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Article abstract

Ce travail a été présenté à la réunion annuelle de l'*Alliance of American Insurers* à Québec, le 12 mai 1987. M. Nails se pose la question : dans quelle mesure le *State Guaranty Fund System* aux États-Unis doit-il subsister ? Il a rendu de grands services, mais, d'un autre côté, certains trouvent qu'il coûte très cher. Quand on sait que ce *Guaranty Fund* vient à la rescousse des sociétés d'assurances en difficulté, on comprend l'intérêt de ce travail. Nous remercions l'auteur d'avoir bien voulu nous permettre de le reproduire ici.

Guaranty Funds : Consumer's last right : the industry's last rite ?[1]

by

Mr. Kenneth H. Nails

*Ce travail a été présenté à la réunion annuelle de l'*Alliance of American Insurers *à Québec, le 12 mai 1987. M. Nails se pose la question : dans quelle mesure le* State Guaranty Fund System *aux États-Unis doit-il subsister ? Il a rendu de grands services, mais, d'un autre côté, certains trouvent qu'il coûte très cher. Quand on sait que ce* Guaranty Fund *vient à la rescousse des sociétés d'assurances en difficulté, on comprend l'intérêt de ce travail. Nous remercions l'auteur d'avoir bien voulu nous permettre de le reproduire ici.*

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I am going to discuss the state guaranty fund system and how the environment in which it operates has changed radically. The significance of these changes will affect your ability to do business and may dictate needed changes in the guaranty fund system if the insurance industry is to survive.

If there is any one mechanism which personifies the fulfillment of a social purpose by the insurance industry, it is state insurance guaranty funds.

While there was true and valid reasons for supporting those funds in 1969, there is no question that they have become a substantial financial drain on each company's bottom line. Today, some even question why the industry ever supported the establishment of these funds in the first place.

Consequently, it is important to review the philosophy behind the establishment of the state guaranty funds and consider whether the decision were made in 1969 need to be reconsidered in light of changes which have occurred in the last three years.

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[1] *Best's Review*, July 1987 © A. M. Best Company – used with permission.

During the five-year period between 1960 and 1965, 58 *high risk* automobile insurers became insolvent, and more than 300,000 policyholders sustained losses in excess of $100 million. Therefore, it came as no surprise that in 1966 congress held hearings and legislation was introduced to establish a federal *motor vehicle* insurance guaranty fund.

Although that Bill died when congress adjourned, senator Christopher Dodd (D. Conn) reintroduced it in 1967 on behalf of 13 other senators as well as himself. In doing so, he stated : "I, personally, find the arguments against federal control to be quite persuasive. However, the simple fact is that state regulation is not adequately protecting the consumer, and at all costs, he must be protected". Senator Dodd went on to say that if the states did not respond immediately and sufficiently, the Federal Government would be left with no alternative but to take action.

While no action was again taken on senator Dodd's Bill, *high risk* auto insurers continued to fail. Another 64 companies failed between 1965 and 1969. In addition, more than a half a million policyholders of insolvent *assessable* mutual companies were assessed more than $60 million to pay off the debts of those companies.

Consequently, pressure continued to grow and in May 1969, senator Warren Magnuson (D-Wash.) introduced on behalf of himself and 6 colleagues the infamous S.B. 2236.

At that time, the Alliance concluded :

"Under this Bill, companies would be required to apply for a Federal guaranty. If rejected, and they continued to issue or reinsure policies, the company would forfeit $1,000 per day, per policy. If policies were guaranteed, the insurer would pay a fee of 1/8 of 1% of its premiums into a pre-assessment fund.

The Federal Insurance Guaranty Corporation would approve an insurer's application *if, and only if, after examination*, it found that the applicant was capable of conducting its business in a sound and solvent manner. In making this determination, the Federal Corporation would consider, along with such other factors as it may deem necessary or appropriate, the applicant's capital and surplus, reasonableness of operational expenses, premium writings as related to surplus, adequacy of loss and expense reserves, reinsurance, investment portfolio, and even managerial qualifications.

This Bill would impose upon insurance companies, in exchange for a Federal guaranty, *an extensive and complete system of Federal control covering all aspects of insurance company operations.* A Federal program of laws and regulations would replace the states as the primary regulator of the business of insurance".

One might say that the industry should have opposed the Federal Bill without suggesting an alternative. However, it must be remembered that there was considerable support in congress for this proposal as a result of the many *high risk* automobile insurance company insolvencies and, a *substantial split within the insurance industry.* Those that supported S.B. 2236 at that time included the American Insurance Association, INA, Nixon administration, United Auto Workers, and the Consumer Federation of America. In fact, with this industry support and support in congress broadening daily, the Alliance concluded that not only should we oppose the Federal Bill, but in order to prevent its enactment and respond to a true consumer need, we were required to seek the enactment of state post-assessment guaranty funds.

As you all know, the Alliance worked with others and the NAIC in drafting the NAIC model state post-assessment insurance guaranty fund act and advocated its enactment with 43 states enacting the laws within the first 2 years. *The rush to enact a Federal insurance pre-assessment fund dissipated.*

I think it is important to note that the architects of the state guaranty fund system put in place a structure that was designed to respond to a true need of the insurance buying public. It was established to respond principally to *high risk* auto insurance insolvency problems ; and, to the insolvency of small one-state or regional carriers the magnitude of which was not great for most of the 1970s and into the early 1980s, the assumptions upon which the state guaranty fund system were grounded has proven to be accurate. However, some disturbing trends have occurred in the last 3 years (1984-1986) which suggest we must review the philosophical basis of the state guaranty funds and determine whether replacement mechanisms are necessary or the existing mechanisms need be changed drastically. These trends include :

1. Number of insolvencies

In the 14 years before 1983, the property/casualty guaranty funds have had to respond to a total of 86 insurer insolvencies. Whereas, in the last 3 years, the funds have been triggered by no less than 60 insolvencies. In the early days, the big year was 1975 when we were faced 20 new insolvencies. At that time, it seemed to be an enormous undertaking. Then came 1984, 1985 and 1986.

Before 1984, we averaged 5.7 insolvencies per year compared to 20 per year in the last three years.

2. Relative size of insolvencies

Simply looking at the number of insolvencies to which guaranty funds have had to respond does not tell the whole story of what has been happening in the guaranty fund area. In addition to the increasing number of insolvencies, their relative size has expanded dramatically. Between 1969 and 1983, only 11 on the 84 insolvencies handled during that period were of such magnitude so as to require the guaranty funds to assess over $10 million to pay for these claims.

However, between 1984 and 1986, that $10 million assessment level was exceeded by 16 of 60 insolvencies. Again we are comparing 14 years to 3 years of experience.

The actual dollar assessments by the guaranty funds for *individual insolvencies* has increased dramatically. Up to 1984, the largest single insolvency was that of the reserve insurance company in 1979 which resulted in an $85 million assessment. This $85 million figure has been eclipsed in the last few years by ideal mutual, which was declared insolvent in 1984 and wrote $170 million. Transit casualty company which was delared insolvent in 1985 and had writings in excess of $225 million ; and, Midland, which was declared insolvent in 1986 and wrote $137 million. No doubt, the mission companies will establish a new record. Present estimates are that the mission insolvency will cost the guaranty funds in excess of $640 million.

3. Kind of business

As the number and relative size of insolvencies increased, so has the kind of insurer becoming insolvent changed.

You will recall that I mentioned earlier, that the state guaranty funds were established to handle principally *high risk* automobile insurer insolvencies. Of great significance is the fact that many of the insolvencies which we face today involve *nationwide* commercial insurers who often write *complex coverages* giving rise to large, complex claims.

Not only are these companies *national* in scope, as opposed to one state or regional writers, but they are substantial writers of general liability, commercial multi-peril liability, and workers compensation. They insure not only Mr. and Mrs. Smith for their automobile insurance, but also insure large corporations such as Raymark, Dart & Kraft, Johns Manville, Union Carbide, Amtrak, Evans Products, U.S. Repeating Arms, W.R. Grace, and many others. These, in addition to municipalities, sheriff associations, transit authorities, and so on.

4. Complexity of lines

We are now being faced through the guaranty funds not with automobile claims, but asbestosis claims, horse mortality, errors and omissions, medical malpractice, sylicosis claims, longshore and harbor worker claims – all of which are far different from personal lines losses of prior years.

5. Size of individual company assessments

Between 1969 and 1983, the guaranty funds assessed a total (now there are total figures) of approximately $454 million, contrywide. This total figure *has been exceeded in the last 3 years.*

In 1984, we assessed $74 million. In 1985, $344 million and in 1986 $530 million. Therefore, in the 14 years between 1969 and 1983, $484 million was assessed as compared to $948 million in the last 3 years.

Of the total assessments to date of $1.4 billion – 68% was made in the last 3 years/2 out of 3 dollars have been assessed in the last 3 years compared to prior 14 years.

6. Comparison to a Federal Fund

Over the years, we have always compared what has actually been assessed by the state guaranty funds to what would have been

assessed had the Federal proposal been enacted. Up until 1983, the state system compared favorably – $454 million versus $1.2 billion. Companies were allowed to retain the difference, invest it, etc. However, when you add in state assessments from 1983-1986, the picture changes dramatically suggesting that what we would have paid in on a pre-assessment basis would today equal about what we have paid through 1986 under the state system.

7. Capacity of the guaranty funds

Recently, the Alliance Research Department postulated a major insolvency using a large existing property/casualty insurance company. They applied the normal payout pattern for various lines of insurance and matched those standard payout patterns against the need for guaranty fund assessments remembering – in order to avoid the domino effect – no guaranty fund can assess more than 1% or 2% in any one year. As result of this study, the Research Department reached these startling conclusions :

A. Deficiencies in the first year occurred in 31 states.

B. Deficiencies in the second year occurred in 29 states.

We should remember, when the guaranty funds were enacted, the insurance industry made an implied, if not, express commitment to guarantee that policyholders and claimants of insolvent companies would not suffer substantial financial loss due to an insurer insolvency.

Whether the reason for an insurer's failure is mismanagement, fraud or failure of the regulatory agency to prevent the insolvency, the industry has accepted an obligation to protect the insurance buying public from the ravages of such insolvency.

Legislators enacted the property/casualty guaranty fund laws with the expectation that they would perform adequately and reimburse policyholders within a reasonable period of time for their losses. While those very legislators allowed for the inclusion of a maximum percentage assessment limit per year, their belief (expectation) was that even with such caps, the guaranty funds could respond within a reasonable period of time after an insolvency. We must remember that while there are legitimate reasons for the maximum yearly assessment, political pressures to reimburse insureds

might very well overcome the need for retention of this maximum assessment limit.

The ability of the guaranty funds to respond is dependent upon the size, number and type of insolvency. If you had 2 major nationwide writers become insolvent, you would have a much greater problem than postulated ; if you have one or more large regional carriers become insolvent, you have another problem ; and if you have a major one state carrier become insolvent, we have a significant problem.

We must make these state guaranty funds work consistent with our need for profitability or provide a substitute mechanism to assure policyholders and claimants that they will not incur financial loss. However, we advocated those state guaranty fund laws in light of small *high risk* principally automobile insolvencies.

Today, the situation has changed. We have an increasing number of insolvencies and each insolvency is of greater magnitude. The companies which are becoming insolvent are large nationwide insurers writing commercial business producing complex claims and, as a result, assessments have *increased dramatically.* This raises questions concerning the capacity of the guaranty funds and the ability of the industry to continue to shoulder this burden.

Should we seek a Federal solution today in light of the changing scene ? Should we change the state guaranty fund system ? Is there some other mechanism which would be more appropriate in light of the experience of the last three years ? These are questions industry will have to face and answer while attempting to fulfill its social responsibility.

Guide des références pour la rédaction juridique. Les Éditions Thémis Inc. 1987. 101 pages

Nous signalons à nos lecteurs ce Guide fort précieux pour qui sont appelés à préparer les dissertations ou études juridiques et qui désirent que leurs sources soient bien citées et puissent être bien comprises.

Comme le signale son auteur, M. Didier Lluelles, professeur agrégé à la Faculté de droit de l'Université de Montréal, cet ouvrage n'a pas d'autre prétention que d'offrir au rédacteur un guide qui se veut utile et sûr. Il y a là un instrument de travail qui rendra service. C'est à ce titre que nous le signalons à nos lecteurs.