

- SUBJECT:** Solvency requirements for insurers and HMOs
- COMMITTEE:** Insurance — committee substitute recommended
- VOTE:** 9 ayes — Smithee, Duncan, Averitt, Counts, De La Garza, Driver, Dutton, G. Lewis, Shields
- 0 nays
- WITNESSES:** For — Fred Bosse and Ross Davidson, USAA
- Against — Will Davis, Texas Legal Reserve Officials Association; John Abdnor, Bankers Commercial Title Insurance Company; Carl Parker, Insurance Alliance of America; Bernie Burner, Texas County Mutual Association; Mark France, Brian Davis, Directors Investment Group; Joe T. Bailey; eight insurance company representatives
- On — Woody Pogue, Caroline Scott, Texas Department of Insurance
- BACKGROUND:** The Insurance Code establishes minimum capital and surplus requirements for insurance companies and authorizes the commissioner to adopt rules requiring companies to maintain capital and surplus in excess of the minimum standards based on the company's nature and type of risks, premium volume, investment portfolio composition and liquidity, reserves adequacy or market fluctuations.
- Subordinated indebtedness, also known as surplus debentures, is a financing mechanism used by insurance companies to raise capital by issuing a note against surplus capital. Under current law the insurer and the creditor must agree that the creditor will be paid only out of the portion of the insurer's surplus that exceeds the greater of a minimum amount stated in the agreement or \$500,000. Surplus debentures hold a low level (a subordinated level) of claim on a company's assets (for example, in liquidation the policyholders would be paid before the debenture holders) and usually are offered at better rates than commercial loans.
- DIGEST:** CSHB 1243 would make changes to insurance and health maintenance organization (HMO) solvency provisions relating to subordinated

indebtedness, capital and surplus requirements, material transactions and reinsurance requirements. The act would take effect September 1, 1995, and the commissioner of insurance would be required to adopt rules not later than December 31, 1995.

Subordinated Indebtedness

CSHB 1243 would require all subordinated liability agreements to be submitted to the commissioner for approval prior to assumption of liability. An insurer could not repay principal or pay interest on a liability assumed on or after September 1, 1995, unless the notice of repayment was provided to the commissioner at least 15 days in advance.

CSHB 1243 also would authorize insurers (and HMOs) to assume a subordinated liability for repayment of advances of cash equivalents or other assets that have a readily determinable value in addition to loans or cash advances currently authorized by law.

Material transactions report requirements

Certain domestic insurers who do business in other states and commercially domiciled insurers would be subject to material transaction report requirements.

Each insurer would be required to file with the commissioner a report that discloses material acquisitions and dispositions of assets or material nonrenewals, cancellations or revisions of ceded reinsurance agreements. The report would be required to contain specified information and to disclose all transactions or agreements on a nonconsolidated basis except under certain circumstances.

An acquisition or disposition would be considered material if it was not recurring or in the ordinary course of business and involved more than five percent of the insurer's total admitted assets. A nonrenewal, cancellation or revision of a ceded reinsurance agreement would be considered material if it affected on an annual basis more than 50 percent of an insurer's ceded written property and casualty premium or more than 50 percent of the total reserve credit taken for life, annuity and health business.

The report would be required to be filed not later than the 15th day after the last day of the calendar month in which the transactions took place. Transactions previously reported or reviewed by the commissioner would be exempt from reporting requirements.

A report would be confidential and could only be subject to a subpoena by a grand jury. The report could not be disclosed except with written consent by the insurer to the insurance department of another state or another authorized governmental agency. The commissioner after notice to the insurer and an opportunity for a hearing, could disclose the report to the public if the commissioner deemed the disclosure to be in the interest of the policyholders, shareholders or general public.

Capital and surplus levels

Provisions allowing the department of insurance to require insurers to maintain capital and surplus levels in excess of statutory requirements would be removed from provisions governing incorporation of insurance companies (Insurance Code, art. 2.02).

CSHB 1243 would authorize the commissioner to establish risk-based capital requirements to apply only to mutual companies, Lloyd's plan companies, reciprocal or interinsurance exchange and risk retention groups that are subject to capital and surplus increase provisions for insurance companies that have less than the minimum capital and surplus required for a newly incorporated company.

The definition of an extraordinary dividend would be changed to include a dividend or distribution whose fair market value exceeds the insurer's net income, instead of an insurer's net *investment* income.

Reinsurance

The commissioner could adopt rules regarding minimum risk transfers and the transfer of all or any part of a insurer's risks in addition to current rulemaking authority. CSHB 1243 would require rules adopted by the commissioner after September 1, 1995, to apply to reinsurance agreements entered into on or after September 1, 1995, or amended after the effective

date of the rules. Reinsurance agreements could contain provisions that allow the offset of mutual debts and credits between a ceding insurer and the assuming insurer.

CSHB 1243 would require certain insurance companies incorporated under the jurisdiction of another state or another country to reinsure excess risk from exposing themselves to any loss or hazard on any one risk that would exceed 10 percent of the company's surplus and, if applicable, 10 percent of a foreign company's deposit with the statutory officer in the state through which the company gained admission to the United States. This requirement would not apply to life insurance, health insurance, annuity contracts, title insurance, workers' compensation insurance, employers' liability insurance or any policy in which maximum possible loss is not readily ascertainable.

**SUPPORTERS
SAY:**

CSHB 1243 would help improve Texas Department of Insurance monitoring and regulation of insurance company and HMO solvency. It also would enact clarification and conforming provisions regarding reinsurance and capital and surplus requirements to simplify understanding of department authorization and insurer duties.

Material transaction reporting requirements, subordinated indebtedness reporting requirements and changes to extraordinary dividends would increase department awareness of company indebtedness or increased liabilities. The material transaction reporting requirements are based on model legislation developed by the National Association of Insurance Commissioners (NAIC) and would most likely also be adopted by several states. The requirements focus on only major or unusual transactions and would be reporting requirements only — they would not establish a cause for commissioner approval or review.

Subordinated indebtedness changes would also be in line with NAIC accounting guidelines and help the department monitor insurance company liabilities, especially on those agreements in which the repayment schedule was not specified or when an insurer was not complying with a agreed repayment schedule. Approval requirements would affect only those agreements entered into after September 1, 1995.

Changes to the definition of extraordinary dividends would increase the number of dividends regarded as extraordinary and therefore reported to the department of insurance. The definition change also is required by NAIC for Texas accreditation.

CSHB 1243 would not adopt NAIC model risk-based capital legislation because the Texas standards, enacted prior to the development of NAIC formulas, may prove to be more stringent overall. More time should be granted to see if other states adopt the NAIC formulas and to allow for any fine-tuning changes in the formula to occur. NAIC formulas also may prove to be more stringent to smaller companies that accept higher risks. Texas should stay in control of its own capital and surplus standards.

OPPONENTS
SAY:

Prior approval of surplus debenture agreements and payments is unnecessary and could impede insurance companies — especially the smaller companies — from raising capital. Material transaction reporting requirements are also a burden to smaller insurance companies.

Surplus debentures are not promissory notes with unconditional repayment commitments — the promise to repay the note is conditioned on the amount of surplus capital the company holds, and because the notes are subordinated, the policyholder risk is minimized. Banks may not be interested in offering surplus debentures if each repayment of a note is conditioned on commissioner approval. Small insurance companies rely on surplus debentures to raise capital more than larger companies.

OTHER
OPPONENTS
SAY:

CSHB 1243 would not go far enough to protect insureds from company insolvencies. Texas still needs better methods to detect and remove from the market illegitimate insurance businesses licensed in other countries. Regulation of HMO solvency could also be improved.

NAIC has developed a more sophisticated method of assessing a company's risk-based capital requirements than existing Texas statutory and regulatory standards. The NAIC method includes a formula identifying a company's capital requirements that is linked to specified and stratified regulatory actions when a company's risk-based capital is insufficient. The NAIC model would also eventually apply to insurance companies not now subject

to Texas capital and surplus requirements. Adoption of the NAIC requirements bring Texas in conformity with nationally developed standards and would assist insurance companies that do businesses in other states.

NOTES:

The committee substitute differs from the original version in that the original version would have:

- amended various portions of the Insurance Code to allow the commissioner to adopt NAIC model rules regarding risk-based capital;
- removed the floor of \$500,000 for repayment of subordinated liability and made all agreements and payments subject to commissioner approval;
- required surplus lines insurers to actually conduct business in the jurisdiction that issued their license;
- would have authorized the commissioner to impose a filing fee for insurers who apply to be exempt from classification as a commercially domiciled insurer;
- would have replaced HMO capital and surplus provisions with requirements that HMOs deposit with the commissioner 100 percent of estimated uncovered health care expenses plus at least \$50,000, and would have restricted HMO exemption from deposit requirements to those HMOs sponsored by organizations worth at least \$2 million;
- increased remedies available to the commissioner for violations of the act and
- exempted certain solvency monitoring committees from the Texas Open Meetings Act.

Rep. Smithee may offer a "clean-up" amendment to the committee substitute to remove provisions and references remaining from previous versions of the bill that related to enacting NAIC risk-based capital model legislation.