THE PERFECT RECEIVER
Number 23
The Safety Net

By Patrick Cantilo

Watchers of this space have long known that it was only a matter of time. Eventually your humble servant would lose the ability to resist writing about *The Guaranty Associations*.

HISTORICAL NOTE

For millennia mankind had been frustrated by the problem of how to measure the volume of irregular objects. Upon descending into the tub for his semi-annual bath, it is said that Archimedes of Syracuse realized that the amount of fluid displaced by such an object (no more irregular one could be found in those days than his own body) would be an exact measure of that volume. Striving (efficient as he was) to simultaneously inform the Crown of his conclusion *and* to entertain the populace, this renowned Greek mathematician promptly ran naked into the street famously shouting "*Eureka!"*

A few hours later, having dried off and paid his fine for άσεμνη έκθεση[1], he took on an even more daunting challenge: how to protect policyholders from loss upon insurer failures. He acknowledged readily that the Genovese would not actually *invent* insurance for another 1500 years or so. But Archimedes was nothing if not a forward thinker. He knew that merely a few hundred years *after that* the need for policyholder protection would burn in the hearts and minds of civilized men.[2] Archimedes reasoned (or so we will pretend) that it would be fair to have the insurance industry itself provide a *Safety Net* for the protection of policyholders in the event of insolvency.

Fast-forward a bit (to the 1960s and 1970s) and we look in as the New World descendants of Archimedes start developing this safety net in detail. Before 1969, a handful of states had enacted some guaranty fund legislation, often for particular lines. The adverse publicity created by a wave of auto insurer failures, and a consequent 1965 U.S. Senate investigation, made insurer insolvency a national issue in the late 1960s. Senator Thomas Dodd (D - CN) introduced a bill which contemplated a FDIC-like federal mechanism. His effort was unsuccessful but Senator Warren Magnuson (D - WA) then introduced a similar bill in 1969, and got it through committee. That's

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[1] In case you have forgotten, Greek for indecent exposure.

[2] Civilized women, on the other hand, devoted their attention to the more pressing issue of how to combine a Y chromosome with reasonableness, sensitivity, and the ability to listen without offering solutions! Alas, so far no success.

all it took!

"*We don't need no stinkin' Feds!*" some of Archimedes' descendants were heard to exclaim. The National Association of Insurance Commissioners ("NAIC") swung into action and promptly released two insurance guaranty association model acts: one for property and liability insurance in 1969, and another for life and health insurance in1970. By 1974, all but three states (Alabama, Arkansas, and Oklahoma) had adopted property and casualty guaranty funds and by 1980 there were no exceptions. It took a bit longer for life and health guaranty associations to get traction but by 1990 every state had one of those too. This was good timing because in the late '80s and in the 90s we broke some pretty big life and annuity insurers!

THE INNARDS

Let's familiarize ourselves with these newly created guaranty funds as they have evolved over time. We are going to ignore the "DO NOT REMOVE!" label on the bottom plate of our L&H Guaranty Fund (GF) and take a peek inside. Make sure your Fund is unplugged before proceeding. As you gently set the cover aside and glance at the guts of your Fund, you will immediately notice the typical four major compartments: the Governance Modulator (GM), the Assessment Proliferator (AP), the Coverage Dispenser (CD), and the Recoupment Extractor (RE). Almost every guaranty act, P&C or L&H, has these four basic components, although they often vary in size, power consumption, and output. Some GFs have additional components like the Coverage Assigner (CA), the Early Access Processor (EAP), the Deposit Aspirator (DA), and the Collateral Collector (CC). We will deal with most of these in future articles in this column.[3]

When properly tuned, the Governance Modulator (GM) will cause the insurance commissioner to select the 15 best looking representatives of the local insurance industry to serve as the board of directors for that state's Fund and to control its operations. Nominally, of course, it is the insurer - not its employee - which is appointed to the Board by the Commissioner. This Board will then recruit a professional staff to run the Fund's day-to-day business, leaving the Board free to go to trade group and NAIC conventions. Some Funds have a significant standing staff and others rely heavily on vendors (who mostly are sitting) specifically engaged for each mission. It is not unusual for a single representative of an insurer to serve on Guaranty Fund boards in more than one state. Apart from annual reports and meetings, in most cases the Board is not very involved in the Fund's normal operations. However, the Board may be called into action when particularly challenging issues are raised by a specific insolvency.

An early Governance Modulator

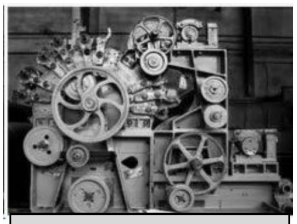
Normally connected to the GM by a white wire and a green wire, the Assessment Proliferator

[3]This is called a "teaser" and is designed to induce you to buy future editions. The weakness here, unfortunately, is that we don't actually sell this magazine. We give one free copy to everyone who has been nice and two free copies to everyone who has been naughty.

(AP) should be found anchored to the back panel of the GF and can be easily identified by the protruding Assessment Tentacles on its base. Make sure that you don't inadvertently press an assessment button because the AP's upper arms will immediately seize your billfold AND checkbook. Dubbed by some "the Heart of the GF", the Assessment Proliferator is responsible for the circulation of a steady flow of currency from the GF's members to the GF itself. Although technically it is the board that controls the AP, newer models can operate with complete independence. Most APs can operate simultaneously in many states, finding the payable departments of target insurers no matter where they may try to hide. The more powerful fifth generation (5G) Proliferators are capable of making multiple assessments in a single year in all the states and territories. They are sometimes called *MF Proliferators* by targeted insurers because of their multi-faceted operations. Moreover, 5G APs have special devices for invalidating assessment exemptions. It is said that AP's are designed to lay dormant for years at a time, operating only when needed. However, there have been no known sightings of dormant APs. A well maintained 5G AP can generate a steady flow of funds into a GF for decades, resorting frequently to long-forgotten insolvencies for which records can be hard to find.

Model 2376b 5G Assessment Proliferator

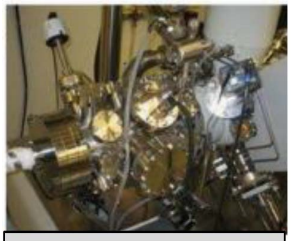
Perhaps the most important component of the GF, the Coverage Dispenser (CD) typically can be found next to the AP, connected to it by a thick black cable. The CD is the component responsible for making claim or benefit payments to insureds of impaired or insolvent insurers. The CD is a complicated piece of equipment that performs several key functions. When a claim or benefit request is introduced through the CD's front slot, it first verifies that the GF has been "triggered" for the insurer that issued the underlying insurance policy. Normally, the GF is triggered involuntarily by the domiciliary state court's entry of an order of liquidation with a finding of insolvency. In very rare cases, the GF can be triggered voluntarily by a vote of its board of directors. However, most Governance Modulators have a solenoid that automatically interrupts the operation of the CD if it is triggered voluntarily. To prevent the solenoid from interrupting the CD from operating, the GM requires extensive debate by the GF's board of directors and polling of its members. In cases of involuntary trigger, or when the voluntary trigger has been allowed to operate, the CD next verifies the claimant's eligibility. To do so it passes the claim or benefit requests through three sequential fine-mesh screens. The first screen, determines the claimant's eligibility by verifying state of residence and coverage in force. The second screen confirms that the claim is within the scope of coverage and limits of the underlying policy. This screen has a double layer that also filters out any portion of the claim covered by other available insurance. The third and final screen rejects claims not covered by the GF and applies the limits of the applicable GF coverage to covered claims, including such things as the Moody's Rollback[4] and other special



A standard P&C Coverage Dispenser

[4]The Moody's Rollback and other high-level operations of the GF are properly the subject of an advanced analysis of this topic to be addressed in subsequent numbers of this column, unless of course the editorial board comes to its senses.

provisions. For claims that pass though all three screens, the CD then generates the appropriate payment for the claimant. In typical property and casualty (P&C) personal lines claims, such as those arising under auto or homeowners insurance, the payment tends to be a single lump-sum amount for the incident giving rise to the claim. For other types of coverage, like disability, long-term care, or annuity, the payments may be recurring in set amounts during the pendency of the claim.



An auto-synchronous Coverage Assigner

In life, accident, and health guaranty funds, on top of the CD is a smaller unit connected to the CD by a ten-pin connector and to the AP by a single green cable. This unit, called the Coverage Assigner (CA), only operates in certain cases. When turned on, the CA disables part or all of the CD and transfers the responsibility for claim payments to another insurer selected by the GF staff. It also diverts payments from the AP that otherwise would go to the CD. Despite its small size, the CA is a critical component of these GFs. It is capable of transferring the coverage obligations of one insolvent insurer to many assuming carriers simultaneously. Auto-synchronous CAs subject claims to the CD's screening process before assigning them. Other CAs transfer the screening responsibilities to other insurers along with the coverage.

The last major component of the GF is the much-maligned Recoupment Extractor (RE). It is normally found on the right side of the GF and is only connected to the Assessment Proliferator by a purple data transfer wire. The RE operates very slowly, typically over five years, to reduce the premium tax burden of insurers whose funds were extracted by the AP. In some exotic models, instead of reducing insurers' premium tax burden, the RE increases the assessed insurers' premiums charged to other customers. In both cases, the intent of the RE is to shift the cost of the GF from member insurers to the taxpayers or the insurance-buying public. However, because they operate so slowly, REs are seldom 100% effective. Generally, they leave member insurers with some of the cost of GF operations. Advanced research facilities have focused intensely on strategies to accelerate RE functions, thus far with no success. However, in certain cases, REs have been made to work in concert with APs to redistribute assessment burdens among member insurers in accordance with arbitrary allocation methodologies.

A dual-mode Recoupment Extractor

We have now taken an initial look at the internal components of most Guaranty Funds. We have gained a basic understanding of the functions of these components and how they interact. You might be tempted to unleash this new-found knowledge on friends and neighbors at your next cocktail party. You should be warned, however, that once you open this subject for discussion, it will tend to dominate the evening. Be prepared for young, very attractive, gentlemen and ladies hanging on to your every word with obvious devotion in their eyes and passionate choruses of "please tell me more!" Just kidding. No one you know or care about wants to hear about GFs. This is a subject best left for the hallowed halls of the NAIC.

Patrick Cantilo is a "mature" Texas lawyer and national receiver who once was president of IAIR and served on its board of directors for ten years until they stopped telling him where they were meeting and he couldn't go anymore! He practices law with Cantilo & Bennett, L.L.P. in Austin. Over the decades he has represented or worked for about half the states in various insurance insolvency or regulatory projects.