

**Managing the Cost of
Property-Casualty Insurer Insolvencies
in the U.S.**

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Executive Summary

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Context, Issues and Scope

The number and cost of property-casualty insurer insolvencies increased significantly in the middle and late 1980s and early 1990s. Over the period 1984-1993, over 400 property-casualty insurers failed; there were 697 property-casualty insurer insolvencies from 1971-2001. Guaranty association assessments for property-casualty insolvencies followed a similar pattern and amounted to \$6.9 billion as of the end of 2000. It should be noted that this figure pertains only to guaranty association assessments and does not include substantial additional costs incurred by those with claims that are not covered by guaranty associations. While insurer insolvencies dropped sharply in the mid-1990s, the historical experience indicates the potential vulnerability of the industry to economic shocks and changes in market conditions. Recently, the number of property-casualty insolvencies has begun to increase due to economic stresses and industry restructuring. The Reliance insolvency is projected to result in guaranty assessments that may exceed the sum of all property-casualty guaranty association assessments to date. Presumably, additional costs arising from the Reliance insolvency that are not funded through guaranty associations also will be large. This underscores the importance of effective solvency regulation and an efficient system for resolving insurer insolvencies.

Unfortunately, this system continues to be plagued by major problems that significantly inflate insolvency costs. Despite concerns raised and calls for reforms by regulators and other experts, the system remains obscured and unreformed. It is a serious matter because of the high private and public costs of insurer insolvencies and the potential for these costs to increase substantially as the industry undergoes further restructuring. This paper examines the system for managing property-casualty insurer insolvencies, assesses factors affecting their costs, discusses major issues and problems, and offers recommendations on how to structure a more efficient system.

Summary of Findings

Our examination reveals several aspects of the U.S. insurer receivership system that contribute to higher insolvency costs. Fundamentally, there are incentive conflicts between regulators, receivers and other stakeholders that the system fails to control. Receivers have incentives to prolong receiverships and inflate costs (to increase their compensation) as these costs are passed on to parties that have little ability to influence the receivers' performance. There is little transparency and accountability, and regulators and the courts do not exercise adequate oversight of receivers and receiverships.

The division of responsibility for insolvencies among the various states compounds these problems. The domiciliary state regulator of an insolvent insurer controls its receivership but insolvency costs are spread among all the states in which the insurer has claims obligations. The domiciliary regulator is not compelled to fully consider the interests of the other states, which leads to further inefficiencies.

We discuss a number of specific problems with the receivership system that arise from these basic structural flaws.

- Some receivers are not selected on the basis of competence or a commitment to efficient performance through incentive-based compensation.
- The interests of many claimholders – creditors and reinsurers - are not protected sufficiently.
- Communication, cooperation and coordination between domiciliary states and non-domiciliary states and guaranty associations are deficient. Inconsistent state laws exacerbate coordination problems.
- Some receiverships are mismanaged, unnecessarily prolonged and result in excessive costs.
- The current structure of guaranty associations contributes to moral hazard problems and higher insolvency costs, despite provisions designed to increase insurance buyers' incentives to seek financially sound insurers.
- In certain circumstances, companies are placed into formal liquidation when alternative resolutions are possible that would be less costly.

Recommendations

Overall System

Fundamentally, an improved system should maximize the efficiency of resolving the insolvencies of multi-state insurers. At the outset, full communication, cooperation and coordination among affected states are imperative. Also, any unnecessary duplication of facilities and effort should be minimized. Further, a "least cost" approach should be

followed in managing any particular insolvency. This approach requires public access to information and data on insolvencies and receiverships that are currently not available to the public, or even to direct stakeholders.

The structural options available will depend on how the overall framework for insurance evolves. If the federal government were to take over insurance regulation, then the federal government or some other national entity would administer receiverships and any insolvency guarantees. Optional federal chartering of some insurers, as proposed by several organizations, would facilitate the use of national insolvency management systems for federal insurers. Either full federal regulation or optional chartering would automatically avoid the parochial nature and coordination problems of the current state system, but the achievement of other efficiencies would depend on the design of the national insolvency framework.

To the extent that a state framework for insurance regulation persists, the task of structural reform becomes more challenging. An interstate compact is one potential mechanism for reform and coordination. Another approach would be federal enactment of minimum standards for receiverships that the states would be compelled to meet. An interim step would be adoption of the *Uniform Receivership Law* (URL) by all the states or its adoption by the federal government as a national standard that the states would be required to administer. An additional measure would be to establish a national standards and accreditation program for insolvency management, akin to the NAIC's financial regulation standards and accreditation program. Also, the NAIC's Insolvency (E) Task Force, or something equivalent, should actively monitor the management of insurer insolvencies, particularly those of national significance.

Transparency, Accountability and Oversight

Transparency, accountability and effective oversight drive the performance of insolvency management. Like non-financial firm bankruptcies, insurer insolvencies should be concentrated under the jurisdiction of courts that can accumulate expertise and establish competence in this area, as well as protect the interests of all claimants and other stakeholders regardless of their locale. Further, the presiding court should hold regulators and receivers strictly accountable for their performance.

Regulators must closely monitor and be fully informed about the insolvencies managed under their office. A regulator should be in a position to determine whether the insolvency manager is performing properly and that all of his actions are appropriate. It follows that managers who failed to meet reasonable performance standards or who took improper actions would have their appointment terminated and be subject to financial penalties. Both effective monitoring and sanctions are necessary to promote the correct incentives for managers.

In turn, a regulator should be required to make periodic reports to the presiding court that demonstrate that he is properly performing his oversight function and that an insolvency is being managed efficiently. Legislative audits also could be used to enhance the

scrutiny of regulators' performance. Additionally, insurance commissioners should be given the financial and staff resources necessary to perform their oversight function.

Another reform would be to strengthen the ability of other interested parties, e.g., creditors, to express their interests in insurer insolvency proceedings. For example, in the URL, all persons with a stake in the outcome of a proceeding have legal standing to intervene and appear before the receivership court. This would require authorities to consider a broader range of interests in managing insolvencies and increase incentives for employing lower cost means of resolving insolvencies.

Transparency is important to ensure that officials and private managers are subject to public scrutiny and to support a deliberative process to determine the least costly and most appropriate course of resolution. The current practice of voluntary reporting is unacceptable. As an initial step, all regulators should be required to file complete and accurate annual reports on receiverships to the NAIC, according to the standardized questionnaire adopted by the NAIC. Information disclosed should include projected distribution dates and percentages to compel receivers to plan and perform accordingly.

These reports should be captured in an electronic database that, at a minimum, should be accessible to all regulators. Arguably, these data also should be accessible to all claimholders to an estate and to the general public. Further, petitions and other court documents should be made readily accessible to all interested parties. The availability of these data and documents would allow both regulators and other affected parties to know how receiverships are proceeding and enable them to raise any concerns they may have.

For the long term, there is a need to determine the kinds of information that should be made available to the public. It would be desirable to establish stringent national standards that would be adopted by the states or that at least would provide a basis for judging a state's performance in this area. The presumption should favor disclosure and a receiver should be required to show why the publication of certain information would compromise the management of a particular insolvency.

Staffing Receiverships and Receiver Selection

Insurance commissioners must have sufficient qualified staff to perform their insolvency oversight responsibilities. This can be accomplished with both insurance department staff and contract receivers. Contractors should be able to perform as effective and efficient managers if they are competent, subject to court and regulatory oversight, and have the proper incentives. A flexible arrangement that enables a state to adjust its human resources according to need is desirable. Smaller states might benefit from some form of facility that would allow them to access experienced liquidation personnel to support their commissioners when they have an insolvency.

The manner of and process for the contracting of receiver-managers of insurer insolvencies is a critical area for reform. Receiver appointments should be based on competence and the expectation of good performance. Many government contracts are subject to a competitive bidding process that, at least in theory, is designed to minimize

cost for a product or service that must meet established specifications and standards. The same principles and mechanisms should be brought to the engagement of managers of insurer insolvencies. The use of independent licensed “Insolvency Practitioners” in the U.K. also is an idea that warrants consideration for the U.S. The ultimate goal should be the establishment of a group of competent professionals and firms that develop a high level of expertise and a good record in managing insurer receiverships. Existing professional organizations for insurance receivers could play a valuable role in receiver certification.

Managing Receiverships

Best practices in the “nuts and bolts” of managing insurer insolvencies are articulated in the NAIC’s *Troubled Companies Handbook* and *Receivers Handbook for Insurance Company Insolvencies*. These handbooks are adequate for their purpose and only need to be revised to the extent that the structure of the receivership system is reformed and new approaches are available.

Importantly, more innovative approaches to resolving certain insurer insolvencies should be explored and implemented with corresponding law changes if necessary. Alternatives to liquidation should be pursued more rigorously. The idea would be to bring managers and all claimholders (which includes creditors) together to attempt to develop a workout plan that would be less costly than a standard receivership or liquidation. The company might still be ultimately dissolved but would be placed in an accelerated run-off mode without a formal receivership. This option is available in the U.K. and warrants further consideration in the U.S.

Another innovative idea would be the sale of an insolvent insurer’s estate, or some substantial portion of it, to a firm that would assume the insurer’s obligations. Assuming the estimated value of the assets exceeded the estimated value of the liabilities, the firm would be paid an amount sufficient for it to be willing to assume the obligations of the insurer. Such transactions could be subject to competitive bidding to transfer obligations at the lowest possible cost.

A variation of this approach would be to sell certain claims to a firm that would assume the obligation of these claims in return for a lump-sum payment. This might bear some similarity to loss portfolio transfers. It would seem to offer the greatest benefits for long-tail claims that would obviate the need for a receivership to remain open to pay these claims.

Renewing the Drive for Reform

The receivership system has proven to be the most difficult area of insurance regulation to reform. Several factors contribute to this challenge, including its lack of saliency with the public, its complexity and the strong vested interests in the status quo. One needs only to review the historical record on the opposition to previous efforts to achieve even modest improvements to understand the fierce resistance to change. Unfortunately, the historical and potential future costs of this inertia are not readily apparent to the public

and most public officials. Economic events could alter the climate of inattention, but it would be preferable to address the structural flaws and problems before a major scandal or crisis occurs. The efforts of some regulators within the NAIC to improve the system are commendable, but there is a need to go much farther. Indeed, past experience suggests that even these efforts may be thwarted. Strong leadership from state and federal officials is needed to increase public awareness of the importance of insurer receiverships and drive a substantive reform program. Hopefully, this report will contribute to a growing drumbeat for action.