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INSURANCE INVESTMENT REGULATION

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1. Introduction and Summary

Insurers are experiencing a time of upheaval and change which involves their ownership and control, their investments, and the regulation of their investments. Many legislative changes are being proposed at the state and federal levels which affect holding companies, solvency, investments of insurers, and the measurement of the profits of insurers. To help provide a background for understanding these problems and evaluating such proposals, this paper reviews the purpose and present methods of insurance investment regulation, describes some of the shortcomings of the present methods, suggests some principles for achieving the purpose of insurance investment regulation, and presents suggested legislation designed to remedy some of the present shortcomings.

The paper concludes that solvency is the paramount objective of insurance investment regulation and that the present methods of regulation are mostly indirect. A direct approach to solvency would be, first, to provide positive protection to the public against the effects of insolvency and second, to define solvency by defining liabilities and by defining a minimum amount and quality of assets needed to assure payment of the liabilities.

Present methods in most cases fail to protect the public against the effects of the insolvencies that do occur, and they fail to provide a direct definition of solvency. Failure of state regulation to protect the public against insolvencies jeopardizes the entire system of state regulation of insurance and may lead to dual federal — state regulation. Failure to define a minimum amount of qualified assets to assure solvency has resulted *in the regulation of all assets of insurers and has also resulted in the non-*

standard method of insurance accounting which obscures the true condition and value of insurers.

The present regulatory methods, being indirect for the most part, are easy to circumvent. Holding companies have illustrated this problem. The danger is that further indirect regulation for solvency will bring state regulation of insurers into increasing conflict with federal regulation of holding companies, which may invite federal regulation of insurers.

The suggested legislation included in the paper creates an insolvency fund at the state level financed by assessments on the surviving insurers after the insolvency occurs. It also defines solvency and regulates the minimum amount of assets required by such definition. All additional assets are admitted and are not regulated. The minimum amount of required assets may not include any investments in affiliates, thereby greatly reducing the need for insurance regulators to regulate holding companies, and thereby also preventing undue concentration of economic power.

It is hoped that discussion of these proposals will contribute to solutions of some of the present problems in insurance investment regulation.

2. *Purpose of Insurance Investment Regulation*

In reviewing the maze of existing statutes which regulate the investments of insurers and in analysing the myriad proposals for change and reform, including those related to holding companies, we are always in danger of overlooking the basic purpose of such regulation.

Many of the problems that face the insurance industry today find some of their roots in legislation that is designed more to regulate investments than to achieve the underlying purpose of investment regulation. If we have the purpose of investment regulation firmly in mind, we will be better able to propose changes that will achieve that purpose without restricting sound insurance managements. Legislation that fails to achieve its purpose only leads to further legislation.

The purpose of regulation of insurance investments is clearly to assure the solvency of insurers. This is the primary concern of regulation because insurance is a business affected with the public interest. Insurance is singled out for special regulatory treatment because:

(a) Insurance is a necessity in our economic society. Lenders usually require insurance to protect the security for their loan. Insurance is therefore necessary to facilitate credit transactions which permit ownership of homes and businesses by individuals of limited means. Insurance encourages investment in enterprises exposed to risks such as fire, wind, theft, and accidents by exchanging the unknown and variable cost of such risks for a known quantity which can be budgeted and planned for in advance. By reducing the uncertainty of the cost of such risks, insurance reduces the cost of bearing risk and thereby helps to reduce the prices of the products of such enterprises.

Insurance is a necessity in a society that is based on private enterprise and private ownership. Insurance is a method of spreading risk which increases the capacity of individuals to own larger properties or businesses by shifting to non-owners the risks over which the owner has little or no control, leaving the owner with a greater capacity to assume those risks over which he has a large degree of control. The only way to spread risk without insurance is by spreading ownership. For example, a society where everything is owned and managed by the government has little need for insurance.

(b) Insurers hold and invest large amounts of other people's money. Insurers collect money in advance in return for a promise to pay for future losses and accidents when and if they occur. The insurers hold this money from the time they collect the premium until they pay the losses, which may vary from just a few weeks for small property losses to the span of a lifetime for weekly or monthly benefits paid to widows and orphans. During the time these funds are held by insurers they must be safeguarded in order to protect the interest of the people who are depending on the promises of the insurer to pay them for their losses.

(c) If an insurer becomes insolvent the policyholders stand to lose far more than the money they paid in to the insurer. For example, if a policyholder paid $100 for $30,000 of insurance on his home, the insolvency of the insurer could cost him his home if his home had burned down before the insolvency became known. An insolvency often leaves destitute those unfortunate few that suffered a severe loss and were depending on their insurer to pay for it.

3. *Present Methods of Regulation*

The present methods of attempting to assure the solvency of insurers are briefly:

(a) To restrict investments to high quality, marketable securities to assure the liquidity and stability of the insurer.

(b) To restrict an insurer from using its assets to form or acquire control of non-insurance enterprises, in order to assure the undivided interest of the insurer's management in the welfare of the insurer. If the assets of an insurer could be used to form or acquire non-insurance enterprises, a type of management might be attracted which would be more interested in using the insurer's assets for their own purposes rather than maintaining the assets of the insurer as security for obligations to policyholders. Such a dividend interest or conflict of interest could work to the detriment of the insurer and its policyholders.

When policyholders pay premiums to an insurer, they are not investing in the insurer, they are buying insurance. The policyholders should not be forced to bear the risks of a shareholder or investor. The assets which back up the obligations to policyholders should therefore not be invested in the insurer or its affiliates.

(c) To restrict an insurer from taking credit for assets which might not be marketable in the event of insolvency, such as prepaid expenses, supplies, furniture, equipment, unsecured loans, and balances due from unlicensed reinsurers. Such assets may be sound and marketable for a going concern but may not be marketable when the insurer has become insolvent. Solvency is safeguarded by valuing an insurer's assets on a liquidating basis under the most adverse conditions rather than on the basis of a going concern.

(d) To require minimum reserves for certain kinds of insurance benefits. Minimum reserves are prescribed by statute for life insurance policies on conservative interest and mortality assumptions, for unearned premiums on a conservative 100% pro-rata basis, and for unpaid bodily injury liability and workmen's compensation claims incurred during the most recent 3 years.

4. *Present Methods Fail to Solve the Central Problem of Insolvency*

The present methods are a study in indirection. None of them attack the problem of insolvency directly, except in a few states where insolvency funds have been enacted to protect selected policyholders, usually only workmen's compensation or automobile liability insurance policyholders.

A direct approach to regulation against insolvency would be: first, to provide the insuring public with positive protection against the effects of the insolvency of an insurer; and second, to define solvency by defining liabilities and by defining the quantity and quality of assets needed to assure a safety margin sufficient to reduce the frequency and severity of insolvencies to an acceptable minimum.

The present failure of state regulation to provide positive protection against the effects of insolvency will not be permitted to endure forever. Eventually someone will provide such protection. And whoever does will necessarily define solvency and regulate insurers to prevent as many insolvencies as possible. Such regulation will include regulation of investments, reserves and annual statement accounting. It will include an examination system to check compliance. And it will include a method of taxing the insurers to pay for the cost of the insolvencies that do occur and to pay for the cost of administering the regulatory and examination system. If that someone is the federal government, we will be faced with dual regulation which will certainly be more burdensome than the present system of state regulation.

5. *Present Methods Fail to Define Solvency Directly*

In most states the present methods have also failed to provide a direct or complete definition of solvency. Instead, various indirect and incomplete attempts have been made.

A definition of solvency would first define the liabilities and would then define a minimum quantity of assets of a minimum quality to protect the liabilities. The present definitions of liabilities are adequate for unearned premiums and life insurance policy reserves but are inadequate for casualty loss reserves. The Schedule P statutes covering casualty loss reserves are inadequate because they do not cover all casualty losses and because both the premiums and losses for bodily injury liability included in Schedule P are either undefined or are subject to manipulation, and because the minimum ratio is obsolete and does not recognize variations in methods of operation from insurer to insurer.

The present investment regulations attempt indirectly to define a minimum quantity of assets of a minimum quality to cover the liabilities by "non-admitting" certain kinds of assets and by prohibiting certain other kinds of investments.

The price of the failure to define directly a minimum quantity of qualified assets has been incalculable. It has resulted in the regulation of *all* assets rather than a defined amount. An insurer with 100 million dollars in liabilities is subject to much the same regulation of investments whether it has a billion dollars in assets or only 110 million. This situation has made insurers of more value to non-insurer conglomerates than to the stockholders of the insurer because the non-insurer conglomerate can shift some of the surplus surplus from the insurer to one of the non-insurer entities in the conglomerate where it is no longer subject to insurance investment regulation. "Non-admitting" some assets has led to a non-standard accounting system which reconciles to the "admitted" assets and which distorts the true financial condition and earnings of an insurer and has depressed the market value of insurance stocks.

Is it worth it?

Is it worth the non-standard accounting system which does not properly match income against expenses and claims, which makes regulators, stockholders, policyholders, security analysts, and the internal revenue service adjust the reported statements of insurers to reflect more nearly their true condition, and which because of the confusion and mystery involved, depresses the market value of insurance stocks? Is it worth the interference and restriction on all the assets of an insurer to avoid defining the minimum amount of assets of a minimum quality?

6. The Present Methods, Being Indirect, are Easy to Circumvent

(a) Present restrictions on investments and on financing and acquiring on-insurance enterprises can be circumvented through a holding company that controls the insurer.

The holding company can transfer some of the surplus of the insurer to the holding company where the restrictions do not apply. It can cause the insurer to loan money to, or buy bonds of the holding company or any of the other subsidiaries of the holding company, thereby using the assets of the insurer to finance the non-insurance operations of the holding company.

Such circumvention is encouraged because the regulation of insurers' investments applies to all the assets of the insurer indiscriminately without appropriate distinction between assets corresponding to the liabilities and minimum capital and the assets corresponding to the "surplus surplus" of the insurer.

(b) Present restrictions on taking credit for non-admitted assets can be circumvented through a holding company and through reinsurance.

A holding company can transfer the non-admitted assets of the insurer to the holding company or one of its subsidiaries in exchange for admitted assets, such as a bond issued by the holding company or one of its subsidiaries, and then lease or rent the non-admitted assets back to the insurer. The holding company can then take full credit for the value of the non-admitted assets in its own financial statement.

Such circumvention is encouraged by requiring a different standard of valuation for insurers than for all other businesses.

An insurer can take credit for prepaid expenses by reinsuring part of its business and receiving a prepaid commission from the reinsurer equal to whatever portion of its prepaid expenses it wishes to take credit for. It can even obtain credit in this way for more than its prepaid expenses if it wishes to. For example, if an insurer's prepaid expenses equal 30% of its unearned premium reserve, it may reinsure 10% of the loss potential in the unearned premium reserve in exchange for 50% of its unearned premium reserve, and receive a commission from the reinsurer equal to 35% of the unearned premium reserve. By so doing the insurer reduces its unearned premium reserve by 50%, reduces its cash by 15% of its unearned premium reserve, and increases its surplus by 35% of its unearned premium reserve. The reinsurer gets 5% of the unearned premium reserve for profit and overhead.

Such circumvention is encouraged by requiring the insurers to use an accounting system which forces the statement of profit and loss to reconcile with the non-standard method of valuing assets. The statement of assets which excludes non-admitted assets does not present a full and true statement of the insurer's condition. And the statement of profit and loss which reconciles to such a statement of assets likewise does not present a full and true statement of the profit or loss of the insurer.

(c) Present requirements for minimum reserves can be circumvented through reinsurance and through expense, claim, and premium allocations, and do not reflect the varying operating methods of different types of insurers.

The minimum reserve for unpaid bodily injury liability and workmen's compensation claims can be circumvented by adjusting the allocation of premiums, expenses, and even claims to such lines of business. The premium for a policy covering bodily injury liability and other coverages at a single premium can be allocated to suit the purposes of the insurer and to minimize the reserve requirement. Likewise a compromise settlement of a claim for bodily injury liability and other coverages can be similarly allocated. Expense allocations are even easier to manipulate. Reinsurance can be used to translate premium income into expense reductions as illustrated in (b) above, in order to reduce the minimum reserve requirements which are set as a percentage of premiums.

The minimum reserve for unpaid bodily injury liability and workmen's compensation claims, being set at the same percentage of premiums for all insurers, does not reflect the different expected loss ratios of insurers that use differing methods of operation. Some insurers operate at lower rates with lower expense ratios and corresponding higher loss ratios. A minimum reserve set at a uniform loss ratio for all insurers is ineffective for insurers with higher than average loss ratios.

Such circumvention is made possible by treating reinsurance the same as direct insurance, by requiring minimum reserves for unpaid losses for only selected kinds of insurance rather than for all kinds of insurance, and by basing the minimum reserves for unpaid losses on expected losses rather than on the combined result of losses and expenses — that is, on profits.

(d) In summary, the present methods of regulating for solvency have caused a lot of work, red tape, and restrictions and have distorted the true financial condition of insurers without accomplishing their objective of protecting the public from the effects of the more than 1,000 insolvencies that have occurred.

The present system is inefficient. It requires a lot of auditing, examining, and nervous vigilance by the regulators. It produces a lot of intervention into the affairs of insurers, their owners, and subsidiaries. It encourages circumvention.

7. *Impact of Holding Companies*

Under the existing indirect methods of solvency regulation, holding companies present two serious problems. First, they make insurance investment regulation more difficult because a holding company is able to make large and sudden changes in and withdrawals from the investments of an insurer, and it has the opportunity to use the assets of the insurer to finance the other activities of the holding company. Second, they bring state regulation of insurers into increasing conflict and overlap with federal regulation of the holding companies. The more state regulation of insurers is forced to interfere in the affairs of federally regulated non-insurers, the more logic and demand there will be for federal regulation of insurers.

Most of the current proposals to deal with the problems posed by holding companies will increase the conflict of state and federal regulation and do not come to grips with the basic problem of solvency. They are designed more for regulating holding companies than for assuring solvency and protecting the public against the effects of insolvency. Being indirect, they will bury the regulators under mountains of paper.

However, if state regulation provides positive protection for the public against insurer insolvencies, and if it defines solvency so as to exclude all investments in affiliates of the insurer, whether parents, subsidiaries or cousins, from the minimum amount of assets required to support the insurer's liabilities, then there would be no need for insurance regulators to regulate holding companies, as far as solvency is concerned. (There may still be a need for disclosure of information regarding tender offers of insurers because of the exemption of some insurers from federal securities regulation.)

The unnecessary intrusion into the affairs of non-insurer holding companies is just one more price we may have to pay to prolong the present indirect and ineffective regulation of insurer solvency. Even if we pay that price we will still face more and more legislation until the public finally has effective protection against insurer insolvencies. Holding companies are not our problem. Insurer insolvency is. Holding companies are merely the instruments that have shown the weaknesses in our present indirect regulation for solvency.

8. Principles for Achieving the Purpose of Insurance Investment Regulation

(a) The public should be affirmatively protected against the effects of insolvency of insurers for all kinds of insurance.

(b) The liabilities of an insurer should have meaningful statutory minimums. The one remaining area still to be so defined are reserves for unpaid losses and loss adjustment expenses for property and casualty insurance. However, in order to avoid interference with standard accounting procedures, any statutory loss reserves in excess of the insurer's own estimates should be carried as part of surplus, "below the line," and used only in determining the minimum required amount of qualified assets.

(c) The minimum amount of qualified assets should be defined. With positive insolvency protection for the public, the minimum amount of qualified assets can probably be set at the sum of the liabilities, reserves, and minimum statutory capital and surplus.

(d) The quality of the assets used to satisfy the minimum amount of qualified assets should be defined so as to assure reasonable liquidity, diversification, and unavailability for financing non-insurance activities of the insurer or its affiliates. It is essential that the minimum asset and investment requirements of an insurer should be the same regardless of the surplus of an insurer and regardless of who owns the insurer. It is pointless to prohibit an insurer to engage in non-insurance related activities if a holding company is able to use an insurer's minimum required assets to finance the holding company's non-insurance activities. Besides, investments in affiliates are often not as liquid as other investments and their value is difficult to establish.

(e) All assets in excess of the statutory minimum, the "surplus surplus," should be unregulated and should be permitted to be valued in accordance with generally accepted accounting principles. In other words, all assets should be "admitted." Any attempt to force an insurer to invest and value its surplus surplus in a more restrictive way than a non-insurer only invites circumvention and take-overs by holding companies. It makes an insurer more valuable to a non-insurer conglomerate than to the insurer's stockholders.

Diversification through holding companies and subsidiaries should be permitted and the requirements for investments and accounting should be unaffected by such diversification. There are many sound reasons for diversification and economies to be gained which should not be blocked so long as the public can be adequately protected from insolvencies and misuse of the assets of insurers.

9. Contingency Reserve for Unpaid Claims

The suggested legislation attached hereto contains a "contingency reserve" for unpaid claims which is used only to determine the minimum amount of restricted assets required for the insurer. It is not required to be shown as a liability or reserve. It would be included as part of the surplus surplus. It is not a perfect minimum claim reserve nor does it imply that any insurer without a contingency reserve has adequate claim reserves. But it is strongly biased against insurers that have inadequate reserves and it is much more effective than Schedule P in protecting against insolvency.

The contingency reserve equals the profits on the latest two calendar-accident years for all kinds of property and casualty insurance, excluding reinsurance. An insurer with redundant claim reserves will show a contingency reserve less than the total profits shown in the two most recent annual statements because the statement profits for the last two years will be the sum of the profits on the two most recent calendar-accident years (the contingency reserve) plus the profits from the release of reserves on claims more than two years old. An insurer with inadequate reserves will show a contingency reserve greater than the total profits in the two most recent annual statements because the statement profits for the last two years will be the profits on the two most recent calendar-accident years minus the reserve deficiencies emerging on reserves on claims more than two years old.

Insurers earning profits will not be penalized because the contingency reserves requires only that those profits be held in restricted assets for two years before disbursement as dividends to stockholders or investment in affiliates or other unrestricted investments. Insurers incurring a loss and reporting a loss will not be penalized because no contingency reserve will be required. Insurers incurring a loss but reporting a profit will be penalized because the profits on the two most recent accident years, where phony profits are generated by understating claim reserves, will be held in restricted assets and the losses from emerging deficiencies on old claim reserves will reduce the insurers' surplus surplus. Insurers who suffer losses but report profits are usually the ones in greatest danger of insolvency and of greatest concern to regulators.

The contingency reserve excludes reinsurance because some reinsurance claims are not reported with date of accident, and because reinsurance can be used to manipulate premiums and expenses as well as claims. It includes all kinds of fire and casualty insurance in order to avoid the manipulation of premium, expense, and claim allocations among the various lines of business. And it uses an expected claim ratio equal to 100% of premiums less the actual expense ratio for each insurer, instead of an arbitrary, uniform expected claim ratio like the 60% and 65% of Schedule P, in order to reflect varying methods of operation and to keep the ratio up to date.

10. Suggested Legislation

Following is a copy of suggested legislation to create an insolvency fund at the state level for all forms of property and casualty insurance, financed by assessments on the surviving insurers after the insolvency occurs. A similar fund would be needed for life insurers.

Also following is a copy of suggested legislation to define solvency and to regulate investments of insurers in accordance with such definition.

Legislation similar to this has been introduced in Michigan in 1969 and represents the work and thought of many people from insurers, insurance industry associations, and state government. It is hoped that full discussion of this suggested legislation in conjunction with the many other proposals currently being made will contribute to solutions which will meet the objectives and eliminate the faults described above.

CHAPTER ..... INSOLVENCY FUND

Sec. 1. (1) To implement the provisions of this chapter, there shall be maintained within this state, by all insurers authorized to transact insurance in this state, except those authorized to transact life insurance in this state, but including the accident fund created by ...., an association of such insurers to be known as the "property and casualty guaranty association," hereafter referred to as the "association." Every such insurer shall be a member of the association, as a condition of its authority to continue to transact insurance in this state.

(2) The association shall be managed by a board of governors, composed of 5 member insurers, each of whom shall be appointed by the commissioner to serve for terms of 3 years and until their successors are appointed and qualified. Three of the governors shall be domestic insurers and two shall be foreign insurers. At least 2 governors shall be stock

insurers and at least 2 shall be non-stock insurers. The 5 governors shall be representative, as nearly as possible, of all the kinds of insurance covered by this chapter. In case of a vacancy for any reason in the office of any such governor, the commissioner shall appoint a member insurer to fill the unexpired term of such vacant office to maintain the membership of the board as required herein.

(3) The association shall adopt a plan of operation and any amendments thereof, not inconsistent with the provisions of this chapter, necessary to assure the fair, reasonable and equitable manner of administering the association, and to provide for such other matters as are necessary or advisable to implement the provisions of this chapter. The plan of operation and any amendments thereof shall be subject to prior written approval by the commissioner. All members of the association shall adhere to the plan of operation.

(4) If for any reason the association fails to adopt a suitable plan of operation within six months following the effective date of this chapter, or if at any time thereafter the association fails to adopt suitable amendments to the plan of operation, the commissioner shall adopt and promulgate such reasonable rules as are necessary or advisable to effectuate the provisions of this chapter. Such rules shall continue in force until modified by the commissioner or superseded by a plan of operation adopted by the association and approved by the commissioner.

(5) In accordance with its plan of operation the association may designate one or more of its members as servicing facilities, but a member may decline such designation. Each servicing facility shall be reimbursed by the association for any expenses it incurs and for any payments it makes on behalf of the association. Each servicing facility shall have authority to perform any functions of the association that the governors lawfully may delegate to it and to do so on behalf of and in the name of the association. The designation of servicing facilities shall be subject to the approval of the commissioner.

(6) The association shall have authority to borrow funds when necessary to effectuate the provisions of this chapter.

(7) The association, either in its own name or through servicing facilities, may be sued and may use the courts to assert or defend any rights the association may have by virtue of this chapter as reasonably necessary fully to effectuate the provisions thereof.

Sec. 2. As used in this chapter:

(1) "Member insurer" means an insurer required to be a member of the association in accordance with the provisions of section 1 (1).

(2) "Insolvent insurer" means a member insurer for which a domiciliary or ancilliary receiver has been appointed in this state after the effective date of this chapter.

(3) (a) "Covered claims" means obligations of an insolvent insurer which: (i) arise out of the insurance policy contracts of the insolvent insurer issued to residents of this state or are payable to residents of this state on behalf of insureds of the insolvent insurer, (ii) were unpaid by the insolvent insurer, (iii) are presented as a claim to the receiver in this state or the association on or before the last date fixed for the filing of claims in the domiciliary delinquency proceedings, and (iv) were incurred or existed prior to, on, or within 30 days after the date the receiver was appointed.

(b) Covered claims shall not include any obligations to refund unearned premiums, nor any obligations incurred after the expiration date of the insurance policy, or after the insurance policy has been replaced by the insured or after the insurance policy has been cancelled by the association as provided in this chapter.

(c) Covered claims shall not include any obligations to insurers, insurance pools, underwriting associations, or any person who has a net worth exceeding $1,000,000.

(d) Covered claims shall not include any claim in an amount of $200 or less, nor the first $200 of any claim in excess of $200, nor that portion of any claim which is in excess of any applicable limit provided in the insurance policy.

(e) Covered claims shall not include that portion of any claim, other than a workmen's compensation claim, which is in excess of $500,000.

Sec. 3. (1) The association shall pay and discharge covered claims. It may do so either directly by itself or through a servicing facility or through a contract for reinsurance or transfer of liabilities with any member insurer, in accordance with the plan of operation.

(2) The association shall be a party in interest in all proceedings involving a covered claim and shall have the same rights as the insolvent insurer would have had if not in receivership: (a) to appear, defend, and

appeal a claim in a court of competent jurisdiction, (b) to receive notice of, investigate, adjust, compromise, settle and pay a covered claim, and (c) to investigate, handle and deny a non-covered claim. The association shall have no cause of action against the insureds of the insolvent insurer for any sums it has paid out, except as provided by this chapter.

(3) If damages against uninsured motorists are recoverable by the claimant from his own insurer or from the Motor Vehicle Accident Claims Fund created by the motor vehicle accident claims act, or any similar fund, such damages recoverable shall be a credit against a covered claim payable under this chapter. If damages against an insured who is not a resident of this state are recoverable by a claimant who is a resident of this state, in whole or in part, from any insolvency fund or its equivalent in the state where the insured is a resident, such damages recoverable shall be a credit against a covered claim payable under this chapter. Any amount paid a claimant in excess of the amount authorized by this section may be recovered by action brought by the association.

(4) The association shall continue coverage for covered claims under all insurance policies of the insolvent insurer that were in force on the date the receiver was appointed until the insurance policy has expired in accordance with its terms, or has been replaced by the insured or has been cancelled by the association as provided in this chapter, but in no event for a period longer than 30 days after the date the receiver was appointed.

(5) The association shall have authority to cancel insurance policies of the insolvent insurer by mailing or delivering to the insured at the last known address within this state a ten days' written notice of cancellation, notwithstanding any statute or policy provision to the contrary.

Sec. 4. The association shall have authority to submit reports and make recommendations to the commissioner regarding the financial condition of any member insurer. Such reports and recommendations shall not be considered public documents. There shall be no liability on the part of, and no cause of action of any nature shall arise against, member insurers, the association or their agents or employees, the governors, or the commissioner or his authorized representatives, for any statements made by them in any reports or recommendations made hereunder.

Sec. 5. (1) Insureds entitled to the protection of this chapter shall cooperate with the association in accordance with their policies in the same manner as they would have been required to cooperate with their insurer if it were not in receivership, and shall be deemed to have assigned to the association any right to make claim against the receiver for a refund of unearned premium for the period of coverage provided by the association beginning on the date of receivership.

(2) Any insured or claimant entitled to the benefits of this chapter shall be deemed to have assigned to the association, to the extent of any payment received, his rights against the estate of the insolvent insurer.

Sec. 6. To the extent necessary to secure funds for the association for payment of covered claims and also for payment of reasonable costs of administering the association, the association shall levy assessments upon all member insurers. The association shall allocate its claim payments and costs to the following 3 categories: workmen's compensation insurance, automobile insurance, insurance other than workmen's compensation and automobile insurance. Separate assessments shall be made for each such category. The assessment for each category shall be used to pay the claim payments and costs allocated to such category and shall be in proportion to the net direct premiums written after deducting dividends paid or credited to policyholders by each member insurer in this state for kinds of insurance included within such category, as reported in the most recent annual statement available at the time of assessment. The rate of assessment shall be a uniform percentage of such premiums for all member insurers. Such assessments shall be remitted to and administered by the association in accordance with the plan of operation. Each member insurer so assessed shall have at least 30 days advance written notice as to the date the assessment is due and payable. No member insurer shall be assessed during any calendar year for more than 1% of any of its net direct premiums written in this state during the previous calendar year. Such assessments shall be recognized in the rate-making procedures for insurance rates in the same manner that expenses and premium taxes are recognized. Any unused assessments and any reimbursements from the receiver remaining in any category in excess of covered claims and expenses allocated to such category shall be refunded by the association to the member insurers who paid the assessments for such category in proportion to their assessments paid. An insurer which ceases to be a member of the association shall have no right to a refund of any assessment previously remitted to the association. The commissioner may revoke the certificate of authority to transact business in this state of a member insurer which fails to pay an assessment when due as provided in this chapter and after demand having been made.

Sec. 7. All proceedings in any court of law of this state to which the insolvent insurer is a party shall be stayed for a period of 60 days from the date a receiver is appointed in this state or in the state of domicile of the insurer, to permit proper defense of all pending causes of action.

Sec. 8. When a receiver is appointed in this state for any member insurer, the receiver shall promptly give notice of this appointment and a brief description of the contents of this chapter by first class mail, to: (a) all persons known or reasonably expected to have or be interested in claims against the insurer, at the last known address within this state; (b) all insureds of the insurer, at the last known address within this state; and (c) the governors of the property and casualty guaranty association. The receiver may also require that agents of the insurer give prompt written notice of the same information, by first class mail, to their insureds at the last known address within this state. The receiver shall also promptly publish such notice in a newspaper of general circulation in the county where the insurer had its principal office in this state not less than once per week, for four weeks, and by publication elsewhere in this state as the court shall direct.

Sec. 9. The association shall be exempt from all license fees, income, franchise, privilege or occupation taxes levied or assessed by this sate, any municipality, county or other political sub-division of the state, except state, county or municipal taxes upon the real or personal property of the association, which is to be assessed and taxed in the same manner as real property and personal property of other non-exempt persons.

Sec. 10. (1) The operation of the association shall at all times be subject to the regulation of the commissioner. The commissioner, or any deputy or examiner, or any person whom the commissioner shall appoint, shall have the power of visitation and examination into the affairs of the association and free access to all books, papers and documents that relate to the business of the association, may summon and qualify witnesses under oath, and may examine officers, agents or employees or any other person having knowledge of the affairs, transactions or conditions of the association.

(2) Any member insurer aggrieved by any action or decision of the association may appeal to the commisioner within 30 days from the action

or decision. Proceedings under this section are subject to the provisions of . . . .

CHAPTER . . . . . INVESTMENTS

Sec. 1. (1) Every domestic insurer authorized to transact insurance in this state, including domestic fraternal benefit societies and the accident fund created by . . . . , shall have the power to loan or invest its funds in any investment, and shall have the power to buy, sell, hold title to, possess, occupy, hypothecate, convey, manage, protect, insure and deal with respect to its investments, property and monies to the same extent as any other person or corporation may do under the laws of this state or of the United States, and may value its assets and liabilities in accordance with generally accepted accounting principles; provided:

(A) Every such insurer or fund shall have assets in cash or as defined in this chapter in a total amount at least equal to its liabilities including its reserves as required by this code, plus an amount for contingencies as defined in section 1(5), plus an amount equal to the minimum capital and surplus required to be maintained by this code. Assets defined by sections . . . . (real estate) shall not be used to satisfy more than 10% of this requirement. Such liabilities and reserves may be reduced by: (i) reinsurance ceded to the extent admitted in accordance with regulations prescribed by the commissioner, (ii) policy loans secured by policies included in such liabilities and reserves but not in excess of the cash surrender value of such policies, (iii) the net amount of life insurance premiums and annuity considerations deferred and uncollected, (iv) amounts receivable from any person to the extent that they offset liabilities or amounts payable to the same person, (v) amounts receivable from an agent or agency which does not have control of more than 10% of all agents' balances of the insurer and which is not affiliated with the insurer as defined in section 1(3), on policies with an effective date not more than one month old, to the extent that such amounts are offset by unearned premium reserves on the same policies. Such assets, liabilities and reserves shall exclude assets, liabilities and reserves included in separate accounts established in accordance with section . . . . The value of any income due and accrued in respect to such assets may be included in such total amount. Such assets shall not be valued at more than the actual value as ascertained in the manner approved by the commissioner, except those assets valued in accordance with section 1(1)(B) by insurers subject to section 1(1)(B).

(B) Every such insurer authorized to transact life insurance, including fraternal benefit societies, shall have assets in cash or as defined by sections ...... (certificates of deposit, government bonds, stock in federal mortgage agencies, corporate bonds, preferred stocks, savings and loan shares, collateral loans, real estate first mortgages, amounts receivable from authorized insurers) in a total amount at least equal to 90% of the reserves established in accordance with sections ...... (reserves on life insurance policies and annuities). Assets defined by section ...... (preferred stock) shall not be used to satisfy more than 1/9 of this requirement. Such reserves may be reduced by: (i) reinsurance ceded to the extent admitted in accordance with regulations prescribed by the commissioner, (ii) policy loans secured by policies included in such reserve but not in excess of the cash surrender value of such policies, (iii) the net amount of life insurance premiums and annuity considerations deferred and uncollected, (iv) amounts receivable from any person to the extent that they offset liabilities or amounts payable to the same person. Such assets and reserves shall exclude assets and reserves included in separate accounts established in accordance with section .... The value of any income due and accrued in respect to such assets may be included in such total amount. Assets defined by section ...... (stock in federal mortgage agencies) may be valued at the cost price thereof. Assets defined by sections ...... (government bonds, corporate bonds, collateral loans and real estate first mortgages) which have a fixed term and rate may, if amply secured and not in default as to principal and interest, be valued as follows: if purchased at par, at the par value; if purchased above or below par, on the basis of the purchased price adjusted so as to bring the value to par at maturity and so as to yield in the meantime the effective rate of interest at which the purchase was made. The purchase price shall in no case be taken at a higher figure than the actual market value at the time of purchase. The commissioner shall have full discretion in determining the method of calculating values according to the foregoing rule. Such other assets shall not be valued at more than the actual value as ascertained in the manner approved by the commissioner.

(2) The assets required by section 1(1)(A) shall not include more than 5% of such assets invested in, loaned to, secured by, leased or rented

to, or deposited with any one person, or invested in any one parcel of real estate, but this restriction shall not apply to obligations of the United States or any state of the United States, or agencies or instrumentalities thereof, principal and interest of which are fully guaranteed by the United States or by any state of the United States.

(3) The assets required by sections 1(1)(A) and 1(1)(B) shall not include any assets invested in, loaned to, secured by, leased or rented to, or deposited with any person that is, directly or indirectly, owned or controlled by the insurer, or that, directly or indirectly, owns, controls or is affiliated with the insurer. Two persons shall be deemed to be affiliated if they are both owned or controlled, directly or indirectly, by the same person or by the same group of persons. Control shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote or holds proxies, representing ten per cent (10%) or more of the voting securities of any other person.

(4) Notwithstanding the limitations in subsections (2) and (3), the assets required by sections 1(1)(A) and 1(1)(B) may include the value of a wholly owned subsidiary authorized to transact insurance in this state in an amount equal to the assets defined by sections 1(1)(A) and 1(1)(B), respectively, as limited by sub-sections (2) and (3), which are held by such subsidiary and which are in excess of the amount of such assets required for such subsidiary by sections 1(1)(A) and 1(1)(B), respectively.

(5) The amount for contingencies referred to in this section for each insurer other than an insurer authorized to transact life insurance and other than an insurer transacting only title insurance, shall equal the sum of its underwriting gain, if any, realized for each of the two most recent calendar years in respect to its entire business excluding reinsurance ceded and assumed, as calculated by subtracting from the premiums earned during each such year the sum of: the incurred policy benefits and adjustment expenses related thereto arising out of accidents or events that occurred during each such year, the other underwriting expenses (excluding federal and foreign income taxes to the extent offset by net investment gain) incurred during each such year, and dividends to policyholders incurred during each such year. The amount for contingencies referred to in this section for insurers authorized to transact life insurance and insurers transacting only title insurance shall equal zero.

Two or more insurers authorized to transact insurance in this state may compute the amount for contingencies referred to in this section on a consolidated basis and prorate the total amount for contingencies to each such insurer in proportion to the premiums earned by each such insurer, if:

(a) they are affiliated through ownership, where each such insurer is wholly owned by or wholly owns one or more of the other insurers in such group, or,

(b) they pool substantially all their business with each other and the commissioner certifies that such computation on a consolidated basis will more accurately reflect the financial condition and affairs of such insurers.

(6) Every insurer or fund, including fraternal benefit societies, authorized to transact insurance in this state on the effective date of this section shall be allowed two years after the effective date of this section in which to comply with the requirements of this section. Any such insurer which fails to meet the requirements of this section at the end of such two years may be granted one extension of an additional two years in which to comply by the commissioner if the commissioner is satisfied such insurer is safe, reliable and entitled to public confidence and would materially suffer from a forced conversion of its assets to comply with this section.

DISCUSSION BY S. C. DuROSE

In this paper, the author proposes certain premises which are said to be the basis for insurance investment regulation and then describes and discusses some of the shortcomings of the persent approach to investment regulation. He also suggests certain principles for achieving his concept of the purposes of insurance investment regulation. Also attached to the paper are copies of legislation proposed in the state of Michigan for the creation of a post-insolvency assessment type fund and for the regulation of insurer investments. It is my opinion that the primary interest of the Society as respects this paper is the author's rationale and discussion of insurance investment regulation.

The author calls attention to the fact that, in most states, there is at present no acceptable solution to the handling of the social problem of paying claimants in event of the liquidation of an insurer. Attention is also directed to deficiencies in the present insurance accounting system and in financial reporting. The author deals with these matters in the framework