National Conference of Insurance Guaranty Funds NCIGF℠

Backgrounder

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Premium Relief Dilutes Fundamental Aim Of Guaranty Fund System

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State property and casualty insurance guaranty associations are statutorily created entities that pay covered policy claims against insolvent insurers. They provide for payments for most lines of property casualty business, including commercial liability, homeowners and automobile.

The guaranty fund system was developed early in the 1970s, when it was recognized that the cost of paying all claims of an insurance company that had become insolvent would be cost-prohibitive. An allocation system to maximize the recovery available to those believed to be most in need was developed. All others not covered under the system would need to seek recovery directly from the insurance receiver, who is appointed by the applicable state insurance commissioner, and subject to court approval.

A version of The National Association of Insurance Commissioner's (NAIC) Post-Assessment Property and Liability Insurance Guaranty Association Model Act ("Model Act") has been adopted by most states. Although there are slight variations on a state-by-state basis, the guaranty funds cover claims arising under most lines of insurance, paying the lesser of the policy limits or $300,000. However, under workers' compensation policies, the full amount of benefits as defined by the states' workers' compensation statutes is payable in virtually all states.

This system is funded by insurance companies paying assessments, based generally on a percentage of the company's net premium written in each state in which the insurer is licensed to conduct the business of insurance. Insurance companies that pay these assessments are permitted to recoup these assessments paid through one of three methods, depending upon the state: through increased premiums, premium surcharges or an offset in the company's state premium taxes.

Since the inception of the guaranty fund system, the insurance industry has changed significantly. Lines of coverage have expanded and new coverage forms have been created. New variations on risk transfer have been created in the 40 or so years the guaranty fund system has been in existence, including policies issued with large deductibles, policies issued over self-insured retentions, excess liability forms, and policies written by risk retention groups. Many of these types of alternative insurance risk mechanisms did not exist at the time the original Model Act was promulgated. As a result the drafters of the Model Act did not contemplate providing protection for them.

The guaranty funds are often the primary source of recovery for insureds and claimants following the liquidation of an insurance company. There are several key issues with respect to guaranty fund applicability, and its provisions and prohibitions that apply to alternative insurance risk mechanisms.

Who and What is Covered?

The first issue is whether a claim under a policy issued by an insolvent insurance company qualifies under the applicable state guaranty fund. Under the Model Act an insolvent insurer is defined as a licensed insurer within the state against which a final order of liquidation has been entered by a court of competent jurisdiction in the insurer's state of domicile. This means that policies written by non-admitted insurers, surplus lines policies and non-covered lines are not eligible for guaranty fund coverage. As an element of protection to policyholders several states require the declarations page, first page of the policy, be "stamped" with a notice indicating the policy is not subject to protection under the guaranty fund laws of that state. An example is the sample New Jersey stamp which is to read as: "This policy is written by a surplus lines insurer and is not subject to the filing or approval requirements of the New Jersey Department of Banking and Insurance. Such a policy may contain conditions, limitations, exclusions and different terms than a policy issued by an insurer granted a Certificate of Authority by the New Jersey Department of Banking and Insurance. The insurer has been approved by the Department as an eligible surplus lines insurer, but the policy is not covered by the New Jersey Insurance Guaranty Fund, and only a policy of medical malpractice liability insurance as defined in N.J.S.A. 17:30D-3d or a policy of property insurance covering owner-occupied dwellings of less than four dwelling units are covered by the New Jersey Surplus Lines Guaranty Fund."

Federal Insurance Programs

Other types of insurance policies that are not eligible for guaranty fund protection include flood and crop insurance, which are covered under federally insured programs, and policies written under risk retention groups. By virtue of federal law, mimicked by virtually all states, risk retention groups are exempt from guaranty fund assessments and are prohibited from participating in state guaranty funds. Risk retention groups are owner-controlled insurance companies authorized by the Federal Liability Risk Retention Act of 1986. The Act was signed into law by President Reagan in 1986. Property, workers' compensation and personal lines coverages are excluded from the Risk Retention Act, and are generally policies whose claims are likely to be covered under the guaranty fund laws.

Limitations

Guaranty fund statutes place a cap on the maximum amount the guaranty fund can pay. Most states limit this amount to $300,000 per claim. If a claim is valued at $500,000, the guaranty fund will pay the first $300,000, and the claimant must look to the liquidator for payment of the balance.

Net Worth

About two –thirds of the guaranty funds have a net worth provision that limits covered claims to those companies having a certain net worth on a particular date prior to the insurer's insolvency.

Self Insurance

Self insurance has historically posed unique questions for guaranty funds and insureds with policies issued by insolvent carriers. Generally, self insurance is not covered by the guaranty fund laws. There are several reasons for this. The guaranty funds were created to alleviate the injuries resulting from insurance company failure. By definition, those who self insure have opted to keep all or a portion of their risk outside the insurance system, and therefore, without the safety net of the guaranty fund system.

Additionally, the entities that have chosen to self-insure are deemed to have evaluated and knowingly assumed more risk in opting out of the standard insurance market. Risk managers are generally involved in these purchase decisions; and the assumption is that issues, such as insurer insolvency and possible loss of collateral, are identified, assessed and agreed on when structuring a risk program that may not include first dollar insurance coverage, or a policy issued with a deductible.

The risk of having no guaranty fund backstop protection is consciously retained by the company. Additional savings may be realized by the business in that premium loads including guaranty fund assessments for premium are not paid on the self-insurance portion of an insurance risk. Shifting assumed liabilities – and accompanying risk – by entities originally seeking premium relief and greater claims control by self-insuring in an effort to obtain the protection under the guaranty fund provisions was not the intention of the drafters of the model acts. Bypassing or avoiding guaranty fund assessment responsibilities, and other premium loads that accompany the admitted market, along with the other benefits of the non-admitted market such as more flexibility in coverage arrangements has its rewards; but it also has risks, including the possibility of no coverage afforded for claims against the guaranty fund system.

Conclusion

The system was designed to take care of individuals and small businesses who could ill afford the loss of their insurance protection. Risk and policy choices made by large companies seeking protection under the system intended for protection of those "who need it the most," the average citizen policyholder, is not the guaranty funds' purpose. Who and which policies are covered is well established. This should only be changed by individual state legislatures.