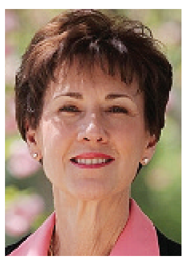
nolhga journal

Volume XVIII, Number 1 | February 2012

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

A New Ballgame

Texas Insurance Commissioner Eleanor Kitzman talks about the move from a small state to a large one and the role the federal government could play in insurance regulation



Eleanor Kitzman was appointed the Texas Insurance Commissioner in August 2011. Prior to that, she served as the Executive Director of the South Carolina Budget and Control Board and was the past Director of the South Carolina Department of Insurance. She is a former clerk for the Texas Supreme Court. She previously held management positions with several insurers and reinsurers and practiced law with the Austin office of Akin, Gump, Strauss, Hauer & Feld. She spoke with the **NOLHGA Journal** *in early January 2012.*

NJ*: You're one of the few people who served as a Commissioner in one state, went to the private sector, and then came back to serve as Commissioner in a different state. What have you discerned so far about how different states' priorities can make the focus of regulatory efforts different from state to state?*

Kitzman: Actually, there are three current Commissioners who have been Commissioners in other states, and that's probably as many as there have been in the history of the NAIC. You have Julie McPeak in Tennessee; she was Commissioner in Kentucky. And Scott Kipper, who is in Nevada, was the Administrator in Oregon and was also the Commissioner in Nevada previously.

I think what probably makes my situation a little different is that I went from being commissioner of a small state to being commissioner of the second largest state and insurance market in the country. That entails a lot of challenges; on the other hand, it's great to have staff. I tell all my small state friends, you just have no idea what it's like to have staff and resources.

When I first came into this position, a friend asked if it was like going from the minors to the majors. I said in many ways, yes,

but in other ways, it's like a different ballgame. Sometimes size matters—other times, not so much. Also, it's important to remember that it's all relative and each state's issues are just as important to that state's Commissioner.

There are certain issues that transcend the number of domestics in a state or the size of the insurance market. Solvency; consumer protection; and robust, healthy insurance markets are important to all Commissioners, consumers, and companies. Larger states may attract more bad actors because there's more money in play; on the other hand, smaller departments may be perceived as not having sufficient resources to fight fraud.

After those overriding issues that are important for all states,

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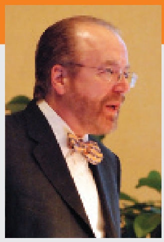


Seven Things We Know About Insurance & the Financial Crisis—That Aren't True

The following is adapted from the President's Address given at NOLHGA's 28th Annual Meeting on October 12, 2011.

Last October I noted the fact that the financial services world had been through several tough years. A financial crisis this serious naturally has attracted a lot of attention to all parts of the financial services industry. That attention has come from politicians, pundits, regulators, academics, and the media. Having seen a lot of the issues from the inside, or at least from not very far away, I've been struck by how much of the discussion in the media regarding *insurance* and the financial crisis has been just plain wrong.

I want to talk now, not so much about financial crisis facts, but rather about reporting errors relating to insurance and the crisis. So without further ado, I am going to address seven things we all *know* about insurance and the financial crisis—propositions that have been repeatedly asserted in the media and in the public dialogue about how to respond to the financial crisis—that are **wrong**.

Insurance Failures & "Rescues"

Our first proposition is that insurance company failures were widespread during the crisis.

That proposition is false. While it's true that the financial crisis battlefield was littered with the corpses of a lot of financial services companies, very few of those (and none of any national significance) were operating insurance companies.

Since the start of 2008, we've seen the failure of nearly 400 banks and thrifts, including the largest banking sector failures in history; we've seen the virtual elimination of the investment banking industry as we had known it for over a century—the whole sector; Fannie and Freddie were placed in federal receivership; two of the three leading auto manufacturers went bankrupt and were bailed out; hedge funds closed right and left; a leading money market fund "broke the buck," and the rest required federal guaranties; hundreds of other banks, finance companies, and other businesses that did not go broke accepted federal capital infusions or guaranties. But insurers? Let's talk about insurers. (I'll be speaking specifically of life and health insurers here, but I am reliably informed that the situation on the P&C side is similar and possibly better in some ways.)

A grand total of eight life insurers and five health insurers went into liquidation from January 2008 through today. That's about three life or health insurers a year, no more than historical averages in a national industry that has about 1,700 market participants. Of those, all but two of the life companies and one of the health companies were tiny, regional entities with liabilities well under $100 million. The two *marginally* significant life company failures had absolutely nothing to do with the financial crisis: Crooks stole the assets.

Combined, all 13 of those cases involved aggregate insurance liabilities of about $900 million. That's right—million, with an "M." At the time of its 2008 bankruptcy filing, the liabilities of Lehman Brothers were more than $765 billion—with a "B." And that's just Lehman. Add in Fannie, Freddie, and the rest of the major failures, and you're talking about liabilities well into the trillions. In essence, life and health insurer liquidations didn't amount to a gnat on the backside of the financial crisis.

Now let's talk about the second often-misstated "fact": that the federal government "rescued" the insurance industry during the crisis.

How many of you have read, even in respected papers and magazines, lines like, "Because taxpayers funded the federal bailouts of the banks, Wall Street, *and the insurance companies*, we need to change financial regulation by doing XYZ" (whatever that might be)?

This, of course, is an instance where it's possible to mislead a lot by telling a little bit of truth.

We know from unpacking the first proposition that there were very few liquidations of operating insurance companies during the crisis; none of those were even close to being systemically significant, and more than half were microscopic in the context of the overall financial system. We also know there was a very long list of very large failures in other industries—financial services and otherwise. So what insurance companies were "bailed out"?

The answer is "None," in the sense that there were no operating insurance companies demonstrably headed for liquidation, in cases where the provision of federal aid clearly prevented their liquidation. Yes, it's true that of the $700-plus billion initially authorized for TARP relief, two life insurers—neither of which was ever remotely close to liquidation—took a couple of billion dollars in total to boost their surplus and working cash. That money was all repaid to the federal government within a year, and with a healthy profit, taking into account both interest payments and the sales of warrants.

And then, of course, there's AIG—about which more, presently. For now, even if you believe AIG's failure was *caused* by its insurance activities (it wasn't), and even if you believe that federal assistance kept the AIG insurance subsidiaries from receivership (unclear but doubtful), there's this: AIG was unique.

No other insurance operation has ever taken on, even

Even if regulatory financial supervision is good, the regulated firm's stakeholders can still be harmed terribly by ineffective *resolution* of the failed company.

remotely, the amounts or kinds of non-insurance risks that were engineered from within the AIG Financial Products operation; and in no other insurance operation were so many critical decisions about entity-wide operating and investment risk made outside the operating insurance companies and effectively imposed on the regulated insurance subsidiaries by "corporate."

So even if, for the sake of argument, you concede the dubious assertion that the federal government rescued some of the AIG insurance subsidiaries, that case would be the lone exception proving the larger rule we saw with the first proposition: Not only did the federal government not rescue the insurance industry: the industry—as a sector—did not *need* rescuing.

What AIG Means

Our third proposition is that the AIG failure proves somehow that big insurance companies are "systemically important" under the Dodd-Frank Act, and therefore they require heightened federal regulation in this Brave New World to prevent future risks to the overall financial system.

You've heard that, right? I can't tell you how many times I've heard it on Capitol Hill, and I'll bet FIO Director McRaith, NAIC CEO Terri Vaughan, Missouri Insurance Director John Huff, and Commissioner Susan Voss, among others, have also heard it.

You can't respond to this proposition without noting that—at least until yesterday, and maybe still—"systemically important" was largely an undefined term as regards so-called "non-bank financial companies," including insurers. Both the Dodd-Frank Act and preliminary output from the FSOC pointed toward some factors relevant to determining which non-bank financial companies are systemically important, but we have all waited a long time for a clear, definitive standard for answering the question of what "systemically important" might mean. That is to say that, at least until yesterday, "systemically important" was like what I remember Justice Potter Stewart saying about "obscenity" at the Supreme Court: "I can't tell you what it is, but I know what I like."

Prior to yesterday, all we had to go on were some factors that would be considered regarding systemic riskiness of a company: size, scale, scope, liquidity, leverage, concentration, interconnectedness, amount of financial assets, asset management activities, degree of primary regulation, reliance on short-term funding, extent of off-balance-sheet financing, importance as a source of credit for businesses and households, and "substitutability"—that is, whether other firms provide the same or similar products or services.

Some reflection on those factors may prompt this conclusion: While they do suggest that, pre-2008, the AIG corporate group (at the parent company level) was systemically important—since it would have been caught on nearly all of those hooks—it's honestly hard to identify even one other insurance operation today that indubitably requires "systemic" designation. Put another way, there's no other insurance operation that remotely resembles AIG in the very factors that made AIG-corporate such a "sink" for systemic financial risk.

Just yesterday, though, FSOC released a proposed rule and interpretive guidance setting forth a rather complex, three-stage screening process for identifying what non-bank financial companies might be considered "systemically important." We've had only a very few hours to begin reviewing the new FSOC release, but my own preliminary reaction is that at least the first stage of the screening process is going to implicate a

["President's Column" continues on page 13]

Uncertain Times

NOLHGA's 2011 Annual Meeting looks at health care, insurance regulation, and the economy—and turns up almost as many questions as answers

By Sean M. McKenna

As NOLHGA's 2011 Annual Meeting came to a close last October in Chicago, classic rock played as attendees made their way out of the ballroom. Somehow, Bob Dylan's *The Times They Are A-Changing'* was NOT on the playlist that day—an unfortunate oversight, because the song's title perfectly captured the mood of the meeting (far better than Abba's *Dancing Queen*, for which we apologize). For two days, industry experts and regulators discussed the future of health-care insurance, insurance regulation, the economy, and the guaranty system, and the one thing they agreed on was that change is in the air—and will be for some time.

On the Regulatory Front

In a fast-paced and entertaining speech, former NAIC President and Iowa Insurance Commissioner Susan Voss summed up the state of affairs nicely when she said, "It's just not your grandfather's insurance regulation anymore." Among the many changes affecting the regulatory landscape, she singled out the growing role of the federal government and the upcoming report on regulatory modernization by the Federal Insurance Office (FIO). "We're being watched very closely by the federal government, and I think we're going to be challenged about what we're doing on receiverships," Commissioner Voss said. "We're going to need to be more responsive."

Some of that responsiveness will have to come before a company is placed in receivership. Commissioner Voss said that regulators and the guaranty system "need to work closely on new products" to determine their guaranty association coverage. She also praised the system, saying, "You have been a great group to work with."

Turning her attention to the FIO report, Commissioner Voss predicted that the report will be "highly critical" of state regulation in some areas, such as market regulation, but she held out hope that the performance of the insurance industry during the financial crisis (when the industry fared far better than other sectors of the financial services market) might be taken into account: "Maybe they won't see us as something that needs to be fixed."

Missouri Insurance Director John Huff also discussed the roles of state and federal regulation, expressing

Political commentator Clarence Page entertained attendees with a speech that touched on the political landscapes of Chicago and Washington. Commenting on President Obama's low approval ratings, even among Democrats, Page noted that the president's calm demeanor, a positive on the campaign trail, was now viewed in a negative light: "Democrats who wanted a Kennedy-esque president now want a Lyndon Johnson arm-twister."

hope that the FIO report will "nudge state regulators along" on issues such as uniformity. "We sometimes need that push," he said. Director Huff also serves on the Financial Stability Oversight Council (FSOC) with FIO Director (and former Illinois Insurance Director) Michael McRaith, and he added that Director McRaith is a strong believer in the value of state regulation.

The FSOC released a proposed set of rules for identifying systemically important financial institutions (SIFIs) the day before Director Huff spoke, and he commented on the importance of the rules for the financial markets and the role those markets play in developing the rules. "Markets respond best when there's regulatory certainty," he explained. "The FSOC needs to provide that certainty" by making the designation of SIFIs clear.

Then-Acting Illinois Insurance Director Jack Messmore welcomed attendees to Chicago and spoke of his career with the department. He called risk-based capital regulation and the NAIC's solvency accreditation program "the biggest improvements I've seen in my career."

Director Huff also emphasized that the proposed SIFI rules are not etched in stone. "I cannot stress enough the importance of comments and feedback in this process," he said, encouraging company representatives to submit comments on the rules. He added that he did not expect many insurance companies to make it past stage one in the three-stage process for determining SIFIs.

Director Huff noted that the FSOC now possesses a good deal more insurance expertise with the appointment of FIO Director McRaith as a fellow non-voting member and the congressional approval of Roy Woodall as the voting insurance representative on the council. "It will be nice to have some insurance folks on the council," he said. "It's been a little lonely these

Members Only

The Major Insolvencies Briefing and Investment Strategies for Guaranty Associations presentation attracted large crowds.

last 15 months." He added that he's optimistic that the three can provide the council with enough insight into insurance to prevent any actions that might inadvertently harm the industry.

Rapid Change & Staying the Course

Nick Thompson (UnitedHealth Group) talked about another issue that many feel might harm the insurance industry—the Affordable Care Act. One of the difficulties in predicting the effect the Act will have on the health-insurance industry, Thompson said, is the Act's complexity. "I've never seen anything like this," he explained, noting that his company had produced a 300-page spreadsheet to track the various provisions of the Act. "It's unprecedented."

Thompson focused in on a few of the most important facets of the Act, such as the addition of a federal rate review process on top of the existing state-level review. Any rate increase over 10% is automatically reviewed, and Thompson predicted that the government will lower that threshold in 2012. The federal review "isn't an approval process," he said. "The government will merely make a pronouncement on whether the increase is justified or unjustified." However, having too many unjustified rate increases can jeopardize a company's ability to operate in the insurance exchanges to be set up in each state.

The government also set a mandatory medical loss ratio (MLR) of 85% for large group insurers and 80% for small group and individual insurance providers. If a com-

The Need for Speed

Speed was on the minds of Outgoing Chair John Mathews and Incoming Chair Tom Ronce as they delivered their addresses at the 2011 NOLHGA Annual Meeting. Mathews spoke about the efforts of the NAIC and ACLI to improve the receivership process, and he highlighted the need for taking prompt corrective action. "Early action is often the best choice," he said, adding that periodic financial reporting to the receivership court would also yield better results.

Outgoing Chair John Mathews

"As regulators and the insurance industry work to improve rehabilitations and receiverships, we should have a seat at that table," Mathews added, while acknowledging that the guaranty system also needs to turn a critical eye on itself in areas such as consistency and coverage determinations for new products. "It's not easy work, but as a system we need to reach consensus on coverage for these products," he said.

Incoming Chair Tom Ronce

Mathews also stressed that the guaranty system needs to prepare itself for change, whether it be new business models for handling the policies of failed insurers or new disclosure rules for the sales process. The key to adapting to changes like these, he said, was being open to them—no matter where they originate: "As we work to make our system stronger, let's remember that good ideas can come from anyone truly interested in helping policyholders."

Ronce also highlighted the changes facing the guaranty system. "NOLHGA and the guaranty system are changing, and being changed, at a pace far faster than what we've seen in years past," he said, emphasizing that the system needs to take control of this process —"to manage our evolution rather than sit back and watch as it happens to us."

A key step in dealing with change will come in 2012 as the NOLHGA Board embarks on an ambitious strategic planning effort. "We're starting with a blank page, and we plan to fill it up with a plan for NOLHGA's future," Ronce said. "A future that will include Dodd-Frank, the FIO, any fallout from ELNY and Penn Treaty, an uncertain economy, and any number of other factors."

Although this project will involve an outside firm, Ronce stressed that the membership will play a key role in the effort. "The most valuable feedback we'll receive will come from you," he said. "Your experiences and perspectives will play a vital role in the decisions the Board makes—about its own performance, the future of NOLHGA, and how best we can support you in that future."

pany fails to maintain that MLR, "you're going to pay a rebate back to the policyholders," Thompson said.

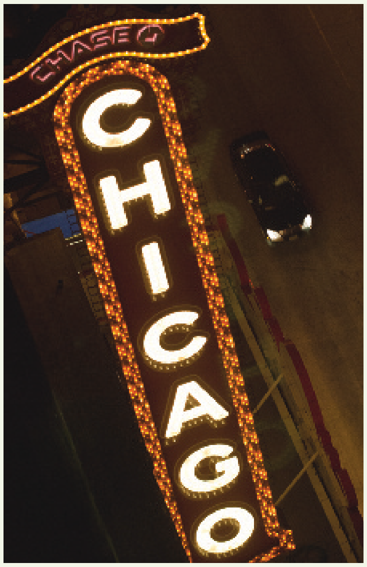
In 2014, the guaranteed issue provisions of the Act kick in—what Thompson called "a fundamental shift in how health insurance is done." Guaranteed issue is predicated on the individual mandate, but Thompson explained that the penalties for not carrying insurance are far lower than the industry expected—making it easy for individuals to go without insurance until they become ill or get injured. As a number of states fight the individual mandate (the Supreme Court is scheduled to hear a mandate case in 2012), the issue of "severability" arises—in other words, can guaranteed issue be retained even if the individual mandate is stricken from the law? This could have a massive impact on company solvency, Thompson said. If it occurs, "We may be down to a handful of carriers in some places."

While Thompson's presentation dealt with future unknowns, Tom Henning (Assurity Life Insurance Company) spoke to the audience about something more permanent—the keys to his company's success, which include a company culture and values that remain unchanged over time.

The first is a clear understanding of what the company is and isn't. "Be sure who you are, and resist the inevitable pull to try to do something for everybody," Henning said. The second key is living the company's core values—ethical behavior, extraordinary associates, innovation, strong relationships, and maintaining

Top of the Town

The reception at the ROOF Lounge was a big hit with attendees.



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Missouri Insurance Director John Huff

financial strength. "How we achieve our results is as important as the results themselves," he explained.

Henning also places great value in the "balanced scorecard" process of performance evaluation. As he explained, "measurement improves performance, and what gets measured gets done." Assurity also has a strong focus on entrepreneurship and seizing opportunity ("you have to embrace change and capitalize on change"), as well as a firm belief in the value that insurance provides—what Henning called "a noble purpose" that drives his company.

Former NAIC President and Iowa Insurance Commissioner Susan Voss

Investment Climate

Andrew Paone (Wellington Management) was placed in the difficult position of being the last speaker at the meeting, but he closed the show with a great presentation on the investment outlook for insurance companies that somehow managed to work in the Red Sox and Rocky movies.

Beginning with a brief look at the economy, Paone said that "the best case is slow, positive growth," but he added that the risk of recession is substantial—due primarily to the European sovereign debt crisis (a good call on his part). While the insurance industry's exposure to that debt is relatively low, there's no shortage of challenges for the industry. Paone singled out three primary threats—low interest rates, fluctuating liquidity needs, and a search for incremental yield.

"The troubling thing is that expectations are that rates aren't going to go much higher," Paone explained. "This is the challenge for insurers in the capital markets." The best approach in this environment, he said, is to invest with liability duration in mind and to minimize portfolio turnover while still trying to take advantage if rates inch upward.

Liquidity concerns are best addressed by having a strong understanding of product design (and the resultant liquidity needs) and by "seeking liquidity beyond cash," in instruments that can be converted to cash easily.

Insurers face a huge challenge in finding yield, and Paone pointed to the corporate bond sector ("we think valuations are quite attractive") and to lower-rated investments (dropping from A ratings to BB or perhaps a bit lower). With the latter approach, he said, "we're not talking about a wholesale shift" (he suggested devoting 5% to 10% of a company's portfolio to this segment), "but the expectations for default are near an all-time low." He also suggested emerging markets corporate and value equity index investments. ✯

Sean M. McKenna is NOLHGA's Director of Communications. All photos by Kenneth L. Bullock.

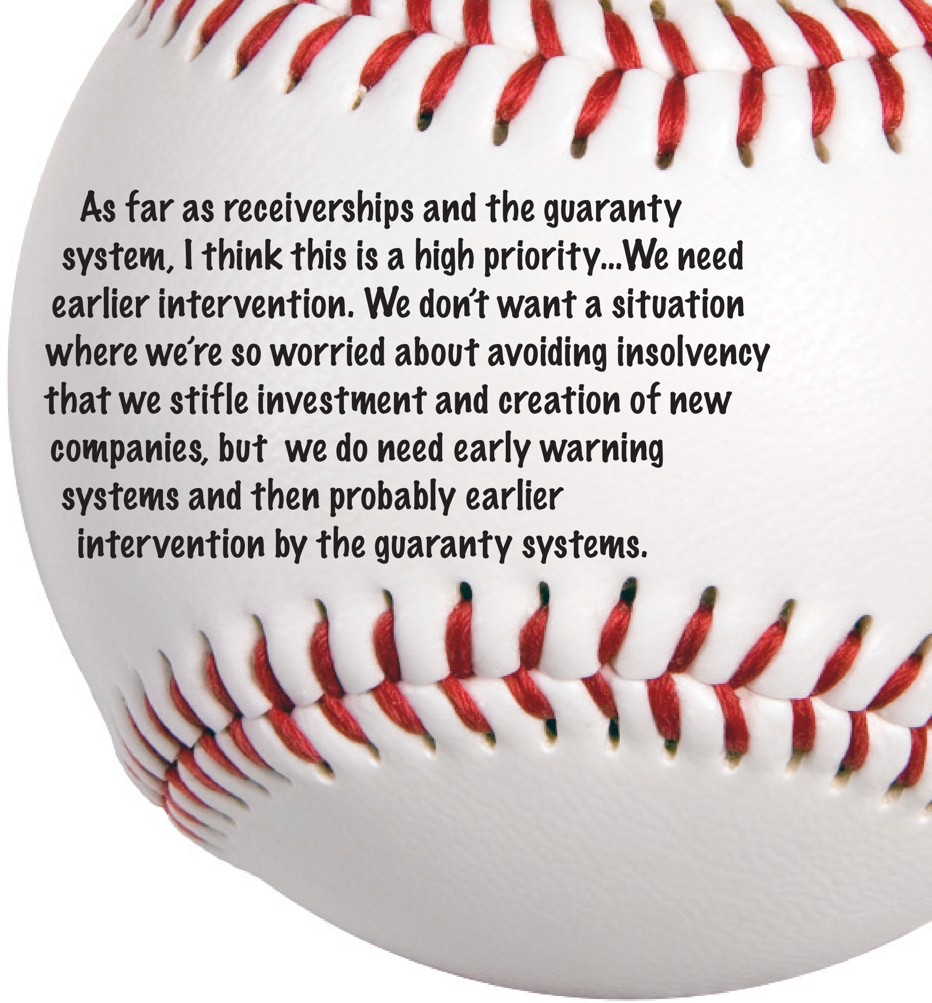
["A New Ballgame" continues from page 1]

I think it then gets into geography and demographics. In Texas we experience just about every catastrophic risk known to man; other states have their fair share, too, but we get them all, sometimes at the same time. We're a big state; we have a huge coastline. And there's a saying that there's always hail somewhere in Texas. That's probably an exaggeration, but not by much. We have tornadoes, we have wildfires—I thought we didn't have sinkholes, but I found out we refer to them as "slab" claims. We even had some tremors recently. Being a big state is generally a good thing because it provides a good spread of risk and a large premium base, and we certainly benefit from those advantages in other lines of business.

The other factor is demographics. Large senior populations, large low-income populations, and large urban populations are demographic factors that affect the way states prioritize and deal with certain issues. Florida's approach is probably more senior-focused; California has an auto insurance program that is specifically targeted to low-income consumers. With health insurance, every state has larger percentages of the population that are uninsured than they would like to have, but states deal with the issue differently. I think low-income population, union participation, government employment—those are factors that impact both the magnitude of the issue in a state and also how the state deals with it. So on some levels every state has the same issues, but depending on some of these other factors, and I think the big ones are geography and demographics, there are going to be different priorities in the different states.

***NJ**: Going back to and before the time you became Commissioner in South Carolina, there was a lot of discussion about state insurance regulatory effectiveness and efficiency. At that time, the industry seemed focused on efficiency. A lot of the discussion over the last few years, since the financial crisis, has been about effectiveness. Where should the focus be?*

Kitzman: I think the debate should be less about efficiency and effectiveness and more about predictability and consistency. We're government, so we're not ever going to live up to the efficiency and effectiveness the private sector achieves—or thinks it achieves. But I think we can provide greater predictability and consistency, while still protecting consumers. Industry should have some idea of what to expect and when. And if they have that, they can manage around everything else.



***NJ**: Are the states, through the NAIC or otherwise, doing all they should be doing to bring about this predictability?*

Kitzman: Are we doing all that we could or should through the NAIC? No. We're better than we used to be and we're trying to get better, but I think it's a moving target oftentimes. I believe we need to focus more on making decisions in a more timely manner than we have in the past.

With the NAIC, we call ourselves a consensus organization, but we don't have a hard and fast definition for that. Sometimes it means a majority, sometimes it's a supermajority, and sometimes it's near unanimity. I'd like to see us focus more on what it's going to take to get to a decision and then driving that process to conclusion more quickly. As I tell my staff, as important as what we do is, we are not curing cancer or splitting atoms. Let's make the best decision we can as quickly as we can and move on, and stop thinking we're going to come up with the perfect decision if we just keep working on it. If there were a perfect decision, there wouldn't be any debate about it. Everybody would see it. There are very few decisions you make where, if it was the wrong decision, you can't fix it. That's been a message that I, in some form or fashion, communicate almost every day to my department, and I think it's something that we at the NAIC need to keep in mind as well.

One way we can and should do that is changing how we manage the task forces and working groups that are designed to be technical resources or to focus on kind of a narrow component of a larger issue. The process sometimes just takes too long, without an appreciable benefit. This year, I think we are going to see the parent committees to these groups be more proactive in giving direction and guidance and in setting some expectations and deadlines for delivering a product. And if they're not able to reach a consensus or a decision, then we'll work with that. We should take it back, take what they've done, and make a decision.

***NJ**: That sounds like a private sector mindset, for lack of a better term. Are there other instances where you think the private sector might have something to teach the regulatory sector, or vice versa?*

Kitzman: Another major initiative of mine is what I call "better information"—not necessarily more data, but doing more with what we have and understanding what's going on in a better way and in a way that means something to consumers and our other stakeholders.

There was an article in the *Wall Street Journal* called "So, What's Your Algorithm?" that I distributed at a staff meeting recently. It's about the fairly new approach to analytics and development of what they're calling self-learning algorithms. The insurance industry and regulators have tons of data. But data does not necessarily equal information. It's what you do with it. One of the things we're looking at in my department is all the data calls we do. Do we need all these? What do we do with them? Are we redundant? Are we at least consistent?

A lot of times we put out reports that don't mean anything except to technicians. If you have the hours to dig through it and analyze it, you could get something meaningful out of it, but who has that time? We need to be looking at tools that are available to help us more quickly reduce all of this disparate data to a dashboard that is easier to understand and provides meaningful information.

For instance, consumers always want to know why rates are so high. And it's one thing to say that rates are what they are because of losses, depending on the line of insurance. And then people say, "Okay, but what does that really mean—what does that tell us?" Because these are always aggregate numbers, and people want to know more. If it's property insurance, they want to know which losses, were they in my county, was it a particular event? If it's health insurance, are we talking about increased utilization, diagnostic testing, or pharmaceuticals? Let's try to break it down into something that means something to the average person and not just to insurance people. We need to be proactive in using that information to see if we can impact those costs. I don't think we do a good enough job on that.

There's definitely a role and a need for the Federal Insurance Office, and unless and until the states and the NAIC become more unified on certain issues, that role and need will grow.

***NJ**: In addition to the information refinement you just mentioned, what are some of your other priorities in leading the Texas Department?*

Kitzman: I think we need to focus more on coverage. The emphasis from a consumer standpoint, from consumer advocates, for a long time has been on rates. It's fairly easy for consumers to compare rates, but if there are differences in coverage that underlie those rates, that's harder for them to do, and I think we need to do more to facilitate that in a plain English, user-friendly way, so consumers can make informed choices.

On the industry side, we have two big issues. One is obviously health insurance. And companies understand the complexity of it and how little control states have over it. Especially right now. Things are just so much in flux, and no one knows what's going to happen when. But even before that, it was just a seemingly intractable situation, and no one from industry was pounding on the door, either in South Carolina or

here, saying, "What are you doing to do about it?"

The other big issue here is, of course, coastal property insurance. Texas has a very large coastline. Currently, over 57% of the coastal property exposure is written by the Texas Windstorm Insurance Association (TWIA). So I have the same challenge as most coastal states in the southeast and Gulf, when it comes to trying to figure out how to get more voluntary market participation and capital into the market. In addition, in February of last year, my predecessor put TWIA into administrative oversight because of claims handling and other operational problems, so I'm also more involved in the day to day operations of TWIA than I'd like to be.

NJ*: Turning to the national scene, as we come out of the long financial downturn, how healthy do you consider the insurance industry in general, and the life and health industry specifically?*

Kitzman: It's generally healthy, but we continue to be faced by enormous challenges, primarily because of the low interest rate environment. Property and casualty companies, which for years were able to offset rate need by investment income, no longer have that. Additionally, property insurers took a beating on losses in 2011 even without any significant hurricane activity.

For the life and annuity companies, they have the same issue, but some of them are locked into long-term obligations that were based on higher interest assumptions. The health insurance industry, frankly, is more affected by the cost of medical care and the fact of uninsured and uncompensated care that spills over into the insured part of that market.

NJ*: The federal government is obviously spending a lot more time on insurance issues than it did when you were Commissioner in South Carolina. What are your observations about how the government is looking at getting more involved in insurance, and where do you see it heading in the future?*

Kitzman: I think there's definitely a role and a need for the Federal Insurance Office, and unless and until

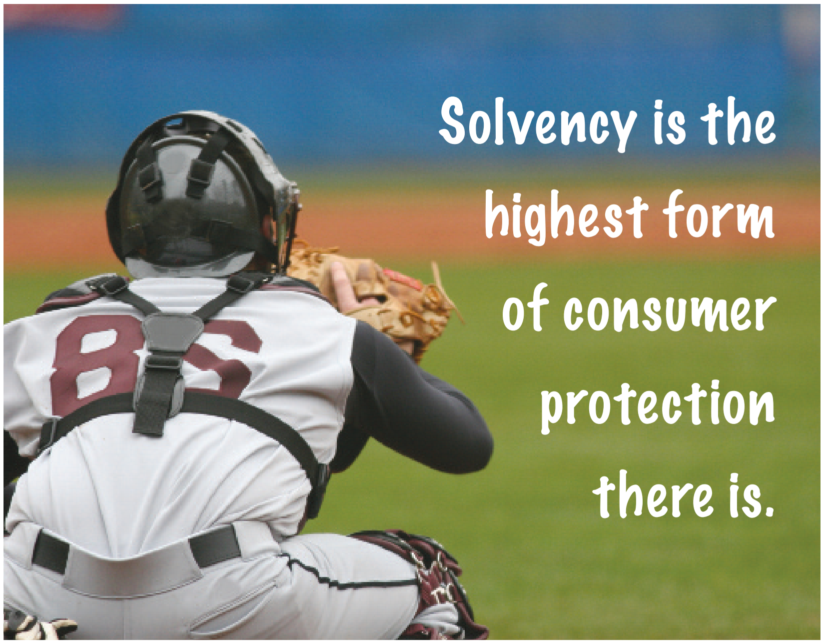
I don't see the likelihood of federal regulation any time in the near future. It seems to me there would be an enormous backlash against something that would grow the federal government…

the states and the NAIC become more unified on certain issues, that role and need will grow. It doesn't mean that the states have to be uniform in everything they do, but we do need to identify those issues that have a national significance and therefore would be of concern to the federal government. We need to find a way to be unified on those issues, and until we do, the NAIC is never going to be able to speak as one voice on an issue, because there are 50-plus voices.

I don't see the likelihood of federal regulation any time in the near future. First of all, it just doesn't seem like a high priority, given everything else that is going on in terms of the economy and all the other issues Congress has on its plate. It seems to me there would be an enormous backlash against something that would grow the federal government, if they were to try to absorb this regulatory responsibility. I guess I don't see that as being imminent or even likely, but again, I do see the need and a role, and I think what that role is and where it goes depends in large part on what we as state regulators, and the NAIC, do.

NJ*: You mentioned that state regulators need to identify some of the national issues that would be important to the federal government. Are there things you have in mind that state regulation needs to do so that the federal government remains in a non-regulatory role?*

Kitzman: If you think about the times in the past when there's been an interest from the federal government, it's come after a large number of insolvencies. Probably the last big one was in the 1990s with Rep. Dingell (D-MI). We know the federal government



will take a very strong interest if we have major insolvencies. And so we need to continue to focus on that, and I would say that is the primary focus of the NAIC. Frankly, solvency is the highest form of consumer protection there is.

As far as receiverships and the guaranty system, I think this is a high priority. We need more uniformity between the states on this. We need earlier intervention. We don't want a situation where we're so worried about avoiding insolvency that we stifle investment and creation of new companies, but we do need early warning systems and then probably earlier intervention by the guaranty systems. I'm not implying that we don't have very good tools now, but we can always be better. I think that's a big one. Solvency is something the federal government has a legitimate interest in, and how we perform will determine what they do going forward.

Catastrophe response is another one that is likely to get their attention. I don't mean in terms of the states' response; I'm talking about the industry's response—getting insurance proceeds into the hands of consumers so that rebuilding can start, and then also the effect of that on solvency and what it does to capital markets.

Those are some areas that come to mind immediately. There are some others that get more into the political realm, like the use of credit scoring, but I wouldn't put that necessarily on the same level as the other two. There's also market conduct and market regulation, which very well could be the subject of any sort of federal insurance function.

***NJ**: When you talk about the need for greater uniformity, are you referring to the guaranty system or to the states' approach to intervention and receiverships?*

Kitzman: I'm talking more about when and how guaranty association coverage is triggered—particularly having to do with residency and things like that. I worked on a couple of projects when I was at Goldman Sachs that touched on this issue, so I became more familiar with it. With benefit levels and coverage, limits on coverage, I know there are NAIC models on that. I think it's probably less important that those be uniform. At least there's some sort of indexing or some basis for it. I could see, arguably, that there could be reasons for differences from state to state, but we need to avoid gaps in the system.

***NJ**: You've had some involvement with international insurance regulation. Are developments in the global regulation of financial services and insurance, like Solvency II, likely to matter to the U.S. insurance market?*

Kitzman: They definitely will. Our U.S. insurers are doing business in non-U.S. markets, and I think we want to support that. You have non-U.S. insurers that are doing business here, and we certainly want to support that as well, to the extent that it brings additional capital, needed capital, into our markets and provides more consumer access and choice. Capital is global, and the U.S. insurance industry is competing for capital against emerging markets that didn't exist 10 years ago. So we are going to need more, not necessarily uniformity, but equivalency. We'll also need some reasonable means of reconciling differences and easing the ability of companies to do business back and forth, while obviously at the same time protecting our consumers here. That's our first priority, but we also want our industry to be good stewards and responsible corporate citizens wherever they do business.

***NJ**: When the Solvency II equivalency evaluation process looks at the United States, will our insurance regulation be deemed equivalent?*

Kitzman: I think it will. If they focus on the outcomes of our solvency regulatory regime, we're equivalent if not better in some instances. And I think that they will do that. That just seems the most reasonable, least disruptive approach, but we have to continue educating international regulators as to the strengths, benefits, and successes of our national system of state-based regulation. ✪

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

fairly large number of insurance companies. That's not the final answer, because companies that meet one of the "stage one" triggers still might not be found to be systemic after the companies are run through stages two and three.

All that said, we live in a political world, and I suspect that, if only for political reasons—that is, the political need to be able to say that Washington has addressed "the AIG case"—any list of "systemically important financial institutions" (SIFIs) announced by FSOC will have more than one insurance operation listed.

Our fourth proposition holds that the AIG failure proves the inadequacy of state insurance regulation and the state safety net. Again, this is something very frequently heard inside the Beltway.

On this one, it's hard to deny that state regulation slipped on AIG. But the larger point is that federal regulation slipped too, and in a bigger way. It might be most accurate to say that *regulation* was inadequate for the AIG case, and that we all learned some things that will help us going forward.

I would offer the following four brief points, with which others may or may not agree—and for almost all of these, I'll cite you to the recent outstanding book on AIG by Roddy Boyd and to both regulators and AIG company people familiar with the case:

First, AIG ran a uniquely risky securities lending operation that involved (but that was, in essence, imposed upon) the insurance operations. It didn't faintly resemble securities lending as done at any other insurance company identified to date. But it did permit a buildup of risk that only came to the surface very late in AIG's demise. It *should* have been spotted earlier by insurance regulators, and insurance regulators are now on the lookout for this particular risk at other companies. Consequently, I don't think we'll ever see another insurer get in serious trouble over securities lending.

Second, the collapse of AIG's securities lending program was an effect, not a cause, of AIG's failure. The cause was exposure coming home to roost on credit derivatives in the Financial Products division, which prompted collateral demands on those contracts and the series of ratings downgrades for the company (at the fleet level) that, in turn, ultimately led counterparties to demand the unwinding of securities lending positions. Insurance regulators had no power over, and indeed were expressly prohibited under federal law from exercising regulatory supervision over, the risks posed by AIG Financial Product's credit derivatives exposure. The parent company's federal regulator, the Office of Thrift Supervision, should have seen that problem coming, but it didn't—at least, not in time to do anything about it.

Third, in the perfect storm that was AIG, recall that the whole operation had, in effect, a one-man risk management operation for most of its modern history. The two poison pills that almost killed AIG—the massive CDS program for CDO deals and, to a lesser extent, the shift to an "anything goes" securities lending program—were both swallowed only *after* Hank Greenberg was forced out as head of the company, and it's highly doubtful Mr. Greenberg would have permitted either. When Greenberg got the ax in 2005, there was no effective plan for succession, especially regarding the risk management function. Someone should have spotted that problem earlier, given how central it was to the whole disaster.

Finally, as to AIG demonstrating the need for a federal safety net, a reasonable person can only conclude: "Not proven—not anywhere close." AIG's operating insurance company subsidiaries, of course, did not fail (in part, *perhaps,* due to the federal takeover of the securities-lending portfolios). Had AIG not been rescued by the Feds—had it filed bankruptcy at the parent level instead—it's not clear that any insurance liquidations would have followed. If they had, it's far from clear that the current insurance guaranty system would have had any insuperable problems protecting consumers. That brings me to the next point I'll touch on today.

Capacity & Caps

Our fifth proposition is an old one: that guaranty associations would not have the financial capacity to handle the failure of a big insurer.

We saw this assertion in print a few times during last fall's media brouhaha over retained-asset accounts. I have yet to see any factual basis put forward in support for the assertion.

To the contrary, the facts point just the opposite way. First, not only would the guaranty associations be able to respond to the failure of a major insurer—they have in fact done so, successfully handling several such failures simultaneously. Some of you here will recall the spate of insolvencies in the early 1990s. During that stretch, when the guaranty associations were handling several dozen company failures at once, three of those (Executive Life, Mutual Benefit, and Confederation Life) involved top-25 writers in this country.

Life and health insurer liquidations didn't amount to a gnat on the backside of the financial crisis.

Not only did the federal government not rescue the insurance industry: the industry—as a sector—did not *need* rescuing.

Second, because, as we will discuss, an insurer failure typically is not an event requiring massive liquidity (unlike a bank failure), the guaranty associations' financial capacity, *coupled with* the assets typically available in a failed insurer, will in any reasonably foreseeable scenario be more than sufficient to cover all maturing covered obligations of the insurer as those obligations become ripe for payment.

Finally, when all else fails, look at the record. We have statistics for over 20 years of guaranty association expenditures to protect policyholders, mapped against the financial capacity of the guaranty system for that period (Figure 1). The aggregate capacity of the associations is depicted in blue; the amount actually required to have been raised for guaranty associations to protect policyholders is in red.

As this chart suggests, we've never even come close to exhausting our capacity in any single year, for reasons we've reviewed before: While the function of the FDIC is to replace bank depositor cash with cash, causing the FDIC to need tremendous liquidity, guaranty associations replace insurance with insurance, and therefore their liquidity needs are much less than those of the FDIC.

This brings us to our sixth proposition, another misstatement often reported over the past several years: That policyholder recoveries in liquidations are limited to guaranty association "caps."

This is a subtle but critical mistake that catches even some smart insurance people who don't work a lot with the guaranty system. The reality is that policyholders with claims against their insolvent insurer in excess of guaranty association caps have a priority claim against the insurer's assets for the excess amount; that excess claim ranks *pari passu* with all other claims at the policyholder level. For that reason, a policyholder can—and often does—recover most or all of her claim in the insolvency, even above the level covered by associations. Let's illustrate.

Suppose you face an insolvency where a policyholder has a claim of $1 million. And suppose for a moment that there are no guaranty associations. What does the policyholder recover? The answer is, it depends on the level of assets available in the insolvency estate, sometimes expressed as a *liquidation ratio,* or the number of "cents on the dollar" available for distribution to policyholder-level claimants. If the estate has 95 cents on the dollar available—a 95% liquidation ratio—the policyholder will recover $950,000 on that $1 million claim, even with no guaranty association protection (Figure 2). On the other hand, if the estate has zero cents on the dollar available at the policyholder level, the policyholder gets nothing.

Now let's suppose the policyholder has the same $1 million claim and resides in a state where guaranty association coverage is $100,000. Now the policyholder will recover (from the guaranty association) 100% of the claim up to $100,000, and she will recover on the rest an amount determined by multiplying the excess claim (here, $900,000) by the liquidation ratio for the insolvency. Again, the liquidation ratio is the ratio of assets over liabilities available at the policyholder level. (You should also recall that general creditors and others rank behind policyholders in distribution rights under the "absolute priority" rule.)

Applying that approach, if the insolvency estate marshals 95 cents on the dollar for policyholder claims—a bit lower than average for life insurance claims in insolvencies—that policyholder will end up with a total of $955,000 on her $1 million claim: $100,000 from the guaranty association and $855,000 (95% of $900,000) in respect of her excess policyholder claim

Figure 1:
Assessment Capacity vs. Assessments Called (Amounts in 000s)

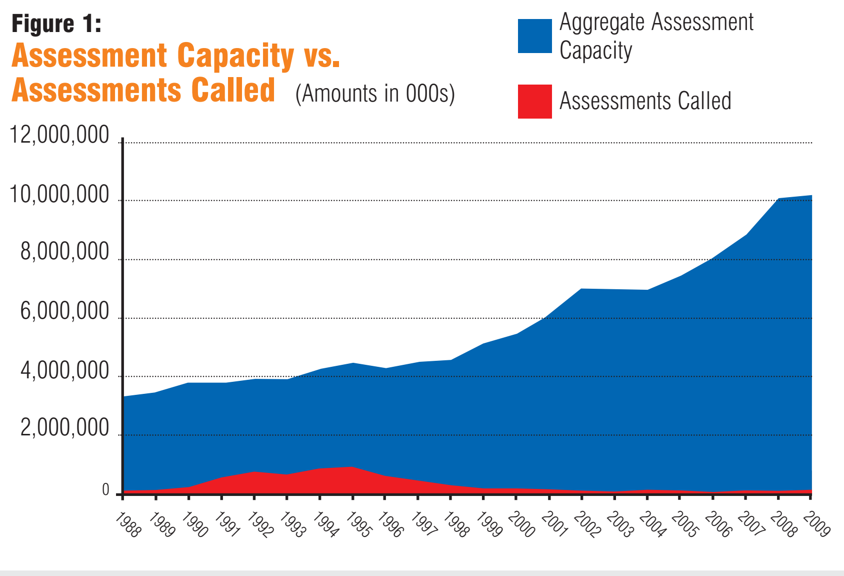


Figure 2:
Policyholder Claim with No GA Protection

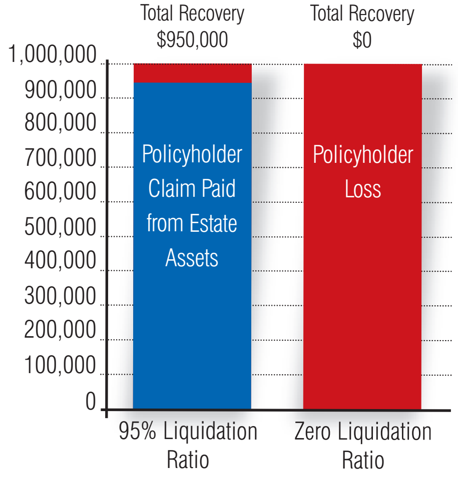


Figure 3:
Policyholder Claim with $100,000 GA Protection

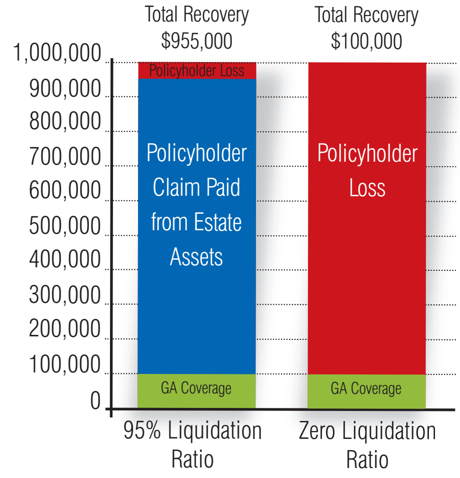
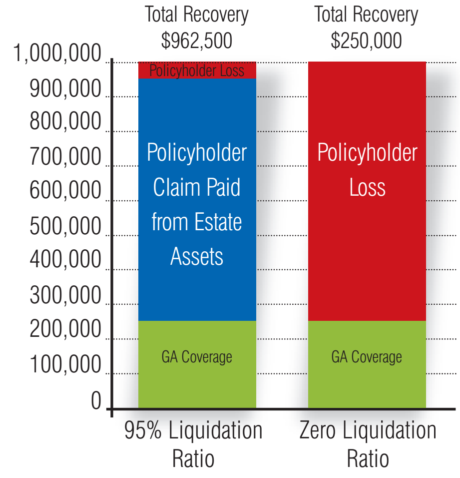


Figure 4:
Policyholder Claim with $250,000 GA Protection

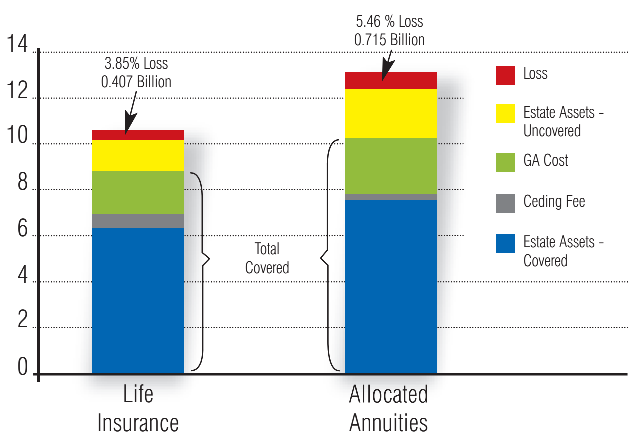


(Figure 3). On the other hand, if the estate marshals zero cents on the dollar, the policyholder's total recovery is limited to the $100,000 that will be paid by the association.

Let's vary the facts slightly once again. Suppose the policyholder resides in a state with a $250,000 guaranty association "cap" (Figure 4). With a 95% liquidation ratio, the policyholder's total recovery then would be $962,500 ($250,000 from the guaranty association and $712,500 from her excess claim)—a modest increase of only $7,500 over what she would have gotten with coverage to $100,000, even though the guaranty association "cap" is two-and-one-half times larger. But in the second hypothetical outcome—with a liquidation percentage of zero—the total policyholder recovery is still only $250,000. That is to say that a very large loss—$750,000—is borne by the policyholder, even with much more guaranty association coverage than in the prior case.

Which brings us to our final proposition: the often-heard but erroneous assertion that the key factor in how a policyholder fares in a liquidation is the amount of the applicable guaranty association "cap."

Figure 5:
Claims Paid in Multi-State Insolvencies 1991–2009 (In Billions)



If you followed the examples we just discussed, you already know this is false. Yes, the cap does set a floor for policyholder recoveries, no matter what else happens in the receivership case. But as we've just seen, the much more important factor—at least for policyholder claims that are significantly in excess of guaranty association limits—is what liquidation ratio is achieved in the insolvency. How many cents on the dollar is the receiver able to pay on policy-level claims?

On that score, let me mention a couple of historical averages. Over the insolvencies of the past 20 years, claims on life policies have been paid, on average, at a level of 96.15 cents on the dollar. Claims on annuity contracts have been paid, on average, at 94.54 cents on the dollar (Figure 5). In other words, in most (though unfortunately not all) life and annuity insolvency cases, the vast majority of policyholders have been made nearly whole, *regardless* of the guaranty association limits in their states. To put it yet another way, those involved in the system—regulators working with receivers and guaranty associations—have done a damned good job of delivering real policyholder protection over the past two decades.

New Year's Resolutions

But what can we do—all of us—to make sure that we're promoting positive outcomes and working to limit bad outcomes? What steps would help us to keep achieving a 95% or greater liquidation ratio, and what are the risk factors that might lead the other way?

Experts in handling insolvencies of regulated entities—not just insurers, but other types of financial firms as well—have long recognized that the keys are, first, spotting financial problems early; and then acting promptly, decisively, and effectively to keep a bad situation from getting worse.

Spotting problems promptly is a function of financial supervision, and much of the success in delivering good receivership outcomes to policyholders over the past 20 years is a direct result of better financial supervision. I refer to financial supervision broadly now, to include assessments by companies of their own risks, risk-spotting by rating agencies, and better risk standards and evaluations by insurance regulators.

Beyond that, the recent financial crisis and attendant policy debates about regulatory reform have cast a bright light on the significance of effective resolutions of failing financial companies. Even if regulatory financial supervision is good, the regulated firm's stakeholders can still be harmed terribly by ineffective *resolution* of the failed company.

Again, among insolvency experts, there's little dispute that two things critical to a successful resolution are early intervention—invoking the liquidation process at a time when assets of the failed company have not yet been substantially dissipated—and professional execution of a resolution strategy that marshals assets of the failed firm as effectively as possible and maximizes their prompt application to proven creditors' claims as directed by law. In the world of banking resolutions, these concepts are sometimes referred to, respectively, as "prompt corrective action" and "least cost resolution."

Although the NAIC's accreditation program of the 1990s resulted in substantial improvements to financial supervision, a similar national commitment to best practices in insurer receiverships—to prompt corrective action and least cost resolution, through processes that are open, transparent, and accountable to stakeholders—has been slower in coming.

Today, though, and in part because of recent public discussions about the importance of effective resolutions, insurance commissioners are turning serious attention to "lifting their game" in insurance insolvencies. If the financial crisis helps spur a systemic improvement in how future insurer receiverships will be handled, this will be one significant positive result of an otherwise dismal period in our economic history.

NOLHGA and its member guaranty associations are committed to assisting regulators in whatever ways we can to improve the receivership process and achieve better protection for consumers. ✪

Peter G. Gallanis is President of NOLHGA.

NOLHGA Calendar of Events

2012

April 11–13	**MPC Meeting** **San Diego, California**
July 24–25	**MPC Meeting** **Boston, Massachusetts**
July 26–27	**NOLHGA's 19th Legal Seminar** **Boston, Massachusetts**
August 11–14	NAIC Summer National Meeting Atlanta, Georgia
October 1	**MPC Meeting** **San Antonio, Texas**
October 2–3	**NOLHGA's 29th Annual Meeting** **San Antonio, Texas**
October 21–23	ACLI Annual Conference Washington, D.C.
November 29– December 2	NAIC Fall National Meeting Washington, D.C.

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NOLHGA Journal
Vol. XVIII, No. 1 | February 2012

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.

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