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”
• **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
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
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
<table>
<thead>
<tr>
<th>Insolvency</th>
<th>Payouts (In Billions)</th>
<th>Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reliance Ins. Co.</td>
<td>$3.5</td>
<td>65%</td>
</tr>
<tr>
<td>Legion Ins. Co.</td>
<td>$1.8</td>
<td>62%</td>
</tr>
<tr>
<td>Freemont Indemnity</td>
<td>$1.3</td>
<td>61%</td>
</tr>
<tr>
<td>California Compensation</td>
<td>$1.2</td>
<td>47%</td>
</tr>
</tbody>
</table>
Where Does the Funding Come From?

Funding - P&C Safety Net
10 year period (2009-2018)

- Estate Assets: 61%
- Industry Assessments: 39%
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
• Loss Claim Payments
• Unearned Premium
• Defense and Cost Containment
• Adjusting and Other
• Other Claim Related Expenses and Reserves
• Ties to UDS “C” Records submitted
• 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
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.

<table>
<thead>
<tr>
<th></th>
<th>HOURS</th>
<th>ADMIN EXP ALLOCATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>INSOLVENCY A</td>
<td>32</td>
<td>23%</td>
</tr>
<tr>
<td>INSOLVENCY B</td>
<td>28</td>
<td>20%</td>
</tr>
<tr>
<td>INSOLVENCY C</td>
<td>40</td>
<td>29%</td>
</tr>
<tr>
<td>INSOLVENCY D</td>
<td>24</td>
<td>17%</td>
</tr>
<tr>
<td>INSOLVENCY E</td>
<td>16</td>
<td>11%</td>
</tr>
<tr>
<td>TOTAL HOURS</td>
<td>140</td>
<td>100%</td>
</tr>
<tr>
<td>ALL OTHER</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>TOTAL HOURS</td>
<td>160</td>
<td></td>
</tr>
</tbody>
</table>
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:

<table>
<thead>
<tr>
<th>Insolvent Company/Statutory Acct.</th>
<th>Total Claim Payments</th>
<th>Percentage/Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insolvency A/Auto Acct.</td>
<td>$30,000</td>
<td>20%</td>
</tr>
<tr>
<td>Insolvency A/Other Acct.</td>
<td>$45,000</td>
<td>30%</td>
</tr>
<tr>
<td>Insolvency B/Workers Comp Acct.</td>
<td>$25,000</td>
<td>16.7%</td>
</tr>
<tr>
<td>Insolvency C/Auto Acct.</td>
<td>$15,000</td>
<td>10%</td>
</tr>
<tr>
<td>Insolvency C/Other Acct.</td>
<td>$35,000</td>
<td>23.3%</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$150,000</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Insolvency A</th>
<th>Insolvency B</th>
<th>Insolvency C</th>
<th>Insolvency D</th>
<th>Insolvency E</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total</strong></td>
<td><strong>Auto</strong></td>
<td><strong>Other</strong></td>
<td><strong>WC</strong></td>
<td><strong>Auto</strong></td>
</tr>
<tr>
<td>$4,000</td>
<td>$800</td>
<td>$1,200</td>
<td>$667</td>
<td>$400</td>
</tr>
<tr>
<td>$2,000</td>
<td>$400</td>
<td>$600</td>
<td>$333</td>
<td>$200</td>
</tr>
<tr>
<td>$1,300</td>
<td>$260</td>
<td>$380</td>
<td>$217</td>
<td>$130</td>
</tr>
<tr>
<td>$1,700</td>
<td>$340</td>
<td>$510</td>
<td>$283</td>
<td>$170</td>
</tr>
<tr>
<td>$1,000</td>
<td>$200</td>
<td>$300</td>
<td>$167</td>
<td>$100</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$10,000</strong></td>
<td><strong>$3,000</strong></td>
<td><strong>$1,667</strong></td>
<td><strong>$1,000</strong></td>
</tr>
<tr>
<td><strong>(20%)</strong></td>
<td><strong>(30%)</strong></td>
<td><strong>(16.7%)</strong></td>
<td><strong>(10%)</strong></td>
<td><strong>(23.3%)</strong></td>
</tr>
</tbody>
</table>
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. FIs 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:**

<table>
<thead>
<tr>
<th>Insolvent Company</th>
<th>Claim Payments</th>
<th>Percentage/Ratio</th>
<th>Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insolvency A</td>
<td>$10,000</td>
<td>20% (10/50)</td>
<td>$6,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>($30,000* .20)</td>
<td></td>
</tr>
<tr>
<td>Insolvency B</td>
<td>$15,000</td>
<td>30% (15/50)</td>
<td>$8,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>($30,000*.30)</td>
<td></td>
</tr>
<tr>
<td>Insolvency C</td>
<td>$25,000</td>
<td>50% (25/50)</td>
<td>$15,000</td>
</tr>
<tr>
<td></td>
<td>$50,000</td>
<td>100%</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

**Time:**

<table>
<thead>
<tr>
<th>Insolvent Company</th>
<th>Time</th>
<th>Percentage/Ratio</th>
<th>Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insolvency A</td>
<td>100 hours</td>
<td>20% (100/500)</td>
<td>$6,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>($30,000*.20)</td>
<td></td>
</tr>
<tr>
<td>Insolvency B</td>
<td>150 hours</td>
<td>30% (150/500)</td>
<td>$8,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>($30,000*.30)</td>
<td></td>
</tr>
<tr>
<td>Insolvency C</td>
<td>250 hours</td>
<td>50% (250/500)</td>
<td>$15,000</td>
</tr>
<tr>
<td></td>
<td>500 hours</td>
<td>100%</td>
<td>$30,000</td>
</tr>
</tbody>
</table>
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
• 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

P&C Funds with Net Worth Provisions

- Yes 77%
- No 23%
State Differences in Defense and Claims Parameters
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

Allocation of Indirect Admin Expenses

- Labor Hours and Claims Paid
- Blended method
- Labor Hours by Statutory Account
- Claims Paid & Claims Exp Paid
- Statutory Account
- Claim Counts (weighted/unweighted)
- Claims Paid
- Labor Hours

N/A

0% 5% 10% 15% 20% 25% 30% 35% 40% 45%
Recent Survey of Guaranty Association Administrative Expense Practices

Allocation Methodology - Labor Hours

- Actual Time: 88%
- Time Studies: 12%
Recent Survey of Guaranty Association Administrative Expense Practices

Guaranty Funds that Allocate 100% of Indirect Admin Expenses

- Yes: 60%
- No: 40%
Recent Survey of Guaranty Association Administrative Expense Practices
Recent Survey of Guaranty Association Administrative Expense Practices

How Non-Allocated Indirect Admin Expenses are Funded

- Cash Flow Surplus
- Closed Insolvency Excess Funds
- Interest Income
- Administrative Assessment
- Combination of Sources Above
Recent Survey of Guaranty Association Administrative Expense Practices

How Often Receivers Ask Questions Regarding Admin Expense Reporting

- Often: 56%
- Occasionally: 28%
- Rarely: 11%
- None: 5%

<table>
<thead>
<tr>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Often</td>
<td>56%</td>
</tr>
<tr>
<td>Occasionally</td>
<td>28%</td>
</tr>
<tr>
<td>Rarely</td>
<td>11%</td>
</tr>
<tr>
<td>None</td>
<td>5%</td>
</tr>
</tbody>
</table>
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
• 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
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
• 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)
• 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
<table>
<thead>
<tr>
<th>GA Expenses (direct and indirect):</th>
<th>Other Expenses:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee/Contractor</td>
<td>Interest $0</td>
</tr>
<tr>
<td>Office Rent &amp; Utilities</td>
<td>Unpaid Assessments $0</td>
</tr>
<tr>
<td>Other Office Expenses</td>
<td>Investment Management Fees $0</td>
</tr>
<tr>
<td>Accounting/Audit</td>
<td>Bad Debt Expense $0</td>
</tr>
<tr>
<td>Legal</td>
<td>Other (explain) $0</td>
</tr>
<tr>
<td>Actuarial</td>
<td>Explanation of Other</td>
</tr>
<tr>
<td>TPA</td>
<td></td>
</tr>
<tr>
<td>IT</td>
<td>NOLHGA Related Expenses:</td>
</tr>
<tr>
<td>Other Professional</td>
<td>Quarterly Insolvency Expenses $0</td>
</tr>
<tr>
<td>Furniture &amp; Equipment/Depreciation Expense</td>
<td>Annual Dues Allocation $0</td>
</tr>
<tr>
<td>Meetings &amp; Travel</td>
<td>Data Survey Allocation $0</td>
</tr>
<tr>
<td>Insurance</td>
<td></td>
</tr>
<tr>
<td>Cost Allocation Method</td>
<td>Total All Expenses $0</td>
</tr>
<tr>
<td>Explanation of Allocation Method if “Other”</td>
<td></td>
</tr>
</tbody>
</table>
• 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