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Closing in on the Finish Line

The drive for functional consistency among state GAs is in the homestretch

By John R. Mathews

If you have ever seen the end of a marathon, you know that runners finish in one of two ways. Some slow down as they see the line and jog across, while others summon their remaining strength and finish with a last burst of energy. There is no right way or wrong way to do it—after 26.2 miles, just finishing is accomplishment enough. Finishing with a spring in your step is icing on the cake.

Over the last few years, NOLHGA's GA Laws Committee has been involved in something of a marathon—since 2010, we have worked to foster greater consistency among guaranty associations by providing assistance to associations seeking to update their statutes to bring them more in line with the NAIC's Guaranty Association Model Act, in particular the revisions that were adopted in 2009. And we have run a good race so far—31 states are now "functionally consistent," meaning that they have adopted key provisions of the Model Act (see "Top Priorities" on p. 15) that will result in enhanced policyholder benefits being delivered in a timely and consistent manner. Another eight states have made significant progress, and a number of states are considering legislation in 2013.

With less than half of the states remaining to adopt the key provisions of the Model Act, we are clearly in the homestretch. And we'd like to finish with one last burst of energy to carry us across the finish line.

Getting Motivated

Why is functional consistency so important? In a word, policyholders. The new Model Act has a number of changes that greatly benefit consumers, such as increased benefits for annuities and long-term-care products and greater uniformity in coverage if someone moves from one state to another. Adopting these changes makes it easier for guaranty associations to provide consistent treatment to policyholders of a failed insurer no matter where they reside. It also makes the guaranty system more efficient, so that people receive their benefits more quickly (and uniformly). That reflects well on guaranty associations, the insurance industry, and the state regulatory system charged with protecting insurance consumers.

The push for functional uniformity is also important because we are doing it ourselves. By "we," I mean the guaranty associations, NOLHGA, the insurance industry (working both locally and through the ACLI), and state regulators. As Congress and the Administration look at the financial services landscape with an eye on where the federal government might best plant its flag, it is vital that the

["Finish Line" continues on page 15]

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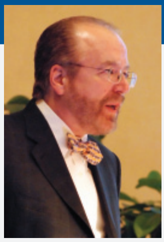


President's Column by Peter G. Gallanis

Turtles All the Way Down—Questioning Our Assumptions in a New Environment

The following is adapted from the President's Address given at NOLHGA's 29th Annual Meeting in October 2012.

A key founder of NOLHGA, Bob Ewald, told me some years ago that he views the NOLHGA President's comments at the Annual Meeting as being like the U.S. President's annual report on the State of the Union—obviously not in national significance or grandeur, but more because this address serves as an occasion for an annual appraisal by all of us of where we stand and of some of our most relevant current concerns.

In that regard, my chief observation is that the state of the life and health insurance guaranty system remains strong, though the challenges confronting us are serious and will continue to require our best efforts and our clearest thinking.

The guaranty system stood tall throughout the financial crisis, and more recently it performed spectacularly in rising to the very difficult challenge of the ELNY insolvency. For reasons we've discussed elsewhere, that case presents very unfortunate outcomes for a small number of annuity payees under some very large structured settlements. Some payees, unfortunately, will see benefit reductions—not because of anything the guaranty associations did or didn't do, but simply because the asset/liability shortfall in the ELNY receivership estate is so great. The point, though, is that the outcome could have been much worse, both for those very payees and for a number of others who, under our plan, instead will be fully protected.

They will be fully protected because of an extremely effective and creative plan developed by this guaranty system, working in close collaboration with industry leadership and through ACLI, and with the ultimate concurrence of the New York Department of Financial Services.

The benefit reductions in ELNY are the exception that proves the rule: In the vast majority of U.S. life and health insurer insolvencies, insurance consumers have faced few if any reductions or losses of benefits. Thus, for example, our members continue to perform spectacularly in the Lincoln Memorial insolvency case—one that, in its own way, was as difficult and challenging as ELNY. That case gets almost no media attention, other than isolated stories about the criminal prosecutions of those who looted the company.

The same is true in a long line of insolvencies dating back to and before the 1999 Thunor Trust company failures caused by the looting and embezzlement schemes of Marty Frankel. In all those cases and so many others, the regulators did their jobs, we did our job, and consumers were substantially protected. It should always work that way.

Change & More Change

Today I'd like to talk about the business environment in which the insurance guaranty system is and will be operating, in the hope that we can work together to understand it and be prepared. My contention, in a nutshell, is that this is not your father's insurance solvency environment anymore.

Even some of the younger people in this group can recall how, not so many years ago, life and health insurance were relatively quiet and predictable parts of the financial services world. But drastic changes in the financial economy (and to some extent, political and governmental responses to those changes) now pose challenges to all financial services segments, including life and health insurance.

All insurers, like their customers, are still dealing with aspects of the recent global financial crisis and recession. The recession technically has been over for some months. But as Europe still struggles, conflicts escalate in the Middle East and elsewhere, and the "fiscal cliff" draws near, we all wonder—will the economy get worse before it gets better?

In particular, historically low interest rates, the Fed's renewed commitment to keeping rates low through a new round of "quantitative easing" (or QE3), and the associated problem of "spread compression" raise special problems for those writing annuities, life insurance, and long-term-care insurance, and also for receivers and guaranty associations charged with developing insolvency resolution responses.

And while no one can claim surprise at *this* development, the demographic reality of baby boomers hitting retirement age—and confronting the financial and health care needs that go with aging—presents both challenges and opportunities for insurers.

In the meantime, the global financial crisis led to a set of questions about financial service providers (including insurers) that do business in multiple sovereign jurisdictions. For example, are there multinational insurance entities that are systemically important to the global financial economy? If so,

how should sovereign regulators coordinate multi-national regulatory supervision of such entities? And if there is a failure of an international conglomerate that writes insurance, how should that entity's receivership be conducted? What sorts of financial safety nets should be in place to protect consumers?

The health insurance field now is barely recognizable, even compared to five years ago, and I doubt there are many in the hall who would be willing to wager on what that segment will look like five years into the future. Health insurers are consolidating. Others are shifting increasingly from the old insurance business model of charging premiums to take insurance risk to a model of charging for the provision of TPA and other technical services. And many

In all those cases and so many others, the regulators did their jobs, we did our job, and consumers were substantially protected. It should always work that way.

in the political world have adopted a mindset that health insurers are best viewed as public utilities that should be regulated primarily according to the public utility model of economic regulation. That, my friends, is *definitely* not your father's Oldsmobile.

Life insurance, not long ago viewed as a pretty sedate field, has also changed dramatically in an almost equally short time.

The traditional life insurance model of promising death benefits and steady, fixed annuity income streams was what people demanded and expected of life insurers for most of the history of the U.S. industry. Note that the risks assumed by insurers in those classic lines are essentially *uncorrelated* risks, meaning that the mortality risk for any one covered life was usually independent of the mortality risk for any other covered life—at least in a reasonably diverse book of business. The same was true for longevity risks in annuity business. I'll come back to that.

Now, though, as Jac Herschler noted yesterday, some of the factors that are core realities of today's world—such as the maturation of the baby boomer generation, not to mention the gradual disappearance of defined benefit retirement programs—have caused changes in consumer needs and demands.

Consumers today want not only the death benefits and guaranteed fixed annuity income that they wanted before, but also some possibility of participating in positive equity market developments. And they want downside protection against equity market slides, with some ability to lock in guaranteed minimum lifetime income and other guaranteed benefits.

And so companies have developed new varieties of annuity products to deliver what many consumers are seeking, as Jac described yesterday. Those products have proven to be quite popular with some consumers, especially in the baby boomer demographic and with some who are younger still.

Different Risks

Changes in consumer needs and demands, and the related changes in the mixture of insurance liabilities of companies supplying such products, may also lead to fundamental changes in the model of insurance company insolvencies that we have long thought we understood.

Here's what I mean: A core feature of newer variable annuity contracts is the guaranties they provide against some risks of adverse developments in the financial markets. By providing guaranties against market fluctuations, where the risks insured affect large numbers of consumers in similar ways and at similar times, the liability so assumed by insurers is much more in the nature of *correlated* risk than the risks traditionally assumed by life insurers. That is, unlike traditional mortality or longevity risk, the new risks tend to move together for a lot of contracts at the same time and for the same reasons.

This growth of correlated risk within the life industry seems to have developed in response to real and profound consumer needs. It's not a bad thing in and of itself, so long as the risk is properly understood, appropriately priced, and adequately reserved. It's also true that there are many things that can and should be done to mitigate or regulate against inappropriate assumption of significant correlated risk, but the *fact* that so much more correlated risk is now being assumed by life insurers—and likely will be in the future—is a change in the model of what life companies do. *That's* not your father's Oldsmobile either.

To those of us who work in the insurance insolvency field, that change in our environment is important. When I started in the field, and even before then, it was an accepted truism (though a bit of an overgeneralization) that property/casualty insolvencies stemmed from problems on the liability side of the insurer's balance sheet, while life company insolvencies stemmed from the asset side.

A lot of that old truism has gone out the window. Life insolvencies are no longer exclusively driven by asset problems. Instead, unanticipated growth of liability exposures for life insurers increasingly is a key factor in troubled company situations and in some actual insolvencies. This is not some

Unlike traditional mortality or longevity risk, the new risks tend to move together for a lot of contracts at the same time and for the same reasons.

Companies have developed new varieties of annuity products to deliver what many consumers are seeking.

theoretical concept that may be manifested in the future: It's a wave that has been lapping at our feet for some time.

For example, the ELNY case that we have been discussing is primarily a liability-side problem. The annuity obligations assumed by the carrier had a very long exposure period (or tail), and when properly valued in terms of reinvestment possibilities over the life of the runoff, those liabilities far exceed what can be covered or ever could have been covered by ELNY's assets. When you heard Jack Gibson say yesterday that, under the new assumptions, "Stochastic mean reversion targets are now 100 basis points lower," that was actuary-speak for: "This company's annuity liabilities (which are 'baked in the cake') cannot be covered by what the assets can reasonably be expected to earn in the marketplace."

It's not just ELNY, either. Penn Treaty and National States are essentially liability-side insolvencies. General American in 1999 was a liability-side problem. The Allmerica Financial problems in 2002 were essentially liability-side problems. And the stock value plunges of so many life companies in early 2009, while driven by many factors, were based to some extent on the widespread perception that at least some companies had variable annuity guaranties that were "in the money" (or close to it) at a time when the equity markets had just taken an astonishing plunge.

So liability-side life company issues aren't just the wave of the future; they are with us today, and that too is not your father's Oldsmobile.

Understand me on this, because I don't wish to be misunderstood: I do *not* view new product development in the life insurance field—or any other field—as an inherently bad thing. Quite the contrary. The new products I've discussed appear to meet a genuine consumer need, and I have every expectation that responsible risk mitigation strategies by the companies offering them, together with vigilant and effective regulation, can help make these new types of insurance products part of the solution for some serious social problems related to consumer retirement security.

The Takeaway

In any case, though, if insurers are going to write these contracts—and they will—and if guaranty associations are going to be obliged to cover them—and it appears they will—then it is critical that we understand this changing aspect of our environment and what it means for our mission.

We can't think about the future only in terms of what we thought was true of the past.

Stephen Hawking reports that the philosopher Bertrand Russell once gave a public lecture on astronomy. He described how the earth orbits around the sun and how the sun, in turn, orbits around the center of a vast collection of stars called our galaxy.

At the end of the lecture, a little old lady at the back of the room got up and said, "What you have told us is rubbish. The world is really a flat plate supported on the back of a giant tortoise." Professor Russell gave a smile and then replied, "What is the tortoise standing on?"

"You're very clever, young man. Very clever indeed," said the old lady. "But you can't fool me: It's turtles ALL THE WAY DOWN."

We can't let our assumptions be like those turtles. We need to recognize that our environment changes, and with it come changes in the challenges we will need to understand and overcome as we continue to protect consumers in new cases.

Thankfully, the administrators and industry representatives who make this organization work so well have devoted and will devote significant study both to the new products that have been developing and their implications for the insolvencies of the future. That ongoing work will be critically valuable to us all.

It has been a pleasure and an honor to serve this great organization for another year, and I look forward to working with all of you in the year to come. Thank you very, very much. ✩

Peter G. Gallanis is President of NOLHGA.

Hazy Answer

NOLHGA's 2012 Annual Meeting speakers look to the future—and find a murky view

By Sean M. McKenna

NOLHGA's 2012 Annual Meeting in San Antonio had no fortune tellers on the program, and none of the speakers consulted their trusty Magic 8 Balls on stage. But the almost 200 people who attended the meeting came to hear predictions of the future—who would win the 2012 presidential race (Spoiler Alert—President Obama was reelected), what will health care look like in a few years, are interest rates ever going back up?

A fragile economy, a health-care law still being written, and a tumultuous regulatory landscape aren't exactly a recipe for confident predictions, but the speakers did their best to put things in perspective and offer some sense of where we're headed in 2013 and beyond. Still, as Outgoing NOLHGA Chair Tom Ronce said in his address, "You run some risks any time you break out your crystal ball."

I See an Acronym in Your Future

Texas Insurance Commissioner Eleanor Kitzman spoke about some threats, foreign and domestic, to the insurance industry and its regulatory structure. She singled out the weak economy, in particular the low interest rate environment, and the possibility of federal and international regulatory upheaval, in the form of the Federal Insurance Office (FIO) established by the Dodd-Frank Act as well as international regulatory bodies such as the International Association of Insurance Supervisors (IAIS).

While Commissioner Kitzman conceded that "there needs to be someone in Washington who can spell insurance if not speak it," she warned that the FIO's powers were not clearly enumerated and that the agency is "taking a very broad interpretation" of its charge. She predicted that the FIO report would not be issued before the presidential election (a good call on her part), but added that she expects it to be critical of state regulation and to "put a certain amount of pressure on state regulators and the NAIC to think about what some of the vulnerabilities are and how to address them."

She praised the performance of the guaranty system—"I think it's a strength"—but cautioned that "there are some inconsistencies" that could be seized on by those wishing to attack the system or state

Author and political analyst Mark Halperin analyzed the upcoming 2012 presidential election—"they've both run absolutely vacuous campaigns" he said of President Obama and Governor Romney—and predicted serious difficulties for the eventual winner in solving the fiscal cliff issue and finding a way to reach across the aisle to work with the other party.

Texas Insurance Commissioner Eleanor Kitzman

ACLI President & CEO Gov. Dirk Kempthorne

Beautiful weather and fabulous music greeted guests at the Annual Meeting Reception.

regulation. She also pointed out that our guaranty mechanism is a "foreign concept" for many international regulators, who don't have a similar system in their countries. This could lead to some problems as international regulatory bodies seek to coordinate their practices with the United States. "They take a very different approach," Commissioner Kitzman said. "They have to go to such great lengths to prevent an insolvency because they have no mechanism for dealing with it." Given the success of the U.S. system, she sees no compelling reason to change its approach to solvency issues.

Commissioner Kitzman also singled out the adoption of Actuarial Guideline 38 (AG 38), which gives companies leeway in deciding how to reserve for universal life products with secondary guarantees, as an example of how well the state-based regulatory system works. "People were very passionate about this issue, and states were not on the same page," she said. The NAIC decided it needed a compromise and turned to the commissioners rather than to staff members, with the resulting guideline passing unanimously. "I don't think anyone loves it, which is probably the definition of a successful compromise," she said, adding that this type of collaborative effort is "the way we preserve the state-based system."

Who Could Have Predicted That?

Jac Herschler (Senior VP, Strategy, for Prudential Annuities) revealed the difficulty in one sort of prediction—that of policyholder behavior—as he took attendees on a whirlwind tour of the variable annuity market. The products took off in the 1980s and 1990s on the strength of their tax deferral features, he said, when many in the industry held the "naïve, starry-eyed view that people understood how these

Jac Herschler (Senior VP, Strategy: Prudential Annuities)

worked—annuitization." That proved not to be the case, and companies realized that "there was something about the products' structure that was viscerally unappealing," he explained. "People were loath to give up control of their money," and so they refused to annuitize. People wanted income without annuitization, which led to the rise in guaranteed benefits.

Looking to the future of the annuity market, Herschler noted that "there are trillions and trillions of dollars in unprotected retirement assets" such as 401(k) plans—plans that lack the guarantees that are now common in variable annuities. The challenge the industry faces is determining how to make it as easy as possible for people to move these funds into annuities and ensuring that there are enough companies to spread the risk around. He cited contingent deferred annuities (CDAs) and withdrawal-based guarantees in defined-contribution plans as two ways to meet this growing need.

Ronce & Nichols Stress Readiness for "Next Crisis"

Outgoing NOLHGA Chair Tom Ronce and Incoming Chair George Nichols III both pointed to the NOLHGA Board's strategic planning initiative as vital to the guaranty system's continuing relevance in their speeches at NOLHGA's 2012 Annual Meeting. Ronce praised the comprehensive nature of the planning process, saying "I've been particularly pleased that we've reached out to so many people, both inside and outside of the guaranty system, to get a 360-degree picture of the system and the trends that are shaping it." He added that the goal of the project was to prepare for the challenges the guaranty system will likely face in the future, such as new products and the prospect of federal regulation.

Fair or not, Ronce said, "in our business, we're only as good as the next crisis." While it's impossible to predict when that crisis will arise, he explained, it's vital to use the time available to prepare the system by encouraging guaranty associations to become as consistent as possible by enacting the latest version of the NAIC's GA Model Act. Many associations have already done so since the latest revision to the Act in 2009, and Ronce encouraged those that have not to consult with NOLHGA's GA Laws Committee to begin the process:"If we're only as good as our performance in the next crisis, doesn't it make sense to do everything we can to put ourselves in a position to succeed when the time comes?"

George Nichols III

In a moving speech that touched on his recent heart attack and the lessons he took from it, Nichols likened the warning signs of a heart attack to some of the outside forces threatening the guaranty system. "Unlike what happened to me, NOLHGA's warning signs are external—which makes them harder to deal with, because we don't control them." Those warning signs include the low interest rate environment, troubles in the long-term-care industry, the potential of federal regulation supplanting state regulation, and the development of complex new products that raise potentially difficult coverage determinations.

Nichols added that the strategic planning process has put NOLHGA and the system as a whole in a good position to meet these challenges, and he called on the system to get out ahead of these issues. "Must we go through a crisis every time to get better at dealing with what happens?" he asked.

Tom Ronce

Nichols joined Ronce in calling for greater consistency among guaranty associations but took that call one step further, arguing that "we should push for good receivership statutes to be part of the NAIC Accreditation process. Good statutes should be fully integrated into the law so that everyone is operating from the same set of rules." He also stated that the guaranty system has to play a role in any discussions—on Capitol Hill or elsewhere—that involve the fate of policyholders of failed insurers. And he made no secret of the role he would like to see the system play. "I want us to be here 10 years from now—not just hanging on, but leading."

The need for retirement planning isn't solely a U.S. concern. Herschler cited a study stating that within 40 years, China will have half a billion elderly citizens. "It's an interesting challenge and an enormous responsibility to help people take responsibility for their retirement," he said, adding that regulators need to be aware of their role in monitoring companies trying to carve out a place in the retirement market. "All of us share an interest that there are no embarrassments in this market," he said.

Tough Times Ahead

Colin Devine, a former Managing Director at Citigroup, echoed Herschler's comments about the promise of the retirement market in his entertaining and sometimes acerbic breakdown of opportunities and threats for the insurance industry. "The post-retirement market is ours to dominate," he said. "And if we can't dominate it, shame on us."

Unfortunately, that was one of the few encouraging things Devine had to say. He pointed to the long-term low interest rate environment as the Achilles heel of the industry. "I don't think there's a bigger issue facing our industry than low rates," he said, stressing that low rates affect lapse rates as well as return on investments. For companies with long-tailed liabilities, he added, "pricing mistakes are immortal."

Devine deemed the industry's capital reserves adequate, but he added that "when I was an analyst, one thing that drove me nuts was how much emphasis my peers put on the RBC (risk-based capital) ratio." The RBC, he said, is not a proxy for capital strength: "I like the RBC ratio, but I wouldn't bet the ranch on it."

Citing the prevalence of guarantees in variable annuities, Devine said that these annuities "look to me much more like a general account liability than a separate account liability." He highlighted the danger posed by some of the more generous guarantees being locked into variable annuities for years or decades to come, predicting that members of the guaranty system "are going to become experts in variable annuities in the next few years."

Devine concluded on a more positive note. "All that said, I still think we have a lot of opportunities," he stated, noting that demographic changes will drive strong demand for retirement products for decades and that the financial health of the U.S. life industry is generally good (though if low rates persist, solvency risks could increase). "I think the odds are very good for the life business."

Tough to Predict

Two presenters had the unenviable task of offering predictions of what the federal government might do in the future, or what the future might hold thanks to something the government already did. Not surprisingly, this proved to be a tall order.

ACLI President and CEO Gov. Dirk Kempthorne discussed the looming fiscal cliff (which is still looming) and the government's efforts to reduce the national debt, which could include ending what the government calls "tax expenditures," such as the life insurance industry's inside buildup. Gov. Kempthorne, a history buff, noted that the tax protection for inside buildup dates back to the Civil War and asked, "Why would you tax those individuals who have imposed a self-tax so the government doesn't have to take care of them? That is a bad idea."

Gov. Kempthorne added that the timing of this idea couldn't be worse. "I believe Americans need our products now more than ever," he said. "There's another cliff—the retirement cliff. And Social Security was never intended to be your sole source of retirement." While the Governor didn't attempt a prediction on the outcome of this debate, he did note that with Baby Boomers nearing or entering retirement age, "you don't change the rules on millions of families after years of investing."

Elizabeth Hall (Vice President of Federal Affairs for WellPoint) guided attendees through the implementation process for the Affordable Care Act (ACA) and the effects the Act will have on the health insurance industry. She noted that while there's no doubt the Act will have a profound effect on the industry—"The ACA is changing most of the rules on how we as health insurers offer our products," Hall said—there's a great deal of doubt as to what that effect will be. "There is so much uncertainty right now because we're still waiting for regulations to be written," she explained, adding that regulations addressing market reform (dealing with issues such as guaranteed issue) and how the health insurance exchanges that will be set up in each state will be regulated have yet to be issued.

Some certainty was imposed on the health-care debate a few months before Hall's presentation, when the U.S. Supreme Court ruled that the insurance mandate in the Act was constitutional. Hall noted that another aspect of the Court's ruling, which enjoined the federal government from forcing states to expand their Medicaid programs by withholding existing Medicaid funding, shouldn't be overlooked. "This is a more meaningful decision than people understand," she said. "It gave states a lot of leverage."

Hall added that many states waited for the Court's decision before making their own decisions on whether they would establish the health insurance exchanges mandated by the ACA, which can be set up by states or, if the states refrain, by the federal government. A large number of states have indicated that they will not set up the exchanges, meaning that the federal government may have to establish more than 30 exchanges by 2014 (enrollment in the exchanges is scheduled for October 2013). "The Administration will not talk about delay," Hall said, but with that many exchanges, a delay could be inevitable.

Despite this uncertainty, the ACA has deadlines in place. "Today, we're about 12 months from having to offer products in the exchanges" Hall said, noting the October 2013 target date. That means developing actuarial and billing models as well as "all sorts of new pieces on an expedited timeline." There are also worries about how the exchanges will be regulated and whether the new regulations will be at odds with existing state-based solvency regulation. "One thing we're concerned about is that we'll get dual regulation and conflicting regulation," Hall explained. ✯

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

A New Perspective

Former Texas Insurance Commissioner Jose Montemayor offers his views on low interest rates, rate review, and the art of acquiring troubled insurers

Jose Montemayor is a Principal with Black Diamond Capital Partners, a specialty private equity firm focused on insurance sector investments with significant value-creation opportunities. With New York roots and now headquartered in Austin, the firm's partners identify insurance companies for investment.

Mr. Montemayor has over 20 years of experience in all aspects of insurance regulation and insurance mergers and acquisitions, including 6 years as the gubernatorially appointed Texas State Insurance Commissioner. He spoke at NOLHGA's 29th Annual Meeting on October 2, 2012. An edited transcript of his discussion with NOLHGA President Peter Gallanis appears below.

Gallanis: *If you don't mind, I'd like to take a step back from some of your comments about the private equity/receivership interaction to look a little bit more broadly at the insurance industry from your perspective. You are a partner at a firm that invests in the insurance industry, and as you consider that as a business sector, how do you feel about the general health of the insurance industry or its principal segments now, compared to your views during the time you provided very distinguished service as an insurance regulator?*

Montemayor: Our system is frequently thought of as arcane and dysfunctional because it has 50 separate regulators. But the fact that we have standardized solvency rules, at least through accreditation and a few other things on the financial side, has kept us all solvent. I think currently most of the industry, thanks to some very strict investment rules, at least on the life side, in terms of the aggregation of exposures and double exposures, has provided an awful lot of protection and served us very, very well.

Where I have faulted primarily my own brethren within the NAIC is this: Shortly after the 2008 meltdown, they were really nowhere to be found on the national stage, where some of the cable financial shows with the talking heads discussed the crisis. They just kept saying "AIG the failing insurer." And it wasn't a failing insurer at all, as you all know. But we failed to get that story out, and as a result the time has come and gone and the impression remains out there, and we missed an opportunity to really tell the story of how good the state solvency scheme is.

I will also tell you that I think this prolonged period of low interest rates is going to be very, very hard, particularly on the P&C industry, because they've had a long period of softness. They sort of get addicted over time to price very aggressively and then try to make it up on investment income on the longer-tail lines, and the returns are just not there and it's very problematic. On the life side I don't see nearly the same type of stress, other than the fact that it's going to be harder and harder to offer some of the very attractive annuities if you just cannot find the new money rates adequate enough to move ahead. Of course, all bets are off if the low interest rates remain in place for a long period of time.

Gallanis: *There's been a lot of discussion of the negative effect of a prolonged low interest rate environment, and usually when people talk about that they talk about it fairly simplistically in terms of spread compression and narrowing of the difference between the returns you offer on your guaranteed products and what's available in the marketplace for your own investments. But*

you mentioned yield chasing. And when we think about difficult financial environments we have seen in the life industry, we can recall from the past some very generous returns being offered on insurance and annuity products by a company that was able to do that by making very aggressive, high-yield investments on the asset side of its balance sheet. There have been some stories in the financial and trade press over the last couple of weeks about yield chasing and the fact that high-yield bonds are at all-time low rates, while there are a lot of complex and hybrid types of products that are being offered now that have to look tempting compared to yields available on other investments. Are you seeing many cases where people are wavering in the direction of those types of investment products?

Montemayor: I would have to say yes to that. I will tell you that some of these instruments—if you just look at the precursors through the 2005 to 2007 timeframe, the instruments got more and more complex—had, optically at least, a pretty good yield. But the risk-reward equation was so obfuscated through the complexity of the product that it was easy to convince yourself that you were buying a good asset that would yield high single digits, when in fact the risk associated with the security was closer to betting the farm.

The collateralized debt obligations, or CDOs, and a lot of the derivative securities, they just were so complex. I'm not sure anybody understood them well. And certainly the level of sophistication required at the smaller and middle-sized insurers that are doing a lot of their own investment management was just fraught with peril there. And that's really where you would find a less disciplined approach to so-called yield chasing. I don't think that we are completely out of it and all right now; however, I think that the industry learned its lesson. I think we're starting to, as you say, drift. The longer this goes on—with the very, very low money rate environment—the more of a danger there will be. And God forbid that we're in a Japan-type environment where it goes through 10 or 12 years with low interest rates. That would be devastating to the industry.

Gallanis: *You probably spend a fair amount of time looking at potential deals, and there are a lot that you don't take and some that you do take. Could you offer some thoughts on how you go about identifying value when you consider acquisitions?*

Montemayor: It's a quick method for sure. You have to look at the company's philosophy and the management. Let's face it—most of the management groups and the private equity firms that you're likely to come across do not have a ready-made stable of people to parachute in and take over an otherwise failing company. So one of the very first things, one of the very first indicia if this is something you really want to do, is whether the management team inside is strong.

Gallanis: *You view it as an asset?*

Montemayor: A total asset. The human capital portion of this equation cannot be overemphasized. While the greenbacks and that side of the capital equation are very important, the human capital is almost more important. Because this is what's going to give you the ability to stay the course, design a strategy, and then stick to it and pull it off successfully. Leadership, management capabilities, and the history of the company are all very important. Certainly you must look into what has been their trajectory, what are their markets? I feel that the so-called middle market and lower-end market is still woefully underserved, and there's lots and lots of room to work there still. And there's still a pretty good-sized vacuum in terms of people filling those needs.

In particular, we're becoming more and more of an immigrant country. People are coming from areas where there isn't necessarily an insurance culture, but they become aware very quickly that to succeed in this country you need to have all sorts of insurance, from health insurance to automobile liability. And soon enough it dawns on them that they're going to need some life insurance as well to provide for their families. And certainly by the second generation they're all well versed on that. But those smaller markets, those middle markets, are still pretty thinly covered.

Gallanis: *You've mentioned that among the things your firm has done—and I'm not sure which of them you've been involved in directly—there's been some P&C involved. And obviously you've been active with some life acquisitions. Are there segments of the insurance marketplace that at this point you don't feel any temptation to enter?*

Montemayor: In the past, we've had a couple of very attractive targets that no longer look as attractive. One of them was in fact annuities. Right after the meltdown, the pricing was very attractive; you could get pretty decent rates, and there was just a dearth of availability. This looked like a quick way to sort of enter and harvest it. We're glad we didn't do that, on further review.

The other one was long-term care. There's a segment of it having to do with substandard risk—you know, the people who don't make it through the underwriting process and get turned down. We thought there would be perhaps some attractive entry points there, in particular if you could do it much like you do on the P&C side, with some of the substandard auto risks. You limit the benefit, charge enough of a premium, and manage it pretty tightly. We felt there were some opportunities there, particularly to go with combination-type products that are qualified and so forth in order to provide for long-term care. Given the current interest environment, and given the difficulties on some of the underwriting, I'm glad we did not pursue that one either, although I still think somebody will eventually because the opportunity is just too rich.

Gallanis: *One of the efforts made in connection with the Affordable Care Act and the run up to it was to put sort of a federal footprint in the long-term-care area—to establish federal long-term care. And then the federal actuaries looked at it and reported back the conclusion that they just couldn't make it work. So at this point that really appears not to be part of the legislative approach. Is long-term care and the need that it's supposed to fill something that in your opinion can be addressed effectively in any sort of broad scale way within the insurance industry, at least the way things are operating now in the regulatory environment? Or if this need needs to be met, is it a need that possibly can only be met by government?*

Montemayor: Well, taking the first question first—yes, there is a need to be met there, and I think the insurance industry has a large role to play. The products are being redesigned and redefined as we speak. I think we were naïve at first. I remember one of the first things that I confronted as a commissioner in the late 1990s was the fact that many of these products had been woefully mis-priced. Since it was a relatively new entrant into the market, there wasn't a large database of experience, so they assigned it proxies like health in terms of the lapse rate. As you know, it's heavily dependent on lapse rates and on crediting ability to earn an interest rate. So in terms of lapses and morbidity and that whole combination—you know, if you try to apply a proxy that resembles health insurance, where it's sticky to a degree but you lose a pretty hefty sliver of the capped rate year after year so that it's peeling off—I think what we learned is that it's pretty sticky. It does not decrease.

Where I have faulted primarily my own brethren within the NAIC is this: Shortly after the 2008 meltdown, they were really nowhere to be found on the national stage, where some of the cable financial shows with the talking heads discussed the crisis.

Another assumption—that we can conservatively assign it a 5% earning rate on the reserves—that was also another serious mismatch, particularly in interest rate environments like ours. And then the morbidity rate assumptions were very flawed as well. We've gotten so much better over the years at keeping people alive that the utilization rate has forced a revision from assuming 18 months of care to 60 months of care or 70 months of care. And quickly it got upside down, and so there were massive increases in the rate requests, which is not for the faint-hearted, let me tell you. If you're in a large state and you award a large increase that affects a lot of the seniors, you hear about it very, very quickly, and you wind up in town halls that are not very receptive to whatever it is that you have to say, whatever rational explanation you have to give.

So it just compounded the problem, in the sense that commissioners would get a little wishy-washy about it and deny the rate increase, even though they had all of the justification in the world to grant the increases, and just keep making the problem worse. And I think you have a task force here at this meeting that dealt with that very same problem—one of the pioneer companies.

Gallanis: *You're referring to Penn Treaty, and what happened in that case was that then-Insurance Commissioner Joel Ario in Pennsylvania petitioned to put the company into liquidation. Owners and management of the company resisted that, there was a very protracted trial on that that took about two years in front of the receivership court, and ultimately the receivership judge denied the petition and ordered the commissioner—by then Commissioner Consedine—to come back to court with a proposal to truly rehabilitate the company. But the thing I wanted to ask you about is, that in the court's approximately 170-page opinion on this, one of the things the court said was that the whole process of rate increase approvals across the country has changed from what should be a technical and automatic process into an excessively politicized process precisely because commissioners don't want to go into that angry town hall meeting. In other words, in her view, if the statutory prerequisites for obtaining a rate increase had been established, and all the papers are there and the certification is there, then the rate approval should be automatic. Do you have any sort of reaction to that perspective?*

Montemayor: I do, and I think it is emblematic of that particular industry. You know, the second part of your last question had to do with, does the government have a role there? The government does have a role, but it's not to take it over or try to administer it directly. I think the private market can do a far better, more efficient job than they can. But they can structure the process so that it's a little bit more of an autopilot, and basically make it where it's easier to get the rate increases and give some cover to the more faint of heart, shall we say, commissioners who loathe the idea of going to an angry town hall meeting. And angry town hall meetings they will get.

Gallanis: *And it's easy for people who don't have to go to those meetings to be critical of the decisions of insurance commissioners. But is that a more general problem that extends beyond long-term care? There are other areas of insurance where rate increases are subject to some form of regulatory review and approval. In your view, is that a process that generally works well and is defensible? Or would there be some advantage, if it were politically possible, to rethinking that from the ground up and trying to come up with something that really is driven more by numbers and less by political discretion?*

Montemayor: The purist in me would say, the open market would set the correct price and would force the weaker competitors out. And what you would get for a market rate is truly the best available rate that provides the product that it promises to deliver and returns to the underwriter an adequate return to keep him motivated to keep offering it and keep competing. I do think that, at the end of the day—and because it is much harder to look at a product, and for a product that has a super long tail, there are fewer—I don't see a lot of takers out there frankly. And I see the underwriting guidelines getting a whole lot tighter and leaving a large group of people in the so-called impaired risk or substandard risk category, underserved and looking for a solution.

If you could offer a product that would give benefits that are capped at 15 months or 18 months, and put a dollar value on what the maximum would be, and try to encourage people to find other solutions, that might work.

It's also a product that is attacked frequently by fraud, as you know. And that has been a terrible enemy. But I think we now know much more about the product. We certainly have got a much better handle on what the claims are likely to be, so we should be able to do a much better job pricing. And I'm not entirely sure what the barriers remaining to competition are, but there certainly appear to be some because of the thin number of providers.

If you're in a large state and you award a large increase that affects a lot of the seniors, you hear about it very, very quickly, and you wind up in town halls that are not very receptive to whatever it is that you have to say.

Audience Member: *Commissioner, what is your view, now that you are looking at purchasing companies, of increasing the premium structure to bridge the gap that's the reason the company is for sale? Because I assume the company is not doing very well and therefore it's on the market. You come in and look at it—how do you decide to what extent you are going to rely on your ability to raise premiums in the future when it comes time to talking to the department of whatever state the company is in? Because that department is looking at that company somewhat protectively, and you as an ex-commissioner knock on the door of a brother commissioner to say you want to acquire the company, but you're looking for some package of increases in rates and you would like the commissioner to agree to that. How do you balance what you thought when you were a commissioner with what you now think as you are a supplicant at the door of the commissioner?*

Montemayor: Believe me, there is a big difference. I realize now, looking back—and I've visited with a number of people who were in the supplicant mode when I was on the granting mode—that there's really a lot to work with there. Obviously, if you are willing to put your own capital at risk and you're evaluating the situation, you might ask for some forbearances—perhaps in the reserving side by being allowed to do some discounting, or working with the guaranty funds to see if there's some level of support you can get where they don't take a total hit for it but instead take a much smaller hit by guaranteeing some portion of that business, or by allowing you to actually implement on a time-based basis some increases that are sorely needed. And for that, you'd want a commitment from, say, a Texas commissioner to talk to his brethren commissioners to allow you to do the same in other states.

I think in theory if you could get there, you as a commissioner would not only have helped your state and your guaranty association and your industry, but you would have also protected your taxpayer base—once you're getting the assessments and the tax increases that we invariably must levy to support it. I think there's a range of possibilities that are possible for a commissioner and a capitalist—call them what they are—willing to put their capital at risk to come to an agreement and actually move the thing forward to benefit everybody.

One of the other things that I was always very worried about as a commissioner is the policyholders. Our business, the insurance business, is a business that runs on trust. You sell them a piece of paper, and they give you money every month on the idea that you're going to be there for them when they call you and they really need you. Trust is really the commodity that we sell, and so they have to be able to rely on us. So at the end of the day, a deal like that protects the system; it gives the system some integrity, and it allows your policyholders not to have to go through the negativity about what's going on with the company—it's been taken over, there's a freeze on our withdrawals, we can't get our money out, etc. All of those things create great turmoil, not just for that set of policyholders, but indeed for everybody around them. And we all lose, because our reputation gets a little tarnished, as does our ability to deliver. And at the end of the day, that's what we're selling—an ability to deliver. And so I think there's a lot of room to work there. I hope that we take more advantage of those. I hope some of you will call me when you are looking for solutions to troubled companies to work something out.

Of course, there are cases where you really can't do very much. But there are many where you can in fact do something about it. Especially if you can put together the right package of forbearances, or an ability to raise the rates or what have you, some sort of a safe harbor. Or get some help from the guaranty fund. I don't think to my knowledge that has ever been tried—where the guaranty fund will basically give you some backstop at some point and provide you with some reinsurance. I mean, there are a number of very creative things that can be done, but they're clearly outside the box. Our laws don't actually give you the guardrails, if you would, to operate within them and feel safe. So it involves taking a lot of personal risk for a commissioner, talking to your general counsel and really getting him or her to say, "Yes, you can do that, but I don't feel good about it." Or "Yes, you can do that, but it hasn't been tried before and we may get really criticized and you may be on the newspaper a lot and not in such glowing terms." It's all those things to consider. ✯

["Finish Line" continues from page 1]

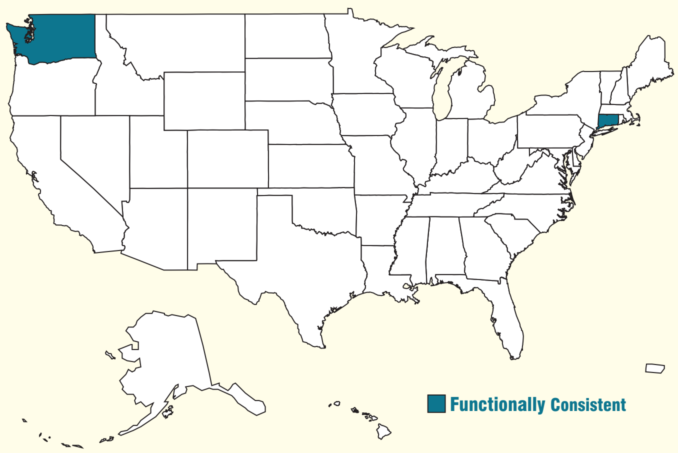
main players in the guaranty system safety net prove that we can work together for the benefit of policyholders—without any help from Capitol Hill.

Momentum

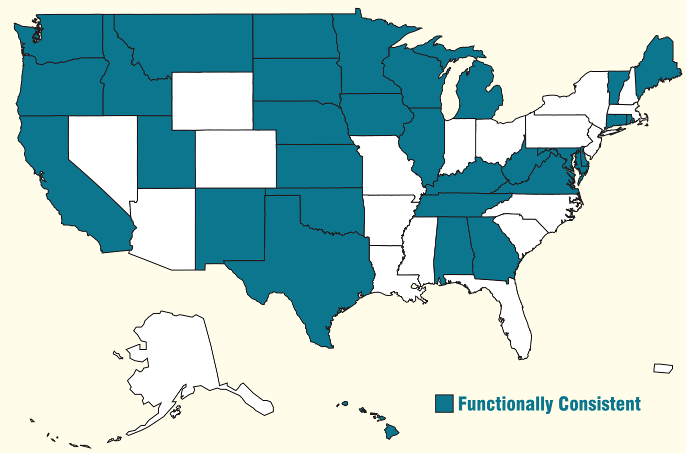
The job is not over yet, but we are making great strides. With more than 30 guaranty associations achieving functional consistency, our system is now more consistent than it has ever been. Guaranty associations across the country have updated their statutes without experiencing any major adverse consequences. And as more and more associations update their Acts, the remaining states are taking notice and considering action themselves.

This is important because updating a state's guaranty association act isn't always easy. Guaranty association acts are complex, and local considerations in a particular state can sometimes make passing legislation a challenging—though by no means impossible—task. That is where partnering with the local

2008 – 2 States Functionally Consistent



2012 – 31 States Functionally Consistent



Top Priorities

NOLHGA's GA Laws Committee has identified the key provisions in the new NAIC Guaranty Association Model Act that are vital to developing functional consistency among the state associations. Some of the most important include:

- Benefit limits for life, health, and annuity policies
- Coverage of non-residents and citizens living outside the United States
- Covered products
- Payee coverage for structured settlement annuities
- Triggering provisions
- Medicare Part C & D coverage exclusion
- Definitions of insolvent and impaired insurers

If you would like more information about the GA Laws Committee or would like to assist the committee, please contact Bill O'Sullivan (bosullivan@nolhga.com) or Meg Melusen (mmelusen@nolhga.com).

GA Laws Committee

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New York Life Insurance Company

Margaret M. Parker
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Timothy J. Ring
Metropolitan Life Insurance Company

industry and the ACLI proves so valuable. The ACLI in particular can help in identifying sponsors and educating legislators and their staff, as well as lining up support for the legislation.

After almost three years on the project, NOLHGA has accumulated a wealth of knowledge and experience to help associations develop a well-crafted approach to updating their statutes. One of the most valuable things we have learned is the importance of taking a targeted approach. Rather than rewriting every section of the existing statute, it is often more effective to pinpoint the provisions that need to be updated and leave the other provisions alone. NOLHGA—working with local industry and the ACLI—can help associations plot the right approach.

Final Steps

Despite the sometimes complicated process involved, guaranty associations have enjoyed good success in their efforts to update their Acts and provide even better service to their policyholders. The ACLI and its member companies continue to view this project as vital to the ongoing success of the guaranty system, and NOLHGA stands ready with a wide variety of resources for any associations that would like assistance (visit the "Updating Your GA Act" page in the members-only section of the NOLHGA Web site to access some of them).

I encourage any state association that has not updated its Act to consider doing so, and to contact NOLHGA staff to discuss how we may best be of service. Working together, we can strengthen the safety net that has served consumers so well for decades while demonstrating that our system is capable of acting quickly and in concert when needed. ✯

John R. Mathews is the Chair of NOLHGA's GA Laws Committee and a member of the Arizona, Illinois, and Wyoming guaranty association boards of directors.

NOLHGA Calendar of Events

2013

April 6–9	NAIC Spring National Meeting Houston, Texas
April 9–10	**MPC Meeting** **Salt Lake City, Utah**
July 9–10	**MPC Meeting** **Chicago, Illinois**
July 11–12	**NOLHGA's 21st Legal Seminar** **Chicago, Illinois**
August 24–27	NAIC Summer National Meeting Indianapolis, Indiana
October 21–22	**MPC Meeting** **Manalapan, Florida**
October 22–23	**NOLHGA's 30th Annual Meeting** **Manalapan, Florida**
October 27–29	ACLI Annual Conference New Orleans, Louisiana
December 15–18	NAIC Fall National Meeting Washington, D.C.

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