

Insurer Insolvency

A **Practical** Guide

for the

Independent Insurance Agent

PREFACE

General Jimmy Doolittle once said, "One trouble with Americans is that we're fixers rather than preventers." Any independent agent who has ever dealt first-hand with the insolvency of one of his or her companies can attest to this. In too many areas, the insurance industry can be characterized as **reactive**...as opposed to **proactive**.

The purpose of this document is, for at least this one issue, to take a proactive approach to minimizing the independent insurance agency's exposure to loss from insurance company insolvencies...to focus on **loss prevention** (i.e., identifying financially-troubled insurers and taking corrective action), rather than **loss reduction** (e.g., turning matters over to the applicable state guaranty fund and/or the agency's E&O carrier).

This project represents innumerable hours of work in reviewing and analyzing literally thousands of pages of insurance company statistics, books, reports, and trade periodicals, and interviewing independent agents who have experienced the trauma of one or more company insolvencies. The initial intent was to produce a comprehensive, scholarly treatise detailing a history of insolvencies, pertinent court cases involving potential agency liability for insolvencies, and so on, all supported by voluminous statistical exhibits.

Initially, a 4-page insolvency "checklist" (with a 12-page explanatory memorandum) was drafted to enable independent agents to produce a detailed, quarterly analysis of each insurer, replete with numerous financial calculations, NAIC ratios, etc. As work progressed and issues were discussed with "real-life" agents, it became increasingly clear that the intended final product would be nothing more than an exercise in futility since it would have no practical value to anyone other than an insurance academician or statistician. In other words, it would be pretty, but nobody would use it.

Therefore, this document and the accompanying checklist were produced. It is not the ideal solution, but hopefully it is one tool that may prove to be useful and usable for independent agents. For those who desire more information, a complete bibliography is provided in the appendix for further study. Note also that this project primarily addresses P&C insolvency issues, but many of the principles enumerated are equally applicable to L&H carriers.

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DISCLAIMER

*This **guide** is intended to be used as just one of many tools in evaluating the insolvency **potential** of an insurance company. Nothing in this **guide** should be construed, either expressly or by implication, to be a definitive indicator of financial difficulty. There is **no** express or implied intent that the evaluative factors in this guide be the **sole** criteria in an independent agent's decision to (not) use or to (dis)continue use of an insurance company. The Insolvency Checklist was produced from an analysis of A.M. Best data on approximately 76 insurance companies and no effort was made to insure statistical credibility of this or any other document in this **guide**. As implied, the purpose of this **guide** is strictly to provide a framework in which an independent agent can make a reasonable effort to evaluate their companies, and no warranties, either express or implied, are made.*

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Is There an Insolvency Crisis?

In its October 1990 report "*Insurance: The Next Industry in Crisis?*", Public Citizen claimed that five of the top twenty P&C insurance companies were financially "vulnerable"...and they named names. There was an immediate (albeit, reactive) response from the insurance community, in this instance with a broad base of support from regulators, legislators and experts in the field, which effectively attacked the credibility of this report.

However, with the extraordinary media attention given to the savings and loan (S&L) "bailout", and with several recent insurer insolvencies, consumers are justifiably concerned about the financial stability of their insurance companies and their ability to pay claims as incurred. Can the S&L debacle happen to the insurance industry? Here, according to the Insurance Information Institute (III) are the facts of the matter:

- ❑ In the last 10 years, less than 0.5% of 3,800 P&C insurers became insolvent, compared to 9.3% of S&L's...a **track record 18 times better**.
- ❑ Since 1989, there have been 23 P&C insolvencies...in that time, **328 S&L's** have gone out of business. Since 1986, the rate of S&L insolvencies is **ten times** that of P&C insurers.
- ❑ Insurer investments are **more heavily regulated** than those of S&L's...not only is investment performance monitored, but also the nature and quality of investments are often statutorily restricted...e.g., banks typically have 7 - 14 times the concentration of P&C insurers in real estate investments and P&C investments are more likely to be concentrated in mortgages on existing properties, as opposed to loans on speculative ventures.
- ❑ Based on current projections of the ultimate cost of the S&L bailout, it would take (at the rate of annual average P&C guaranty fund payouts) about **1,000 years** for the P&C industry to match this record.
- ❑ The ratio of net worth to assets for P&C insurers is about **triple** that of S&L's.
- ❑ At recent earnings/loss levels, it would take the bottom 20% (in terms of net income performance and capitalization) of L&H insurers until the year **2028** to exhaust their capital (P&C insurers have been profitable, so this issue is moot)...the bottom 20% of banks would have until the end of **1994**.
- ❑ According to a February 1990 report of the U.S. House of Representatives Energy and Commerce Subcommittee on Oversight and Investigation, there is "*...no evidence of an overall crisis threatening the existence of the insurance industry at this time.*"

In short, no, there is not a **crisis**.

Should Agents Be Concerned?

In a word...Yes. Once again, here are some facts:

- ❑ According to a 1989 study by the National Association of Independent Insurers, of the over 150 P&C insolvencies since 1969, almost **half** occurred in 1984-89.
- ❑ Prior to 1981, the largest single guaranty fund liquidation was \$85 million...the Mission Insurance Company insolvency of 1985 itself cost almost **\$500 million**.
- ❑ In 1988, **over 21%** of all P&C insurers were targeted by the National Association of Insurance Commissioners (NAIC) for regulatory attention.
- ❑ Most state regulatory agencies are grossly understaffed. A 1989 General Accounting Office (GAO) report on five states indicated that an average examiner would have to review a company annual financial statement **every** working day just to keep up with the workload of that one responsibility.
- ❑ **At best**, most states can only conduct an insurer field examination every 3 - 5 years and each examination may take months, if not years, to complete.
- ❑ While state laws establish **minimum** capital and/or surplus requirements for companies, most do **not** distinguish between new and existing insurers, **nor** must minimum capital (other than financial ratio guidelines) reflect the amount of written premiums **or** the degree of risk inherent in the business being written.
- ❑ The 1945 New York case of *Curacoa Trading Company v. William Stale and Company* established that, "*The subsequent insolvency of the insurance company has been held not to impose liability on the agent or broker if the company was solvent when the policy was procured.*" **However...**
- ❑ In the 1987 Texas case of *Higgenbotham & Associates, Inc. v. Greer*, the appellate court stated that, "*We...conclude that an agent is not liable for an insured's lost claim due to the insurer's insolvency if the insurer is solvent at the time the policy is procured, unless at that time or at a later time when the insured could be protected, the agent knows, or by the exercise of reasonable diligence should know, of facts or circumstances which would put a **reasonable** agent on notice that the insurance presents unreasonable risk.*" [emphasis added]

As the last court case implies, the agent is expected to exercise reasonable care in carrying out his or her responsibilities to the client. Failure to do so may result in liability. As the Roman statesman Cicero said, "*The safety of the people shall be the highest law.*"

What Are an Agent's Responsibilities to Clients?

In addition to the usual fiduciary and common law responsibilities owed to clients, the Higgenbotham case clearly established that the agent may have . . .

- ❑ An on-going duty to place coverage in solvent insurers
- ❑ An on-going duty to *reasonably* monitor the financial condition of insurers
- ❑ A duty to disclose solvency information to the insured
- ❑ A duty to protect an insured when the risk of insolvency becomes too great

The key issue here is what is *reasonable*? There is no absolute answer to this question...while most court cases to date seem to have indicated that the agent has little or no direct responsibility for carrier insolvencies, the question can only be resolved on a case-by-case method. Some basic E&O principles are outlined later in this document to address this issue.

Clearly, within the context of an overall E&O loss control program, the agent must weigh the cost of ascertaining information necessary to evaluate the financial reliability of a company with the cost of doing business and generating a profit for the agency. As implied in the Preface to this guide, it is unreasonable to expect the average independent agent to have the time or expertise to conduct a detailed financial analysis of each company represented.

To assist in the discharge of any express or implied responsibilities, the following sections of this report are devoted to profiling a "typical" insolvent company, identifying many of the historical common elements among insolvencies ("financial difficulty indicators" if you will), and explaining how this quantitative and qualitative information can be used as a component of the loss prevention phase of an E&O program.

Profile of An Insolvent Company

Base largely on the June 1991 A.M. Best Company Special Report "*Best's Insolvency Study - Property/Casualty Insurers 1969-1990*", an analysis of 372 P&C insolvencies, the following is a composite profile of a hypothetical insurance company that will be declared insolvent a year from now.

<i>Organization:</i>	Stock company <i>Comment: Failure rate is four times that of mutual companies.</i>
<i>State of Domicile:</i>	FL, CA, TX, PA, NY, or IL <i>Comment: Accounted for about 50% of all insolvencies.</i>
<i>Years in Business:</i>	15 (or fewer) <i>Comment: Accounted for 52% of all insolvencies (41% < 10 yrs old)</i>
<i>Primary Line of Business:</i>	Private passenger auto <i>Comment: Accounted for 38% of all insolvencies (WC was 2nd).</i>
<i>Policyholders' Surplus:</i>	\$5 million (or less) <i>Comment: Accounted for 63% of all insolvencies.</i>
<i>Annual Growth:</i>	None or Over 25% <i>Comment: Over 80% of insolvencies involved abnormal growth.</i>
<i>Best's Rating:</i>	NA-___ <i>Comment: 74% had a Best's Rating of NA or were not followed by Best one year prior to loss...7% had an "A" rating, 12% a "B" rating, and 7% a "C" rating one year prior to loss.</i>

OTHER BEST'S FACTS

- ✓ 80% of companies had a rating less than "A-" 3 years prior to insolvency.
- ✓ 97% of companies had a rating less than "A" in the year of insolvency.
- ✓ 0% of companies had a rating of "A+".
- ✓ Virtually 100% of companies had a rating downgraded within 3 years of insolvency.
- ✓ 42% of insolvent companies in the last 5 years had no Best's Rating.
- ✓ Insolvencies are most likely to occur at the end of a soft market.

Common Elements in Insolvencies

According to *Best's Special Report*, the primary causes of insolvencies during the study period were (% of insolvencies in parentheses):

- Deficient loss reserves and/or inadequate prices (28%)**
- Rapid premium growth (21%)**
- Alleged fraud (10%)**
- Overstated assets (10%)**
- Significant changes in business (9%)**
- Reinsurance failures (7%)**
- Catastrophe losses (6%)**
- Other (9%)**

NOTE: *Factors 1 and 2, in particular, may simultaneously contribute to an insolvency and/or accelerate the inevitable...special attention should be given when a company is rapidly gaining market share with a very competitive rate structure. See also Exhibit 1 in Appendix.*

Financial Difficulty Indicators

*The following are events or conditions that **may** indicate financial problems. If a company is experiencing one or more of these factors, it does not necessarily spell trouble; in fact, it may reflect a conscious, wise decision...however, a prudent agent would want to know why an abnormal condition exists.*

MARKET CONDUCT

- Dramatic increase in nonrenewals, particularly if in blocks or by line.
- State or regional market withdrawals (voluntary or involuntary?).
- Sale of blocks of business to other insurers or assumption of questionable books of business.
- Attempted large-scale mid-term cancellations.
- Abnormal premium growth or stagnant growth over 3+ years.
- Entrance into an unfamiliar and/or "unfriendly" market, particularly a high cash flow line.
- Dramatic changes in agency force...wholesale appointments or reductions made.

UNDERWRITING & PRICING CHANGES

- Dramatic increases/decreases in agency binding and/or underwriting authority.
- Significant rate decreases/increases, particularly if on nonstandard or high-risk business (and particularly if mandated by regulators).
- Willingness to write "unpopular" business at low rates.
- Pricing structure that is significantly above or below normal.

AGENCY/COMPANY TRANSACTIONS

- Large-scale terminations of agencies.
- Relatively high commissions on high-risk business and/or low rates.
- Cash flow problems...slow return of unearned premiums, commissions, contingencies, etc.
- Attempted unilateral, adverse changes in agency/company agreement.

CLAIMS HANDLING & LOSS RESERVING

- Denials of obviously covered claims.
- Delays in claims servicing or payment.
- Change in reserving practices or declining balances.
- Significant, on-going differences between paid losses and reserves.

Financial Difficulty Indicators (cont'd)

ORGANIZATIONAL CHANGES

- Staff appears to have low morale, high turnover, understaffing, etc.
- Major changes in top management (e.g., as you enter the home office, the president runs out the front door and yells to you, "You're in charge!").
- Ownership changes or ownership/management by "non-insurance" people.
- Major staff reductions and office closings (*once again, this and other listed items do not necessarily spell bad news...this may be a needed, positive change...but find out why*).
- Unexpected notice from top management to disregard rumors of problems (possibly rumors that you weren't even aware of).
- No apparent corporate mission or strategy or frequent changes in operational policies or procedures.
- Possible overreliance on MGA's with delegation of significant authority to transact business
- Generally poor and/or deteriorating service, delays, mistakes, etc.
- Suspicion of fraudulent or criminal activity.

FINANCIAL CONDITIONS / PERFORMANCE (*see also Exhibit 1 in Appendix*)

- One or more reductions in Best's Rating in the last 3-5 years, particularly if from an "A+" to an "A-", or a drop below "A-".
- A Best's Rating of NA-3, NA-5, NA-6, NA-7 (replaced by "D" in 1992), NA-10 (replaced by "E" or "F" in 1992), or NA-11 (added in 1992), or a rating modifier of "c", "q", "w", or "x".
- Abnormal results on four or more NAIC tests.
- A trend of declining stock value.
- Abnormally high combined ratio (even if only on one major line), particularly if it continues for 3 or more years, is increasing and/or if interest rates are declining.
- A trend of negative operating income / cash flow, particularly for 3 or more years.
- Sale or other reduction in assets.
- Abnormal decline in policyholders' surplus, growth in excess of 10% annually, or an offsetting increase from non-operational funds (e.g., paid-in capital), or significant fluctuations.
- Investment portfolio changes such as decline in bonds (did they mature or have to be sold at a discounted value?), increase in loans (particularly real estate and/or investments in affiliated companies), movements into cash/short-term accounts, low net asset yields, or other questionable investments.
- An increase in net written premiums in excess of 25%, stagnating growth or fluctuations.
- Ratio of net written premiums to surplus in excess of 2:1 and/or rising.

Financial Difficulty Indicators (cont'd)

THIRD-PARTY INFORMATION

- Premium finance company refuses to finance premiums, has company on "watch list", and/or requires a larger down payment
- Coverage refusals by umbrella / excess carriers over company's primary coverage
- Refusal of agency's E&O carrier to provide insolvency coverage due to a particular company
- Inability to meet mandated guaranty fund, assigned risk plan, etc. assessments
- Insurance department problems...fines, cease-and-desist orders, late filing of annual statements, orders for increased rates or deposits, mandated use of industry standard forms, increased consumer complaints, etc.
- Investigations (or worse) by agencies such as the SEC, IRS, FTC, etc.
- Persistent and widespread rumors

As indicated earlier, this type of checklist, in conjunction with a detailed, quantitative analysis of Best's and NAIC ratios is an ideal method of evaluating carrier solvency. Not to be overlooked, the qualitative analysis and comments in *Best's Insurance Reports (P/C)* are invaluable. For an example of what can be accomplished with this product, refer to Exhibit 2 and its Addendum.

However, it is acknowledged that few agents are willing and/or able to take the time necessary to do an exhaustive financial and operating review of their companies. Therefore, the next section contains an abbreviated version of this information in the form of a checklist that can be reproduced and used in the agency on an on-going basis. Again, this checklist is not all-inclusive, but contains some of the more important factors that, based on our research, are most likely to be reasonably reliable indicators of potential financial problems. The Exhibit 2 Addendum may be helpful in illustrating the use of the Insolvency Checklist.

Note: *This project relies extensively on A. M. Best data for evaluatory considerations. It was the opinion of the research committee that Best's financial information has generally become accepted as an industry "standard" due to its widespread availability and use. This is not to imply that other sources of information cannot be of significant value. This includes, but is not limited to, a company's NAIC Annual Statement, NAIC IRIS ratios (of limited availability), ISO/NAII Operating Results & Fast Track Monitoring System, Moody's, Standard & Poor's Insurance Rating Service, company SEC filings and shareholder reports (available when a share of common stock is bought), insurance department examinations, and others. For further information, refer to the Bibliography in the Appendix.*

INSOLVENCY CHECKLIST

Agency: _____ Name: _____

Company: _____ Date: _____

Answer each of the questions below by checking the "Yes" or "No" block. There is no magic formula for evaluating the financial stability or predicting the insolvency of a company, but 3 or more "Yes" answers to questions that appear in *italics* or an accumulation of *any* 8 or more "Yes" answers may indicate a need for further investigation. This survey may be conducted at least annually for each company represented, preferably immediately after the publication of the latest A.M. Best data, and conducted more often (at least quarterly) for companies suspected to have real or potential financial problems (including those accumulating 5 or more "Yes" answers).

YES NO

ORGANIZATIONAL FACTORS

- | | | |
|--------------------------|--------------------------|---|
| <input type="checkbox"/> | <input type="checkbox"/> | 1. Has the company been in business for less than 15 years? |
| <input type="checkbox"/> | <input type="checkbox"/> | 2. <i>Is the company's primary line(s) PP auto, workers comp, or predominantly commercial or E&S/specialty?</i> |
| <input type="checkbox"/> | <input type="checkbox"/> | 3. Is there any atypical ownership/management recent changes, heavy use of MGA's or delegated authority? |
| <input type="checkbox"/> | <input type="checkbox"/> | 4. Have there been any general premium finance company or E&O or umbrella/excess carrier refusals? |
| <input type="checkbox"/> | <input type="checkbox"/> | 5. Have there been any known problems with insurance departments or other government agencies? |

CAPITALIZATION & GROWTH FACTORS

- | | | |
|--------------------------|--------------------------|---|
| <input type="checkbox"/> | <input type="checkbox"/> | 6. Is current policyholders' surplus (PHS) less than \$5 million? |
| <input type="checkbox"/> | <input type="checkbox"/> | 7. Has there been an abnormal decline, or significant fluctuation, in PHS in the last 3-5 years? |
| <input type="checkbox"/> | <input type="checkbox"/> | 8. <i>Have there been any significant increases in PHS from non-operating revenues in the last 3-5 years?</i> |
| <input type="checkbox"/> | <input type="checkbox"/> | 9. <i>Is the ratio of net premiums written (NPW) to PHS significantly in excess of 2:1?</i> |
| <input type="checkbox"/> | <input type="checkbox"/> | 10. <i>Have there been increases in NPW or reinsurance of 25%+, or erratic NPW fluctuations, in the last 3-5 years?</i> |

CASH FLOW & PROFITABILITY FACTORS

- | | | |
|--------------------------|--------------------------|---|
| <input type="checkbox"/> | <input type="checkbox"/> | 11. Have there been any cash flow problems (claims payments, unearned premium returns, commissions)? |
| <input type="checkbox"/> | <input type="checkbox"/> | 12. <i>Have any significant combined ratios been abnormally high or increasing in the last 3-5 years?</i> |
| <input type="checkbox"/> | <input type="checkbox"/> | 13. <i>Has there been any negative operating income or sustained underwriting losses during the last 3-5 years?</i> |
| <input type="checkbox"/> | <input type="checkbox"/> | 14. <i>Are there any questionable investments (in affiliates, real estate, cash increases, low yields, etc)?</i> |

MARKETING FACTORS

- | | | |
|--------------------------|--------------------------|--|
| <input type="checkbox"/> | <input type="checkbox"/> | 15. Have there been any major market withdrawals/changes or assumed books of business? |
| <input type="checkbox"/> | <input type="checkbox"/> | 16. Has the company (particularly if involuntarily) implemented any significant rate increases or decreases? |
| <input type="checkbox"/> | <input type="checkbox"/> | 17. <i>Does the company pay above-average commissions on below-average premiums?</i> |
| <input type="checkbox"/> | <input type="checkbox"/> | 18. <i>Does the company's product pricing seem overly competitive for the market and nature of risks?</i> |

BEST'S RATING FACTORS

- | | | |
|--------------------------|--------------------------|--|
| <input type="checkbox"/> | <input type="checkbox"/> | 19. <i>Is the company's current Best's Rating less than "A-"</i> ? |
| <input type="checkbox"/> | <input type="checkbox"/> | 20. <i>Is the company's Best's Rating a D, E, F, NA-3, NA-5, NA-6, NA-11 or no rating?</i> |
| <input type="checkbox"/> | <input type="checkbox"/> | 21. Does the company's Best's Rating include a "q," "w," or "x" rating modifier? |
| <input type="checkbox"/> | <input type="checkbox"/> | 22. <i>Has there been a significant or multiple declines in the company's Best's Rating in the last 5 years?</i> |
| <input type="checkbox"/> | <input type="checkbox"/> | 23. Any other adverse Best's, or other, information: _____ |
| | | _____ |
| | | _____ |

Guaranty Funds

Most states and U.S. territories have P&C and L&H guaranty funds. These funds are generally set up as nonprofit, unincorporated entities that respond to claims (and, in some cases, return of unearned premiums) of insureds' whose carriers have been declared insolvent (only NJ has a surplus lines fund).

Except for New York, guaranty funds are funded by assessments, typically based on written premiums, of admitted carriers following a declared insolvency (NY has a pre-assessment program). Guaranty laws vary from state to state, the information provided here is for the state of Tennessee.

P&C GUARANTY FUND

The Tennessee Insurance Guaranty Association (TIGA)

Information from *TCA, Title 56, Chapter 12 - Insurance Guaranty Associations*

Lines Covered. All P&C lines excluding life, credit life, credit accident and health, title, surety, disability, credit mortgage guaranty, ocean marine, and credit insurance.

Eligibility. In general, to be a "covered claim" the claimant or insured must be a Tennessee resident at the time of loss or the property must be permanently located in Tennessee. Amounts due in a subrogation action are not covered.

Priority of Claims. Property claims are filed in the state where the property is located. Liability claims are filed in the insured's resident state. Workers compensation claims are filed in the claimant's resident state.

Trigger. The "insolvent insurer" must be authorized to transact business in Tennessee at the time of policy issuance or when the loss occurred and must have been declared insolvent by a "court of competent jurisdiction".

Recovery Limitations. Subject to the terms and conditions of the applicable policy (and any guaranty fund statutory restrictions), claims in excess of \$100 are payable, up to a maximum of \$100,000, with the exception of workers compensation claims which are limited only by statutory provisions. Unearned premiums are refundable in excess of \$250, with a maximum recovery of \$10,000, for all lines (including workers compensation) except for credit adjustments developed under retrospective rating plans. In bodily injury cases, payment is limited to medical bills and actual lost wages.

Assessments. The Tennessee P&C fund has assessment accounts split between workers compensation and all other eligible lines. Following an insolvency, insurers can be assessed a maximum of 1% of their net direct written premiums of the previous calendar year...if such assessments would cause an insurer's capital or surplus to fall below statutory minimums, the assessment may be exempted or deferred.

Guaranty Funds (cont'd)

Assessments (cont'd). Insurers can credit against premium taxes due in any one calendar year (maximum 25%) until the aggregate of all assessments paid to TIGA has been offset by premium tax credits.

Procedure. The insurance commissioner has 3 days to notify TIGA after receipt of notice of determination of insolvency and may require TIGA to notify insureds (not typically required) and any other interested parties of the insolvency. In-force policies are cancelled effective 30 days following the date of insolvency and agents must replace the coverage by then for it to continue. When the insured recovers, their rights under the policy are assigned to TIGA to the extent of TIGA's payment (e.g., TIGA can sue a third-party tortfeasor).

L&H GUARANTY FUND

The Tennessee Life & Health Insurance Guaranty Association (TLHIGA)

Information from *TCA, Title 56, Chapter 12 - Insurance Guaranty Associations*

The TLHIGA is structured similarly to the P&C fund. The L&H fund maintains four accounts, including life insurance, health insurance, annuities, and defined contribution plan accounts.

Recovery is limited to \$300,000 in life insurance death benefits (but not more than \$100,000 in cash value), \$100,000 health insurance benefits (including cash value), and \$100,000 in present value of annuity benefits (including cash value)...maximum total recovery is \$300,000.

In general, claims are payable if incurred by renewal date (minimum 30 days) if a group policy, or otherwise by renewal or within one year (minimum 30 days).

NOTE: For further information, refer to the referenced Tennessee Code Annotated (TCA) Chapter 12 or contact the guaranty fund offices. In addition, related information is contained in TCA Chapter 9 - *Rehabilitation and Liquidation of Insurance Companies*.

E&O Loss Control

The industry-wide costs of an insolvency can be staggering just from the standpoint of guaranty fund payments, as evidenced by the Exhibit 1 list of major insolvencies of the last decade totaling over \$3 Billion. However, this doesn't really reveal the total financial picture.

Most guaranty funds have deductibles and/or limits built into them. There may be unrecoverable claims (e.g., awards for noneconomic damages such as pain and suffering), direct-bill commissions, and unearned premiums, particularly if an ineligible (e.g., surplus lines) carrier is involved. Insolvencies also incur a number of intangible costs such as the additional work involved in moving accounts and dealing with the paperwork, the cost of rewriting the business from the standpoint of underwriting, rating, etc., the possible loss of reputation for the agency, and the numerous tangible and intangible costs of defending potential lawsuits from insureds, receivers, and so forth.

The previously outlined preventative measures may of great value in identifying financially-troubled insurers but, as Charles Dickens said, "*Accidents will occur in the best-regulated families.*" In some instances, an agency's E&O carrier may enter the picture shortly after an insolvency occurs. While this phase of the insolvency loss control process is typically after the fact (i.e., loss reduction), now is the time to take stock of the agency's current loss control program, from a preventative standpoint, with respect to E&O protection in the event of insolvency.

Here are some of the questions you may want to ask about your current E&O program:

- ❑ *Does your policy cover insolvencies? If so, are there any exceptions for individual companies, lines of insurance, ancillary agency activities (such as consulting recommendations), etc.? Does it cover only claims or does recovery include unearned premiums?* According to a 1987 study by Ronald Horn of Baylor University (see Bibliography), he estimates that, for agents with E&O coverage, about **two-thirds are not covered** for insolvencies.
- ❑ *Are your limits adequate?* For "problem" companies identified by your Insolvency Checklist evaluation, you may be able to estimate your potential exposure for insolvency losses and reevaluate your E&O policy limit.
- ❑ *Will the defense costs provision of your policy respond and are they payable in addition to the policy limit and/or are they subject to a deductible or participation?*
- ❑ *Does your claims-made policy cover prior acts? Is ERP coverage guaranteed?* The potential for unrecoverable liability claims against an insured affected by a prior insolvency can be catastrophic. Any agency that has experienced an insolvency should be sure to purchase an ERP tail if their E&O policy is terminated or discontinued.

E&O Loss Control (cont'd)

BASIC E&O PRINCIPLES

- ❑ Monitor the financial stability of your existing companies using the Insolvency Checklist (or a more detailed analysis, if possible) on an on-going basis, taking corrective action as warranted. According to Employers Reinsurance Corporation, a major agents' E&O insurance carrier, about 1% of E&O claims are due to insolvencies and this figure is growing.
- ❑ Before contracting with a new company, investigate it and conduct an insolvency analysis. If necessary, ask for financial information from the company, a copy of a CPA-prepared statement, annual report, information on reinsurers, any past problems with regulatory agencies, senior management resumes (are they "insurance people"?), etc.
- ❑ For E&S and other "non-admitted" (e.g., uninsured trust funds, self-insurance plans, etc.) markets...
 - ✓ Investigate the organization's financial condition, experience, claims practices, etc. (Caveat: Never do business with a company smaller than your agency!).
 - ✓ Investigate E&S brokers' reputation, length of time in business, experience in specialty area, financial condition (get a credit report if necessary), brokerage agreement provisions (your E&O policy probably doesn't cover contractual liability), their E&O coverage, etc. and try to deal with as few as possible.
 - ✓ Follow the statutory surplus lines requirements of your state and, if required, use only an Insurance Department "Approved" carrier (e.g., in Tennessee, an agent may be held **personally liable** on coverage placed through an unauthorized insurer).
 - ✓ Review policy forms thoroughly and evaluate their concurrency with primary or excess forms, including any umbrella "drop-down" provisions in the event of insolvency.
 - ✓ Thoroughly explain to insureds why the carrier is being used, what you know (if anything) about the carrier's financial condition, that the guaranty fund will not respond in the event of insolvency, etc. in an E&S waiver letter (see Exhibit 3 in the Appendix) and adequately and accurately document all conversations and transactions on a standardized format.

E&O Loss Control (cont'd)

BASIC E&O PRINCIPLES (cont'd)

E&S Markets (cont'd)...

- ✓ Use an "Acknowledgment of No Binder" form (also use this form, even with standard markets, anytime you do not have binding authority for a certain risk, line of business, residual plan, flood policy, life insurance, etc.).
- ✓ Use an "E&S Waiver" form (hold-harmless agreement) in conjunction with your waiver letter to the insured (see Exhibit 4 in the Appendix).
- In the event of an insolvency . . .
 - ✓ Contact your agents association office and/or stand by for news from them (e.g., when American Universal was declared insolvent, the Insurors of Tennessee had information and instructions to their members within 3 hours using the I-NET telecommunication network).
 - ✓ If you have reason to believe that an insured may take legal action against you, contact your E&O carrier immediately.
 - ✓ Carefully weigh any decision for the agency to voluntarily settle any claims or return any unearned premiums (for one thing, your E&O policy most likely prohibits any actions prejudicial to your E&O carrier or their subrogation rights).
 - ✓ Follow the procedures specified for the applicable state guaranty fund unless advised otherwise by your state agents association, E&O carrier, or legal counsel.
 - ✓ Appoint an "insolvency coordinator" and conduct staff meetings, as warranted, to keep all employees informed and develop a plan of action (the Insurors of Tennessee advised that three months after the insolvency of American Universal, an agency CSR called their office to see if anyone knew why the company's phone had been disconnected...she handled six accounts for the company and had never been advised of their insolvency!).

E&O Loss Control (cont'd)

BASIC E&O PRINCIPLES (cont'd)

In the event of an insolvency (cont'd)...

- ✓ Advise insureds in writing of the insolvency (they should be advised at the outset of any financial difficulty, including a letter if the company has been placed in receivership), what you plan to do, and the role of the guaranty fund, and keep them informed about the status of claims, return of unearned premiums, remarketing efforts, etc.

SUMMARY

A basic fundamental of E&O recommendations is that solutions should be *simple* and procedures should be *practical* in order for the E&O program to be *effective*. This same fundamental principle applies to any insolvency loss control program.

Hopefully, the information contained in this document, particularly the Insolvency Checklist, has been presented in a simple, practical, useful, and usable way. The monitoring of company solvency, within the overall scope of agency operations, may seem to be a nonproductive use of time. However, since the very survival of the agency, and the very essence of the business, depends on the financial stability of insurance carriers and their on-going ability to pay claims, this is an activity every bit as essential and important - to the agency and its clients - as marketing and servicing.

This activity is, by and large, simply a matter of habit and should be incorporated into the agency's procedures manual and invariably practiced. As Horace Mann said, "*Habits are like a cable. We weave a strand of it every day and soon it cannot be broken.*"

APPENDIX

Exhibit 1 *Major Insolvencies in the Last Decade
(Source: A. M. Best) & Best's Rating Classifications
and Modifiers*

Exhibit 2 *"How to Use A.M. Best Information To Evaluate
Your Companies"*

Exhibit 3 *Sample E&S Waiver Letter*

Exhibit 4 *Sample E&S Waiver Agreement*

Bibliography

Blank Insolvency Checklist

"How to Use A.M. Best Information to Evaluate Your Companies"

The following is a more detailed analysis of most of the insolvencies listed in Exhibit 1. This analysis is based almost totally on information contained in the *Best's Insurance Reports (P/C)* edition that preceded the insolvency by at least one year. It also incorporates an evaluation of the company using the *Insolvency Checklist* on page 7 of this manual. [Note that almost a third of the checklist factors (#4, 5, 11, 15, 16, 17, 18) are best answered by the agent, implying that the Insolvency Checklist Score (ICS) for each company might be understated.] The information on each company is listed as follows:

Name of Company (Best's Rating at least one year prior to insolvency)

Year of Insolvency (Primary cause of insolvency)

Insolvency Checklist Score (Number of factors with "Yes" answers)

Observations

This analysis concludes with a summary of these observations and was used, in conjunction with *Best's Special Report*, in the decision of which Insolvency Checklist factors should be *italicized*.

Ambassador Insurance Company (A+)

1983 (Alleged Fraud)

ICS = 5 (Factors 2, 8, 10, 13, 14)

As the Best's rating and ICS indicate, it is difficult to predict an insolvency whenever alleged fraud may be involved. However, the Best's information did indicate some "warning signals". There was a dramatic increase in the "other invested assets" category of the balance sheet which included a \$4,800,000 (18% of PHS) note receivable from an affiliate. A year of underwriting losses and flat NPW followed four years of rapid growth in medical malpractice, auto liability and surplus lines using E&S brokers.

Ideal Mutual Insurance Company (A)

1984 (Rapid Growth)

ICS = 6 (Factors 2, 9, 10, 12, 13, 14)

Premium growth exceeded 25% annually for the prior four years, combined with increased reliance on reinsurance, and three years of deteriorating underwriting results (with two years of successive losses) and a decline in PHS produced a five-year profit margin of only 0.7%. There were dramatic changes in the company's balance sheet, with dramatic declines in bond and cash portfolios and corresponding increases in short-term investments and premium balances.

Using A.M Best Information (cont'd)

Excalibur Insurance Company (C+)

1984 (Inadequate Pricing)

ICS = 10 (Factors 2, 8, 9, 10, 12, 13, 14, 18, 19, 22)

This specialty carrier experienced three successive years of rapid growth, coupled with significant underwriting losses (15% of NPW). PHS was maintained through a major infusion of capital equivalent to 63% of net surplus. The company's balance sheet indicated a dramatic increase in short-term investments, on a corresponding decrease in the amortized value of the bond portfolio, equivalent to 88% of net surplus.

Universal Casualty Insurance Company (NA-3)

1984 (Rapid Growth)

ICS = 10 (Factors 1, 2, 6, 8, 9, 10, 12, 13, 19, 20)

This specialty auto carrier was less than three years old at the time of insolvency. The year prior to their 1983 Best's report, they had written premiums of \$22.8 million and ceded \$20.2 million in reinsurance, for a NPW of only \$2.6 million. Direct paid losses, coupled with modest reinsurance recovery, resulted in a pure loss ratio of 306.5%.

Mission Insurance Company (A)

1985 (Rapid Growth)

ICS = 7 (Factors 2, 8, 12, 13, 14, 17, 18)

This predominantly workers compensation carrier experienced a rapid decline in underwriting results (117.6% combined ratio) in the latest year of Best's financial information preceding insolvency, causing an underwriting loss equivalent to 25% of PHS and a bottom-line operating loss as well. PHS would have declined precipitously without a \$45 million contribution by the company and a \$16 million income tax recovery. The balance sheet indicated a \$141.7 million investment in affiliates (almost 61% of PHS) with an investment return of only 1.1%.

Transit Casualty Company (B+)

1985 (Rapid Growth)

ICS = 9 (Factors 2, 3, 10, 12, 13, 14, 15, 19, 22)

During the five years prior to the latest Best's report, this carrier more than doubled its direct written premiums, but had a sustained decline in NPW of almost 46% from the base year. During the latest three years, the company experienced substantial underwriting losses (combined ratios ranging from 107.3% to 116.2%), with a bottom-line operating loss and PHS decline in the latest year. The company withdrew from the motor transport business. The company had substantial investments in affiliates.

Using A.M Best Information (cont'd)

Enterprise Insurance Company (A)

1985 (Rapid Growth)

ICS = 9 (Factors 1, 2, 3, 7, 8, 10, 12, 13, 14)

This six-year-old company was owned by the Mission Insurance Company and wrote predominantly workers compensation. The company's balance sheet indicated a significant decline in the bond portfolio, coupled with a similar increase in cash, short-term investments and payables to affiliates. For profitability problems, refer to the Mission observations.

Iowa National Mutual Insurance Company (A+)

1985 (Inadequate Pricing)

ICS = 4 (Factors 9, 12, 13, 18)

Although this company's total ICS rating was not unusually high and the company inexplicably maintained an A+ Best's rating, problems in key evaluation areas were significant, including a most recent year operating loss on top of five successive years of underwriting losses. Growth in NPW significantly exceeded any corresponding growth in PHS.

Carriers Insurance Company (NA-5)

1985 (Inadequate Pricing)

ICS = 13 (Factors 1, 2, 7, 8, 9, 10, 12, 13, 17, 18, 19, 20, 22)

Even a minimal review of this company would have indicated that serious financial problems had existed for several years and were rapidly deteriorating. During the past three years, the company's combine ratio had increased from 98.3% to 140.9% to 219.3%. Its PHS had declined by 58% during the same period, and it had experienced major underwriting and operating losses.

Kent Insurance Company (NA-7)

1985 (Inadequate Pricing)

ICS = 12 (Factors 1, 2, 3, 8, 9, 10, 12, 13, 18, 19, 20, 22)

*This company, predominantly a workers compensation carrier, experienced very poor underwriting and operating results during the most recent two years (coupled with a three-year decline in NPW) despite a change in ownership which contributed \$7 million to surplus in less than a year. The balance sheet showed a substantial decline in bond values with a corresponding increase in cash and short-term investment accounts...**this apparent movement of funds into more liquid cash and short-term securities was found to be a quite typical precursor of insolvency in the companies reviewed.** Net yield of all assets during the reported period was less than 1.8%.*

Using A.M Best Information (cont'd)

Allied Fidelity Insurance Company (B)

1985 (Rapid Growth)

ICS = 10 (Factors 1, 2, 7, 8, 9, 10, 13, 14, 19, 22)

This surety bond specialty company had assumed a large book of business from Ideal Mutual Insurance Company which had been declared insolvent during the year before the subject insolvency. Despite surplus contributions of \$9.4 million during the most recent five years, an average annual growth in NPW of almost 75%, coupled with three years of deteriorating underwriting losses and an operating loss, outpaced the company's capitalization. Without an infusion of \$3.25 million, PHS would have been reduced by 46% in the most recently reported year.

Union Indemnity Insurance Company of New York (NA-3)

1985 (Inadequate Pricing)

ICS = 12 (Factors 1, 2, 3, 7, 8, 9, 10, 13, 14, 18, 19, 20)

Following a four-year dormancy, this ten-year-old specialty and E&S company experienced an average annual NPW growth during the last three years of over 60% without a corresponding increase in PHS. During the most recent year of experience, a substantial underwriting loss was incurred (over 40% of PHS), resulting in a bottom-line operating loss and a decline in PHS.

Glacier General Assurance Company (A)

1985 (Catastrophe)

ICS = 2 (Factors 2, 14)

Once again the relatively high A.M. Best rating and low ICS rating indicates how difficult it is to evaluate the insolvency potential of a company which may arise from alleged fraud or catastrophic losses. The Best's report, however, does indicate a balance sheet abnormality which most likely precipitated this insolvency...over 26% of invested assets were involved in mortgage loans and advance payment on mortgage loans to be acquired (primarily in California)...a very atypical insurance company line item, and one obviously at risk to catastrophic loss.

Integrity Insurance Company (NA-7x)

1986 (Alleged Fraud)

ICS = 11 (Factors 2, 3, 8, 10, 12, 13, 14, 19, 20, 21, 22)

This company experienced a three-year period of rapid expansion, followed by two years of heavy underwriting/operational losses (most recently a 131.2% combined ratio). The company was characteristic of many other insolvent companies...heavy affiliated holdings (39% of PHS), a significant movement of assets into cash and short-term securities, a major influx of paid-in capital (\$18.7 million) to avoid a PHS decline, etc. The company also heavily relied on reinsurance, part of recoverables due from the defunct Mission Insurance Company.

Using A.M Best Information (cont'd)

Midland Insurance Company (B+)

1986 (Inadequate Pricing)

ICS = 10 (Factors 2, 7, 8, 9, 12, 13, 14, 18, 19, 22)

This specialty company wrote predominantly workers compensation and liability coverages, with E&S markets handled exclusively by an MGA. Like the Carriers Insurance Company insolvency, minimal review of financial information would have revealed serious solvency problems. For at least five years this company had experienced increasing underwriting losses, culminating in a massive \$40+ million underwriting loss (153.9% combined ratio), a \$30+ million operating loss, and a decline in PHS of 60% (NPW:PHS ratio = 4.5:1).

The Great Global Assurance Company (NA-5)

1986 (Rapid Growth)

ICS = 10 (Factors 2, 3, 6, 7, 8, 9, 10, 19, 20, 22)

A complete change in the ownership and management of this specialty company immediately preceded an increase in direct written premiums from \$4.7 million to \$16.2 million to \$59.7 million, with heavy reliance on unlicensed reinsurers. PHS declined in the most recent year by 44%. And...similar to other insolvent carriers, cash and short-term investments increased to over 43% of total admitted assets.

Professional Mutual Insurance Company (Omitted)

1986 (Inadequate Pricing)

ICS = 9 (Factors 2, 6, 7, 12, 13, 18, 19, 20, 22)

This specialty malpractice carrier had not made an underwriting profit since at least 1979 (the last year of experience available) and had a five-year average combined ratio of 154.8%. In the most recent year, PHS declined by over 79%, resulting in a NPW:PHS ratio of almost 8:1.

Homeland Insurance Company (NA-6)

1987 (Significant Business Change)

ICS = 11 (Factors 1, 2, 6, 8, 9, 10, 13, 14, 19, 20, 22)

This nine-year-old, predominantly workers compensation carrier experienced an average annual increase in NPW of almost 50%, coupled with substantial underwriting losses, an operating loss equal to 47% of PHS, and a decline in PHS.

Using A.M Best Information (cont'd)

Consumers Indemnity Company (B+w)

1988 (Inadequate Pricing)

ICS = 8 (Factors 1, 2, 6, 9, 10, 18, 19, 21)

This eight-year-old specialty company has maintained PHS near minimum capitalization requirements, while NPW grew at a rate of up to 69% annually during the most recent three years, resulting in a NPW:PHS ratio of 5:1. Once again, cash and short-term investments increased to a level of 60% of total admitted assets.

American Excel Insurance Company (NA-3)

1987 (Rapid Growth)

ICS = 11 (Factors 1, 2, 3, 6, 8, 9, 10, 14, 15, 19, 20)

This eleven-year-old specialty carrier, relying on MGA's, experienced a change in ownership and management four years prior to insolvency. NPW declined, then drastically increased without a comparable increase in PHS. At the expense of perpetual reiteration, the company's cash and short-term investments increased tremendously in the year prior to insolvency to comprise 83% of admitted assets.

American Mutual Insurance Company of Boston (NA-5)

1988 (Inadequate Pricing)

ICS = 9 (Factors 3, 7, 9, 10, 12, 13, 18, 19, 20)

This predominantly workers compensation carrier had experienced, during the most recent five years, combined ratios ranging from 117.1% to 126.1%, resulting in a 46% decline in PHS, significant underwriting and operating losses, and major management changes. The ratio of NPW to PHS had consistently exceeded industry averages. The financial predicament of this company was evident for a number of years.

Coastal Insurance Company (NA-4)

1989 (Alleged Fraud)

ICS = 5 (Factors 2, 3, 9, 10, 19)

This is another example, where the primary cause of insolvency was allegedly fraud, of the difficulty in predicting insolvency. The only significant, atypical potential insolvency factors were extremely rapid growth during the most recent three years of information, plus heavy investment in affiliates.

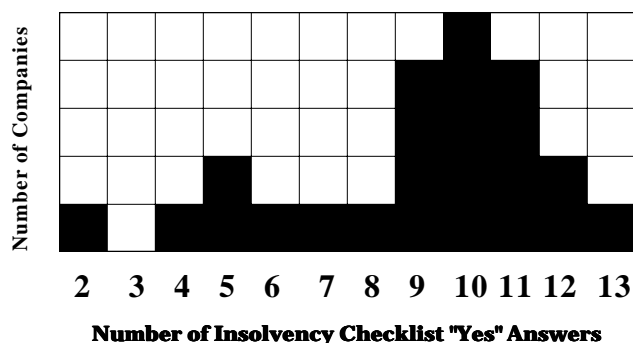
Using A.M Best Information (cont'd)

SUMMARY

It is clear that there are circumstances (e.g., fraud and catastrophes) which make it difficult, if not impossible, to "predict" insolvency. However, it is likewise clear that even a minimal review of pertinent financial information can reveal potentially serious problems.

This analysis, in conjunction with the information contained in *Best's Special Report* was used to evaluate commonalities in company insolvencies. The primary result of this effort is the *Insolvency Checklist* on page 7 of the manual.

A frequency distribution of the checklist analysis conducted in this exhibit shows the following:



As shown above, over 2/3 of the insolvent companies reviewed had an Insolvency Checklist Score (ICS) of 9 or more.

In addition, several Checklist questions were answered affirmatively for a majority of companies reviewed. The following is a ranking of each Checklist question in the order in which it was answered "Yes" most often. Note that questions 4, 5, 11, 15, 16, 17, 18, and 23 were omitted since they are best answered by the agent, as opposed to empirical data.

<u>Question</u>	<u># Companies w/ "Yes" Answer</u>	<u>Question</u>	<u># Companies w/ "Yes" Answer</u>
2	21	3	9
13	18	7	8
19	17	6	6
10	17	21	2
9	16		
8	15		
14	14		
12	13		
20	11		
22	11		
1	9		

Sample E&S Waiver Letter

Big Bluff Insurance Agency

"We're No Worse Than Anybody Else!"

**P.O. Box 3825
Smallville, Tennessee 37051**

Ernest Agent, Owner

Founded 1989

January 18, 1991

Ms. Sue Moffin
888 Deposition Lane
Big City, TN 37256

Dear Ms. Moffin:

After a diligent search for a standard market for your Day Care/Rodeo business, we are unable to find an admitted insurance company that is able to provide the general liability coverage you are seeking. We have, however, located a surplus lines company, the Amalgamated Indemnity Company of Upper Volta, that appears to be willing to provide coverage. The decision to place your business with this company is solely yours, but you should consider the following:

We are not aware of any information that would indicate that this company is not properly funded and able to pay claims. However, the A.M. Best Company has not evaluated or rated them. They are currently authorized by the Tennessee Department of Commerce and Insurance to transact business in Tennessee and apparently meet at least their minimum financial requirements to do so, but the Department has not comprehensively examined them.

In the event that this company should become insolvent, you would not be protected in any way by the Tennessee Insurance Guaranty Association for unpaid claims nor unearned premiums. If you would like to apply for coverage with this company, please complete the enclosed indemnification and hold-harmless agreement and return it to us promptly.

If you have any reservations or questions whatsoever about this, please feel free to call me at your convenience.

Sincerely,

Ernest Agent

Sample E&S Waiver Agreement

SURPLUS LINES WAIVER AGREEMENT

The undersigned hereby acknowledges that the Big Bluff Insurance Agency has fully explained the risks of placing general liability coverage with the Amalgamated Indemnity Company of Upper Volta and understands that this coverage is not subject to the protection and benefits of the Tennessee Insurance Guaranty Association.

The undersigned expressly waives any and all rights against the agency or its personnel if the surplus lines carrier fails to honor any claims or return of premiums.

In consideration for the agency's assistance in placing such coverage, the undersigned agrees to hold the agency, its owners, agents, employees, etc. harmless for any direct or indirect damages arising out of the failure of the surplus lines company to fulfill any of its obligations at any time and in any manner.

Signed: _____

Date: _____

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*The following is a list of publications used in the research for this document. Those that appear in **bold face** type are highly recommended for further study and the source of contact is listed for your convenience.*

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