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"You Can't Be Accountable to 30-Year-Old Analysts on Wall Street"

Northwestern Mutual's Ed Zore discusses the financial crisis, the mutual company model, and why the insurance industry has the solution to one of the country's major problems

Edward J. Zore is the Chairman and CEO of Northwestern Mutual, the nation's largest direct provider of individual life insurance, with over $1 trillion of individual life insurance in force and assets of more than $155 billion. Trained as an economist, he joined Northwestern Mutual's investment department in 1969. He was named CEO in 2001.

Mr. Zore conducted a question and answer session at NOLHGA's 2009 Annual Meeting on October 13 with moderator Peter Gallanis (NOLHGA President). An edited transcript appears below.

Gallanis: Mr. Zore, I'm very happy you could join us. Over the past two years, we've seen the decline in the financial economy starting with the subprime problem, spreading from there to investments generally, and then finally to the real economy. Now some experts are saying that the recession is over, and that we're even at the start of a rather sharp V-shaped sort of recovery. As someone who's been a professional economist, what do you think of that contention?

Zore: I don't think it's V-shaped. I've gone through a number of these things, and this one's different. I remember looking at what was going on, probably starting in the middle of last year, and saying, "You know, this is really ugly." It was like looking into a black hole. That's why the stock market got hammered so badly, because everybody was looking in a black hole. They couldn't see how we were going to get out. In late March,

["Ed Zore" continues on page 10]

As a group insurers tend to be a little more conservative than some of the bankers who refashion themselves as investment bankers or "Wall Street types."

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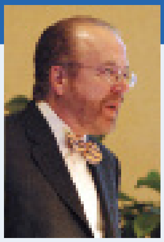


The State of Financial Regulatory Reform

When Scoop, my editor, convened the *NOLHGA Journal* staff in the City Room some weeks back to plan this issue, he asked if I could whip out a quick column on the state of financial services regulatory reform.

"Piece of cake, Scoop," I replied. Everyone then expected that by mid-January, congressional efforts at health-care reform would be behind us and the Senate would have either finished work on a bipartisan financial regulatory reform bill or settled on a Democratic plan along the lines of the one proposed late last year by Senator Dodd.[1]

Not so fast.

Health-Care Reform & Recent Election Results

Among the many things I once expected to be writing about on the morning of January 20, 2010—one year to the day after the inauguration of President Obama—the furthest thing from my mind was a conservative Republican's election the day before to fill the Massachusetts Senate seat held for 47 years by the esteemed "liberal lion," Edward M. Kennedy. That Massachusetts Senate election was contested to a significant extent as a referendum on the pending health-care reform plan and on the broader reform agenda of the current administration and congressional leadership.

How much to read into a single election is always a mystery. To be sure, local factors and the campaign strategies and tactics of both candidates in the Massachusetts race mattered greatly. Still, that race, taken together with November gubernatorial victories by Republicans in solidly "blue" New Jersey and recently blue Virginia—three races where virtually the only uniting thread was widespread opposition to current federal reform initiatives—has left many wondering about the prospects for the various reform proposals and for financial services regulatory reform in particular.

I mention the recent electoral developments neither to celebrate nor to mourn the choices made by voters, but rather because the effect of those elections on the national political agenda may be significant for the insurance industry and the guaranty system, as to both timing and substance.

Timing Issues

The administration and Congress had ascribed to health-care reform the highest priority of any item on the congressional agenda for most of 2009 and early 2010. It remains true that nothing of significance will move in Congress until leadership decides what to do with health-care reform, now that the Democratic Senate majority is no longer "filibuster-proof."

As I write, it seems unlikely that the House will simply vote to accept unchanged the version of health-care reform previously passed in the Senate, though some discussion continues of holding such a House vote coupled with a contemporaneous "reconciliation" bill to resolve differences between the Senate and House on certain issues. Other, more drastic legislative options are now said to be off the table.

If, as seems almost certain, the House will not accept the Senate health bill as passed, the remaining alternatives for the administration and congressional leadership appear to be either stepping back to renegotiate with at least some Republicans a scaled-back health-care reform bill, abandoning the effort for now, or assigning to health-care reform a slightly lower priority and longer timeline.

The timing implications of that choice are important. As long as cutting a deal on health care remains the clear policy priority of Congress, other major agenda items (such as financial regulatory reform) cannot advance. There simply isn't the "shelf space," in terms of committee and staff time, energy, and attention, to advance multiple important bills simultaneously.

On the other hand, a quick decision either to drop health-care reform or to move it to the "back burner" likely would move financial regulatory reform close to the top of the congressional agenda. That is because reforming financial regulation remains widely viewed (both by Democrats and by many Republicans) as an important policy goal. Moreover, it is a goal for which there appears to be considerable bipartisan support, and members on both sides of the aisle could use a significant accomplishment to tout going into the 2010 election season. In addition, financial regulatory reform would be a high-profile bill that Congress could pass without increasing taxes or directly affecting the federal deficit. Other major congressional agenda items, e.g., a "jobs bill," likely would have a steep price tag, would provide no immediate political dividends, and could easily bog down in partisan disagreements.

Nothing of significance will move in Congress until leadership decides what to do with health-care reform.

Policy Issues

Aside from the timing implications of the recent election results, there also may be policy implications. While “spins” on the recent Republican victories depend to some extent on the political orientation of a given spinner, the Massachusetts election puts the administration and congressional leadership in the position of needing a political victory. To achieve a meaningful political victory, some suggest that changes in political strategies and tactics are required.

On that score, there are two common views. One view, typified by Senator Bayh (D-IN), is that the administration and the majority in Congress must tack toward the center and bipartisan consensus on significant legislation. Another view, endorsed by some in the Democratic progressive wing, is that bipartisanship and a quest for consensus should be abandoned altogether: that the administration would be better served by launching a full-bore attack on Republicans and business interests—especially major banks, health insurance companies, energy companies, drug makers, and others—to “get on the right side of populist rage” against Wall Street.

Political and business journalists claim to have detected at least a nascent trend in the latter direction in the recent administration proposal for a “financial crisis responsibility fee” and in criticisms of Wall Street compensation and health insurer opposition to elements of health-care reform legislation. In a similar vein, the administration has just announced a new initiative to include in the financial services reform legislation now before Congress some elements of the 1933 Glass-Steagall Act and to control the size of banks, certain investments of their funds, and proprietary bank trading operations.

While the President’s recent support for what he calls the “Volcker Rule” (a return to the spirit, if not the letter, of Glass-Steagall) has received significant support (and some criticism) from voices across the ideological spectrum, it is a major change in course from the financial regulatory blueprint previously released by the administration, supported by Treasury Secretary Timothy Geithner, and largely adopted by the House in December.

To sum up: Whether, when, and how financial regulatory reform proposals now will progress depends significantly on whether a resolution of the health-care debate will remain the prime focus of the administration and Congress. But whether or not financial regulatory reform progresses, an increase in anti–Wall Street rhetoric (and not just by Democrats) is a certainty as November’s elections approach; that change in the tone of public discourse itself will affect the course of the regulatory reform debate. There appears to be no political downside to bashing bankers’ bonuses.

A quick decision either to drop health care or to move it to the “back burner” likely would move financial regulatory reform close to the top of the congressional agenda.

The Status of the Financial Reform Effort

But Scoop asked for a status report, and I aim to please.

The current efforts at financial regulatory reform began in the spring of 2009, when Secretary Geithner unveiled a 73-page “blueprint” for regulatory reform. The blueprint (similar in some ways to the regulatory reform blueprint released a year earlier by then-Secretary Paulson) was the basis for the bill that emerged over the summer from the House Financial Services Committee and ultimately passed in the House on December 11, 2009.

In the meantime, the Senate Banking Committee set off on a tack different from the administration’s. When a bipartisan committee consensus did not emerge by November 2009, Chairman Dodd (D-CT) released his own massive reform proposal. The Dodd proposal resembled some elements of the bill passed in the House, but it differed significantly in other areas. That proposal met immediate resistance from all Republicans and some Democrats on the committee, which led Chairman Dodd to pull back somewhat and assign to bipartisan teams of committee members the task of developing and marking up different sections of the bill.

Those teams are still meeting in late January 2010. Substantial bipartisan progress has been reported on various matters, though no redrafts have yet appeared. Informed scuttlebutt had been

[“Regulatory Reform” continues on page 15]

NO GUARANTEES

The economy may be recovering, but the guaranty system faces an uncertain regulatory future and the prospect of more impairments

Early in his President's Address at NOLHGA's 26th Annual Meeting, NOLHGA President Peter Gallanis observed that "The guaranty system—and state-based insolvency protection of insurance consumers—is in more danger today than at any point in the system's history." That sense of danger—to the economy, state regulation of insurance, and the guaranty system itself—was a constant theme throughout the two-day meeting, as various experts discussed the likely outcome of financial services modernization, the role state insurance regulation should play in a new regulatory regime, and the economic outlook for the insurance industry and the United States. Good news mixed with bad, and opportunities were cited alongside threats, but attendees of the October 2009 meeting walked away knowing that the guaranty system faces trying times.

New Attitude & New Insights

Commissioner Roger Sevigny, head of the New Hampshire Insurance Department and then-President of the NAIC, spoke of the need for new financial services regulation and the dangers of going too far down the road toward a single "super-regulator" of systemic risk. "We do not believe financial stability is strengthened by vesting all authority within a single systemic risk regulator," he explained, adding that the NAIC believes insurance firms are unlikely to present such risks. "We think a system of systemic risk regulation should integrate the state insurance regulatory system and not displace it."

The focus of this new system, Commissioner Sevigny said, should be on "coordination, collaboration, and communication among the various regulators. It should promote working together." With that in mind, he noted that the NAIC has undergone a significant change in its approach to Congress. "A few years back, the membership was generally opposed to using Congress as an avenue for solving any problem," he explained. "The general attitude was, keep Congress out of

Luncheon speaker George Will provided attendees with a humorous and contrarian view of the scene in Washington and across the country, decrying the sense of entitlement among many Americans—"a lot of what are called 'problems' aren't," he said—and noting that "the retreat of the state has been halted" by the Obama Administration.

our business—we can solve our own problems." This attitude has given way to "a willingness to engage with the Congress on insurance regulatory issues."

This new engagement with Congress is based on several core principles adopted by the NAIC in regard to a nationwide system of state insurance regulation. In these principles, Commissioner Sevigny said, the organization acknowledges "the need for greater uniformity and reciprocity" but also stresses the importance of local or regional standards where necessary and the key role state regulators play in setting and enforcing these standards as well as working with functional regulators when dealing with holding company structures.

Scott Alvarez, General Counsel in the Legal Division of the Federal Reserve Board, gave attendees some insights into the Board's stance on systemic risk regulation. Joking that "we've been trying at the Fed to keep the financial system afloat with loans, credit facilities, a little bit of chewing gum, and some twine," Alvarez went on to describe some of the important lessons the Board took from the recent economic crisis. "We've learned that we've got to do our microprudential supervision of individual institutions a little bit better," he said. "We can improve our capital rules—put more reliance on the quality of capital in addition to the quantity."

Perhaps most importantly, "we've got a too big to fail problem," Alvarez said. "Here and internationally, investors look to the federal government to bail out institutions and believe we're going to do it, and they act accordingly." To eliminate the moral hazard this creates, he added, "we need a realistic alternative to bailing out institutions. That's why the Fed has endorsed the establishment of a new federal resolution regime for systemically important financial firms as an alternative to bailouts and to what we view as a disorderly bankruptcy option. There must be a real prospect with this new regime that shareholders and creditors will accept losses."

In what was probably music to Commissioner Sevigny's ears, Alvarez remarked that any new resolution authority "has to account for the fact that some types of financial firms already are subject to special resolution frameworks. That includes FDIC-insured depository institutions, insurance companies, and security broker dealers at a minimum." The key to success for a new resolution authority, he said, would be coordination between the federal entity and the primary regulator of the failing company.

In a freewheeling question and answer session, Alvarez addressed topics such as the commercial real estate problem—"I say a little prayer every night that it isn't as big as the residential problem was," he said—and how the current insurance guaranty system would work with a federal resolution mechanism. In response to a question about the failure of a holding company with insurance subsidiaries, Alvarez said that "the new federal regime would not reach into the regulated insurance company—the insurance company would continue to be resolved under the insurance scheme with the priorities that would apply under state law."

Alvarez also touched on how a federal resolution authority might be funded (there's been no decision on whether assessments would be made before or after a systemically significant failure) and whether payments to other resolution funds—such as guaranty association assessments—might be factored into a

Difficult Choices, Difficult Times

Outgoing NOLHGA Chair Chris Kelly began his address at the 2009 Annual Meeting by praising the passion and dedication of the members of the guaranty community. "Our administrators and state board members demonstrate a day-in, day-out commitment to their work that is truly remarkable," he said, adding that he hopes that commitment can be passed on to the next generation of guaranty system leaders.

"I do wonder about that next generation—whether we're doing enough to groom our new leaders," Kelly said. In noting that a good portion of the "institutional knowledge" in the room might be leaving the system for retirement in the coming years, he encouraged attendees to "give some thought to how we can best preserve all the know-how we have in this system."

Kelly then turned to an issue he cited in his 2008 address—"I'm becoming sort of a one-issue drummer when it comes to system uniformity," he joked—warning that "our relevance and even survival as a system is at stake" if the associations don't act to make their various statutes more uniform. "We need to demonstrate to the industry, Congress, and anyone else who's watching that we're moving to eliminate these gaps and become a truly national system, a truly national safety net," he said.

Incoming Chair Steve Lobell also discussed survival—of an insurance company. Lobell explained the guiding principles of his company, the challenges it faced during the economic crisis, and how his work with NOLHGA has helped him become a better CEO.

"The first thing we tell people at any level is that they have to tell the truth in all circumstances," Lobell said. "We want folks who aren't afraid to tell their boss he or she is wrong. Nobody has all the answers, and we welcome input from above or below." The company also stresses the dangers of excessive greed and the importance of taking a long-term perspective. "We're willing to lose a lot of little skirmishes to keep from losing the war," Lobell explained.

"Those three ideas have kept us in business for 100 years and helped us avoid being the subject of one of your task forces," Lobell said. The principles also helped guide the company through the recent economic crisis.

Lobell believes the guaranty system and the insurance industry can benefit from each other's teachings. "For me, every insolvency you administer is a casebook study about a mistake to avoid," he said, adding that the principles that keep a company on solid financial ground can be applicable to the guaranty system as well. "I hope gaining a little insight into companies that aren't clients of the guaranty system—knock on wood—may help you do your job better."

company's payments to the federal authority. "If you're paying into another fund that's going to be contributing to solving the problem, should you get some credit for that in assessments?" he said. "That's something the insurance industry should feel free to raise, because it hasn't been considered so far."

Resolving failed companies—and the risks inherent in doing so—was also on the mind of Karen Shaw Petrou, Managing Partner with Federal Financial Analytics. According to Petrou, the many bank failures of the past two years contain lessons for the insurance industry and guaranty system. "In the banking sector, we've really seen how quickly risk metastasizes and can go from systemic risk challenges to mom and pop institutions," she said. "One of the lessons I draw from the banking crisis is how quickly people spook, whether they're counterparties at the giant financial institutions involved in complex financial instruments they thought they understood but didn't, or whether it's average depositors."

If panic can set in even with FDIC protection—a system most people understand and have great faith in—what sort of panic might set in among annuity holders unfamiliar with guaranty association coverage? "I think it's very important to think about resolution, not just in the systemic risk context but also in the day-to-day one," Petrou said. "Because a panic, let alone one where there were losses, would challenge the fundamental strategy of a life insurance industry where people simply don't think about their annuities or their life insurance coverage. That kind of a shock to the system would be a significant strategic risk not just to the state guarantee and the regulatory structure, but I think also to the industry."

Petrou went on to speak of other risks facing the insurance industry, including the increasingly complex structure of finan-

Spies Like Us

The reception at the International Spy Museum was one of the highlights of NOLHGA's 2009 Annual Meeting.

Stephanie Guethlein McElroy

cial services institutions. "We need to think very hard about inter-affiliate transactions, domestic and offshore, the branch versus substructure—about barriers between inter-affiliate transactions and how we wall off insured entities," she said. "The insurance regulatory structure has never expected the kind of holding company framework that bank regulation to some degree has anticipated, and therefore, I think the inter-affiliated risks are if anything even more grave."

As the FDIC struggles with these and other issues, Petrou said, "I would strongly recommend thinking about what they're doing, looking at how they're handling the crisis and the lessons they're learning the hard way, even at some small institutions, because I think you will see those going forward in the insurance sector both in the systemic risk framework that Treasury is trying to craft and in the more day-to-day ones that you encounter."

Petrou also issued a warning about the guaranty system's ability to cope with today's complex economic environment: "Your guaranty agency approach is really designed for a calmer day," she explained. "The expectation is that failures will be relatively contained one-off situations and that market panic will not ensue from them, permitting orderly resolutions. But the complexity embedded even in the most seemingly simple institutions has made that far more difficult." She voiced her support for the concept of organizational "living wills—forcing institutions to think bad thoughts about themselves and make them tell you as the regulator how they could be unwound."

Petrou did offer some encouraging news to attendees—this is the perfect time to be tackling these issues. "The good news is that right now we are in the eye of the storm—it's calm, firms are somewhat humbled, and markets are cautious," she explained. "This is a great time to think hard thoughts about disciplinary actions, prudent regulation, and orderly resolutions. This is a great opportunity to do things many of you have wanted to do in the regulatory and resolution regime for years, knowing the risks that were being run and finding it very difficult for anyone else to take them seriously. Trust me, people know this is serious."

Economic & Insolvency Outlook

Stephanie Guethlein McElroy, Manager of Rating Criteria and Rating Relations for A.M. Best, detailed just how serious the situation has been for the insurance industry since the economic crisis began. A.M. Best placed a negative rating outlook on the industry in September 2008, and the outlook remains negative. "We still expect rising credit defaults that will impact life insurers' balance sheets," McElroy said. "We still expect asset impairments. Credit spreads have tightened, but insurers still have significant unrealized losses on their balance sheets. And we maintain that there is still uncertainty in the macro-economic fundamentals."

With these trends working against the industry, McElroy added, "we think there may be additional impairments in the industry, particularly as companies realize that their capital structure cannot support the business they have. Whether that is dealt with through being acquired by a larger entity or selling a block of business, we don't know. But we do expect that impairments may occur, particularly as liquidity remains tight."

McElroy explained that this recession has been harder on life and health insurance companies than their brethren on the property and casualty side. "Life insurers in general have felt the turmoil of this recession more than property and casualty insurers because the life insurance industry is more highly correlated to the equity markets, and because the asset side of the insurers' balance sheet is certainly more focused on invested assets as well as fees earned on invested assets under management," she said. "So we have been hit significantly."

As with any challenging period, there are opportunities for companies that can take advantage of them. McElroy cited retirement income products—"Social Security cannot be fully funded for those of us sitting in this room," she said, to no one's delight—longevity products, and a resurgence in simpler products such as basic whole life. "Going forward, we'd like to see a focus on preserving capital and maintaining liquidity," she added.

More encouraging news was provided by Bob Baur, Chief Global Economist for Principal Global Investors, who also spoke at the 2008 Annual Meeting. After detailing the causes of the global economic crisis (no good news there), Baur informed attendees that his company believes the United States is "building the foundation for a sustainable recovery." This view is based on the belief that the auto and housing industries will stop being large drains on the economy, the anticipation of a significant increase in production—after a huge inventory liquidation, "business has to ramp up production, because Old Mother Hubbard's cupboard is just about bare," he said—and the expectation that the deterioration in the labor market is winding down (in part due to the expected increase in production).

Baur cautioned that the economy is not out of the woods yet. There's a danger that "businesses may not find an incentive to expand" due to concerns about higher taxes and heightened regulation. It's also possible that consumer spending, needed to drive the recovery, may stay depressed. And finally, there's the threat of a major policy mistake. "The Federal Reserve has created an enormous amount of liquidity, so at some point they've got to mop it up," Baur explained. "If they do it too fast, they could hurt or hinder this nascent recovery that we have. If they do it too slowly, we could have inflation or another credit boom or asset bubble."

Despite these threats, Baur was optimistic about the future, but he also forecasted significant changes. "We've got to rebalance this unbalanced global economy," he said. "In other words, in the United States, we need consumer spending to probably not grow as fast as we've been used to in the last 20 years or so. It means that the savings rate may have to continue to rise a little more. But we think that can happen with a positive but still sluggish economic growth."

Commissioner Roger Sevigny

Baur also predicted a U.S. economy driven more by exports—high-tech products as well as services. "Services are a fast-growing part of our exports," he explained. "It means lawyers, accountants, architects going aboard who work for U.S. companies—those are exports of ours. It means software engineers and supply chain management from people in the U.S. going aboard, but it also means medical devices, pharmaceuticals, and even agricultural products."

In closing, Baur stressed that "we think there can be a sustainable recovery as we move forward. It's a delicate piece and we don't know for sure, but we think the things we see today give us some hope." ✯

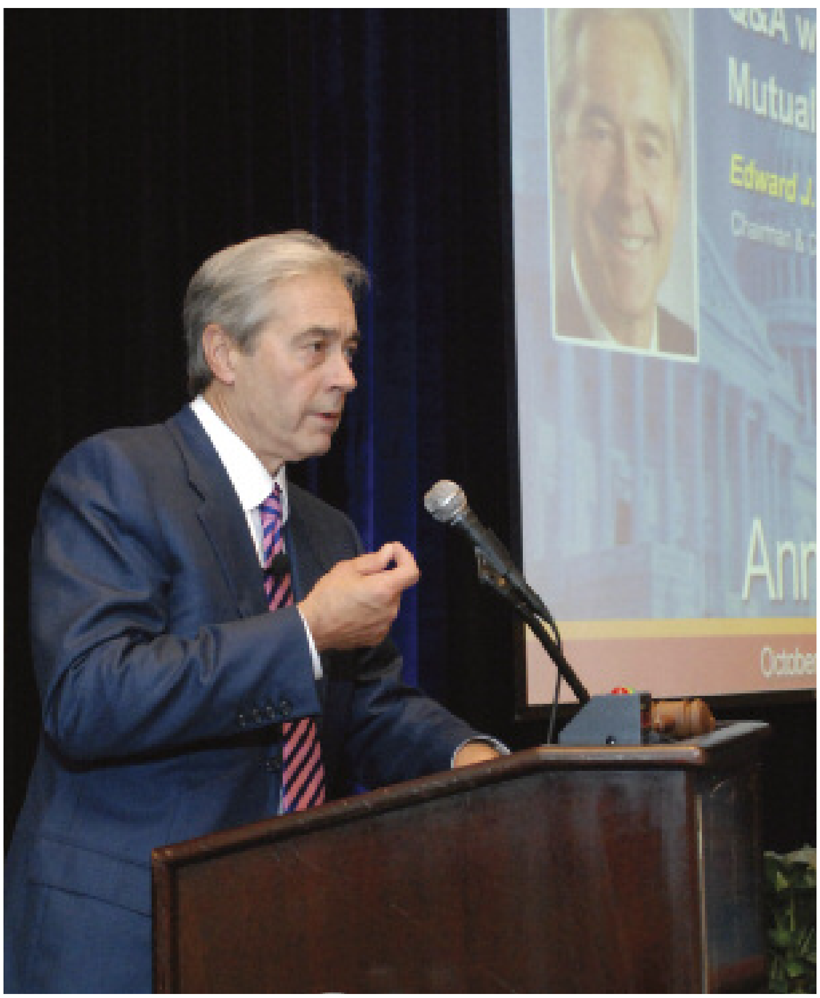
Sean M. McKenna is NOLHGA's Director of Communications.
All photos by Kenneth L. Bullock.

[“Ed Zore” continues from page 1]

people started to see that maybe there is a bottom to this thing. Then all of a sudden the stock market started to come up.

This period we’ve been in, probably starting in the mid-1990s on, was fueled by a lot of cheap credit and available leverage. I mean, anybody could get a house with almost no money down. Anybody could borrow money for almost anything. And this created a huge problem of excess leverage in the financial system and in the household sector and the corporate sector—probably not as much in manufacturing. But this all has to be undone, and that doesn’t happen overnight.

Back in the old days when the government would grease the skids with easy credit, people would go out and be able to find a loan, take more money out of their credit cards, find money to buy a house, or get easy credit from the banks. But the banks aren’t lending now—they’re still licking their wounds. Consumers don’t have the ability to borrow. I think a lot of them don’t want to borrow anymore, so you don’t have that artificial prop to get things going, and that’s why this thing’s gone down and is kind of coming up right now. But it might be that it comes up and then we chug along for a while at slow growth. That would be my best guess.



Gallanis: **What are your thoughts on what this period has taught us about the life industry and the way it is regulated?**

Zore: Other than AIG and some of the monoline companies, the life insurance industry wasn’t as leveraged and wasn’t as concentrated in bad assets or goofy stuff as the rest of the financial services sector. So our ability to survive was much higher. I think part of that is due to the regulatory environment—the fact that we have robust risk-based capital metrics from the regulatory side. We had limits on what we could invest in as institutions. I think those were all positive influences. Also, as a group insurers tend to be a little more conservative than some of the bankers who refashion themselves as investment bankers or “Wall Street types.” So I think it was a confluence of things that helped the insurance industry.

But I remember a common thing when the subprime mess first surfaced. The industry wasn’t overexposed to subprime; our company had very little. We tried to avoid it. And I don’t know of any company in our industry that was overexposed to subprime. There’s a lot of other stuff out there that’s causing problems, but not subprime—we didn’t follow that siren. It was, I think, the more intelligent investment management course.

Gallanis: **How would you describe the biggest problems that *did* emerge in life company portfolios? And are there big problems that have not yet emerged?**

Zore: We have a pretty diversified portfolio, so the usual things that you’re going to lose money on, you lose money on. If you have common stocks and the stock market goes down, you’re going to lose money on common stocks. You’re going to lose money on private equities because they kind of follow the stock market. But the big problem was the stuff concocted by the Wall Street wizards—the CDO squares, the CDOs, commercial mortgage-backed securities.

For example, we are a major lender in commercial real estate and a major investor in commercial real estate. We have been for about 150 years, so we know our way around. We have certain metrics that we use that have been time-tested, and we found ourselves in a situation where we couldn't compete with Wall Street. Nobody would borrow money from us because they could get it a lot cheaper and on a lot better terms from Wall Street. Well, that stuff was just packaged by Wall Street—they sliced and diced the stuff and then sold it back out there. That was the marketplace, and those are the kinds of things now that are surprising people. Not the run-of-the-mill investments where you understand what's going on, but stuff where you really have to peek underneath the covers and say, "What's really in this thing?"

Gallanis: **If you talk to people in this town, particularly people on the congressional staffs, it's almost conventional wisdom that there is a remaining problem that we've hardly begun to see ripen yet with investments in commercial real estate. Is commercial real estate a bubble that has yet to pop?**

Zore: Yes and no. I was at the Financial Services Roundtable meeting here in Washington a few weeks ago, and the federal regulators who spoke to us didn't think commercial real estate would be anywhere near the problem of residential because they didn't think there was the fraud or the really goofy stuff going on in commercial real estate. Having said that, every building has tenants that pay rent. And every time one of those tenants goes out of business and stops paying rent, that reduces the cash flow in the building. At some point, if it's got a mortgage against it, the mortgage is going to have a problem. But that doesn't mean that it goes down to zero. It just means it has to be adjusted. So the problem in commercial mortgages is out there, but I do not think it is as big a problem as some people fear.

Gallanis: **Let's flip to the liability side of the balance sheet. We've heard about exposure to equity-related guarantees that some companies were heavily into on their variable annuity products. Are we mostly past those types of worries, or are there other types of worries that might yet emerge on the liability side of the balance sheets of some major players in the life industry?**

There's nobody in
Washington
who knows a thing about us.

Zore: I think the major concerns about guarantees that were deep in the money related to the decline in the stock market—the options that were deep in the money and weren't hedged. I think those concerns have somewhat subsided. But I will tell you that back in March, I referred to this at an ACLI board meeting, that most people in the industry were really, really concerned.

A lot of these guarantees weren't hedged appropriately because this was a tail event and none of the models ever suggested this would happen. And people were scratching their heads and saying, "What's going on?" I think to some extent the industry has been able to recalibrate some of the hedges on some of these guarantees. You can't get rid of them. But a lot of companies aren't offering some of these guarantees in their products any more.

The other thing that's happened is that the industry itself has been very aggressive in getting more capital. Every major company has gone out to the marketplace because the marketplace is open right now, and they're tried to recapitalize to build up their capital base, which mitigates some of the risk they had in the capital exposure based on the guarantees.

Gallanis: **Some people have been asserting for some time that this financial crisis—and particularly the federal bailout of AIG—proves that the federal government needs to become involved in the regulation of insurance companies. Is that the proper lesson to draw from the AIG side of the crisis?**

Zore: I think somebody in Washington has to be aware of what's going on in the insurance industry. Because in addition to AIG, but not as visible, were the monoline insurers. You had MBIA and AMBAC, which guaranteed a whole lot of other stuff out there that was in bank portfolios, and there was a huge concern about them bringing down the system if they went

When I look at the problems we have in our society, at the disconnect between what people need for financial security and what they're doing for themselves—I think we're in just a wonderful position.

I think the industry has a solution to a lot of the problems.

belly up back in late 2008. They were under the radar—nobody even knew they were out there or what they did. And all of a sudden, poof, here they are. And a lot of the paper that was out there in the marketplace was guaranteed by these folks.

So you had AIG and the monolines, but what's really important to focus on is that you have an industry that's got five and a half trillion dollars of assets and liabilities—just the life insurance industry, not property and casualty—and there's nobody in Washington who knows a thing about us. So they can concoct regulations. They can concoct tax laws, and there's nobody to say, "If you do that, it's going to hurt the industry." Some groups try to, but there's nobody sitting at the table in the Oval Office.

Back in March—I don't know if you remember the Bridgewater Report. It basically illustrated a doom scenario for the insurance industry— assets going down, liabilities blowing up, all the options that they had in the contracts were in the money. And it said NOLHGA and the guaranty associations didn't have enough money to bail them out. That was the scenario that was out there.

A couple of people in the industry said, "My God, what if this is right? What are we going to do?" Remember, the banks had the Federal Reserve and the Treasury—they were getting TARP money. Some folks in the insurance industry wanted to participate. Ben Bernanke said, "We don't know how we can get money to the insurance industry because we don't have any leverage here in Washington." So I was with a small group in late March that went to the White House. We met with Larry Summers and basically said, "You have an industry with five and a half trillion dollars in assets, and nobody in Washington knows anything about it. Nobody's looking over our shoulder, and you've got two problems. Number one, you have some companies that, if things don't get better, are going to be on the ropes. And number two, you have guaranty associations that might not have enough money. So how can we have some help here?" That happened behind the scenes.

Gallanis: We're hearing a lot about systemic risk and ways in which it might be appropriate for the federal government to monitor and regulate it. Is there an unmet need in that area?

Zore: Systemic risk is where one entity or a group of entities with the same exposure could bring down the whole system. And I think you do need to regulate that. They bailed out AIG because if it had gone down, all the counterparties that were on the other side of the derivative transactions that AIG had would have gone with it. Lehman Brothers, it turned out, was a systemic issue. And after they let Lehman Brothers go, they realized, "We've got to fix this thing fast," and that's why they bailed out AIG. They thought Bear Stearns was systemic, so they forced the merger. Merrill Lynch probably would have been systemic; you can go right down the list.

So I think we need somebody to be aware of who and what is going on that is important to the whole system. Northwestern Mutual is a big company. If we went down, our policy owners would feel the pain, but I don't think we'd take anybody else down with us. But there are other companies out there that would, and those are the ones that folks have to be concerned about. Frankly, in the insurance industry, we scratch our heads and say, "Who's systemic here?" We know AIG is, but we don't know if anybody else is and we don't know what the definition of systemic will be. One of the worries is that everybody will get swept into the systemic pool when they really aren't systemic.

Gallanis: The Obama Administration, starting with the President himself, has been saying consistently for some period of time that we need federal

legislation to provide resolution authority powers to the FDIC as an alternative to either traditional bankruptcy or the bailout of what might otherwise be called a "too big to fail" financial institution. Do we need that kind of legislation?

Zore: I think we have to have some uniformity. Bear Stearns folded up, Merrill Lynch had a shotgun wedding, Lehman Brothers was let go, and Fannie Mae and Freddie Mac were treated differently. Then AIG. You do have to have somebody who can control how these events are straightened out.

Gallanis: **The conventional wisdom is that a big part of what went wrong over the course of the last two years is that rating agencies decided to get into some new profit centers by rating structured vehicles. They didn't do a very good job of it. Innocent bystanders excessively relied on what was said by the rating agencies, and that led us all to wrack and ruin. In your opinion, have the rating agencies messed up as badly as conventional wisdom would have it? Or might there have been at least a little bit of user error as well?**

Zore: We deal with all of them—A.M. Best, Standard & Poor's, Moody's, and Fitch—and they all come at it a different way. But as long as they come in and try to understand what it is we do, why we're different than Prudential, what makes us tick, then I think it's fine. Where I see rating agencies get in trouble is when they have some model, and they try to put stuff into a model and they say this model fits everybody. And they had that model with all the subprime stuff and all the CDOs and all the CBOs.

And they said, real estate prices never go down. So our models are going to assume that we're going to have defaults, but there won't be much in the loss in real estate. They went back the last 30 years, but they didn't go back to the 1800s. And that's the major problem when they have models. And we've seen this a lot of times when rating agencies come in and they have a new model on something, and they try to put everybody into this model—it just doesn't work real well. So you've got to use your head and your gut on these things. And I think that's where they really failed. They trusted their models. If you just trust a bunch of models that you put together based on historical statistics, I think you have a problem. You have to add some other intellectual capital to that.

Gallanis: **Are there any long-term lessons about insurance company product offerings that the industry should take away from the experience of the last couple of years?**

Zore: Yeah, try to keep it simple. At Northwestern Mutual we have a unique model and we are blessed because we only sell our products through our own dedicated field force. They understand what it is we do and how we do it and why we do it. They might take some issue with the fact that we're not on the leading edge or we don't do all these things that some of the other companies do. But we don't have to buy shelf space. We already have shelf space. All we have to do is make sure that our representatives go out and meet people and deliver the right product.

I think what's happened in the industry is that more and more companies have gone to brokerage models and have to get shelf space to sell their products. They have to have the latest gimmick. They have to have the latest option. They have to have the lowest price. There's a whole combination of things to make the product attractive, so that people pick that product as opposed to another product. And I think that's where the industry has got to watch out. Because you have to make sure you don't go down to the lowest common denominator in competition.

Gallanis: **A few years ago, a lot of people in the financial and trade press were saying that whole life policies and mutual life insurance companies were really relics of a bygone era.**

Zore: Five years ago, I was at a conference where they had a stock analyst, a portfolio manager, an investment banker, and some other person on a panel. They all specialized in insurance companies. The argument there was that any company with a triple A rating or anything above a single A was wasting capital because they weren't maximizing the efficiency of capital, and they had way too many excess reserves. Obviously, that was wrong.

I do think the mutual industry has been able to focus more on long-term financial health and less on short-term earnings. In fact, at our company, we don't pay much attention to short-term earnings. And the return on capital is to make sure we have enough capital to be around.

In our industry, I think we'll see a change. How much do we need in reserves to make sure we can pay our bills? And let's make sure that we have the right amount of capital. The agenda is changing. And it's going to be changed for a while.

I don't have a problem with stock models. But I do think you can't be accountable to 30-year-old analysts on Wall Street who think your rate of return ought to be the same as Goldman Sachs's. I just think that's unreasonable, and I think you have to frame it a little differently.

Gallanis: **As head of one of our largest life insurance companies, you are also one of the heaviest payers of assessments to the guaranty system. Are there any observations you'd like to make for those of us who work in the guaranty system about how we could better serve the life industry's consumers?**

Zore: It's pretty hard to advertise that you have a guaranty system. But going back to those really dark days earlier this year, the banks had FDIC insurance coverage. And in fact, they raised the coverage to $250,000. For the insurance industry, there was this mystery about what's backing us up. That was an issue, and the concern was that somebody would yell "fire" and there would be a run for the exits. And in a constrained liquidity market, that would create some problems.

I don't know how to fix that. We know that we're doing a good job. We know that unless everybody goes down, we have the wherewithal to support the guarantees on the liability side. But I'm not sure the general public understands that.

Gallanis: **I think they know it a little bit better than they did six or eight months ago. One other thing that has received a lot of attention recently in terms of marketplace developments is the explosion in the secondary market for life contracts, particularly for securitized stranger-originated life insurance. What implications do you see from the secondary market?**

Zore: It's bad for the industry. When the insurance products that we deliver to provide financial security death protection to the beneficiaries of people become financial instruments used by hedge funds, we've got an issue. I think there's a moral issue and a regulatory issue. If I'm a tax writer in Congress and I see that a lot of insurance company products end up in the portfolios of hedge funds, I'm going to think, "What's so special about insurance?" So it's something we've got to try to fix.

I can see there's a need for viaticals. I can see if somebody has been paying into a policy for years and years, and suddenly their circumstances change, there should be an option. In our company, if you have cash value, nobody is going to give you a better deal than our cash value. So I'm not worried about it. But the ones that bother me the most are when you can take out a policy on somebody and it's immediately in the money, which means you immediately have a positive expected rate of return because of high lapse assumptions, high investment assumptions, mortality assumptions that aren't realistic, or table shaving. That's where a lot of this business comes from. You know, they'll use a 75-year-old who's just a convenient medium to acquire a life insurance policy that's going to guarantee a 12% rate of return because of those four factors in some combination, pay the premium for a couple of years, and then they'll flip them to a hedge fund. That bothers me.

Gallanis: **Finally, as you look back at the things you've done with your company and in this industry, what causes you to say, "That really makes me proud?"**

Zore: I think the industry has evolved. It used to be a sleepy industry. I think our company used to be regarded as a real stable company, but kind of sleepy. We've evolved our business model, and we continue to build it out during my tenure. We're not just an insurance company anymore; we're a financial security company. We realize if we're going to take care of the needs of our clients, we've got to sell them the right product—not just sell them a product that we happen to manufacture and want to have a high margin in. So we've changed our business model to encompass more products, but the focus and the strategy are the same. Let's make sure we deliver the right solution to people for the right reasons.

I think the industry has evolved to providing more comprehensive financial security products to our constituents. And when I look at the problems we have in our society, at the disconnect between what people need for financial security and what they're doing for themselves—I think we're in just a wonderful position. I think the industry has a solution to a lot of the problems. You know, somehow we just have to make the connection to make sure that people understand and that they participate. We've gone from a society where for a few years we had a negative savings rate to a society that probably has to save 8%. We are part of that solution, and I think that's really a good thing for the industry. ✯

["Regulatory Reform" continues from page 3]

that a bill was unlikely to emerge from the committee before mid-February. Now, however, with the administration changing course by proposing the Volcker Rule concept, Senate Banking Committee members suggest that the timeline for a Senate bill could extend into the summer.

Which leaves us, in a nutshell, with this: A House bill has been passed that tracks many (though not all) of the administration's original proposals; a rather different Senate bill is in development, but at least some weeks from completion; and the administration has now reconsidered some important elements of what it wishes to see included in a final regulatory reform bill.

The Potential Elements of Financial Regulatory Reform

Absent major additional proposals to change the regulatory reform agenda, the following items are among the most critical elements, from an insurance sector perspective, of the congressional regulatory reform debate; some of these items appear settled, others much less so.

First, it seems certain that the final legislation will establish a Federal Insurance Office in the Department of Treasury. The primary powers of the Office will be to gather information about the insurance sector, though some hope (and others fear) that the Office will be a "beachhead" from which federal regulatory efforts will later expand.

Second, much of the focus of the regulatory reform effort has been on the problem of financial entities described as "too big to fail" (TBTF) companies. Think AIG. Both the House bill and Senate efforts have addressed the TBTF issue in several different ways. Both chambers appear inclined to vest in some federal agency or council responsibility for monitoring and regulating the largest financial companies (including insurance holding companies) for potential risks to the national financial system ("systemic risks"). In the event a company is failing in a way that threatens the financial system, both chambers would establish a special process for the resolution or dissolution of such a company.

The House version would vest in the FDIC (and in the case of securities broker-dealers, the SEC) the power to resolve or dissolve such companies, and would create a pre-funded "war chest" of up to $200 billion to cover resolution costs (presumably meaning, to pay claims of counterparties and other creditors). That amount would be funded by assessments levied on specified financial companies, including some of the larger insurers.

By contrast, the Senate version of the legislation apparently will contemplate a specialized bankruptcy dissolution procedure for systemically risky companies, but there likely will be no pre-funded war chest to use for paying counterparties. Instead, any such resolution costs would be funded (as insurance guaranty associations are today) on the basis of post-insolvency assessments.

As passed, the House bill is not intended to interfere with the operation of current state insurer insolvency processes and guaranty system operation. By all reports, the Senate version is likely to be in accord.

Other elements of the regulatory reform proposals are less directly related to the insurance sector, but are important both as public policy issues and for their impact on the legislative process for the overall financial regulatory reform package.

For example, the administration has long touted as a primary objective of regulatory reform the establishment of an independent consumer financial products regulatory agency. The House bill would establish such an entity (with narrower scope and powers than originally proposed by the administration), but whether the Senate will concur is still in doubt.

Almost certainly, the Senate will agree with the House to tighten up regulation of derivative trading and to force many derivative trades onto a public exchange and otherwise increase such trading's transparency, at least to regulators.

In addition, banking supervision will be consolidated to some degree: The OTS would be eliminat-

There appears to be no political downside to bashing bankers' bonuses.

ed under the original administration blueprint and the House bill, although Chairman Dodd has proposed consolidation of all banking regulation into a single agency. The politics of congressional supervision of bank regulation (if nothing else) makes the Dodd proposal a "heavy lift" for the final bill.

Finally, the role of the Federal Reserve itself is deeply at issue on Capitol Hill. While the administration proposed that the Fed should be responsible for monitoring and policing systemic risks, the House watered down the Fed's powers in that regard and assigned some of the responsibility for systemic risk regulation to other financial regulators acting by committee. The Senate appears inclined not only to reject the Fed as a systemic risk regulator, but also to strip it of some of its current bank regulatory authority.

In fact, as of late January, even the Senate confirmation of Chairman Bernanke for a second term appeared in some doubt. While many agree he responded well to the crises of 2008, critics contend that the Fed made mistakes in monetary policy and bank supervision in earlier years that contributed to the crisis. Doubtless concerned about the impact on financial markets of a confirmation failure, the administration and Senate supporters of Chairman Bernanke redoubled efforts to secure his confirmation.

Where from Here?

Where the financial regulatory reform effort goes from here will be determined by several major factors. The first, as noted above, is the course to be chosen by the administration and congressional leadership on health-care reform efforts. Beyond that, developments in the economy will have some effect: If financial markets continue to improve as they have since March 2009, and if the real economy recovers to the point where unemployment statistics improve, some of the pressure for regulatory reform will diminish.

Finally, political considerations now are beginning to affect the regulatory reform debate more than has been the case over the past year. If focus on regulatory reform devolves to the level of campaign sloganeering, the type of gridlock that developed in the health-care reform debate is not impossible. If, on the other hand, the regulatory reform debate remains informed, objective, and bipartisan (as much of it has been to date), a bill could still pass before summer. ✩

Peter G. Gallanis is President of NOLHGA.

End Note

1. The House passed its version of regulatory reform, H.R. 4173 ("The Wall Street Reform and Consumer Protection Act of 2009"), on December 11, 2009; in the normal course, differences between the House version and any bill passed by the Senate would be resolved in a conference committee.

NOLHGA Calendar of Events

2010

March 26–29	NAIC Spring National Meeting Denver, Colorado
April 13–15	**MPC Meeting & Education Day Albuquerque, New Mexico**
July 13–14	**MPC Meeting New York, New York**
July 15–16	**NOLHGA's 18th Legal Seminar New York, New York**
August 14–17	NAIC Summer National Meeting Seattle, Washington
October 4	**MPC Meeting Seattle, Washington**
October 5–6	**NOLHGA's 27th Annual Meeting Seattle, Washington**
October 17–19	ACLI Annual Conference Baltimore, Maryland
October 18–21	NAIC Fall National Meeting Orlando, Florida

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