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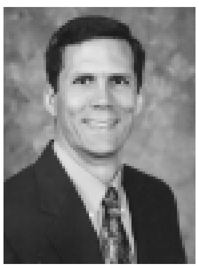
NOLHGA JOURNAL

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

After Complex Issues Are Resolved, American Standard Life Closes

by William P. O'Sullivan
General Counsel, NOLHGA



A long period of uncertainty came to an end for policyholders of American Standard Life and Accident Insurance Company (ASL) with the recent closing of a NOLHGA sponsored assumption reinsurance agreement. The assumption reinsurance agreement provided for ASL's guaranty association covered policy obligations to be assumed by American Fidelity Assurance Company, an Oklahoma domestic insurer with an A+ rating from A.M. Best.

NOLHGA's ASL Task Force, working in concert with ASL's receiver, arranged for the assumption reinsurance transaction after having been involved in the case for only 13 months. This article will chronicle some of the challenges overcome by the task force in closing the assumption reinsurance agreement.

ASL was first placed under insurance department supervision on December 6, 1988 with the entry of an order of conservation. On February 22, 1992, the Oklahoma District Court ruled that ASL's financial statements materially overstated its assets and the company was placed under an order of rehabilitation. ASL remained in rehabilitation for over five years. During this time the receiver pursued claims against the Guardian Life Insurance Company of America under a reinsurance agreement. The favorable resolution of this litigation was expected to provide sufficient resources for ASL to be rehabilitated. The litigation was ultimately resolved in March 1997 with the Oklahoma Supreme Court ruling that Guardian was not liable under the reinsurance agreement.

While ASL was able to pay claims in full during rehabilitation, it did not have the resources for much needed upgrades to its computer systems and policyholder service operations. As a consequence, policies were being serviced on an antiquated IBM System 38 without the benefit of a trained operator or an operations manual. Moreover, each policyholder hard copy file was a combination of paper records and microfiche. To compound matters, most of ASL's business had been assumed from 40 different companies. As a result, the business

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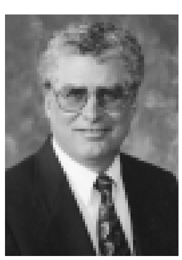
In This Edition

With Year 2000 Looming, NOLHGA Committee Begins Addressing Y2K Issues

by Jack Falkenbach
Executive Director, Delaware Life and Health Insurance Guaranty Association



It seems that every time you pick up a newspaper or trade publication, you see articles discussing the Y2K problem, otherwise known as the millennium bug. The problem, which stems from the limited availability of memory in the early years of computers, relates to the fact that some computers and software programs denote the year with only two digits, rather than four. When the year 2000 is reached, the computer's internal clock will read 00 and some computers will be unable to tell whether the 00 should read 1900 or 2000.

Opinions expressed about the impact of this problem run the spectrum, from the issue not being a problem worth being concerned about, to predictions of airplanes falling out of the sky. The answer is likely somewhere in between. It is a serious issue with potentially catastrophic effects for the financial services industry if appropriate remedial actions are not taken. For the guaranty association system, the needed planning and action falls into several categories. NOLHGA is already looking at this issue internally to determine and address its impact on the equipment and software being used by NOLHGA, which serves as the central coordinator and disseminator for the national network of state life and

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Chairman's Column

Selection Committee Begins Search For Next NOLHGA President

In my remarks at the NOLHGA's 15th Annual Meeting in Portland, Oregon, I committed myself to ensuring that NOLHGA has the resources to continue to serve the guaranty association system at a level that those of us who depend on the work of NOLHGA have become accustomed. I can think of few decisions that the Board of Directors will make in the upcoming year that will more directly impact NOLHGA, and its continued ability to serve the system in the future, than the selection of the next NOLHGA President.

In order to find the candidate that will likely lead NOLHGA into the next millennium, the NOLHGA Board of Directors has appointed an ad-hoc Selection Committee to search for and select candidates to serve as NOLHGA's next president. This committee will be charged with delivering its recommendations to the NOLHGA Board of Directors for final consideration and action. The members of the Selection Committee are the members of the Board's Executive Committee (Doug Goto, chair; Bill Fisher, vice-chair; Bill Brown, secretary; Roger Harbin, treasurer; and George Coleman, immediate past chair), Jim Jackson, director, Peggy Parker, director and MPC Chair, John Colpean, administrator and counsel, Michigan Life and Health Insurance Guaranty Association and Michael Marchman, administrator, Georgia Life and Health Insurance Guaranty Association. The Board contemplates that the Selection Committee will be able to quickly commence its proceedings, drawing from the search performed in 1997, and expects the process to be performed within an accelerated time frame.

The Selection Committee is soliciting candidate recommendations, expressions of interest and any other suggestions, comments or advice relevant to the selection process from all NOLHGA constituents. Recommendations and comments should be directed to myself or to any member of the Selection Committee.

The position of NOLHGA president will remain vacant until a successor is elected by the Board of Directors. On an interim basis, Dick Klipstein, executive vice president, will be responsible for the management of the NOLHGA offices.

1998-99 Chairman Douglas M. Goto (r) recognizes outgoing Chairman George Coleman during NOLHGA's Annual Meeting in Portland, Oregon.

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National Organization of
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NOLHGA Committee Begins Addressing "Y2K" Issues

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health insurance guaranty associations.

The responsibilities of individual guaranty associations, as a safety net for policyholders in the event of insolvencies in the life and health insurance industry, require them to be prepared in advance of December 31, 1999 to respond timely to satisfy their obligations to policyholders and to assist regulators in mitigating any damage that may result from member insurers that experience Y2K problems. In October, the NOLHGA Board established a committee to do just that. The committee is comprised of Bart Boles of the Texas Life, Accident, Health and Hospital Service Insurance Guaranty Association, Art Dummer of the Utah Life and Disability Insurance Guaranty Association, Doug Furlong of the New Jersey Life and Health Insurance Guaranty Association, Tom Peterson of the Kentucky Life and Health Insurance Guaranty Association, Tim Hart of Arthur Andersen, Dick Klipstein and Paul Peterson of NOLHGA, and myself as the committee's chair. Committee members were drawn from a broad range of disciplines, including an actuary, accountants, administrators and an attorney.

The Committee held its first meeting in October and began identifying issues and establishing a work plan and timetable that will allow the committee to make a report to the NOLHGA Board of Directors in January. The report will include a situation analysis defining the scope of the potential problem and the steps necessary to properly position guaranty associations to react effectively in the event of an insolvency where guaranty associations become obligated to provide benefits to policyholders of an insolvent insurer that has Y2K compliance problems.

Issues Identified

At its initial meeting, the committee identified issues that must be considered, and addressed and organized those issues into five broad categories. These categories include insolvency-specific issues, guaranty association readiness, public confidence, relationships and crisis planning. The group plans to identify the many Y2K issues that may be present in the case of an insolvent member insurance company. The committee will also be looking at guaranty association readiness and available technical resources, the availability of replacement products, including off-the-shelf products and the potential for restructuring of products. The committee will also examine the need to modify the process for transferring the business of an insolvent carrier to address Y2K compliance problems.

In the event of widespread Y2K compliance problems, although unlikely in the insurance industry, it is possible that there could be a failure of public confidence. The committee will discuss what steps, if any, the guaranty association system should be taking to address this possibility. Also to be examined are what various individual states will be doing in this area and whether the federal government is likely to become involved.

Building Relationships

Guaranty associations will not be alone in having to deal with the potential problems flowing from an insolvent carrier with Y2K compliance problems. The National Association of Insurance Commissioners and the American Council of Life Insurance are already considering the issue with respect to their member companies. One charge of the committee is to identify other parties with whom guaranty associations will need to interact in the event of an insolvency, as well as those who are currently monitoring the insurance industry regarding the potential for Y2K-related insolvency problems. Once the other interested parties have been identified, the committee will establish the necessary working relationships to allow the guaranty association system to function as efficiently as possible should insolvencies with Y2K compliance issues occur.

There are numerous questions to be explored with the insurance industry's regulators. These include: What will the NAIC and the various state insurance departments do in advance of the year 2000 if their monitoring activities disclose the likelihood of an insurance insolvency with Y2K compliance problems? What information will insurance departments need? What information will guaranty associations need should this situation occur? To what extent can insurance regulators and guaranty associations work to-

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> *"The responsibilities of individual guaranty associations, as a safety net for policyholders in the event of insolvencies in the life and health insurance industry, require them to be prepared in advance of December 31, 1999 to respond to their obligations to policyholders and to assist regulators in mitigating any damage that may result from member insurers that experience Y2K problems."*

"Convergence" of Banks, Insurers May Cause Headaches For Guaranty Associations

by Peter Marigliano
Communications Manager,
NOLHGA

With the announcement of the merger of Citicorp and Travelers, the traditional firewall between banks and insurers shows the first signs of being breached. A key focus of NOLHGA's 15th Annual Meeting in Portland, Oregon, was what the implications of the continued blurring of the bank versus insurance company divide might mean to guaranty associations.

Richard Hokenson, a demographer for Donaldson, Lufkin and Jenrette, laid out in stark terms the arena in which insurers will have to compete in the coming decades. Hokenson predicted that insurers will have to come to grips with a continuing decline in interest rates, making it difficult for them to offer attractive returns to baby boomers who will begin focusing in earnest on retirement and estate planning. At the same time, Hokenson noted that businesses will have difficulty raising prices as consumers have increasing access to comparative pricing information via the internet and other sources.

Financial Services Panel Members (l-r) Charles Gullickson, Bruce Winterhof, Charles Richardson and Roger Harbin discuss the potential impact of a future financial services "mega-insolvency."

How then can insurance companies maintain or increase their profit growth? One way is by capitalizing on the economies of scale and new distribution channels that mergers with banks and / or investment houses could bring. However, these potential financial services powerhouses could create new worries for the guaranty association system, either through increased federal regulation of such entities or through tremendous obligations should one of these global conglomerates fail.

Victor Palmieri, chairman and CEO, The Palmieri Company and a receiver in several major insolvency cases, including Confederation Life and Mutual Benefit Life, used the term "convergence" to describe the developing trend in the financial services industry towards mergers of insurers, investment houses and banks as evidenced by the Citicorp-Travelers merger. Palmieri was less than optimistic about what these mergers might mean for the future of the insurance industry and the guaranty association system. The three lessons learned from the real estate crisis of the early 1990s, according to Palmieri are, first, that booms not only precede busts, they also cause them and that the industry has to relearn this lesson with every peak and valley in the business cycle. Secondly, bank credit officers are no better than insurance investment officers in restraining credit in good times, and lastly, that bank directors and federal regulators are no better than insurance company boards in monitoring risks. According to Palmieri, "From a solvency standpoint, therefore, there's no apparent reason to take comfort from the prospect of the Citibank / Travelers convergence, except perhaps for the cynic who would argue that it creates an enterprise too big to fail."

On the regulatory front, Palmieri sees the convergence and globalization of the financial services industry possibly leading to dual system of insurance regulation. For the big global financial conglomerates of the future, Palmieri envisions a federal charter system, whereby these conglomerates would be licensed and regulated by federal authorities. This would leave smaller, less capitalized insurers under state regulation. This dual system likely will result in new strains for the guaranty association system because of the reduced assessment capacity of state guaranty associations as the largest companies opt for federal regulation.

What if the impossible did happen and in the year 2003, one of these global financial services behemoths fails? How severely would guaranty associations be impacted? What other consequences would the guaranty association system face?

A panel of industry experts attempted to answer these questions. Panelist Bruce Winterhof, principal, Milliman & Robertson, addressed the international aspects of such an insolvency. According to Winterhof, an insolvency of a huge financial services company would open U.S. guaranty associations to tremen-

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Convergence, *From Page 4*

dous liabilities. First, asset liability management is not well developed overseas. When coupled with limited appropriate investment opportunities resulting from poorly developed bond markets, particularly in Asia, guaranty associations may be open to tremendous potential obligations if an insurer operating internationally were to fail.

Domestically, a key question impacting guaranty associations in the wake of a mega-insolvency is the role of federal regulators. Charles Gullickson, executive director and counsel, South Dakota Life and Health Insurance Guaranty Association, questioned whether federal officials would pursue claims on insurance company assets and guaranty associations to make up for the shortfall faced by the Federal Deposit Insurance Corporation in covering the bank depositors of a failed financial services giant. Such claims by the FDIC could result in potentially astronomical obligations for guaranty associations.

Charles T. Richardson, a partner with Baker and Daniels and playing the part of an insurance commissioner for the panel, argued state regulators would look for cooperation among affected parties to resolve the difficult issues that such an insolvency would raise.

Finally, Roger Harbin, executive vice president, SAFECO Life Insurance Co., observed that cooperation would be extremely difficult among those groups affected by the insolvency. He envisioned a scenario where the industry loses political clout because various factions are unable to agree on a course of action as they all scramble to minimize their exposure to the obligations an insolvency would bring.

It is increasingly apparent that convergence in the financial services industry is a fact of life. What is not quite so apparent is the regulatory framework in which these industry giants will operate. As is clear from the continuing debate surrounding legislation to revamp the current environment in which financial services companies operate, Congress, insurers, banks and other constituents still have not yet themselves decided on what the future will look like. It is clear, however, that the future will hold some major challenges for the guaranty association system, not all of which will be pleasant to discuss.

"Take Heed: The Next One Could be Not Just a Big Mac But A Real Whopper."

Victor Palmieri on the possible insolvency of a global financial services giant.

1998 A Busy Year for GIC Litigation

by Angela J. Franklin
Assistant Counsel, NOLHGA

Judicial interpretations of life and health guaranty association laws have expanded over this past year on the topic of guaranteed investment contract (GIC) coverage. GICs are investment contracts designed to provide a fixed rate of return similar to a certificate of deposit. GICs usually are used to fund the "fixed income" portion of a pension and savings or 401(k) plan.

When an insurer becomes insolvent and is seized by a state insurance commissioner, interest payments on products like GICs, referred to as "unallocated annuities" by several GA laws, often cease, at least initially. Some employers have gone on the offensive and sued their respective state guaranty associations, arguing that GICs, like allocated annuities, should be covered by the associations. The issues involved are still in flux but rulings in several states have created an early pattern of decision-making. Much of the litigation has arisen out of the Executive Life insolvency, however, lawsuits are pending against guaranty associations arising out of GICs issued by the now insolvent American Protectors Insurance Company, Inter-American Insurance Company and Mutual Security Life Insurance Company. This year, decisions have been handed down in Alaska, California, Illinois (2), Michigan, Mississippi, New Jersey, Oregon and Washington on the issue of GIC coverage.

Determination of whether GICs are Annuities

Are GICs annuities? Courts answered in the negative in California, Michigan, Alaska and Washington. On April 21, the Michigan Circuit Court for the County of Ingham, granted the Michigan association's motion for summary judgment, in *Unisys vs. Michigan Life*. The court's decision that the Execu-

"Some employers have gone on the offensive and sued their respective guaranty associations, arguing that GICs, like allocated annuities should be covered by the associations."

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included a wide range of products - whole and term life insurance, disability income, noncancelable health, burial insurance, individual annuities and preneed insurance - with little commonality among the underlying contracts. ASL's list of plan codes alone took up 17 pages of computer printout and its specimen policy forms filled a tall filing cabinet in ASL's Enid, Oklahoma offices.

American Standard Life In Brief

Domiciled	Oklahoma
Affected States	22
Conservation	Dec. 6, 1988
Liquidation	Sept. 22, 1998
Close	Sept. 22, 1998
Assuming Carrier	American Fidelity
Policyholder Obligations	$15.2 Million

To address these problems, substantial financial resources were dedicated to compiling information needed to determine guaranty association obligations and to transfer the business to an assuming carrier. In addition, an actuarial appraisal was performed on ASL's business. The primary purpose of the appraisal was to assist potential assuming carriers in reviewing and evaluating ASL's business. As a side benefit, the actuarial appraisal model was also used to allocate policy reserves among affected guaranty associations for determining coverage obligations.

Because of the challenges posed by ASL's systems and records, financial and actuarial work took almost four months to complete. This work was finally completed in early February, 1998. Shortly thereafter, a request for proposal (RFP) was distributed to 22 parties which had expressed an interest in assuming ASL's business. Seven companies submitted proposals to assume ASL's business. Among the proposals received, American Fidelity offered the best financial terms. In addition, American Fidelity had the highest financial rating among the bidders and, like ASL, it was an Oklahoma domestic insurer. After American Fidelity's bid was selected, the parties moved quickly to negotiate an assumption reinsurance agreement for ASL's policies. The agreement was signed on July 20, 1998.

Stockholder Objects to ASL's Liquidation

Notwithstanding the successful RFP process, uncertainty remained with regard to finalizing the assumption of ASL's covered policies. This uncertainty arose from the fact that ASL's controlling stockholder had appealed the entry of a liquidation order against ASL. Guaranty association coverage obligations are typically triggered by an order of liquidation. As a consequence, the possible reversal of ASL's liquidation order on appeal created business and legal risks for guaranty associations. If guaranty associations funded their obligations and ASL's liquidation order was later overturned, it was not clear how the associations would recover their funds.

Nevertheless, the decision was made to press forward given the time sensitive nature of the assumption as well as legal analysis which suggested the shareholder's appeal was unlikely to be successful. The strategy was to enter into an unwind agreement with American Fidelity and ASL's receiver to cover the contingencies posed by the appeal. The agreement would provide for the reimbursement of guaranty association expenses if the liquidation order was overturned on appeal. Fortunately, through the good efforts of the receiver, the shareholder ultimately agreed to withdraw his appeal and the agreement became unnecessary.

This cleared the way for the transfer of ASL covered policies to American Fidelity on Sept. 22, 1998.

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gether in advance of a potential insolvency to be prepared to address guaranty associations' statutory obligations? How can receivers and guaranty associations obtain critical data needed to administer an insolvent company's policy liabilities when that insurer's systems are not Y2K compliant? While it is possible that there will be no insolvencies of companies with Y2K problems, guaranty associations cannot afford not to consider the possibility that there will be such insolvencies and take the steps necessary now to prepare for such an eventuality.

It is a different challenge from those which we, as guaranty associations, regularly face, but one which is imperative we undertake to be prepared in case a future insolvency involves the need to deal with administrative systems which are not Y2K compliant.

GIC Litigation Results a Mixed Bag for Guaranty Associations in 1998

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tive Life contracts at issue were unallocated was based on what it termed a "plain reading" of the Michigan Life and Health Insurance Guaranty Association Act. Notably, the court relied on Unisys' IRS 5500 tax forms indicating that the contracts were unallocated annuities and rejected Unisys "beneficial ownership" argument. Unisys is appealing this decision. The Washington and Alaska associations reached similar results in their defense of identical suits brought by Unisys. The trial courts in each case granted the associations' summary judgment motions, which argued that the statute of limitations for Unisys' claim had expired. Decisions favorable to guaranty associations in Oregon and New Jersey were also reached at the trial court level in their defense of suits brought by Unisys.

Continuing the trend, in a decision dated April 28, the California appeals court affirmed the *Unisys vs. California Life* trial court decision that the Executive Life group annuity contracts at issue were GICs, unallocated annuities, and not covered under the California guaranty association act. In reaching its decision, the court defined unallocated annuities as "not issued to or owned by an individual, except to the extent that benefits are guaranteed by the contract." The court held that the exception did not apply to the contracts in question. On appeal, NOLHGA filed an amicus brief in support of the California association, discussed the decisions in other states and asked the California Court to construe the California definition of unallocated annuity contracts in a manner consistent with constructions adopted in other jurisdictions. NOLHGA further argued that such construction was consistent with the intent of the drafters of the Model Act and the California legislature. The April 28 decision became final Aug. 12, when the California Supreme Court denied Unisys' petition for review.

> **" The *Meyers Moving & Storage vs. Michigan Life and Health Insurance Guaranty Association*** decision was the first to establish that an association has no duty to cover unallocated annuities protected by the PBGC."

Residency

The Illinois appellate court has determined in several decisions that residency must be determined specifically as of the time when the insurer is determined to be insolvent. This position was strengthened this year. On Sept. 22, the Illinois Department of Insurance affirmed the Illinois association's denial of a claim *In the Matter of the Life and Health Guaranty Association Claim of the Trustees of the Booz Allen and Hamilton Capital Accumulation Trust.* The grounds for the denial was that the claimant was not a resident at the time of insolvency. The case was remanded to the Department by the Illinois Appellate Court which had ruled that residency must be determined specifically as of the time when the insurer is determined to be insolvent and that "historical facts" must be discounted. The ruling is consistent with Illinois department rulings handed down last year in *Dynamic Systems Inc. vs. Boozell and Illinois Life and Health Insurance Guaranty Association* and *Illinois Life and Health Ins. Guar. Ass'n vs. Boozell* ("Revere Copper").

PBGC Exclusion

In the area of PBGC exclusion, the Michigan appellate court's decision in *Henry L. Meyers Moving & Storage vs. Michigan Life and Health Insurance Guaranty Association* was the first to establish that an association has no duty to cover unallocated annuities protected by the federal Pension Benefit Guaranty Corporation (PBGC). Two decisions this year in Illinois reached conclusions consistent with this ruling, while a Mississippi decision declined to do so.

In *In re Life and Health Insurance Guaranty Association Claim of Beaven Companies, Inc.*, the Illinois Department of Insurance agreed with the association's position that the contracts were unallocated annuities protected under the Pension Benefit Guaranty Corporation and therefore were not covered by the association. The hearing examiner in the case concluded that the Beaven Plan was protected by the PBGC based on the statements of the NAIC when it amended the Life and Health Insurance Guaranty Association Model Act. (The hearing examiner also concluded that the contracts at issue were "unallocated annuity contracts" because their terms identified the contract holder as the sole owner; no individual owned or was issued an annuity contract; and no individual was guaranteed benefits.) In a subsequent case, *In the Matter of the Illinois Life and Health Insurance Guaranty Association Claim of Underwriters Laboratories, Inc., Pension Finance & Benefits Committee,* which was decided on Oct. 23, the hearing examiner reached the same conclusion, following the decision in the Beaven case and citing the Meyers Moving case.

In contrast, in *Bank of Mississippi vs. Mississippi Life and Health Ins. Guar. Assn.*, the Mississippi Supreme Court held that the Mississippi act's exclusion for unallocated annuities protected by the PBGC did not apply where the pension plan had already terminated and no PBGC benefits were paid. The ruling of the court reversed a contrary lower court ruling. NOLHGA filed an amicus brief in support of the association's position.

Pending Litigation

Several cases are still pending on the issue of whether GICs are annuities and decisions are expected in the coming year. The tension continues as to whether GICs are allocated annuities and/or are

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beneficially owned by plan participants, rather than plans, although currently the scales appear to be tilted generally toward the assumption that GICs are not "annuities" under most association statutes. This would be in keeping with the intent of the Model Act, as NOLHGA has argued in the past, most notably in the Hilti litigation, that the "fundamental purpose" of guaranty associations is to cover individuals buying insurance "as protection against financial loss from death, sickness and longevity." Such individuals generally are not able to evaluate the financial and actuarial soundness of the carrier, whereas large pension funds have professional investment managers with the ability and the fiduciary duty to investigate and analyze the financial soundness of the insurance companies that issue GICs. Further, unlike the typical small insurance buyer, retirement funds can also limit their risks of default by diversifying their GIC investment portfolio.

UPCOMING EVENTS

December 5-9	**NAIC Winter Meeting** **Orlando, FL**
January 25-26	**NOLHGA Board of Directors** **Hawaii**
February 3-4	**NAIC/IAIR Insolvency Workshop** **West Palm Beach, FL**
February 17-19	**NOLHGA MPC Meeting** **Tucson, AZ**
March 6-10	**NAIC Spring Meeting** **Washington, DC**
April 27-28	**NOLHGA Board of Directors** **McLean, VA**

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