ILMA Institutional Life Markets Association

INVESTOR NOTES

Protecting Policyholders From Insurance Carrier Defaults: Regulations and Procedures

Introduction

Numerous regulations exist to ensure that life insurance companies remain financially sound and are able to meet their obligations to pay death benefits. However, if a carrier becomes financially unstable, there are key procedures in place to protect the interests of policyholders or their beneficiaries. This letter will highlight these procedures as well as address the role of key players in the regulatory framework.

Regulation of Carriers

State insurance departments regulate carriers under the supervision of a State Insurance Commissioner ("Commissioner"), who can be elected or is appointed by the Governor. It is the responsibility of the Commissioners to ensure the fiscal accountability of carriers operating in their state through the issuance and implementation of regulatory measures and the exercise of oversight over the carriers. Specific regulations imposed on insurance carriers include a) restrictions on the types of investments carriers may hold, b) minimum capital requirements, c) periodic financial exams by state regulators**,** d) filing of annual and quarterly statements with National Association of Insurance Commissioners ("NAIC"), e) application of NAIC's Insurance Regulatory Information System ("IRIS") which sets key financial ratios and allowable ranges, f) underwriting limitations on the amount of new business that can be written, based on the level of capital and surplus to support such business and g) specified reserve requirements. In addition, any extraordinary dividend or distribution by an insurance company to its shareholders is subject to regulatory approval. Furthermore, regulations on insurance holding companies aim to shield the solvency of an insurance carrier against actions of its parent and affiliates. An example of this protection is prior notification and state regulatory review of any material transactions between affiliates and the insurance company.

Stages of Financial Instability

The specifics vary from state to state, but there generally are three options available to the Commissioner when an insurance company faces financial distress. The first option is to determine whether or not the company can be rehabilitated. If rehabilitation is not possible then the commissioner will decide whether or not the company should be liquidated or absorbed by another insurance company.

Rehabilitation

When a carrier faces severe financial difficulty and cannot meet its obligations, the Commissioner may begin the rehabilitation process whereby it makes every attempt to enable the company to regain financial stability. The exact triggering event and the amount of discretion vested with the Commissioner will vary based on state law. At this point, a receiver could be appointed to perform this duty. The receiver can be an employee of the state insurance department or an otherwise qualified independent professional.

Insolvency – Liquidation or Transfer Assets

If rehabilitation fails, the carrier is declared insolvent and the commissioner must take certain actions to arrange for a sale of some or all of the carrier's obligations to another solvent insurance company or commence a state court action in order to liquidate the company. If appointed, a receiver will handle the liquidation or sale as well as overseeing the accounting of carrier assets and liabilities and administer the estate of the company, seeking to maximize the value retained for company assets and distribute cash according to payment priorities. Every state requires that distributions be made on a class-by-class basis which means that the claims of one class must be completely paid before any payments are made to subordinate classes. The priorities vary by state, but policy holders possess a senior claim behind the repayment of administrative costs such as payments to the receiver for services rendered and certain fees to state guarantee associations. Each member of a given class must be treated equally which means that applicable law would require that all institutional owners of policies rank *pari passu* with individual policy holders in a liquidation scenario. To our knowledge, there has never been a failure of a major life insurance carrier where beneficiaries of the affected life insurance policies were not paid in full, although there may have been a delay in timing of payment. A.M Best noted in a recent presentation at the Institutional Life Markets Association (ILMA) conference (London, May 2009) that the rating agency is not aware of losses on death benefits to policyholders in the worst impairment stretch betweeen 1988 and 1992.

Two caveats should be noted. First, liquidation statutes do not apply to a receiver during the rehabilitation phase, which means it could discriminate in the treatment of policy holders. However, any such discretion used by the receiver regarding liquidation statutes poses a small risk as it requires court approval. Second, in the unlikely event of simultaneous insolvencies or the massive insolvency of a single carrier, there may be significant political pressure to require institutional investors to accept a lower settlement than what is mandated by law. There has not yet been a major carrier insolvency in recent times where institutional investors made up a significant portion of the affected policy holders.

State Guarantee Association (“Association”)

State guarantee associations exist in each state to protect policy holders of insolvent insurance companies by supplementing any shortfall for policy holders from liquidation proceeds up to a specified threshold. All licensed carriers in a given state must join their respective association. The association assists the Commissioner and/or receiver in determining whether a financially challenged carrier can be rehabilitated or if a failed company should be liquidated or transferred to another insurance company. Although laws governing the maximum limits and types of policies covered vary from state to state, the following generic limits apply:

- $300,000 in life insurance death benefits
- $100,000 in cash surrender value or withdrawal value for life insurance
- $100,000 in withdrawal and cash values for annuities
- $100,000 in health insurance policy benefits

Most states enforce an additional cap of $300,000 per life. In order to cover the aforementioned obligations, each insurer is assessed a share of the amount due based upon the amount of premiums they collect in the state.

Resources & Credits

http://www.naic.org/index_about.htm
http://www.nolhga.com/
http://www.insurance.wa.gov/publications/tips/FinanciallyUnhealthy.pdf
http://www.ins.state.pa.us/ins/lib/ins/consumer/brochures/2003_Liquid_Rehab.pdf

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About the Institutional Life Markets Association, Inc. (ILMA)

The Institutional Life Markets Association, Inc. (ILMA) is a not-for-profit trade association comprised of a number of the world’s leading institutional investors and intermediaries in the longevity marketplace, formed to encourage the prudent and competitive development of a suite of evolving longevity related financial businesses, including the businesses of life settlements and premium finance. ILMA’s members include: Credit Suisse; EFG Bank; Goldman, Sachs & Co.; JP Morgan Chase & Co.; Mizuho International plc; UBS AG; and WestLB AG.

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