Order Code RL32175

CRS Report for Congress

Insurance Guaranty Funds

Updated February 27, 2008

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Prepared for Members and
Committees of Congress

Insurance Guaranty Funds

Summary

Some constituencies are urging Congress to allow insurers to become federally regulated, like banks. Other constituencies are urging Congress to instead ratify its 1945 delegation of insurance regulation to the states. In the past few years, various pieces of legislation have been introduced to implement some form of federal charter for insurance companies. The latest such legislation is the National Insurance Act of 2007 (S. 40 and H.R. 3200).

How to protect insurance policyholders in the event of their insurer's insolvency is among the thorniest issues in insurance regulation, whether federal or state-based. The current system of protection for insurance policyholders is called "insurance guaranty funds." This interdependent system is a cooperative effort among regulators and insurers in the states where the insolvent insurer operated. It is administered state-by-state and funded by assessments on insurers. Though it has developed relatively recently, the system has provided some protection for policyholders of both large and small insolvent insurers.

If Congress were to consider regulating insurers federally, it would confront the issues of whether and how to provide that policyholder protection. Should Congress wish to protect insurance policyholders in an insolvency, it might choose to establish or expand a federal program like the Federal Deposit Insurance Corporation, the Pension Benefit Guaranty Corporation, or the National Credit Union Share Insurance Fund. Another option would be to require federally regulated insurers to participate in the state-based guaranty fund system.

Establishing federal protection for policyholders of insolvent federally regulated insurers would have costs and benefits. Direct costs would include, at the least, the costs of establishing and administering the system. Costs could also include funding of catastrophic shortfalls, as happened in the savings and loan crisis in the 1980s. Indirect costs could include inefficiencies that might result from dampening market discipline. The measure of benefit to policyholders would depend on the scope of protection offered. The potential benefit to the U.S. economy would require further analysis.

Requiring federally regulated insurers to participate in state guaranty funds would have costs and benefits as well. The costs would include the economic inefficiencies created by externalizing the costs of ineffective solvency regulation. The benefits would be simplicity and a consolidated assessment base.

This report describes generally how state-based insurance guaranty funds operate currently. It also compares the extant insurance system to protections offered bank depositors, potential and current pensioners, and credit union participants. It was originally prepared by Carolyn Cobb, Insurance Consultant, Government and Finance Division, and will be updated as warranted by legislative events.

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Insurance Guaranty Funds

Revising Insurance Regulation: The Debate[1]

Proponents of federal regulation of insurers make analogies to banks and their regulation. They argue that insurers, like banks, should be allowed to elect whether to hold a state or a federal charter and to reap the perceived benefits of choosing their regulator. The analogy of insurers to banks is useful — insurers and banks are both financial intermediaries performing similar important functions in the U.S. economy. They are also both so important that our society has constructed protection for consumers holding contracts with insolvent financial intermediaries of both types. The federal insurance funds of the Federal Deposit Insurance Corporation (FDIC), the Pension Benefit Guaranty Corporation (PBGC), and the National Credit Union Share Insurance Fund (NCUSIF) provide similar protections. They operate differently, however, than the state-based system of insurance guaranty funds.[2] These differences may gain significance if Congress considers federal regulation of insurers.

How Insurance Guaranty Funds Work

Provision for policyholders of insolvent insurers began slowly in the late 1930s. By the 1950s, some states had security funds for disabled workers covered by insolvent workmen's compensation insurers, and a few had similar provision for policyholders of insolvent automobile insurers. Then, in the late 1960s, Congress considered creating a federal fund, similar to the FDIC, to protect all property-liability policyholders. State regulators and insurers objected to federal regulation, and they cooperated to create a model law that at least 47 states had enacted in some form by 1974.[3] Most states did not enact life and health insurance guaranty fund laws until after the Baldwin-United insolvency in 1983 and the Executive Life

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[1] For the more complete information on this debate and current legislation, see CRS Report RL32789 *Insurance Regulation: Issues and Background*, by Baird Webel.

[2] See the Appendix of this report for a brief overview of the similarities and differences among these protection systems. For more information, see CRS Report RS21987, *When Financial Businesses Fail: Protection for Account Holders*, by Walter W. Eubanks.

[3] See National Association of Insurance Commissioners, "Post-Assessment Property and Liability Insurance Guaranty Association Model Act," *Model Laws, Regulations and Guidelines* (Kansas City, MO: National Association of Insurance Commissioners, October 2007), vol. III, pp. 540-1 through 540-20 for the text of the model and citations to analogous state laws.

insolvency in 1990.[4] All states had enacted life and health insurance guaranty fund laws by late 1992.[5]

Three principles guided the drafters of both model laws: policyholders should not lose their risk protection upon insolvency; losses due to insolvency should be shared; and claim payments should not be unduly delayed by an insolvency. These principles operate differently in property-liability insurer insolvencies than they do in life and annuity insolvencies, as discussed below. Property and liability coverages are short-term contracts, usually no longer than one year, while life and annuity contracts are long-term contracts, often for the life of the insured.[6]

Under both model laws, once the home state insurance commissioner determines that the insurer — whether property-liability or life — is financially troubled, the commissioner is required to take steps to protect policyholders and claimants. The commissioner can order the insurer to take corrective steps and to suspend business. The commissioner can petition a state court either for an order of rehabilitation, if it is determined that the insurer's problems can be corrected, or for an order of liquidation, if it is not. The court's order of liquidation appoints the commissioner as liquidator, and the commissioner appoints a receiver. The receiver takes possession of the insurer's offices, records, and assets. Assuming the records are adequate, the receiver advises policyholders and claimants of the insurer's liquidation and of the process for filing a claim against the insurer's estate.[7]

Cooperation among the states where the insolvent insurer operated is essential. Usually the insurance commissioner in the insurer's state of incorporation — known as its "domicile" or "domiciliary state" — petitions first for an order of liquidation from a state court in that domicile, and that court retains principal jurisdiction over the insurer's liquidation. The domiciliary insurance commissioner also appoints the lead receiver. Insurance regulators in the other states where the insurer operated will appoint ancillary receivers, after entries of orders of liquidation in those states. The

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[4] See National Association of Insurance Commissioners (NAIC), "Life and Health Insurance Guaranty Association Model Act," *Model Laws, Regulations and Guidelines* (Kansas City, MO: National Association of Insurance Commissioners, October 2007), pp. 520-1 through 520-51, for the text of the life and health guaranty fund model and citations to similar state laws. For information on these insolvencies, see U.S. General Accounting Office, *Insurance Regulation: Weak Oversight Allowed Executive Life to Report Inflated Bond Values*, GAO GGD-93-95 (Washington: GPO, December 1992), available at [http://161.203.16.4/d36t11/148197.pdf]; U.S. General Accounting Office, *Insurer Failures: Life/Health Insurer Insolvencies and Limitations of State Guaranty Funds*, GAO GGD-92-44 (Washington: GPO, March 1992), available at [http://161.203.16.4/d32t10/146456.pdf].

[5] See Spencer L. Kimball and Noreen J. Parrett, "Creation of the Guaranty Association System," *Journal of Insurance Regulation*, vol. 19, winter 2000, pp. 259-273.

[6] Christopher J. Wilcox, "The U.S. Guaranty Association Concept at 25: A Quarter-Century Assessment," *Journal of Insurance Regulation*, vol. 14, spring 1996, pp. 370-404.

[7] See NAIC, *Model Laws, Regulations and Guidelines*, vol. 3, pp. 555-1 through 555-67.

lead and ancillary receivers cooperate, with the assistance of the guaranty funds and the national associations of guaranty funds.[8]

The order of liquidation in each state generally triggers the operation of that state's guaranty fund, though the trigger varies by state. Each guaranty fund is a mandatory association of all licensed insurers doing business in that state. Each fund has a board of those insurers, and the board governs the fund. An accumulation of money does not actually exist until after the insolvent's liabilities and assets are evaluated, each participating insurer is billed for its proportionate share of the shortfall, and each insurer remits its allocated share for that particular insolvency.[9] The "fund" is the sum of those remittances. The term "guaranty fund" can also refer to insurers' statutory obligation to participate in this protection system.[10] In general, each state's guaranty fund is responsible for the policyholders residing in that state, and the protection extends only to policyholders of licensed insurers within the limits of statutory coverage in that state of residence.

Property-Liability Insurers

The entry of an order of liquidation of a property-liability insurer typically terminates all existing property-liability policies within 30 days, though the insurer remains liable for any claims that arose before the order. The order usually prohibits the insurer from issuing any new policies, and it suspends all claims payments to allow an orderly and equitable evaluation of the insurer's liabilities and assets. State laws give policyholders' claims on the assets precedence over general creditors, but not over the expenses incurred by the liquidator, receiver, and guaranty associations.

The entry of the order of liquidation obligates that state's property-liability guaranty association to begin processing claims from residents, though it is not obligated to cover all claims. For example, most states' laws usually cap coverage at $300,000 and exclude claims for punitive damages. The property-liability insurers that are members of the guaranty association assess themselves proportionate to their premium volume in that state to fund the difference between the insolvent's assets and the residents' claims. The assessments are imposed first on the particular type of property-liability insurance that occasioned the insolvency and are limited to 1% to 2% annually of each insurer's premium volume in that line in that state. If that assessment proves insufficient, then other types of property-liability insurance — known as "accounts" — may be assessed as well. Most states allow assessed insurers

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[8] Ibid. The National Organization of Life and Health Guaranty Associations (NOLHGA), assists in coordinating administration of insolvencies of life insurers. See [http://www.nolhga.com/]. The National Conference of Insurance Guaranty Fund (NCIGF) assists in coordinating administration of insolvencies of property and liability insurers. See [http://www.ncigf.org].

[9] The New York property-liability insurance guaranty fund is the exception. Property-liability insurers licensed in New York must quarterly pay 5% of that quarter's total premium into the New York guaranty fund, if necessary to maintain the fund's balance of at least $150 million but not more than $200 million. See N.Y. Ins. Law §7601 *et seq*.

[10] See generally Insurance Information Institute, "Insolvencies/Guaranty Funds," in *Hot Topics & Insurance Issues*, at [http://www.iii.org/media/hottopics/insurance/insolvencies].

to include the assessments in their rates, though some states allow insurers to surcharge policyholders or offset the assessment against their premium taxes.[11]

Life Insurers

The entry of an order of liquidation of a life insurer, in contrast, does not cancel life or health insurance policies or annuity contracts. The rationale is that, unlike property-liability coverage, which an insured may replace easily, life and health insurance and annuity contracts may be difficult to replace. The model law's drafters decided that, to preserve the policyholder's risk protection through an insolvency, coverage issued by a life insurer should be continued through an insolvency. In practice, life insurance guaranty associations often meet this obligation collectively by selling or transferring the covered policies to another life insurer.

As with property-liability insurance, there are limits on life insurance guaranty fund protection. Generally, $300,000 is the limit on life insurance death benefits, $100,000 is the limit on cash values in life insurance and annuity contracts, and $100,000 is the limit on health insurance policy benefits. Most states' laws cap coverage for any one life at $300,000, though some states have higher limits. Guaranty association coverage usually extends neither to any policy or portion of a policy in which the policyholder bears the investment risk, nor to HMOs.

Also as with property-liability insurance, licensed life insurers in each state assess themselves for the shortfall. Typically, assessments up to 2% of each life insurer's premium volume, by type or "account," are imposed annually. If that assessment proves insufficient, then other types or accounts may be assessed. Most states allow life insurers to recoup those assessments by offsetting up to 20% of the assessment against their premium taxes for five years.[12]

Other Financial Intermediaries' Protection Systems

The FDIC protects deposits in banks and savings associations. The Pension Benefit Guaranty Corporation (PBGC) protects participants in defined benefit pension plans. The National Credit Union Share Insurance Fund (NCUSIF) protects "share" accounts in credit unions. Each represents legislative interest in maintaining confidence in financial intermediaries and legislative choices about how to spread potential losses should a financial intermediary fail, as does the insurance guaranty fund system.

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[11] For further information, see National Conference of Insurance Guaranty Funds, "Guaranty Fund Laws Summary," *2007 Summary of Property & Casualty Insurance Guaranty Association Acts of the Various States and U.S. Territories*, available at [http://beta.ncigf.com/guaranty/summary.asp].

[12] For further information, see National Organization of Life and Health Guaranty Associations, "Facts & Figures: Guaranty Association Laws," available at [http://www.nolhga.com/factsandfigures/main.cfm/location/stateinfo].

Unlike the insurance protection system, however, the FDIC, PBGC, and NCUSIF are all congressionally created protection plans and are administered federally. There are other differences among the protection systems, too, including whether the protection fund exists before the insolvency, whether the contributors to the fund pay based on the risk each presents to the system's solvency, and whether those contributors can recoup the costs of their payments to the system.

The similarities and differences among the various protection systems are summarized in a chart in the **Appendix**.

Policy Issues

Opinions differ markedly over whether the current insurance guaranty fund system functions well or poorly. Supporters say that the current system has been very effective. The President of the National Conference of Insurance Guaranty Funds (NCIGF) notes that funds have paid out about $21 billion in claims that would have gone unpaid in the last four decades.[13] The National Organization of Life and Health Guaranty Associations (NOLHGA) indicates that, since 1983, guaranty funds have protected 2.2 million policyholders by guaranteeing more than $21.2 billion in benefits and contributed $4.4 billion to ensure that policyholders received their benefits.[14] Some critics of the current state insurance guaranty fund system say it is inefficient, slow, parochial, and fragmented, and they urge that it be replaced with a federal system or significantly reformed.[15] Other critics say the existence of guaranty funds distorts incentives by allowing some insurers to increase risk-taking behavior and by imposing the costs of that behavior on more conservative insurers.[16] The critics say that the current system "provide[s] a powerful risk subsidy incentive that [solvency] monitoring does not entirely offset."[17] That effect is exacerbated by flat-

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[13] National Conference of Insurance Guaranty Funds, *The Property and Casualty Guaranty Fund System: Paying Claims, Protecting Policyholders*, available at [http://www.ncigf.org/media/files/public_gfbrochure.pdf].

[14] National Organization of Life and Health Guaranty Associations, *Facts & Figures*, available at [http://www.nolhga.com/factsandfigures/main.cfm].

[15] Debra J. Hall and Robert M. Hall, "Insurance Company Insolvencies: Order Out of Chaos," *Journal of Insurance Regulation*, vol. 12, winter 1993, p. 145 et seq. See also Martin F. Grace, Robert W. Klein, and Richard D. Phillips, *Managing the Cost of Property-Casualty Insurer Insolvencies*, Center for Risk Management and Insurance Research, Georgia State Univ.,Executive Summary Research Report 02-1, December 2002, available at [http://rmictr.gsu.edu/Papers/RR02-1_abstract.pdf] and David A. Skeel, Jr., "The Law and Finance of Bank and Insurance Insolvency Regulation," *Texas Law Review*, vol. 76, March 1998, pp. 723-781.

[16] William R. Feldhaus and Paul M. Kazenski, "Risk-Based Guaranty Fund Assessments: An Allocation Alternative for Funding Insurer Insolvencies," *Journal of Insurance Regulation*, vol. 17, fall 1998, pp. 42-64.

[17] David H. Downs and David W. Sommer, "Monitoring, Ownership, and Risk-Taking: The Impact of Guaranty Funds," *Journal of Risk and Insurance*, vol. 66, September 1999, pp.
(continued...)

rate assessments, they say. These critics argue for risk-based assessments similar to that required by the FDIC.[18] One critic has observed that incentives are further distorted by "the existence of tax offsets and by the insurers' ability to pass some of these costs to policyholders."[19]

Whether to change the current system of policyholder protection would be a significant policy issue in any legislation to authorize or require federal regulation of insurers. In the 110th Congress, Senators John Sununu and Tim Johnson introduced the Senate version of the National Insurance Act of 2007 (S. 40), and Representatives Melissa Bean and Ed Royce introduced a House version (H. R. 3200). Both bills would require all federally licensed insurers to participate in state guaranty funds, with the possibility of a federal guaranty fund if the state guaranty funds do not treat national insurers in the same manner as state insurers. Versions of the National Insurance Act (S. 2509 and H.R. 6225) were also introduced in the 109th Congress, by Senators Sununu and Johnson and Representative Royce.[20]

In the 108th Congress, Senator Ernest Hollings introduced legislation (S. 1373) to require all interstate insurers to be federally licensed and regulated. It would have established a pre-funded national insurance guaranty association and required all interstate insurers to pay into the fund. In the 107th Congress, Representative LaFalce introduced legislation (H.R. 3766) to allow insurers to elect federal licensing and regulation. It would have required all insurers electing federal regulation to participate in state guaranty associations. Senator Chuck Schumer proposed similar legislation in the 107th Congress to create an optional federal charter for insurers.[21] It also would have required federally regulated insurers to participate in a state-based system of policyholder protection operating generally as it does now.

Some of the policy issues that Congress might confront should it consider federal chartering for insurers are as follows:

- *Should federal legislation create a federally based protection system for federally chartered insurers, or instead require them to participate in the state-based guaranty fund system?*

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[17] (...continued)
477-498 (quoting from p.494).

[18] Feldhaus and Kazenski, "Risk-Based Guaranty Fund Assessments," pp.48-63.

[19] James Barrese and Jack M. Nelson, "Some Consequences of Insurer Insolvencies," *Journal of Insurance Regulation*, vol. 13, fall 1994, p. 3 (noting that the present value of guaranty fund costs actually retained by surviving life and health insurers was 15% of the total costs and the present value of such costs retained by property-liability insurers was 28%).

[20] See CRS Report RL34286, *Insurance Regulation: Optional Federal Charter Legislation*, by Baird Webel.

[21] Senator Schumer's bill did not receive a number during the 107th Congress. See Michelle Heller, "In Brief: Senator Schumer Proposes Optional Charter," *American Banker*, vol. 167, issue 247, December 28, 2001, p. 3.

Creating a federally based protection system would entail direct federal costs at least for establishing and maintaining its administrative infrastructure, even if the system were administered by the FDIC. Requiring federally regulated insurers to participate in a state-based protection system would entail significant, though unquantifiable, indirect costs to policyholders, insurers, and taxpayers. This is because incentives would be misaligned: that is, the costs of insolvencies would fall on the states, not on the federal regulator, and the states, though bearing the financial burden, would have no control over the effectiveness of federal regulation for solvency. These conflicting objectives could create the potential for significant economic inefficiencies.[22]

- *If Congress considers federal regulation of insurers, should it also consider creating a federal system of policyholder protection?*

Creating a federal policyholder protection system for federally regulated insurers might stress the federal budget and arguably undermine market discipline. On the other hand, it might more directly align behavioral incentives, because a federal regulator would have both the responsibility for regulating for solvency and the responsibility for all or some portion of the unfunded claims of an insolvent insurer, as well as for administering the liquidation.

- *Should any federal system of policyholder protection include or exclude state-regulated insurers?*

Including state-regulated insurers in any federal policyholder protection system could distort incentives, because it would bifurcate the responsibility for solvency regulation of state-charted insurers from the consequences of any failure of that regulation. On the other hand, excluding state-chartered insurers from any federal system might destabilize either or both of the federal and state protection systems. This is because fewer insurers would be members of either system, which would mean that any assessments would be imposed on a reduced premium base.

- *If Congress were to create a federal protection system, what limits should apply?*

The principal issues would be deciding what types of policyholders would be protected in the event of an insurer's insolvency and what the limits on their recovery should be. This would be challenging, especially for property coverages for regional disasters, such as earthquakes and hurricanes, and for business liability coverages. Also, if Congress wished to protect only policyholders of federally regulated insurers, then constituents might have different levels of protection depending on whether their insurers were state-regulated or federally regulated. Alternatively, Congress might require states to adopt levels of protection identical to the federal levels.

- *If Congress were to create a federal policyholder protection system, should it be pre-funded or post-funded?*

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[22] See generally Jean-Jacques Laffont and David Martimort, *The Theory of Incentives: The Principal-Agent Problem* (Princeton, NJ: Princeton Univ. Press, 2002).

Insurers would likely argue strongly for post-funding, as they have been historically averse to paying for any government-held fund. Their competitors in the financial intermediation marketplace, such as banks and savings institutions, might argue that insurers should be subject to pre-funding like themselves. There would be technical issues, too, such as whether to maintain separate funds for life insurers and property-liability insurers and how to calculate an appropriate fund balance.

- *If Congress were to create a federal policyholder protection system, should an insurer's assessments be based on its risk profile?*

Though some argue that flat assessment rates dilute market discipline, determining how to profile insurers' risks could become technically complicated and politically contentious. Insurers are required currently to hold additional capital based on their risks. Very generally speaking, life insurers calculate that additional required capital based on a categorization of the riskiness of their investments, and property-liability insurers calculate it based on the types of insurance they underwrite and their past experience in each line of insurance.[23] Whether analogous calculations would be feasible for guaranty fund assessments has not been studied.

Other issues would include whether insurers should have access to the Federal Reserve Board's discount window and the relationship of any federal system of policyholder protection to the FDIC.[24]

Conclusion

Whether to maintain some level of policyholder protection against insolvency may be a significant issue in any congressional consideration of federal regulation of insurers. How to offer that protection will likely entail more difficult decisions. Policy considerations could include whether to offer federal protection or to require federally regulated insurers to participate in the existing state system. Should Congress decide to offer federal protection, technical issues could include how to fund the protection, its scope, the location of the administering agency in the executive branch, and how to enforce market discipline fairly.

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[23] Dan Swanson, Insurance Accountant, National Association of Insurance Commissioners, telephone conversation with Carolyn Cobb, December 1, 2003.

[24] Based on Scott E. Harrington, *Optional Federal Chartering of Property-Casualty Insurance Companies* (Downers Grove, IL: Alliance of American Insurers, 2002), pp. 43-46 and p. 70; and Bert Ely, "The Fate of the State Guaranty Funds After the Advent of Federal Insurance Chartering," in Peter J. Wallison, ed., *Optional Federal Chartering and Regulation of Insurance* (Washington, DC: AEI Press, 2000), pp. 135-152.

Appendix. Comparing Features of Various Protection Systems

Feature	Deposit Protection	Pension Protection	Credit Union Protection	Insurance Protection
Administration	Federal agency (Federal Deposit Insurance Corp. — FDIC)	Self-supporting federal agency; receives no general revenue appropriation (Pension Benefit Guaranty Corp. — PBGC)	Federal agency (National Credit Union Share Insurance Fund — NCUSIF)	State-by-state cooperation among state administrators and non-profit associations of licensed insurers, funded by insolvent's estate
Funding	All national and state banks and thrifts pay assessments prior to any insolvency to maintain fund balance, which is part of the consolidated federal budget	Employers pay assessments into fund prior to any insolvency	Member credit unions (all federal and electing state) pay assessments prior to insolvency to maintain fund	Licensed direct insurers pay after an actual insolvency; no fund exists
Risk-based Assessment	Yes	Underfunded plans pay an additional premium	No	No
Recoupment	None, other than business expense deduction on federal taxes	None, other than employers' business expense deduction on federal taxes	None	Life insurers in 45 jurisdictions and property-liability insurers in 20 may deduct assessments from their premium taxes; also business expense deduction on federal taxes
Product Line Differentiation	None	One program for single-employer plans and another for multi-employer plans	None for assessment purposes	Insurers are assessed by market share in particular types of insurance
Coverage Limit	$100,000 per standard account, $250,000 per retirement accounts	Only basic benefits are guaranteed up to federal statutory maximums	$100,000 per standard account, $250,000 per retirement accounts	Coverage limits vary by state