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Backgrounder

The Property and Casualty Guaranty Fund System: Supporting the Insurance Promise for 50 Years

At the heart of the insurance contract lies the assurance that when misfortune happens, insurance will be there to soften the blow with coverage for one's losses.

But what happens when a property and casualty insurance company becomes financially troubled and fails? What happens to policyholders who draw on coverage written by an insolvent company?

The good news is they are protected because the property and casualty guaranty fund system pays the claims.

Established in the late 1960s by the insurance industry and public policymakers to cover the outstanding claims of insolvent insurance companies, the guaranty fund system has delivered protection to thousands of policyholders and beneficiaries who otherwise would have no coverage.

The guaranty funds maintain an essential safety net for policyholders, one that makes good on the foundational promise of insurance: to pay losses covered under the policy.

A promise kept

The property and casualty guaranty fund system is a privately funded, nonprofit state-based program. The system, which pays covered claims up to a state's legally allowable limits, has safeguarded countless policyholders who might otherwise face financial ruin because of unpaid claims related to an insolvency.

The guaranty fund system supports the insurance promise by assuring the viability, commitment and reputation of the property and casualty insurance industry, adding substantial value both to the insurance industry and for its customers.

A state life and health insurance guaranty fund system also exists; but it operates independently from the property and casualty system.

In some – but not all – ways, guaranty funds perform a consumer protection function similar to the Federal Deposit Insurance Corporation (FDIC) and its protection of bank deposits. Guaranty funds ensure that when a policyholder of an insolvent insurance company incurs a covered loss, it is covered within limits determined by individual state laws and the insurance contract.

Guaranty funds represent "a promise kept on a promise made," says Roger Schmelzer, president of the National Conference of Insurance Guaranty Funds (NCIGF), a nonprofit national association that provides support and coordination to the state property and casualty guaranty funds.

"For nearly five decades the guaranty fund system has kept its promise, paying out more than $35 billion to cover claims against about 600 insolvencies," said Schmelzer. "Through the years, the system has successfully met every challenge that's come its way, and has been instrumental in supporting the insurance promise."

The roots of the guaranty fund system

Today's property and casualty guaranty fund system traces its origins to 1969 when the National Association of Insurance Commissioners supported the Model Liquidation Act – legislation that provided an administrative framework for conducting liquidation proceedings.

The same year saw the formation of the first state property and casualty guaranty fund associations. Since then, every state, the District of Columbia, Puerto Rico and the Virgin Islands have established an association for administering guaranty funds.

State laws require that licensed property and casualty insurance companies belong to the guaranty funds, the relationship that enables them to transact property and casualty insurance business.

The guaranty funds: how they work

The failure of an insurance company is administered differently than other business bankruptcies. This is because insurance is regulated by the states and failures are exempted from federal bankruptcy law.

When an insurance company becomes insolvent and is unable to pay outstanding claims, a state's courts and the insurance commissioner begin a legal process to determine if the company should be placed into receivership. Receivership is a form of bankruptcy in which a company can avoid liquidation (that is, selling its assets) by reorganizing with the help of a court appointed trustee.

Among the options available to a commissioner prior to liquidation is conservation, a judicial proceeding that gives the commissioner direct control over the assets of an insurer. Another step a commissioner might take is placing the troubled company into rehabilitation. Under rehabilitation, the commissioner takes title to the insurers' assets and closely supervises the company with the view toward rehabilitating it.

The "last resort" option is liquidation. If a company is unable to pay its debts or has insufficient assets, the courts and the state insurance commissioner conduct a thorough investigation of its financial condition. If the commissioner deems the company incapable of being rehabilitated, it is placed into liquidation and its assets are liquidated.

During liquidation the commissioner becomes the receiver of the company's "estate." The commissioner marshals the company's assets, determines liabilities and begins distributing assets to the estate's creditors.

A company in liquidation is unable to issue new policies. Its current policies are cancelled, and policyholders are notified and directed to seek coverage elsewhere.

Enter the guaranty funds

Liquidation does not halt payment of outstanding claims against the company. Instead, liquidation triggers involvement of the state's guaranty association. The state guaranty association works with the receiver and regulators to pay claimants, answer questions, assist in claims data management and generally play a coordinating role in overseeing the liquidation.

Covered claims are paid according to policy amounts and state-established limits. The law defines the guaranty association as a creditor of what is termed the "estate" – one that is, however, statutorily authorized to obtain early disbursements of estate funds, which it passes on to claimants.

How estate assets are distributed varies from state to state. In most states, the receiver prioritizes distribution of estate assets, paying liquidation-related administration costs first, claimants next, and remaining creditors last.

The receiver/guaranty association partnership ensures that claimants and beneficiaries are among the first creditors to be paid.

Covered within statutory limits

State statutes determine coverage types and limits of the guaranty fund system; these limits vary from state to state. This means the guaranty funds pay claims within the scope of the policy, statutory limits, or "caps," fixed by the state.

Most states maintain $300,000 caps on property and casualty claims (caps, however, do not generally apply to Workers' Compensation claims.)

These caps, which were established in the early days of guaranty funds, reflect the original intent of the system: to protect individuals and small businesses – those potentially hardest hit by insolvencies. Caps enable the guaranty fund system to ensure sufficient funds, or "capacity," is available to serve all claimants.

Generally, a policyholder whose claim is greater than the statutorily determined limit can apply to the estate to get full payment. However, such payment places the claimant with other creditors who sometimes must wait years for estate asset distribution.

Funded by assessments

When an insolvent company does not have enough money to cover all its claims, a state's guaranty fund is statutorily empowered to fund the amount needed to pay the claims through mandatory industry assessments.

These assessments raise funds to pay claims and administrative and other estate-related costs.

Assessments and the means of collecting them vary from state to state. Generally, guaranty funds levy assessments against solvent companies that write similar types of policies in their states. Assessment are typically a small percentage of business written. In most states there is an annual assessment cap of two percent of net direct written premium. In some states, assessments may be recouped through tax offsets.

To the extent possible, the funding to enable the guaranty funds to fulfill their statutory duties is obtained from remaining estate assets. These include the insurance company's assets (including reinsurance) and funds deposited with state regulators in certain states while the company is still writing business. Guaranty funds also are funded through assessments from member insurers – that is, insurance companies licensed to write business in a state.

All but three guaranty funds (the New York Liquidation Bureau, New Jersey Workers' Compensation Security Fund and the Pennsylvania Workers' Compensation Security Fund) assess post-insolvency. These guaranty funds use a pre-insolvency assessment process.

"Like all businesses, insurance companies are not free from the threat of failure," said Roger Schmelzer. "But when insolvencies do occur, the guaranty fund system is with an effective and proven safety net that provides policyholder protection to the maximum legally allowable limits."

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