PAYING FOR POLICYHOLDER PROTECTION: AN ESSENTIAL COMPONENT OF STATE INSURANCE REGULATION

The Guaranty Fund Perspective

IAIR Workshop

March 10, 2021

Agenda

- Legal Foundations
- Property & Casualty Perspective
- Life, Health & Annuity Perspective
- Discussion/Questions

Speakers

- **Amy Clark** – Vice President of Administration & CFO, NCIGF
- **Caryn Glawe** – Partner, Faegre Drinker Biddle & Reath
- **Barry Miller** – Executive Director, Delaware P&C Insurance Guaranty Association and Controller, Delaware L&H Guaranty Association
- **Paul Peterson** – Vice President, Accounting and Finance, NOLHGA
- **Roger Schmelzer** (Moderator) – President, NCIGF

Legal Foundations

Caryn Glawe, Faegre Drinker

Guaranty Association/ Funds

- Created Under State Law to Provide Protection When Insurer Fails
- Essential Component of the State-Based Insurance Regulatory/Solvency System
- Must Maintain Operations Even When Insolvency Activity is Low
- Dodd-Frank Title II: Systemic Liquidations at State Level
- Authority to Hire Employees, Engage Service Providers
- Authority to Join NOLHGA and NCIGF

Expenses

- Sources of Funding
  - Assets of Insolvent Insurer
  - Member Insurer Assessments
    - Tax Offsets
    - Policyholder Surcharges
  - Statutory Deposits
  - Investment Income

Creditor of Insolvent Insurer

- Types of Claims
  - Administrative Expense
  - Policyholder Coverage
  - General Creditor (e.g., Unpaid Assessments)
- Priority
  - Expenses of Liquidation
  - GA Administrative Expenses (Same or Just Below Expenses of Liquidation)
  - Policyholder Claims / GA Claims for Coverage of Policyholders
  - Lower Priority Claims
- GAs Generally Are the Largest Creditor
- Often Assets Insufficient to Satisfy Policyholder Priority Claims

Claim Priority (Examples)

- **Pennsylvania:** Class (a) includes "the expenses of a guaranty association in handling claims"
- **North Carolina:** Class (2) (policyholder level claims) includes "claims of domestic and foreign guaranty associations, including claims for the reasonable administrative expenses of domestic and foreign guaranty associations"

Claim Priority (Examples)

- **Illinois:** Class (a) includes "The reasonable expenses of the Illinois Insurance Guaranty Fund, the Illinois Life and Health Insurance Guaranty Association, and the Illinois Health Maintenance Organization Guaranty Association and of any similar organization in any other state, including overhead, salaries, and other general administrative expenses allocable to the receivership (administrative and claims handling expenses and expenses in connection with arrangements for ongoing coverage), but excluding expenses incurred in the performance of duties under Section 547 or similar duties under the statute governing a similar organization in another state. For property and casualty insurance guaranty associations that guaranty certain obligations of any member company as defined by Section 534.5, expenses shall include, but not be limited to, loss adjustment expenses, which shall include adjusting and other expenses and defense and cost containment expenses. The expenses of such property and casualty guaranty associations, including the Illinois Insurance Guaranty Fund, shall be reimbursed as prescribed by Section 545, but shall be subordinate to all other costs and expenses of administration, including the expenses reimbursed pursuant to subparagraph (ii) of this paragraph (a)."

NAIC Guidance

2004 RITF White Paper

- "Guaranty association involvement should be early enough that the guaranty associations can immediately undertake their statutory duties upon liquidation. As a practical matter, this calls for involvement as soon as it appears that there is a significant possibility of liquidation. This point may be reached even before the insurer is under administrative supervision or in conservation or rehabilitation."
- Balance Benefits of Early Involvement with Costs
- **Goal = Protect Policyholders**

NAIC Guidance

2004 RITF White Paper (Con't)

- GAs Need Information to Prepare to Handle Claims
- GAs Can Assist Receiver in Formulating Plan
- Reduce Delay in Transitioning Claims
- Usually Largest Creditor
- Smooth Transition of Reinsurance
- Planning for Transfer of Life/Health Annuity Blocks

NAIC Receiver's Handbook

Receivers' Expectations for Guaranty Fund/Association Dues and Expenses

(Chapter 6, Section IV)

- Intended to further objective of guaranty funds/associations and receivers working closely together, including pre-liquidation
- Expenses must be reasonable
- Intended to promote consistency
- Principle 1: Some fixed costs will be incurred regardless of pending receiverships and should not be charged to estates
- Principle 2: Expenses must be documented clearly to support Receiver's reporting to the Court
- Principle 3: Guaranty funds/associations should be aware of Receiver's reimbursement guidelines for travel

Potential Issues

- Differences Across the System
- Pre-Liquidation Expenses
- “Overhead” Expenses
- NOLHGA and NCIGF Membership Expenses
- Requirements/Expectations of GA State Regulator vs. Receiver
- Tax Offsets/Policyholder Surcharges
- Scope of Administrative Expense Priority
- Cost of Resolving Disputes Over Expense Reimbursement

P&C Perspectives

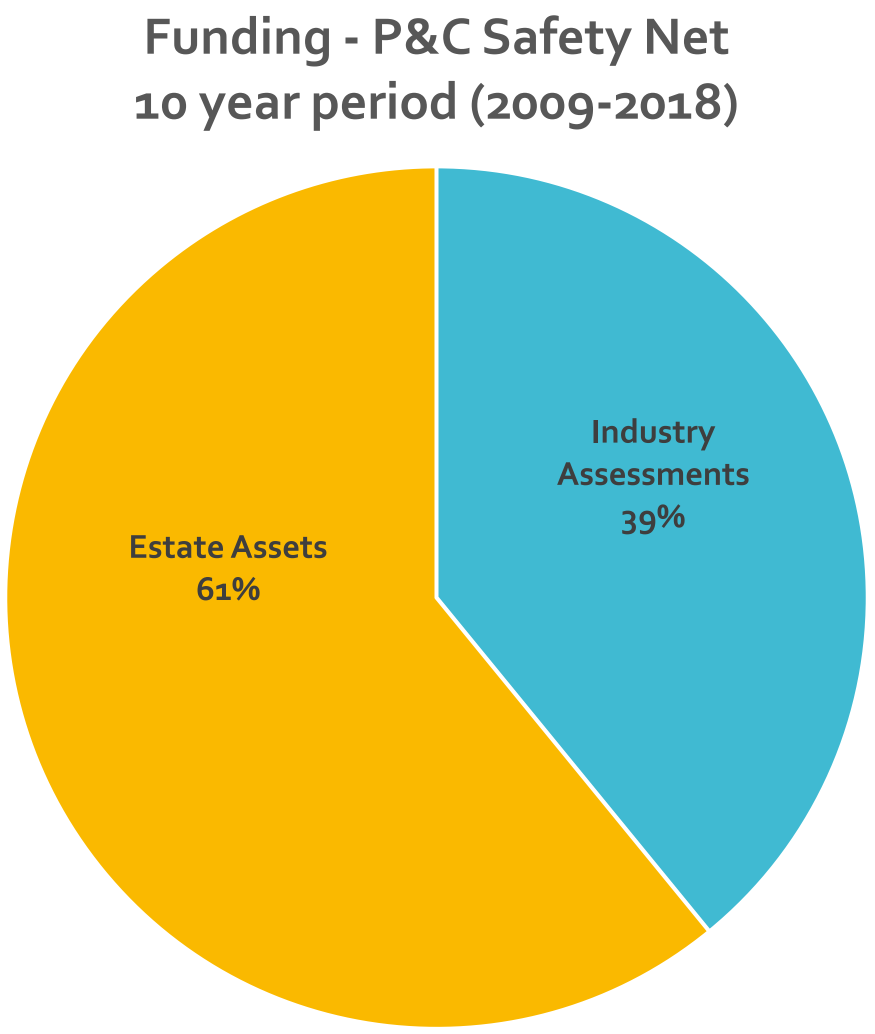
Amy Clark, NCIGF

Barry Miller, Delaware P&C and Life/Health GAs

Where Does the Funding Come From?

Insolvency	Payouts (In Billions)	Recovery
Reliance Ins. Co.	$3.5	65%
Legion Ins. Co.	$1.8	62%
Freemont Indemnity	$1.3	61%
California Compensation	$1.2	47%

Where Does the Funding Come From?



Estate Asset Distribution

- Determined by State Laws
- Guaranty Fund Expenditures
  - Policyholder Claims
  - Claimant Claims
  - Administrative Expenses

Factors Related to Guaranty Fund Administrative Costs

- Operate Pursuant to Prudent Business Judgement
- Overseen by Guaranty Fund Boards
- Also Overseen by Insurance Department Personnel

Efforts to Mitigate Costs

- 30 (Over Half) of all P&C Associations involved in Cost Sharing Agreement
  - Multi-State Management
  - Joint P&C and Life & Health
  - Shared Resources
  - Handle other State Funds

Reporting of Guaranty Fund Payments / Expenses

- NAIC Uniform Data Standards (UDS)
  - Fund to Receiver Records
    - UDS “C” Loss, Loss Expenses, UEP, and other Claim Specific Data
    - UDS “D” Financial Reporting

UDS "D" Section 1 Claim File Information

- Loss Claim Payments
- Unearned Premium
- Defense and Cost Containment
- Adjusting and Other
- Other Claim Related Expenses and Reserves
- Ties to UDS "C" Records submitted

UDS "D" Section 2 Administrative and Claim Expense not Directly Charged to a Claim

- Claims Adjusting Expenses for non-employee (TPA)
- Medical Cost Containment
- Administrative
  - Employee, Legal, Professional, Travel, Rent, and Other Expenses
- Other Line Items that can be Customized

UDS “D” Section 3 Estate Related Revenue Items

- Special Deposits
- Receiver Distributions
- Other Receipts (not reported on the UDS “C” record)
- Other Line Items that can be Customized

Guidance from the Accounting Guidelines Manual

- Acceptable Allocation Methodology
  - Labor Hours
  - Claims Paid
  - Statutory Account

Allocation Using Labor Hours

The total labor hours allocated to an individual insolvency are divided by the total labor hours worked, excluding the “other” category, in the month to create the allocation percentages.

	HOURS	***ADMIN EXP ALLOCATION***
INSOLVENCY A	32	23%
INSOLVENCY B	28	20%
INSOLVENCY C	40	29%
INSOLVENCY D	24	17%
INSOLVENCY E	16	11%
TOTAL HOURS	140	100%
ALL OTHER	20	
TOTAL HOURS	160	

Allocation Using Claims Paid

8.3 Allocation Methodology for Indirect Administrative Expenses Based on Claims Paid

The allocation of indirect administrative expenses may be based upon the ratio of claims paid (which would include return premium, loss and DCC/AO payments), to the total payment for claims in each accounting period. It is recommended that these allocations be prepared on a monthly or quarterly basis.

Allocation to the individual insolvencies and statutory accounts is based upon the ratio of total claim payments for each insolvent company by statutory account to the total of all claim payments in each accounting period and is calculated in the example below, with total claims paid of $150,000:

Insolvent Company/Statutory Acct.	***Total Claim Payments***	***Percentage/ Ratio***
Insolvency A/Auto Acct.	$30,000	20%
Insolvency A/Other Acct.	$45,000	30%
Insolvency B/Workers Comp Acct.	$25,000	16.7%
Insolvency C/Auto Acct.	$15,000	10%
Insolvency C/Other Acct.	$35,000	23.3%
Totals	$150,000	100%

Each indirect administrative expense is distributed to the individual insolvency by statutory account based on the percentages determined above for each accounting period as indicated below:

	Total	Insolvency A Auto	Insolvency A Other	Insolvency B W/C	Insolvency C Auto	Insolvency C Other
Employee Exp	$4,000	$800	$1,200	$667	$400	$933
Office Rent & Utilities	$2,000	$400	$ 600	$333	$200	$467
Other Office Exp	$1,300	$260	$ 390	$217	$130	$303
Professional Exp	$1,700	$340	$ 510	$283	$170	$397
Travel & Meeting Exp	$1,000	$200	$ 300	$167	$100	$233
Totals	$10,000	$2,000 (20%)	$3,000 (30%)	$1,667 (16.7%)	$1,000 (10%)	$2,333 (23.3%)

Allocation Using Statutory Account

8.4 Allocation Methodology for Indirect Administrative Expenses Based on Statutory Account

This method is used in conjunction with one of the previously mentioned methodologies for allocating administrative expenses to one statutory line of business. GFs that maintain accounting records by statutory account will on occasion have expenses that should only be allocated to one statutory account, for example if an actuary were retained to evaluate your Workers Comp claims this expense should only be allocated to insolvencies with Workers Comp exposure.

Depending on your method of allocation, either Claims Paid or Time, you would need to capture this data by statutory line of business. An individual insolvency allocation would be based on a percentage of the total. It is recommended that these allocations be prepared on a monthly or quarterly basis.

Examples:

Received a $30,000 invoice for actuarial services for Workers Comp

Claims Paid:

Total WC

Insolvent Company	Claim Payments	Percentage/Ratio	Allocation
Insolvency A	$ 10,000	20% (10/50)	$6,000 ($30,000*.20)
Insolvency B	$ 15,000	30% (15/50)	$9,000 ($30,000*.30)
Insolvency C	$ 25,000	50% (25/50)	$15,000
	$ 50,000	100%	$30,000

Time:

Total WC

Insolvent Company	Time	Percentage/Ratio	Allocation
Insolvency A	100 hours	20% (100/500)	$6,000 ($30,000*.20)
Insolvency B	150 hours	30% (150/500)	$9,000 ($30,000*.30)
Insolvency C	250 hours	50% (250/500)	$15,000
	500 hours	100%	$30,000

Unallocated Administrative Expenses

- Recently Added to the Guidelines
- At the Discretion of:
  - Individual Guaranty Fund Boards
  - Plan of Operation
  - Statute

Options for Addressing Unallocated Administrative Expenses

- Use of Net Investment Income not Allocated to Insolvencies to Maintain a General Operating Account
- Use of an “Inactive” Account
- Use of an Administrative Assessment if Permitted by Statute

Items that Cause Variances in Expense Ratios by Jurisdiction

- Claims Volume
- Block of Business
- State Differences in Defense and Claims Parameters
- Domicile of Insolvent Carrier
- Other Factors

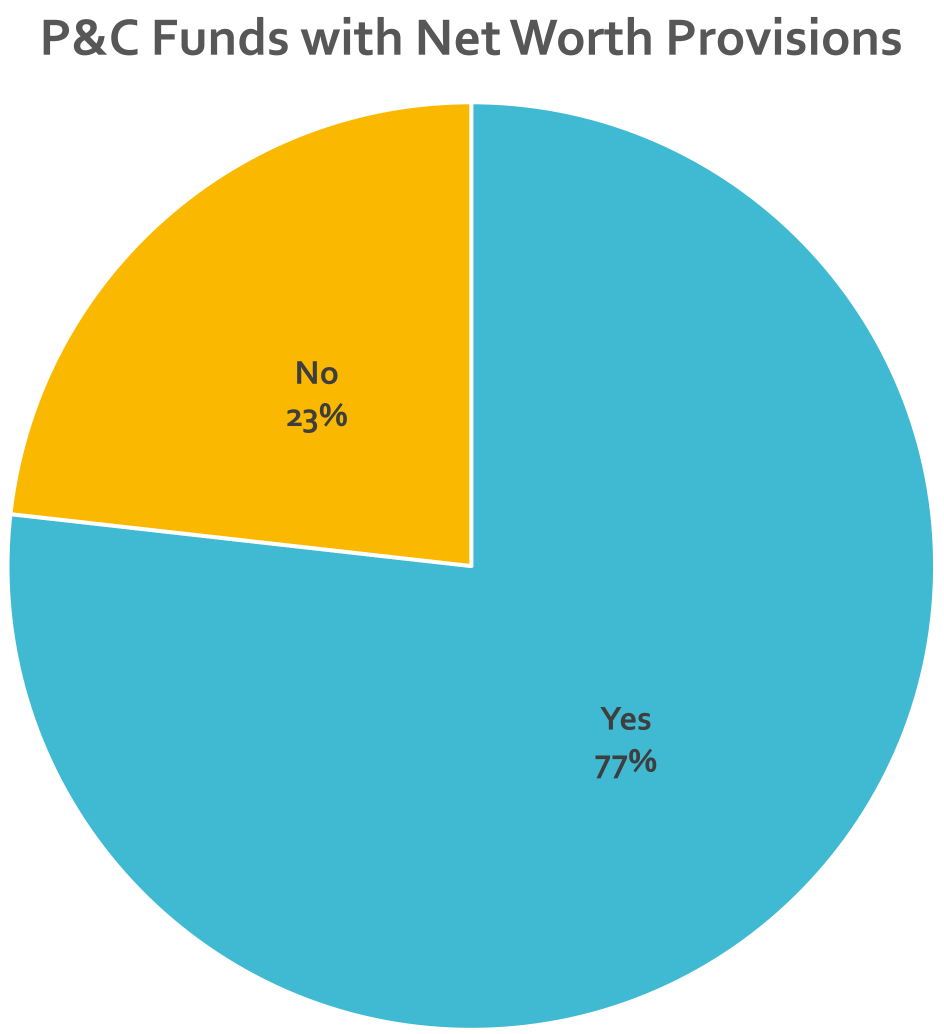
Block of Business

- Complex Commercial Liability
  - Open Longer
  - Complex Issues
  - Cap Restrictions
- Auto
- Workers Compensation

State Differences in Defense and Claims Parameters

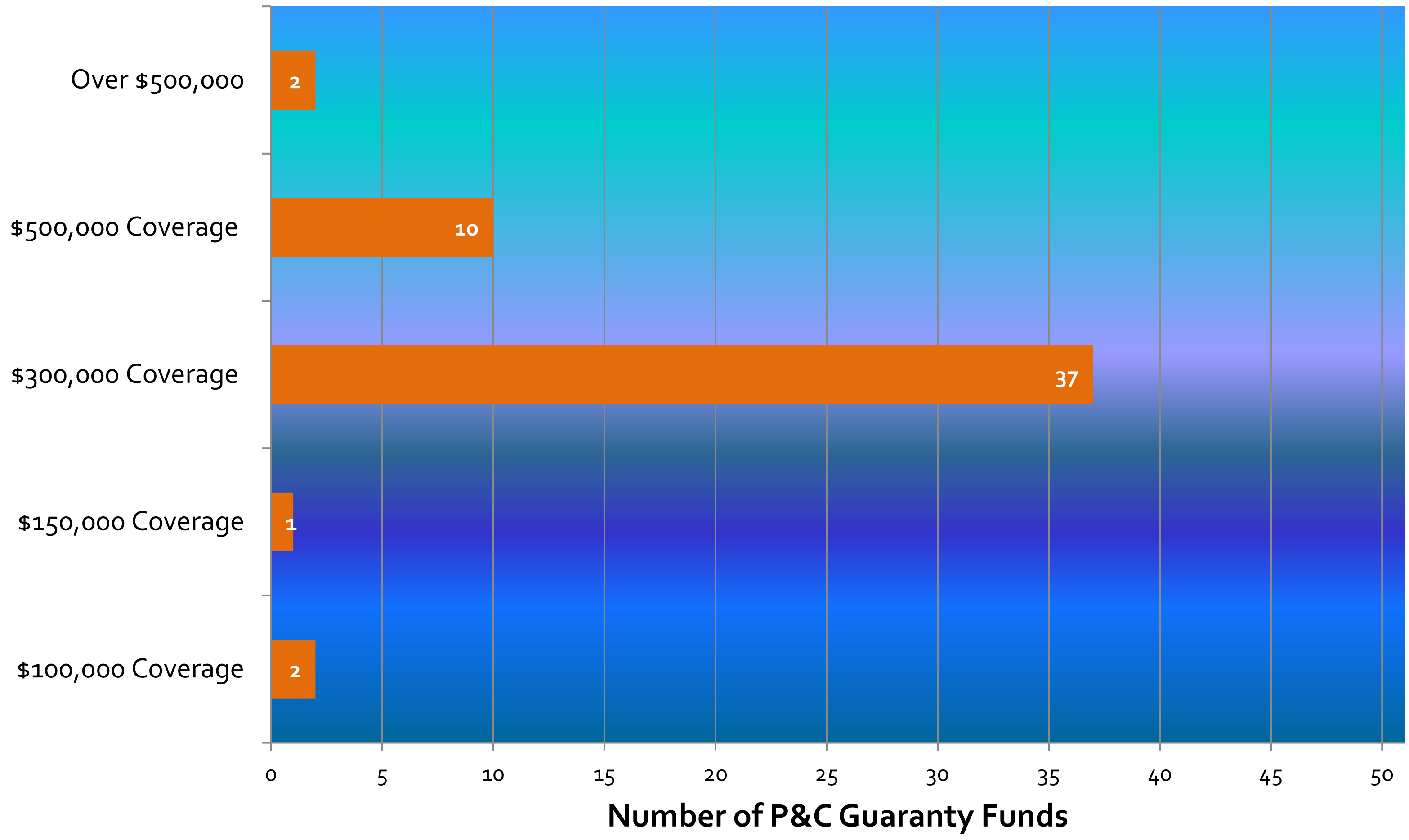
- Statutory Defenses
  - Exhaustion of Other Coverage
  - Net Worth Limitations
  - Caps on Some Blocks of Business

State Differences in Defense and Claims Parameters



State Differences in Defense and Claims Parameters

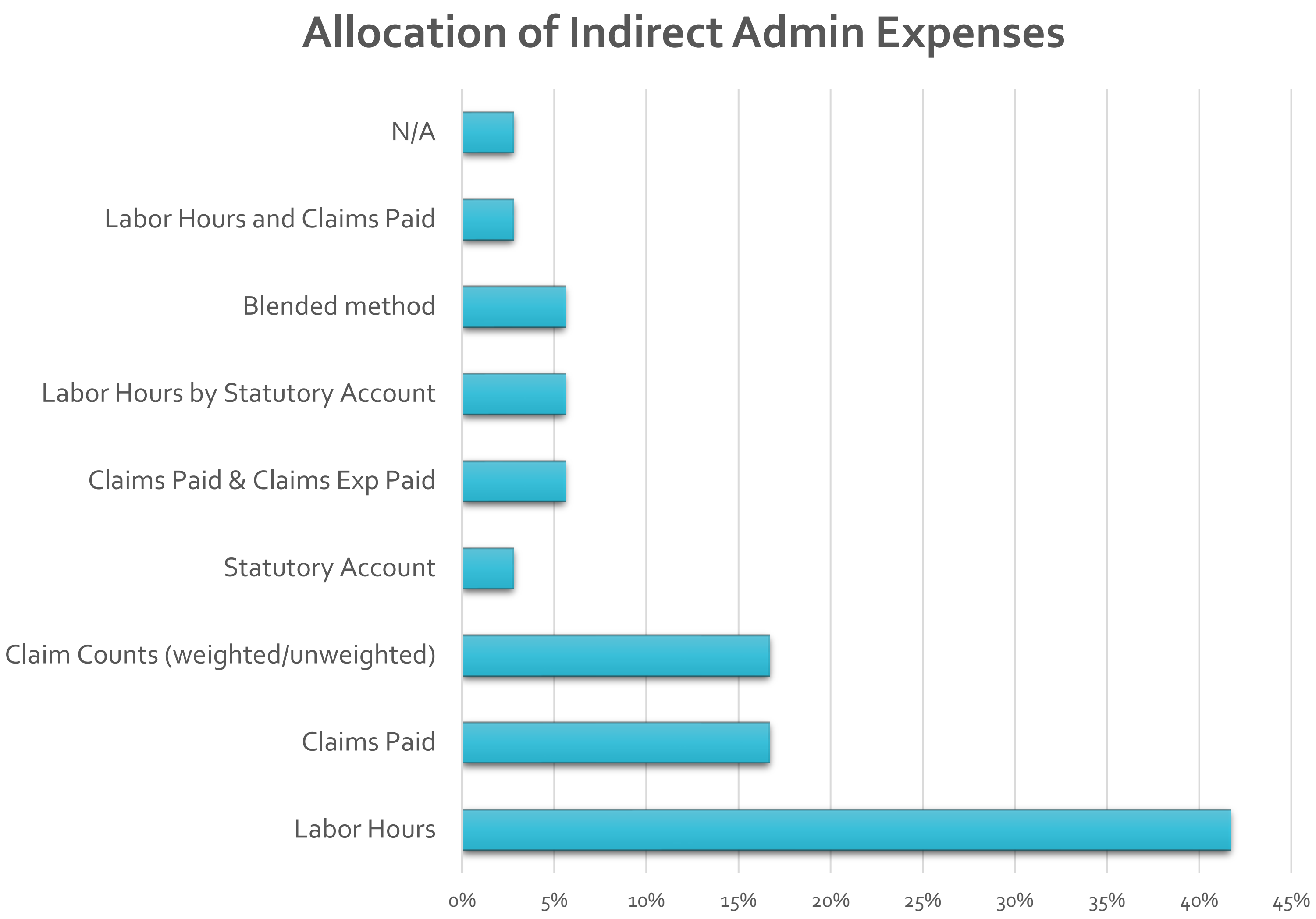
P&C Claim Caps for All Lines of Business (Except Workers' Compensation)



Other Factors

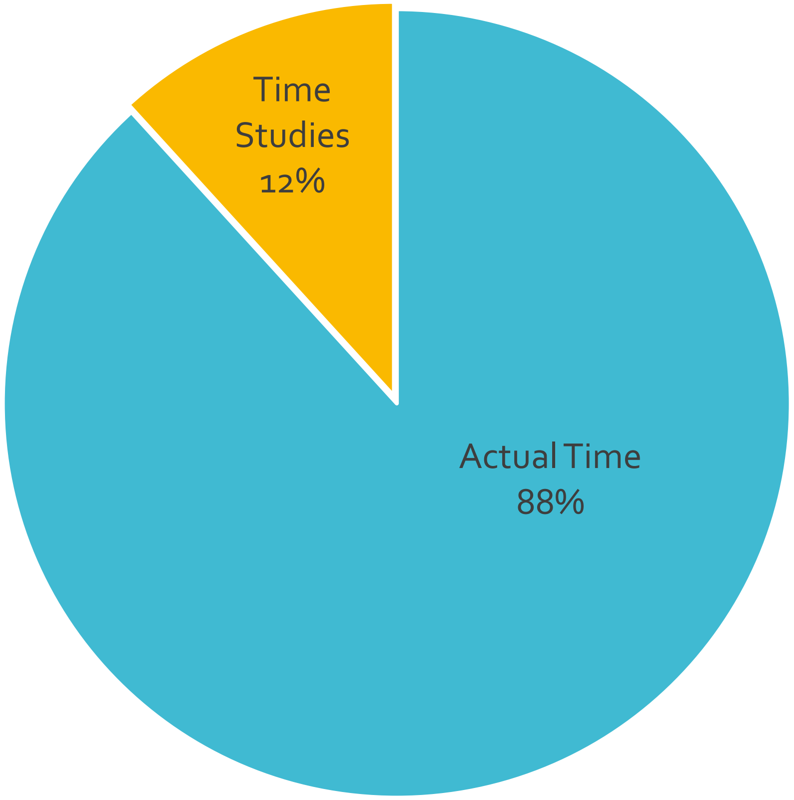
- Guaranty Fund Expense Allocation Method
- Geographical Cost
  - Varying Defense Cost
  - Length of Time to Settle Cases
- Complexity of Estate
  - Handling of Large Deductible Claims

Recent Survey of Guaranty Association Administrative Expense Practices



Recent Survey of Guaranty Association Administrative Expense Practices

Allocation Methodology - Labor Hours



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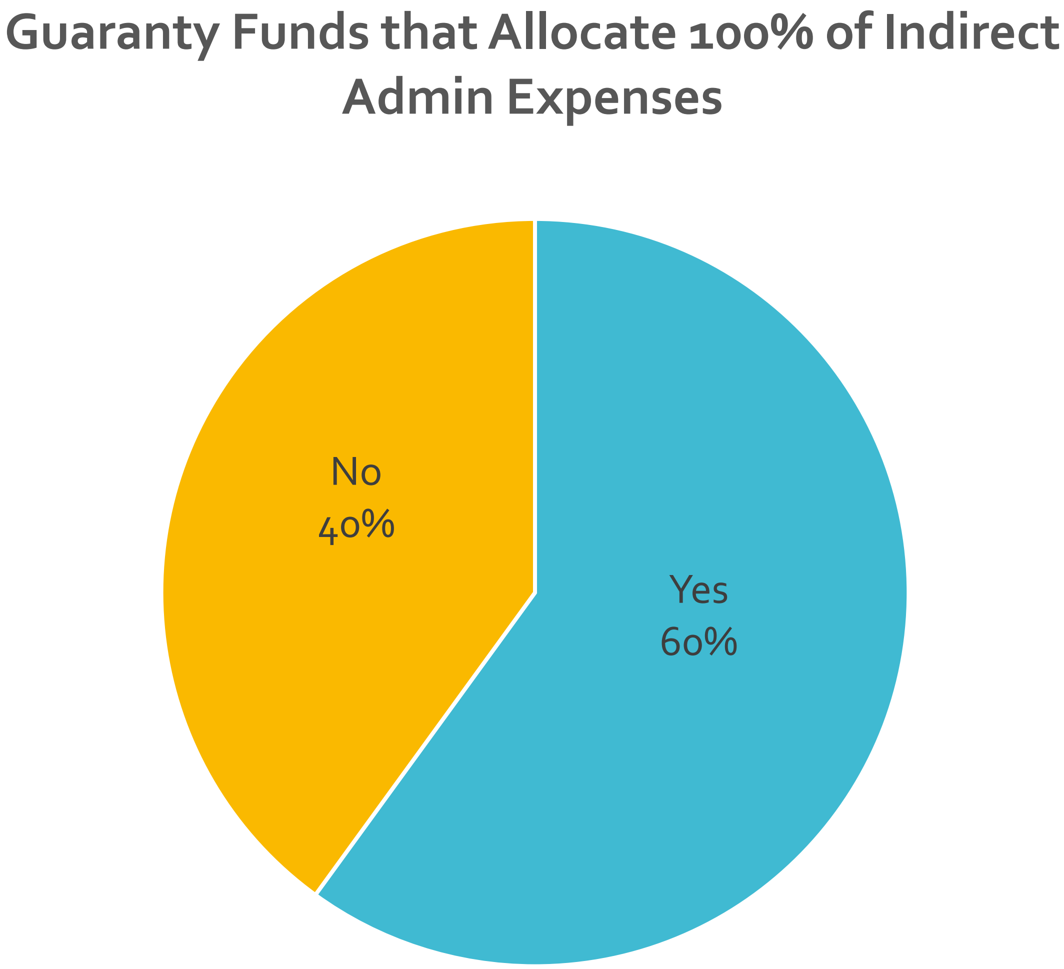

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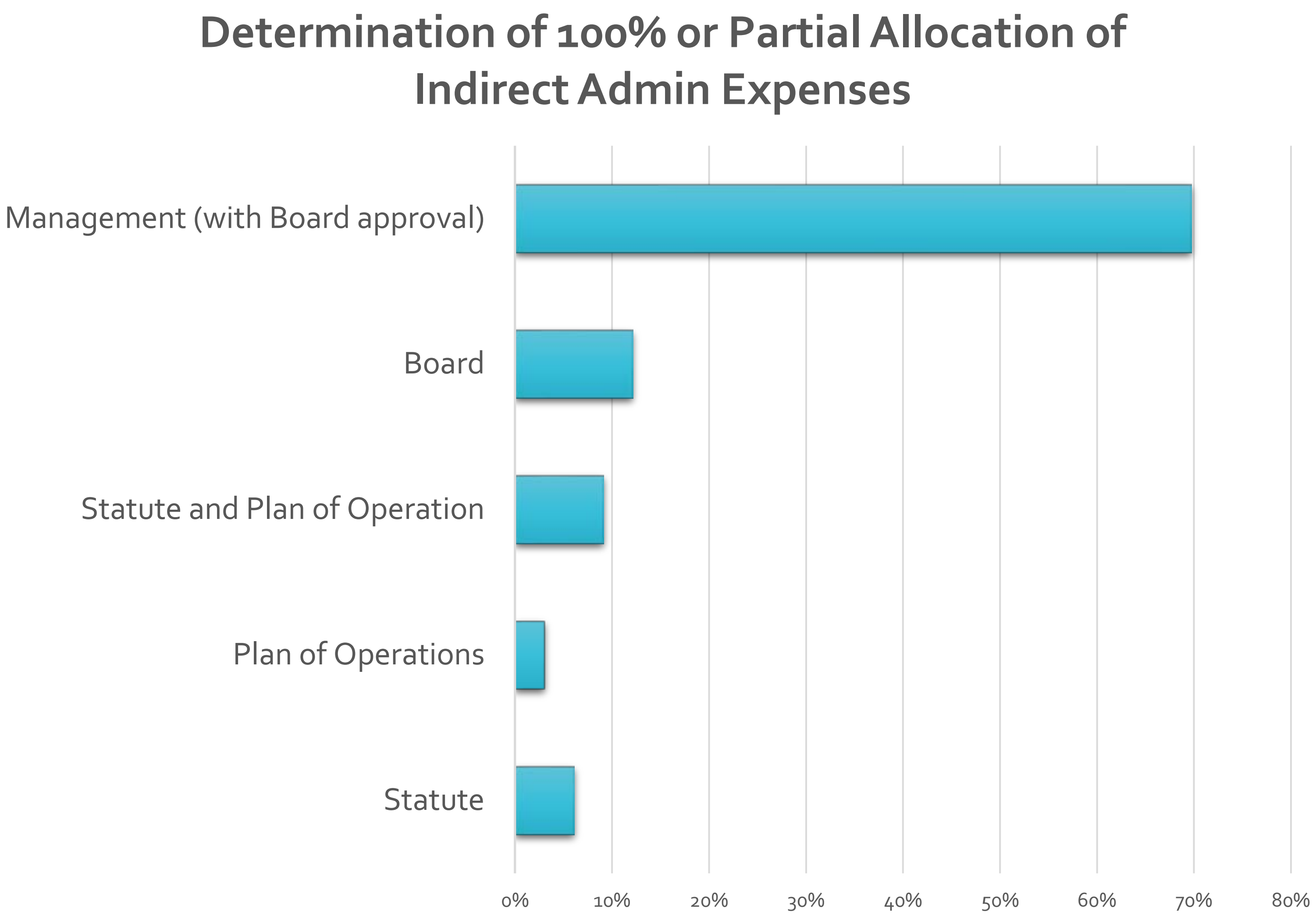

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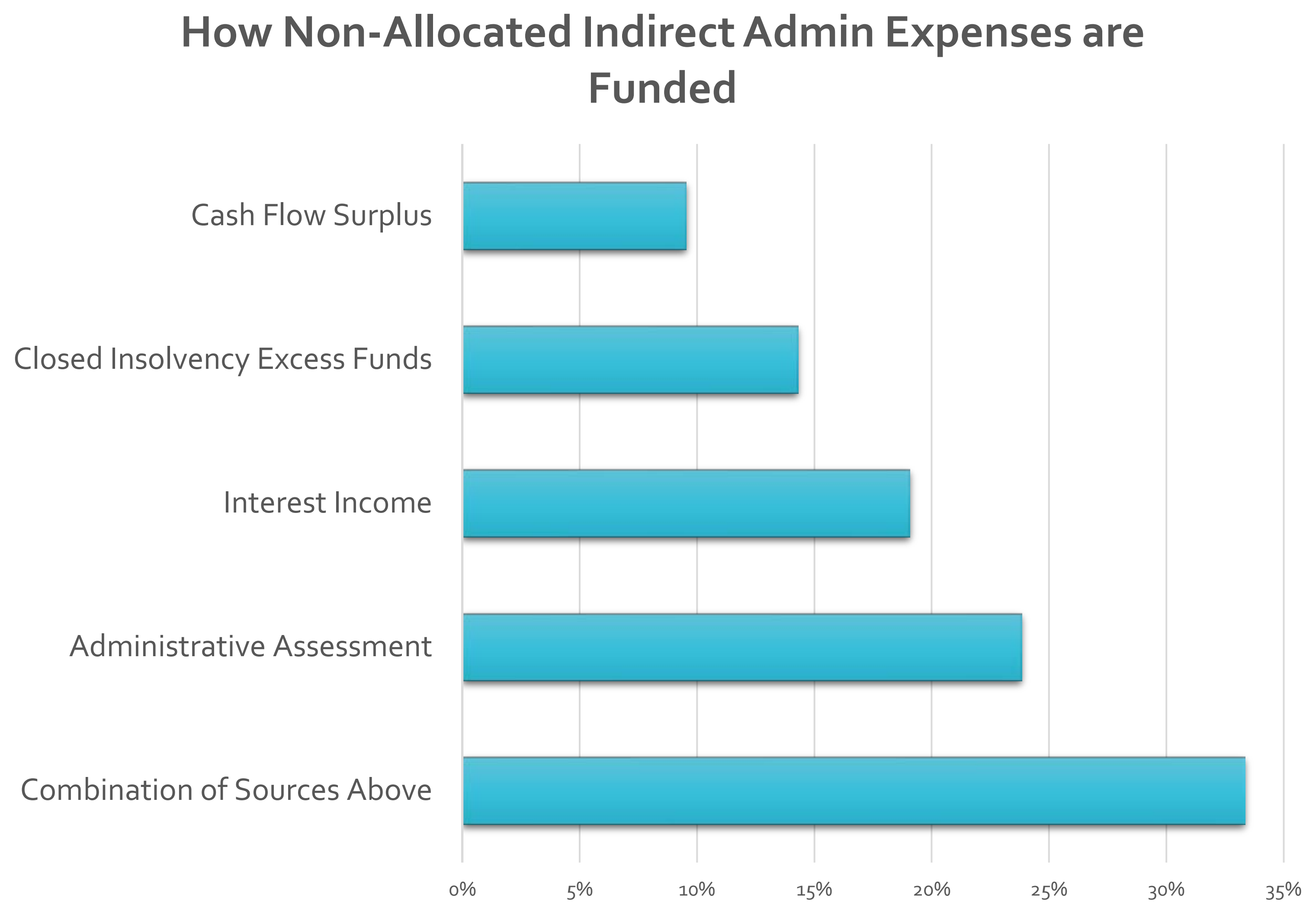

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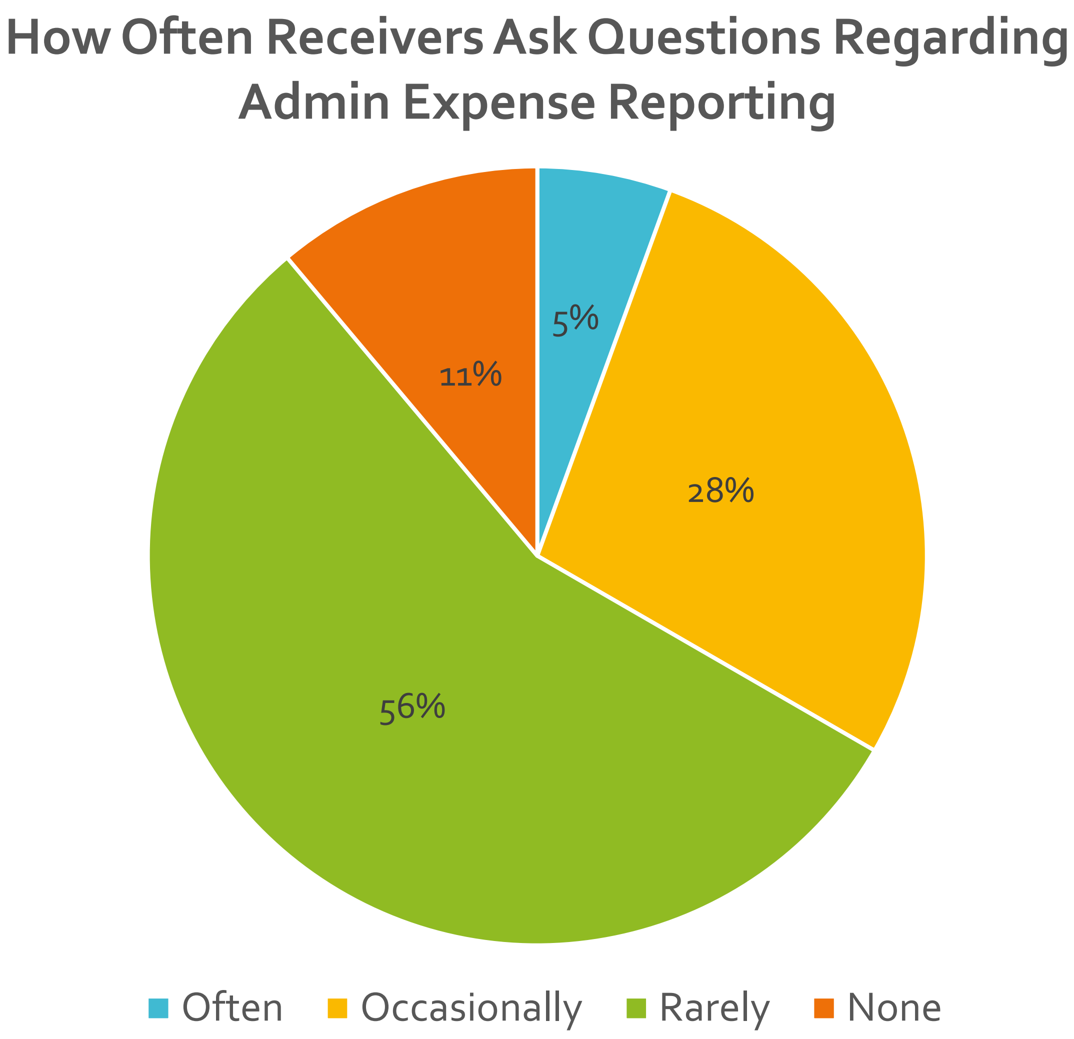

Life, Health & Annuity Perspectives

Paul Peterson, NOLHGA

General Background

- Life, Health and Annuity Guaranty Associations (LHAGA) are independent entities from NOLHGA and most Insurance Departments
- LHAGA's vary in size and setup:
  - Most only have 1-2 people
  - A few administer multiple association types - life, HMO, P&C (AZ, DE, GA, IL, IN, MO, OH, WI). A few have larger staffs (TX) so can perform inhouse administration if needed
  - Many administrators work at law firms as primary job, so setup is within the law firm
  - A few are part of Insurance Department
- UDS is NOT utilized by LHAGA's

General Background

- Type of arrangement may lead to different approaches as to expense allocation:
  - Can be an employee or have an independent contractor arrangement
  - If independent contractor, some may only allocate direct time billings to given cases along with other direct charges
  - Other independents may allocate certain "office/overhead" to cases in addition to time or direct expenses
  - Similar alternative approaches if an employee setup
  - Allocation process may be impacted by Insurance Department and/or LHAGA Board

General Background

- Level of expense allocation is more a "philosophical position" as opposed to an accounting process:
  - - Some view sole existence of LHAGA is to provide coverage to policyholders, thus all expenses are eligible for allocation
  - Others view expenses as a "cost of doing business" in a state and thus don't allocate at all
  - Most are somewhere in between the above
  - Materiality will impact decision

General Background

- Life, Health, Annuity Guaranty Associations operate and handle insolvencies differently from P&C counterparts
- LHAGA's have an ongoing obligation beyond the liquidation date to continue insurance policies unless they are cancellable (only certain health)
- Typical approach is to fund the transfer of blocks via assumption transactions, avoids ongoing administration
- Recent years have seen a growth in ongoing administration cases (LTC, poor records etc.)
- If ongoing admin, generally done via outside TPA, not inhouse. Use either existing receiver and staff, move to new TPA and in some cases formed guaranty association captive

Task Force Concept

- Multi-state cases will involve establishment of Task Force
- Task Force made up of GA administrators
- Primary purpose is to develop a plan to handle policies of any given case that may be adopted by the entire system
- Brings consistency to approaches how to handle policies
- On life side, states have a "shared expense" concept to develop plan nationally as opposed to each state handling
- May have expenses charged to case by Task Force states that don't have obligations…this is not unusual
- States will still incur expenses to review plans, policy data etc. developed by Task Force

Types of Expenses

- NOLHGA – staff time, consultants, some overhead
- GA expenses – direct and indirect.
- NOLHGA Accounting Guidelines Manual:
  - Recommends Guaranty Associations Use Time
    - "Actual employee time analysis is the recommended method for guaranty fund indirect administrative expense allocation".
  - Provides detailed guidance for using time allocation
- MPC Study Group endorsed this approach

Expense Methodology Guideline

- Captures data for POC expense submission categories and line of business reporting
- Assumes admin fund (non-insolvency work) time is NOT allocated to insolvencies
- Assumes all expense categories are allocable
- Direct vs. indirect expense allocation
- Direct – charged to specific insolvency and possibly line of business.
  Examples:
  - Travel to meetings
  - NOLHGA insolvency-related assessments
  - Professional services (TPA, accounting, actuarial, legal)

Recommended Expense Methodology

- GA Indirect:
  - Time based allocation methodology
  - Expense categories may include: salaries, taxes, benefits, rent, insurance, non-task force travel, NOLHGA dues/data survey, overhead items such as: postage, telephone, dues & subscriptions
- Some expenses can be either direct, indirect or both (example: travel, legal)
- State-based system – some allocate, some don't'!!
- GA's are independent entities, NOLHGA can't "force" adoption of certain accounting/reporting processes

NOLHGA Omnibus Proof of Claim Process

- NOLHGA Omnibus POC Process In Use Since 2002
  - Expense categories and terminology largely based on NAIC UDS
  - GAs report expense electronically on NOLHGA POC System
- NOLHGA compiles results for all GAs
- NOLHGA Files Omnibus Proof of Claim with Receiver and serves as initial point of contact to respond to Receiver questions and issues
- Process results in standardization of reporting in terms of type of expenses reported and terminology used

POC Reporting Format

GA Expenses (direct and indirect):			Other Expenses:	
Employee/Contractor	$ 0		Interest	$ 0
Office Rent & Utilities	$ 0		Unpaid Assessments	$ 0
Other Office Expenses	$ 0		Investment Management Fees	$ 0
Accounting/Audit	$ 0		Bad Debt Expense	$ 0
Legal	$ 0		Other (explain)	$ 0
Actuarial	$ 0		Explanation of Other	
TPA	$ 0			
IT	$ 0		NOLHGA Related Expenses:	
Other Professional	$ 0		Quarterly Insolvency Expenses	$ 0
Furniture & Equipment/Depreciation Expense	$ 0		Annual Dues Allocation	$ 0
Meetings & Travel	$ 0		Data Survey Allocation	$ 0
Insurance	$ 0			
Cost Allocation Method			Total All Expenses	$ 0
Explanation of Allocation Method if "Other"				

Reporting Format

- Explanation of Allocation Methods:
  - Claim counts
  - Claim Dollars
  - Reserves
  - Time
  - Other (ex: combination of time and claim volume)
- For states that allocate expenses, TIME used in virtually all
- Overall, GA and NOLHGA expenses app. 2% of covered obligations

Discussion & Questions

Panel