National Conference of Insurance Guaranty Funds

Backgrounder **September 2006**

Guaranty Funds Seek Changes to Meet Needs of the Most Vulnerable Personal Insurance Consumers

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More than 30 years ago, America's state legislatures devised a low-cost structure to help protect people and small businesses least able to absorb the impact of an uninsured loss that could result from an insurer insolvency. This structure consisted of a network of property/casualty guaranty associations enabled by statute in the various states.

Today, the National Conference of Insurance Guaranty Funds (NCIGF) is committed to public policy solutions that will strengthen the integrity of the safety net known as the property/casualty guaranty fund system.

The guaranty associations that administer the funds are only one part of a comprehensive legal framework that supports insurance consumers. Critical to the overall picture is the solvency monitoring responsibilities of insurance regulators intended to spot problems early. Additionally, underwriting restrictions, rate adequacy, loss mitigation and land use regulations are public sector responses that affect an insurer's ability to meet contractual obligations to its customers.

The federal government, while leaving insurance regulation to the states, even acknowledges that some losses are too large for private industry to withstand alone and has provided a temporary backstop in the event of terrorism losses.

State guaranty fund law may not be top of mind in the complex insurance infrastructure, but it works in concert with these policy responses to take care of personal insurance consumers. How these laws are written and enforced could impact the bottom line of every property/casualty insurance company in the United States.

That is why NCIGF members favor limits on the coverage of claims made by high-net-worth commercial insureds and persistently press receivers for early distributions from what remains of the insolvent company's estate.

At first blush, these goals might seem to be divergent or unrelated, but they are not. How can cutting back on paying claims be consistent with protecting consumers? What does a distribution from a receiver have to do with policyholder security? These matters are inextricably related. Sound state policy action in just a few important areas is imperative to assure that the funds are able to deliver on their statutory mandate to provide cost-effective consumer protection. The key concepts are "integrity" and "safety net." The "safety net" is the countrywide

system of state-authorized guaranty associations that individually protect residents of their state, and together serve as a cohesive system that can provide a national response to help those impacted by an insurer's insolvency. Individual state laws must work well together in order for protection to be as broad as is needed.

By "integrity" we mean reliability. Since inception of the system, managers have administered more than $17 billion in claims payments on behalf of insolvent p/c insurers. The professional and resourceful handling of an unprecedented volume of claims from insolvencies in 2001-2004 provides the best and most recent evidence of the system's capabilities.

Scope and Funding of Guaranty Association Protection. Determining the appropriate measure of protection under state law is challenging given an insurance market that includes continually evolving products and services. Despite the millions of dollars in otherwise unmet claims paid out by the guaranty associations, every claim is not paid in full; it would not be possible or desirable to raise sufficient funds to do so. The safety net was designed to provide relief, not necessarily wholeness.

State statutes exclude certain lines of business from coverage altogether. Generally speaking, workers' compensation benefits are paid in full, but other claims are subject to an individual limit of typically $300,000. These limits are necessary because funds available to a guaranty association are limited. There is also an annual limit on the amount of monies that can be raised from assessments to member insurers, typically 2% of premiums written in covered lines.

A limit on assessments is needed to guard against market disruption. Safety net funding must be structured to avoid creating any affordability or other problems in the insurance market. In addition to the cost of regulation and other overhead passed on to consumers, a much higher assessment, say in the range of four to six per cent would likely have a very detrimental impact. Consumers would move to typically lower priced residual market products, increasing costs that are passed on through cross-subsidization. Alternative products would also be purchased, shrinking the premium base on which assessments are based and exacerbating any funding problems. Moreover, the shift of greater number of customers to non-insurance mechanisms, such as self insured groups or risk retention groups, exposes these purchasers and third party claimants to greater losses in the event of insolvency since these mechanisms generally do not have a safety net system of their own.

Priority #1: Limiting High-Net-Worth Claims. The operation of the guaranty association system over the last thirty years has helped identify certain shortcomings with insolvency laws. Guaranty association laws as originally enacted thirty years ago did not, but should have, limited payout on claims made by high-net-worth insureds. Personal lines insolvencies were the problem when the present system was created; the insolvency of a large commercial insurer was simply not contemplated. We have learned since then however that payouts on claims of commercial insureds drain guaranty association resources needed to pay losses on personal lines policies.

The inability of an insurer to provide insurance coverage for a large casualty loss could mean personal bankruptcy for an individual or small business. However, a large commercial insured with a high net worth is situated entirely differently. A loss for this kind of insured that is in effect uninsured, while clearly undesirable, is manageable, and will not result in financial ruin. This is the reason that the NCIGF model act includes a provision to establish an express limit on insured net worth required to qualify for coverage.

Priority #2: Prompt, Significant Distributions from the Insolvent Estate to the Guaranty Association. Another critically important component to the insolvency process that must be handled effectively in order for claimants to be served by the guaranty association system is the timely distributions from regulator-appointed receivers of significant assets from the insolvent estate. Guaranty associations are so insistent on this point that they are sometimes criticized for caring only about money. If so, it is only because the insurance department-appointed receiver is statutorily obligated to distribute funds as quickly as possible to the GAs as creditors on filed claims so that they can be paid to those that suffered the actual loss. Furthermore, the guaranty associations believe it is in the public interest to use the insolvent insurer's own money to pay its claims whenever possible.

Historically, distributions from estates make up one-third of the total funds available to pay claimants. This is important. Distributions result in a dollar for dollar increase in guaranty association capacity. A $50 million distribution to guaranty associations increases claim paying capacity by that amount. At times, when capacity has been tested for a particular guaranty association, distributions have enabled claims to continue to be paid.

Also important is that delayed or smaller distributions result in the need for guaranty associations to make larger assessments on insurance companies in order to make claims payments. Prompt distributions are therefore model public policy. With insurers contributing two-thirds of the funding to make good on the failed promises of their competitors, every dollar collected from the insolvent company reduces the cost of the insolvency that is eventually passed on to insurance consumers and the public.

Where will the Battles be Fought? The struggle to maintain the integrity of the safety net is already well underway. Last year, the NAIC completed a four year debate on the Insurer Receivership Model Act (IRMA). During those discussions regulators heavily debated matters concerning the extent and timeliness of estate distributions to the guaranty associations and guaranty association rights to participate in the Court proceeding which oversees the insolvency process. Significantly, suggestions were made that would have impaired the guaranty associations' ability to pay claims in a timely and efficient manner and challenges were even waged contesting the associations' authority to adjust the claims which they are statutorily obligated to pay.

Also underway at the NAIC is work on revision to the P/C Model Guaranty Association Act. In this discussion some regulators are questioning some of the important limits we believe are essential to preserve capacity for the average insurance consumer.

Strangely, guaranty associations occasionally find themselves at odds on their interpretation of state law with regulator-appointed deputy receivers. Although not rampant, there have been some instances recently where a receiver has taken a number of positions contrary to well established principles and the plain language of the law.

Typical of these types of disputes are cases where the receiver is insisting on reviewing and denying claims already approved by the guaranty associations. This is in spite of state law which clearly binds the receiver to the association's claim determination.

A foundational principle of the current insolvency system is the statutory assignment to the guaranty associations of the responsibility for payment of certain policy claims, binding the deputy receiver to settlement of these covered claims. The reason for this rule is, first and foremost, to permit the guaranty association to pay claims in the most expeditious manner

possible. Concerns related to receiver reevaluation of fund claim determinations could lead to delays in payments to deserving claimants who have already suffered some harm as the result of the insolvency. Secondly, the rule serves to avoid the creation of a duplicative claims review process that would inevitably result in an expensive duplication of effort if every claim were to be re-examined.

No legitimate public policy purpose is served by engaging in an expensive claim-by-claim administrative review, particularly where the result will be that each disputed claim will then have to be resolved in separate hearings before a hearing officer and the court. Every dollar spent by an estate in this type of litigation is one dollar no longer available to pay its claims; every dollar spent by the guaranty associations is one more dollar that will eventually be passed back to policyholders and consumers.

What You Can Do. Take an interest in the guaranty association and solvency laws in the states where your companies do business. Although we frequently provide technical assistance in understanding the laws and the consequences of proposed changes, NCIGF is not a lobbying organization. We encourage you to speak directly to the manager of your state guaranty association and the state insurance trade association that represents p/c insurers at the state legislature.

Conclusion. The industry is emerging from an unprecedented period of insolvency activity during which the guaranty system responded both efficiently and effectively. A great strength of our property/casualty industry is fierce competition among carriers. The guaranty association system supports a competitive marketplace by standing ready to make good on promises of unsuccessful companies, thereby helping to preserve the reputation of the entire industry.

It is easy, when guaranty association assessments are lower, to not give much thought to the system and how it works. NCIGF suggests that in fact, the opposite is true. There is a window, between now and the inevitable next spate of insolvencies, for those interested in preserving the integrity of the safety net through a series of commonsense reforms to do so.

The National Conference of Insurance Guaranty Funds is a non-profit organization that provides assistance and support to the property and casualty insurance guaranty funds in all 50 states, Puerto Rico and the District of Columbia.

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