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NOLHGA JOURNAL

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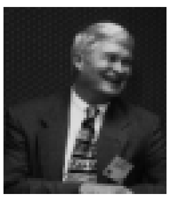
Centennial Life: Lessons Learned

by Mark Femal, Task Force Chair
Wisconsin Insurance Security Fund



Charles Richardson
Task Force Legal Counsel
Baker & Daniels

Centennial Life Insurance Company was a Kansas-domiciled health and LTD insurer that was placed in rehabilitation and then liquidation in 1998 by the Kansas Insurance Commissioner. Because Centennial was the most significant national health insolvency to be faced by NOLHGA, the Task Force faced many complicated legal, financial and administrative issues that either had not been faced before or, had not been faced at the magnitude presented by Centennial.

While the health business issues are largely behind us — some of the lessons learned in that area are the subject of this article — the LTD business remains a focus of the Task Force's attention. Nevertheless, it is not too soon to take stock of the task force's experiences so far. These are ideas that grow out of the joint work of the receivership and guaranty system over the past twenty-plus months in dealing wth health coverages.

A few words of caution. First, there is room here for only a few highlights of what the Task Force, in cooperation with the Kansas Receiver, did to deal with Centennial's health block and to get the thousands of claimants paid as promptly as possible. Furthermore, no two insolvencies are alike, and it is impossible to take the Task Force's experiences in Centennial and try to establish a set of "rules" to follow in the future.

What First?

It should not be difficult to figure out the order of focus when a new insolvency involves health coverages with immediate payment demands. However, to set the stage for the lessons learned summarized below, here are five key components of a health receivership workplan:

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Protected Cells: A Primer

by Meg Melusen,
Assistant Counsel, NOLHGA

In 1999, the NAIC's Financial Condition Subcommittee developed model legislation that would allow insurance companies to securitize insurance risk through a vehicle set up within the company known as a protected cell. This Protected Cell Company Model Act was approved and adopted by the NAIC at the San Francisco meeting in December. Two states (Illinois and Rhode Island) enacted legislation in 1999 that closely tracks the model. Additionally, protected cell bills are currently being considered in South Carolina and Iowa.

The model act (and the state legislation) was designed to enable domestic insurers to conduct securitizations out of protected cells, insulated from the insolvency of the insurer. In this context, "securitization" is basically the packaging of risk and selling it in the form of securities (such as bonds or other debt instruments) to investors. For years, the banking industry has marketed securities products backed by mortgage and credit card debt—the risk being a reliance on the mortgagor or credit card debtor's promise to pay. Because any future stream of payments can form the basis of an investment, investment options have broadened over the past several years to securities products backed by home equity, student loans, manufactured housing, rental car fleet financing and health care receivables. Even rock star David Bowie netted $55 Million in 1997 selling invest-

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Financial Services Modernization: Back to the Future?

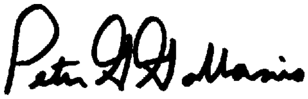
Recent efforts to "modernize" the marketplace for financial services, by recognizing and facilitating the convergence of products and "one-stop-shopping" from their providers, might lead one to believe that these are new notions. Nothing could be further from the truth. As in other professions and industries, the marketplace for "financial services" once was much more unified and cohesive than today, before generations of specialization fragmented lines of products and services and their providers.

I was reminded of that fact while reading the excellent new first novel by financial historian David Liss, *A Conspiracy of Paper*. Liss tells a sophisticated, noir crime story set in London in 1719, just before the implosion of the "South Sea Bubble," the first major stock market crash in the English-speaking world.

The British South Sea Company was a venture that issued stock, raised a huge amount of capital, produced nothing of substantial value, and seldom if ever turned an honest profit. Nonetheless, the South Sea Company was the subject of intense speculative investment, which drove stock prices to stratospheric levels before the bubble burst in 1720. Any similarities to phenomena in today's stock markets cannot have been intended by the author.

Embedded in a fine story of financial intrigue that might inspire a Martin Frankel, were he not otherwise occupied, is a vivid picture that Liss paints of the City of London at that time. Within a tiny area of several square blocks, a cluster of small coffeehouses, shops, and restaurants provided the physical "marketplace" for most of the major financial transactions of the British Empire. Literally anyone could (and seemingly everyone did) buy and sell insurance, banking, securities, and gaming products. Huge fortunes were made overnight by the rich and poor willing to take risks; and rich and poor alike could be, and were, wiped out overnight by deals that foundered, or that were frauds from the start. When people lost their investments in failures like the South Sea Bubble, there was no system of "safety net" protection to cushion their fall.

In today's discussions of financial services modernization, not even the staunchest supporters of laissez-faire capitalism advocate a return to the practices prevailing in London in that era. Even idealized capitalism requires a marketplace free of fraud and forced exchanges. Today we do not debate whether there should be regulation of the financial markets, but rather the appropriate scope and structure of a regulatory scheme that will let markets function efficiently without undue risk of fraud or the financial ruination of those unable adequately to protect themselves. In that context, the nature of insolvency protection



provided to consumers is critical in any consideration of the future of the American financial services marketplace, particularly insolvency protection for insurance products.

The current legal infrastructure reflects a variety of approaches tailored to meet the differing needs of consumers of different types of financial services. These approaches range from a loss-insurance system, that protects depositors in banks, to a more disclosure-oriented, "buyer beware" approach under the federal securities laws.

In the insurance arena, an elegant framework of consumer protection employs both the best aspects of government regulation and the economic efficiency of the private sector. As in the se-

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NOLHGA
13873 Park Center Road
Suite 329
Herndon, VA 20171

TEL.: 703.481.5206
FAX: 703.481.5209

E-Mail Address:
pmarigliano@nolhga.com

Managing Editor: Peter Marigliano

Will The Industry Embrace Protected Cells?

Cells, *from Page 1*

ments based on future income from his record sales.

As investors in the marketplace became increasingly receptive to new risks, the insurance industry began to create investment opportunities based on insurance risk. The concept of securitizing insurance risk became popular in the '90's as an alternative means of protecting property and casualty insurers from financial ruin in the event of catastrophic losses. But until now, all insurance securitization transactions took place off-shore through "special purpose reinsurers" in jurisdictions having favorable regulatory and tax treatment such as Bermuda.

In the off-shore transactions, an insurance company would typically set up a Special Purpose Reinsurer (SPR)—a separate entity established for a single securitization transaction for a defined period of time, usually one year. The insurance company could then purchase reinsurance from the SPR for a specific risk—let's say $50 Million in property insurance exposure near an earthquake fault. To offset its exposure, the SPR would securitize the risk by issuing $50 Million worth of securities in the form of options, futures, swaps, bonds or other insurance specific debt instruments like surplus and capital notes. While the outcome would depend on the terms of the reinsurance contract and the securities themselves, the following is a typical result: if the insurer did not suffer losses due to earthquake property damage within one year, the SPR repaid the principal and agreed-upon interest to its investors, then wound up its affairs and dissolved. If the insurer did suffer some or all of the $50 Million loss, the investors' principal and unpaid interest was available to the insurer to pay the claims.

While these securitization transactions have been taking place in remote jurisdictions, the Protected Cell Model Act and state legislation represent efforts to bring insurance securitization on-shore. Unlike the special purpose reinsurer used off-shore, a protected cell is not a separate entity, but can instead be likened to a "separate account." Under the Model Act, an insurance company can establish a protected cell and attribute portions of the company's insurance obligations to it. In shifting the risk, the insurer must fund the protected cell account in an amount that is at least equal to the liability reserve that is commensurate with the attributed risk. To avoid being deemed an insurance company by the IRS, or being subject to regulatory requirements like premium taxes and guar-

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"As investors in the marketplace became increasingly receptive to new risks, the insurance industry began to create investment opportunities based on insurance"

Mark Your Calendars!!!!!

JOINT NOLHGA/NCIGF/IAIR SEMINAR
November 15-17, San Antonio, Texas

NOLHGA, the International Association of Insurance Receivers, and the National Conference of Insurance Guaranty Funds will host a workshop examining the implications of Financial Services Convergence.

Participants will work in teams as they examine a Case Study and develop a solution for handling the insolvency of a failed international financial services conglomerate.

The NOLHGA Journal welcomes reader comments, suggestions for articles and submssions on topics of interest to the guaranty association system and its constituents.

Correspondence should be directed to:

Peter Marigliano, Managing Editor
NOLHGA Journal
13873 Park Center Road, Suite 329
Herndon, VA 20171
pmarigliano@nolhga.com

NOLHGA Legal Committee

by William O'Sullivan
General Counsel, NOLHGA

For better or for worse, guaranty association work often involves complex issues of a legal nature. Since its inception, NOLHGA's Legal Committee has been an important resource in helping the guaranty system address and respond to those issues. This year will be no different.

With financial services modernization on everyone's radar screen, the Legal Committee will be devoting substantial time this year to dissecting the Gramm-Leach-Bliley Act and analyzing the implications to the guaranty system. The Committee also has a wide range of other projects on its agenda for the year.

For persons involved in the financial services industry, the passage of the landmark Gramm-Leach-Bliley Act, commonly known as the Financial Services Modernization Act, was the major story of 1999. The Act repeals depression era barriers which prevented securities firms, banks, and insurers from affiliating, and establishes a holding company mechanism and a regulatory framework for allowing entities to engage in diverse financial services activities. Generally speaking, the act embraces the concept of functional regulation pursuant to which state insurance departments will continue to regulate entities engaged in insurance activities, while federal regulators will continue to regulate banks and banking activities. At this point there are many open questions as to how this will work. It is anticipated that implementation regulations currently being considered will answer some of these questions.

While the Act does not expressly deal with the activities of guaranty associations, it has potential implications for insurer insolvency proceedings - and by extension the guaranty system - because of the revolutionary changes that it portends for the financial services industry.

These potential implications could become a reality in the event of the insolvency of a financial conglomerate that is subject to dual regulation by federal and state authorities. Some of these potential implications are currently being discussed at the NAIC. These include: to what extent may state guaranty association and liquidation laws be preempted by federal legislation; will the Federal Reserve Board, as the regulator of financial holding companies under the Act, have the authority to compel or conduct examinations of insurance companies, or to compel insurers to act; will there be restrictions on the power of a state regulator to place an insurer into receivership; and the potential for conflicts between federal and state regulators over assets of a financial conglomerate and its insurer affiliate.

Federal Issues Subgroup

The Legal Committee's Federal Issues Subgroup, chaired by Charles Richardson of Baker & Daniels, has been charged with reviewing Gramm-Leach-Bliley and reporting on the possible implications to the guaranty system. It is anticipated that the subgroup will release its report in time for NOLHGA's Annual Meeting in October.

Model Laws Subgroup

While the Federal Issues Subgroup is contemplating what the future may bring in the era of financial services modernization, the Committee's Model Laws Subgroup, chaired by NOLHGA's former general counsel Anthony Buonaguro, will revisit the past by preparing a report on amendments to the Life and Health Insurance Guaranty Association Model Act. The report will cover the model act amendments adopted by the NAIC in 1997, as well as more recent amendments that made coverage of unallocated annuities optional, clarified coverage of equity-indexed products and excluded charitable gift annuities from coverage. The purpose of the report is to provide detailed explanation and analysis of the amendments, including an assessment of their importance in terms of protecting guaranty interests and enhancing the timeliness and efficiency of the guaranty system's response to multi-state insolvencies.

The Legal Committee has a number of standing subgroups formed to complete projects on an annual basis. One of these subgroups is the Legal Seminar Planning Committee. This year's planning committee, chaired by James (Tad) Rhodes of the Oklahoma Association, is already well along in formulating an excellent program for this year's edition of NOLHGA's Annual Legal Seminar. This year's Seminar, which will be held July 20-21 at the Fairmont Copley Plaza Hotel in Boston, will focus on cutting-edge issues facing the guaranty system and the insurance industry including financial services modernization and e-commerce.

Amicus Subgroup

The Amicus Subgroup is another standing subgroup. This subgroup, Chaired by Frank O'Loughlin, counsel to Colorado, Montana and Wyoming, is charged with the extremely important task of considering requests for NOLHGA amicus support. The subgroup has a number of criteria that it uses to assess such requests, including whether the issues to be addressed are of national import to guaranty associations.

The Annotated Model Act Subgroup is charged with publishing an annotated version of the Guaranty Association Model Act. This year's subgroup will publish the fifth edition of the Annotated Model Act, which will reflect the most recent cases interpreting provisions of guaranty association acts across the country. This subgroup is chaired by Jackie Rixen, counsel to Texas Association.

Finally, the Legal Committee is planning a joint meeting with the Legal Committee of the National Conference of Insurance Guaranty Funds (NCIGF). The joint meeting, tentatively scheduled for September, will focus on issues of common interest to life/health and P&C guaranty associations, including financial services modernization, *Fabe* cure legislation, the superpriority statute and the URL.

Lessons Learned

Lessons, *from page 1*

1 Communicate with policyholders quickly about the current situation and plans for fixing or stabilizing it

2 Start paying claims

3 Deal with existing servicing relationships and conduct a thorough review of all policies, in force lists, etc.

4 Select a claim processing servicing agent for the long term

5 Enhance claim-processing procedures and institute some form of audit / quality control process

Each of those basic building blocks includes a subset of issues, factual and legal challenges, and financial implications for Receivers, GAs and the policyholders and claimants on whose behalf the receivership and guaranty system toils.

From the Centennial task force perspective here are our views on the priorities and order of decisions:

1 Quick assessment of situation:

* Status of claim handling and backlog
* Inventory of external relationships
* Adequacy of estate assets to pay current claims
* Identify over-limits claims;

2 Develop short term game plan with the Receiver; assume the Receiver will process claims over the short term;

3 Joint communication with policyholders and claimants and providers;

4 Claim payments:

* If estate assets are to be used to pay claims, seek to negotiate an Early Access Agreement and implement procedures for GA approval of those claim payments
* If GA assets are to be used to pay claims, implement procedures for GA review, approval and funding of claim payments
* Work closely with claim processor on initial claim batches to ensure correctness of matching explanation of benefits (EOBs) with checks and GA / internal reporting; review of EOBs and inclusion of GA (or state) name on the EOB or check is critical;
* Handle claims over GA limits early;

5 Evaluate; and then continue or revise or terminate existing external relationships;

6 Evaluate the Receiver's ability to provide long term claim processing; consider outside TPA alternatives;

7 Evaluate methods to reduce any claims backlog.

Lessons Learned

Here are a few lessons about the priorities listed above. Again, none of these rises to the level of a "rule".

1 Health insolvencies bring a potential for claimant complaints and anxiety that do not exist in other types of insolvencies. The best (and maybe only) way to mitigate that potential is to have sound communication to all interest groups and to make timely (or nearly so) claim payments. Money must go to claimants on a regular basis. Reducing any claim backlog is probably the number one goal.

"Reducing any claim backlog is probably the number one goal."

2 Another of the goals should be minimizing the number of changes to pre-insolvency policy service and claim handling procedures so that policyholders and claimants do not suffer unnecessary confusion or disruption of service. Major administrative changes can cause misunderstandings and repetitive claim handling steps may contribute to payment delays. It is important to create a system for handling disputed (or appealed) claims in such a way that the processing of original claims is not interrupted.

3 The administration of health business is almost always more complex and difficult to manage than anyone thinks at the beginning of the process. That usually leads to an underestimation of the time required. It is very important that a Receiver and Task Force take the time to evaluate all external relationships the insolvent company had (such as with discount service providers, drug card providers.

4 Given the amount of GA money being disbursed periodically to claimants, a Task Force should consider an outside audit or quality control process to give comfort to the GAs. Unlike a typical closing of a life or annuity reinsurance transaction, where the Task Force's consultants provide pre-closing assurances on the correctness of each GA's funding accounts, the GAs in a health insolvency where no transfer of obligations is feasible must fund their obligations every single month that the insolvency is open! The GAs writing the checks need evidence that the process is producing reliable data.

5 Any agreement that is reached with a servicing agent, whether it be the Receiver or an outside TPA, should be clear on the accounting for premiums post-liquidation. Those premiums belong to the GAs, and steps need to be taken to assure their proper accounting. That must include unearned premiums on or after the liquidation order date.

6 A task force should consider having a NOLHGA or GA representative on site at the beginning of the process to monitor the policy service and claim adjudicating functions and to give appropriate feedback, both to the servicing agent and to the task force.

7 As with so many other areas of insolvency practice, coordination between the Receiver and the GAs leading up to the entry of a liquidation order is very important in a health insolvency. The short-term nature of the health policy obligations calls for quick communications with policyholders and

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Protected Cells

Cells, *from Page 3*

anty association / fund assessments, the Model Act makes it clear that the cell is not a stand alone insurance company; i.e. the cell is limited to assuming risk from the company's general account and may not issue policies or become directly liable to policyholders.

The insurer can then securitize the risk attributed to the protected cell by issuing bonds from the cell. The bonds must contain a disclosure stating that only the assets within the protected cell are available to satisfy the obligations. As with the SPR, depending on the terms of the bonds issued, if the specified loss does not occur, then the bond purchasers receive their principal and typically a very high rate of interest. If the specified loss does occur, the investors lose all or part of their principal and interest, and the insurance company can use the assets in the protected cell to pay claims.

All assets and liabilities associated with the protected cell or the insurance obligations within the cell must be maintained in separately established and identified accounts bearing the name or designation of that protected cell. The protected cell assets are not subject to liabilities arising out of any of the insurer's other business nor are the insurer's general account assets and activities subject to liabilities of the protected cell. Significantly, the Model Act excludes protected cell obligations and activities from being subject to the guaranty association act. Although this raised concerns that a claimant traditionally afforded guaranty association coverage would, in the event of insolvency, become "lost" in a cell where no coverage is supposed to exist, this concern was alleviated when the act was amended to prohibit direct business being written out of the cells or the cell having direct obligations to policyholders.

Although it has primarily been property and casualty insurers which have tested the insurance securitization waters (only using off-shore vehicles to date), the drafters / legislators clearly contemplated protected cell use in the life and health industry because protected cells are specifically excluded from life and health guaranty association coverage and assessment. Nevertheless, questions remain about the possible impact protected cells may have on life and health insolvencies, especially with respect to the availability of protected cell assets to pay claims and continue coverage post-insolvency. As protected cells come into use in the coming years, their application and effect on the industry should continue to be considered from an insolvency perspective.

Mark Your Calendars!!!!!

NOLHGA Legal Seminar
July 20-21, Boston, MA

This year's Seminar, which will be held at the Fairmont Copley Plaza Hotel. The Seminar will focus on cutting-edge issues, such as Gramm-Leach-Bliley and e-commerce, facing the guaranty association system and the life and health insurance industry.

For more information contact Meg Melusen at 703.787.4130.

Financial Services Modernization

Modernization, *from Page 2*

curities markets, insurance regulators mandate certain disclosures and enforce rules governing the substantive propriety of certain transactions in which insurance companies engage. In addition, however, state laws have established the current life and health insurance guaranty system, which, through an essentially private-sector mechanism, provides not only for the payment of losses that were the responsibility of the failed company before its insolvency, but also for the continuation of contractual benefits to consumers. These contractually guaranteed prospective benefits are often the most financially significant aspects of insurance policies.

Without a guaranty system that will honor pre- and post-insolvency obligations of failed insurers, the insureds of an insolvent carrier would be no better off than those ruined by the South Seas bubble in 1720.

The guaranty system's success in accomplishing its mission can be measured both in terms of qualitative and quantitative components. The qualitative concern is that consumers be placed with solid assuming carriers as soon as possible after the failure of their insurer – that they get the ongoing insurance protection for which they bargained. The quantitative concern is that this consumer protection be accomplished in a way that best preserves the continuing capacity of the guaranty system, and that minimizes the costs of insolvencies to the policyholders, taxpayers, and insurance company shareholders who ultimately foot the bill. The track record of the current system has been impressive in meeting both of those objectives – protecting consumers' insurance expectations, and doing so at a reasonable cost. As a result, public confidence in the current insurance marketplace seems much less affected by news of an insolvency than was the case ten years ago.

The accomplishments of the current guaranty system have resulted in no small measure from the way in which the system is constituted. Administrators of the individual Associations effectively oversee the satisfaction of their Associations' obligations to in-state consumers and to their member insurance companies. NOLHGA staff assists the GAs and their members by providing project support and "institutional memory." Member companies that have both a financial and reputational interest in the successful resolution of insolvencies help shape and direct the efforts of the system. Finally, long-term relationships with outstanding service providers help ensure competence, efficiency, and continuity.

As the exploration of further financial services reform continues, it is incumbent on anyone claiming to be concerned with the interests of consumers not to diminish consumer protections currently provided. In other words, an intellectually honest reformer must ask, does any new proposal protect consumers as well as the current system, and at as low a cost to society? Unless the system contemplated by such a proposal builds in the participation of experienced insurance experts whose self-interest is linked to successful protection of consumers, the promise of such a system may be no more than another empty bubble.

Lessons, *from page 5*

claimants on policy service and claims handling to prevent massive confusion, even panic, among policyholders, claimants, providers, and others. The Receiver and the GAs should jointly plan ad communicate so that the stage is set for a thorough examination of the situation once the initial communications have stabilized the situation.

8 Another question that should be considered early on is whether there will be any kind of temporary moratorium and, if so, whether there should be a set of hardship exceptions sanctioned by the Receiver or the receivership court. If so, the Task Force should attempt to preserve as much flexibility as possible to accommodate state-by-state GA requirements on hardship payments, since decisions about which claims should be covered in the face of a post-liquidation moratorium rest ultimately on the affected GAs.

9 In the area of GA claim payment processing, one size does not necessarily fit all GAs. Caution must be taken in insuring that a multiplicity of GA payment procedures does not cause problems for everyone, including the Receiver. A Task Force should recommend to the GAs one payment method and explain clearly how uniformity helps in reducing the policy service and claim handling backlog that almost always accompanies a major health insolvency. Nevertheless, any plan must accommodate the requirements of individual GAs.

10 In a health insolvency, communication from the task force, receiver and claims administrator to the policyholder or claimant constituencies, as well as state regulators who may be involved is critical. The servicing agent, whether the Receiver or an outside TPA, should receive clear instructions from NOLHGA on what should be said and not said about GA involvement, procedures, limits, coverage, etc.

11 When there is a significant claim backlog policyholders or claimants are often calling the insolvent company constantly asking about the delay. There needs to be consistent response to providers

Conclusion

The above represent only a few of the lessons learned in dealing with claim payments and communication issues in a health insolvency. That atmosphere is markedly different from what the GAs face in a typical life/annuity company insolvency. The on-going experience in Centennial serves as a template, though admittedly an incomplete one, that future Task Forces can consider in the health arena.

UPCOMING EVENTS

May 2-3	**NOLHGA Board of Directors** **Tysons Corner, VA**
May 17-19	**NOLHGA MPC Meeting** **Minneapolis, MN**
June 10-14	**NAIC Summer Meeting** **Orlando, FL**
July 20-21	**NOLHGA Legal Seminar** **Boston, MA**
August 16-18	**NOLHGA MPC Meeting** **San Francisco, CA**
October 9-11	**NOLHGA Annual Meeting** **Orlando, FL**
November 14-17	**Joint NOLHGA/NCIGF/IAIR Workshop and NOLHGA MPC Meeting** **San Antonio, TX**

NOLHGA®
National Organization of Life and Health
Insurance Guaranty Associations
13873 Park Center Road • Suite 329
Herndon, VA 20171-3223