Volume XIII, Number 1 | January 2007

nolhga journal

A Publication of the National Organization of Life and Health Insurance Guaranty Associations

Interesting Times

NOLHGA's 23rd Annual Meeting tackles Social Security, the new retirement paradigm, regulatory battles, and more

By Sean M. McKenna

In his first address to the membership, new NOLHGA Chair Christopher L. Chandler mentioned an old Chinese proverb and/or curse, "may you live in interesting times." Times are extremely interesting for the insurance industry and guaranty association system these days, with an expanding economy, possible regulatory changes, and a potentially booming market in retirement thanks to the problems with Social Security and corporate pension plans.

The challenge for speakers at NOLHGA's 23rd Annual Meeting, which was held in Dana Point, Calif., in October 2006, was to take these interesting if not chaotic times and make some sense of them for the 160 meeting attendees—and to keep it interesting. Using Chinese proverbs, transmogrification, and references to obscure baseball pitchers, they did just that.

Luncheon speaker Howard Fineman, national political reporter and **Newsweek** *senior editor, offered his insights into the 2006 congressional elections—"I think there's a kind of 'pox on both your houses' mentality," he said—and also assessed possible candidates for the 2008 presidential race.*

Shifting Burdens

The first day of the meeting focused on Social Security and Medicare and on the changing nature of insurance and retirement planning. In her presentation *Social Security and Medicare: Risks and Reform Opportunities*, Pamela F. Olson (a partner with Skadden, Arps, Slate, Meagher & Flom LLP) provided an overview of the huge challenges facing both systems and of possible solutions to these problems.

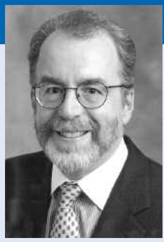
Olson began by noting that the challenges, while daunting, are not insurmountable. "The risks are great, but there are tremendous reform opportunities as well," she said. "But we really do have to act." The need is pressing, she added, because in approximately 40 years, Social Security, Medicare, and Medicaid will account for 18.3% of America's gross domestic product (GDP). Since this figure is also the 30-year average of total federal tax revenue as a percentage of GDP, these three programs are projected to demand all the federal tax revenue in 2047, barring any benefit cuts or tax increases.

There's no shortage of reform options, according to Olson. "There are things we can do that would have dramatic effects," she said, including tying future benefit increases to price increases rather than wage increases, boosting the retirement age to 70, and reworking the cost-of-living adjustments for Social Security benefits. In addition, there are a variety of benefit reduction and tax increase combinations that could help the system achieve long-term actuarial balance.

Olson also addressed President Bush's plan for personal accounts, what she called "the padlock to Al Gore's lockbox" because the accounts put some Social Security funds outside the reach of the government. These accounts present problems, she added, because the current generation of workers would have to fund the benefits of

["Interesting Times" continues on page 7]

IN THIS ISSUE



The "New Runoff": Threat or *Menace*?

The following is an abstract of remarks delivered on December 10, 2006, in San Antonio at the 9th Annual Breakfast Symposium ("Resuscitating the Ailing Insurance Company") sponsored by the International Association of Insurance Receivers; the Society of Financial Examiners; Reinsurance Solutions International, L.L.C.; and the law firm of Stroock, Stroock & Lavan. The opinions expressed are solely the personal views of the author and not those of NOLHGA nor its member guaranty associations.

I have been asked to address some proposals now being debated that would permit what has been characterized as a new type of insurance company "runoff." While the proposals that have been publicly discussed to date in the United States appear to have little relevance to the life and health industries, that could change; they are, in any event, of interest to anyone who works with troubled insurance companies.[1]

The runoff concept is not new in the insurance industry; rather, it has been around for a very long time—at least in the commonly understood sense of runoff. The commonly understood sense of runoff involves companies ceasing the sale of new business, either entirely or with respect to certain lines, and paying off claims from the closed blocks in full as the claims come due, all in accordance with the terms of the policies. In the case of a company-wide runoff of all in-force business, once the business is retired or transferred to another carrier on agreed terms, the runoff company self-liquidates and any remaining assets are distributed to general creditors, subordinated creditors, and shareholders.

In that traditional sense, runoff is just another business strategy—neither inherently bad nor good, but rather good in some circumstances and perhaps bad in others. There is a significant and growing sub-market in the insurance industry of people who engage in, trade in, and service runoff projects, and the individuals who work in that market are as professional and honorable as anyone you will find in the industry.

My comments here are restricted to another type of approach that is sometimes touted now in the United States as a type of runoff or "New Runoff." However, my principal contentions will be, first, that the proposed approach in fact is not properly characterized as a runoff at all—at least not in the traditional sense in which the term "runoff" has been used; and second, that the approach would alter some fundamental aspects of U.S. insurance law and practice in ways that should give serious pause to those considering the approach.

I begin by attempting to identify some core values that should be served by any proposal to run off insurance business over time. Then I will outline a few elements of some of the proposals for permitting the New Runoff. I will offer a few personal concluding observations, and I would be happy to address comments or questions in an appropriate forum.

Runoff Rationales & the Insurance Promise

Why do managers of insurance companies consider runoffs, and why do insurance regulators choose to facilitate them? A variety of reasons have been expressed. The most obvious reason for a traditional runoff is that it is an honest way to exit an unprofitable line of business: The company simply stops issuing contracts that are not meeting the company's objectives, while honoring its commitments under extant contracts as those commitments ripen. Another reason is to permit the eventual return of capital maintained as reserves for the liabilities represented by the books of business being run off.

A different set of reasons has been advanced to justify the New Runoff. One such reason is to "ring-fence" old liabilities, as discussed below. It has also been proposed that the New Runoff may decrease the need for regulatory intervention (rehabilitation or liquidation), which some assert is a worthy goal in itself; help to avoid claims by third parties against officers and directors of the company; or help to maintain the local employment base. There are also suggestions that the New Runoff may eliminate the expense and uncertainty of a lengthy conventional runoff—of having to deal with all those messy "risk" issues—while allegedly still protecting the business reputation of the runoff company.[2]

Now let us consider how those objectives of the New Runoff match up against our fundamental conceptions of the insurance business, insurance contractual commitments, and the regulation of insurance. It is something of a commonplace that the insurance promise is a special sort of promise. The commitment that insurers make to insureds is a contractual commitment of a special, preferred category. Honoring that commitment, as a priority matter, is something that is a core element of the business of insurance and how it is regulated.

That special nature of insurance is part of our culture and part of how insurers relate to consumers on the most fundamental level. Insurers aren't just selling widgets to consumers. They're selling essential promises, along with a bedrock commitment to honor those promises. You buy a policy from Allstate because they're the "Good Hands People." You turn to New York Life because it's the "Company You Keep." That's not a piece of paper you're getting from Prudential; it's a "Piece of the Rock." You trust State Farm because, "Like a Good Neighbor," they'll be there.

The primacy—the special nature—of the insurance promise goes well beyond advertising. Look, for example, at the priority distribution provisions of our receivership laws. Those laws say that, when an insurer fails, its receiver must pay policy-level claims first and in full. Then the receiver pays general creditors—in full. Then the receiver pays other creditors—in full. And then, only if assets remain at the end of that absolute priority "waterfall," are distributions of any such residual assets made to equity owners.

The special, preferred nature of the insurance policy is also hard-wired into our rehabilitation law, which provides under the so-called *Carpenter* test[3] that, when an insurance company enters rehabilitation—not an estate entered into unadvisedly, lightly, and without dire cause—policy commitments to consumers and other creditors may only be impaired if and to the extent that, after the impairment, the result to policyholders is no worse than what they would receive were the insurer to be liquidated. In other words, you can't legally pursue a rehabilitation, the "success" of which can only be obtained by picking the pockets of policyholders.

A Question of Priority

Now I would like to turn to some key elements of proposals to change the insurance laws to permit New Runoffs and to consider how they differ from the traditional concept of runoff. The purposes sought to be served by true runoffs we have already discussed. Getting out of unprofitable lines and eventually freeing the capital associated with reserves for runoff books are, of course, things that can be done in traditional runoffs and by using other, commonly available, routine, transactional techniques that rely *entirely* on voluntary, freely chosen agreements between contracting parties.

The crux of the issue is the other set of objectives now sought to be pursued through the concept of the New Runoff and how those objectives are proposed to be pursued—objectives such as "ring-fencing" old liabilities (that is, turning some liabilities of the insurer into something less than priority claims against the insurer's general account assets); avoiding the initiation of receivership proceedings that, for different reasons, may be undesirable both for the company and the domiciliary regulator; evading claims by third parties against officers and directors; maintaining local employment; and eliminating the expense and uncertainty of a lengthy runoff while protecting the business reputation of the runoff company.

All of these objectives are perfectly valid in and of themselves—*all other things being equal*, and if done by the free choice of each affected party. But note also that each and every one of those goals is an objective whose importance, I believe, would be ranked by all of us as falling below the importance of honoring the essential promise inherent in a contract of insurance. That is true whether viewed in terms of how insurance is bought, sold, and advertised in the marketplace; in terms of how our liquidation priority statutes are written; or in terms of the core "anti-impairment" provision of our rehabilitation law—the *Carpenter* test—that I mentioned earlier. To put it another way, all of the objectives of the New Runoff that have been proffered as justifications by proponents[4] are what might fairly be called "Lower Priority Objectives," when compared to honoring the basic insurance promise.

Let us look at how the New Runoff concept would accomplish these lower priority objectives. These approaches are not peripheral components of New Runoff proposals—they are at the core of the concept. Without them, there would be virtually no need to consider New Runoff proposals.

In the first place, New Runoff proponents advocate making the device available both to solvent and to marginally solvent or insolvent companies. But as to insolvent companies, they also propose that any runoff plan be done in connection with a rehabilitation order and a formal plan of rehabilitation. Since there appear to be no material benefits that a New Runoff scheme would bring to an effort to rehabilitate an insolvent or marginally solvent company that cannot be accomplished today under existing rehabilitation law and a well-crafted plan of rehabilitation, I will focus the balance of these comments exclusively on the use of the New Runoff in the context of solvent insurers. To state it differently, the following issues relate not to insurance companies that *cannot* honor their insurance contract obligations as those come due, but to companies that would *elect* not to honor them in order to serve one or more of the Lower Priority Objectives identified by New Runoff proponents.

Two substantive tools, or weapons, that are fundamental to the New Runoff are forced commutations and "ring-fencing." The idea of forced commutation is that the runoff company would propose a plan to commute policy obligations on specified, disclosed terms that, by definition, would impair the contractual commitment to the policyholders. The company would then put the proposal to a vote of similarly situated policyholders. If the requisite number of voters were to approve the plan, it would bind all members of the class, including particularly the dissenters. As to the dissenters, the commutation terms would be "crammed down," regardless of the dis-

["President's Column" continues on page 11]


The
Troubled Company
Road Show
IAIR's team of insolvency experts
could be coming soon to an
insurance department near you!

By Daniel A. Orth III

Several years ago, the head of the International Association of Insurance Receivers (IAIR) Education Committee came up with a novel idea: put together a program to bring directly to state regulator staffs on the "front lines" an explanation of what happens to a company after its financial statements have been examined and found wanting. Such a program would give financial staff members a better idea of what lies in store for a troubled company's policyholders, employees, and owners and help them understand how their job, done well, can lessen the pain that will otherwise be inflicted on so many. It would also point out some of the "red flags" analysts and examiners should be aware of as they go about their work.

This financial review is vitally important. People turn to insurance companies to protect them against any number of potential problems. They pay a premium today in return for a promise that their insurer will be there for them tomorrow. If that promise is broken, everyone involved pays a price, but none a higher price than the insuring public that relied on that promise.

Therefore, state regulators must be vigilant as they guard against the financial instability of an insurer. To that end, regulators engage the services of financial examiners and analysts to review the financial statements filed by insurers licensed in their jurisdictions. These examiners and analysts are the frontline financial troops that IAIR seeks to reach with its Regulator Education Program—better known to those of us who took part in it as "the road show."

A Promising Debut

IAIR's stated mission is the promotion of professionalism and ethics in the administration of insurance receiverships. IAIR views education as a significant component of its mission, which is why it has a permanent Education Committee. A former chair of this committee, Kristine Johnson (Navigant Consulting), originally conceived of the idea of taking insolvency education on the road. The hope was that financial examiners and analysts might be better armed to recognize potentially troubled companies if the receivers who later had to deal with these companies could identify some red flags that became apparent after the companies were placed in receivership.

The idea lay somewhat dormant, but not forgotten, until early 2005, when IAIR's Barry Leigh Weisman (with the Sonnenschein Nath & Rosenthal law firm) developed an outline of subjects to be covered and recruited presenters. As the program was developed, the original target audience was expanded to include the staffs of state receivership offices as well as the examiners and analysts.

The resulting program debuted in California for the San Francisco staff of the California Liquidation Office (CLO) on May 12, 2005. It covered information technology, claims, accounting, and reinsurance, and it dealt almost exclusively with property and casualty insurer insolvencies. (The program also contained a segment on human resources, which was not continued in subsequent programs.)

The "road show" was greeted with enthusiasm by CLO management and attendees. The program content was well-suited to the audience, and the "price was right"—no CLO travel, hotel, or meal expenses were incurred, and the presenters volunteered their time and covered their own expenses.

Extended Run

In 2006, IAIR's Education Committee was chaired by Pam Waldow. The enthusiastic response to the 2005 CLO program prompted an inquiry to the CLO as to whether a repeat performance of the road show was desirable. It proved to be so and was held on June 29, 2006, at the San Francisco State University Conference Center. At $75 per person (to cover the facility costs), the program was still a great value for attendees—principally state regulators and receivership staff, along with any IAIR members interested in attending. The 2006 program placed additional emphasis on what receivers need to do their job when a company goes into receivership, what regulators can do to help, and ways for regulators and receivers to ensure a smooth transition.

When the agenda for the original May 2005 CLO presentation was disseminated, the lack of a guaranty association component was raised; however, the concern was voiced that an open discussion between regulators and receivers might be "chilled" by the presence of "outsider" guaranty associations. This issue was considered anew after the June 2006 CLO presentation. This time a different conclusion was reached, and a guaranty association component was added for subsequent 2006 presentations.

IAIR received requests from the Ohio, Florida, and Utah departments to bring its road show to their offices. The show "performed" in Ohio on October 19; in Florida on October 26 and 27; and in Utah on November 1, as a sort of tag-on (at the front end) to the IAIR/NCIGF Joint Summit held in Salt Lake City on November 2 and 3, 2006.

The Ohio, Florida, and Utah programs all contained guaranty association components, with property and casualty and life and health sharing a single presentation slot on the program. Ed Wallis, formerly with NCIGF, presented the P&C component in Ohio and Florida, while Kevin Harris of NCIGF presented in Utah. I presented the L&H component in all three presentations with help from Frank Gartland in Ohio and Henry Grimes in Florida (sitting in for William Falck, whose son's wedding for some reason took priority.) Art Dummer's prior commitments made it impossible for him to be present at the Utah presentation. While Art was unable to make it, Utah's extremely capable and involved insurance commissioner, D. Kent Michie, spent time with the presenters and his staffers prior to the meeting and then delivered opening remarks.

Our P&C colleagues went first in our shared time slot, with a very refined NCIGF PowerPoint presentation that explained the steps of activation by entry of an order of liquidation, continued coverage for 30 days, the payment of benefits, and the guaranty associations' claim against the estate. In my L&H presentation, I pointed out that the life and health guaranty associations had a continuing obligation to policyholders after the insolvency and explained why. I also described the structure of the guaranty association safety net, the coverage limits for each line of business (using NOLHGA's 2006 *The Nation's Safety Net* brochure), how the public can be impacted by the insolvency of a single company licensed in multiple states, and how the life and health guaranty associations of the affected states cooperate through the NOLHGA insolvency task force process.

For a purely personal standpoint, I thought the road show was a valuable exercise for all those involved—an informative and educational experience for a good number of attendees and an excellent refresher for the more experienced. I was impressed by the turnout at the Ohio and Florida departments and by the quality of the questions asked by attendees. As in many cross-discipline or cross-culture programs, I believe there is value in learning where your job fits into a bigger picture, and in understanding that there are people out there who are greatly affected by how well you do your job.

At the IAIR Annual Meeting in San Antonio in December 2006, President Joe DeVito said that IAIR will continue, refine, and improve its Regulator Education Program, but he said it will never again try to put on three presentations in a two-week period. Too much of a good thing can cause "road show fatigue." Amen to that, Joe! ✯

Daniel A. Orth III is the executive director of the Illinois Life & Health Insurance Guaranty Association. He is also a member and former director and second vice president of the International Association of Insurance Receivers (IAIR).

A Cast of (Not Quite) Thousands

The topics and presenters for the various IAIR road shows included:

May 2005 (San Francisco CLO Presentation)

- Introduction: Barry Leigh Weisman (IAIR) and David Wilson (CEO of the CLO)
- Information Technology: Jenny L. Jeffers (Jennan Enterprises)
- Accounting: Joseph J. DeVito (Navigant Consulting and IAIR President) and Richard Pluschau (Pluschau Consultants)
- Claims: William C. Barbagallo (Navigant Consulting)
- Reinsurance: Barry Leigh Weisman (IAIR)

October 2006 (Ohio Department of Insurance)

- Introduction: Pam Waldow (IAIR), Bill Rossback (Ohio Department of Insurance), and Mike Motil (Ohio Department of Insurance)
- Ohio Liquidations: Ohio Special Deputy Receiver Doug Hertlein
- Reinsurance Red Flags: Pam Waldow and Barry Leigh Weisman
- HMO Concerns: Mary Jo Lopez (Navigant Consulting at the time)
- Guaranty Association Issues: Ed Wallis (formerly with NCIGF), P&C; Daniel A. Orth III (Illinois guaranty association) and Frank Gartland (Ohio guaranty association), L&H

October 2006 (Florida Office of Insurance Regulation)

- Introduction & Reinsurance: Francine Semaya (Cozen O'Connor law firm)
- Information Technology: Jenny L. Jeffers
- Claims: William C. Barbagallo
- Accounting: Joseph J. DeVito
- Guaranty Association Issues: Ed Wallis, P&C; Daniel A. Orth III and Henry Grimes (Florida guaranty association), L&H

November 2006 (Utah Insurance Department)

- Introduction & Opening Remarks: Francine Semaya and Utah Insurance Commissioner D. Kent Michie
- Information Technology: Jenny L. Jeffers
- Accounting: Joseph J. DeVito and Richard Pluschau
- HMO Concerns: Mary Jo Lopez
- Guaranty Association Issues: Kevin Harris (NCIGF), P&C; Daniel A. Orth III, L&H

["Interesting Times" continues from page 1]

current Social Security recipients while also generating funds to place in their own personal accounts. This is problematic, to put it mildly, when benefit payments are already expected to exceed contributions to Social Security in 2017.

In contrast to the many options available for Social Security reform, "nobody has any good ideas for Medicare and Medicaid," Olson said. The problems here are an aging U.S. population and the enormous increases in the cost of health care. "We have a problem because there's no incentive to control costs" in health care, she added, noting that even as health-care costs have skyrocketed, out-of-pocket expenditures have dropped by two-thirds since 1964. The only way to address the problems with Medicare and Medicaid, Olson said, is to develop a program to control the growth of health-care costs and bring it in line with GDP growth.

The implications of the troubles with Social Security, as well as the well-documented downfall or many corporate pension plans, were addressed in *Understanding the Financial Burden Shift*, a presentation by MetLife Chairman, President, and CEO C. Robert Henrikson. According to Henrikson, "individuals are shouldering more of the financial burden than ever before because they know they can no longer count on the government, their employer, or the stock market for their financial security."

Whereas in the past people could rely on Social Security or company pensions and insurance for financial stability, today's workers are facing the prospect of footing a large percentage of retirement and other costs themselves. "Without insurance, the average consumer cannot adequately and efficiently self-insure" against risks such as morbidity, mortality, and even longevity, Henrikson said. But despite this, many Americans "have no personal insurance or are grossly underinsured."

As an example, Henrikson noted that according to MetLife research, people purchase life insurance to help their families should they pass away. The research also revealed that the median amount of life insurance coverage in the United States is three times a person's annual salary. This, he said, raises an obvious question: "How long are you going to be dead?" If it's more than three years, the insurance is inadequate.

As life expectancy increases and Social Security and pension plans become less reliable, Americans will need "guaranteed income that they cannot outlive," Henrikson said. "Only an insurance company can make this guarantee, through annuity products" such as so-called "longevity insurance."

Consumers, Henrikson said, are recognizing the additional financial burden they face, and they're looking for help in meeting it. "Consumers are craving advice" he explained. "They want to do things that are smart. They're afraid of making stupid decisions, and it paralyzes them." It's up to the insurance industry to provide "simple, straightforward, jargon-free, trustworthy information" to help consumers craft a financial plan that addresses their short- and long-term needs.

This being the case, the retirement market holds great promise, according to Henrikson. "I believe that retirement will be the single largest opportunity for the insurance industry, now and for the foreseeable future," he said. The key, he emphasized, lies in getting consumers to focus on a long-term income stream rather than a "bag of cash" as the goal of retirement planning: "They should focus on how to create a 'paycheck for life' and protection for their future."

Regulation & Transmogrification

Talk on the second day of the meeting turned to a possible shift in insurance regulation, as NAIC President-elect Walter A. Bell's presentation, *Making Progress…Together*, touched on changes to state regulation and the possibility of increased

According to MetLife Chairman, President, and CEO C. Robert Henrikson, "individuals are shouldering more of the financial burden than ever before because they know they can no longer count on the government, their employer, or the stock market for their financial security."

federal regulation of insurance. While Bell, who is also the Alabama commissioner of insurance, is no fan of federal regulation—"we all know how well Washington regulates insurance," he joked—he did say that the momentum for federal regulation is stronger than it has been in years. In particular, he cited the National Insurance Act of 2006, which proposes the creation of an independent office of federal regulation in the Department of the Treasury.

Rather than simplifying things, Bell said, this "will provide more levels of regulation" and will also leave open the possibility of regulatory arbitrage, allowing companies to search for the most lenient regulatory framework in which to do business. He also questioned whether the federal government possesses the needed expertise: "When Treasury has a question about insurance, they call the NAIC."

Bell warned that federal regulation would have negative economic consequences for state government. "Ultimately, we think there will be reduced revenue to the states," he said. He also predicted that taxpayers could feel the burden as well: "That's the way the feds pay their bills—raise taxes or go further into debt."

Bell acknowledged that state regulation has its own problems—"we have to make some changes," he said—but he maintained that the NAIC's modernization efforts of the past few years have begun to bear fruit. He pointed to the Interstate Compact, which recently became operational when a total of 26 states (now 28) enacted it, as a sign of what the NAIC can accomplish

California Dreamin'

A beautiful setting and a wonderful reception at Mission San Juan Capistrano made for an Annual Meeting to remember

with federal prodding rather than intervention.

Pacific Life Insurance Company Chairman & CEO Thomas C. Sutton offered his perspective, gained from more than 40 years in the insurance industry, on some of the major issues confronting the industry. He began by citing a 1984 article titled "Upheaval in Life Insurance" and joked that "we've been heaving ever since" due to the vast number of changes in the industry.

Sutton touched on the hot-button issue of consolidation, which he said has been and will continue to be quite a trendy topic. "Ten years from now, you'll still be hearing comments from people at podiums about consolidation," he said, while warning that "the jury is still out on whether bigger is better." He also noted that the move toward convergence of financial services institutions "seems to have disappeared" for a very good reason: "I have not noticed any significant successes in cross-marketing."

Sutton then turned his attention to transmogrification, reminding attendees of the Calvin & Hobbes comic strip in which Calvin could transmogrify into a dinosaur and then back into a small boy. He likened this to the changes of "our industry dinosaurs—the mutuals" into publicly held companies. Noting that "unlike Calvin, they can't change back," Sutton warned of the detrimental effects of demutualization, namely "the accelerated focus on short-term results, often at the expense of the long-term view."

Commenting on the increasing proliferation of guarantees in recent new products, Sutton said that "we're collectively selling guarantees like hot-

All meeting photographs by Kenneth L. Bullock cakes, and maybe at the same price." If these guarantees are being priced incorrectly, he added, companies could one day fall into the "benevolent clutches" of the guaranty system when they become insolvent.

Despite these and other challenges, Sutton expressed great confidence in the future of the industry. "At the core, our industry has demonstrated amazing resiliency through the years," he said.

The final presentation of the meeting featured an economic analysis by Strategic Asset Alliance President & CEO Alton Cogert. In his presentation, *Economic Outlook & the Impact on Insurance Company Investments*, he dubbed the economy "the Jamie Moyer economy" after the Seattle Mariners pitcher who, Cogert said, had three speeds for his pitches: "slow, slower, and slowest." The slow growth of the U.S. economy, coupled with rising inflation, make a recession in the next year a 50/50 proposition, according to Cogert.

Consumer spending drives the economy, and Cogert predicted a slowdown there as well. "The consumer is concerned with cash in/cash out," he said, and factors such as increased job insecurity, rising prices and price volatility, and the increase in adjustable-rate mortgage payments will lead to a decrease in spending.

Commenting on insurance company investment strategies, Cogert warned of possible dangers in derivatives—what he called "the elephant in the room." Credit derivatives have a nominal value of $283 trillion, he said, "and if there are any systemic problems in that market, look out."

Cogert closed his presentation by stressing the importance of dynamically modeling various risk scenarios, such as reinvestment, interest rate, and market risks. "The key is to have a risk model that everyone in the company understands," he said. "If you don't have this risk model in place, you can't properly quantify a consensus 'risk appetite' for the company." ✩

Sean M. McKenna is NOLHGA's director of communications.

NOLHGA Chairs Focus on Internal, External Challenges

Outgoing Chair Merle T. Pederson and Incoming Chair Christopher L. Chandler praised the success of the guaranty associations while highlighting a number of threats to the system in their addresses at NOLHGA's 23rd Annual Meeting.

Pederson, who pointed out that his father had been fortunate to enjoy the protection of a guaranty association during the Midwest Life insolvency, noted that the key to the continued success of the guaranty system lies in the ability of its members to work together. "The guaranty system's greatest strength lies in the teamwork and deliberate decision making of its many members, and our ability to call on those members—and the expertise they bring—will continue to serve us well in the future," he said. He mentioned the work of the Guaranty System Modernization Task Force (GSMTF), which received input from all sectors of the guaranty community, as a model of what the system can accomplish.

Pederson acknowledged that members can disagree at times, but he said that these disagreements can be helpful so long as all parties remember that they share the common goal of protecting policyholders. "We will fail if we lose trust in each other, or in where we're going, or if we lose faith in the belief in where we can and should go together," he said.

In listing some of the challenges the system will face in the coming years, Pederson said that "I think the greatest threat comes from within—complacency. We are only as good as our handling of the next high-profile, national insolvency." He added that he expects the system to not only survive but thrive because of the strong leadership it enjoys: "As I look out at this audience, I see a passion for excellence, a deep and abiding respect for our colleagues, a pride in the work we do, and a drive to do it even better."

Chandler also praised the GSMTF, which he said performed the "critical role of self-analysis" for the guaranty system, and stressed the importance of constant and consistent improvement. "While it is difficult in a system such as ours to make radical change," he said, "one can set an expectation which over time can be achieved."

This type of improvement, which Chandler called the hallmark of any successful organization, has become even more important due to the outside scrutiny the system faces. Thanks to the ongoing debate about federal insurance regulation, he said, "we have been thrust into the legislative arena." If the guaranty system is unsuccessful in educating Congress about its history of success, all the system's accomplishments could be swept away.

While Chandler said that "we have a really good story to tell," he also cautioned that "we remain in play and will remain in play until the debate is over." Noting that "our major weakness is inconsistency from state to state," he called on the associations to adopt the latest version of the NAIC's Life & Health Insurance Guaranty Association Model Act and to strive to achieve consistency in the interpretation of coverage statutes. He also emphasized the importance of promoting efficiency and improving the corporate cultures of the associations in areas such as governance guidelines and transparency. ✩

The **"New Runoff"** approach would alter some fundamental aspects of U.S. insurance law and practice in ways that should give serious pause to those considering the approach.

["President's Column" continues from page 3]

senters' desires to have their contracts honored according to their terms.[5]

A related proposal is that a dissenter from a proposed commutation plan may be required to choose between two alternatives. One alternative is to be involuntarily cashed out of his policy and any existing policy claims based only on an estimate of the value of the claims—thus receiving back from the runoff insurer, against his will, an involuntary re-transfer of the risk assumed by the insurer when the contract was first freely agreed on by both sides. The other alternative is to be subject to an involuntary transfer of the responsibility for his claims from the runoff insurer (to whom that responsibility is a general account liability) to a liquidating trust funded only with a finite set of assets, thus eliminating the policyholder's claim against the general assets of the solvent runoff insurer.[6] That is the essence of "ring-fencing," a term used to reference both an objective sought to be permitted under New Runoff proposals and also the technique for achieving the objective. Like forced commutation, ring-fencing is done for the explicit purpose of permitting the solvent runoff insurer to redeploy its assets for one or more Lower Priority Objectives that would now be possible solely because of the repudiation of the company's original insurance commitments.

Turning from substantive elements to procedure, it should be noted that most key decisions in the development, structuring, and execution of New Runoff plans would be made not by the creditors themselves or representative committees of creditors, as would be done in a U.S. bankruptcy or a U.K. Scheme of Arrangement—this has been rejected by New Runoff proponents as "commercially infeasible"[7]; nor by a statutory receiver who is a fiduciary for all creditors, as under current U.S. practice; but rather by the runoff company itself, albeit subject to some regulatory and judicial oversight.[8]

A statute authorizing New Runoffs and constructed along these lines would face a host of significant legal and constitutional challenges, relating to, for example, (i) extraterritorial enforceability of basic plan decisions (like cram-down commutations or ring-fencing schemes) in non-domiciliary states; (ii) impermissible impairment of contracts[9]; and (iii) the improper taking of property interests for solely private purposes and without just compensation.

In the context of solvent companies, the proposed New Runoff concept appears not only to violate the concept of the primacy of insurance commitments, whether as viewed in the marketplace, under the liquidation priority laws, or under rehabilitation law; it also appears to depend entirely upon the forced conversion of private property rights from those rights for which a consumer had freely bargained to those he is deemed by others—not himself—to need.

In most places other than Cuba, North Korea, and certain select U.S. zip codes, the economic philosophy of "to each according to his needs" has been rejected in favor of the free market. A more appropriate conclusion might be the one reached by the only economist ever to win the Nobel Prize for sartorial splendor, the late, great bow-tie wearer, Milton Friedman, who maintained always that each of us should be "Free to Choose."[10] ✯

Peter G. Gallanis is president of NOLHGA.

End Notes

1. One such proposal was passed out of the Committee on Insurance and Real Estate of the Connecticut Senate in April 2005—S.B. 1301, January Session (CT 2005) ("An Act Concerning the Voluntary Restructuring of Insurers") (the "CT Bill"); a proposal virtually identical to the CT Bill was circulated and informally debated in New Mexico in 2006 but apparently never introduced (the "NM Proposal"). A more restrained version of such legislation was adopted as law in Rhode Island, R.I. Gen. Laws § 27-14.5 (2002) ("Voluntary Restructuring of Solvent Insurers"). Proponents of the CT Bill published a widely circulated report on April 20, 2006, discussing a number of the issues addressed in the CT Bill and suggesting some refinements to the bill's concepts;

["President's Column" continues on page 12]

["President's Column" continues from page 11]

H. Horwich (reporter), *Final Report of the Special Task Force on Insurance Company Run-Off and Reorganization*, Hartford, CT 2006 (copies available from your author) (the "Task Force Report").

2. See generally Task Force Report at p. 2.
3. *Neblett v. Carpenter*, 305 U.S. 297 (1938), *affirming Carpenter v. Pacific Mut. Life Ins. Co. of California,* 10 Cal.2d 307 (1938).
4. *Ibid.*
5. See generally Task Force Report pp. 7–9.
6. *Ibid.* at p. 9.
7. *Ibid.*
8. *Ibid.* at pp. 9–10.
9. In this connection, recall that in the *Carpenter* case a challenged rehabilitation plan was ultimately vindicated against a Contracts Clause challenge only because it was held to be a valid exercise of the police power in the context of a receivership presided over by the state insurance commissioner. The court specifically observed that the insurer, by itself, could *not* have cut contract benefits without unconstitutionally impairing policyholders' contracts; query what police power exercise is involved in a solvent runoff? See *Carpenter v. Pacific Mut. Life Ins. Co. of California,* 10 Cal.2d 307, 331-2 (1938)
10. See Milton & Rose Friedman, *Free to Choose* (Harcourt 1990).

Since these remarks were first presented, it has been suggested to the author by the reporter for the Task Force Report that the New Runoff concept may be less threatening than it might seem—in part because the Task Force Report concludes that such schemes should be restricted only to commercial lines carriers and reinsurers (there is no such restriction in the CT Bill or the NM Proposal) and also because the domiciliary insurance regulator would oversee such a runoff and would be able to veto inappropriate plans.

With respect, I disagree with both contentions. To the extent that New Runoffs for solvent companies depend fundamentally upon the forced transfer of wealth that is inherent in the runoff company's decision to repudiate its promises to policyholders under cover of legislation authorizing New Runoffs, the nature of the victim does not determine whether a law permitting such a forced transfer is right or wrong. Permitting such a forced transfer is simply wrong (and likely illegal, unconstitutional, and unenforceable) regardless of who ends up being the victim.

As to the involvement of the domiciliary regulator, that is, of course, a marginal "cold comfort" factor. But in the not-unheard-of case of a regulator passing on the plan of a company, most of whose policyholders are not residents of that regulator's state, a properly crafted statute provides much greater protection for policyholders than would be provided by depending solely upon the proper employment of regulatory discretion.

NOLHGA Journal
Vol. XIII, No. 1 | January 2007

The *NOLHGA Journal* is a publication of the National Organization of Life and Health Insurance Guaranty Associations dedicated to examining issues affecting the life and health insurance guaranty system.

NOLHGA
13873 Park Center Road, Suite 329
Herndon, VA 20171
TEL: 703.481.5206
FAX: 703.481.5209
Editor: Sean M. McKenna
E-mail: smckenna@nolhga.com

NOLHGA Calendar of Events

2007

February 1–2	IAIR Insolvency Workshop Tucson, Ariz.
March 10–13	NAIC Spring National Meeting New York, N.Y.
April 18–20	**MPC Meeting Philadelphia, Pa.**
May 3–4	NCIGF Annual Meeting Baltimore, Md.
June 2–5	NAIC Summer National Meeting San Francisco, Calif.
July 10–11	**MPC Meeting San Francisco, Calif.**
July 12–13	**NOLHGA's 15th Annual Legal Seminar San Francisco, Calif.**
September 29–October 2	NAIC Fall National Meeting Washington, D.C.
October 8	**MPC Meeting Amelia Island, Fla.**
October 9–10	**NOLHGA's 24th Annual Meeting Amelia Island, Fla.**
October 21–23	ACLI Annual Conference Washington, D.C.
December 1–4	NAIC Winter National Meeting Houston, Tex.