Runoffs – Friend or Foe?

Runoff of a statutory insurer or a discontinued line of business has been a method used for years by typically large insurance organizations when exiting a market or a line of business. This kind of runoff has been managed internally within the organization and is largely invisible to the outside world. As of late, there seems to be a growing trend of insurance regulators running off troubled companies. At present, Kemper, Highlands and Frontier are in runoff, under the formal or informal supervision on their respective insurance departments. This article presents and discusses the issues raised by these regulator-supervised runoffs.

At first glance, runoff may appear, to at least regulators, to be an attractive alternative to attempting to rehabilitate an insurer, or liquidating an insurer through a formal, judicially supervised process. A liquidation is viewed by many regulators as something to be avoided at all costs. A troubled insurer is also an in-state employer providing local jobs that can, at least temporarily, be preserved with a runoff. Further, the bankruptcy of an insurer, although arguably a natural occurrence in an intensely competitive marketplace populated by a large number of companies selling a largely homogenous product, is still viewed by many as a regulatory failure. Runoff allows this negatively viewed outcome to be avoided.

As a good friend has pointed out to me, the fact that a liquidation has occurred does not by itself indicate a regulatory failure. A poorly run liquidation or poorly handled troubled company that results in higher costs passed on to the public ***is*** a regulatory failure. The goal should not be to avoid liquidation, it should be to minimize the cost of any liquidation that becomes necessary.

In any case, a regulator may see a runoff as attractive because it also means that guaranty funds are not triggered. Guaranty fund assessments are not required. If a state which allows premium tax offset for assessments is involved, premium tax revenues do not decrease.

My message to primary insurers is quite simple. We need to tell regulators to HOLD EVERYTHING! STOP! Please take a break. We need to ask whether runoffs are a good thing. Is the insurance consuming public better off with a runoff? The primary purpose of insurance regulation is to protect policyholders. All things considered, are runoffs in the best interests of policyholders?

These are all good questions that have not been answered. I would submit that an important step has been skipped. Has anyone looked at this on a public policy level? That is, what are the public policy implications of this change in approach? From a financial standpoint, is it clear that runoff provides a better result to those impacted by an insurance insolvency?

Decades ago, legislators in the many states acted in a surprisingly uniform way to address the problem of insurance insolvencies by putting in place a network of state insolvency laws. These laws embodied the measure of protection that would be provided to the various individuals and organizations impacted by an insurer insolvency. There were winners and losers – some parties would be protected, others would not. Legislators decided that

troubled companies that were insolvent, or operating in a way that was hazardous to policyholders or the public, would be taken out of the marketplace, with the policy claims of those most in need of protection paid by the state guaranty funds. Claims against the insurer including claims under policies were required to be substantiated, and would be paid subject to a priority of distribution scheme that preferred policyholders and claimants, and also the guaranty funds that protected those policyholders and claimants.

Guaranty funds would be administered by those who know best how to handle insurance claims – the insurers themselves. Guaranty funds would be examined and regulated just like insurance companies, since insurance regulators would have a similar interest in ensuring that policyholders were protected, whether or not an ongoing insurer is involved. Protection of policyholders was the pervasive theme and principal goal shared by insurance regulators and guaranty funds, with the goal achieved through the operation of the state system of guaranty funds.

The benefits that are provided by runoffs are unclear. Runoffs are conducted without established regulatory standards (e.g., policyholder's preferred status for protection and claims priority) similar to those that exist in insolvency laws. There seems to be little evidence available at least to the author that indicates that companies in runoff receive the same vigorous level of regulation as ongoing insurers. While writing this article, I have been trying to recall the last time I heard about a regulatory examination of a company in runoff. Whatever good public policy is represented by runoffs remains unclear.

Further, it is not at all clear whether a runoff (that is almost always followed by a liquidation) results in lower costs ultimately passed on to insurance consumers, state taxpayers, estate creditors and other stakeholders. The case really has not been made by way of financial analysis that runoff provides a better overall result to these important stakeholder groups.

To address the matter from a practical standpoint, and from the guaranty funds' perspective, it is critically important that regulators conduct a runoff in such a way as to be consistent with the overall goal of protecting policyholders. A runoff must meet certain minimum requirements to do this: (1) The same rules should apply on claims, insureds and claimants must be treated fairly, (2) A runoff cannot result in a "deepening" of insolvency, and (3) Any runoff must include a separate effort to work with the guaranty funds to plan for liquidation, should liquidation become necessary.

To explain, claims adjusted and paid in runoff should be handled in the same manner as claims handled by ongoing insurers. There should be no question about whether claims processed during runoff are being promptly and fairly investigated, adjudicated and paid. There is at least anecdotal evidence that different rules sometimes exist for settling claims in runoff.

A runoff should not result in higher costs passed on the public through the guaranty fund system. Runoffs almost always involve financially troubled insurers. A runoff should not result in a larger deficit or shortfall than what existed at the outset.

Finally, the runoff should be conducted in such a way that an orderly transition to liquidation can occur, should liquidation be necessary. This is essential to ensuring that policyholders are protected, even when it is necessary to liquidate the insurer. Every effort should be minimize the disruption that results from placing an insurer in liquidation. With proper planning and consultation with the guaranty funds, a smooth transition to liquidation is achievable.

From an ongoing insurer's perspective, a runoff can seem attractive – guaranty fund payout is postponed and possibly reduced. However, runoffs cut both ways. Guaranty funds in effect lose the benefit of their preferred position in the priority of distribution scheme, and are forced to "share" assets with all creditors, through the operation of the insurer while in runoff. The latter will almost certainly result in lower distributions to guaranty funds. To the extent that there is a double standard that applies from regulatory perspective, and policyholders suffer as a result, guaranty funds may easily be viewed as the problem even though not involved. So, while runoffs may seem superficially attractive, there may be a "cost" borne by industry that is not initially apparent.

Difficult issues are raised by the runoff of an insurer. Important questions have yet to be answered. Hopefully this article has helped these issues and questions to be seen more clearly.