

December 16, 2011

## **JOINT COMMENTS OF NOLHGA AND NCIGF IN RESPONSE TO FIO'S REQUEST FOR PUBLIC INPUT**

The National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) and the National Conference of Insurance Guaranty Funds (NCIGF) respectfully submit their joint comments in response to the request by the Federal Insurance Office for public input.

NOLHGA and NCIGF were created to support the activities of their member guaranty associations, which were established by state legislatures to protect insurance policyholders whose insurance carriers become insolvent. Their member guaranty associations perform a function in the insurance market that is roughly analogous to the function the FDIC performs with respect to its member and insured depository institutions. NOLHGA's members are principally concerned with protecting consumers of failed life, annuity, and health insurers. NCIGF's members are principally concerned with protecting consumers of failed property and casualty insurers. Both organizations coordinate the protections provided by their members when an insurer enters receivership proceedings.

NOLHGA and NCIGF are pleased to provide these comments in response to the request for public input and look forward to providing any other information that the FIO might specifically request. Our comments presume that the FIO is committed to continuing what has historically been the primary goal of insurance regulation: policyholder protection. We begin with some brief observations about policyholder protection, including the important role that guaranty associations play in providing that protection, followed by our detailed responses to certain questions posed by the request for public input.

### **The Importance of Policyholder Protection**

#### ***Why policyholders need protection***

Courts and lawmakers have determined that insurance is a business affected with the public interest. In large part, that's because insurance companies collect premium dollars *today* in return for a promise to pay or indemnify the insured upon the occurrence of some contingency (such as death, sickness, accident, or other loss) *in the future*. Depending on the type of insurance involved, benefits may be paid months, years, or even decades after a policy is issued.<sup>1</sup> The public's keen interest in making sure that

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<sup>1</sup> For example, health insurance policies are issued/renewed on an annual basis, and most claims are submitted and paid during the policy term or shortly thereafter. Auto insurance works much the same way. At the other end of the spectrum, life insurance policies, annuities, and many property/casualty policies can

insurance companies are able to pay claims whenever they come due is precisely why the business of insurance is so heavily regulated. Insurance regulation is all about policyholder protection, and the best way to protect policyholders is to make sure that their claims are paid when due.

### ***How policyholders are protected by solvency regulation***

Guaranty associations are part of an overall “seamless web” of policyholder protection that follows insurers from the time they are formed; through the period they operate; and into and through the process of marketplace exit, winding up, and – in cases of insurer failures – receivership. While the guaranty associations take care of policyholders whose insurers are liquidated in receivership proceedings, solvency regulation of insurers conducted by state insurance regulators is designed to limit the number and severity of insurance company insolvencies. More specifically, solvency regulation monitors and safeguards the claims-paying ability of insurers by (among other things):

- Requiring insurers to establish and maintain reserves for future liabilities in accordance with actuarial standards;
- Restricting the kinds of investments that insurers may make;
- Requiring insurers to comply with capital and surplus requirements and risk-based capital standards;
- Requiring insurers to submit quarterly and annual financial statements prepared in accordance with accounting practices and procedures adopted by the National Association of Insurance Commissioners (NAIC);
- Conducting periodic financial examinations; and
- Reviewing changes of control and other material transactions to determine their impact on the insurer’s financial strength.

Efforts by insurance regulators to monitor and safeguard the solvency of insurance companies proved remarkably effective during the recent financial crisis. Since the start of 2008, just 8 small life insurers, 5 small health insurers and 22 small property & casualty insurers have entered liquidation, as compared to the nearly 400 banks and thrifts that have failed during the same period.<sup>2</sup>

Policyholders will benefit from even stronger protections in the future, thanks to recently adopted changes that will give insurance regulators an improved ability to assess enterprise risk within an insurance holding company system. All of this regulation, of course, has one goal in mind – to protect policyholders by ensuring that their claims will be paid when due.

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have a much longer term, with claims being made and benefits being paid out years or even decades after the contract is issued. Similarly, in the workers’ compensation context, claims may be made in the short term, but benefits for these claims may be payable over many years.

<sup>2</sup> While the AIG holding company encountered enormous difficulties, its insurance companies never went into receivership and were largely seen as sound. The most serious problems arose from AIG’s Financial Products unit, not from the insurance operations. For one recent account of AIG’s problems, including AIG’s securities lending program, see Roderick Boyd, *Fatal Risk* 165-69 (2011). Two other insurers took relatively small amounts of TARP funds during the crisis, but paid back the monies within a year with a significant return to the federal government.

### ***How policyholders are protected when insurers fail***

No matter how effective insurance regulators are in detecting an insurer's weakness, a certain number of insurance company insolvencies are inevitable in a competitive marketplace. When an insurance company fails, it does not enter bankruptcy, but rather is placed into receivership by the insurance regulator of the jurisdiction that granted the insurer's charter (the "domiciliary jurisdiction").<sup>3</sup> The receivership proceeding, which is conducted according to the jurisdiction's insurance receivership statute, resembles a federal bankruptcy proceeding. It is conducted before a judge in the domiciliary jurisdiction, and the insurance commissioner of that jurisdiction serves as the statutory receiver of the company.

By definition, an insolvent insurance company does not have sufficient assets to pay all of the company's obligations in full. That's where the guaranty system comes in. Guaranty associations protect insurance consumers by paying specified losses that arise under policies<sup>4</sup> issued by the failed insurer and, with respect to long-term policies issued by life and health insurers, by continuing coverage. Protection for consumers generally is provided by the guaranty association of the jurisdiction where the consumer resides or, in the case of property insurance, where the property is located. Importantly, guaranty associations do not provide rescue or "bailout" financing for financially troubled insurers, nor do they protect the general creditors of such companies. Like insurance regulators, the guaranty associations' mission is to make certain that the insurer's obligations to policyholders are honored, up to applicable statutory limits, once the duties of the guaranty associations have been "triggered" by a judicial order of liquidation and determination that an insurer is insolvent.

By public policy design, guaranty associations draw from multiple sources of funds to pay claims. Their largest source of funding is from the assets of the insolvent insurer. (It is important to note and often overlooked that, even though insolvent insurers are unable to pay *all* claims in full, they typically have significant assets on hand that are used to pay insurance obligations on a pro rata basis.)

Under the insurance receivership statutes of all U.S. jurisdictions, when estate assets are distributed, policyholders and guaranty associations have an absolute priority over the lower-ranking claims of general creditors and subordinated creditors.<sup>5</sup> In other words, policyholder and guaranty association claims must be paid first – and in full – before any payment of general creditors or other subordinated claimants is permitted. Because the assets that remain when an insurer fails are often substantial, this absolute priority dramatically lessens the insolvency's impact on policyholders, and it provides the

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<sup>3</sup> U.S. insurance companies are expressly ineligible to be debtors under the federal Bankruptcy Code, 11 U.S.C. § 109(b)(2).

<sup>4</sup> In addition to protecting policyholders, property and casualty guaranty associations also protect those who have claims against policyholders that are covered by an insurance policy issued by an insolvent insurer.

<sup>5</sup> A guaranty association is subrogated to a policyholder's claim against an insolvent insurer to the extent that the guaranty association covers the policyholder's claim. The policyholder retains any portion of the claim against the insolvent insurer that is not covered by the guaranty association.

guaranty associations with critical funding that helps them fulfill the insurer's obligations to consumers.

To satisfy their obligations beyond what these estate assets can finance, the guaranty associations operating in states where the failed company wrote policies assess other insurers doing business in those states based upon each insurer's statewide market share for the lines of business that guaranty associations cover. The dollars raised through these assessments are used to "bridge the gap" between the guaranty associations' obligations to policyholders and the estate assets available to meet those obligations.<sup>6</sup> The guaranty association assessments available from insurers are quite substantial and historically have proven to be well in excess of amounts needed for associations to meet their obligations to consumers.<sup>7</sup> Some states offer insurers an offset on state premium taxes as a way to recover, over an extended period of time, a portion of the funds paid by the companies to protect consumers. In other cases (particularly for property and casualty coverage) assessments are recouped by means of rate increases or policy surcharges.

### **Potential Consequences of Subjecting Insurance Companies to a Federal Resolution Authority**

In response to questions posed in the FIO request, we offer the following comments regarding the potential impact that a federal resolution authority for insurance companies could have on policyholders, the operation of the guaranty system, and life insurance company separate accounts. Our comments presume that any proposal to establish a federal resolution authority would seek to maintain the primacy of policyholder protections that have always been at the core of insurance regulation.

#### ***Impact on policyholder protection (FIO Request No. 12(ii))***

Neither the federal Bankruptcy Code nor the orderly liquidation provisions of Dodd-Frank apply to insurers. Accordingly, they do not make special provision for policyholder claims. If Congress were to consider a federal resolution authority for insurers, maintaining the historical policyholder claims priority status would be an absolute imperative.

Insurance is a promise to pay a policyholder in the event of a claim that is covered under the insurance contract. The public policy of every state calls for the fulfillment of the contract even if the insurance company fails. Putting policyholders on the same level as

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<sup>6</sup> Assessments are levied in proportion to the insurers' market shares within the jurisdiction, and are subject to an assessment cap each year. For life and health insurers, the cap is typically 2% of a company's gross premium in the assessed line of business – life, health, or annuity. For property and casualty insurers, the cap is typically 1 or 2% of net written premium. In most states, an assessment may be deferred or abated if it would compromise the financial strength of the company being assessed.

<sup>7</sup> Some commentators on the guaranty system who are unfamiliar with the system's history, structure, financing, and capabilities have speculated about the ability of the system to protect consumers in adverse economic conditions and occasionally have reached conclusions contrary to the relevant facts. To clarify any such misunderstandings, NOLHGA and NCIGF have set forth in Appendix A a list of the questions sometimes raised in such speculations, together with accurate responses to those questions.

general creditors under a federal resolution authority instead of granting policyholder claims priority status would undo settled public policy in this country. Not only would policyholders be deprived of a significant protection afforded by the current state-based system, the primary objective of insurance regulation would be undermined in the process.<sup>8</sup>

Under the current insurance receivership system, estate assets typically prove sufficient to cover 85-95% of policy level claims in life insurer insolvencies and 55-65% of policy level claims in property and casualty insurer insolvencies. Lumping policyholder claims together with claims of general creditors and other creditors would decrease those percentages dramatically, effectively depriving policyholders of protections that they currently enjoy. The magnitude of the harm suffered by policyholders would depend on the specific facts presented by each insolvency.

Moreover, eliminating the priority status of policyholder claims would significantly increase the burden on the guaranty system, which must bridge the gap between guaranty association-covered obligations and the estate assets allocable to meet those obligations. (The amount of that increased gap, of course, would vary by insolvency.) One reason why the guaranty system works so effectively is that guaranty associations can look to estate assets as their primary source of funding. With those assets redirected to pay general creditor claims, the financial strength of the guaranty system would be diluted.

***Impact on the guaranty system and the policyholders it protects (FIO Request No. 12(i))***

State legislatures enacted the guaranty system more than 40 years ago. Guaranty association coverage is the final element in furtherance of insurance regulation's primary public policy goal – fulfillment of the insurance contract by paying policyholder claims when due. The merits of the system have been reaffirmed by state lawmakers many times since the system was first put into law, and its technical elements have been adjusted over time to reflect evolving circumstances.

Each state's legislature establishes by law the coverage for the residents of its state by adapting national model life/health and property/casualty guaranty association statutes to local conditions and policy priorities. Most life/health guaranty associations provide coverage at limits of at least \$300,000 for life insurance death benefits, \$100,000 for life insurance cash surrender values, \$250,000 for annuity withdrawal or payment values, and \$100,000 for health insurance benefits. Most property/casualty guaranty associations provide coverage on a per-claim basis for personal injury and property damages up to \$300,000, provide full benefit coverage for workers' compensation claims, and provide for premium refunds.

Since its statutory establishment, the guaranty system has:

- Directly expended more than \$30 billion to pay and protect policy benefits;

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<sup>8</sup> In addition, eliminating the priority status of policyholder claims would put the United States at odds with the approach taken by the European Union. Since 2003, EU members have been required to prioritize policyholder claims over claims of other unsecured creditors.

- Guaranteed another \$25 billion in insurance coverage; and
- Protected consumers impacted by hundreds of insurer insolvencies.

Most of these insolvencies involved tiny insurers, but some involved simultaneous failures of multi-billion dollar insurance companies operating in all or virtually all states. When that happened, the nationwide safety net enabled the timely payout of billions of dollars in claims and benefits, as well as continued insurance coverage for life/health consumers. It is therefore critical that any federal insurance resolution mechanism, especially one that retains the policyholder priority as we recommend, continue the current guaranty system's emphasis on providing policyholder protection.

Although the current guaranty system was not designed in contemplation of a federal resolution mechanism for insurers, with some adjustments, the existing guaranty system could provide the same protections in federal resolutions. Absent the protection afforded by the guaranty system, policyholders of insolvent insurers would suffer significant harm, and the underlying goal of insurance regulation would be frustrated.

***Impact on life insurance company separate accounts (FIO Request No. 12(iii))***

Under state law, a life insurance company may establish a separate account and then sell products that are backed by the separate account, such as variable life insurance and variable annuities. For purposes of this discussion, the following are key aspects typical of separate accounts:

- Assets held in the separate account are not subject to the investment restrictions otherwise applicable to life insurance companies.
- Income and losses from the assets held in the separate account are credited to or charged against the account without regard to the other income or losses of the insurer. (Said another way, assets held in the separate account are not chargeable with liabilities arising out of any other business the insurer may conduct.)

We perceive no reasons why any federal resolution authority for insurance companies would or should affect the insulation afforded separate accounts under current law. Purchasers of products issued in connection with insulated separate accounts should continue to receive the benefit of their bargain in the event of insolvency. Any other outcome would appear to impair the contract rights of consumers providing insulation for separate account products.

**Supporting Documentation**

Attached are Appendix A (questions and answers clarifying occasional misunderstandings about the guaranty system), brochures that NOLHGA and NCIGF use to describe the guaranty system, along with written testimony the two organizations submitted to the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity for its hearing on November 16, 2011.

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## APPENDIX A

### ANSWERS TO COMMON QUESTIONS ABOUT THE INSURANCE GUARANTY SYSTEM

To respond to common misunderstandings about the U.S. insurance guaranty system, the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) and the National Conference of Insurance Guaranty Funds (NCIGF) offer the following questions and answers. References below to “FIO Submission” are to the joint submission to the Federal Insurance Office (FIO) by NOLHGA and NCIGF on December 16, 2011, in response to FIO’s request for public input; “NOLHGA Testimony” refers to the written testimony of NOLHGA submitted to the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity for its November 16, 2011 hearing; and “NCIGF Testimony” refers to the written testimony of NCIGF for the same hearing.

#### **1. Do failures of conventional insurance companies happen frequently?**

Insurance company failures have been rarer and less severe than for other financial services providers. As in all competitive businesses, conventional insurance companies do fail from time to time for various reasons. However, as discussed in connection with questions 2 and 3, compared to the failures of, for example, commercial banks and thrift institutions, insurer failures have been relatively rare. The majority of conventional insurers that have failed have been quite small, and the outcomes for policyholders from such failures on average have been relatively positive.

#### **2. How did insurers fare in the recent financial crisis and other bad economic cycles?**

Since the beginning of 2008, a significant number of failures have occurred in the financial services sector, but few of the failed companies were conventional insurers, and none of those were nationally significant. During that period, approximately 400 banks and thrift institutions failed, including some major institutions; Fannie Mae and Freddie Mac were placed in receivership; two of the three major auto companies went bankrupt; many hedge funds closed; and all five of the largest investment banking firms either collapsed, were acquired, or fundamentally altered their structure. By contrast, in the same period only 8 small life insurers, 5 small health insurers, and 22 small property and casualty insurers entered liquidation (out of a population of approximately 1,100 life and health insurers and roughly 2,700 property and casualty insurers).

The results were similar in earlier difficult economic periods. For example, in the recession of 1988 through 1994, a total of 42 life and health carriers and 198 property and casualty carriers entered liquidation, compared to, for example, the approximately 1,656 banks and thrifts that failed during the same period.

Even during the Great Depression, the experience was fundamentally similar. Consider, for example, that in 1940, Congress conducted a study of the 19 life reserve companies that failed between 1930 and 1939 having initial losses in excess of \$1 million. According to Congress, the estimated losses to policyholders from these 19 companies amounted to \$130 million, which compared very favorably with over 14,000 banks that were closed during that same period with losses estimated at approximately \$3.5 billion.

3. **Why have there been comparatively few insurer failures?**

The business models of conventional insurers are fundamentally different from those of other types of financial institutions that have had greater difficulties. In general, insurers have comparatively low leverage, are not highly reliant on short-term funding, and do not engage in widespread “maturity transformation,” all of which are traits that rendered other types of financial institutions vulnerable in the recent recession and in prior difficult economic periods. In addition, improved U.S. insurance regulation (especially since the NAIC accreditation program began in the mid-1990s) and other factors have made insurers subject to comparatively conservative rules on liability (reserve) reporting, permitted investments, accounting practices, and required capital. In particular, “risk-based capital” rules adopted by state insurance regulators in the 1990s required capital cushions for insurers that were unavailable to some other types of financial services entities in the recent financial crisis.

4. **What happens when an insurer becomes insolvent?**

An insolvent insurer is placed in receivership in a state court proceeding akin to bankruptcy, and the insurance commissioner of the state where the company is chartered becomes the company’s statutory receiver. The receiver then works with the guaranty system to try to achieve the best possible outcome for consumers. (See FIO Submission at p. 3; NOLHGA Testimony at p. 5; NCIGF Testimony at p. 1.)

5. **How severely have consumers been affected when insurers have failed?**

As noted in the discussion of question 2, even during the Great Depression, policyholder losses in respect of life insurance failures were comparatively modest. More recent experience is consistent with the 1940 Congressional findings: average policyholder recoveries from insurer insolvencies have been substantial. For example, average recoveries in respect of life policy claims over the past 20 years have exceeded 96 cents on the dollar, and average recoveries on annuity claims have been almost 95 cents on the dollar. (See NOLHGA Testimony at p. 11.) Recoveries for property/casualty claims have been somewhat lower but still substantial.

6. **What are insurance guaranty associations?**

Guaranty associations are entities created by state legislatures under special legislation that charges each association with consumer protection responsibilities and provides the association with statutory powers needed to perform those responsibilities. (See FIO Submission at p. 3; NCIGF Testimony at p. 2; and NOLHGA Testimony at p. 2.)

7. **Who is protected by guaranty associations?**

In general, guaranty associations protect residents of their states for losses, within specified limits of coverage, on virtually all lines of insurance written for consumers and on some types of commercial insurance. The guaranty associations do not provide liquidity support to failed (or failing) insurers, nor do they protect the insurers’ general creditors. (See NOLHGA Testimony at p. 2-3 and NCIGF Testimony at p. 2-3.)

8. **How do guaranty associations protect consumers?**

The specific nature of guaranty association protections is a function of the type of insurance benefit at issue. For claims on policies that are pending at the time an insurer is placed in liquidation, the involved guaranty association adjusts covered claims and makes any required

payment in the same manner as would have been done by the failed insurer. (See, e.g., NCIGF Testimony at p. 2.) Continuing benefits under covered life, annuity, and non-cancellable health contracts are provided by the guaranty associations, usually by working with the insurance receiver to secure the assumption of the failed insurer's responsibilities by another healthy insurer. (See NOLHGA Testimony at p. 4-5.)

**9. How are guaranty association consumer protections funded?**

Guaranty associations pay for the delivery of consumer protections from a combination of funding sources.

First, guaranty associations “step into the shoes” of the consumers they protect and assume the rights of the consumers, as claimants, to assets of the failed company. Since failing insurance companies, although insolvent, typically nonetheless have substantial assets when they enter liquidation, these “subrogation” claims effectively entitle the associations to employ assets from the failed carriers to finance a significant part of the costs of protecting policyholders.

Second, guaranty associations have the ability to assess a substantial amount of money, pro rata on a market share basis, from their member insurance carriers writing covered lines of business. The maximum annual assessment capacity of the life and health guaranty system now slightly exceeds \$10 billion, while that of the property/casualty guaranty system is approximately \$6.7 billion. These amounts “refresh” each year, meaning that, for a two-year period (at the same maximum capacity), the total available to protect policyholders would be \$20 billion and \$13.4 billion for each system respectively. Historically, even during the periods of heaviest insolvency activity, assessments called did not remotely approach the theoretical maximum annual assessment capacity of the guaranty associations.

Finally, guaranty associations may have access to other funds, such as future premiums on continuing policies, “ceding” commissions paid by carriers who assume ongoing business (e.g., life and annuity contracts) and loans against the security of future assessments.

For these reasons, analyses focusing solely on the guaranty system's assessment capacity are incomplete. Assessments are not the sole (or even the primary) source of funding for the guaranty associations, and the associations' obligations to policyholders often stretch out for years or even decades, meaning that funds to match the total obligations of a failed company are not immediately required. (For additional discussion of timing of payment obligations, see question 14 below.)

**10. Do guaranty associations have a track record of protecting consumers in insurer failures?**

Yes, guaranty associations have an extensive track record of protecting consumers from the financial consequences of insurer failures. Since guaranty associations came on the scene in the early 1970s, guaranty associations have spent over \$30 billion to pay policy benefits to consumers and have guaranteed coverage of an additional \$25 billion of benefits, thereby protecting millions of consumers in hundreds of separate insolvencies. (See FIO Submission at p. 5-6; NCIGF Testimony at p. 5; NOLHGA Testimony at p. 8.)

**11. Have guaranty associations ever had to protect consumers from the failure of a large insurance company?**

Yes. Fortunately, the majority of U.S. insurers that have failed were small local or regional carriers. However, the member guaranty associations of NOLHGA and NCIGF have also protected consumers in a number of cases involving major carriers doing business in virtually all states. (See discussion of question 13 below.)

**12. Have guaranty associations ever failed to meet their coverage obligations to consumers on a full and timely basis?**

No.

**13. Do guaranty associations have the financial capability to protect consumers in a bad economic cycle or when multiple companies fail simultaneously?**

Yes. Not only do guaranty associations have the financial capability to protect consumers through bad economic cycles and in the face of multiple carrier failures, they have in fact done so. For example, in the early 1990s, NOLHGA's member life and health guaranty associations protected consumers against losses from the contemporaneous failure of approximately three dozen different carriers, including three of the top 25 life and annuity insurers in the country. NCIGF's property/casualty guaranty association members have similarly protected consumers from losses during the contemporaneous failures of multiple carriers (including some national companies). In neither case did the costs of protecting consumers ever remotely approach the limits of the financial capacity of either system. (See NCIGF Testimony at p. 5; NOLHGA Testimony at p. 7-8.)

**14. Would it be better for consumers if guaranty associations were pre-funded?**

No. On balance, pre-funding of the insurance guaranty system would provide no appreciable value for consumers and could be a net detriment for consumers. Simply stated, insurance failures are fundamentally different than banking failures, and different types of safety net systems provide the best, most cost-effective protection for consumers in the two different types of financial institution failures (banking and insurance).

A bank failure is invariably a liquidity crisis, since most liabilities of banks are effectively demand deposits. To protect consumers whose bank deposits are all due and payable on the day a bank fails, a consumer safety net for banks requires massive liquidity, and that need for liquidity is the primary justification for the FDIC's Deposit Insurance Fund.

By contrast, the consumer liabilities on the balance sheets of insurance companies for the most part are NOT due and payable at the time an insurer fails. Some are contingent and may never ripen into claims (e.g., claims on liability policies where liability of the insured remains to be established), while others will not be due and payable until years, decades, or even generations after the insurer enters liquidation (e.g., death benefits on life policies and certain annuity payments).

Although the liquidity requirements for protecting consumers in an insurer failure generally are not high, most insurers entering receivership – particularly larger companies and those doing life and annuity business – have a relatively high percentage of assets (including liquid assets) available to address the liabilities that are maturing at the time the insurer fails. As a

consequence, the amount of liquidity typically required from guaranty associations at the start of a receivership is vastly less than the amount required for a bank failure of similar magnitude.

But while massive liquidity thus is NOT required to provide consumer protection at the inception of insurer insolvencies, the costs of maintaining an unnecessary pre-funded “war chest” would be high, both directly for the companies that would be called upon to advance the funds (and to replenish them after they would be drawn down) and indirectly for their customers, who would eventually pay those costs in higher premiums.

**15. Does the obligation to pay guaranty association assessments pose a threat to insurers or the financial system?**

No. Insurers’ obligations to pay guaranty association assessments do not pose a threat either to insurers or to the financial system; to the contrary, insurer participation in the system tends to promote the financial stability of both individual insurers and the broader financial system.

Guaranty association assessments to member insurers in each state are subject to annual statutory “caps” that effectively limit in each year the amount of assessments an individual carrier would be provided to pay to support guaranty association protection of consumers.

In light of the points noted above (the relative infrequency of insurer insolvencies, the typically high level of assets available when an insurer fails, and the low level of liquidity required to fund claims that are due and payable at the time of liquidation) that cap – typically about 2% of premium collections – provides ample funding to support consumer safety net protection, and the cap in fact has seldom been approached for a given insurer in a single state, let alone nationally.

At the same time, the statutory cap on assessments also limits the guaranty system funding strain that can be imposed, either on a single insurer or on the industry or the financial system as a whole.

But while the costs of providing the consumer safety net are relatively modest, the benefits of the guaranty system are profound – both to the millions of consumers who have been protected to date, together with those who will be protected in the future – and to an industry whose consumers have an additional source of financial protection in the unlikely event that an insurer fails.



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**TESTIMONY FOR THE RECORD**  
**OF**  
**THE NATIONAL ORGANIZATION OF LIFE AND HEALTH INSURANCE GUARANTY**  
**ASSOCIATIONS**  
**BEFORE THE**  
**HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON INSURANCE, HOUSING AND**  
**COMMUNITY OPPORTUNITY**

**HEARING ENTITLED**  
**“INSURANCE OVERSIGHT AND LEGISLATIVE PROPOSALS”**  
**NOVEMBER 16, 2011**

The National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) is pleased to submit these comments in response to the invitation of the Subcommittee Chair. NOLHGA’s 52 members are the guaranty associations (sometimes called “GAs”) formed by the 50 states, Puerto Rico, and the District of Columbia to provide protection for consumers facing financial harm from the failure of a life or health insurance company. NOLHGA’s members, along with the state property and casualty insurance guaranty funds belonging to the National Conference of Insurance Guaranty Funds (NCIGF), have provided a nationwide insolvency “safety net” for American insurance consumers since the 1970s.

The objective of this written testimony is to provide the Subcommittee with an overview of the life and health insurance guaranty system and its operations, history, and ability to protect consumers—even in a challenging economic environment. NCIGF is concurrently submitting parallel testimony on the property and casualty insurance guaranty system.

**THE LIFE AND HEALTH INSURANCE GUARANTY SYSTEM TODAY**

From its inception in the early 1970s, the life and health insurance guaranty system has evolved into an effective national network that has fully performed its obligations to provide protection to consumers. The system has protected consumers in 80 insolvencies of insurers who wrote business in multiple states, and in another 326 instances where smaller single-state or regional

carriers failed.<sup>1</sup> In those cases, the system has protected, in the aggregate, more than 2.8 million policyholders, and it has guaranteed policyholder values in an aggregate amount of about \$25 billion.

Although the recent financial crisis laid waste to a number of financial service providers of many kinds, operating insurance companies stood up well to the many challenges of the period: Only 13 life and health insurers (8 life and 5 health) were placed in liquidation from January 1, 2008, through November 16, 2011, with aggregate liabilities to policyholders of about \$900 million.<sup>2</sup> And while the insurance industry has fared comparatively well through the crisis, the guaranty system's financial and operational resources are greater now than they have ever before been, supporting the conclusion that the system can and would protect consumers in a challenging future financial environment, as it has done in the past.

### **Development of the Current Life and Health Insurance Guaranty System**

There was no organized national consumer insurance safety net before the early 1970s, but by then a consensus had developed that such a system was needed. As a result, insurance regulators, legislators, and the industry developed guaranty association model legislation (the "Model Act"<sup>3</sup>) that states adopted widely in the 1970s and 1980s as the foundation of the current guaranty system.<sup>4</sup>

By 1991, life and health insurance guaranty associations had been established by the legislatures of all 52 of NOLHGA's current member jurisdictions.

NOLHGA was formed by the guaranty associations in 1983 to provide a process, facilities, and staff to coordinate and support the activities of the member guaranty associations, particularly in connection with the insolvencies of insurers writing business in multiple states.

### **How Guaranty Associations Work**

Insurance guaranty associations provide protection to consumers; they do not provide rescue or "bailout" financing for financially troubled companies. The fundamental responsibility of an insurance guaranty association is to assure the provision of insurance protection to consumers, up to a statutorily established maximum level of guaranteed protection, once the duties of the guaranty association have been "triggered" by a judicial determination that an insurer is insolvent and should be liquidated.<sup>5</sup>

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<sup>1</sup> Also included in the larger number are some cases where failed property and casualty insurers wrote a small amount of health insurance, and where the insolvency case triggered obligations of both property and casualty guaranty funds and some life and health guaranty associations.

<sup>2</sup> Compare, for example, the initial bank and bond debt of Lehman Brothers alone, which was reported on the first day of Lehman's bankruptcy as totaling approximately \$765 billion.

<sup>3</sup> See NAIC Life and Health Insurance Guaranty Association Model Act ("Model Act").

<sup>4</sup> The development of the consensus favoring the guaranty system, the related model legislation, and enactment of the model legislation in the states are summarized in *The U.S. Guaranty Association Concept at 25: A Quarter Century Assessment*, Christopher J. Wilcox, 14 J. of Ins. Reg. 370 (Spring 1996).

<sup>5</sup> Certain conditions must exist in order for a guaranty association to have statutory responsibility to consumers. For example, in general the insured must be a "covered person" (see Model Act Section 3A); the contract under which

A working understanding of how guaranty associations protect consumers thus requires first a working understanding of the insurance receivership process.

### The Conduct of Insurance Receiverships

Domestic U.S. insurance companies are excluded from the definition of “debtor” under the U.S. bankruptcy code, and thus their financial failure is resolved outside of the federal bankruptcy process.<sup>6</sup> Rather, an insurer receivership is an insolvency proceeding conducted in a state court of the state where the insurer is chartered and primarily regulated (the “domiciliary state”).

Under the laws of most states, the receivership is commenced by the filing of a petition by the state’s attorney general on the relation of the state’s insurance commissioner, who is appointed statutory receiver if the court grants the petition.

Receiverships are of several different types. For example, in Illinois (and many other states), the mildest form of receivership is “conservation,” under which the insurance commissioner is appointed conservator for purposes of securing the finances and records of the company, thus protecting the status quo pending a determination of whether a more serious form of receivership is required. If serious solvency concerns are raised, a company can be placed into “rehabilitation,” where the commissioner, as rehabilitator, is expected to develop and propose to the court a rehabilitation plan aimed at addressing the causes for concern about the company. If a company is financially troubled and cannot be rehabilitated, the commissioner petitions for “liquidation,” under which the commissioner is appointed liquidator and directed to marshal the assets of the failed company, evaluate claims against it, and distribute the assets to those with valid claims in the manner specified in the state’s receivership law.<sup>7</sup>

Three aspects of the insurance receivership process are particularly relevant to how guaranty associations protect consumers.

*First*, insurance receivership judicial proceedings, like bankruptcy cases, generally provide for notice to and participation by creditors on material issues. While the development of a resolution plan for a failed insurer usually is proposed in the first instance by the domiciliary commissioner as receiver, this is done with knowledge that affected creditors will have opportunities to comment upon or object to all or part of the proposal.

*Second*, state receivership laws generally confer priority creditor status on claims against the “estate” of the failed insurer that arise from the insurer’s direct policies of insurance. Since receiverships follow an “absolute priority rule,” all claims at the insurance policy level must be paid *in full* before any payments may be made on lower-ranking claims, such as general creditor claims, claims in respect of subordinated financing, or equity claims.

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the insured seeks coverage from the guaranty association must be a “covered contract” (*see* Model Act Section 3B(1)); the failed insurer must have been a “member insurer” of the guaranty association (*see* Model Act Sections 3B(1) and 5(L)); and no coverage “exclusions” must apply to the insured’s claim for coverage (*see* Model Act Section 3B(2)). These conditions are routinely satisfied in cases involving typical insolvent insurers that wrote traditional consumer lines of life or health insurance.

<sup>6</sup> *See* Bankruptcy Code, 11 U.S.C §§ 109(b) and (d), preventing domestic insurance companies from qualifying as “debtors” under Chapter 7 and Chapter 11 bankruptcy.

<sup>7</sup> *See, e.g.,* 215 ILCS 5/187 *et seq.*

*Third*, guaranty associations are subrogated to the claims of the insurance policy owners that the associations protect; that is, after protecting the consumers, the associations step into the shoes of those policyholders as creditors of the insolvent insurer at the (preferred) policyholder creditor level.<sup>8</sup> In effect, the associations are responsible—within coverage limits—for the entire amount of covered policy liabilities to consumers, but if the estate has significant assets when the insurer is placed in liquidation, the associations’ subrogation claims to those assets effectively become part of the associations’ financing. If the consumer has a claim exceeding association coverage limits, that “over limits” portion of her claim is *entirely* dependent on the availability of estate assets.

Viewed another way, since the obligation of a guaranty association is to assure that consumers are completely protected *up to* the association’s limit of coverage, the amount of assets that can be marshaled by the receiver are critically important not only to the guaranty associations and those paying the associations’ costs (by reducing the expense of providing coverage within the associations’ limits), but also to policyholders with large claims (by maximizing the assets available to cover any portion of a policyholder’s over-limits claim). Accordingly, the comparative success of a receivership—and how well (or badly) policyholders with over-limits claims and other stakeholders fare in the receivership—is primarily a question of whether the receiver marshals assets covering a significant percentage of policy-level liabilities. (For a more detailed discussion of this issue, see Appendix A – The Critical Role of “Prompt Corrective Action.”)

As a consequence of the three receivership aspects described above, the activities and interests of insurance receivers and the guaranty system are closely inter-related, a fact recognized widely among state regulators and receivers.<sup>9</sup>

### *The Operations of the Guaranty System in a Receivership*

Once a guaranty association is triggered by a judicial determination that an insurer is insolvent and should be liquidated, the association has two principal sets of duties to consumers. First, the guaranty association must pay, up to coverage limits, any claims that are or become ripe for payment. Second, as to contracts that the failed insurer had no right to cancel prospectively (e.g., annuities, most non-term life insurance contracts, and some types of health insurance contracts), the guaranty association must guaranty, assume, or reinsure the continuing insurance coverage. In other words, the association must make sure that the coverage continues, as long as the consumer pays any required premium.

Regarding the first set of obligations—payment of “ripe” claims—the duties of life and health guaranty associations are substantially similar to those of property and casualty guaranty funds. The function of the triggered guaranty association is to process, adjudicate, and pay claims coming due in much the same way that the insurer would have done, had it not failed.

However, because non-cancellable contracts, such as life and annuity contracts, are purchased to cover an extended period of time for contract terms and premiums that are often permanently established at the inception of the contract (unlike, for instance, property and casualty coverage,

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<sup>8</sup> See Model Act Section 8K.

<sup>9</sup> See generally, “Communication and Coordination Among Regulators, Receivers, and Guaranty Associations: An Approach to a National State Based System,” NAIC (2005).

which is purchased annually and may be subject to annual re-pricing, re-underwriting, contract term changes, or even cancellation by either party), the policy owner has an investment or “equity” interest that cannot be fully protected unless the contract is, in effect, kept in force. For example, a policyholder might have been in good health when she purchased a life policy 10 years before the insurer entered liquidation, but at the time the insurer failed, her health might have deteriorated to the point where she might be unable to purchase replacement coverage on similar terms, or at any price.

Consequently, for the “safety net” to work regarding non-cancellable contracts, the guaranty association must assure the continuing covered benefits promised by the contract on the terms originally agreed between the policyholder and the (now-failed) insurer. This is often accomplished by the negotiation of an arrangement known as an “assumption reinsurance” transaction. In such a transaction, a healthy carrier agrees to assume all or part of the policy liabilities of the failed insurer in exchange for a transfer of assets to support the liabilities—assets that are usually provided in part by the receiver from the estate of the insurer, and in part by guaranty associations. In other cases, guaranty associations simply assume the covered liabilities of the insolvent insurer for whatever period is required for the liabilities to run off. A combination of both approaches can also occur, in which the guaranty associations assume the covered liabilities for some period of time, after which a healthy carrier takes over the liabilities via assumption.

#### *Coordination of Guaranty Association Responses*

Guaranty association coverage responsibilities under current law are determined by the residence of the covered person: A covered person is protected by the guaranty association of the jurisdiction where the person resides, even though the insurer whose liquidation triggers the association’s coverage responsibility may be domiciled in a different jurisdiction.

In some cases, an insurer may be licensed to do business only in its state of domicile and may only sell contracts to individuals in that state. If such a company fails, that state’s guaranty association provides all of the available guaranty association coverage.

In many other cases, a failed insurer may have been licensed in (and may have contracts with residents of) many states, in which case coordination of the coverage responses of multiple guaranty associations is necessary. The guaranty associations effect that coordination through NOLHGA and its processes, with the result that the receiver and potential assuming carriers can deal with a single point of contact and contracting instead of having to engage in multiple discussions, negotiations, and contracts with a variety of different associations. That said, and though the process is essentially invisible from a consumer standpoint, the protection afforded each contract owner and the related funding for that consumer’s protection always come from the guaranty association of the jurisdiction where the contract owner is deemed a resident.

NOLHGA’s offices are in Herndon, Virginia, where a permanent full-time staff of 15 insurance, finance, MIS, and legal professionals and administrative staff members support the work of the member guaranty associations. Its management is overseen by a 13-member board of directors, and all significant decisions regarding major insolvencies are made by NOLHGA’s member guaranty associations.

### Guaranty Association Powers and Duties

Each guaranty association is a creature of statute whose powers and duties are established by legislation adopted in its state. Since all guaranty association enabling laws are drawn from the Model Act, many of the provisions are similar or identical from state to state, though there are some differences. In some cases, the differences exist because the state insurance commissioners have amended the Model Act several times since it was first promulgated, with the result that there is usually a time lag of several years before most states' legislatures will have had an opportunity to consider updating their guaranty associations' enabling statutes in light of Model Act changes. For example, the Model Act was amended in 2009 to (among other things) raise the coverage limit for annuities from \$100,000 to \$250,000. To date, the laws of 35 jurisdictions cover annuities to a limit of \$250,000 or more and other states are considering amendments to that effect, but some states currently are still at the old \$100,000 coverage limit. (For more detail on guaranty association coverage limits as of October 2010, please refer to the brochure, "The Nation's Safety Net," which accompanies this testimony.)

All insurers licensed to market covered lines of business in a jurisdiction are obliged to be members of the guaranty association of that jurisdiction. The costs of covering consumers and of operating the association that are not provided from assets of an insolvent carrier or any ongoing premiums in respect of contracts continued by the association are financed by assessments payable by member companies. Those assessments are levied in proportion to the insurers' market shares within the jurisdiction and are subject to an assessment cap each year (typically 2% of an insurer's gross premium in the assessed line of business—life, health, or annuity).

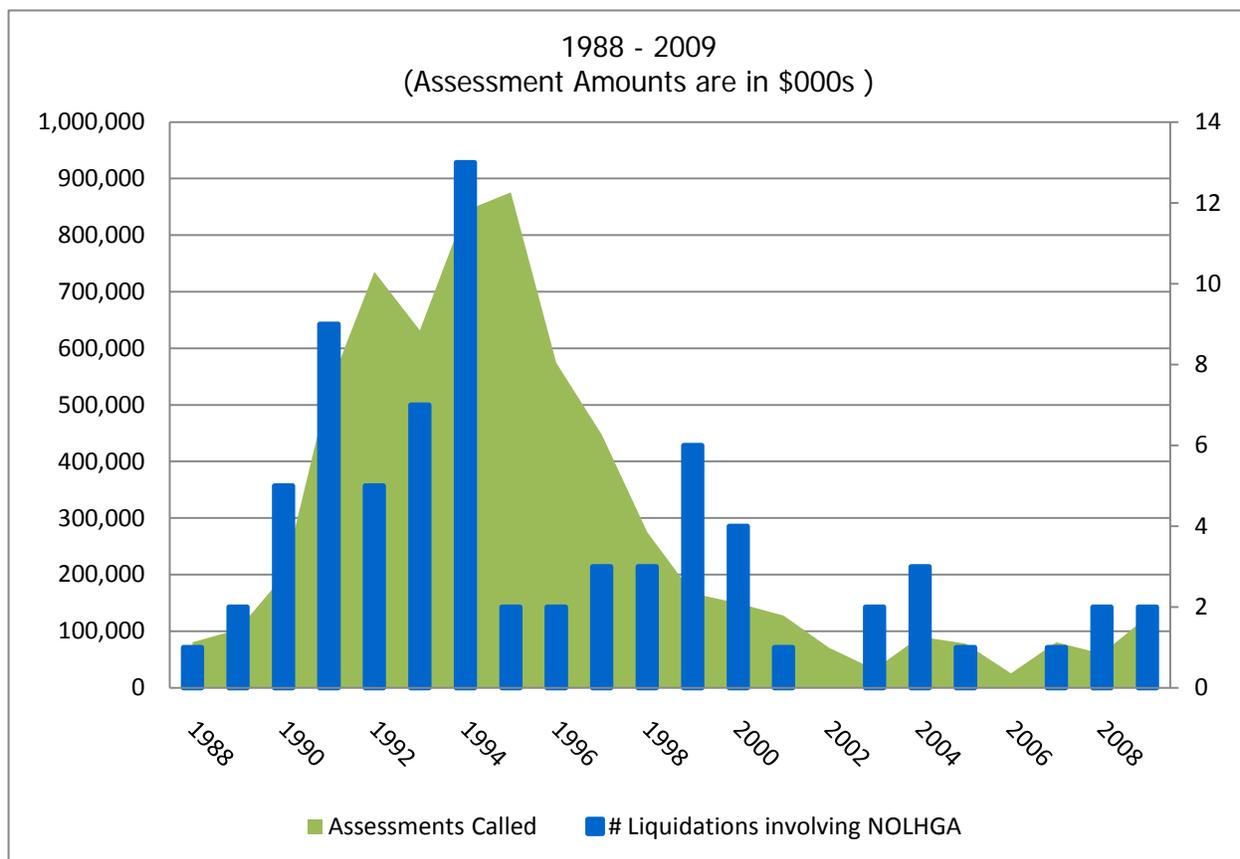
Under Section 13 of the Model Act, a state's legislature has the option of providing a "premium tax offset" to association members for portions of the assessments a member pays to that association to provide guaranty association protection for consumers. Many state legislatures have provided such premium tax offsets, in recognition of the practical difficulties preventing a member from recovering assessment expenses from any other source.

Each guaranty association is subject to regulatory supervision and examination by the insurance commissioner of its jurisdiction, and its responsibilities are prescribed by its enabling statute and by a plan of operation approved by the insurance commissioner. Operations are governed by a board of directors elected by the membership in accordance with the enabling legislation, plan of operations, and bylaws of the association.

Daily operations of guaranty associations are primarily the responsibility of an executive director, sometimes referred to as an "administrator," engaged on behalf of the association by its board of directors. Depending on the activity level of the associations, the administrators may supervise staff of varying sizes; the administrators also typically oversee work done for the associations by counsel or other professional advisors.

## Historical Insolvency Performance of the Life and Health Insurance Guaranty Associations

Guaranty associations have protected consumers in 80 multi-state insolvencies coordinated through NOLHGA. In addition, they have protected consumers in approximately 326 smaller or single-state insolvencies in which NOLHGA was not directly involved. Set forth below is a chart displaying by year the frequency and cost (by assessments “called,” or collected from guaranty associations’ member insurers) of the 74 insolvencies from 1988–2009 coordinated through NOLHGA:



As the chart suggests, insolvencies have tended to increase and decrease—both in frequency and severity—in apparent “waves” or cycles that bear some relationship to broader economic and financial trends.

For example, the chart shows a marked increase in the frequency and cost of insurer failures in the first half of the 1990s, when the U.S. economy was emerging from a general recession and the financial sector was also still feeling the consequences of negative developments in the commercial real estate and corporate high-yield bond markets. A number of the more significant life company insolvencies in this period were precipitated by significant deteriorations in real estate or bond investments.

Interestingly, the recent financial crisis—which saw the failure of nearly 400 commercial banks and thrifts, several major investment banking firms and hedge funds, finance companies,

government-sponsored housing entities, and other firms—resulted in very few liquidations of operating life and health insurers. Of the 13 life and health companies that entered liquidation since January 1, 2008, almost all were comparatively tiny regional writers; none were remotely “systemically important;” and their aggregate liabilities to policyholders were approximately \$900 million—compared to, for example, the initial general creditor liability of Lehman Brothers alone, which was reported at the start of its bankruptcy filing as being approximately \$765 billion.

There are several reasons why the effect of the recent recession on the insurance industry and its consumers has been relatively mild. One reason is that standards for evaluating and managing investment and underwriting risk (by companies, their actuaries, regulators, and insurance rating agencies) have become considerably more sophisticated than they were in the years prior to the early-1990s recession. Another reason is that the methods and systems U.S. insurance regulators have employed in monitoring and responding to financial solvency concerns at operating insurance companies have become significantly more effective than they were in prior periods.

### **Ability of the Life and Health Insurance Guaranty System to Protect Consumers in Challenging Economic Environments**

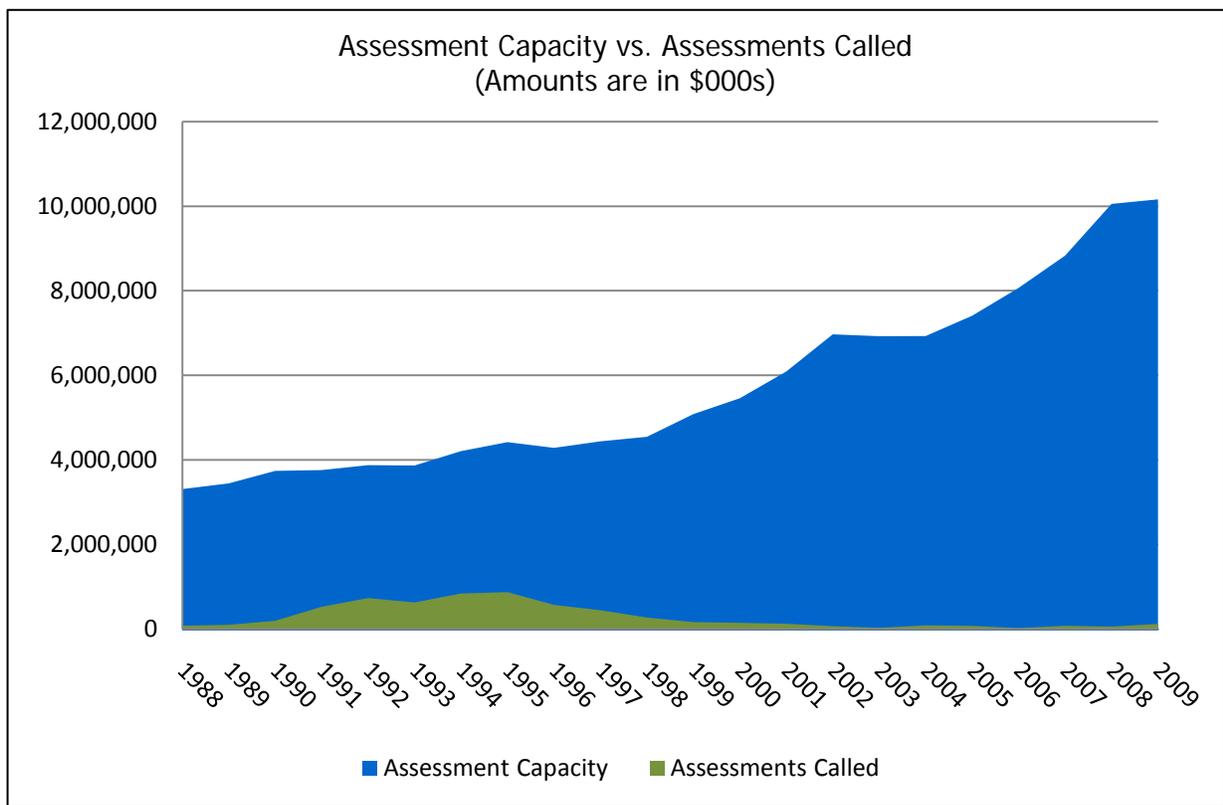
The experience of the recent financial crisis understandably has led people to inquire whether the insurance guaranty system has the financial ability to protect consumers if, for example, several major insurers were to fail simultaneously. Those who have reviewed the available evidence have been able to conclude both that the system has in fact met that challenge in the past, and that it could do so if necessary in the future.

#### **Historical Performance**

While the current recession has caused the liquidation of relatively few operating insurers, that was not true of the last significant U.S. recession. As a consequence of the recession in the early 1990s, a total of nearly 40 life and health carriers were liquidated, and their resolutions were addressed simultaneously by NOLHGA and its member guaranty associations. Three insurers ranking among the top 25 writers in the U.S. market were among those liquidation cases. Yet even in the worst years of that period, the costs to the guaranty system of protecting consumers (sometimes referred to as “assessments called,” i.e., collected from member insurers) did not remotely approach the theoretical maximum annual assessment capacity of the life and health insurance guaranty system, as illustrated in the following chart<sup>10</sup>:

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<sup>10</sup> The chart depicts the actual assessments collected from association member companies by year, charted against the aggregate theoretical maximum assessment capacity for all lines of insurance for all of NOLHGA’s 52 member guaranty associations. The entire theoretical maximum capacity may not be available for a particular insolvency, since each individual guaranty association generally covers only residents of its jurisdiction, so that—in theory—an individual association could meet its annual capacity limit before satisfying all of its obligations. In practice, even individual association “caps” are seldom approached in an insolvency, and in the rare cases when they are, associations have the ability to borrow against the security of future assessments to meet current needs. Furthermore, insolvencies of life and annuity carriers generally tend to produce a relatively normal distribution of policyholders by state, with the result that association funding needs generally line up relatively well with association capacity, further minimizing the impact of what otherwise might be viewed as a “silo” issue.



*Current and Projected Financial Ability*

As depicted in the foregoing chart, the maximum annual assessment capacity of the life and health guaranty system now slightly exceeds \$10 billion. That amount “refreshes” each year, meaning that, for a two-year period (at the same maximum capacity), the total available to protect policyholders would be \$20 billion, and so on. By comparison, the total net assessments, from the inception of the guaranty system to date, required to provide all life and health guaranty protection—guarantying obligations on almost \$25 billion of policyholder obligations for about 2.8 million policyholders—has been roughly \$5.3 billion. In other words, the current year’s assessment capacity, by itself, is almost twice the total net costs that have been required to protect consumers since the beginning of the system decades ago.

The ability of the guaranty system to respond in challenging times is not, however, limited to its annual assessment capacity. This is true for several reasons.

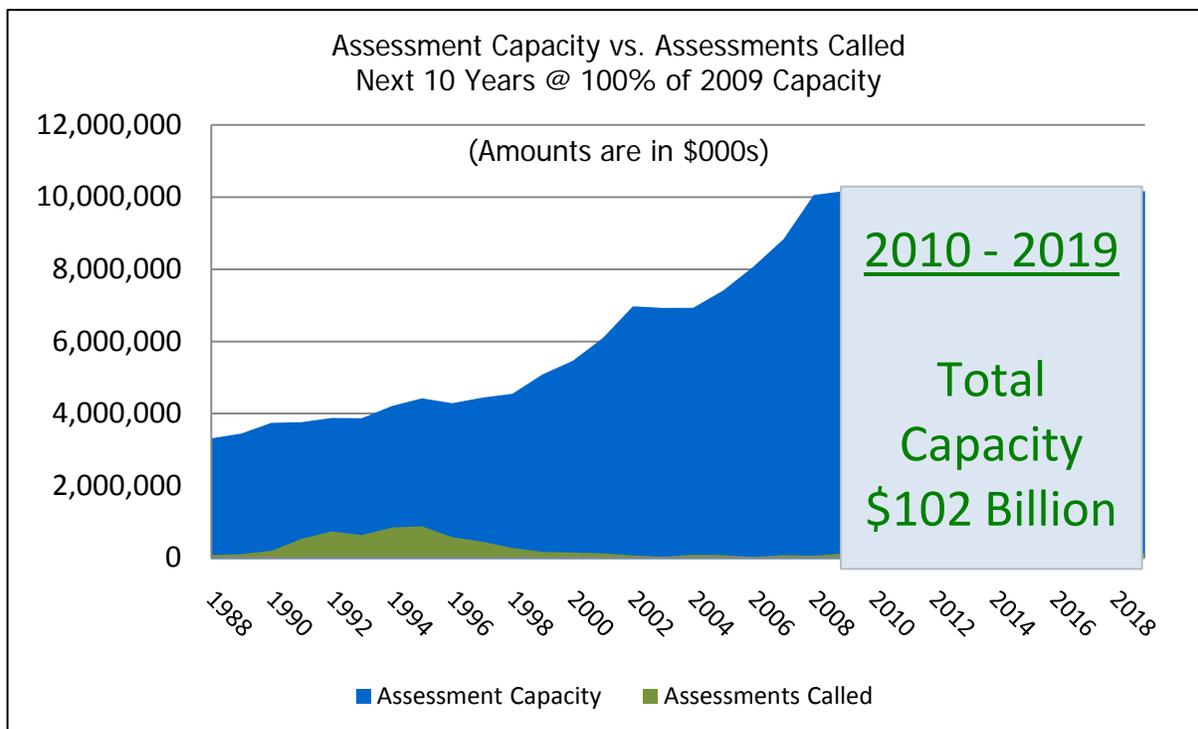
First, the liabilities of a troubled insurance company do not all come due on the date that an insurer enters liquidation; for a typical insurer, many or most of its liabilities will not come due until years, decades, or even generations after the company fails. For that reason, much less liquidity is required to meet the covered liabilities of a failing insurer than in the case of, for example, an FDIC-insured bank, whose consumer liabilities primarily consist of deposits contractually available to the consumer on demand.

Second, most life insurer insolvencies involve only small shortfalls of assets versus liabilities. The shortfalls are seldom more than 15% in larger cases and are more typically in the range of 5% to 10%. As a consequence, the need that must be funded currently by the guaranty

associations when the company fails is reduced to the extent that estate assets are available to the receiver in devising a resolution plan to protect policyholders. If the solvency problem is identified early by the regulator and prompt and effective regulatory intervention takes place, the cost of the insolvency is minimized—both for guaranty associations (and their funding sources) and for policyholders with claims exceeding guaranty association “caps.” (For further discussion of this point, see Appendix A – The Critical Role of “Prompt Corrective Action.”)

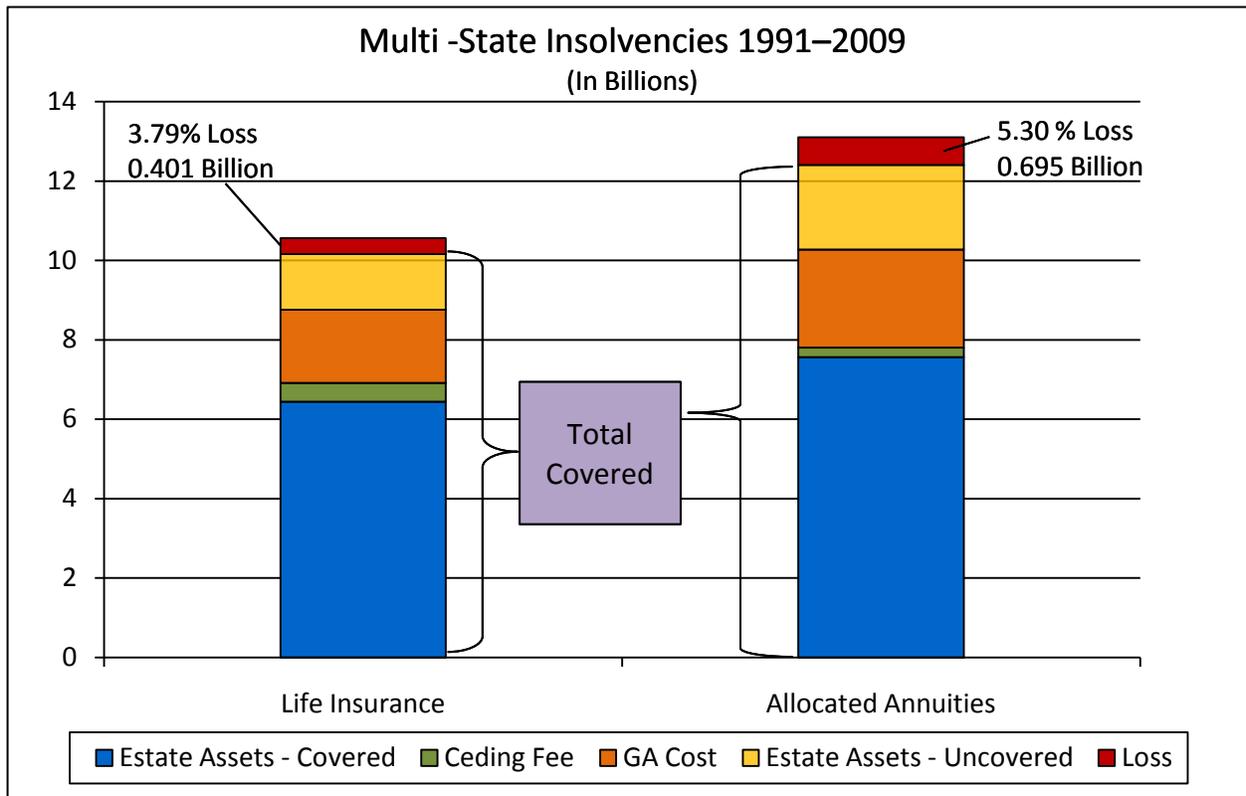
Third, even a financial crisis of unprecedented proportions, involving insurers with unusually large shortfalls of assets to liabilities, could be addressed by utilizing the assessment capacity of guaranty associations that would develop in the years following the initiation of receivership proceedings. Because a significant proportion of the insurers’ liabilities would mature in future years, a resolution plan could provide for the “runoff” of those liabilities (i.e., payment of the liabilities from the receivership estate, “topped up” or enhanced as necessary by guaranty associations, over the years in which the liabilities would by their terms mature). Such a runoff would only be paid from the assessment capacity of the guaranty associations in the years in which the payments would be made—not all in the year in which the receiverships commenced. In addition, associations have the ability to borrow today against future assessment capacity, in the event a liquidity need might arise. Accordingly, an appropriate yardstick for the financial ability of the guaranty system to perform its mission is not the maximum assessment capacity of the system in the year a crisis arises, but rather the aggregate capacity of the system over the projected runoff period.

The point is illustrated in the following chart, which assumes, for illustrative purposes, that capacity would remain level for the next 10 years, producing an aggregate maximum financial capacity of more than \$100 billion.



Average Recoveries by Policyholders

One final point should be noted regarding the protection that has been achieved for policyholders in prior life insurer insolvencies. Because of factors noted above—particularly the protections afforded through the guaranty system, the generally conservative nature of insurance company investments, and the effectiveness usually demonstrated by regulators in intervening promptly when life insurers face financial difficulties—actual losses typically suffered by consumers with life policy and annuity claims against insolvent carriers have on average been modest. The point is illustrated by the following chart, which shows that, after application of “estate” assets to both the claims covered by guaranty associations and those policy claims exceeding coverage limits (or otherwise not covered), average recoveries have exceeded 96% on life claims and 94% on annuity claims.<sup>11</sup>



<sup>11</sup> The figures in the chart reflect only multi-state life insurer liquidations in which NOLHGA was involved. A small number of health insurance insolvencies in which the companies wrote residual life and annuity business have been excluded, as has one life insurer liquidation for which we do not possess reliable financial data. The figures are based on guaranty association records, financial information provided by receivers, and estimates on recoveries on “above coverage limits” amounts derived from guaranty association recoveries of their subrogation claims. The figures do not reflect the time value of money.

## **Conclusion**

The recent financial crisis, like other adverse financial periods before it, has challenged both individuals and institutions. Fortunately, the insurance industry has weathered the storm rather well and continues to meet its commitments to consumers. In the few instances when life or health insurers have failed, the life and health insurance guaranty system has ably discharged its mission to protect consumers. It stands ready to do so in the future.

We welcome the opportunity to provide any further information that may be required by the Subcommittee; please direct questions to:

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## APPENDIX A

### THE CRITICAL ROLE OF “PROMPT CORRECTIVE ACTION”

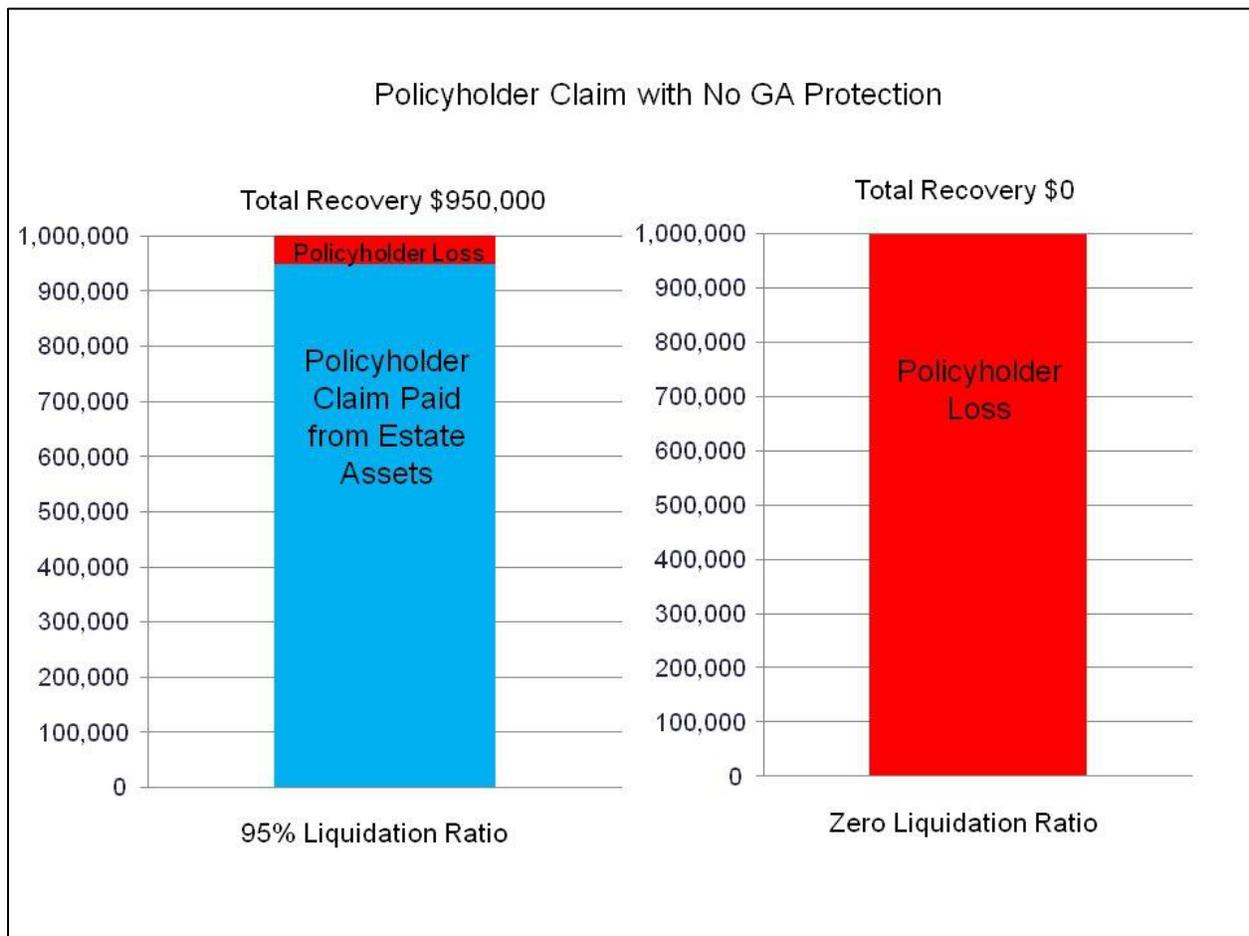
It is a common misunderstanding that policyholder recoveries in insurance liquidations are limited to guaranty association coverage limits or “caps.” The truth is that whether a policyholder recovers all or most of her claim *above* guaranty association caps depends significantly on whether regulatory intervention occurs before the failed company’s assets have been substantially dissipated, and whether assets are effectively protected and marshaled in the company’s receivership.

This is a subtle but critical misunderstanding suffered even by financially sophisticated people who do not often work with insurer insolvencies and the guaranty system.

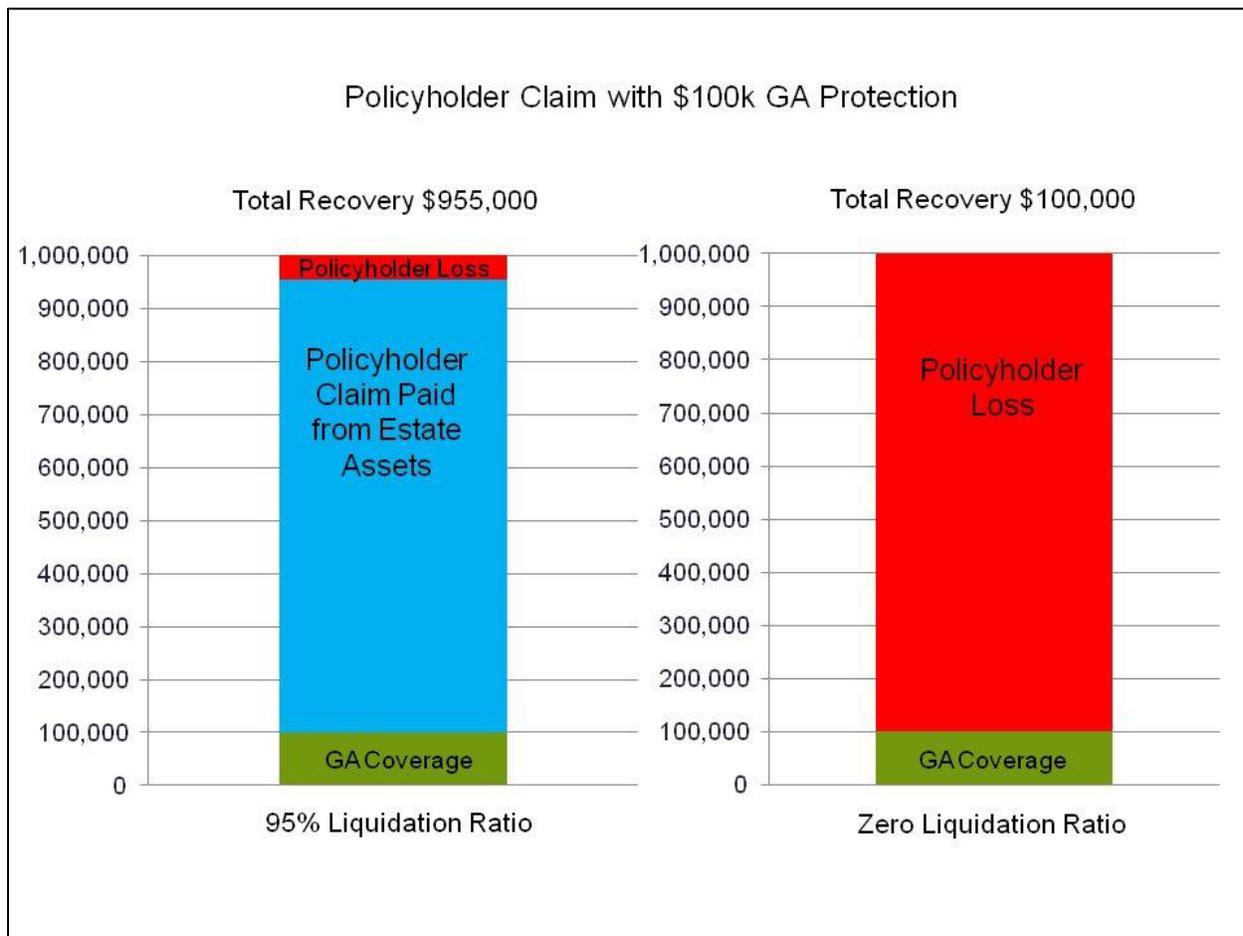
Policyholders with claims against their insolvent insurer in excess of guaranty association caps have a priority claim against the insurer’s assets for the excess amount. That excess claim ranks *pari passu* with all other claims at the policyholder level. For that reason, a policyholder can—and often does—recover most or all of her claim in the insolvency, *even above* the level covered by guaranty associations. The point can be seen in the following illustrations.

Imagine an insolvency in which a policyholder has a claim of \$1 million, and suppose further that there was no guaranty association to provide a financial safety net. What would the policyholder recover? The answer: It depends on the level of assets available in the insolvency estate, compared to the amount of the policy-level liabilities. This relationship is sometimes expressed as a *liquidation ratio*, or the number of “cents on the dollar” available for distribution to policy-level claimants.

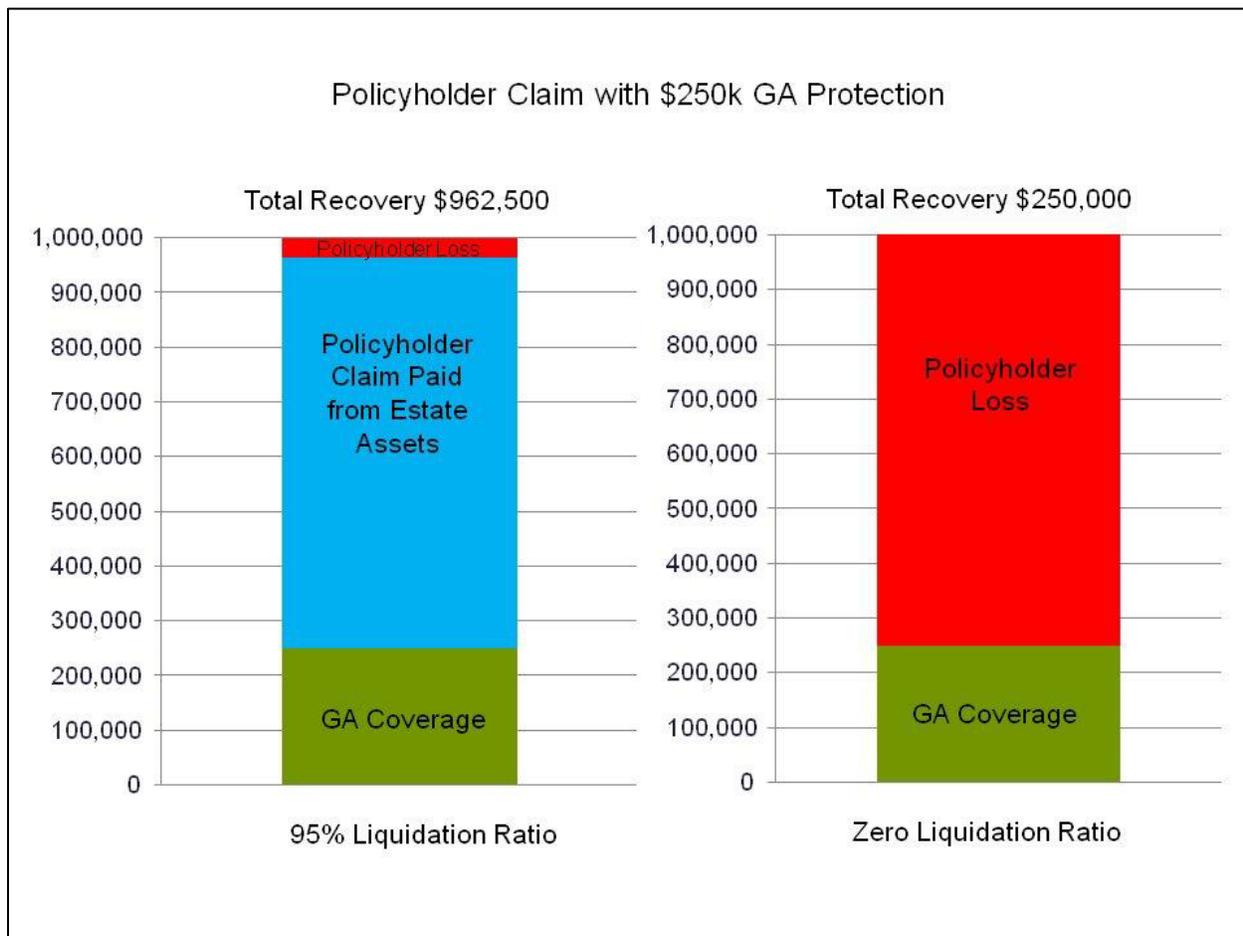
Consider the outcomes illustrated in the following chart. If the estate has 95 cents on the dollar available—a 95% liquidation ratio—the policyholder will recover \$950,000 on that \$1 million claim, even with no guaranty association protection. On the other hand, if the estate has zero cents on the dollar available at the policyholder level, the policyholder will recover nothing.



Now imagine that the policyholder has the same claim for \$1 million and resides in a state where guaranty association coverage is \$100,000. Consider the outcomes illustrated in the next chart. In this case the policyholder will recover (from the guaranty association) 100% of the claim up to \$100,000, and she will recover on the rest of her claim an amount determined by multiplying the excess claim (here, \$900,000) by the liquidation ratio for the insolvency. If the insolvency estate marshals 95 cents on the dollar for policyholder claims—which is a bit lower than average for life insurance claims in insolvencies—that policyholder will end up with a total of \$955,000 on her \$1 million claim: \$100,000 from the guaranty association and \$855,000 (95% of \$900,000) in respect of her excess policyholder claim. On the other hand, if the estate marshals zero cents on the dollar, the policyholder’s total recovery is limited to the \$100,000 that will be paid by the guaranty association.

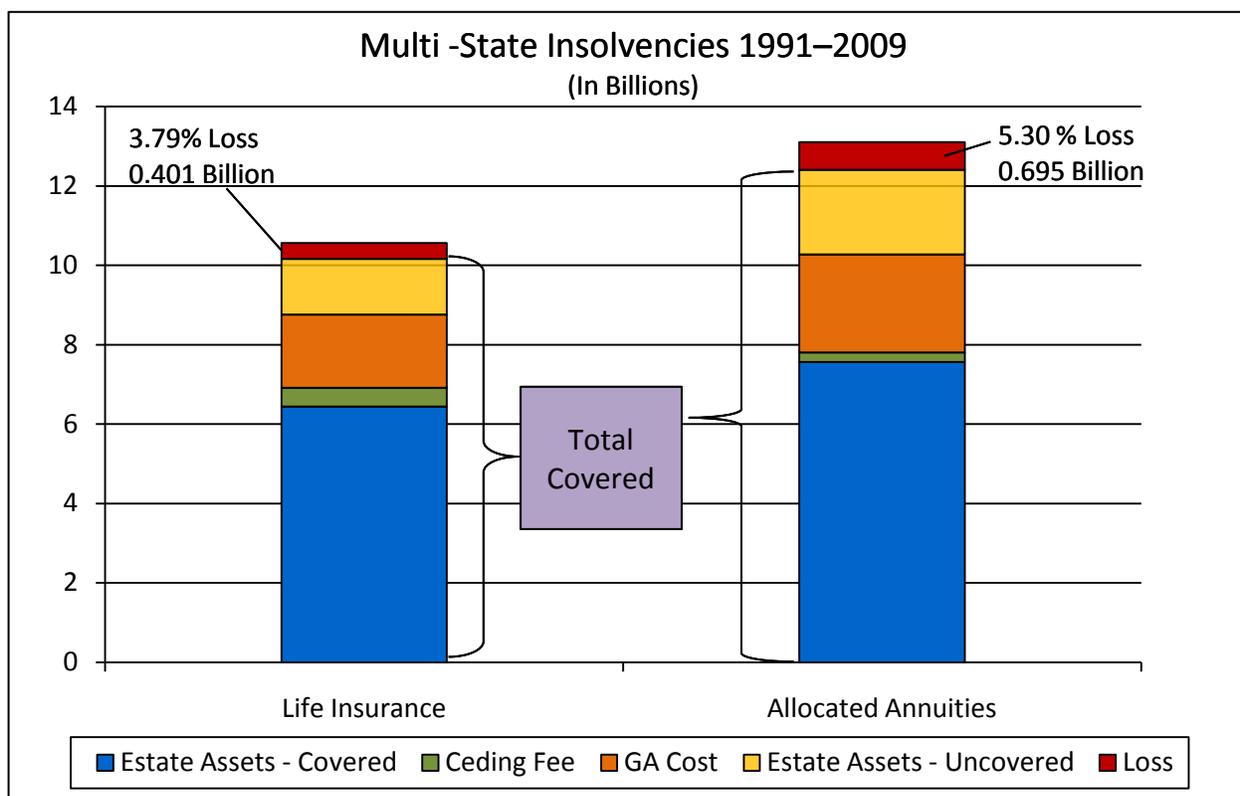


Imagine next a slightly different set of facts, illustrated in the next chart. Suppose the policyholder resides in a state with a \$250,000 guaranty association “cap.” In the first hypothetical outcome in this series of examples—a liquidation ratio of 95%—the policyholder’s total recovery then would be \$962,500 (\$250,000 from the guaranty association and \$712,500 from her excess claim): a modest increase of only \$7,500 over what she would have received with guaranty association coverage to \$100,000, even though the guaranty association “cap” is two-and-one-half times larger. But in the second hypothetical outcome—with a liquidation percentage of zero—the total policyholder recovery is still only \$250,000. That is to say that a very large loss—\$750,000—is borne by the policyholder, even with much more guaranty association coverage than in the prior case.



A guaranty association’s coverage limit or “cap” does set a “floor” for policyholder recoveries, no matter what else happens in the receivership case. But as the foregoing illustrations demonstrate, the much more important factor—at least for policyholder claims significantly in excess of caps—is the liquidation ratio achieved in the insolvency. How many cents on the dollar is the receiver able to pay on policy-level claims?

On that score, the historical averages are significant. In the insolvencies of the past 20 years, claims on life policies have been paid, on average, at a level of 96.21 cents on the dollar. Claims on annuity contracts have been paid, on average, at 94.70 cents on the dollar.



In other words, in most (though unfortunately not all) life and annuity insolvency cases, the vast majority of policyholders have been made nearly whole, *regardless* of the guaranty association “caps” in their states. The obvious conclusion is that regulators, working with receivers and guaranty associations, have done an effective job of delivering real policyholder protection over the past two decades.

Prospectively, the key is to make sure that such outcomes (or better) are achieved in the future.

Experts in handling insolvencies of regulated entities—not just insurers, but other types of financial firms as well—have long recognized that the keys are, first, spotting financial problems early; and then acting promptly, decisively, and effectively to keep a bad situation from getting worse.

Spotting problems promptly is a function of financial supervision, and much of the success in delivering good receivership outcomes to policyholders over the past 20 years is a direct result of better financial supervision. In this sense, “financial supervision” is intended broadly to include assessments by companies of their own risks, risk-spotting by markets and insurance rating agencies, and better risk standards and evaluations by insurance regulators.

Beyond that, the recent financial crisis and attendant policy debates about regulatory reform have cast a bright light on the significance of effective resolutions of failing financial companies. Even if regulatory financial supervision is good, the regulated firm’s stakeholders can still be harmed significantly by ineffective resolution of the failed company.

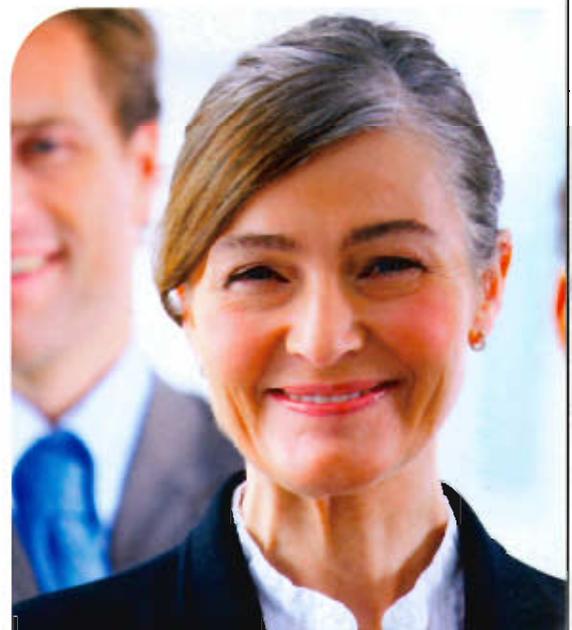
The two things critical to a successful resolution are early intervention—invoking the liquidation process at a time when the assets of the failed company have not yet been substantially dissipated—and professional execution of a resolution strategy that marshals the assets of the failed firm as effectively as possible and maximizes their prompt application to proven creditors' claims as directed by law. In the world of banking resolutions, these concepts are sometimes referred to, respectively, as “prompt corrective action” and “least cost resolution.”



2010 Edition

The Life & Health Insurance Guaranty Association System

# The Nation's Safety Net



## A Foundation of Protection

Each of the 50 states, along with the District of Columbia and Puerto Rico, has a life and health insurance guaranty association to protect residents if an insurance company licensed in that state is placed in liquidation. (A separate set of state guaranty funds provides protection for property & casualty insurance claims—contact the National Conference of Insurance Guaranty Funds ([www.ncigf.org](http://www.ncigf.org)) with questions about this type of coverage.)

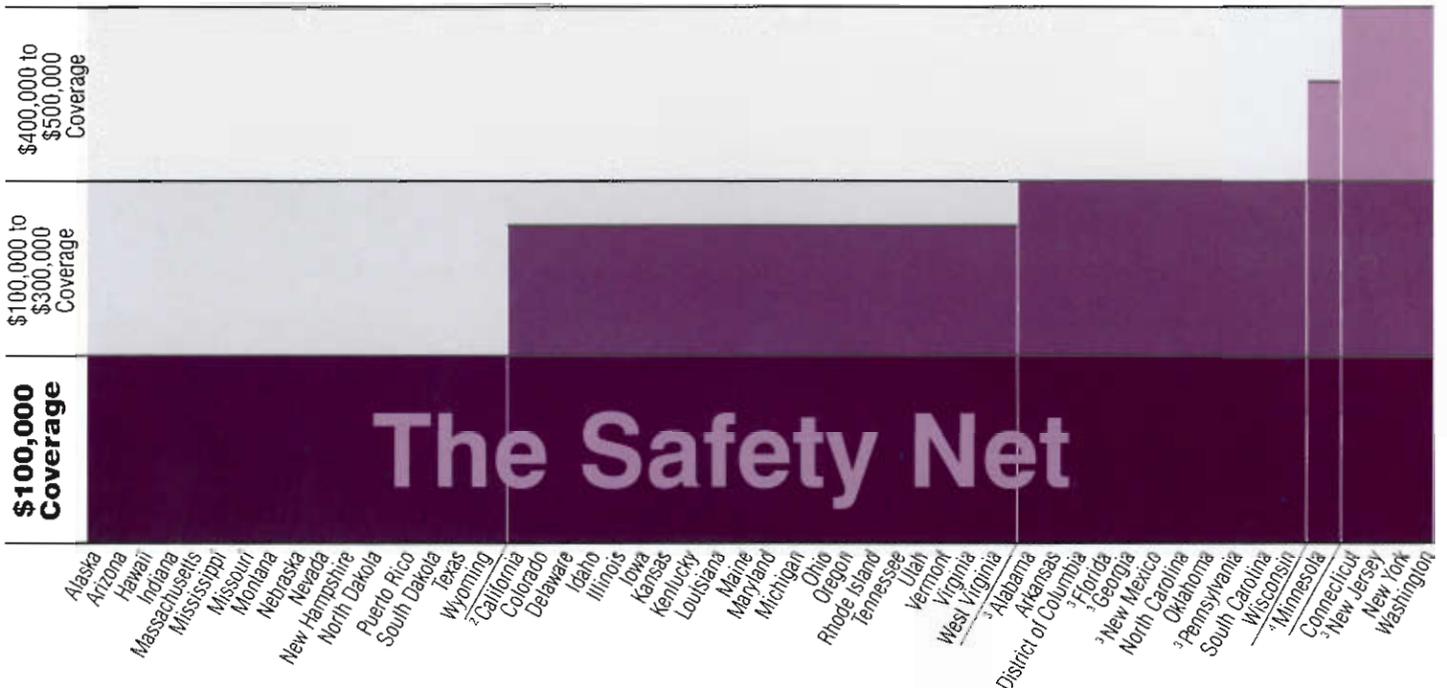
Each state's guaranty association law is based on a version of the National Association of Insurance Commissioners Life and Health Insurance Guaranty Association Model Act, which has been updated several times since its creation in 1971. The most recent update occurred in 2009, and it included an increase in annuity coverage from \$100,000 to \$250,000 as well as a \$300,000 benefit level for long-term-care insurance. Many states have already increased their limits to comply with the new version of the Model Act—in fact, more than half of the guaranty associations now provide the increased benefit levels for annuities and long-term-care insurance—and others are in the process of doing so. It's important to note that policy amounts above guaranty association limits are backed by the remaining assets in the insolvent company, which are often quite substantial.

No matter where they live, policyholders throughout the United States can look to state guaranty associations to provide a nationwide safety net of protection should their insurance company fail.

## ANNUITIES

All state guaranty associations offer resident policyholders a minimum of \$100,000 in benefit protection for **fixed annuities**<sup>1</sup>, regardless of whether the annuities are in deferred or payout status at the time of insolvency; most states provide at least \$250,000 in protection. Guaranty associations do not cover the variable portions of **variable annuities**, but generally speaking, if there are obligations under a variable annuity contract that are guaranteed by a member insurer, this guaranteed portion of the contract will be eligible for guaranty association coverage, subject to applicable limits and exclusions on coverage.

### Policyholder Protection: Annuity Benefits

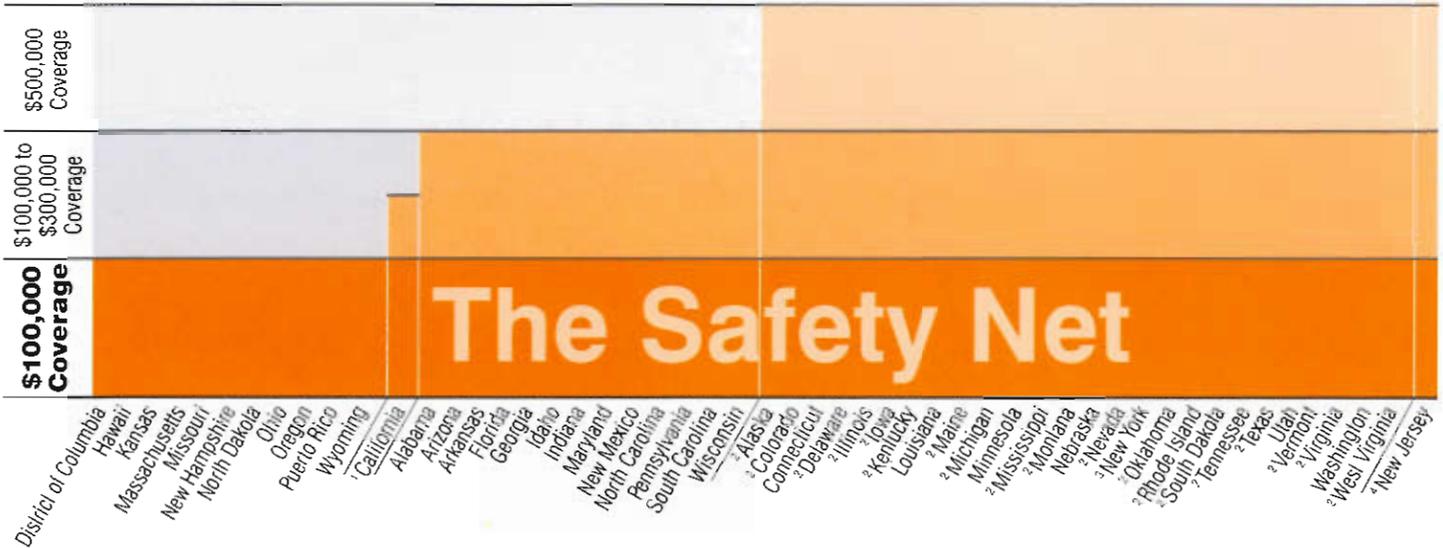


1. In general, protection is provided for contracts or certificates, or portions thereof, issued to individuals, which are guaranteed by the insurer and under which the policy owner has not agreed to bear investment risks such as stock market or interest rate fluctuations.
2. California covers 80% of the annuity contract value with a \$250,000 benefit limit.
3. In these states, the \$300,000 or \$500,000 benefit limit applies if the annuity is in payout status. If the annuity is deferred, a \$100,000 cash value limit applies (in Florida, the cash value limit is \$250,000).
4. The \$410,000 benefit limit applies if the annuity is in payout status. If the annuity is deferred, a \$250,000 cash value limit applies.

## HEALTH AND LONG-TERM-CARE INSURANCE

All guaranty associations offer resident policyholders up to \$100,000 in benefit protection for health insurance. More than half provide even more protection to their policyholders. Health Maintenance Organizations (HMOs) are not typically covered by guaranty associations.

### Policyholder Protection: Health Insurance Benefits



Long-term care insurance is typically considered health insurance for guaranty association purposes. While all guaranty associations offer resident policyholders up to \$100,000 in benefit protection, many states provide even more protection.

### Policyholder Protection: Long-Term-Care Insurance Benefits



- Health insurance and long-term-care benefits are adjusted from the \$200,000 level based on changes in the health-care cost component of the Consumer Price Index from January 1, 1991, to the date of the insolvency.
- These states provide up to \$500,000 for basic hospital, medical, and surgical insurance or major medical insurance; \$300,000 in disability coverage; and \$100,000 for health benefits not defined as disability insurance or major medical insurance (with the exception of Maine, which provides \$300,000 instead of \$100,000 for supplemental health coverage, and Texas, which provides \$200,000 instead of \$100,000 for supplemental health coverage).
- Coverage is provided only for health and long-term-care insurance issued by a life insurance company. The \$500,000 benefit limit applies to individual health policies; group or blanket health insurance is covered up to the limits stated in the policy.
- New Jersey sets no cap on its medical coverage, covering claims up to the limits of the policy but limiting the benefit to 80% if the provider seeks coverage as opposed to the insured.

**NOTE:** The information and charts provided in this report are general in nature and are based on information available as of November 1, 2010. They are not intended as legal advice, and no liability is assumed in connection with their use. For specific coverage provisions, consult the applicable guaranty association statutes.

## LIFE INSURANCE

All guaranty associations, with the exception of California (see the charts below), offer resident policyholders up to \$300,000 for life insurance death benefits and \$100,000 for net cash surrender and net cash withdrawal values. Some states provide even more protection to their policyholders.

### Policyholder Protection: Life Insurance Death Benefits



1. California covers 80% of death benefits up to \$300,000.
2. In Utah, the \$500,000 limit applies if death occurs before the guaranty association is triggered. If death occurs after triggering, the benefit is limited to the covered portion of the policy as defined by statutory reference to the covered cash value (see below).

### Policyholder Protection: Life Insurance Net Cash Surrender & Net Cash Withdrawal Values



1. California covers 80% of the cash surrender value with a \$100,000 benefit limit.

# Keeping Promises

Learning that your life or health insurance company is in trouble can be frightening, but policyholders can take comfort in knowing that the guaranty association safety net will be there when they need it. By continuing coverage for policyholders of a failed insurer and providing benefits under its policies, state life and health insurance guaranty associations play a vital role in standing behind the promises made by the insurance industry—even when a company fails (i.e., is found to be insolvent and ordered into liquidation). In the last 30 years alone, guaranty associations have:

- Provided protection to more than 2.6 million policyholders
- Guaranteed more than \$24.5 billion in coverage benefits
- Contributed more than \$5.3 billion in benefits toward fulfillment of insurer promises

Each state, along with the District of Columbia and Puerto Rico, has a life and health insurance guaranty association to protect its residents if an insurance company licensed in the state fails. When a company failure occurs, affected associations are triggered to provide benefits to policyholders living in their states. If the company does not have enough funds to meet its obligations to policyholders (a common occurrence with insolvent insurance companies), each guaranty association ensures that the covered claims of resident policyholders continue to be paid.

Associations may also provide continuing coverage—a vital aspect of the life and health insurance safety net. In some cases, it would be difficult for people whose company has failed to find comparable coverage elsewhere. When a failure does occur, guaranty associations often place the policies of an insolvent insurer (including the policies of those who might otherwise be uninsurable) with a financially sound insurer. In other cases, guaranty associations simply provide covered benefits directly.

The guaranty system safety net has evolved over the years as associations have become more experienced in meeting the needs of policyholders of failed insurers. One major step in this evolution was the creation of the National Organization of Life & Health Insurance Guaranty Associations (NOLHGA) in 1983. NOLHGA was created to help the state guaranty associations deal efficiently with the large-scale challenges presented by the failure of an insurance company that affects policyholders in many states.

In short, the guaranty system safety net has grown stronger through the years, and it stands ready to protect policyholders if their company fails.



# Protecting Policyholders

America's life and health insurance policyholders have a powerful friend—one whose presence is felt only in times of trouble. Should their insurer fail, residents of every state can count on their life and health insurance guaranty association to provide protection for both local and national insolvencies. Each association serves as a safety net, ensuring that residents continue to receive insurance coverage without interruption.

In the face of an insolvency that affects policyholders in many states, one of the guaranty system's greatest strengths becomes evident—the seamless cooperation of state guaranty associations working together to provide protection to policyholders across the country. Even in a multi-state insolvency, the guaranty association system stands ready—the safety net is in place.

The core protections offered by this safety net are similar no matter where policyholders live. Some state guaranty laws offer additional benefit levels to their residents, but the foundation of coverage provided by the guaranty association system stretches across the nation.

In times of economic uncertainty, the protections offered by guaranty associations are more important than ever. No one can be sure when the next insurer insolvency will occur. When it does, the nation's safety net will do what it has done so well for years—protect policyholders in their time of need.



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**TESTIMONY FOR THE RECORD**  
**OF**  
**THE NATIONAL CONFERENCE OF INSURANCE GUARANTY FUNDS**  
**BEFORE THE**  
**HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON INSURANCE, HOUSING AND**  
**COMMUNITY OPPORTUNITY**  
**HEARING ENTITLED**  
**“INSURANCE OVERSIGHT AND LEGISLATIVE PROPOSALS”**  
**NOVEMBER 16, 2011**

While they may not know it, American insurance consumers are protected by a nationwide system of insurance guaranty associations (sometimes also called “guaranty funds”). State lawmakers and insurance regulators formed this system over 40 years ago to pay the claims of the average property/casualty and life/health/annuity insurance policyholder if an insurance company fails. The safety net operates in every state and territory and is coordinated by two national entities – the National Conference of Insurance Guaranty Funds (NCIGF) and the National Organization of Life & Health Insurance Guaranty Associations (NOLHGA). NCIGF is pleased to submit the following testimony regarding the state based property/casualty insurance guaranty system to the House Financial Services Committee, Subcommittee on Insurance, Housing and Community Opportunity. NOLHGA is submitting similar testimony describing the life/health/annuity guaranty system.

**THE CURRENT SYSTEM OF INSURANCE RECEIVERSHIP**

To understand the property/casualty insurance safety net, it is important to understand some of the fundamentals of state insurance receivership. Just as insurance companies are regulated almost entirely at the state level, insurance receiverships are administered by the insurance commissioner of the state where the company is chartered – in effect, its state of incorporation – pursuant to the insurance receivership laws of that state, and under the supervision of a court in that state. The insurance receivership laws in each state have as a primary goal to make sure that a failed insurer's policyholder obligations are honored to the greatest extent possible. The guaranty funds work with state receivers to ensure that this happens quickly and efficiently.

## HOW THE PROPERTY/CASUALTY INSURANCE GUARANTY SYSTEM WORKS

### **How the Guaranty Fund System is Structured.**

Generally speaking, every state and the District of Columbia have a property/casualty fund created by state law, overseen by the state's insurance regulator, and typically operated as a non-profit association.<sup>1</sup> Each property and casualty insurance company licensed to do business in that state is required by state statute to be a member of the guaranty fund. Typically, a guaranty fund is governed by a board of directors, drawn mostly from the fund's member insurance companies. Some guaranty funds also have public members when mandated by statute.

A state guaranty fund manager (often assisted by staff) delivers the policyholder protections required by statute, working in coordination with the receiver of the failed insurer. Although most guaranty funds are subject to the supervisory oversight of their state insurance commissioner, they are not generally<sup>2</sup> or in any meaningful sense operated by state government, and they do *not* have a role (even in their own states) in monitoring or policing the solvency of insurers. Similarly, guaranty funds almost never serve as the receiver of a failed insurer.

Protection for consumers generally is provided by the guaranty fund of the state where the consumer resides or, in the case of property insurance, where the property is located. Each guaranty fund responds to an insolvency by paying claims of the residents of that fund's state, regardless of where the failed company may have been domiciled, regulated, or placed in receivership.

### **How the Guaranty Fund System Protects Policyholders.**

The nationwide property/casualty insurance guaranty system honors the contractual commitments made by failed insurers to their *policyholders*. The safety net does not provide liquidity support to failed (or failing) insurers, nor does it protect their general creditors.

Guaranty funds are "triggered" once a state court finds that an insurance company is insolvent and orders it into liquidation. Once that occurs, the receiver of the failed company physically transfers the claim files (either in paper or electronic form) to the state's guaranty fund. Essentially, the guaranty fund "steps into the shoes" of the insolvent company to pay claims consistent with a state's insurance code and, by law, policyholders are at the "head of the line" of an estate's creditors. Covered policyholders are paid promptly by means of the guaranty association mechanism.

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<sup>1</sup> Several states have separate guaranty mechanisms to provide protection in respect of certain specific types of benefits or programs, such as workers' compensation insurance.

<sup>2</sup> The form of most insurance guaranty funds is that of a special, non-governmental, not-for-profit entity established by specific state enabling legislation. However, in four states (Arizona, Arkansas, New York and Pennsylvania), at least some elements of the guaranty mechanism are operated as part of state government

When an insurer fails, there are two overriding policyholder concerns addressed by existing public policy– (1) the continuation of the insurance coverage that the policyholder has lost as a result of the insurer's failure and (2) payment of valid outstanding claims.<sup>3</sup>

The answer to the first concern is fairly straightforward; in a competitive insurance marketplace, consumers can find another company to underwrite a potential loss. Policyholders who do not have a claim pending with the failed carrier do not need significant protection from the guaranty fund system; they need only purchase a new insurance policy. In most states the guaranty funds cover claims for unearned premium, thereby helping policyholders pay for replacement coverage.

The second concern – payment of claims – is the core responsibility of the guaranty system and is much more than simply writing checks to policyholders with claims. Guaranty fund representatives adjust the pending claims, just as claims adjusters in a solvent company would do. This requires insurance claims specialists qualified to analyze contract duties under the law of their state, analyze bodily injury claims and assess liability as well as the litigation risk associated with the claim.

Each state's law establishes the coverage for the residents of its state. Nearly all states have guaranty fund laws adapted to local conditions by each state legislature from the model property/casualty guaranty fund statutes promulgated by the National Association of Insurance Commissioners (NAIC). Guaranty funds pay covered claims within the limits set by individual state laws and the insurance contract. Typically, the claim limit for personal injury and property damages is \$300,000 on covered claims, with some states covering as much as \$500,000 to \$1,000,000. Notably there is one state with a covered claim cap of \$5 million. (Nine states provide limits higher than \$300,000, and eight states and territories have somewhat lower limits.) Most guaranty funds pay 100% of statutorily-defined workers' compensation benefits. Claim caps allow the system to have sufficient money to pay claims and ensure “capacity” needed to serve all claimants. Guaranty funds play no role in setting coverage caps.

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<sup>3</sup> Under insurance liquidation laws, virtually all property and casualty insurance contracts are cancelled within thirty days of the date of liquidation, leaving the guaranty funds responsible for the adjudication and payment of claims that had accrued prior to liquidation and thirty days thereafter.

## How the Guaranty Fund System is Funded.

Guaranty funds do not have the same immediate funding requirements that banks require because of the long-term nature of many insurance obligations. State laws require guaranty funds to pay claims “promptly,” but many claims become due, and consequently are paid out, over a period of several years. By design, guaranty funds draw from several sources of funding to pay claims:

The assets remaining in the insurance company, including those from ongoing reinsurance collections, which can be made available to the guaranty funds on an expedited basis. These assets are usually substantial and provide the primary source of funding guaranty fund payments to consumers in most insolvencies.<sup>4</sup>

Statutory deposits that may have been collected in some states to secure the insurance company’s claim payment obligations.

Assessments collected from member insurance companies.

This funding mechanism was designed to use as much of the failed company’s remaining cash as possible. The guaranty funds levy assessments on viable insurance carriers only to the extent that a shortfall remains after the available estate assets have been exhausted. In that case, the state guaranty fund assesses the healthy insurers who do business in that state, up to annual statutory limits, typically 2% of net direct written premium in the year prior to the assessment. The amount of the assessment is determined by the amount of money needed by the guaranty fund to supplement the initial sources of funding.

The guaranty fund system delivers on its policyholder protection mission economically. Nationwide, annual guaranty fund general operating expenses are about \$66 million, with a staffing level of approximately 650 employees. The fact that guaranty funds deliver maximum consumer protection at a low cost is underscored by the system’s overall operating costs when contrasted with those of the insurance industry. Research by the NCIGF shows that historically, the Loss Adjustment Expenses and General Operating Expenses of guaranty funds were on par with those of the insurance industry.

**National Coordination – The Role of NCIGF.** The protections provided by as many as 50 or more property/casualty guaranty funds are coordinated through the National Conference of



<sup>4</sup> Estate assets typically are sufficient to cover 55-65% of policy level claims in property and casualty insolvencies.

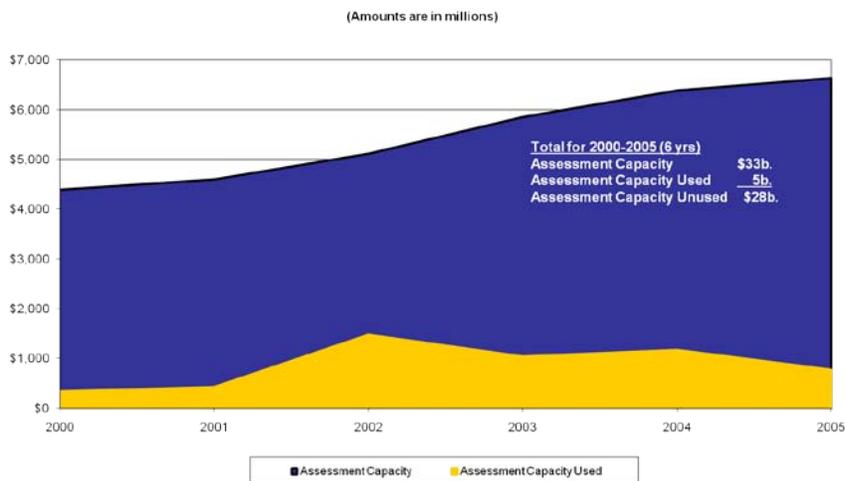
Insurance Guaranty Funds, a 501(c)(6) not-for-profit organization incorporated in Illinois and based in Indianapolis, Indiana and made up of independent property and casualty insurance guaranty funds in every state and the District of Columbia. NCIGF does not pay claims, but rather coordinates the multi-state claims-paying activities of its member guaranty funds, monitors litigation that may affect guaranty funds, coordinates with the property and casualty insurance company trade associations on state legislative matters, conducts education and training seminars for guaranty funds, provides financial information concerning the guaranty system, serves as a clearinghouse of relevant information, and provides a national forum for discussion and liaison with the NAIC and insurance receivers.

### HISTORY OF DEPENDABLE CONSUMER PROTECTION

The existing property/casualty insurance guaranty system has a proven track record of protecting policyholders. Since the early 1970s, the guaranty system has provided protection to policyholders in more than 550 cases of insurer insolvencies, paying a total of approximately \$27 billion in claims and expenses. The insurance guaranty system has met all of its obligations and promptly provided protection to all consumers for whom they are responsible in each and every case of insurer failure.

During the heaviest period of insolvency activity – 2000-2005 – the guaranty fund system paid out \$10 billion against assessment capacity of about \$33 billion. Of that \$10 billion paid, \$5 billion came from the insolvent companies' assets and statutory deposits.

**Property & Casualty Insurance Guaranty Fund System  
Period of Heavy Insolvency 2000-2005  
Assessment Capacity and Assessment Capacity Used**



Today, the overall assessment capacity of the property and casualty guaranty fund system is about \$6.7 billion, renewable every year. Reliance on assessments to pay claims has never exceeded 35 percent of capacity in a single year. When assessment capacity is laid on top of estate assets (again, the primary funding source for guaranty fund payments) and statutory

deposits, the guaranty system has more than ample funding available to handle multiple large insolvencies – especially considering the often long-term nature of insurance obligations.

**THE GUARANTY SYSTEM IS PREPARED TO DEAL  
WITH FUTURE INSOLVENCIES**

The nationwide network of property/casualty insurance guaranty funds has proven extremely effective at achieving its principal mission the protection of policyholders. As with any effective organization, the insurance guaranty system has evolved over the years and operates with a high level of cooperation, coordination, and consistency that comes only with experience.

NCIGF has also evolved over the years into a national coordinating mechanism that has established effective and credible working relationships with both insurance regulators and industry members. NCIGF employs a complete complement of full-time staff professionals who are well versed in the technical and practical complexities inherent in any insolvency.

The resources and coordination NCIGF provides helps minimize costs by facilitating a national response plan for protecting policyholders in multi-state insolvencies. This coordination of effort also reduces the length of time it takes to respond to a multi-state insolvency and provide policyholders their statutorily prescribed benefits.

While NCIGF serves as the national coordinating body for protecting policyholders, its individual guaranty fund members are aware of and sensitive to local circumstances and respond quickly to the concerns of resident policyholders when an insolvency occurs. The volume of calls and letters from concerned policyholders is understandably high in the aftermath of an insolvency. Individual guaranty fund staffs respond quickly to explain coverage benefits and the claim submission and payment process; provide status reports; and resolve specific inquiries. NCIGF's member funds understand their states' tort law and court systems and how to adjudicate claims promptly and efficiently. For these reasons, the existing insurance guaranty system is able to enjoy the operational efficiencies of a national system, while effectively responding to the often-local concerns of insurance consumers experiencing financial and other stresses associated with the failure of their insurance company.

Given its significant experience, operating efficiency, and credibility, the current state-based insurance guaranty system is prepared to fulfill its statutory duty: protection of the nation's insurance consumers from future insolvencies of property/casualty insurers.

\* \* \* \* \*

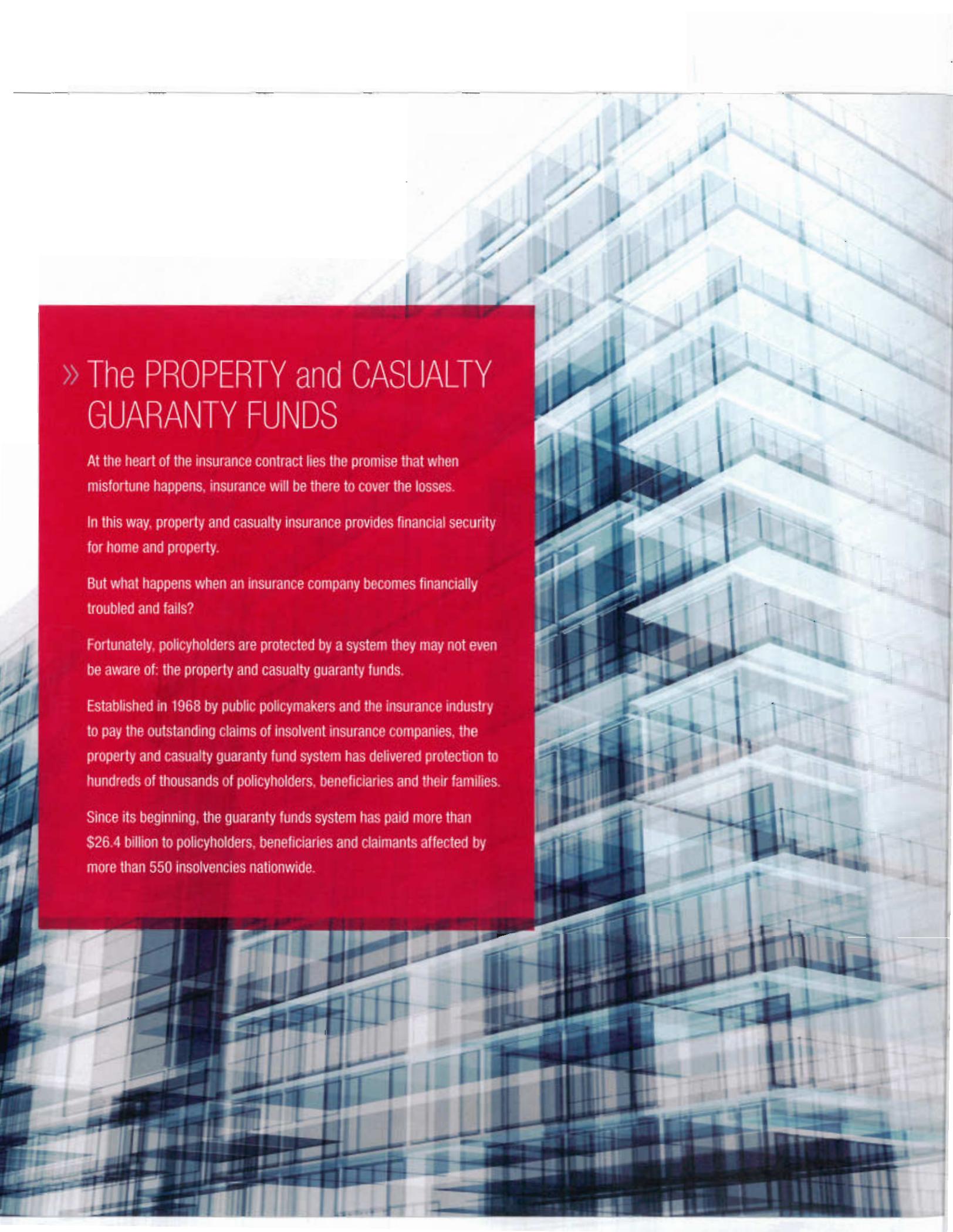
NCIGF and NOLHGA have worked together the past several years to educate Congress, federal agencies, and other policy and decision makers about the insurance consumer safety net. We appreciate this opportunity to continue that effort.

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The PROPERTY and  
CASUALTY GUARANTY FUNDS

40 YEARS OF INSURANCE CONSUMER PROTECTION

BUILT TO  
WORK



## » The PROPERTY and CASUALTY GUARANTY FUNDS

At the heart of the insurance contract lies the promise that when misfortune happens, insurance will be there to cover the losses.

In this way, property and casualty insurance provides financial security for home and property.

But what happens when an insurance company becomes financially troubled and fails?

Fortunately, policyholders are protected by a system they may not even be aware of: the property and casualty guaranty funds.

Established in 1968 by public policymakers and the insurance industry to pay the outstanding claims of insolvent insurance companies, the property and casualty guaranty fund system has delivered protection to hundreds of thousands of policyholders, beneficiaries and their families.

Since its beginning, the guaranty funds system has paid more than \$26.4 billion to policyholders, beneficiaries and claimants affected by more than 550 insolvencies nationwide.

## » BUILT to WORK

The guaranty fund system is “built to work,” employing a post-insolvency funding mechanism that first draws on the assets of the failed insurance company before assessing industry. Without it, most claimants would receive only a fraction of what they were owed under the terms of their insurance policies. The system has safeguarded countless policyholders who, without it, might have faced financial ruin because of unpaid claims.

The privately-funded, nonprofit state-based system, which provides an essential safety net for policyholders, is made up of independent guaranty funds in every state and the District of Columbia.

Guaranty funds pay policyholder claims within limits set by state laws and insurance contracts. The system helps consumers avoid long delays in receiving payment for claims. By law, policyholders are at “the head of the line” of an estate’s creditors, and they are the first to be paid by guaranty funds.

State legislatures created the guaranty fund system with the vision to create a consumer protection solution that avoided financial loss for insurance consumers. The guaranty fund system continues to deliver on that mission today.

## » PAYING CLAIMS, PROTECTING POLICYHOLDERS

In most states the guaranty fund is activated when a state court finds an insurance company insolvent and issues a final order of liquidation. After liquidation, the failed company’s receiver transfers the claim files to the state’s guaranty fund. Guaranty fund representatives adjust the claims, just like claims adjusters in a solvent company.

Guaranty funds use the assets of the insolvent insurer to pay covered claims up to a level set by state law. Most insolvent insurance companies retain sufficient assets to fund a significant portion of the guaranty funds’ obligations. Any shortfall is made up by assessments on other insurance companies doing business in the states where the failed insurer wrote policies.

Essentially, the guaranty fund “steps into the shoes” of the insolvent company to pay claims in a way consistent with a state’s insurance code.

### GUARANTY FUNDS:

- *Are individual organizations made up of licensed property and casualty insurers. These organizations are required to become members of the guaranty fund in states where they write business*
- *Operate under the authority of each state’s insurance code*
- *Work cooperatively with the insurance commissioner of each state to protect policy claimants of an insolvent insurer, and*
- *Pay covered claims as defined by state law.*

“*Claims paid by the guaranty fund system protect those least able to absorb the impact of a loss of payment related to an insolvency – individuals and small-business owners.*”

## » How the GUARANTY FUND SYSTEM is Funded

**GUARANTY FUNDS WORK IN PARTNERSHIP WITH INSURANCE REGULATORS TO PROTECT POLICYHOLDERS.**

### 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).
- Funds deposited with state regulators 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 and casualty lines covered by the funds.

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

Policyholder claims 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) cash already on deposit with state regulators and c) assessments on insurers licensed to write business in a state.

**PAYMENTS ARE MADE PROMPTLY.**

## » GUARANTY FUND COVERAGE

**PROPERTY AND CASUALTY GUARANTY FUND COVERAGE VARIES FROM STATE-TO-STATE.**

- Guaranty funds pay covered claims within the limits set by individual state laws and the insurance policy. Typically, the claim limit is \$300,000 on covered claims, with some states covering as much as \$500,000 to \$1,000,000.
- Claim caps allow the system to have sufficient money to pay claims and ensure the "capacity" needed to serve all claimants. Caps are fixed by state statute. Guaranty funds play no role in setting coverage caps.
- Most guaranty funds pay 100 percent of statutorily-defined workers' compensation benefits.

The life, health and annuity insurance industry also has a guaranty fund system, but it operates independent of the property and casualty system.

## » DELIVERING CONSUMER PROTECTION ECONOMICALLY

The guaranty fund system delivers on its policyholder-protection mission economically. Nationwide, annual guaranty fund general operating expenses are about \$66 million, with a staffing level of around 500 employees.

The fact that guaranty funds deliver maximum consumer protection at a low cost is underscored by the system's overall operating costs when contrasted with those of the insurance industry. Research by the NCIGF shows that in 2005-2007, the operating expenses of guaranty funds were moderately to significantly lower than the insurance industry in Loss Adjustment Expenses and General Operating Expenses.

The protection consumers enjoy under the guaranty fund system is solid. During the heaviest period of insolvency activity – 2000-2005 – the guaranty fund system paid out \$10 billion against an assessment capacity of about \$33 billion. Of that \$10 billion paid, \$5 billion was ultimately recovered from the insolvent companies' assets and statutory deposits.

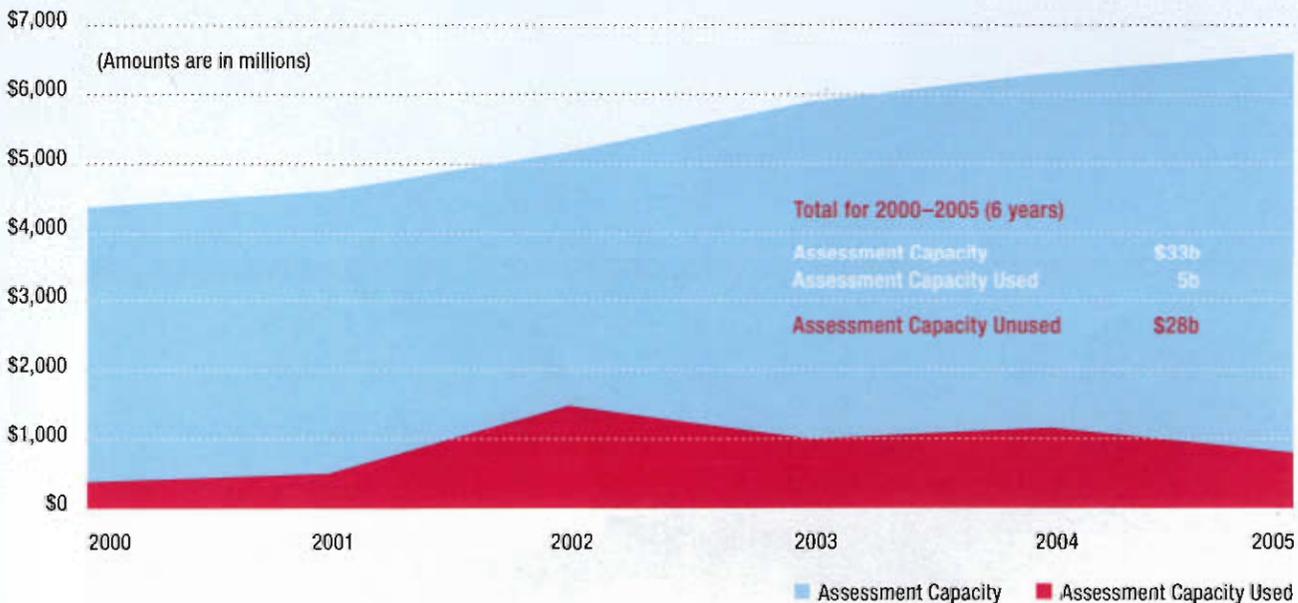
Today, the overall assessment capacity of the property and casualty guaranty fund system is about \$6.7 billion, renewable every year.

FOR ADDITIONAL INFORMATION  
SEE THE NCIGF WEB SITE AT:

» [NCIGF.org](http://NCIGF.org)

## » Period of HEAVY INSOLVENCY 2000–2005

### PROPERTY AND CASUALTY INSURANCE GUARANTY FUND SYSTEM ASSESSMENT CAPACITY AND ASSESSMENT CAPACITY USED



## » The GUARANTY FUNDS: More complex than covering bank deposits

The goal of the guaranty funds is protecting consumers from the consequences of insolvency. However, covering insurance claims is more complex and involved than the way bank deposits are backstopped by the Federal Deposit Insurance Corporation (FDIC).

Claims handling requires just that – handling. Guaranty funds operate seamlessly within the guidelines of specific state laws to administer insurance contracts, which are written and endorsed based on state law requirements.

The current guaranty fund system successfully navigates the intricacies of the insurance claims-paying function, helping policyholders, and freeing government from getting into the business of adjusting and paying policyholder claims.

## » PROTECTING POLICYHOLDERS: It's a good business to be in

For more than 40 years the property and casualty guaranty fund system has worked, and worked well. It has met its statutory obligations by paying claims to policyholders, beneficiaries and claimants who find themselves insured by – and having claims against – an insolvent company. What's more, the system is well-positioned to keep on working into the future in the interest of policyholders.

The National Conference of Insurance Guaranty Funds and our member guaranty funds play an essential role in fulfilling the public policy charge entrusted to us by lawmakers. We do this by supporting and coordinating guaranty fund activity nationwide, and serving as the trusted experts in insolvency-related issues.

The NCIGF and our members continue to honor our core commitment to keep the guaranty fund system strong, flexible and “paying the claims.”



## » ABOUT the NCIGF

The NCIGF is a nonprofit, member-funded association that provides national assistance and support to the property and casualty guaranty funds located in each of the 50 states and the District of Columbia.

Incorporated in December 1989, the NCIGF coordinates information for multi-state insolvencies and provides legal, data management, administrative, communications and public policy support to our members across the nation.

National Conference  
of Insurance Guaranty Funds **NCIGF™**

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