National Conference of Insurance Guaranty Funds NCIGF℠ PROPERTY AND CASUALTY Guaranty Funds

**Backgrounder** **November 2007**

## Remaining Ready: Preparedness is the Key to Effective Insolvency Management by the Property and Casualty Guaranty Fund System

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If the high insolvency activity of the early 2000s[1] confirmed anything, it showed a need for a prepared guaranty association system. For a state guaranty fund—just as it is for the local firehouse—future effectiveness exists in direct proportion to the degree of preparedness it maintains. Standing ready to deal with the next insolvency, or series of insolvencies, is basic to the property and casualty guaranty fund system's continued ability to deliver on its statutory charge of paying the covered claims of policyholders and claimants quickly and efficiently, thereby preserving the sanctity of the insurance contract.

Preparing for future insolvencies: the guaranty association rapid response. After a company is declared insolvent, state guaranty funds step into the shoes of the failed insurer and immediately begin paying covered claims.

But the ability of the guaranty fund system to perform its statutory mandate to pay claims promptly requires that guaranty associations be prepared to respond quickly when new insolvencies – expected or not – occur. Moreover, the state guaranty fund system must work within the confines of the structure and business practices of the insolvent company to ensure a smooth transition to the state funds of their claims handling function.

The liquidation of the Reliance Insurance Company in October of 2001 illustrates just how suddenly insolvency can hit. It also provides a compelling "case study" of how preparation can ready guaranty associations to manage the challenges of a major insolvency.

Prior to the Reliance liquidation, the guaranty associations and the Pennsylvania regulator had worked together to closely monitor the situation and prepare for a possible liquidation. However, among the fallouts of September 11, 2001 was a disruption of ongoing reinsurance collections by Reliance that were critically important to its cash flow.[2] The disruption was the death knell for the company; within weeks, the Pennsylvania Court ordered its liquidation. Fortunately for policyholders who awaited payment of outstanding claims against the company

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Between 1999 and 2005 the guaranty funds paid out about $10 billion as a result of such mega insolvencies as Reliance, Legion, PHICO and Fremont in the early 2000s – almost half of the $21 billion paid by the system since its inception in the late 1960s.

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In a press release dated October 3, 2001, then Commissioner Diane Koken states "[t]he ongoing shortfall of cash receipts -- especially those of reinsurance -- needed to pay policyholder claims and administrative expenses has been exacerbated significantly by the terrorist attack on the World Trade Center. Recent output from the financial model shows that Reliance will be unable to pay policyholder claims as early as the fourth quarter of 2001."

the property and casualty guaranty funds had invested both their professional talents, skills and coordinated efforts to prepare for this sudden and unpredictable event.

Groundwork performed by the guaranty fund system prior to the Reliance insolvency did much to help the system respond quickly in the weeks following the failure. Experienced professional guaranty association staffs provided a depth of institutional knowledge for the intense work of the insolvency. Also enabling the system to bear up under the taxing demands of Reliance was Uniform Data Standards (UDS), an electronic communication protocol with defined computer file formats allowing a fast and efficient reporting of policy and claim information. The standardized reporting that UDS provided was developed in 1995 and allowed the funds to "hit the ground running" in a period of unprecedented claims volume. In addition, state statutes had been updated in key areas – specifically regarding net worth and bar dates.

The demands of the Reliance insolvency were daunting: the liquidation required that more than 80,000 claim files be moved to the guaranty funds. The guaranty funds were ready, due in large part to pre-Reliance investment in facilities, information technology resources and its proactive efforts to develop and maintain core professional staffs of claims adjustors, coupled with uniform standards for communicating claim and policy information.

The scope and magnitude of the Reliance insolvency and its sudden liquidation is not typical. However, Reliance clearly showed that effective preparation for unknown "short-fused" insolvencies is essential. It also showed this level of preparedness is only possible when the guaranty fund system strategically works to maintain a state of readiness.

"Working to remain ready" with a core professional guaranty association staff. Guaranty fund staffing generally contracts and expands depending upon the number of claim files a particular fund has under review. However, even in times of relatively light insolvency activity, state funds must maintain core professional staffs; there is a certain staffing level under which it would be unwise to fall. By maintaining adequate staffing, funds ensure continuity of practice and institutional knowledge of systems, laws and policies and the ability to train newly hired staff when activity increases. Standing professional staffs serve as repositories of important guaranty fund-related information, and encourage positive working relationships with receivers. It is the foundation on which the work of a state guaranty fund rests.

A standing, professional guaranty fund staff is also essential because often, the last few, usually older, claims are the most complex and offer the highest potential for litigation. In addition to supporting ongoing claim activity, staff must pursue and report subrogation recoveries, and prepare and file claims and other reports with the estate's liquidator, necessary actions to marshal the reinsurance recoveries that reduce company assessments. These and other tasks exist over the life of an insolvency – a period that can extend 20 years or more.

Preparing for the next insolvency in the constantly evolving insurance environment. While the insurance industry is dynamic and ever-changing, the central charge of the guaranty fund system is not; covered claims must be paid efficiently notwithstanding insolvency's challenges or complexities.

State guaranty associations were formed in the late 1960s around the principal that the insurance contract into which a consumer enters should be honored within defined limits as a matter of public policy. Relief was intended for insolvencies of companies that, at that time, wrote mostly personal line policies in single states. Insolvencies of these companies tended to be generally smaller and simpler, and were easier to administer. The most common claims were those related to substandard auto and house fires. 3 Much has evolved in the insurance marketplace and the realm of insurance insolvencies since the 1960s.

The 1980s witnessed a growing number of large insolvencies among insurers writing significant amounts of commercial insurance. Recent insolvencies occurring mostly in the early 2000s have involved complex commercial insurance products, such as large deductible policies and policyholders doing business (and consequently presenting claims with the funds) in several states. In addition, many of these insolvencies, such as Reliance, Fremont Indemnity Company and Legion Insurance Company, were larger than any the system had before absorbed.

The insolvency of a large commercial insurer then was viewed as almost impossible to occur. There was certainly no "track record" available at the time to inform the decision to extend coverage to the commercial market segment, with policyholders as varied as main street storefronts to Fortune 500 conglomerates. Additionally, subsequent developments in commercial lines products were difficult, if not impossible, to foresee at that time, and the state guaranty fund laws were never expected to cover such products. The report on the hearing of the U.S. Senate Subcommittee held on June 25, 1968 discussing the need for a safety net to cover insurer insolvencies suggests that such a safety net was intended to protect individual policyholders and claimants rather than large commercial insureds. For example, in that hearing, Senator Dodd advocated the need for the safety net by stating that individuals who are driven by the unstable market force to high risk insurers "must face the fact that their families can never be secure by their fireside knowing that the insurance company standing between any judgment and their home may become insolvent." See Hearings on S. Res. 233, Part 13, Automobile Liability Insurance before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary United States Senate, 90th Cong. (1968). These factors have significantly changed the landscape for guaranty funds, requiring that they adapt to this new world. Recently, the guaranty funds have been faced with:

• High volume of claims resulting from large, multi-state, multi-line insolvencies;
• Claims operations that have been delegated to various third party administrators;
• Paperless record-keeping by companies that become insolvent;
and
• Pockets of capacity strains that resulted from insolvencies of significant size – either as large, multi state companies or as companies with significant presence in discrete states.

These challenges have brought renewed focus on the need for policymakers to examine guaranty fund operational practices and statutes with an eye toward strengthening their protections for those whom they were originally intended – the average citizen and small business policyholders and claimants.

Guaranty funds continue to develop the electronic systems and legal and operational structures to enable them to deliver protections in a changing insurance world. Human and financial investment greatly enhances the ability of the guaranty fund system to address the changing industry.

Many recent enhancements to the functionality of the guaranty fund system and its statutory underpinnings have their origins in "lessons learned" from periods of heavy activity dealing with complex multi- line, multi-state insolvencies. Today, Reliance and other insolvencies are seen as the catalyst for many of the statutory and operational developments which are viewed as "cutting edge" in insolvency practice.

Currently, the funds are proposing solutions to such matters as privacy protection for claims data, and dealing with imaged files. At the end of the day. Common wisdom suggests that good preparation today ensures success tomorrow. The truth of this axiom is borne out by the state-based guaranty funds.

Like a local firehouse, the occupants of which stand ready to rush to the assistance of a property owner, the guaranty fund system is prepared to step into the shoes of an insolvent insurer and protect policyholders by paying outstanding covered claims, the role policymakers and industry envisioned for the system nearly 40 years ago.

The strength of the guaranty fund system – today and tomorrow – rests on preparedness. Because of the funding mechanism that shifts the costs of insurance insolvencies to policyholders, and in some states taxpayers, it is critical that the guaranty fund system works efficiently and cost-effectively.

With insolvency activity at a relatively low ebb, state guaranty funds are refining and streamlining their systems, adding tools and working to strengthen their readiness for tomorrow while protecting policyholders today. By doing so, the state property and casualty guaranty fund system is undertaking the important ongoing work necessary to meet its statutory duties to policyholders and claimants while ensuring that the sanctity of the insurance contract will be preserved.

***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.***