

INSURANCE

Guaranty Funds Are Efficient and Effective

Though imperfect, guaranty funds have met their obligations, to the tune of \$21 billion in claims, to policyholders whose carriers have become insolvent. BY ROGER H. SCHMELZER

Public policy is a creature of consensus and compromise. An essential social mechanism with many tasks to fulfill, public policy, when it works best, balances interests, promotes society's general welfare, serves disparate constituencies and, of course, walks the fine line of practical politics. In short, public policy is the product of legislative solutions that, while imperfect, are generally sound and bring the "greatest good to the greatest number."

Perhaps nothing better reflects public policy's virtues and inherent challenges than the state property/casualty guaranty-fund system. For nearly 40 years, guaranty funds have fulfilled their original public-policy mandate: to protect policyholders and claimants. It is a proven system, one that has met its statutory obligations by paying \$21 billion in claims to policyholders, beneficiaries and claimants whose insurance company became insolvent.

Property/casualty insurance is based on a delicate public-policy balance that distributes the risk of property loss among millions of consumers under the watchful eye of state departments of insurance. A key element of that balance is the low-cost structure of state-based guaranty funds that helps protect people and small businesses least able to absorb the impact of an uninsured loss related to a property/casualty insurer insolvency.

Guaranty associations are statutorily mandated for a reason: They deliver an essential public service for property/casualty insurance consumers. They were created to pay average "citizen" policyholders, first and foremost. While guaranty funds have an obligation to be efficient, their primary duty is to fulfill their statutory

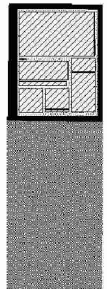
responsibilities to the policyholder. This is the charge policymakers set for the system at the outset: bringing the greatest good to the greatest number of people.

The success of the system has not gone unnoticed. Speaking in the summer of 2006, the Deputy Assistant Secretary of the U.S. Treasury for Financial Institutions David G. Nason said: "While there are passionate views on virtually all aspects of the (insurance) modernization debate—the viability and merit of the state guaranty system is rarely, if ever, called into question."

DIFFERING POINTS OF VIEW

Still, like any outgrowth of public policy, the guaranty-fund system isn't perfect. No system is. Differing opinions come from many quarters. This is not only understandable, it is positive. Diverse viewpoints expressed about a public system should be expected and encouraged. Opinions broaden the debates they inform and bring to issues a healthy mix of perspectives that can help identify solutions. Jim Schacht and Lynn Prescott Hepler of Navigant Consulting have provided a useful contribution to this discussion in their recent series on the general topic of insolvencies in these pages. The issues they raised over the past few months are interesting and offer one perspective on the guaranty-fund system (See the Risk & Insurance® in-depth series on insurance insolvencies in the January through April 1, 2007, issues.)

Of course, the opinion of the property/casualty guaranty-fund system that matters most is that of the authors of each state's insolvency statutes



that define the system and its mission. But guaranty-fund policy is a discrete area of state law, one that typically gets little attention until there is an insolvency. Issues associated with this policy do not lend themselves to easy conclusions.

The first priority of every state legislator is, or should be, the protection of her constituents, who could potentially be harmed by an insurer failure. As lawmakers evaluate the merits of policy options for the current guaranty-fund system, they might well find guidance in the words of American economist Thomas Sowell. As Sowell put it, anything under examination must “stand up to three questions: (1) Compared to what? (2) At what cost? and (3) What are the hard facts?”

As Sowell suggests, legislators are well-advised to make any review of state guaranty-fund-related issues through the critical and objective prism of public policy because it is public policy that gave birth to the safety net in the first place.

TAKING RESPONSIBILITY

That is exactly what the state guaranty-fund system is doing. The property/casualty guaranty funds are undertaking a thoughtful, candid and broad-based self-examination of the culture and process of the state system through a strategic planning initiative created by the National Conference of Insurance Guaranty Funds board of directors.

The initiative, begun in January 2006, has evolved into the most ambitious self-examination of the state guaranty-fund system in its history. As part of the effort, we have sought out and received the participation of the guaranty funds’ insolvency partners. The goal: to assess how we perform on key fronts, and how the guaranty-fund side of the insolvency equation can improve.

Advised by former Iowa insurance commissioner and

one-time president of the National Association of Insurance Commissioners, Dr. Terri Vaughan, and her Drake University colleague, Dr. Robert Cooper, the project’s initial phase involved the use of surveys and interviews to gather information from the insolvency system’s stakeholders. The surveys probed virtually all key aspects of the guaranty funds. Questions invited input on everything from state guaranty-fund laws to guaranty-fund board membership.

The first phase of the study gave participants the opportunity to express opinions about a broad range of insolvency-related topics, including runoffs and net worth, resource-sharing, consolidation of guaranty-fund operations and other questions. The results of the surveys and interviews will be used by working groups led by state fund managers for the analysis of guaranty-fund performance and possible improvements.

Through this initiative, the NCIGF and its member guaranty funds are taking responsibility for the guaranty-fund system by committing to a regimen of continual improvement. The goal of the initiative directly serves the guaranty funds’ public-policy mandate by establishing meaningful benchmarks based on reliable and objective systemwide data.

Those who stand to benefit most from the guaranty funds are those whom the guaranty funds have been statutorily charged to protect from the very beginning—the average citizen insurance consumers who rely on the system to provide the kinds of safeguards and service it delivers.

NEW CHALLENGES

Challenges to the guaranty-fund system began to mount in the 1980s, an active period of insolvencies among insurers, many of which wrote large amounts of commercial insurance. The guaranty-fund system was first

designed by state policymakers to cover straightforward, simple lines, or personal and homeowners business. It was never anticipated that it would be asked to handle the kinds of large and complex multistate commercial products that now make up a growing segment of the property/casualty business.

Many of the alternatives and proposed changes to the insolvency system, while tested to greater or lesser degrees, are as yet largely unproven. This uncertainty exists in contrast to a system that, while not perfect, has performed in accord with the spirit and the letter of its statutory mandate.

With these alternatives and proposals, questions remain unanswered, such as: Will these alternatives deliver the greatest good to the greatest number? Will they offer the greatest protection to the greatest number of those constituents who public policy has always sought to protect—the average policyholder? What will be the costs associated with a new system, or changes to the existing one?

There are other, even more fundamental challenges related to the state guaranty-fund system to be addressed—chief among them, exactly who is covered by the funds? Despite state statutes that clearly spell out who is eligible, the hundreds of millions of dollars in play with each major insurer failure, the dynamics of the contemporary property/casualty marketplace and recent heavy insolvency activity have made the scope of coverage a pressing matter of public policy with potential significant impacts.

The original system was intended to serve as a limited backstop to protect consumers from insurance company failures that inevitably arise in competitive markets. Perhaps more importantly, it made a powerful public-policy statement about the sanctity of the insurance contract. As statutory payment

limits and other failsafe methods that have been added by state legislatures make clear, it was not planned for the guaranty-fund system to become a source of funds from which broader relief can be drawn.

Regardless, there exists a school of thought that it is acceptable to expand guaranty-fund coverage to include individuals and businesses that opted out of guaranty-fund protection. In the end, however, these matters too must be resolved by the state legislatures responsible for establishing the public policies that allow the property/casualty industry to compete in their states.

AN ESSENTIAL SAFETY NET

The insolvency burden for insurance consumers, taxpayers and solvent insurers has been considerable in recent years; yet, insolvencies have been handled successfully in an established public-policy structure designed to make property/casualty insurance available and dependable to consumers. The guaranty funds have performed as an effective and proven system, one that has provided an essential safety net serving thousands of policyholders and claimants least able to deal with losses related to more than 600 insurance company failures.

The NCIgf's member guaranty funds will continue to honor their core commitment to keep the system agile, strong and flexible so that claims can be paid even as we are attuned to current and emerging issues. Operational modifications arising from the guaranty funds' current assessment of the system will improve it and provide the flexibility needed to meet future challenges.

We live in an era marked by megacatastrophes, terrorism risk and renewed political interest in the regulation of insurance markets; we must not take the proven performance of the guaranty-fund system for granted. Guaranty-

fund public policy has been—and should be—accorded a higher profile on the policy landscape. We welcome those who wish to engage with us constructively in these deliberations.

Now is the right time to look ahead and plan for a future for the state-based property/casualty guaranty-fund system. The window is open to undertake commonsense reforms while we are in a period of comparative lull in insolvency activity. These reforms promise to advance a forward-thinking agenda that will deliver cost-effective protection to insurance consumers while reducing costly and burdensome aspects of the present system that can delay and hinder essential protection for consumers and policyholders.

The NCIGF and our member guaranty funds seek nothing less than the opportunity to provide

an even higher level of service and protection to property/casualty insurance consumers. It's an opportunity we embrace; we invite our insolvency partners to join us.

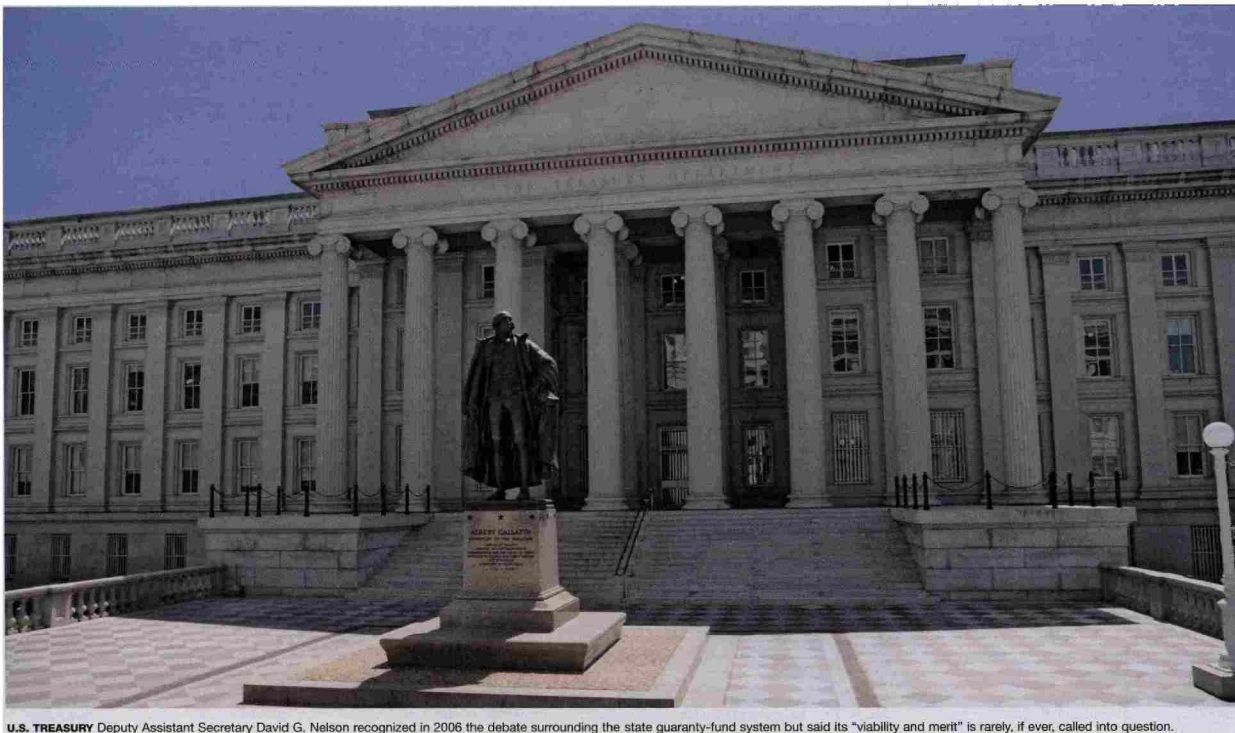


ROGER H. SCHMELZER

is the president and CEO of the National Conference of Insurance Guaranty Funds. He can be contacted at riskletters@lrp.com.

Summary

- Guaranty funds deliver an essential public service to property/casualty policyholders, and always have.
- Alternatives and proposed changes to the insolvency system are largely unproven.
- Proposed reforms promise to make the guaranty-fund system even stronger than it is today.



U.S. TREASURY Deputy Assistant Secretary David G. Nelson recognized in 2006 the debate surrounding the state guaranty-fund system but said its "viability and merit" is rarely, if ever, called into question.