Insurer solvency regulation

Destroying myths that now surround the solvency issue

By Peter H. Bickford

EVERYONE IS CLAMORING FOR more effective action to detect and rid the market of insolvent insurers. The report compiled last year by the House Oversight and Investigations Subcommittee, chaired by Rep. John D. Dingell, D-Mich., "Failed Promises—Insurance Company Insolvencies," (*BI*, Feb. 26, 1990), warns of a savings and loan-sized debacle unless strong action is taken, hinting that the task may be beyond the ability of state regulation.

The National Assn. of Insurance Commissioners responds by adopting a number of measures designed to help state regulators detect financially troubled insurers sooner and by adopting minimum standards of proficiency for each state's insurance department to make full and effective use of all these new detection techniques.

Many trade associations and some industry leaders, sensing the political importance of the issue, have publicly supported the cries for greater efforts in solvency detection and action, including the possibility of a federal role in this effort.

Presumably this increased attention to the "insolvency problem" will result in even more companies being declared insolvent and placed in receivership, rehabilitation or liquidation, and the industry critics will be sanguine in the knowledge that they have made the insurance market a better, safer place. But is the detection of insolvent insurers and their swift removal from the market such a panacea? While we are spending all this time looking at the issues of detection and action, are we ignoring the equally important process of dealing with those entities after their removal from the market? Is it enough to look at guaranty funds to cover any shortfall?

Perhaps we need to look more closely at the present system and begin to ask a few basic questions: Is liquidation the best or only answer in dealing with insolvent insurers? Should we be examining methods other than liquidation to deal with insolvent insurers? Are there better, more efficient alternatives to a state-run liquidation?

> **Industry leaders must recognize that the skills necessary for the conduct of the business of insurance are quite different from the skills necessary to regulate the business of insurance.**

Before we can look for answers, we must first examine the myths surrounding insurance liquidations—myths that must now be challenged in light of the new pressures being placed on regulators to detect and act upon insolvencies much more rapidly and forcefully than ever before.

- **Myth: Liquidators are regulators.**

Reality: The winding-up of the affairs of an insolvent insurer after it has been removed from the marketplace is a management function, not a regulatory function.

Look at the tasks that a liquidator must perform, and compare them to the definition of the conduct of the business of insurance under any state insurance law. With the exception of underwriting new or renewal business, the job of a liquidator is the conduct of the business of insurance. The liquidator is essentially managing assets, keeping records, pursuing contractual rights of the insolvent company against others and determining the validity of claims against it. Clearly, these are not regulatory functions, which may explain why regulators find it necessary to hire so many consultants in carrying out their function as liquidators.

- **Myth: Regulators are the best parties to act as liquidators.**

Reality: Regulators, by the nature of their purpose, are not and should not be expected to be trained in the business and management skills necessary for the efficient and fair marshaling, management and distribution of assets of an insolvent insurer.

In fact, the background and training of the regulator is not necessarily conducive to good management skills. This is not a criticism of the regulator. Rather, it is a recognition that the skills necessary for the conduct of the business of insurance are quite different from the skills necessary to regulate the business of insurance.

Historically, state insurance commissioners were designated by state insurance laws to act as liquidator as part of an overall scheme of state regulation of the business of insurance. The liquidation of insurers was an infrequent and relatively modest effort that did not raise the necessity for questioning the role of the commissioner as liquidator. The current age of mega-insolvencies necessarily requires that we re-examine this structure. Huge sums of assets still exist even in insolvent estates, and we must ensure that those assets are maximized for the benefit of the policyholders and creditors of the insolvent insurer.

If the commissioners are to continue to act as both regulator and liquidator, we must also review the relative objectives of each to ensure that one function does not interfere with the other.

- **Myth: The interests of liquidators are the same as the interests of regulators.**

Reality: The primary responsibility of the regulator is to regulate the health of the "living" insurer, and protect the interests of policyholders. When a healthy insurer is a debtor or creditor (or both) of an insolvent insurer, their interests may be in direct conflict.

The current offset issue is an example of this inherent conflict of interest. A healthy insurer with large offsets against an insolvent insurer could suffer serious financial difficulties if offsets are not allowed.

Is it appropriate for a commissioner in his role as liquidator to argue against offsets, when in his role as regulator he should be seeking to preserve the health of a solvent company? The issue is not the propriety of offsets, but the conflicting interests of the two roles of the commissioner. Why should the regulator be a primary litigant on a legal issue between contracting parties? Yet that is exactly the position insurance commissioners have assumed regarding the offset issue, and the position they have assumed is contrary to their primary function as regulators.

There are numerous other examples of the interests of the liquidator being contrary to or in conflict with the interests of the regulator. Since the business of winding up an insolvent insurer is akin to the business of insurance, these tensions are nothing more than the natural order of things—the expected interaction between regulators and the entities they regulate.

- **Myth: Liquidators are properly accountable for their actions.**

Reality: Liquidators conduct an insurance business substantially free of all generally recognized standard reporting requirements, and are subject only to limited review and oversight by non-insurance entities: the courts. Thus, the business of liquidation of insurance companies is, in effect, unregulated.

Professionals in liquidation bureaus get quite upset at the suggestion that they are not accountable for their actions. This observation is not intended as criticism of the professionalism or the integrity of the liquidation professional. It is merely a recognition that the system does not engender appropriate management or regulatory accountability.

The courts are certainly in no position to spend any significant time in reviewing the actions of the liquidator. Almost all matters considered by the courts are brought to the court's attention by the liquidator, who controls the flow of information to the court. When others bring matters before the court, the court's attention is usually focused by the regulator because of the restraints of time and the court's limited knowledge of the business of insurance.

Furthermore, the court only has one case before it at a time. From this perspective, it is not possible for any one court to review overall policy issues with regard to a particular state's liquidation process. Although a court may be able to respond to specific legal issues in a particular estate, it is not possible for a court to adequately oversee an entire state's liquidation process from the vantage point of only one estate, particularly when the liquidation bureau may be controlling dozens of these proceedings.

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- **Myth: Liquidation is in the best interests of the policyholders of an insolvent insurer.**

Reality: Liquidation is often the least effective method of maximizing the available assets of an insurer to meet the claims of its policyholders. Yet most other options—managed runoff, reorganization, spinoff, sale, commutation, reinsurance supervision or rehabilitation—are either not considered or are viewed as mere interim steps before liquidation.

Many, if not most, insolvencies involve companies that are currently able to meet their obligations as they accrue. They are deemed insolvent because the estimate of future liabilities is in excess of their current assets. If the effort to detect and act against solvent companies is meaningful and fruitful, the number of companies that are declared insolvent though still able to meet their current obligations will increase as a percentage of the total. In view of that fact, liquidation as an option for the efficient management of assets should decrease proportionately, not increase.

However, most liquidators, by the nature of their charge, are not necessarily focused on restoring companies to the marketplace or in maximizing the return of assets to policyholders or creditors, or to restore companies to financial viability. If anything, the incentives that do exist tend to avoid conclusion of insolvent estates and to keep them open for extraordinarily long periods of time.

The liquidation process need not continue to be an inefficient, time-consuming and costly addition to the problem of insurer insolvencies. The process can be changed to compliment and enhance the effort to detect and deal with insolvencies sooner. Not only would this strengthen the resolve of regulators to deal with the problems of insolvency, it would also demonstrate the ability of state regulation to control and supervise the conduct of the business of

Continued on next page

Continued from previous page
insurance.

The basis for the re-examination and restructuring is simple: Recognize the liquidator as a manager of an insurance business. This would have three major consequences:

✔ The liquidator must be a separate entity from the regulator.

A state insurance commissioner should not act as the liquidator of an insurance company. There should be a separate liquidator for each insolvent estate. The court or the commissioner could be given authority to appoint a specific liquidator for each liquidation occurring in its jurisdiction.

Liquidators could be appointed from any number of sources. Accountants, actuaries, lawyers, former insurance executives and consultants are being hired by liquidators to perform services like those necessary for liquidation. They could easily be the pool from which the courts or the commissioners could select appropriate liquidators for each estate.

These people are currently hired to do the work anyway, but without any of the responsibility for the result. By making them the actual liquidator, rather than a paid consultant, a system of accountability with separation of regulator and liquidator could readily be established from existing pools of talent.

✔ The liquidator should be a regulated entity.

Not only should the liquidator be an entity separate from the regulator, but the estate of an insolvent insurer should be a regulated entity. In other words, companies in liquidation should be required to continue to file statutory statements with insurance regulators and be subject to review and examination by the regulator. These filings would have to be modified to emphasize the status of assets and liabilities rather than such things as adequacy of reserves, premium income and other ongoing business portions of the existing statements.

Presently, there is no adequate means by which policyholders and creditors can ascertain the status of the assets in an estate, the scope and nature of claims against it or the expenses of administering the estate. Examples abound of creditors and policyholders frustrated in their efforts to ascertain the status of estates in liquidation. It is no answer that the courts are overseeing these estates and protecting their interests since the courts do not have the expertise or resources to adequately perform this function. In many instances, no reports are filed with the court at all until there is a distribution, which could be many years after the order of liquidation, and the reports that are filed are usually of minimal value at best.

✔ With accountability goes rewards.

Managers of insurance companies in liquidation should be rewarded for the effectiveness of that management. Systems should be discussed and devised to reward managers for success in marshaling and distributing assets, or in otherwise restoring insolvent companies to financial viability.

It may be abhorrent to regulators to consider such a reward system in the management of insolvent estates. However, if you accept the premise that liquidators are managers and you would like to develop as efficient a system of management as possible, it is necessary to reward those who do so most efficiently.

It also would be a marvelous opportunity to take advantage of all of those "experts" who are offering their services for substantial fees to do the management work for the liquidator without any of the responsibility. Perhaps it's time to let these experts assume some responsibility for their work.

If the industry were to develop a system of liquidation based on the separation of liquidator from regulator, proper accountability and reward for effective management, we would see far more ingenuity and effectiveness in the management of insolvent estates for the benefit of their policyholders and creditors. Such effective management could lead to more companies actually being saved with a greater return to policyholders and creditors, and would allow the regulators to concentrate on what they do best: regulation. The regulators would also be less likely to be looking over their shoulders in determining whether to take action against a particular entity that may be insolvent, knowing that the responsibility for the management of that entity in liquidation will fall on someone else.

Free to perform their primary functions, state regulators would be better equipped to carry out their primary function, and further confirm the effectiveness of state regulation and the lack of need for a federal system. Pressures on the funding of guaranty funds by solvent, well-managed insurers should also be reduced since such funds will be less likely to have to pay for the inefficiencies and waste inherent in the present system. These benefits could ultimately help sustain a healthier, more energetic insurance industry. ■

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