Weathering Any Storm

The Guaranty System Safety Net

By Mike Heard and Sean McKenna

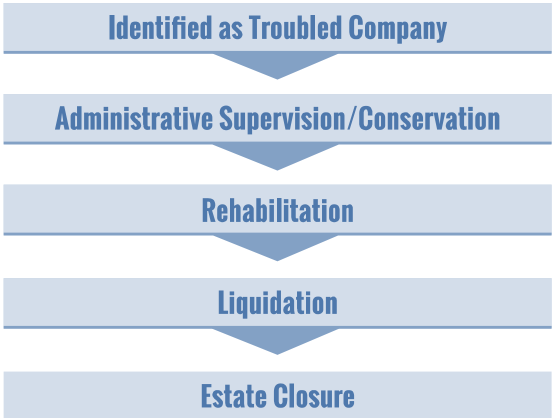
The news has been filled with scary financial stories lately: inflation, rising interest rates, the cryptocurrency crisis, and now bank failures. For your long-term care insurance clients, the fairly recent liquidation of Penn Treaty Network America Insurance Company, along with concerns about the long-term care insurance product line, are probably creating a fair bit of angst. After all, it has only been 15 years since financial institutions—and their customers—were battered by the financial crisis of 2008 and 2009, which brought with it industry bailouts, the fall of financial giants, and the failure of hundreds of banks. With similar news popping up now, who can blame consumers for asking if their money is safe?

Fortunately, there's good news for insurance policyholders. First, insurance company failures are rare. And second, when they do occur, state life and health insurance guaranty associations are ready to step in and protect policyholders.

The state life and health insurance guaranty associations were created to keep the promises of the life and health insurance industry (with similar guaranty funds at work in the property and casualty arena). Over the last 40 years, the safety net provided by the associations has protected almost three million policyholders of failed insurers and contributed more than $9 billion to ensure that guaranteed benefits are paid to consumers.

ASSOCIATIONS AND THE RECEIVERSHIP PROCESS

Insurance companies are regulated by the state—companies must be licensed in each state in which they do business, and state insurance departments monitor their financial stability. The states also oversee the guaranty association safety net—each state, along with the District of Columbia and Puerto Rico, has a life and health insurance guaranty association to protect its residents if an insurance company fails. All companies (with limited exceptions) licensed to do business in the state are required to be members of the guaranty association (in other words, a company that does business in 25 states would be a member of 25 guaranty associations).



If an insurance company is found to be financially unstable, the insurance department in its home state (also known as its domiciliary state) steps in and takes control of the company. This begins what is known as the "receivership process," and in this first stage, the company is considered to be in "rehabilitation" (some states use a different term) as the insurance department attempts to improve the company's financial status. The state insurance commissioner becomes the "receiver" for the troubled company, although commissioners often appoint special deputy receivers to oversee the company's operations.

If the attempt to rehabilitate the company is successful, the receivership process ends. If the company's financial difficulties are too great to overcome, however, the commissioner petitions the court to declare the company insolvent, and the receivership process moves into the next stage—liquidation (similar to a company being declared bankrupt). In this stage, the receiver or deputy receiver attempts to maximize the company's assets to pay off as many creditors as possible—chief among them policyholders.

When a company is liquidated, state life and health insurance guaranty associations are triggered to provide continuing coverage and benefits for the covered policies of policyholders living in their state. Policyholders who reside in states where the insolvent insurer was not licensed are covered, in most cases, by the guaranty association of the company's domiciliary state. If the company does not have enough funds to meet its obligations to policyholders, each state guaranty association uses a combination of company assets and assessments of member insurers in its state to meet the claims of resident policyholders.

BENEFITS AND CONTINUING COVERAGE

Much like the FDIC's coverage of the banking industry, state guaranty associations provide benefits up to a specified level, with any benefits above that level being funded from remaining estate assets. For the associations, these levels are spelled out in state law.

While laws governing maximum levels and types of policies covered vary from state to state, most states are consistent with the National Association of Insurance Commissioners (NAIC) Guaranty Association Model Act and provide coverage at least in the amounts specified below. Check your state association's website to confirm the applicable benefit levels in your state.

Line of Business	Statutory Limit
Life Insurance	
Death Benefits	$300,000
Net Cash Surrender and WD	$100,000
Annuities	$250,000
Health Insurance	
Major Medical	$500,000
Disability	$300,000
Other Health	$100,000
LTC Insurance	$300,000

In most states, the aggregate benefit level for an individual life in any one insolvency is $300,000 (except if there is covered major medical insurance or covered basic hospital, medical, and surgical insurance, in which case the aggregate benefit is $500,000). The above coverage levels apply separately for each insolvent insurer.

One important aspect of the life and health insurance safety net is that continuing insurance coverage is provided for policyholders when their policies give them the right to keep their coverage in force. In some cases, it would be difficult for people who have lost coverage due to the failure of their insurance company to find comparable coverage elsewhere.

To avoid this, guaranty associations provide continuing coverage, often by placing the policies of an insolvent insurer (including the policies of those who might otherwise be uninsurable) with a healthy insurer. In other cases, guaranty associations simply take on the policies and fulfill the terms themselves.

FUNDING THE SYSTEM

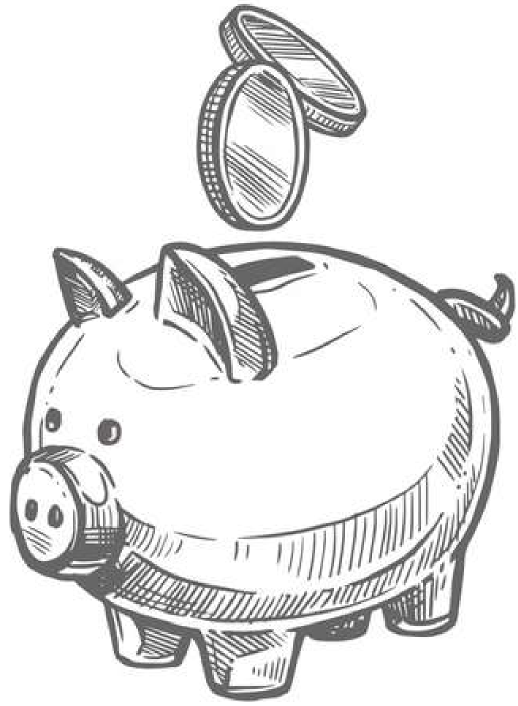
Liquidations of large companies such as Penn Treaty Network America Insurance Company, which involve policyholders in nearly every state, understandably raise questions about the capacity of the guaranty system. These questions stem in part, no doubt, from the post-insolvency funding mechanism employed by the associations. Unlike the FDIC, the guaranty system does not have a pre-funded "war chest" available in advance of a particular insolvency. Instead, when an insurance company fails, guaranty associations are authorized by their enabling statutes to assess and collect from insurance companies writing covered lines of business in the state (an association's "member insurers") the amount needed to satisfy the association's obligations to policyholders. Assessments are collected only when they are needed to help pay the costs of insurance benefits coming due to consumers.

Member insurers are obliged to pay those assessments, which are allocated ratably in accordance with their market shares, as a condition to maintaining their authority to write business in the state. For this reason, collection of assessments has never been a problem for the guaranty system.

The *advantage* of this post-funding approach is that capital is not removed from the industry prior to the need for such capital, and consumers are not required to pay in advance (through higher premiums) for funds that may never be needed to protect other consumers in an insolvency. The perceived *disadvantage* of this approach—the lack of a "war chest" of funds—isn't quite what it seems, thanks to the assets remaining in the estate of the failed insurer and the timing of when insurance obligations come due.

When a bank fails, the FDIC must be ready to step in and cover customers' deposits as quickly as possible—if a bank closes on a Friday, by Monday it reopens with all protected deposits available to depositors. The FDIC steps in to provide instant liquidity.

	FDIC	Guaranty System
Jurisdiction	Federal	State
Funding	Every year to pre-fund	Post liquidation order
Priority Scheme	Protect depositors	Protect policyholders
Protection	Fund deposits	Continue insurance
Obligation Timing	Short-term	Long-term
Limits	Capped by statute	Capped by statute



The obligations of an insurance company are quite different (and more complex). Insurance and annuity products are in essence commitments to deliver funding upon specified events (e.g., the death of an insured under a life policy) or pursuant to a scheduled need (e.g., installment obligations payable under a fixed annuity contract). Unlike a demand account, many insurance obligations do not become due and payable to consumers until years after an insurer's failure. The FDIC replaces dollars with dollars, but the guaranty associations replace insurance with insurance—fulfilling promises and making payments that can stretch out for decades.

Thus, when an insurer fails, the "hole" left by its failure does not need to be filled in a day or week. Rather, the guaranty associations evaluate their obligations and how far into the future those obligations reach. For short-term or immediate obligations, guaranty associations have access to the remaining assets in the insurance company. If those assets are not enough to cover the long-term obligations of the associations, member insurers are assessed their share of a particular association's obligations. But the association can schedule assessments for long-term obligations over years or even decades, easing any pressure on financially sound insurers while still fulfilling its obligations to policyholders.

WHY THE SYSTEM WORKS

State guaranty associations exist for three main reasons:

- To provide continuing coverage to policyholders of a failed insurer

- To protect the benefits due to policyholders
- To ensure that policyholders are protected as quickly and efficiently as possible

The guaranty system safety net has evolved over the years as associations have become more experienced in meeting the needs of policyholders of failed insurers. One major step in this evolution was the creation of the National Organization of Life & Health Insurance Guaranty Associations (NOLHGA) in 1983. The state guaranty associations created NOLHGA to help them deal effectively and efficiently with the large-scale challenges presented by national insurance company failures, which affect policyholders in many states.

This efficiency is achieved in several ways. Through NOLHGA, all state associations can call upon the expertise of a single set of guaranty system professionals and experienced consultants as they protect the policyholders in their state. Thanks to frequent collaboration with state insurance departments, this group (known as a NOLHGA Task Force) is often formed before an insurer is even declared insolvent. This advance preparation enables the guaranty associations to meet the needs of policyholders as quickly as possible.

> **Continuing Coverage.** Thanks to the guaranty associations, every eligible policyholder has been given the opportunity to have their policy assumed by another healthy carrier or had the covered portions of their policies fulfilled by their guaranty association itself (certain insurance policies that are not guaranteed renewable are sometimes canceled in accordance with the terms of the policies). In the multi-state insolvencies with which NOLHGA has been involved, more than 2.85 million policies were protected by the guaranty system.

> **Protection of Benefits.** As mentioned earlier, state guaranty associations provide benefit protection up to the levels specified in their state's laws. While these levels can result in partial coverage of high-dollar policies, in recent insolvencies more than 96% of policyholder life insurance benefits and more than 88% of policyholder annuity benefits have been covered in full.

> **Rapid Protection.** State guaranty associations were established to quickly protect policyholders in their time of need. Put simply, policyholders benefit when their policies are moved to a strong insurance carrier quickly. Thanks to the coordination the guaranty associations achieve through NOLHGA, task forces often develop a plan to protect policyholders of a troubled company before the company is declared insolvent.

THE SAFETY NET IS THERE FOR POLICYHOLDERS

The financial news lately has been troubling, and it's only fair for people to ask questions about the safety of their assets held in financial institutions. The good news for your clients—policyholders of insurance companies—is that the safety net is in place and ready to respond to any crisis.

MIKE HEARD

Mike is the Executive Vice President and Chief Operating Officer of the National Organization of Life & Health Insurance Guaranty Associations (NOLHGA), www.nolhga.com. He supervises NOLHGA resources deployed to assist state guaranty associations in managing insolvencies, develops and implements the organization's strategic initiatives, and oversees NOLHGA's communications efforts. In addition, he is responsible for the efficiency and effectiveness of the internal operations of NOLHGA.

Sean McKenna, NOLHGA Director of Communications, contributed to the content of this article.