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What happens if the solvency measures don't work?

by Greg Jacobs

Much has been written and many discussions have been undertaken on the subject of insurance company solvency. As a result of the most active period of insurance company insolvencies since the 1930s, the actuarial profession and insurance regulators have put their energies into developing several solvency measures. Among these measures are the new valuation law and the asset adequacy analysis, risk-based capital, and stricter reinsurance regulations.

Actuarial meetings repeatedly have focused on solvency — improved capital management techniques, a renewed emphasis on proper product pricing, expense control measures, and monitoring and improving investment performance.

Insurance commissioners, through the National Association of Insurance Commissioners (NAIC) or on their own, have worked on risk-based capital standards and stricter reinsurance regulations. They also have taken a hard look at the financial examination process. Insurance department budgets have increased substantially over the past five years. The accreditation process has, to some extent, spurred this increased interest in solvency issues.

Much high quality work and thought have gone into these measures.

What if a company becomes insolvent?

If an insurance company ends up in the hands of a department's insolvency office, the insurance industry is faced with rehabilitation or liquidation. The United States has a state guaranty fund network for life and health insurers and for property and casualty insurers. Many, however, have expressed concern about the U.S. guaranty fund network. Never has it been so tested as in the past three to four years.

In Canada, a federally incorporated private company administers a protection plan, established in 1988. The plan replaced a network similar to the one now in place in the United States. Preliminary indications from Canada are that the new plan is well received and is working effectively.

Background on U.S. state guaranty fund network

Each state now has a guaranty association. The association is a nonprofit entity empowered by the NAIC Life and Health Insurance Guaranty Association Model Act. The original model act, adopted in 1970, has been revised many times. Individual states have altered the terms of the model act, so there is a lack of uniformity across state lines.

Never has (the U.S. guaranty fund network) been so tested as in the past three to four years.

Usually, all insurers licensed in a state are members of that state's guaranty association. The association, a legal entity, can exercise its rights to enter into contracts, make personnel decisions, sue or be sued, and borrow money. It is directed by the insurance commissioner and a board made up of senior management of its member companies. The association's primary function when faced with an insolvency is to provide coverage to the policyholders, up to the maximums defined in the law. Coverage is provided from a combination of assets owned by the failed company and assessments made against on-going solvent carriers in that state.

Normally, a guaranty association's coverage extends to residents only. However, many states cover all policyholders if the failed company was domiciled in its state. The maximum amount covered varies by state and by line of business. The typical coverage limit is $100,000 in cash values or $300,000 for all benefits. The association can assess its members some percentage of premium written in that state. The percentages vary, from as low as 1% to as high as 4%. The amount assessed usually can be used as a premium tax offset.

It is interesting that the model act includes a prohibition against advertising that such coverage exists.

The guaranty association of the state of domicile takes the lead in the rehabilitation or dissolution of the failed company. To help coordinate the efforts of the lead association and all participating associations, the National Organization of Life and Health Guaranty Associations (NOLHGA) was formed in 1983. Through its Disposition Committee, NOLHGA streamlines the process of covering the policyholder liabilities and settling the transfer of assets between the various participating associations.

CompCorp

Formed in 1988 and operating in early 1990, the Canadian Life and Health Insurance Compensation Corporation (CompCorp) protects Canadian policyholders of member companies against loss of benefits. CompCorp is a federally incorporated, nonprofit company. Membership in CompCorp is voluntary (at least initially) and is open to all life and health carriers in Canada that meet certain financial requirements. It is expected that the federal and provincial governments will require membership before a company can conduct business in a province.

If a member company fails, CompCorp will either cash out the policyholder's contract or find replacement coverage, both with certain limits. The three limits are:

- Class A — Life Policies and Accumulation Products
  $200,000 in life protection
  $ 60,000 in cash withdrawals
- Class B — On-Benefit Annuities and

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Solvency measures cont'd

Disability Income
$2,000 monthly income

- Class C — Health Benefits other than Disability
$ 60,000 in total payments

Some benefits are not covered at all.

Post-funding assessments are made against the members' average annual premium from covered policies in Canada, with the maximum being 0.5% per year. Assessments can be made for as long as needed to cover an insolvency.

Finally, member companies can advertise that CompCorp coverage exists.

Criticisms of the U.S. system

The U.S. state guaranty association system has had much criticism levied against it. Some of the concerns expressed are:

- Lack of uniformity of coverage
- Lack of coverage for some lines of business
- Inefficiencies in handling large, multi-state, multi-line insolvencies
- Potential capacity problems
- Non-risk-based assessments
- Lack of pre-funding

These criticisms have spawned many alternative proposals. Some have come from industry trade groups (an ACLI Study Group report, October 1991); some have come from the federal government (Senator Metzenbaum's Insurance Protection Act of 1991); others have come from the life and health industry.

View of best system

These concerns have caused the insurance industry and the actuarial profession to ask what would make a better guaranty fund system. My view of the "best system" includes six characteristics:

1) The cost of insolvencies should be borne by those presenting the most risk.

One of the guiding fundamentals of insurance pricing is risk classification. Individuals with higher expected mortality or morbidity should pay higher premiums than those with lower expected mortality or morbidity. The same should hold true for insolvency costs. Assessments for insolvencies could be based on a percentage of a company's risk-based capital. This idea could lead to some form of pre-funding to get some assessments while the carrier is taking the risks, as opposed to only assessing the surviving carriers.

The only acceptable form of pre-funding would include an experience refund provision to return unused and unneeded assessments.

2) The coverage granted in an insolvency should be consistent with the coverage that is lost.

An insured that loses his or her protection (life insurance, disability insurance, health insurance, guaranteed insurability, benefit payments) should be restored with similar replacement coverage, with some limits. These limits should apply only in situations where the insured was receiving protection beyond what would reasonably be provided given the premium dollars paid for such coverage. This would require a reduction in benefits in situations where the insolvent carrier underpriced the coverage. This implies that a "reasonable price for benefits" could be established.

The cost of insolvencies should be borne by those presenting the most risk.

If an insured loses his or her investment (accumulation annuity, GIC), a guarantee similar to the FDIC or SIPC should be put in place. This will place insurance investment products on a level playing field with other investment alternatives. Limits also should be placed on these coverages in situations where higher than reasonable interest rates were either illustrated or guaranteed.

The limits in both the loss of protection and the loss of investment cases are premised on establishing reasonable prices or interest rates. These could be set at the mean or median price or interest rate of insurers with an adequate market share in the particular line of business, or they could be set by the board of the national association.

3) Both the assessment function and the providing of coverage should be directed at the national level, consistent across state lines.

The NAIC or NOLHGA or some future national (member-owned, not-for-profit) entity should direct each of the existing state guaranty associations to provide the manpower in an insolvency.

4) Membership in the national association would be by application, not automatic.

Certain financial measures and an acceptable business plan would be required to become a member of the national association. Publicizing membership in the association would be permitted and encouraged.

5) Federal income taxes should apply only to net assessments (assessments less refunds).

Assessments made into the system would be tax deductible, while refunds received would be included in taxable income. Assuming there would be some insolvencies, the net assessments would create an overall federal tax deduction.

6) Assessments made would not be offset by premium tax reductions.

The net cost of the assessments would be a "cost of doing business" and would be passed on to the policyholder.

This is only one view, expressed to challenge the U.S. actuarial profession to think about alternatives to the current guaranty system. Although I chair a special Society task force researching this issue, the ideas in this article are mine and not those of the task force.

The mission of the Society's Task Force for Research on U.S. Life Insurance Insolvency Guarantees is to "suggest ideas for improvement to the current life insurance insolvency guarantee system in the United States and to offer practical suggestions for implementation of any new program." I invite interested individuals in the profession to agree or disagree, modify or revise, or otherwise contribute to the discussion on this important topic. We are looking for individuals to help the task force in its charge. Please let me know if you can help.

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