development of The Dodd–Frank Act, other federal insurance-related proposals, and recent state and local elections.

Signed into law on July 21, 2010 the Dodd-Frank Act preserves the current system of insurance guaranty funds while opening the door for future federally-mandated changes.

GUARANTY FUNDS WORK

in partnership with insurance regulators to protect policyholders.

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

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

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

Payments are made promptly.

HOW THE GUARANTY FUND SYSTEM IS FUNDED

Recoveries

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

- The insurance company's remaining assets (including reinsurance)
- Funds deposited with state regulators in certain states while the company is still writing business

Assessments from Insurers

Charged to insurance companies licensed to write business in a state

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

Here are the highlights that relate to insurance company insolvencies:

- The guaranty system's existing role in protecting policyholders will remain intact; however a newly created Federal Insurance Office (FIO) will study the possibility of subjecting insolvent insurance companies to a federal resolution authority and the potential impact of such an authority on the guaranty system.
- Large, interconnected financial companies that are systemically significant will be subject to oversight by the Federal Reserve Board. This could include insurance companies and insurance holding companies, although most observers contend that few (if any) insurers are systemically significant.
- The FDIC will resolve systemically significant financial companies other than insurance companies.
- All insurance companies (including any that are systemically significant) will remain subject to state insurance insolvency laws.

2010 Elections

In the November elections, Republicans realized the largest increase in U. S. House seats for either party since 1948 to win the majority; however, Republicans did not gain the 10 seats needed to take control of the Senate. This means Democrats will lose control of the House Financial Services Committee, but maintain the Chairmanship of the Senate Banking Committee. However, both committees will look very different in the 112th Congress; a new group of policymakers will be looking with fresh eyes at how insurance insolvencies are resolved in the future.

In the States…

At the state level changes are afoot as well. According to a *National Underwriter* report of November 3, "As many as half the nation's insurance commissioners could be new following Tuesday's elections, as one incumbent commissioner lost her bid to be re-elected while Republicans won the governor's office in 10 states." Guaranty funds work in cooperation with insurance regulators to protect policyholders when an insurance company becomes insolvent and is ordered into liquidation. While the funds are, for the most part, private entities created by state statute rather than state agencies, they enjoy close day-to-day relationships with their state's commissioner.

The state legislatures were active in 2010 reviewing new proposals for the guaranty funds and the insurance liquidation acts. With the encouragement of the National Association of Insurance Commissioners, (NAIC) several states discussed – and many floated – bills to institute provisions of the NAIC model property casualty guaranty fund act adopted by the NAIC last spring. Notably:

- Oklahoma enacted various components of the NAIC model including revised net worth and subrogation provisions. However, Oklahoma retained its current $150,000 covered claim cap. (New NAIC Model language calls for a cap of $500,000.)
- A bill was enacted in Louisiana that would up the covered claim cap to $500,000 and revise the act's net worth provisions in accordance with the NAIC model. The Louisiana law also reversed the impact of recent case law relating to excess coverage for self-insurers.
- In Rhode Island a new law was enacted to add the assumed business coverage provisions from the NAIC model along with other NAIC-styled changes.

More targeted measures were implemented in Iowa and Illinois; both states enacted legislation to increase the covered claim cap to $500,000.

Next year, we look for more states to consider guaranty fund act changes. New NAIC model language will certainly be put on the table, and states will also consider the National Conference of Insurance Legislators

(NCOIL) and NCIGF model guaranty fund acts in determining the best fit for their states. Local state guaranty fund managers are an excellent resource to explain how any changes proposed would impact guaranty fund coverage parameters, efficiency and cost. We encourage those with interest in such legislation to consult with the local guaranty fund managers.

While it's been some time since anyone has attempted to propose a comprehensive liquidation act bill based on the Insurer Receivership Model Act (IRMA) Model, we have seen IRMA (or similar) language regarding treatment of swaps and derivatives (investment vehicles used by insurance companies) being proposed in several states. At this time there is no apparent opposition to this technical measure, and we expect more of these proposals to be floated in 2011. Such provisions are now in place in Connecticut, Illinois, Iowa, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Texas and Utah. We anticipate proposals to be vetted in 2011 in Indiana, Maine, Nebraska, New Jersey, Tennessee, and Virginia.

We would also anticipate some activity with regard to collateral requirements for admitting non-US reinsurers in the states. The NAIC has adopted a new, more liberal framework related to reinsurance. States do not have to enact it to maintain accredited status. We anticipate some of the Property and Casualty trades may oppose such efforts to loosen collateral requirements. Insolvency practitioners have expressed concern that less collateral will make the asset marshalling job more difficult if an insurance company liquidates.

More New Insolvency Activity

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

The company was licensed to write property and casualty insurance in 46 states plus the District of Columbia. The company's only line of business written was large deductible workers' compensation insurance. Like sister company Park Avenue Property & Casualty Insurance Company, which was liquidated in November 2009, coverage was written primarily to Professional Employer Organizations (PEOs). As of the date of liquidation there were approximately 476 open claim files. The liquidation order terminates all policies issued by Imperial as of June 11, 2010.

Another Oklahoma company, Pegasus Insurance Company, was ordered into liquidation on August 12. Pegasus was authorized to transact accident and health, property, casualty, marine, vehicle, surety and workers' compensation insurance in Oklahoma and approximately 19 other states.

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

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

Closing Efforts – Estate Distributions

Estate distribution and closing efforts continue in several jurisdictions.

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

The California Liquidation Office has been diligent as well. Notable California estate distributions include the Superior National Companies with a 2010 distributions totaling approximately $327,503,000.

Home distributed $7 million in expenses in November 2010. A petition for payment of $10-12 million was filed in December, and is expected to be paid in first quarter 2011.

Legion/Villanova Insurance distributed $212 million in August 2010.

Transit Casualty distributed $28 million in December 2010.

The Vesta Companies distributed $5.7 million.

In Missouri, the liquidator for Lutheran Benevolent Insurance Exchange (LBI) is making progress towards closing the estate. This company was ordered liquidated in December of 1996. The Court has authorized the liquidator to distribute 65 percent on Class 2 (policyholder class) claims and an additional distribution at this level for almost $2 million has been submitted to the Court for approval.

The liquidator of Credit General Insurance Company and Credit General Indemnity Company, via pleadings filed May 25 of this year obtained approval for a petition to distribute $12 million as a partial administrative expense distribution to guaranty funds. Checks were mailed on July 1. Motions were filed with the court to make an additional distribution on November 23. If approved, another $19 million would be paid from the estate to guaranty associations for their administrative expense payments. The Credit General Companies, Ohio domiciled insurance carriers, were liquidated in December of 2000 and January of 2001.

New York estates Midland and Union Indemnity recently mailed distribution checks for approximately $22 million for each eligible estate.

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

In late 2010, the estate of Transit Casualty Company moved toward its anticipated administrative closing in 2011. In December 2010, Judge Kinder, who was assigned to oversee the administrative closure process of the estate, filed his recommendations for the final stages of the Transit liquidation. The recommendations included provisions for a final distribution to Class 2 creditors in 2012, additional compensation for members of the liquidator's staff and counsel, a plan for the retention and destruction of the company's records, and provisions for addressing potential tax liabilities and for seeking a waiver from the U.S. Department of Justice.

The plan contemplates a dormancy period until December 2011 at which time the liquidator expects to have resolution of all outstanding tax issues and completion of the collection of remaining assets. The liquidator expects to make a final distribution of between 1-2 percent to policyholder level creditors, after which the estate will be closed. The estate's remaining records will be held for a period of five years, after which they will be held or destroyed in accordance with the approved plan.

There were no objections made to the proposed closing order. It is expected that the liquidation court will adopt Judge Kinder's recommendations early 2011.

New Reporting Requirements Should Facilitate Accounting for Guaranty Fund Assessments

The NAIC's Statutory Accounting and Principles Working Group adopted revisions for recognizing liabilities for insurance-related assessments in SSAP No. 35R – Guaranty Fund and Other Assessments, and Issue Paper No. 143 – Prospective-Based Guaranty Fund Assets at the October 2010 NAIC Meeting. Effective January 1, 2011 SSAP 35R fixes the problems identified over the past nine years by property and casualty companies in recording their assessment liabilities.

SSAP 35, which was adopted in 2001, required insurers to estimate an assessment liability for the ultimate loss expected from known insolvencies. Insurance companies experienced great difficulty getting enough current information to calculate the ultimate expected assessment exposure.

SSAP 35R adopts the Generally Accepted Accounting Principles (GAAP) guidance (with some statutory modifications) and coincides with how the majority of guaranty funds make assessments. Under SSAP 35R the liability to be recorded is what can be reasonably estimated and relates to premium writings for the year preceding the year of assessments. Two events must occur to trigger liability for post-insolvency assessments: 1) the insolvency itself and 2) the writing of the premium in the base year for guaranty fund assessments.

Over the past two years the NCIGF has enhanced its Assessment Liability Report by making it compliant with the new SSAP 35R and providing updates prior to quarter-end to meet insurers reporting deadlines. Insurers have noted their auditors accept the report as support for their assessment liabilities. The Assessment Liability Report can be found on the NCIGF's public Web site under Industry tab/Financial History and Assessment Liability Information.

Medicare Reporting and the "MARC" Coalition

The Medicare Secondary Payer provisions in Section 111 of the Medicare, Medicaid, and SCHIP Extension Act of 2007 impose information reporting requirements on insurance companies and other entities that provide payments pursuant to non-group health insurance plans, including liability insurance, self insurance, no fault insurance, and workers' compensation insurance plans.

Guaranty funds and other organizations that may be subject to new Medicare reporting requirements are working hard to:

- Understand the application of the new law in the context of various complex coverage arrangements (such as large deductible programs) and servicing arrangements with Third Party Administrators, and
- Gear up to "go live" with electronic reporting.

The MARC (Medicare Advocacy Recovery Coalition) is a group formed to advocate for improvements in Medicare Secondary payer system. MARC is made up of a group of entities affected by the Medicare reporting requirements; this includes attorneys, brokers, insureds, insurers, insurance and trade associations, self insureds, and third party administrators. (Additional information is available on MARC's Web site at www.marccoalition.com.) The group also acts as a clearing house for letters of support submitted by other interested entities including the U.S. Chamber of Commerce and the Trial Lawyers Association.

MARC is seeking support for HR 4796, federal legislation introduced in March 2010. The bill currently has 35 co-sponsors in the House; sponsors are not yet identified in the Senate.

The key provisions of HR 4796 are:

- Improve the coordination of benefits process
- Bring finality to MSP claims
- Establish an appeal process for disputed MSP claim amounts
- Mandate an efficient and reasonable threshold amount for MSP claims
- Add a three year statute of limitations for MSP claims
- Create safe harbors for companies that attempt to comply with MSP laws
- Amend the reporting fine provision and establish a reasonable fine for "willful" reporting violations
- Reduce reliance upon social security numbers

Rehabilitations and Run-Offs

In some cases a state regulator will attempt to resolve a troubled company's claims by means other than a statutory liquidation. In these cases the guaranty funds are not activated. Proponents for alternative approaches cite orderly claims processing, low cost, and greater flexibility to achieve commercially acceptable results. However, the efficiency and cost-effectiveness of an alternative – versus a statutory liquidation – to our knowledge has never been established.

Most recently, the NAIC finalized a white paper which discussed the various alternative approaches in depth. The paper concluded with this statement:

"First and foremost, it is the responsibility of regulators to protect insurance consumers. Thus, proponents of alternative mechanisms for troubled insurers should be pressed to prove to the regulator's satisfaction that the claims of greater efficiency or flexibility will not be used to strip policyholders and claimants of their policy rights so that value can be returned to investors. And regulators should ensure that all alternative mechanisms for troubled insurers place the interests of consumers ahead of other competing interests, coupled with a clear statement of goals and objectives and a meaningful oversight mechanism."[1]

Probably the most well known company in which this approach has been taken is the Lumbermens (formerly Kemper) run off.[2] Lumbermens Web site indicates "Lumbermens Mutual Group filed its third quarter 2010 financial statements (LMC financial statement - AMM financial statement) on Thursday, November 11, 2010. Lumbermens Mutual Casualty Company (LMC) posted a statutory surplus of $12.1 million as of September 30, 2010. American Manufacturers Mutual Insurance Company (AMM), a mutual company under common management with LMC, posted statutory surplus of $10.5 million for the same period." The company has reduced its liabilities from annual statement reported amount for 2003 of about $5 billion to about $1.1 billion at end of year 2009.

Rhode Island has had a run-off law in place for several years. For the first time a proposal has been approved by the court for a commutation pursuant to the Rhode Island Statute. This matter involves assumed reinsurance business written by GTE Reinsurance Company Limited. GTE novated remaining non-related business and redomesticated its assumed reinsurance block to Rhode Island. A commutation plan was

1 "Alternative Mechanisms for Troubled Insurance Companies 2009." NAIC White Paper.

2 Per press release dated. June 29, 2010 Lumbermens Mutual Casualty Company and its affiliates have ceased the use of the name "Kemper Insurance Companies" and will continue winding up their operations under the trade name "Lumbermens Mutual Group." Historically, Kemper has been the marketing and trade name for Lumbermens and its affiliates, including American Motorists Insurance Company and American Manufacturers Mutual Insurance Company. In connection with this change, Lumbermens Mutual Group today concluded the sale of its rights in the Kemper name to Unitrin, Inc.

approved on June 25. There is no direct insurance business involved. Four hundred and forty cedants remain and all will have a vote on the commutation plan. Involved parties needed to submit their proxies by end of month October.

Highlands Insurance Company, a Texas domiciled stock, fire and casualty insurance company, was placed into receivership in November, 2003. In July 2008, the 250th Judicial District, Travis County, Texas, approved the Second Amended Plan of Rehabilitation. The rehabilitation plan calls for the special deputy receiver to manage Highland's assets and liabilities and pay its claims without placing the company into liquidation. The plan also calls for the special deputy receiver to monitor the progress of the plan and to advise the court if at any time it appears there will not be sufficient assets to pay all claimants in full during the course of the runoff.

According to the special deputy receiver's August 31, 2010 financial statements filed with the court, Highlands has assets of $226.6 million and liabilities of $412.4 million. Notwithstanding this gap, the special deputy receiver continues to pay Highland's policyholder claims and projects he will have sufficient cash to enable him to pay the claims through 2032.

It is expected that Highlands will remain in runoff under its Second Amended Plan of Rehabilitation Plan indefinitely, or until such time as it appears that the plan does not have sufficient cash to meet its claims obligations to all policyholders and claimants.

Frontier Insurance Company was placed into rehabilitation in October 2001. Since that time, the rehabilitator has been paying claims and has stated its desire to see Frontier eventually returned to financial health. According to Frontier's 2007 annual statement, the most recent financial statement available on the receiver's Web site, Frontier had a negative surplus of $103 million.

In early 2010, Steven Poizner, the California Insurance Commissioner, filed a petition in the New York County Supreme Court seeking an order compelling James Wrynn, the New York Superintendent and rehabilitator of Frontier, to file a petition for the immediate liquidation of Frontier. In his petition, citing the company's $90 million negative surplus, Poizner alleged that the eight year effort to rehabilitate Frontier had failed and that further attempts at rehabilitation were futile. Following a hearing, the court declined the petition on the grounds the action must be brought against Wrynn in his official capacity as superintendent rather than as Frontier's rehabilitator. However, the court issued an order compelling Superintendent Wrynn to develop and submit to the court for approval a plan of rehabilitation for restoring Frontier to solvency, including an assessment of how long continued rehabilitation efforts are expected to continue. The order also provided for interested parties to have an opportunity to comment on the proposed rehabilitation plan.

To learn more…

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

Look for an update of insolvency trends in July 2011.

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

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