Insurance Insolvency: The More Things Change, the More They Stay the Same

By Mark D. Harris

Insurance company insolvency has been a thorny issue spanning many decades. The only consistency is that there is no one solution and that an agent can be held liable for placing coverage with a company that becomes insolvent. Agents E&O policies have been challenged with how to adequately address insolvency exposure. This remains an ongoing concern with no single solution. Risk managers evaluate internal risk and categorize it according to how the exposures will be addressed: avoid, retain or transfer. Insurance Agents E&O policies have proven to be disparate and difficult risk transfer vehicles.

In prior times, insolvency funds covered admitted companies and in some states there was even a non-admitted insolvency fund. This may have given agents and policyholders a false sense of security, and the landscape changed in 1987 with the failure of Mission Insurance Company. It was the largest Property and Casualty insurer insolvency at the time. Suddenly, insolvency became more of a concern, and exclusionary wording on Agents E&O policies was strengthened. Over a period of years, the rating standard became an A.M. Best Company "A-" rating. Agents and others alike relied on A.M. Best and were comfortable that none of the highly rated carrier giants could fail.

A.M. Best was the gold standard for solvency metrics in Agents E&O policies. However, the events of September 11, 2001 challenged the predictive abilities of the A.M. Best rating and sent tremors of disbelief through the industry. Within a short period of time, four large well-known companies all failed (although only one had a clear connection to 9/11 losses): Reliance Insurance Company, Kemper Insurance Group, Atlantic Mutual Insurance Company and Legion Insurance Company. All were presumed to be too big to fail and were rated "A-" or better by A.M. Best at the time. Agents E&O carriers recoiled and tightened insolvency restrictions on their policies yet again, but the reality was that reliance solely on an A.M. Best rating could not guarantee future financial stability or protection for agents and their E&O carriers.

Since the failure of Mission Insurance Company, other rating agencies such as Demotech, Inc. have emerged, providing an alternate method of assessing carrier financial stability as well as an evaluation of carriers not previously considered. The effect was an overall increase in the number and type of rated carriers in the marketplace and the ability of agents to compare and contrast ratings from multiple sources. Additionally, agents could now take a more active role in how the insolvency exclusion in their E&O policy was structured by requesting that ratings from multiple sources be accepted (A.M. Best, Demotech, Moody's, S&P, etc.).

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Other factors exist which complement the picture of a carrier's financial health, especially when viewed along with a financial rating. Examples include a review of the "yellow book" (statutory financial statement), reinsurance protection purchased (and from whom), sources of capital, and reserving practices. Unfortunately, this information is not always easily accessible to an agent or insured, and review of this information is often outside their area of expertise. Without this information it is difficult to make an informed decision about the solvency of a carrier, and complicating this decision is the pressure agents face to win business in an increasingly competitive and crowded environment.

At the very least, an agent should address the rating/lack of rating of a carrier in their proposal, and obtain a written acceptance of this rating from the prospective insured. It is widely known that if an agent places business with a market that becomes insolvent, the courts can hold them liable regardless of how highly rated the carrier is at the time of failure. Having the buyer provide written direction (a risk avoidance technique) may defray any charges that the agent knew or should have known of an insurer's financial difficulties and/or potential insolvency.

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demand an insolvency exclusion, and some who don't. There are pros and cons to each approach. Use of an insolvency exclusion with a specific rating threshold should encourage agents to actively participate in tracking the financial ratings of the companies they place business with. Market forces, however, cause agents to consider new carriers (sometimes unrated), which in turn means communicating with the E&O underwriter. Failure to do so, can be ruinous for the agent, making an Agents E&O policy not respond as expected and turning the placement into an unexpected retention event.

An Agents E&O policy with no insolvency exclusion appears much simpler at first glance, but may give agents a false sense of security and lead to less diligent tracking of carrier ratings. Any E&O market that deploys no insolvency exclusion is likely relying on information contained in an application; things tend to change between the time the application is completed and the end of a policy term. Communication is important. The addition of a new and unrated carrier could spell disaster; even if the E&O carrier were to pay an insolvency claim (a transfer technique), the loss history would likely negatively impact the agent's future E&O renewals.

The downgrading of a carrier's financial rating is always a headache for agents, regardless of the insolvency exclusion language in their Agents E&O policies. Agents need to communicate this change in writing to affected policyholders, explain their options going forward and the repercussions of any action (or inaction). Irrespective of the language in the Agents E&O policy, the agent may be held liable if sued by a client due to unpaid claims arising out of a carrier's insolvency.

Written communication is the best way to protect an agent from the short term memory of a buyer. As an example, ten years ago, an agency we know was asked by a client to research a trust writing workers compensation for a specific industry group in their state. The trust was not rated but was clearly the most economical option presented. The agent was concerned about the financial health of the trust, but ultimately acquiesced to the client's desire, and did so without any written acceptance from the insured of his concern.

When rates went up dramatically several years later, much of the business written by the trust moved back into the standard market. It took less than two years before the trust was put into receivership. In the eighth year, the state started assessing those clients back to the original year of the placement to recoup losses. The savings enjoyed nearly ten years prior were now being taken back, but were spent by the client during the interim. The client was still working with the agent, but the quantum being assessed by the state was compelling. Ultimately, an E&O demand was made against the agent for the funds being assessed. Who could have predicted this? Regardless, good risk avoidance practices by the agent, especially getting the buyer to document their decision, would have gone a long way in preventing the chaos that ensued.

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While the insolvency landscape has evolved, there still appears to be no solid footing. Agents need to identify which risk management technique — avoid, retain or transfer — is best for their agency, and when it can be used effectively. In the context of insurance company insolvency, avoidance is a critical strategy, followed by transfer and finally retention. One can only conjecture what the next evolution will bring, but an understanding of risk management techniques will undoubtedly be a vital component of any agency's success. The one certainty is the more things change, the more they stay the same.

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