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HEADLINE: Failing at failures: in the first of a four-part series, two writersexplore how insurance insolvency laws and the guaranty-fund system are a patchwork of systemic shortcomings, inefficiency and a lack of political will. What to do?;
REGULATION

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BODY:

A property/casualty insurance insolvency is a devastating event for employees, management, insureds, claimants and other stakeholders. Employees are terminated without payment of all accumulated benefits.

Insureds and claimants, if they are not covered by guaranty funds,wait and wait and wait to receive but a portion of their claim. Creditors grow frustrated by their inability to influence the process or to get information.

Fortunately, property/casualty insurance insolvencies have never been a major problem in the industry when viewed in terms of the number of failed companies nor the industry's total premium volume writtenby companies that become insolvent. The failure rate has ranged from0.3 percent to 1.4 percent depending on the time period (see chart 2on page 25)--a very small percentage.

[GRAPHIC OMITTED]

But if you were to take a look at the history of the number of P/Cinsolvencies compared with the industry's combined ratio, you would see that the number of failures lags but ultimately tracks with the combined-ratio trend line. Intuitively, this seems logical. Yet it calls into question whether all of the regulatory tools put in place, particularly since the 1980s, have had any impact.

Skeptics say that the rules have had little effect and that insolvencies are a natural result of a competitive environment and the cyclical nature of the industry. While there is some evidence that the level and quantity of regulation has had little impact, others concludethat without these rules it would have been worse.

A look at the history of these regulatory tools, however, offers insight into their impact and explanations for their failure to handlethe most recent trends in P/C insolvencies.

DEVELOPMENT OF INSOLVENCY LAWS

Despite the importance of receivership provisions for the regulation of insurers, even in their "final hours," such laws were late in developing. In fact, it was long after insurance regulation became fairly sophisticated that receivership matters were addressed in insurance codes. Development of the guaranty-fund system occurred even later.

Ever since the first permanent federal bankruptcy laws were enacted by Congress, including the law of 1898 and the present one, insurance companies have been excluded from these provisions, either explicitly or implicitly.

In the late 1800s and early 1900s, insurance-company delinquency proceedings were handled by state courts under the traditional equity powers. In those days, almost anyone could petition the court to place a company in receivership, and the court decided who was appointed the receiver. (Today, only the insurance commissioner can petition and be appointed the receiver.)

From 1909 to 1930, states began moving away from judicial receiverships. State laws were developed setting forth specific grounds for receivership and conferring on the insurance commissioner broad discretionary powers to rehabilitate or liquidate a troubled insurance company.

In 1933, the National Convention of Insurance Commissioners adopted a law for a failed insurer that conducted multistate business. The law created a uniform procedure so that all creditors, including policyholders and claimants residing in reciprocal states, were on an equal footing with those in the domiciliary state.

This law was also a response to the perceived threat that, if the states did not get their house in order, the federal government woulddo so for them. This may have been the first threat of the federal government assuming control of an aspect of insurance regulation.

In 1965, Wisconsin created a comprehensive receivership system based upon the federal bankruptcy act. The act allowed an insurance commissioner to fashion a result benefiting creditors and a myriad of issues cropping up in delinquency proceedings.

In 1977, the National Association of Insurance Commissioners, drawing on the Wisconsin law, developed a model act. The model act had substantive, as well as drafting, differences from the Wisconsin law, and the legislative history provided by the extensive commentary in Wisconsin was deleted from the model act.

The absence of extensive discussion allows for the "reinvention ofthe wheel" syndrome to persist. The flexibility in the Wisconsin lawwas substantially curtailed in the model act.

For example, the ability to move a proceeding to federal court if necessary to seize assets was eliminated. The NAIC model was based oninsolvencies seen to date--at that time, companies writing fire insurance and later automobile insurance.

Since 1977, the NAIC has, from time to time, amended the model act, but for the most part, it has not addressed completely the insolvencies of recent times where liability is the principal line of business.

Liability claims are complex, unclear and often dispersed geographically, as liability products are complex. Coverages and subsequent liability issues are, not surprisingly, complicated.

Recently, as in the Legion Insurance and Reliance Insurance insolvencies, products linked to various alternative risk transfers have created problems. These claims take a long time to resolve; hence, it takes a long time to collect reinsurance. The creation of solutions that present the least risk or potential for criticism often are not solutions that conserve estate money for creditors. This often means triggering the safety net, the guaranty funds, so that the average claim gets paid.

The Great Depression made it obvious that a device similar to the Federal Deposit Insurance Corporation was needed to protect insurancepolicyholders and their beneficiaries against catastrophic loss.

To that end, insurance guaranty funds first came into existence inthe United States in the 1930s.

Workers' compensation insurance was the first line of insurance tobe provided with a government-sponsored "insurance of insurers."

Once again, the state of Wisconsin led the way with the first workers' compensation security fund in 1935. New York and a handful of states followed in 1937, following the failure of several workers' compinsurers. By 1939, New York had established the first automobile insurance guaranty fund. Not until the 1960s did significant developmentoccur in guaranty-fund laws for property/casualty insurers. The consumer protection movement and the demand for security through increasingly comprehensive insurance programs paved the way for interest in amore comprehensive system for "insuring insurance."

A study prepared in 1966 by former Sen. Thomas Dodd, D-Conn., served as a major catalyst for the creation of guaranty-fund laws.

Dodd analyzed the insolvencies of more than 60 substandard auto insurance companies and proposed a federal guaranty system to protect policyholders and claimants with protections similar to those providedby the FDIC for bank depositors.

Dodd introduced a bill to establish a Federal Motor Vehicle Insurance Guaranty Corporation, and laid responsibility for these auto-insurer failures with state insurance regulation.

The NAIC criticized this federal proposal as an intrusion on stateregulatory authority, bristling at the idea of a system whereby well-run companies would be required to pay for the losses created by insolvent and poorly managed companies. The NAIC responded by minimizingthe nature of the problem.

But in 1968, former Sen. Warren Magnusson, D-Wash., authored a bill that would provide a federal guaranty corporation covering virtually all lines of property/casualty insurance. The bill was never passedby Congress. The NAIC now had to focus on preserving state authorityin this area and, along with much of the industry, moved to adopt a model guaranty-fund law across the states to avoid federal legislation and intrusion into the area of solvency regulation.

In the three following years, there was intense activity in the various state legislatures to adopt the model.

The guaranty-fund system that today accounts for the redistribution of almost $10 billion was thus created during a four-year period between 1969 and 1972, as a reaction to federal intrusion. There was little discussion as to whether such a system should even be developed at all. Little or no debate occurred regarding the covered lines of insurance, the provided limits of liability, or the benefited persons or corporations. And the sea change to provide protection for all policyholders and claimants of property/casualty insurers appears to have received no attention whatsoever from Congress.

By the end of 1970, 22 states had post-assessment guaranty funds, 35 states a year later.

Over time, changes to the Guaranty Fund Model Act have been proposed to make it more adaptable to varying circumstances. The most significant changes occurred in the 1980s. NAIC eliminated in 1980, for instance, the deductible for insurance claims but not for unearned premium claims.

In 1984, the work of a NAIC task force led to the reconsideration of the scope of the act, excluding several products from coverage andenhancing fund capacity by reducing fund obligations. Rather than exclude fund coverage for the wealthy insured, public-policy makers decided at the time to set a threshold of $50 million of net worth to determine who is "wealthy."

As a result, the fund is obligated to pay third-party claims but is allowed to make a claim against the wealthy insured for reimbursement.

The threshold for coverage for first-party claims of certain wealthy insureds was suggested to be $10 million of net worth. Additional steps were taken during the 1980s to exclude coverage for noninsurance transactions. The result of all these nips and tucks is that receivers are dependent on the 50-state guaranty-fund system for data and information to marshal assets of reinsurance, retro premiums and subrogation, but the system is not efficient because of this fragmentation.

There is no question that current insurance industry practice and products no longer resemble the business paradigm that served as the foundation for the development of both insurance insolvency laws and the guaranty-fund system. The patchwork of modifications that have been made over the years cannot continue, but what should be done?

Does the government deserve to continue in its receivership role, or should the system be privatized? Should creditors drive the resolution process? Perhaps answers can be had based on the few observations that can be made about the insolvencies of the last three decades or so.

First, they were far larger. Each decade's largest insolvency was exceeded by that of the next decade. The Reliance Insurance Co. insolvency in 2001 was larger than that of the Transit Casualty Insurance Co. in 1985, which was larger than the collapse of Reserve Insurance Co. in 1979.

Insolvencies are also no longer local or regional, but national and international. Reinsurance ceded arrangements are complex. The lineof business dominating recent insolvencies is liability, and increasingly so.

These attributes of recent failures have caused unforeseen havoc for guaranty funds and receivers. The havoc is eventually resolved, but at considerable cost.

So does history provide answers? On the contrary. Practical business solutions to these issues aren't so obvious when they appear in a very legal environment such as receivership proceedings. These challenges, nevertheless, create opportunities to bring the current system in line with today's insurance failures.

First in a Four-Part Series

This month, in the opening story in a series to run over the next four issues, two writers with the insurance consultancy Navigant Consulting, explore how insolvency laws and guaranty funds came to be. For more information on this series, please turn to page 24.

Solutions for the Insolvent: About This Series*

Editor's note: Insurer insolvencies are astronomically expensive. With the Reliance Insurance Cos. insolvency in its fifth year and theMission Insurance Cos. insolvency taking 21 years to close, this is an issue that is compelling enough to be on the radar screen of any commercial insurance buyer. There is a need for this series to expose and increase awareness of the flaws in the nation's insurance system.This four-part series is not intended to be an indictment of those that work within this system, but simply a recognition that readers could benefit from a system laced with more transparency, accountability and efficiency, whether that system is state-based or federal. Thisseries is also intended to alert readers and commercial buyers who find their insurance company in receivership, and to provide a glimpseof what to expect.

January 2007

Insurance Insolvencies, Part 1

This first part of the series takes a look at the U.S. system for handling property/casualty insurance failures. It is a system that isfailing insurance buyers, particularly commercial insureds, because of systemic problems that lead to excessive costs and extraordinary delays. The article provides a historical perspective on the state insolvency and guaranty-fund systems, helping the reader understand how and why they have evolved over the years--yet have not kept pace overthe last three decades with the changing nature of insolvencies.

February 2007

Insurance Insolvencies, Part 2

The second article in this series will take a look at the treatment of claimants, creditors and other stakeholders and how more complexreceiverships under the present system do not serve these constituencies well. Here the systemic shortcomings, redundancies and deficiencies in the current approach will be made apparent, as well as how thelack of political will and the vested interests in the status quo have stood in the way of reform.

March 2007

Insurance Insolvencies, Part 3

The third article will feature a case study on the failure of a major U.S. insurer. To provide insight, the case will be contrasted with the collapse of the HIH Insurance Group, Australia's second-largestinsurer.

April 2007

Insurance Insolvencies, Part 4

The fourth and final article in the series--to be published in theApril 1 issue--will identify and discuss recommendations to make thesystem more efficient, less costly and more responsive to creditors.

About the authors and Navigant Consulting: Navigant Consulting Inc. is a specialized independent consulting firm providing litigation, financial, health-care, energy and operational consulting services togovernment agencies and large companies facing the challenges of uncertainty, risk, distress and significant change. The company focuses on industries undergoing substantial regulatory or structural change and on the issues driving these transformations.

* The views expressed in these articles are those of the authors and not Navigant Consulting, its clients or affiliates.

Coming in February 2007

Insurance Insolvencies, Part 2.

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Chart 1: Insurance Insolvencies 1850-1968

Average Number of Insolvencies Per Period

Year

1850-1899 (1) 9

1900-1944 (1) 18

1945-1958 (1) 8

1959-1968 (2) 8

1. Dr. Halem Bisham Thesis: An Analysis of Insurance Company

Insolvencies and the Public Interest

2. 1969 Vol.II NAIC Proceedings

Note: Property & Casualty

Insolvencies only in 1958-1969. All

other periods include life & P&C

Note: Table made from bar graph.

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