» Insolvency

TRENDS Winter 2014

National Conference of Insurance Guaranty Funds NCIGF

A biannual publication providing updates on recent property and casualty insolvencies and public policy developments

GUARANTY FUNDS WORK

in partnership with insurance regulators to protect policyholders.

A state court finds an insurance company insolvent and orders it liquidated.

Policyholder claim files are transferred to the guaranty funds for servicing.

Covered claims are paid from a pool of money drawn from three sources made available at the time of the insolvency: a) the insolvent insurance company's remaining assets, b) statutory deposits collected in certain states, and c) assessments on insurers licensed to write business in a state.

Payments are made promptly.

HOW THE GUARANTY FUND SYSTEM IS FUNDED

Recoveries

To the extent possible to fulfill guaranty fund statutory duties, monies are obtained from remaining estate assets.

- The insurance company's remaining assets (including reinsurance)
- Statutorily mandated deposits collected in certain states while the company is still writing business

Assessments from Insurers

Charged to insurance companies licensed to write business in a state

- Typical cap is 2% of "net direct written premium"
- Assessment is determined by the amount of money needed by the guaranty fund to supplement the funding pool described above
- Some guaranty funds have separate "assessment accounts" allowing them to segregate assessment billing and payments into various lines of business—a typical structure would be workers' compensation, auto, and all other property & casualty lines covered by the funds

Welcome to the 2014 winter issue of the National Conference of Insurance Guaranty Funds' (NCIGF) *Insolvency Trends*. Authored by the legal and public policy staff of the NCIGF, the publication provides an update on recent events in insolvency law and practice and a look ahead at what is on the horizon.

See inside for…

- FIO Report update
- International developments
- Developments from the federal front on issues such as Dodd-Frank implementation
- Insurance insolvency developments; new liquidations this year and status of estates
- Developments in state laws
- Run-offs of troubled companies

PROPERTY AND CASUALTY GUARANTY FUNDS: CONTINUING TO EVOLVE TO PROTECT POLICYHOLDERS

The guaranty fund system was established in 1969 by the property and casualty insurance industry, insurance regulators, and states to provide a safety net that protects insurance consumers if an insurance company fails. The system is an innovative and common-sense mechanism that draws first on the assets of the failed insurance company before turning to assessments of healthy insurers in each state. Since its inception, the system has paid out more than $27 billion to policyholders, beneficiaries, and claimants related to more than 550 insolvencies.

Following liquidation, the statutorily created guaranty funds seamlessly step into the shoes of a defunct company and pay the covered claims of policyholders and claimants whose claims otherwise would go unpaid by an insolvent insurance company.

Today, the guaranty fund system remains true to its original intent: delivering protection to those least able to weather the impact of insurance company insolvencies.

FIO REPORT RELEASED

Almost two years after it was due, the U.S. Department of the Treasury's Federal Insurance Office (FIO) has released its long-awaited report on how to modernize and improve the system of insurance regulation in the United States.

The FIO has concluded that in some circumstances, policy goals of uniformity, efficiency, and consumer protection make continued federal involvement necessary to improve insurance regulation. However, insurance regulation in the United States is best left to a hybrid model, where both state and federal regulatory bodies play complementary roles.

The FIO suggests that if states don't make specific changes, Congress could allow the federal government to serve as a coordinating body with rules and standards that preempt state law or take on direct regulation of certain areas or particular lines of insurance.

Establishment of uniform guaranty fund caps was one area in which potential congressional action was specifically suggested by the FIO "so that all policyholders, irrespective of where they reside, receive the same benefits from guaranty funds."

The FIO report devoted attention to the topic of insurance receiverships. Recognizing that policyholders and creditors have an important interest in the status and cost of receiverships, the FIO suggested that states should “develop requirements for transparent financial reporting by receivers about the insolvent estate as well as the cost of administration that have been incurred, require timely preparation and filing of reports on a regular basis and make pertinent aspects of the information publicly available.”

Taken as a whole, the results of the FIO report were a positive reflection on the guaranty fund system although potential areas for change exist. While it should be noted that this is the first of several reports from the FIO that are anticipated, at this point it seems clear that the FIO views the NCIGF and the state guaranty funds as credible and effective elements of insurance consumer protection.

Regarding international issues Treasury stated that because insurance regulatory issues “will increasingly require international attention and cooperation,” the federal government’s predominant role in foreign affairs is a reason that its presence is needed in insurance regulation. “It would be much less costly, much less prone to arbitrage, and much easier to negotiate internationally for more efficient and effective oversight of the insurance sector if U.S. insurance regulation had greater uniformity and predictability,” the FIO said in the report.

THE INTERNATIONAL SCENE: DEALING WITH INSOLVENCY IN A WORLD ECONOMY

International issues have been at the forefront recently both for banking and non-banking financial institutions such as insurance companies. The Financial Stability Board (FSB) “has been established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. It brings together national authorities responsible for financial stability in significant international financial centers, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts.”[1] The FSB has recently weighed in on insurance insolvency matters. In August, the FSB exposed for comment a document titled “Application of the Key Attributes for Effective Resolution Regimes to Non-Bank Financial Institutions.” Included is an Annex on Resolution of Insurers. Standards that are proposed to be applied to certain systemically important insurers include the following:

As part of its statutory objectives and functions, and where appropriate in coordination with other authorities, the resolution authority should:

[1] See FSB website at http://www.financialstabilityboard.org

(i) pursue financial stability and ensure continuity of systemically important financial services, and payment, clearing and settlement functions;

(ii) protect, where applicable and in coordination with the relevant insurance schemes and arrangements, such depositors, insurance policyholders and investors as are covered by such schemes and arrangements;

(iii) avoid unnecessary destruction of value and seek to minimize the overall costs of resolution in home and host jurisdictions and losses to creditors, where that is consistent with the other statutory objectives; and

(iv) duly consider the potential impact of its resolution actions on financial stability in other jurisdictions.

The draft identifies protection of policyholders as a criterion that should be reviewed in conjunction with insurers. The NCIGF has commented on this proposal in conjunction with sister organization the National Organization of Life and Health Guaranty Associations (NOLHGA). The comments support the FSB's focus on policyholder protection and its recognition of the important role played by policyholder protection schemes (i.e. guaranty funds).The comments are available by clicking here.

The International Association of Insurance Supervisors (IAIS) recently released a study of guaranty associations, which they call "guarantee schemes." Guarantee schemes, as they are termed outside the U.S., are insolvency protection mechanisms. The paper, titled "Issues Paper on Policyholder Protection Schemes" is a fairly objective analysis of the safety mechanisms that exist worldwide. The publication is available on the IAIS website (www.iaisweb.org).

The Organization for Economic Cooperation and Development (OECD) has also released a white paper on "guarantee schemes." According to its authors this paper "investigates policyholder protection schemes in OECD member countries and selected non-OECD countries. It is selective in its scope: it examines the rationale for a policyholder protection scheme; the relationship between certain design features and moral hazard; the role of a policyholder protection scheme within the overall resolution framework; and some cross-border features of these schemes. While the paper focuses on protection schemes for policyholders, it seeks to draw lessons from compensation schemes in the banking and occupational pension fund sectors, while recognising [sic] sectoral differences."[2] The OECD paper is also available on line (see link below.) Both papers feature information on the state-based system in the United States along with a wealth of information on various guaranty schemes throughout the world. The

[2] OECD (2013), "Policyholder Protection Schemes: Selected Considerations," *OECD Working Papers on Finance, Insurance and Private Pensions*, No. 31, OECD Publishing.http://dx.doi.org/10.1787/5k46l8sz94g0-en

International Association of Insurance Supervisors held its annual meeting in Taiwan in mid-October. Here are the highlights:

1. The IAIS announced that it will be developing a global capital standard for internationally active insurance groups (IAIGs). The capital standards are to be formulated by 2016 and fully implemented by 2019. (Prior to that time, the IAIS will be developing the capital standards that apply to GSIIs.)

2. The Federal Reserve Board attended the meeting and has been accepted for membership in the IAIS. We are keeping an eye on the Fed's increasing involvement in insurance regulation, domestically and internationally.

With the growing interest in the international insurance marketplace, we expect continued dialogue on insurance safety nets world wide.

DODD-FRANK, RESOLUTION OF SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

Enacted in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act creates a new system for regulating large, interconnected bank holding companies and nonbank financial companies whose distress or failure could threaten the financial stability of the United States.

The law calls for large, interconnected financial companies that are systemically important to be identified by the Financial Stability Oversight Council (FSOC) chaired by Treasury Secretary Timothy Geithner. Systemically important financial institutions could include insurance companies and insurance holding companies, although most observers contend that few, if any, insurers are systemically significant. Once identified, these companies will be subject to stringent regulation by the Federal Reserve Board.

The legislation also creates a new mechanism for liquidating systemically important financial institutions whose failure could destabilize the economy. **While the Federal Deposit Insurance Corporation (FDIC) will be appointed receiver of – and will liquidate – most types of financial companies, insolvent insurers (including any deemed systemically important) will remain subject to state receivership and guaranty association processes.**

Resolution of Systemically Important Financial Institutions (SIFIs) will be funded by a post-liquidation resolution fund. If any insurers are tapped to contribute to such a fund, the amount of their contributions will take into account guaranty fund assessments already paid.

Even though insurer insolvencies will be conducted under state law, under certain circumstances the FDIC could be appointed receiver of certain subsidiaries of insurance companies if those companies are in default, are in danger of default, or if their failure would have a significant adverse effect on the U.S. economy. Any value remaining after claims are paid would be paid to the parent company.

FDIC Single Point of Entry Strategy (SPOE)

While the Dodd-Frank Act does not specify how a resolution should be structured, Title II clearly establishes certain policy goals. The FDIC must resolve the covered financial company in a manner that holds owners and management responsible for its failure accountable—in order to minimize moral hazard and promote market discipline—while maintaining the stability of the U.S. financial system. Creditors and shareholders must bear the losses of the financial company in accordance with statutory priorities and without imposing a cost on U.S. taxpayers.

To implement its authority under Title II, the FDIC is developing the SPOE strategy. In choosing to focus on the SPOE strategy, the FDIC determined that the strategy would hold shareholders, debt holders and culpable management accountable for the failure of the firm. Importantly, it would also provide stability to financial markets by allowing vital linkages among the critical operating subsidiaries of the firm to remain intact and preserving the continuity of services between the firm and financial markets that are necessary for the uninterrupted operation of the payments and clearing systems, among other functions.

To implement the SPOE strategy the FDIC would be appointed receiver only of the top-tier U.S. holding company, and subsidiaries would remain open and continue operations.

- The FDIC would organize a bridge financial company, into which it would transfer assets from the receivership estate, primarily the covered financial company's investments in and loans to subsidiaries.
- Losses would be apportioned according to the order of statutory priority among the claims of the former equity holders and unsecured creditors, whose equity, subordinated debt and senior unsecured debt would remain in the receivership.
- Through a securities-for-claims exchange the claims of creditors in the receivership would be satisfied by issuance of securities representing debt and equity of the new holding company or holding companies (NewCo or NewCos). In this manner, debt in the failed company would be converted into equity that would serve to ensure that the new operations would be well-capitalized.

The newly formed bridge financial company would continue to provide the holding company functions of the covered financial company. The company's subsidiaries would remain open and operating, allowing them to continue critical operations for the financial system and avoid the disruption that would otherwise accompany their closings, thus minimizing disruptions to the financial system and the risk of spillover effects to counterparties. Because these subsidiaries would remain open and operating as going concerns, and any obligations supporting subsidiaries' contracts would be transferred to the bridge financial company, counterparties to most of the financial company's derivative contracts would have no legal right to terminate and net out their contracts. Such action would prevent a disorderly termination of these contracts and a resulting "fire sale" of assets.

THE FINANCIAL STABILITY OVERSIGHT COUNCIL

The Financial Stability Oversight Council (FSOC) was established by Dodd-Frank. It is charged with three primary responsibilites:

- To identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace.

- To promote market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the U.S. government will shield them from losses in the event of failure.

- To respond to emerging threats to the stability of the U.S. financial system.

Pursuant to Dodd-Frank, the Council consists of 10 voting members and five nonvoting members and brings together the expertise of federal financial regulators, state regulators, and an insurance expert appointed by the president.

Insurance representatives include former Kentucky Insurance Commissioner Roy Woodall (a voting member), Missouri Insurance Director John Huff and FIO Director Michael McRaith.

The FSOC voted in June 2013 to identify Systemically Important Financial Institutions (SIFIs). American International Group, GE Capital and Prudential were among those designated. Prudential had appealed the proposed decision to the FSOC in July 2013, but has since been notified it lost the appeal. Prudential has chosen not to pursue continued appeals in federal court.

One aspect of the additional regulation is the requirement that the company write a "living will" that details the steps they would take if the company had to wind down its operations. This analysis will almost certainly include a description of the guaranty fund system. As a result, the guaranty fund mechanism will be subject to scrutiny by Federal Reserve staff empowered with oversight of institutions of systemic importance, a significant development because it casts light on the state safety net from an entirely new perspective.

GAO REPORT ON INSURANCE MARKETS, IMPACTS OF AND REGULATORY RESPONSE TO THE 2007 – 2009 FINANCIAL CRISIS

In a report dated June 2013 the United States Government Accountability Office (GAO) issued a report on the insurance regulatory response to the financial crisis. The report indicates that "actions by state and federal regulators and the National Association of Insurance Commissioners (NAIC), among other factors, helped limit the effects of the crisis" on insurers.[3] The report may be viewed by clicking here.

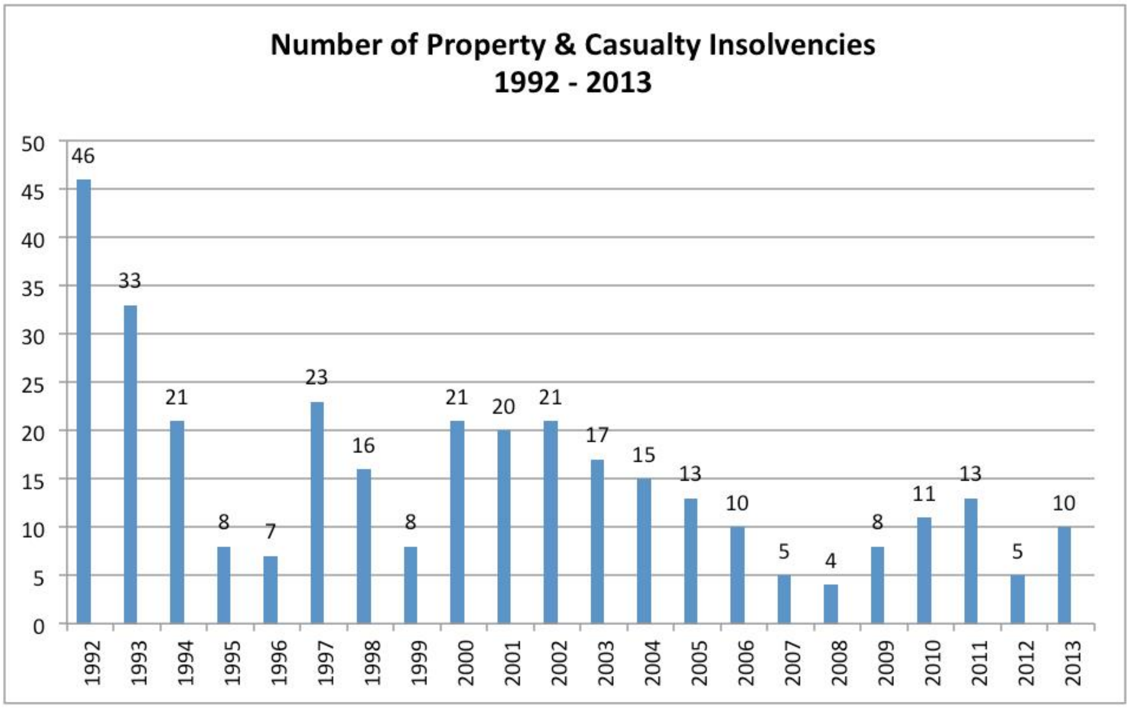
NEW INSOLVENCIES THIS YEAR: THE PROPERTY CASUALTY GUARANTY FUNDS CONTINUE TO PROTECT CLAIMANTS

Ten insolvencies occurred during 2013: Lumbermens companies (Lumbermens Mutual Casualty Company, American Manufacturers Mutual Insurance Company and American Motorists Insurance Company) domiciled in Illinois and licensed in all states; ULLICO Casualty Company, domiciled in Delaware and licensed in all states except Maine, New Hampshire and Rhode Island; Santa Fe Auto Insurance Company, a small automobile insurance company domiciled in Texas, licensed and with claims in eight states (Arizona, Arkansas, Georgia, Nevada, New Mexico, Oklahoma, Texas and Utah); Drivers Insurance Company, a small automobile insurance company domiciled in Oklahoma, licensed in 11 states and with claims in Georgia, Oklahoma and Texas; American Fellowship Mutual Insurance Company, a Michigan single-state personal auto and homeowners company; Pride National Insurance Company, a small automobile insurance company domiciled in Oklahoma, licensed in 13 states and with claims in seven states (Arkansas, Kansas, Kentucky, Mississippi, Missouri, Oklahoma and Tennessee); Gramercy Insurance Company, a small automobile and trucking insurance company, domiciled in Texas and licensed in 37 states; and ICM Insurance Company domiciled in New York, licensed in 18 states with claims in four states (Colorado, Texas, Utah and Wisconsin). The NCIGF staff assisted in various capacities in these new liquidations.

From 2011 through 2013, 28 property and casualty companies went into liquidation. *The list of liquidations from 2011 through 2013 can be found in the table on the following page.*

[3] GAO-13-583 Insurance Markets Impacts of and Regulatory Response to the 2007-2009 Financial Crisis.

Name of Company	Liquidation Date	State of Domicile	Type of Company	States Licensed
Constitutional Casualty Co.	1/3/2011	IL	Private passenger auto and homeowners multiple peril; some commercial liability	IL only
Aequicap Insurance Co.	3/7/2011	FL	Commercial auto	FL, GA, OK, SC, TX
Seminole Casualty Insurance Company	3/15/2011	FL	Personal and commercial auto	8 states (claims primarily in FL and MD)
Atlantic Mutual Insurance Company	4/27/2011	NY	Workers' compensation, commercial multiperil, private passenger auto, homeowners, surety, aircraft	All states
Centennial Insurance Company	4/27/2011	NY	Workers' compensation, commercial multiperil, private passenger auto, homeowners, surety, aircraft	All states
Reinsurance Company of America	4/27/2011	IL	Workers' compensation, non-standard auto liability	20 states (all claims in TX)
Western Insurance Company	9/13/2011	UT	Surety	35 states
National Group Insurance Company	10/10/2011	FL	Commercial auto, commercial property	FL and GA (all claims are in FL)
National Insurance Company	10/25/2011	PR	Commercial auto	PR and FL
American Sterling Insurance Company	10/26/2011	CA	Private passenger auto, auto physical damage	AZ, NV, KS
Homewise Preferred Insurance Company	11/4/2011	FL	Primarily homeowners insurance	FL, TX, SC
Homewise Insurance Company	11/18/2011	FL	Primarily homeowners insurance	FL and LA
Southern Eagle Insurance Company	12/16/2011	FL	Workers' compensation	FL only
Autoglass Insurance Company	1/9/2012	NY	Private passenger auto	NY only
First Sealord Surety, Inc.	2/8/2012	PA	Bond and surety	38 states
Garden State Indemnity Company, Inc.	6/22/2012	NJ	Professional liability, surety	NJ only
Northern Plains Insurance Company, Inc.	9/18/2012	SD	Automobile	SD only
Frontier Insurance Company	11/9/2012	NY	Workers' compensation, fire, allied, homeowners and commercial multiperil, inland marine, medical malpractice, other liability, product liability, private passenger auto liability, auto physical damage, fidelity, surety, burglary and theft, warranty	All states
Santa Fe Auto Insurance Company	4/5/2013	TX	Private passenger auto, auto physical damage	AZ, AR, GA, NV, NM, OK, TX, UT
Lumbermens Mutual Casualty Company	5/10/2013	IL	Workers' compensation, fire, homeowners and commercial multiperil, ocean marine, inland marine, medical professional liability, group accident and health, other accident and health, other liability, product liability, private passenger auto, commercial auto, auto physical damage, aircraft, fidelity and surety	All states
American Manufacturers Mutual Insurance Company	5/10/2013	IL	Workers' compensation, homeowners and commercial multiperil, inland marine, other liability, product liability, private passenger auto, commercial auto, auto physical damage, fidelity and surety	All states
American Motorists Insurance Company	5/10/2013	IL	Workers' compensation, homeowners and commercial multiperil, ocean marine, inland marine, medical professional, other liability, product liability, private passenger auto, commercial auto, auto physical damage, aircraft, fidelity and surety	All states
ULLICO Casualty Company	5/30/2013	DE	Workers' compensation, fidelity, surety, fiduciary liability, professional liability, commercial auto and commercial multiperil	All states except ME, NH and RI
Drivers Insurance Company	5/30/2013	OK	Private passenger auto, commercial auto	AR, GA, IA, KS, KY, LA, MS, MO, NE, OK, TX
American Fellowship Mutual Insurance Company	6/12/2013	MI	Personal auto and homeowners	MI only
Pride National Insurance Company	7/10/2013	OK	Private passenger auto, auto physical damage	AR, AL, KS, IA, KY, LA, MS, MO, NE, NC, OK, TN, TX
Gramercy Insurance Company	8/26/2013	TX	Inland marine, private passenger auto, commercial auto, auto physical damage and credit	37 states
ICM Insurance Company	12/23/13	NY	Private passenger auto, auto physical damage	18 states (claims in 4 states)



This chart shows the overall number of property and casualty insolvencies from 1992 –2013.

For comprehensive information on the companies the guaranty funds are handling with payout information, please see our Web site at http://www.ncigf.org

ESTATE DISTRIBUTION AND CLOSING EFFORTS

A critical component of the guaranty funds' ability to pay claims of insolvent insurance companies in a timely manner is the distribution of remaining assets of the insolvent estates. Guaranty funds work together with estate liquidators to ensure that guaranty fund loss and expense payments are reported on a timely basis and legal documentation is in place to permit available funds to flow to the guaranty associations on an expedited basis. In 2011 and 2012 the guaranty funds recovered from the insolvent companies' estate assets more than $475 million and $456 million, respectively. To date, in 2013 distributions have been recieved or proposed for distribution to guaranty associations totaling more than $453 million.

ESTATES NEARING CLOSURE

Closing efforts continue in several jurisdictions. The liquidator for the two Credit General estates in Ohio (Credit General Insurance Company and Credit General Indemnity) targeted the end of 2013 to propose a plan for estate closure. While the Credit General Indemnity Company closure is moving forward, as of this writing, the closure of Credit General Insurance Company may be delayed pending receipt of certain releases from the federal government. The American Mutual insolvencies are also moving toward closure, with $110 million distributed in 2011. The court approved an additional $50 million in the fall of 2012, which was sent out to the guaranty funds in October 2012. In both cases the receivers needed to settle up on values with the guaranty funds on remaining blocks of open claims, in particular long-term workers' compensation cases. These are cases that the guaranty funds may be servicing for an extended period after the estate closes. We are also seeing indications that one Illinois insolvency, the Coronet Insurance Company, is moving toward closure.

TRANSIT CASUALTY COMPANY: CLOSED

Transit Casualty Company, a Missouri domiciled, was placed into liquidation in December 1985. The receiver for Transit Casualty Company filed a petition with the receivership court seeking approval to make a final distribution from the Transit estate. The guaranty associations and other policyholder-level claimants have received prior distributions of 86 percent of their allowed claims. Following approval of the liquidation court, the receiver made the final distribution to policy-level claimants, bringing the final dividend to 87.3 percent. A hearing on the receiver's petition to close the estate was held on December 20, 2012. The estate is closed; however, certain essential records will be held for a period of five years.

RECIPROCAL OF AMERICA

Reciprocal of America (ROA) was placed into liquidation in June 2003 in Virginia. The company wrote workers' compensation, professional liability, and general commercial liability policies. As of 2012, the estate has made distributions of 95 percent to policyholder-level claimants, with an additional 5 percent to the guaranty associations as early access. In 2012, the receiver announced its intention to sell the estate's entire block of workers' compensation insurance to an outside insurer in an effort to accelerate closure of the estate. In August 2013 the ROA liquidator filed a petition seeking the approval of the Loss Portfolio Transfer. The guaranty associations are working with the liquidator to develop file transfer protocols to facilitate the transfer of files to the purchaser when the transaction is approved by the court. Non-guaranty fund claimants have filed objections, although we anticipate the objections will be addressed and the court will approve the LPT sometime in 2014.

FRONTIER INSURANCE COMPANY

Frontier Insurance Company, a New York domestic, was placed into rehabilitation in October 2001. Following a court ruling that held that certain bond claims were entitled to the same priority as the company's other policy claims, thereby complicating the rehabilitation, the company was placed into liquidation in October 2012.

RUN-OFF PROPOSALS

In some cases a state regulator will attempt to resolve a troubled company's claims by means other than a statutory liquidation. In these cases the guaranty funds are not activated. Proponents of alternative approaches cite orderly claims processing, low cost, and greater flexibility to achieve commercially acceptable results. However, the efficiency and cost-effectiveness of a liquidation alternative – compared to a statutory liquidation – to our knowledge has never been established. In fact, there are many questions about how a prolonged run-off, versus a statutory liquidation, would impact the various stakeholders, including policy claimants.

HIGHLANDS

Highlands was placed into receivership in Travis County, Texas, in November 2003. In 2007 the court approved the Second Amended Plan of Rehabilitation. Under the terms of the plan, the receiver was ordered to administer a Monitoring Plan to ensure the estate will continue to have sufficient funds to pay the company's claims as they come due. As of August 31, 2013, the estate held total assets of $187 million against total liabilities of $344 million.

LINCOLN GENERAL

On February 9, 2009, Lincoln General discontinued the writing of new business and began a process that would result in a voluntary, solvent run-off of all business. Year-end 2012 financials indicate a policyholder surplus of approximately $1.8 million after augmentation for permitted practices that increased reserves by a total of almost $9 million. The acquisition of control by Tawa plc ("Tawa") of Lincoln General Insurance Company was approved by the Pennsylvania Insurance Department on October 5, 2011. Tawa is an entity that manages the run-off of non-life insurance companies and portfolios of policies.

INSURANCE CAPITAL AND ACCOUNTING STANDARDS ACT OF 2013

In May, Representatives Gary Miller (R-CA) and Carolyn McCarthy (D-NY), both members of the Housing and Insurance Subcommittee, introduced HR 2140, the Insurance Capital and Accounting Standards Act of 2013.

The bill seeks to have state law capital requirements apply to insurance companies that are depository holding companies, or are subsidiaries of such. It seeks to do so by amending Dodd-Frank. Similarly, state-law accounting standards for nonbank financial companies supervised by the Federal Reserve would be applicable.

Of interest is Section 5, which would amend the FDIC Act by limiting the ability of a federal banking regulator to treat an insurance company as a source of strength for an affiliated depository institution (including savings and loans institutions). Under the bill, the insurance company could not be used as a source of strength without the consent of its domestic regulator, and the domestic regulator would have to certify that he or she considered the insurance company's safety and soundness prior to giving the consent.

MEDICARE SECONDARY PAYER

On January 10, 2013, President Obama signed the Strengthening Medicare and Repaying Taxpayers Act of 2011 (SMART Act). The law will amend provisions of the current Medicare Secondary Payer statute, greatly streamlining the processes attendant to Medicare secondary payer reporting.

NAIC'S SOLVENCY MODERNIZATION INITIATIVE (SMI)

The financial crisis has brought about increased efforts to globalize regulation and accounting principles. Many changes have already occurred in major insurance markets, including those in the U.S. and Europe. These insurance regulatory and accounting changes potentially impact the ability to detect insolvencies.

The NAIC consolidated its regulatory improvement and update efforts under its Solvency Modernization Initiative (SMI). According to the NAIC Web site: "SMI is a critical self-examination to update the United States' insurance solvency regulation framework and includes a review of international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in U.S. regulation." SMI has been described as the NAIC looking at all the "tools in its tool box" and deciding what stays, what goes, and what needs to be changed. The SMI (E) Task Force adopted an SMI White Paper, "The U.S. National State-Based System of Insurance Financial Regulation and the Solvency Modernization Initiative," on August 25, 2013. The white paper states its purpose is "to explain the U.S. solvency regulatory framework and how and why it works successfully," and also to "discuss the SMI self-evaluation and highlight the strengths of the national state-based system of insurance regulation and the improvements made over the last several years in the SMI." To view the SMI white paper, click here.

There are three topics the NAIC's Solvency Modernization Initiative is studying that could potentially have an impact on the property and casualty guaranty associations:

1) NAIC'S ORSA: The first is the NAIC's Own Risk Solvency Assessment (ORSA). On September 12, 2012, the NAIC adopted the ORSA Model Act, which will be a regulator resource to assess and monitor insurers' and groups' risk management processes, and to align regulatory requirements with business practices and the insurers' ability to withstand stresses. The NAIC's ORSA is expected to increase the chances that the U.S. insurance regulatory system will be viewed as "equivalent" to Europe's regulatory system under Solvency II. As encouraged by the industry, the ORSA will be less burdensome than Europe's to complete.

The Model Act provides for an effective date of January 1, 2015.

An annual ORSA report will be required by large insurers (at least $500 million in annual premiums that are part of an insurance group with at least $1 billion in annual premiums). Under certain circumstances, the report could be requested by state regulators, federal agencies, or international insurance supervisors.

The NAIC adopted the ORSA Guidance Manual in March 2011. The manual provides general guidance to an insurer or insurance group for completing the annual ORSA report.

2) FUTURE OF GAAP AND STATUTORY ACCOUNTING: The second item of interest is the international and U.S. accounting board (IASB and FASB) project that seeks to converge to a single set of global accounting standards. Because Statutory Accounting evaluates Generally Accepted Accounting Principles (GAAP) accounting and makes adjustments when called for, Statutory Accounting will be affected by whichever method (U.S. GAAP vs. International Financial Reporting Standards, or IFRS) is adopted by the U.S. Some maintain it may be more difficult to assess solvency if the U.S. moves toward IFRS, because it is principles-based, and therefore more subjective than the U.S. rules-based method.

The NAIC will make policy decisions regarding IFRS after the SEC's decision. An SEC convergence decision is pending completion of priority projects: financial instruments, leases, revenue recognition, and insurance contracts. The SEC's final staff report released in 2012 was expected to make a recommendation regarding using IFRS. The report identified areas and factors relevant as to whether, when, and how the U.S. system is transitioned to IFRS. The report also noted that IFRS is not supported by the vast majority of participants in U.S. capital markets and is not consistent with methods employed by other major capital markets.

3) INSURANCE CONTRACTS: The third item of interest is the U.S.-based Financial Accounting Standards Board and London-based International Accounting Standards Board's convergence project on insurance contracts. Despite pressures from the G20, convergence on insurance contracts is unlikely. The IASB's initial exposure draft did not distinguish the differences in practices between life insurers and property and casualty insurers, especially with regard to short-term contracts. The IASB issued a revised exposure draft late June 2013 that built on previous consultations from 2007 and 2010. During the same week in June 2013, the FASB issued a proposed updated GAAP standard for insurance contracts. Both the IASB and FASB proposals were open for comment until October 25, 2013. The IFRS Web site's "Snapshot: Insurance Contracts" compares the two proposals, stating "most of the conclusions reached by the IASB and FASB are consistent, although important differences remain in how the IASB and FASB each propose to portray the pattern of profit recognition and in how the entity reflects changes in the estimates of the profit that is earned from insurance contracts."

IN THE STATES…

ARIZONA SB 1013 – TRANSFER OF "SPECIAL FUND" TO PROPERTY AND CASUALTY GUARANTY FUND. There is discussion of transferring the operation of the Arizona "Special Fund," which pays workers' compensation claims for Arizona, into the property and casualty guaranty fund. SB 1013 is a first step in this possible transition process. It calls for a report, supported by an actuarial opinion, on the funds available in the Special Fund for payment of workers' compensation claims. We understand this legislation has been enacted. Any additional action in this regard would probably take place in 2014.

STATE WORKERS' COMPENSATION FUNDS. In Oklahoma a bill was enacted in 2013 (SB 1026) to privatize the state-run fund, CompSource, and make it a member of the property and casualty guaranty fund effective in 2015. The bill states that pre-2015 obligations will not be obligations of the guaranty fund. Similar legislation was discussed last year in Colorado with regard to its state fund, Pinnacol. However, no push to implement a change in Colorado was made in 2013.

Also in Oklahoma, legislation has been enacted to permit employers to opt out of the workers' compensation system either by purchase of alternative insurance or by self-insuring (SB 1062). The legislation charges the Oklahoma Insurance Guaranty Association to administer guaranty funds created for the alternative insurance and for opt-out self-insurers.

FLORIDA SB 324 AND HB 211 FIGA ASSESSMENTS. Legislation was introduced in Florida to call for assessments to be collected from policyholders before remittance to the guaranty fund. The measure died in 2013 but has been reintroduced in modified form for the 2014 legislature (HB 143).

FLORIDA PEOS AND LARGE DEDUDCTIBLE POLICIES. The Florida Workers' Compensation Insurance Guaranty Association (FWCIGA) conducted a study of Professional Employment Organizations' (PEOs') use of large deductible programs. Problems arise when the programs are undercapitalized and when the insurance company is closely affiliated with a PEO. Recent insolvencies with a large deductible and PEO component include Park Avenue, Pegasus, and Southern Eagle Insurance Company. A working group was formed by FWCIGA to study this matter. The working group deliberations led to the suggestion that legislation be enacted to 1) strengthen collateral requirements, 2) protect collateral, 3) strengthen eligibility requirements for carriers, and 4) strengthen eligibility requirements for insureds using large deductible programs. No legislative action was taken in 2013.

ILLINOIS HOUSE BILL NO. 981 PUBLIC GUARANTY FUND BOARD MEMBERS. This bill adds one public member to the Illinois Guaranty Fund board. It has been enacted.

ILLINOIS SB 1873 TRANSFER OF GROUP WORKERS' COMPENSATION POOLS TO ILLINOIS GUARANTY FUND. Legislation was introduced in 2013 to make group workers' compensation pools in Illinois members of the Illinois Guaranty Fund. Assets and liabilities of these pools (regardless of time of occurrence) would be transferred to the fund. This bill failed to pass during the 2013 session.

INDIANA GUARANTY FUND ACT (SB 431). A comprehensive proposal was enacted to raise the covered claim cap to $300,000 with unlimited benefits for workers' compensation (the norm in most states). The bill also eliminates an exclusion for "special" damages, which has been the source of much litigation in Indiana.

MASSACHUSETTS SB 480 TO INCREASE COVERED CLAIM CAP TO $600,000. Legislation was introduced in 2013 to increase the covered claim cap in Massachusetts to $600,000. This bill has been introduced in previous sessions and typically does not gain traction.

MISSOURI SB 59 increases the assessment cap to 2 percent from the current 1 percent; excludes workers' compensation coverage from the $300,000 deductible exclusion; and increases the board from seven to nine members. The governor has signed the bill. The new provisions went into effect August 28, 2013.

BUSINESS TRANSFERS. *(Vermont – H. 198)* In Vermont, legislation was introduced to "regulate the receipt and management by Vermont companies of closed blocks of non-admitted commercial insurance policies and reinsurance agreements." This legislation would call for closed blocks of business to be transferred to Vermont insurance carriers. The transaction would amount to a novation under Vermont law and all obligations of the transferring entity would be extinguished. While guaranty funds typically do not cover reinsurance and surplus lines products, there may be some confusion on the status of coverage when a non-admitted block of business is transferred to an entity that is a licensed insurer. Further, whether the transaction would amount to a novation outside of Vermont may be questionable. The state of Vermont would garner significant fees once a transaction were approved – a $30,000 administrative fee and 1 percent of the first $100,000,000 of business transferred and .5 percent for additional amounts. The bill was amended to call for transferred blocks of business to be exempt from the requirements of the Vermont guaranty fund act. The bill passed the House and was pending action in the Senate as the 2013 legislature adjourned.

WASHINGTON SB 5675. COMPETITIVE WORKERS' COMPENSATION MARKET. Legislation was introduced in Washington State to make the state's workers' compensation fund a competitive rather than monopolistic fund. Claims from private carrier insolvencies would flow to the Washington Insurance Guaranty Association. No action has been taken on this measure to date.

WYOMING SB 113 AMENDMENTS TO GUARANTY ASSOCIATION ACT. SB 113 has been enacted. The new law: 1) increases the covered claim cap to $300,000; 2) eliminates the $250 per claim deductible; 3) establishes an independent bar date 25 months after the date of liquidation (or has the guaranty association bar date coincide with the liquidator's bar date, if it occurs sooner); 4) excludes incurred-but-not-reported (IBNR) claims; and 5) excludes claims for punitive and exemplary damages (unless they are covered by the policy).

FEDERAL HOME LOAN BANKS. Recently there has been interest in clarifying the status of federal home loan banks in a state-governed insurance liquidation. While claims of such entities are generally treated as "secured" in an insolvency, promoters are floating proposals to further strengthen their status by exempting them from the preference and stay provisions embodied in the Insurer Receivership Model Act (IRMA).

The NAIC's E Committee has adopted a report on this matter. The report does not take a position for or against the FHLB proposal but offers some suggested considerations for states that may consider such amendments in upcoming legislative sessions and some possible modifications to those amendments. In the meantime, legislation has been enacted in Nebraska (L. 337). Indiana and Michigan have taken similar measures through modifications in their liquidation act provisions relating to swaps and dirivatives. FHLB legislation is being actively promoted and we expect additional activity in the states in 2014.

GUARANTY FUND FOR TITLE INSURANCE. Two drafts have been exposed by the NAIC to create a mechanism to provide guaranty association coverage for title insurance claims. One option is a standalone fund; the other proposes adding the coverage to the Property Casualty Guaranty Fund Act and creating a separate assessment account for title insurance. The NCIGF filed comments suggesting that the separate guaranty fund was the appropriate approach if a title insurance guaranty mechanism was deemed to be necessary. Technical comments on the draft were also offered. NCIGF comments may be viewed by [clicking here.]

DODD-FRANK AMENDMENTS. The NAIC has adopted a guideline to assist states in modifying their insurance liquidation acts to deal with an insolvency of an insurance company that may be part of a Systemically Important Financial Institution (SIFI). Three states have enacted these measures so far: California, Texas and Illinois.

SWAPS AND DERIVATIVES. We understand that 21 states have adopted swaps language based on Section 711 of the Insurer Receivership Model Act. This continues to be a matter of interest to property and casualty and life and health insurance companies, both of which use these devices to some extent. In light of the high interest in implementing IRMA 711-based statutes in the various states, the NAIC took another look at the provision, inviting experts on the topic to address the working group. While it appears that Section 711 will remain intact, there is a "guideline" being exposed to address liquidation stay provisions related to these devices. There was more Section 711 activity in 2013. Kansas (SB 166) enacted a law in the 2013 session. The state of Washington introduced a bill (SB 5065) during the 2013 session.

TO LEARN MORE…

More information about the property and casualty guaranty fund system is available on our Web site at http://www.ncigf.org

Look for a new issue of NCIGF's *Insolvency Trends* in July 2014.

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 and the District of Columbia.

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