

Impairment, Insolvency and Underwriting in Difficult Times

Introduction What causes an insurance company to fail? What turns a strong carrier into an impaired one and, eventually, an insolvent one? What impact does an insurer that ceases to exist have on the industry, on the market and on society in general? This paper will take a look at a variety of reasons why companies go out of business, ranging from mismanagement, poor decision making, and—in some cases—outright fraud and criminal activity.

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“It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope it was the winter of despair, we had everything before us, we had nothing before us...”⁽¹⁾

Experienced underwriters point out that, during this protracted soft market, the usual dynamics of a cycle appear to have somewhat stalled. In addition to the typical capital, we have seen an abundance of “new capacity” in the marketplace. We have also witnessed the usual step of government intervention, with the infusion of tax payer funding, to support a large company that could have—or possibly should have—failed. These actions have significantly impacted the length and depth of the soft market. This may lead us to ask why it’s important for companies to remain solvent. We may wonder why it is necessary to have effective regulation over the financial viability of carriers. In this paper, we will look at the impact impaired and insolvent carriers have on the industry, on the market, and on society in general.

Insolvency and Impairment: The Difference

Before we begin, we need to understand the difference between insolvency and impairment:

Impairment: A situation when an insurer is in financial difficulty to the point where its ability to meet financial obligations or regulatory requirements is in question.⁽²⁾

A financially impaired insurance company is an insurer that has had an official action taken against it by regulators in a state where it conducts business, even though the company technically might not be insolvent. State actions might occur when there are restrictions on the company to conduct business normally, when capital and surplus are deemed inadequate to meet legal requirements, and when general financial condition has triggered regulatory concern.⁽³⁾

The impacts of impairment can be wide ranging, including:

- Policyholders are denied claim payments or face delays
- The cost of insurance for other policyholders increases
- Local economies suffer from lost jobs and revenue

Insolvency: A situation when an individual or organization can no longer meet its financial obligations with its lender or lenders as debts become due. Insolvency can lead to insolvency proceedings, in which legal action will be taken against the insolvent entity, and assets may be liquidated to pay off outstanding debts.⁽⁴⁾

Notable Property and Casualty Insurers That Have Failed

During my tenure as a reinsurance and insurance specialist in the professional liability field, I have witnessed companies fail for a variety of reasons. Whether through heavy loss activity, shoddy management decisions, insufficient rate setting for collections premiums, or a combination of any of these, companies became insolvent. Where did these carriers go? Some were absorbed via merger and acquisition activity, while others were closed down in run-off. The basic equation is always the same: protracted period of loss **plus** expensive activity exceeding premiums collected **equals** failure. The following cases are examples of just such instances.

Example 1: PHICO (Pennsylvania Hospital Insurance Company) - Pennsylvania

In November 2001, Pennsylvania Insurance Commissioner M. Diane Koken filed suit against 15 former PHICO officers and directors in the wake of an investigation by state regulators. The investigation concluded that the insurer was hugely under-reserved by at least \$250 million. A state judge ordered PHICO liquidated effective February 1, 2002.

Commissioner Koken's official statement, the court order, and other documents regarding PHICO Insurance Company (In Liquidation) and the liquidation process are available on the insurance department's website at www.insurance.pa.gov.⁽⁵⁾

Background: Started in the 1970s during the medical malpractice crisis, PHICO provided medical malpractice, general liability, and workers compensation insurance for hospitals, physician groups and individual physicians.

According to the state's official suit, PHICO's troubles began in 1996 when it launched an aggressive growth campaign to expand into new regions and substantially underprice competitors on malpractice liability, workers compensation, and other insurance products.

The insurer's net premium volume in an already competitive market shot from \$172 million in 1997 to \$268 million in 1999, the suit says. By late 1999, though, PHICO's actuaries and its outside auditor, PricewaterhouseCoopers LLC, had concluded that the insurer was facing massive losses and would have to boost reserves as of year-end by \$130 million, an amount equal to about half its surplus at the time, the suit said.

PHICO's board also hired PricewaterhouseCoopers to review its claims, underwriting and pricing practices, and the audit produced a report that criticized PHICO's chronic under-reserving. In May 2000, the state asserted that PHICO launched an "absurd" effort⁽⁶⁾ to push down the insurer's already deficient reserves to bolster its reported financial condition and prevent downgrading by rating agencies, regulators alleged. The effort included:

- Establishing reserves for only one policyholder on claims that involved multiple PHICO policyholders.
- Imposing an arbitrary incurred loss "budget" on the claims department that made it impossible to increase reserves.
- Revoking the authority of claims department personnel to set reserves.⁽⁶⁾

Leading up to the insolvency, PHICO operated on a "pay as you go" system, with reserves increased only to make current loss or expense payments, the suit says. Regulators charged PHICO management with breaching fiduciary duties to the insurer and misrepresenting its operations and financial condition to PHICO's board. The suit also charged PHICO directors with breaching fiduciary duties by failing to discover and act on evidence of PHICO's growing problems.⁽⁶⁾

Example 2: Heath International Holdings (HIH) - Australia

On March 15, 2001, HIH received approval from the New South Wales Supreme Court to place HIH into provisional liquidation. Tony McGrath of KPMG was appointed as provisional liquidator to HIH and 17 of its controlled entities. Provisional liquidation is a temporary operations and assess the financial position. HIH insurance is now in run-off, which means it is managing its outstanding claims and not writing any new business. This process could take several more years to complete.⁽⁷⁾

Background: Many factors led to the insolvency of HIH, the most grievous included:

- Misjudgment of Risks: Under-reserving of approximately \$5 billion⁽⁸⁾
- Poor management decisions⁽⁸⁾
- 1998 purchase of FAI. Tony McGrath, Sydney, Australia-based liquidator of HIH, said earlier that HIH bought a worthless insurer when it paid \$295M Aus. for FAI. FAI's subsequent insolvency has been cited as a major factor of HIH's failure in 2001, becoming Australia's largest corporate collapse.⁽⁹⁾

Results: HIH creators recovered more of their lost money after liquidator Tony McGrath settled a \$450 million claim against the collapsed insurer's financial advisers and reinsurers. Six years after lodging the claim, Mr. McGrath has secured an undisclosed sum from three companies which acted as financial advisers and reinsurers to FAI Insurance when it was acquired for \$300 million in 1998. Goldman Sachs Australia, Gen Re and Guy Carpenter were defendants in the case. They have agreed in the NSW Supreme Court to settle with Mr. McGrath.^{(10) (11)}

Example 3: Reliance Insurance Company - Pennsylvania

In 2001, a Philadelphia area insurer, Reliance, collapsed under a \$1.1 billion shortfall in reserves. The company's failure made Reliance the nation's largest insurance company collapse that year, according to Weiss Ratings, Inc.⁽¹²⁾

Background: As a public company, Reliance's directors and officers faced substantial liability from shareholder lawsuits following alleged poor decision making. That liability included civil lawsuits filed by regulators and government authorities, and potential criminal charges.

Results: In the case of Reliance Insurance Co., the Pennsylvania Insurance Department reached an \$85 million settlement in a lawsuit against Reliance's former directors and officers.

Example 4: Frontier Insurance

Frontier Insurance Company is a property and casualty insurer domiciled in the State of New York. The company was placed in rehabilitation and the New York Superintendent of Insurance was appointed as Rehabilitator by order of the Supreme Court of the State of New York. Frontier wrote commercial auto, workers compensation, homeowners, general liability and medical malpractice coverage as well as surety bonds.⁽¹³⁾

Background: According to BestWire (March 20, 2001), Frontier's President and CEO, Harry W. Rhulen, said the P&C company started writing medical malpractice policies in the early 1990s in New York, where the business turned a profit. Medical malpractice in New York is different than any other state, because the insurance department sets the rates. "We weren't competing based on rates, like in any other state," he said. The company believed medical malpractice was a profitable line because of the long-tail nature of the claims. "The problem really was we lacked the underwriting controls and infrastructure to properly do that type of business," Rhulen said.

However, the company expanded the business to competitive medical malpractice states, such as Florida and Texas, where many companies were doing "cash-flow underwriting," which is the practice of under pricing premiums with the expectation that lost revenue would be made up through investments. "That's where we really got ourselves in trouble" Rhulen said. "We didn't realize companies were intentionally writing at a very significant underwriting loss... we priced to that level, but reserved to our historic profitable levels (from New York business)."

In the early days, as much as 50% of the company's business was medical malpractice. That percentage was later dropped down to as low as 25%, but losses from the medical malpractice business began to outweigh the rest of the company's business and dragged the bottom line into the red. "When you're writing \$100 million in premium at a 150 combined ratio, you're losing \$50 million a year. To make up that profitability...it's almost impossible" Rhulen said.⁽¹⁴⁾

In March 2001, the company stopped writing new and renewal business due to the mismanaged underwriting and pricing of the early to mid 1990s. Allegations of fraud were raised in court. According to court documents: "The Plaintiffs allege that during the Class Period, Frontier engaged in irresponsible and negligent insurance practices. The Plaintiffs focus on three areas of the Defendants' conduct. First, the Plaintiffs allege that the Defendants implemented reserve policies with the deliberate purpose and systematic effect of under-reserving for claims. Second, the Plaintiffs allege that the Defendants' information systems were grossly inadequate, such that reserves could not properly be recorded and claim histories necessary for responsible actuarial analysis were unavailable. Third, in order to cover the revenue shortfalls created by Frontier's failure to reserve adequate sums and price policies correctly, the company engaged in a "pyramid scheme" whereby it rapidly expanded its business by acquiring other insurance companies, offered policies at predatory prices, and used the premium income thus generated to pay claims on existing policies. The Plaintiffs allege that the individual Defendants were aware that these policies were reckless, and that they ignored or fired employees and independent actuaries who raised concerns about these policies."⁽¹⁵⁾

Example 5: The Reciprocal Group/Reciprocal of America (Virginia Insurance Reciprocal)

The Virginia Insurance Reciprocal was formed during the 1970s to respond to the medical malpractice crisis and was originally sponsored by the Virginia Hospital Association and its member hospitals. Reciprocal of America and The Reciprocal Group were placed into Receivership on January 29, 2003, by the Circuit Court of the City of Richmond, Virginia.⁽¹⁶⁾

Background: In February, former Reciprocal of America ("ROA") officers Kenneth R. Patterson and Carolyn B. Hudgins pleaded guilty to conspiracy to commit insurance fraud, and Patterson pleaded guilty to two counts of mail fraud. Hudgins' guilty plea reveals that, beginning in at least the late 1990s, she and others were engaged in a complex scheme to commit insurance fraud. Patterson's guilty plea reveals that, when Patterson signed the Increased Limit Proposal Form in April 2001, he was actively participating in an ongoing criminal conspiracy to defraud insurance regulators and others about the financial condition of ROA. In his guilty plea, Patterson admitted that, by at least March 2001, he had joined the conspiracy and that, in or about March 2001, he recognized that he and his co-conspirators had mischaracterized a \$10,000,000 transaction on ROA's books and records."⁽¹⁷⁾

Results: On January 29, 2003, the Circuit Court of the City of Richmond, issued its Final Order Appointing Receiver for Rehabilitation or Liquidation (the "Receivership Order"), which placed Reciprocal of America and its attorney-in-fact, The Reciprocal Group, into receivership. The Receivership Order came pursuant to an examination by the Bureau of Insurance (the "Bureau") of the State Corporation Commission of the Commonwealth of Virginia (the "Commission"), which determined that ROA and TRG were in a hazardous financial condition."⁽¹⁸⁾

Understanding the Causes of Insurer Failure. What Can Go Wrong?

In 2009, A.M. Best published a study on 871 financially impaired P/C insurance companies. The study dated back 34 years and was an update to a previous insolvency study that had been published in 1991. Key factors of note during the time period studied are as follows:

“A.M. Best reached its conclusions after examining 871 financially impaired P/C insurance companies, dating back 34 years. Best’s Insolvency Study, Property/Casualty U.S. Insurers 1969 to 2002, is an update to the landmark insolvency study first published in 1991. The new research provides a broader base for analyzing the causes of financial impairment than ever used before. The study was conducted over a long enough period of time, beginning in the late 1960s, for the industry to have experienced ‘both the best and the worst of operating environments.’”

- On the upside were four hard markets, five economic booms, and the greatest bull stock market in history.
- On the downside were three soft markets (the last one of unusually long duration); a series of the most costly natural and man-made catastrophes in history; six recessions; extremes of inflationary pressures and interest-rate gyrations; and two major bear stock markets. Also contributing to the downside were factors such as an increasingly litigious society, enormous environmental liabilities, global competition and state-mandated rate rollbacks.

The study found that a majority of the financially impaired companies tended to be stock companies, “where the impairment frequency was about four times (1.2 percent vs. 0.3 percent) that of mutual companies. Most impaired companies were small, as measured by premium volume, and the majority wrote commercial lines—which experienced more volatile underwriting results and lower profitability—particularly during the 1980s and 1990s.” Best identified the primary causes of financial impairment in 562 of the 871 companies.

- The leading cause of impairment, at 37.2 percent, was “**deficient loss reserves/inadequate pricing.**”
- **Rapid growth**, which is closely related to deficient loss reserves, was the second highest cause of impairment, at 17.3 percent.
- **Alleged fraud** was the third-highest identified cause (8.5 percent). The rating agency rather pointedly added that, “with the possible exclusion of catastrophe losses,” it “believes all the primary causes of insolvencies in this study reflected some form of **mismanagement.**”⁽¹⁹⁾

The full range of issues (from the A.M. Best study) revealed the following ⁽²⁰⁾:

Primary Cause	Details
Deficient Loss Reserves/Inadequate Pricing	Deficient loss reserves are the main cause of impairments. From 2000-2001, this accounted for two-thirds of all impairments. For 2002, 2004 and 2005, it was sighted as the chief cause in more than 85% off all P/C impairments.

Primary Cause	Details
Rapid Growth	Diminished capital strength becomes a greater probability for insurers that embark on long-term, aggressive expansion strategies, particularly when new lines of business and a lack of related underwriting experience are involved.
Alleged Fraud	Impairments attributed to alleged fraud increased through the 1980s, into the early 1990s, but then tapered off after 1992 as regulators increased their oversight of the industry.
Investment Problems/ Overstatement of Assets	Impairments from this cause tend to occur when assets are reduced by an amount greater than the company's capital and surplus, especially when the market value of invested assets declines or an audit reveals misstatement of reported asset values.
Catastrophic Losses	Impairments due to catastrophe losses are caused by acts of nature that can lead to insolvency when related claims exceed an insurer's financial resources.
Significant Change in Business	Impairments can be the result of a significant change in business, especially when an insurer expands into new products or territories in which it lacks experience or expertise.
Impairment of an Affiliate	Mergers and Acquisitions combined with increasing complex corporate structures and reinsurance failure help account for affiliate-related impairments.
Reinsurance Failure	Impairments attributed to this cause typically occur when a company's reinsurer does not fulfill its contractual obligation for payment of reinsured claims.
Miscellaneous	This category includes various causes of impairments that either were not applicable to the primary causes or were rare or unusual circumstances.
Source: "1969-2008 Impairment Review," Best's Special report, April 6, 2009, Page 8, U.S. Property/Casualty, A.M. Best Company, Inc, Pages 19-21.	

The State, Federal, and Other Bodies Governing Insurance Operations

As an insurance company operates in applicable jurisdictions, state insurance departments take on the responsibility of helping to monitor rates and forms, as well as the financial strength and viability of insurance organizations. They do so in order to ensure that carriers will be properly financed when a claim needs to be paid. Recently, the government took a look at how insurers fail and whether states are monitoring the results adequately.

According to a report issued by the U.S. House of Representatives Energy and Commerce Subcommittee on Oversight and Investigations titled "Failed Promises: Insurance Company Insolvencies," there were several characteristics shared by the failed companies:

- An **excessive delegation of management authority** to managing general agents, brokers and others
- **Under-pricing** of insurance products
- **Under-reserving** the resulting losses
- **Rapid growth**, often into new unfamiliar product lines
- **Excessive reliance of reinsurance**
- **Incompetent management** and, in some cases, fraud
- **Inadequate regulation** and enforcement by state insurance departments⁽²¹⁾

Besides the state departments that are responsible for enforcing regulations on insurers, there are a number of organizations that review insurance company operations while providing reviews of policy forms and rates. Here are a few examples:

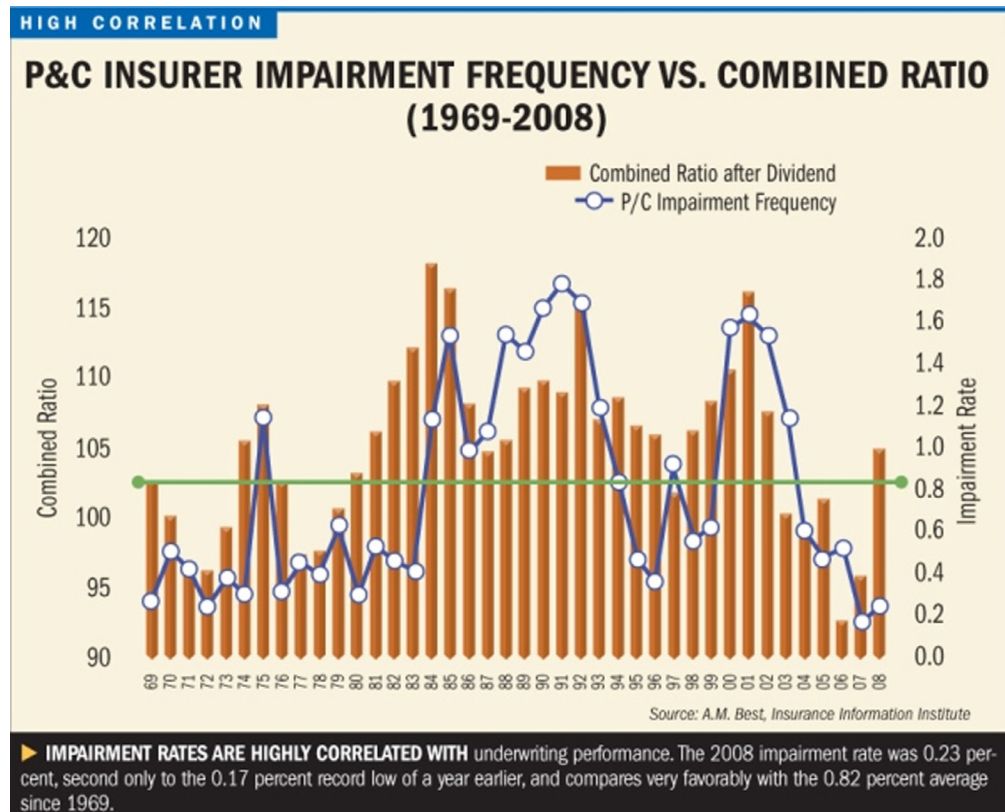
<p>1. State Insurance Departments are the main regulators</p>	<p>“Because of the McCarran-Ferguson Act (1945), the states have regulated insurance.”⁽⁸⁾</p>
<p>2. State Legislators also have an impact</p>	<p>“State legislators are involved in the regulation of insurance and often directly control the budgets of state insurance departments and pass insurance laws that insurance commissioners are charged to enforce.”⁽⁹⁾</p>
<p>3. National Association of Insurance Commissioners (NAIC)</p>	<p>“The NAIC is to coordinate the regulation of insurers operating in multiple jurisdictions (1871).”⁽²²⁾</p>
<p>4. Federal Laws</p>	<p>“For most businesses operating on an interstate basis, federal regulation is primary to state regulation. State laws and regulations can be void under the U.S. Constitution under the following circumstances:</p> <ol style="list-style-type: none"> 1) When a state law contradicts a federal law. 2) When the courts determine that a state law interferes with the purpose or results of a federal law. 3) When state law imposes improper burden on Interstate commerce, even if no federal law exists. <p>Federal law is often comprehensive and cannot continue with differing results under various states laws. In these situations, federal law can preempt state law.”⁽²³⁾</p>
<p>5. Legislation</p>	<p>When court decisions interpret particular insurance laws that differ from the interpretation of regulators/legislators, the insurance industry is likely to experience a change in the way it is regulated.</p> <p>Courts can also directly influence the activities of those within the insurance industry when:</p> <ol style="list-style-type: none"> 1) Courts interpret policy language. 2) Courts decide whether claims have been settled appropriately in light of the policy language.

How the Market Cycles Can Impact the Solvency of an Insurer

As we discussed in our previous white paper, market cycles can have an impact on loss ratios. However, when it comes to insurer insolvency, the A.M. Best study revealed the underlying actions that can come into play, notably poor management decisions.

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The chart⁽²⁴⁾ on the following page shows the correlation between impairment frequency and combined ratios. It becomes obvious that there are certain loss and premium dynamics that need to be carefully monitored at all times.



The possibility of large forecast errors, management of reported losses and thus earnings, and accounting conventions that focus on calendar-year losses—which include revisions in forecasts of costs for claims arising in earlier years—all make it difficult to evaluate the relation between premium growth and loss growth.⁽²⁵⁾

Significant reductions in interest rates during 1983-1987, 1991-1993, and 2001-2003 produced significant increases in the discount factors. Two of those periods coincided with rapid growth in medical malpractice incurred loss estimates, thus putting further upward pressure on medical malpractice premiums.⁽²⁵⁾

The pressure mounts over time for executives to be on top of his or her game. Per Jon Wright, SNL Financials director of insurance, “After analyzing data for 95% of the industry, SNL Financial found that the U.S. insurance industry’s negative returns on underwriting continue to deepen and the short-term boost from over-reserving for prior years is running out. Overall premium growth continued to recover in 2010, and our findings point to further continuance of that trend in 2011.”⁽²⁶⁾

In a somewhat related note, we see statements made by Munich Re that “The earthquake which hit Japan with a magnitude of 9.0 in March was the most expensive natural catastrophe on record in terms of economic losses. It cost about \$210 billion –more than the \$125 billion of economic losses caused by Hurricane Katrina in 2005– and killed at least 15,500 people. However, in terms of insured losses of about \$30 billion, the Japanese earthquake remained below the level of Katrina. Overall insured losses from catastrophes in the first half of this year –those losses which insurers and reinsurers will have to cover– were \$60 billion, almost five times the first-half average since 2001.”⁽²⁷⁾

The Financial Cost of Insurance Company Failures

When an insurance company fails, what costs are incurred? James Bohn and Brian Hall give us some hints with their research-based conclusions⁽²⁸⁾:

“We examine the costs of resolving property-casualty insurance company insolvencies. When a P&C insurance company becomes insolvent, solvent insurance companies are forced to pay assessments, which are a form of taxation, to state guarantee funds in order to protect the policyholders of the failed companies. Our estimates imply that the costs incurred by guarantee funds to resolve insurance company insolvencies are remarkably high – about 100 percent of the book value of assets in the year before the company was declared to be insolvent. This implies that insolvent companies have liabilities that are approximately twice as large as their assets when they are declared to be insolvent. These costs are more than three times as high as the costs incurred by the FDIC and FSLIC in resolving the failures of commercial banks and S&L in the 1980s.”⁽²⁸⁾

“We also find that the ratio of net costs to assets tends to be higher for small firms, poorly capitalized firms, firms writing significant amounts of premiums in long tail lines, and firms that fail because of disasters. Our findings also indicate that the resolution of insolvencies is typically quick. More than 60 percent of all costs to the fund for a given insolvency occur within two years, and more than three-quarters of total costs occur within three years. However, we find that firms with a high proportion of premiums in long-tail lines take much longer to resolve, perhaps because companies are gaming the solvency fund system, a type of moral hazard.”⁽²⁸⁾

How can this tremendous cost be minimized? In his work “The High Cost of Insurance Company Failures,” Richard D. Phillips at Georgia State offered some opinions and solutions:

“Our results also strongly suggest that earlier regulatory intervention, before an insurer actually becomes insolvent, will likely lead to dramatic savings. The source of the benefits would come from reduced risk-taking incentives by insurance company managers, better information for supervisors regarding the true economic worth of the firm, and increased transparency through the release of private information by the domiciliary regulator of the insurer...Similarly, there is a lack of uniformity among the states in how receiverships are set up, how the receivership operates, and a lack of ability to judge the efficiency of the receivership. Ideally, a benefit to a federal system is competition between ideas as to how one should properly regulate or administer a particular state function.”⁽²⁹⁾

How Carriers Can Avoid Insolvency

Obviously, one of the best ways to avoid an insurance company failure is not to take those actions (or inactions) that lead to the failure in the first place. Running a sound insurance operation means you need to have the right leadership team in place. Best practices include recruiting and retaining top notch management, underwriters, claims handlers, actuaries and support staff.

This process requires not just hiring the right personnel, but also offering a quality environment in which people can survive and thrive as they work. Providing a healthy culture is overlooked in many insurance companies today. A healthy culture is linked to more than just corporate goals and financial results - it's linked to the core of human respect. It helps keep people engaged and motivated.

In addition to motivation and talent, it takes planning, preparing and consistent monitoring of the liabilities of the operation. It is obvious from the companies discussed earlier that some leaders were not monitoring the actual value of liabilities. But how does one do this, when the models we create are not foolproof? We as an industry derive much of our current rates on projecting costs from past experience. Even with evidence based on models used in calculations and reliance on outside monitoring tools, companies can still fall short. According to the report "Crises in Medical Malpractice: Excessive Price Cutting in the Preceding Soft Market,"

"We provide evidence that firm-level growth in malpractice insurance premiums for growing firms during the 1994-1999 soft market was positively related to subsequent loss development. This result is consistent with the hypothesis that some firms priced too low ex ante, leading to relatively rapid growth and adverse loss development, and plausibly deepening the soft market, which in turn would be expected to aggravate the subsequent hard market that commenced in 2000. Perhaps due to the inherent difficulty of identifying firm characteristics associated with under pricing using financial statement data, our reduced estimates of cross-firm determinants of premium growth and loss development during 1994-1999 provide some evidence that lack of specialization in medical malpractice insurance contributed to relatively rapid growth and adverse loss development, but the results are otherwise uninformative. Consistent with inadequate ex ante prices, some malpractice insurers that became insolvent towards the end of or following the 1994-1999 soft market had abnormally large premium growth. However, other malpractice writers that ultimately failed shrank significantly during the sample period. If rapid growth induced by under pricing contributed to those firm's problems, it apparently did so the mid-1990's."⁽²⁵⁾

Monitoring Company Results: A Potential Future Framework

Moving on from modeling loss costs to the topic of monitoring companies, McKinsey & Company wrote a paper in 2008, suggesting how the industry could improve property and casualty insurance regulation in the United States.

Clearly there is a more focused need for specified regulation in the United States. Companies are under increased pressure to have profitable results for not only the investors, but for the sustainability of the policy holder. The McKinsey paper offers five different options, and

provides opinions as to which type of regulations may work best – both from a National and State perspective. The chart⁽³⁰⁾ below titled “Benefits of National Regulatory Options” shows a comparison between various regulatory options.

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Benefits of national regulatory options

Assessment criterion	Options for national role in insurance regulation				
	Option I: Systemic Risk Regulator	Option II: Split Stability Regulator	Option III: Comprehensive Stability Regulator	Option IV: National Regulator for Large and Complex	Option V: Integrated Financial Activities Regulation
A. Safety and Soundness	Additional oversight on risk, but conflicts between state and national, and lack of clear accountability for solvency	Conflict between solvency (national) and prices (states)	Full purview over solvency, covering all insurers, with the best experts	Full purview over solvency, covering all riskiest insurers, with the best experts	Full purview over solvency purview, covering all insurers, with the best experts
B. Fair treatment of Customers	States solely responsible for customer treatment	States solely responsible for customer treatment	States solely responsible for customer treatment	Consistency for large insurers, but multiple regulatory standards, and potentially confusing to customers	Consistent across U.S. and clear roles, but less local knowledge
C. Efficiency	Substantial duplication of regulatory effort	Some duplication of regulatory effort	From 51 to 1 regulator, for most functions, and all insurers	From 51 to 1 regulator, for almost all functions, for bulk of industry	From 51 to 1 regulator, for all functions, for all insurers
D. International competitiveness	No change; new regulator has insufficient purview to represent U.S. on insurance	Negotiate some elements of solvency	Full authority to negotiate solvency	Strong authority to negotiate for bulk of industry	Full authority to negotiate all aspects of industry regulations

As to the degree of implementing such ideas, the McKinsey paper discusses these in the chart “Ease of Implementation of National Regulatory Options,”⁽³¹⁾ seen below:

Ease of implementation of national regulatory options

Stakeholder	Options for national role in insurance regulation				
	Option I: Systemic Risk Regulator	Option II: Split Stability Regulator	Option III: Comprehensive Stability Regulator	Option IV: National Regulator for Large and Complex	Option V: Integrated Financial Activities Regulation
Customers	• No change versus today	• No change versus today	• Some change in residual markets	• Need to identify which regulator if lodging complaint	• Some change in residual markets
Agents	• No change versus today	• No change versus today	• Transfer of licensing to new regulator • Changes to policy forms	• Some transfer of licensing to new regulator • Changes to policy forms	• Transfer of licensing to new regulator • Changes to policy forms
Insurers	• Substantial additional reporting; duplicative regulators, sometimes at odds	• Manage tensions between two regulators	• Interface with new regulator; potential for dual regulation if have bank operations	• Interface with new regulator; potential for dual regulation if have bank operations	• Interface with new regulator
State regulators	• Manage duplication of purview • Need to educate national regulator	• Manage tensions between price and solvency • Some transfer of knowledge, etc.	• Transfer all solvency-related knowledge and personnel	• Transfer knowledge and personnel devoted to largest insurers	• Transfer all knowledge and personnel
National regulator	• Moderately expand scope of existing national regulator	• Moderately expand scope of existing national regulator	• Substantially expand scope of existing national regulator	• Establish new national regulator, with regional offices, etc.	• Establish new national regulator(s) • Redesign all financial regs.

In its conclusion, the McKinsey paper states that three of the options look like the best ones. From their perspective:

“Three options are viable and more attractive: creating a Comprehensive Stability Regulator, responsible for solvency, pricing, and products; establishing a National Regulator for Large and Complex Insurers and establishing an integrated Financial Activities regulation, with exclusive purview over all financial activities, across banking, insurance, securities, and other industries. Each of these options would fundamentally improve safety-and-soundness regulation in the U.S., improve the efficiency of the industry, and allow the U.S. to improve international competitiveness in insurance.”⁽³²⁾

Professional Liability Carriers are Impacted by Insurer Insolvency

The concept of insolvency affects not just the consumer - it can have a large impact across the entire insurance and reinsurance industry. In my line of insurance work, for example, we specialize in providing Professional Liability insurance coverages to professionals and professional firms. This includes such lines as Management Liability (D&O products), Professional Liability (E&O products) and Medical Professional Liability (Health care Liability products). Insolvency can lead to additional claims activity (losses and defense costs) to insurers of Professional Liability. Some of the more targeted areas where the pain is felt are in Accountants Errors and Omissions Liability Insurance, Lawyers Professional Insurance and Directors and Officers Liability, and fiduciary coverages.

Besides the notable cases we described at the beginning of this document, let’s look at some other professional liability cases brought against insurers for various professional liability coverages following an insolvency:

<p>Accountants Errors and Omissions</p>	<p>In <i>Bonhiver v. Graff</i>... a failed insurance company’s receiver sued the company’s accountants because their records and work papers did not reflect massive embezzlement by company management. The receiver claimed that, had the state insurance examiners received accurate information from the accountants, the state would have attempted to close down the company, thereby preventing further embezzlement (Page 9).⁽³³⁾</p>
<p>Actuarial Errors and Omissions</p>	<p>To date, at least fifty actions have been filed against actuaries, with over 70% coming in the last decade. Thirty-four of the suits, or 68%, have been filed by clients or their successors. Nineteen of the client actions were brought against pension actuaries by corporate sponsors, pension plans, or liquidators.⁽³⁴⁾ Ten of the suits were brought against casualty actuaries by client companies, controlling shareholders, liquidators, and a purchaser who retained an actuary in acquisition. Five of the actions were brought against life and health actuaries by client companies and liquidators.⁽³⁵⁾</p> <p>In the paper “Navigating The Litigation Minefield,” it claims that liabilities can be for the following reasons:</p>

<p>Actuarial Errors and Omissions (Continued)</p>	<ul style="list-style-type: none"> · Data Problems · Unreasonable Assumptions · Improper Methodology · Careless Calculations · Professional Ignorance
<p>Agents/Brokers Errors and Omissions</p>	<p>An insurance agent who places a policy for a client with an insolvent or unauthorized insurer may be exposed to liability to the client. If the insurance agent has knowledge that an insurer is insolvent or unauthorized by the state during a time when an insured could have been protected, then the agent may have a serious exposure to the client. This was the case in <i>Sappington v. Covington</i>, where an agent placed a group health insurance plan with an insolvent insurer. The client brought suit asserting the agent knew or should have known that the insurer was not financially sound.” However, an insurance broker who complied with customary industry standards has been found to have exercised due care in examining the financial strength of certain insurers (Page 281).⁽³⁴⁾</p> <p>Agents must continually monitor the financial condition of the insurers with whom they write business... Agents and brokers should always notify their insureds when the ratings of their insurers have been lowered (Page 301).⁽³⁴⁾</p>
<p>Directors and Officers Fiduciary</p>	<p>Corporate directors guiding distressed companies through today's difficult economic times face an immense amount of pressure. In the event of insolvency or near insolvency, it is even more important for such directors to maintain communication with the corporation's executive officers, obtain competent legal advice, and ensure that the corporation's indemnification provisions and director and officer insurance policies are up to date.⁽³⁶⁾</p> <p>The Pennsylvania Insurance Department has agreed to accept \$10 million to settle its lawsuit against 15 former executives and officers of PHICO Insurance Co. A proposed settlement has been approved by a state judge and is now being considered by a federal bankruptcy court judge. The \$10 million would be paid by an insurance policy that protects PHICO directors and officers against allegations of wrongdoing. The insurance department sued officials of the Silver Spring-based medical malpractice insurer in 2001, accusing them of carrying out a reckless business plan and failing to take action as the company.⁽³⁷⁾</p>

Conclusion

We have reviewed insurance company insolvencies from the perspective of various experts detailing the high risk factors that lead to failure. What –if anything–should be done about this problem? Do we let companies continue to fail? Do we allow the government to step in and use tax payer money to rehabilitate them, or do we assign more responsibility to the state and federal government for additional oversight?

Munich Re recently was quoted as having some interest in tackling this issue. In a prepared statement, they said: “Major insolvencies often destroy capital and jobs on a large scale and, accordingly, the social and political pressures on creditors’ committees and insolvency administrators are intense. Their task is to give companies an economic future, if possible, and to lead them out of the crisis. This has not always been the case, because until now most insolvent companies in Germany have been wound up (run out) instead of being restructured. As a result of the crisis, however, there has been a sea of change. As in the USA, in future the aim in Germany also is for the insolvency process to be an instrument of restructuring, which creates new opportunities. However, in order to be able to take advantage of these opportunities, insolvency administrators and creditors’ committees need professional liability insurance tailored to the complex risks of restructuring. In the case of major insolvencies, the insured sums often amount to hundreds of millions and cover must be made available as soon as possible.”⁽³⁸⁾

Finally, ask yourself how you can get involved with this issue. It has the potential to touch everyone in the industry, and it has not been resolved. All ideas are welcome.

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