SENATE STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT

(This document is based on the provisions contained in the legislation as of the latest date listed below.)

BILL: CS/SB 2518

SPONSOR: Banking and Insurance Committee and Senator Webster

SUBJECT: Insurance-Solvency Issues

DATE: April 4, 2003 REVISED:

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Emrich	Deffenbaugh	BI	Favorable/CS
2.			HC	
3.			AGG	
4.			AP	
5.				
6.				

I. Summary:

Committee Substitute for Senate Bill 2518 changes the law relating to insurance company solvency and accountability. Specifically, the bill provides for the following:

- Proposes guidelines and restrictions which must be followed when insurance companies enter into transactions or agreements with affiliated parties.

- Prohibits insurers from writing additional premiums based upon the surplus of a subsidiary insurer under specific circumstances.

- Allows assuming insurers to use qualified letters of credit to provide part of the funding for specified trust funds.

- Prohibits premium finance companies, home and service warranty associations, motor vehicle service agreement companies, and continuing care retirement communities from lending funds to their officers, directors or stockholders.

- Eliminates the requirement for domestic and specialty insurers to make acquisition filings with the Office of Insurance Regulation due to reorganization within the insurer's holding company and which does not result in a change in control, or a change in officers, directors, or the insurer's business plan.

- Adds provisions applying to the examination of insurers to include that the rates charged to the insurer being examined are consistent with rates charged by other firms in a similar profession and that the firm selected by the office to perform the examination has no conflict of interest. It eliminates the requirement that there must be an agreement between

the Financial Services Commission and the insurer (to be examined) to use CPAs, actuaries, investment specialists, information technology specialists, and reinsurance specialists to conduct examinations, and removes other provisions.

This bill substantially amends the following sections of the Florida Statutes: 624.310, 624.316, 624.610, 628.461, 628.4615, and 440.20.

The bill creates the following sections of the Florida Statutes: 634.042, 627.8401, 634.3076, 634.4062, and 651.029.

II. Present Situation:

Enforcement and Regulatory Activities by the Department of Financial Services and the Office of Insurance Regulation

Under s. 624.310, F.S., the Department of Financial Services (DFS) and the Office of Insurance Regulation (OIR) may take disciplinary action against a licensee or an affiliated party of a licensee and such persons may be removed from participating in the affairs of an insurer.[1] Disciplinary action may include issuing cease and desist orders, ordering the removal of affiliated parties, suspending or revoking the rights and privileges of the licensee, or imposing administrative fines against any person who violates the Insurance Code. An affiliated party who is removed or prohibited from participation in the affairs of a licensee may petition DFS or OIR for modification or termination of the removal, restriction, or prohibition.[2] However, the affiliated party is not eligible for such modification or termination unless given express authorization by DFS or OIR.

According to representatives with OIR and DFS, insurance companies quite frequently establish affiliated entities to provide services to the insurer. The services provided may include claims servicing, policy administration, premium collection, premium financing, investment management services, accounting services or other administrative or management services. Specific disclosure requirements and guidelines as to the agreements between insurers and affiliated parties are necessary, according to these representatives, in order to ensure that the affiliated entities are not unjustly enriched for the services they provide and to preserve and protect the assets of the insurer. Also, specific requirements are needed for officers, directors and stockholders of insurers to comply with affiliated party transactions. These representatives assert that many examples can be drawn from insolvencies of other insurers and from failed companies such as Enron and Worldcom which would indicate that restrictions, prohibitions, and disclosures governing affiliated party transactions is justified.

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[1] Effective January 7, 2003, the Department of Insurance was transferred to the Department of Financial Services and to the Office of Insurance Regulation (ch. 2002-404, L.O.F., “the 2002 act”). CS/CS/SB 1712 makes changes to the Insurance Code to conform to the 2002 act. Under CS/CS/SB 1712, both the Department of Financial Services (DFS) and the Office of Insurance Regulation (OIR), will exercise the powers under s. 624.310, F.S., but only with regard to the licensees that they each regulate, affiliated parties of such licensees, and unlicensed persons within their respective jurisdictions.

[2] S. 624.310(4)(g), F.S. An “affiliated party” is defined to mean any person who directs or participates in the affairs of a licensee and who is a director, officer, employee, trustee, committee member, or controlling stockholder of a licensee, other than a controlling stockholder which is a holding company, or an agent of a licensee or a subsidiary or service corporation of the licensee. A “licensee” means a person issued a license or certificate of authority or approval under the Insurance Code or registered under the Code.

An example of the problems related to affiliated party agreements with insurers recently occurred regarding the insolvency of a Florida automobile insurer, Aires Insurance Company (Aires), which was placed in liquidation in November 2002. According to DFS and OIR officials, the financial statements filed by Aries prior to January 7, 2003, reported that Aries had a number of affiliate companies. Included among these were a managing general agent, an adjusting company, multiple premium finance companies, a computer services company, and a collections company. Aries had substantial business transactions directly and indirectly with each of these entities. When Aires was placed in liquidation, the company's managing general agent owed several million dollars to Aires, which has not been repaid. Additional amounts are owed to Aries by other affiliates, which also have not been repaid.

In motions filed with the court during the receivership process, entities which were not reported by Aries as affiliates have asserted that they are, in fact, affiliates. According to a recent *Florida Trend* magazine article, the special receiver overseeing the Aires liquidation is trying to determine what happened to "tens of million of dollars of premiums collected by the affiliates."[3] Two affiliates collected $50 million in commissions and fees alone from Aries, and, according to the article, that amount is "in the abuse category." The article stated that the cost of Aires insolvency will approach $140 million and the "mismanagement and abuse on the part of Aries' owners and managers also hastened the company's collapse."

Solvency of Insurers

Under current law,[4] there are specified procedures utilized by insurance regulators when it is determined through financial reports, examinations, or other sources that an insurance company has failed certain solvency tests or is otherwise in unsound financial condition.[5] The company may be placed under administrative supervision, however, when such protections fail, DFS may seek to be appointed as the Receiver of an insurance company through a judicial proceeding (e.g., a delinquency proceeding) for the purpose of rehabilitating an impaired insurer or, if rehabilitation is unsuccessful or otherwise inappropriate, liquidating the insolvent company. The department, as Receiver, is placed in control of the impaired or insolvent insurer. If the assets of liquidated insurers are not sufficient to meet their obligations to policyholders, then the appropriate guaranty fund must levy assessments against other insurers to pay these obligations.[6] State law provides for the "sole and exclusive method of liquidating, rehabilitating, reorganizing, or conserving an insurer."

Examination of Insurers

The department (now, Office of Insurance Regulation) has the authority pursuant to s. 624.316, F.S., to "examine the affairs, transactions, accounts, records, and assets of each authorized

[3] *Florida Trend,* February 2003.
[4] Part I of ch. 631, F.S., provides authority for insurance regulators relating to insurer solvency, rehabilitation and liquidation proceedings. Under s. 624.80, F.S., regulators may place an insurer under administrative supervision.
[5] According to DFS, there were a total of 17 Florida domestic insurers that became insolvent and were placed in liquidation over the past 5 years.
[6] The Florida Insurance Guaranty Association is established under part II of ch. 631, F.S., and it pays the claims of insolvent property and casualty insurers other than workers' compensation insurers.

insurer . . . as often as it deems advisable." These so-called "desk exams" may occur any time the department deems it necessary to protect policyholders and in the public interest. The law requires the department (office) to examine each domestic insurer not less frequently than once every 3 years, and all insurers must be examined on a schedule that depends on the length of time they have held a certificate of authority.[7]

The department (now, the Financial Services Commission) must also adopt rules providing that, upon the agreement between it and the insurer, an examination may be conducted by an independent certified public accountant (CPA), an actuary, and a reinsurance specialist. Such rules shall provide that no agreement is required if the department (Comm.) suspects criminal misconduct on the part of the insurer; that the department must provide the insurer with a list of three firms acceptable to the department from which the insurer must make a selection to conduct the exam; the insurer must pay for the exam directly to the firm performing the exam in accordance with the agreed upon rates and terms; and, if the exam is conducted without the consent of the insurer, the insurer must pay all reasonable charges of the exam, if a finding is made of impairment, insolvency, or criminal misconduct on the part of the insurer. Also, the department is authorized to conduct "investigations of insurance matters . . . as it deems proper."[8]

The Insurance Code currently provides restrictions for how much in premium dollars an insurer can write against its policyholder surplus.[9] According to the Office of Insurance Regulation, it is commonly referred to as the "writing ratio restrictions." For example, if Insurer A owns a subsidiary insurer (Insurer B), then a portion or all of Insurer's B surplus can be included in Insurer's A surplus.[10] Since writing ratios are calculated by dividing premiums written by surplus, then Insurer A would currently be allowed to write more premiums than they would if they didn't own Insurer B. This causes Insurer A to be more highly leveraged. Since Insurer B is already allowed to write premiums based upon its surplus, Insurer A should not also be allowed to write additional premiums on Insurer B's surplus simply because it owns Insurer B.

Specifically, under this provision, whenever an insurer's ratio of actual or projected annual written premiums as adjusted[11] to current or projected surplus as to policyholders as adjusted[12] exceeds 10 to 1 for gross written premiums or exceeds 4 to 1 for net written premiums, the department must suspend the insurer's certificate of authority or establish the maximum gross or net annual premiums to be written by the insurer, unless such insurer can demonstrate that exceeding the ratios does not endanger the financial condition of the insurer or interests of the policyholders.

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[7] A "domestic" insurer is one formed under the laws of this state (s. 624.06, F.S.). However, an examination must be conducted by the department at least once every year with respect to a domestic insurer that has continuously held a certificate of authority for less than 3 years.

[8] S. 624.307(3), F.S.

[9] S. 624.4095, F.S.

[10] Currently, there are approximately 250 property and casualty insurers and approximately 170 life insurers with investments in insurance company subsidiaries. The total number of such companies is approximately 420.

[11] The adjustment refers to premiums which are calculated as the product of the actual or projected premiums and the following: property insurance (0.90); casualty insurance (1.25); health insurance; (0.80); all other insurance (1.00).

[12] Exempts life insurance written by life or life and health insurers, or life and health insurers which have a specified surplus as to policyholders.

Reinsurance

Insurance companies authorized in Florida that buy reinsurance are allowed to receive credit on their financial statements if the reinsurance is a type that is authorized, accredited or trusteed.[13] For example, an insurer is limited by state law as to the amount of premiums it may write as a percentage of its surplus ("premium to surplus ratio"). By buying reinsurance and ceding premiums to a reinsurer, the insurance company may obtain credit on its financial statements and deduct the ceded premiums from its net premium to surplus limitations. The insurer buying the reinsurance is referred to as the *ceding insurer* and the reinsurer is referred to as the *assuming insurer.*

Currently, the assuming insurer must maintain a trust fund in an amount not less than the assuming insurer's liabilities attributable to reinsurance ceded by United States ceding insurers, and the assuming insurer must maintain a trusteed surplus of not less than $20 million.[14]

III. Effect of Proposed Changes:

Section 1. Amends s. 624.310, F.S., relating to enforcement provisions under the Insurance Code, to address transactions and agreements between insurers and affiliated parties. Specifically, it amends the definition of "affiliated party" to remove the provision "other than a controlling stockholder which is a holding company" which is an exception to the current definition. The bill clarifies the section by inserting the term "licensee," and conforms all provisions to the current reorganizational structure of the Department of Insurance by deleting the term "department" and inserting "office."[15]

The bill provides guidelines and restrictions that must be adhered to anytime an insurer enters into a transaction or agreement with an affiliated party. It provides for a new section entitled "Conflict of Interest" to provide that an affiliated party of a licensee cannot participate in any business on behalf of the licensee that would result in a conflict of the party's own interest with those of the licensee, subsidiary, or service corporation with which he or she is affiliated, unless:

- such business is conducted in good faith and is honest, fair and reasonable to the licensee and on terms no more favorable than would be offered to a disinterested third party.
- a full disclosure of such business is made to the Board of Directors.
- such business is approved in good faith by the Board, with any interested director abstaining, and such approval is recorded in the minutes.
- any profits inuring to the affiliated party of the licensee are not at the expense of the licensee and do not prejudice the best interests of the licensee, subsidiary, or service corporation.

[13] S. 624.610, F.S.
[14] S. 624.610(3)(c)3.a., F.S.
[15] See footnote 1.

- such business does not represent a breach of the fiduciary duty of an affiliated party of a licensee and is not fraudulent, illegal or ultra vires.[16]

The bill provides that the OIR may require disclosure by affiliated parties of a licensee of their personal interests, either directly or indirectly, in any business on behalf of a licensee, subsidiary, or service corporation. Furthermore, restrictions are imposed to govern the conduct of affiliated parties to provide the following:

- a director of a licensee cannot accept director fees unless such fees have been previously approved by the Board of Directors.
- an affiliated party may not purchase or obtain ownership of any asset of the licensee at less than fair market value.
- an affiliated party cannot have any interest of any evidence of indebtedness of the licensee.
- an affiliated party acting as proxy for a stockholder of a licensee may not transfer such vote in any consideration of a private benefit or advantage.

Section 2. Amends s. 624.316, F.S., relating to examination of insurance companies, to add certain provisions and delete other provisions relating to this section. It adds the following requirements: that the rates charged to the insurer being examined are consistent with rates charged by other firms in a similar profession and that the firm selected by the office to perform the examination has no conflict of interest. It eliminates the requirement that there must be an agreement between the Financial Services Commission and the insurer (to be examined) to use CPAs, actuaries, investment specialists, information technology specialists, and reinsurance specialists to conduct examinations; deletes the provision stating such agreement is not required if the department suspects criminal misconduct by the insurer; removes the provision that the department provide the insurer with a list of three firms acceptable to the department, and that the insurer must select the firm to conduct the examination from the list provided; and, if the exam is conducted without the consent of the insurer, the insurer must pay all reasonable charges.

Section 3. Amends s. 624.4095, F.S., to prohibit insurers from writing additional premiums based upon the surplus of a subsidiary insurer. Current law provides restrictions for how much in premium dollars an insurer may write against its policyholder surplus. This is commonly referred to as “writing ratio restrictions.” This bill provides further restrictions in that surplus as to policyholders for property and casualty insurers must be calculated as follows: (actual surplus as to policyholders) minus (surplus as to policyholders of all subsidiary insurers as allowed pursuant to s. 625.325, F.S. (Section 625.325, F.S., applies to investments by insurers in subsidiaries and includes specified limitations on the costs of such investments.)

The bill provides for a similar limitation for surplus as to policyholders for life and health insurers. Such a calculation must include the reduction (minus) of surplus as to policyholders of

[16] Ultra vires refers to acts beyond the scope of powers of a business entity.

all subsidiary insurers as allowed pursuant to s. 625.325, F.S. According to insurance regulators, this provision protects the solvency of the parent company because it prevents insurers from using the surplus of the wholly owned subsidiary to support additional premium writings of the parent company.

Section 4. Amends s. 624.610, F.S., relating to reinsurance, to allow assuming insurers to use letters of credit to provide part of the funding for the trust fund which must be established to allow the ceding insurer to take credit for such reinsurance on its financial statements. The bill would allow assuming insurers to use letters of credit to constitute up to 50 percent of their required trusteed surplus of $20 million. Such letters must be clean, irrevocable, unconditional, and evergreen letters[17] of credit, issued or confirmed by a qualified U.S. financial institution, effective no later that December 31 of the year for which the filing is made, and in the possession of the trust on or before the filing date of its annual statement, and may be used to fund the remainder of the trust fund and trusteed surplus.

This provision allows assuming insurers more flexibility while at the same time provides protection and collateral for the ceding insurers. This also makes the provision more closely aligned with the current National Association of Insurance Commissioners (NAIC) model regulation regarding credit for reinsurance.

Section 5. Creates s. 627.8401, F.S., relating to prohibited investments and loans, to prohibit premium finance companies from lending any of its funds to its officers, directors or stockholders. Specifically, this provision states that a premium finance company shall not directly or indirectly invest in or lend its funds upon the security of any note or other evidence of indebtedness of any director, officer or controlling stockholder of the finance company. According to insurance regulators, this provision will protect the solvency of the premium finance company. A similar prohibition currently applies to insurers under s. 625.332, F.S. This section is similar to Sections 8, 9, 10, and 12 of this bill.

Section 6. Amends s. 628.461, F.S., applying to the acquisition of controlling stock, to eliminate the requirement of a domestic insurer to make an acquisition filing with the Office of Insurance Regulation if a change in stock ownership is simply triggered because of a reorganization within the domestic insurer's holding company and which does not result in a change in control, or a change in officers, directors or the insurer's business plan. This provision will streamline the process by eliminating many filings which are currently required.

Section 7. Amends s. 628.4615, F.S., relating to specialty insurers, to eliminate the requirement of a specialty insurer to make an acquisition filing with the Office of Insurance Regulation if a change in stock ownership is simply triggered because of a reorganization within the specialty insurer's holding company and which does not result in a change in control, or a change in officers, directors or the specialty insurer's business plan. This provision will streamline the filing process.

Section 8. Creates s. 634.042, F.S., relating to prohibited investments and loans, to prohibit motor vehicle service agreement companies from lending any of its funds to its officers, directors

[17] Evergreen letters of credit means that they do not expire.

or stockholders. Specifically, this provision states that a motor vehicle service agreement company shall not directly or indirectly invest in or lend its funds upon the security of any note or other evidence of indebtedness of any director, officer or controlling stockholder of the service agreement company. This is similar to the provisions in Sections 5, 9, 10, and 12.

Section 9. Creates s. 634.3076, F.S., applying to prohibited investments and loans, to prohibit home warranty associations from lending any of its funds to its officers, directors or stockholders. This is similar to the provisions in Sections 5, 8, 10, and 12.

Section 10. Creates s. 634.4062, F.S., applying to prohibited investments and loans, to prohibit service warranty associations from lending any of its funds to its officers, directors or stockholders. This is similar to the provisions in Sections 5, 8, 9, and 12.

Section 11. Creates s. 651.027, F.S., relating to prohibited investments and loans, to prohibit continuing care retirement communities from lending any of its funds to its officers, directors or stockholders. This is similar to the provisions in Sections 5, 8, 9, and 10.

Section 12. Amends s. 440.20, F.S., relating to time for payment of workers' compensation, to correct a statutory cross-reference.

Section 13. Provides for the effective date of the act to be October 1, 2003.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

Insurers and their affiliated parties will be subject to restrictions and guidelines regarding their agreements and business dealings under the provisions of this bill. Insurers with investments in subsidiaries will also be restricted from writing additional premiums under the specified conditions of this bill.

Policyholders, the public, and investors should enjoy increased protection by the prohibition of self-dealing in that premium finance companies, home and service warranty associations, motor vehicle service agreement companies, and continuing care retirement communities will be prohibited from lending funds to their officers, directors or stockholders. Furthermore, the elimination of extensive reporting requirements for acquisitions where no major operational or management changes have occurred will represent cost savings to the regulated entities. By allowing trusteed reinsurers to utilize qualified letters of credit in their trusteed surplus account, it will be a more efficient method of establishing collateral. This change to the reinsurance statute may allow additional competition in that reinsurers will not have to post in this state a different form of collateral than is allowed in other states.

C. Government Sector Impact:

The Department of Financial Services and the Office of Insurance Regulation will have more regulatory responsibilities under the provisions of this bill. There will not be a fiscal impact under the provisions of this bill according to representatives with DFS and OIR.

VI. Technical Deficiencies:

None.

VII. Related Issues:

None.

VIII. Amendments:

None.

This Senate staff analysis does not reflect the intent or official position of the bill's sponsor or the Florida Senate.