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HEADLINE: Receiving reform: the way insolvencies are done just doesn't work intoday's complex insurance universe. While the "how" of reform can bedebated, the "why" is all too apparent;
INSOLVENCIES

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BODY:

The time has passed to put a few Band-Aids on the property/casualty insurance insolvency system. It's time to fix this relic that is inefficient, expensive, slow and unfair. Property/casualty insurers, risk managers and insurance buyers deserve far better.

The states must fix it or the U.S. Congress will. But what should be done? Fundamentally, as this series has shown, there are structural problems in the status quo. The business paradigm for the existing insolvency laws and the state guaranty system no longer works. Today's insolvencies have far-reaching, even international implications, and increasingly involve complex reinsurance arrangements and liabilityproducts. The unforeseen havoc created for receivers and guaranty funds as the result of recent failures and the systemic shortcomings ofthe current system cannot continue. The system does not address insurers that might find it necessary or desirable to run off its insurance business and related losses. A dramatic transformation of the insolvency system for property/casualty insurers is required.

Several important principles underpin reform recommendations. First, and most importantly, "going out of business" is still a business.Stakeholders expect and deserve it to be conducted within the context of certain necessary rules. To the extent possible, the reform should be within the current state-based system. Next, creditors should be given an opportunity to fashion a dissolution plan before an insurer is placed in liquidation. Surely the claimant deserves an importantrole in the process and not one that, at best, is on the outside looking in. A statutory framework for allowing this to happen must be created. If that does not succeed, the receivership system must make provisions for creditors to act in a meaningful role during the liquidation proceedings.

In addition, insurance companies, through the guaranty-fund system, are called upon to pay many of the loss claims of competitors, but without their significant input. Insurers must have authority and a formal role in the insolvency system that are commensurate with this redistribution of wealth and extraordinary requirements imposed upon them. The guaranty-fund system needs to be less fragmented and linked closer to the receiver to improve efficiencies. It must have lower costs, and have the flow of information within it enhanced to allow assets to be marshaled effectively.

Further, changes in receivership law are needed to improve transparency and accountability. Incentives and other procedures must be established to improve the speed at which receivership estates are resolved. Also, the government's role in receiverships should be altered from an administrator to an overseer and regulator. Receivership management can then be assumed by professionals who are smiled and experienced in running off insurers, as well as knowledgeable about the specific receiverships requirements. A state insurance commissioner's hegemony over insurance receivership business was never preordained, andthere are compelling reasons to reconsider and change it.

Finally, the public is entitled to know what caused an insurer, particularly, a significant one, to fail. What did the regulators do todetect and regulate it before bankruptcy happened? How well did the insolvency system perform after the failure?

In order to encourage the development of creative alternatives to traditional receivership, data and information will be needed. A central data repository must be created consisting of key statistical andfinancial information for all insolvencies.

Based upon these principles, here are specific recommendations to improve transparency, accountability and efficiency in the system.

RECOMMENDATIONS

A major statutory structural change should be made to create a "window" for an insolvent insurer. This would give regulators time to develop, with creditors, a plan of finalization or dissolution, perhapsmaking it possible to avoid liquidation. Guaranty funds should be a part of this new process. The objective is to fashion a plan that speeds resolution though voluntary agreements among a majority of creditors, thus saving significant dollars. In itself, that would make the process much fairer for everyone.

In this process, creditors and reinsurers would agree to a methodology for resolving long-tail claims, the claims that typically impedeand prolong the settlement of an insolvency. Certain legal protections would have to exist, such as "stays and injunctions," to allow thedevelopment of an appropriate plan that preserves values for claimholders. Unlike today, government would oversee the process but would not be responsible for its creation. That solution would come from theparties that hold the biggest stake in the resolution of the insolvency.

This structural change would include procedures for insurers for which solvency is unknown or problematic, and where solvency is presumed but not a certainty. In this case, creditors and claimants could accelerate finality through an arrangement approved by a majority of the insurer's creditors. Again, this avoids lengthy receivership proceedings in the event the insurer is found to be insolvent.

While no one desires to disturb the principle underlying the purchase of insurance--exchanging uncertainty and risk of loss for certainty--this is a fair compromise. Because under the current system, unless risk is transferred, uncertainty persists that creates a situationthat delays, if not blocks, the resolution of the issues. These situations happen, for example, when there is a ratings agency downgrade,a deterioration in riskbased capital or a variety of other unforeseen adversities. The purpose of such a new statute would be to establish a creditor-driven process that would seek to make prompt payments to creditors and to look for effective ways to maximize assets for claimholders.

Today's environment demands a new and expanded role for the National Committee of Insurance Guaranty Funds that draws upon the available skills and resources. The NCIGF was formed in 1971 primarily to help states design appropriate property/casualty guaranty-fund legislation and to serve as a national forum to exchange information and ideas. While its mission has evolved somewhat over the years, dramatic changes are now needed to address the complex situations now encountered.

By way of example, in today's environment, it is illogical that the guaranty-fund system not be a part of the decision-making process for resolution of a troubled insurer. Would not a cost-effective and creative solution for an insurer's "soft landing" be preferable, if atall possible, to the costs and inefficiencies of receivership?

This is not to suggest the guaranty-fund system has not performed well, because it has performed superbly given the situation. However,structural changes are needed to meet the challenges of today.

All state guaranty funds should be required to be members of the NCIGF. The NCIGF would have clearly defined duties and responsibilities. The members would elect a board of directors of the NCIGF, all of whom must be member insurers. One of the NCIGF's "new" responsibilities would include centralization of the claims administration functionand, perhaps, establishing a central claims facility for all guaranty funds to use that could be closely linked with each receivership. The multistate guaranty-fund system could be maintained for funding purposes but not claims administration. Alternatively, the guaranty funds could utilize the failed insurer's claims personnel and systems. NCIGF would also represent the guaranty funds in determining a course of action for a troubled insurer and the selection of a qualified individual to administer a workout plan, or if necessary, the liquidation of an insurer. The NCIGF would also establish standards for guaranty funds to follow in reporting financial and other information to theorganization, all of which would be mandatory. This would create a centralized repository for guaranty-fund costs including expenses.

Today, local guaranty funds are accountable to their board of directors, members and regulators through a variety of ways including audited financial reports. However, no one effectively aggregates data from all guaranty funds to determine the cost of an insolvency on a gross or net basis after recoveries. The NCIGF would also be a part of the extremely important postmortem process, allowing all parties to learn how to lessen the impact of future insolvencies or prevent them entirely.

Several reforms are needed to address fundamental concerns with the system for managing insurer insolvencies in the United States. As noted in earlier articles in this series, the present statutory, structure is flawed with incentive conflicts, a perceived lack of control and oversight, as well as high costs.

First, the responsibility for administering an insurance receivership would not be in the hands of the state insurance commissioner, but rather, a person experienced in insurer receiverships selected by the commissioner, the state insurance guaranty funds, through the NCIGF, and noncovered creditors. Winding up an insurer is a management function, not a regulator function, and the system should recognize that distinction. For example, whether litigation should be pursued by areceiver should be determined by a cost-benefit analysis and not based upon whether the perceived wrongdoers deserve to be penalized.

Others have noted that the resolution of problems presented by a failed or failing insurer is not best handled by government. Once a company has been found to be in such condition to warrant the cessationof business, it moves from being a governmental concern to one of protecting and finding the best resolution for its creditors. The concern is no longer protecting the general public.

The International Association of Insurance Receivers has professional certification programs for insurance receivers. The association has in process an enhancement of that program to include a course of study and testing before a designation can be granted. This program can be used to create a pool of potential candidates to serve as qualified insurance receivers. As mentioned earlier in this series, in several other countries, only licensed insolvency practitioners can serveas receivers and administrators and the same should occur in the United States.

Previously, we discussed the problems created by insurance products within the liability lines of insurance. These products have dominated the insolvencies of the recent past and likely will be present infuture insolvencies. These products create long-tail claims, which have considerably lengthened the closure time for many insolvencies. The system needs to find a solution for this problem. Our suggestion is that

the priority of distribution of assets needs to be changed. First,creditors with liquidated claims should be given higher priority over unliquidated and contingent claims. Second, unliquidated claims should be granted priority over contingent claims. Then contingent claims should be allowed if assets remain, and then only if there is an actual insured event or occurrence that can be valued and estimated as to amount. Granted there are complications to be considered; nevertheless, the notion is that known claims should be paid first before more speculative claims are addressed.

Receivers should be accountable for their actions, policies and procedures. This observation is not intended to criticize or question the integrity of receivers; it is just recognition that the current system does not engender accountability. Our prior suggestions to change the insurance commissioner's role to that of an overseer would assist the situation; however, more needs to be done. A rigorous system of standardized reporting requirements, to not only the supervising court and creditors but also a public central repository, needs to be instituted. Such information is necessary to improve transparency and accountability, and such a database will be needed to fashion creative and innovative solutions for companies in financial trouble.

State and public policy-makers must make the redemption of the insurance insolvency system a priority. Unfortunately, one of the system's most glaring deficiencies is the lack of transparency. The lack ofa central data repository hides from most public policy-makers the need for systemic change.

Nevertheless, it is hoped that this series of articles has demonstrated a need for at least a preliminary inquiry to confirm that the need for reform is real.

Few troubled insurers are evident today as contrasted with prior periods. This relatively tranquil period of time allows for careful study of the system and thoughtful consideration as to how to fix it. The authors readily admit that the reforms suggested in this article do not answer all questions or address all problems of the insolvency system. Similarly, we recognize that our ideas require further development and study; we hope that these articles have at least stimulatedthe process. As Samuel Johnson stated, "Language is the dress of thought."

Solutions for the Insolvent

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 thosethat 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

This series is also intended to alert readers and commercial buyers who find their insurance company in receivership, and to provide a glimpse of what to expect.

JANUARY 2007

Insurance Insolvencies, Part 1

This first part of the series took a look at the U.S. system for handling property/casualty insurance failures. It is a system that is failing insurance buyers, particularly commercial insureds, because of systemic problems that lead to excessive costs and extraordinary delays.

FEBRUARY 2007

Insurance Insolvencies, Part 2

The second article in this series took a look at the treatment of claimants, creditors and other stakeholders in insolvencies and how more complex receiverships under the present system do not serve theseconstituencies very well.

MARCH 2007

Insurance Insolvencies, Part 3

The third article featured a case study on the failure of a major U.S. insurer, Mission Insurance Cos. To provide insight, the case wascontrasted with the collapse of the HIH Insurance Group, Australia'ssecond-largest insurer.

APRIL 1, 2007

Insurance Insolvencies, Part 4

The fourth and final article in the series identifies and discusses recommendations to make the system more efficient, less costly and more responsive to creditors and other stakeholders in the insolvencyprocess.

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