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Ask Again Later

Attendees of NOLHGA's 2017 Legal Seminar learned that the future—of healthcare, LTC, regulation, or tax reform—is hard to predict

By Sean M. McKenna

The theme of NOLHGA's 2017 Legal Seminar was *The Path Forward in a Change Environment*. Change can be scary, especially if you're standing in front of an audience that expects you to know where it's heading. Many presenters at the Seminar found themselves in that boat—trying to predict where Congress and the White House might take the country on health insurance reform or tax reform, for instance, in what can charitably be called uncertain times. One presenter summed the mood up perfectly, saying, "we've told our clients that we're just coming up with new ways to say, 'I don't know.'"

Which is not to say that the Seminar, which brought more than 200 people to Chicago in July, was simply an exercise in shrugged shoulders and deep-dish pizza. As usual for the Legal Seminar, panels of experts gave attendees penetrating insights into some of the main issues facing the guaranty system and insurance industry. It's just that for many of those issues, concrete answers were hard to come by.

Regulatory Realities

The Seminar got off to a one-two-three punch with three presentations addressing regulatory modernization. In *The State Insurance Regulatory System on the Move: 2017 & Beyond*, moderator Pat Hughes (Faegre Baker Daniels), Ted Nickel (NAIC President and Wisconsin Insurance Commissioner), and Kristine Maurer (New Jersey Department of Banking and Insurance) discussed some of the main issues facing state regulators. Commissioner Nickel said that the NAIC was engaging in a strategic planning project to "figure out where we are and where we need to be in 5 to 10 years." He added that "our use of innovation and technology is really going to drive our relationships with companies."

Commissioner Nickel listed several other issues the NAIC is tracking, including the ongoing rollercoaster-like debate concerning repealing or replacing the Affordable Care Act ("the lack of predictability is causing a lot of problems for companies"), the low-interest-rate environment and the threat that companies might over-reach for yield, and troubles in the long-term-care (LTC) market.

Maurer also cited the LTC market, noting that the NAIC's Receivership Model Law Working Group is analyzing realignment of the assessment base for LTC products and whether to include HMOs as member companies in the guaranty system. "There's been notable support by a consensus group of health and life insurers for those paths," she said. Maurer also discussed state regulators' work on macro-prudential regulation and group-wide supervision, saying that New Jersey has a unique perspective as the state group-wide supervisor of Prudential Financial, its domestic internationally active insurance group (IAIG).

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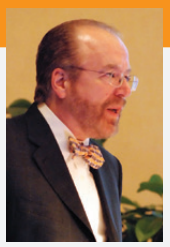

Critical Thinking in Action—Problem Insurer Resolutions

Regular readers of this column—both of them—may wonder why I devoted most of the last issue's installment to a seemingly abstract concept: the elements of critical thinking (or, more simply put, effective problem-solving). I described that approach as involving three major steps: defining and understanding the problem to be solved; analyzing the important component considerations; and using those component considerations to synthesize and articulate an effective solution.

To dispel any misconceptions, an effective critical thinker is what I'd *like* to be, not what I think I am. But to be something better than what we are now, we need goals, inspirations, and models, along with real-world illustrations of how we can get from good to great.

Today's column is not only about the real world—it's about *our* real world: The realm of troubled insurance companies, and how regulators, receivers, and the guaranty system most effectively go about the business of addressing our real-world problems.

Defining and Understanding the Problem. The "problem" of troubled insurers looks a bit different when seen from the differing perspectives of regulators, receivers, and the guaranty system, but a broad goal is shared by all of them: Preventing or mitigating adverse consequences of an insurer failure to the stakeholders (especially policyholders and policy beneficiaries) who depend upon the full and timely performance of the insurer's promises.

To a financial regulator, that means regulating for solvency, with the goal of preventing avoidable insurer failures. To a receiver, that means finding a resolution pathway—timely intervention to stop a bad situation from worsening; developing strategies for rehabilitation (and possible recovery); and making an effective plan for liquidation, where liquidation is unavoidable and the "least bad" outcome for stakeholders. For guaranty associations, that means finding an efficient and cost-effective way of delivering to covered policyholders the statutory promise of "safety net" protection.

From all three perspectives, some core component considerations are critically important.

Analyzing Important Component Considerations. Our grandparents told us that pictures can say more than words, and that's often true. The considerations most important in mitigating the adverse consequences of an insurer's failure lend themselves well to graphic presentation.

For the concept behind the graphics here, I am indebted to a true critical thinker, former MetLife General Counsel Nick Latrenta, who was a key thought leader behind the resolution plan for the ELNY insolvency (along with Ted Mathas and George Nichols at New York Life, John Strangfeld and Susan Blount at Prudential, former MetLife CEO Rob Henrikson, and ACLI President Dirk Kempthorne, working with a NOLHGA Task Force ably chaired by Jack Falkenbach). I use the ELNY example here not because it is a typical life/health resolution case, but rather because (as explained below) it was particularly *atypical*, requiring true creativity in developing an optimal response. The core analytical components are present, however, in most insolvency cases.

Nick's analytical approach was to illustrate the problem graphically, and then to use graphics to conceptualize the components of a resolution plan. The task force and its working group (including counsel Kevin Griffith and Caryn Glawe at Faegre Baker Daniels and actuary Jack Gibson at Willis Towers Watson) came to refer to these illustrations as Nick's "Picasso mosaic."

The most significant challenges in the ELNY resolution involved an extraordinarily low ratio of assets in the "estate" of the insurer, compared to the liabilities at the preferred, policy level of asset-distribution priority in liquidation (sometimes called the "liquidation ratio"). The low liquidation ratio was exacerbated by the relatively high number of ELNY's high-value annuities issued to fund "structured settlements" (SSAs) of disputes such as tort claims. Many of ELNY's SSAs had values well above guaranty association statutory benefit levels, and they were the principal sources of income for many severely disabled payees and their dependents or caretakers.

In most failures involving nationally significant life and annuity issuers, assets of the failed insurer are sufficient to cover 85% to 95% of policy-level liabilities—meaning that, even for policyholder contractual entitlements above guaranty association benefit levels, payments can be made on those "excess claims" at a level of 85 to 95 cents on the dollar. (In most such insolvencies, it is also the case that only a relatively small number of policy-level claims would exceed guaranty association coverage levels.)

Viewed one way, the outcome-mitigation challenge of ELNY was fundamentally similar to challenges posed by any insurer failure, and illustrations from other cases may be used to illustrate that point in future columns. The special challenge of ELNY was to find extraordinary ways to diminish the impact of the insurer estate's low liquidation ratio on payees with high-value claims.

Visualizing the Essential Component Considerations. The ELNY experience and Nick Latrenta's analytical approach have confirmed my own experience of nearly 30 years working in this field and my direct experience with a few hundred insolvency cases. Whether approaching the challenge from the perspective of a regulator, a receiver, or the guaranty system, the first and most essential question is, "what are the liabilities to the policyholders?"

That question sounds simple, especially to those more familiar with the banking industry than the insurance world. Unlike deposit accounts at banks, which are relatively simple to value at any time, the value (upon liquidation) of insurance contractual obligations may depend in some important respects on abstract concepts like future investment and reinvestment earnings; mortality rates; for some contracts, morbidity rates; for some contracts, future premiums that may be collected or changed; and the unavoidable and somewhat unpredictable costs of administering complex claims and policies issued on multiple forms in many states. All those factors are hard to quantify, but good actuaries can do the job, and we try to engage the best, given the overwhelming importance of getting the best possible understanding of this bundle of complex liability valuation issues.[1]

Thus, the first consideration in addressing the ELNY challenges, as in any troubled insurer situation: *In the beginning are the liabilities* (see Figure 1).

Predictably, the next key question is, "what assets of the insurer are reasonably expected to be available to pay the contractual liabilities as they come due?" As with liability valuation, valuation of assets can pose challenges, but this is often a simpler exercise than valuing complex, long-tailed contractual liabilities. If no special asset valuation issues apply, the next step in analysis is to ask, "how do insurer assets compare to policy-level liabilities?"

Figure 1. In the beginning are the liabilities.

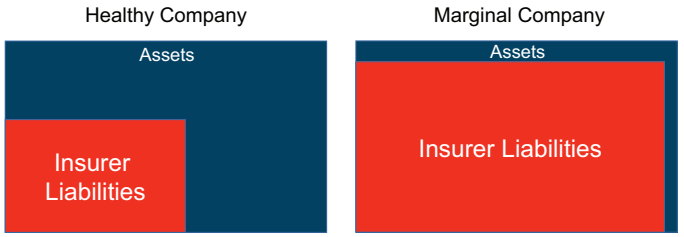

Figure 2 *Figure 3*

Figures 2 & 3. Healthy & marginally healthy companies

These first two questions—about the relationship between liability values and asset values—are just as important to solvency regulators, rating agencies, insurers' counterparties, and investors as they are to receivers and guaranty associations, so let's pause for a moment to consider conceptually how a very healthy insurance company—and a marginally healthy company—might look (see Figures 2 and 3).

Next, consider (see Figure 4) a marginally *insolvent* insurer, but before considering the role of the guaranty associations upon liquidation. Sometimes a company with assets *less than* policyholder liabilities can be saved through a rehabilitation or recovery plan. For example, sometimes an outside (or related-party) investor is willing to infuse capital for strategic reasons.

If such a rescue cannot be accomplished, both law and standard regulatory practice require institution of formal receivership proceedings (or even liquidation) before the insolvency "hole" gets deeper.[2]

The illustration in Figure 4 is fairly typical of insolvencies predominantly involving life and annuity contracts, in that it reflects a relatively high liquidation ratio.

Now consider conceptually the role of the guaranty associations. The design of the insurance safety net (like most other financial safety nets in the United States and elsewhere) provides that guaranty associations succeed to (or are "subrogated" to) the claims against estate assets for contracts that they cover. Because guaranty associations in that way use

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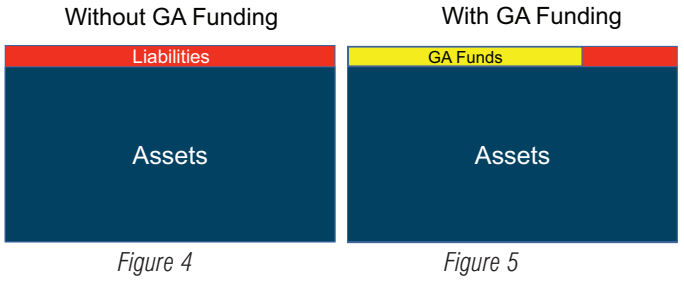

Figure 4 *Figure 5*

Figure 4. A marginally insolvent insurer before GA funding.
Figure 5. Guaranty association top-up funding.

"The Fabric of the American Promise"

Former FIO Director Mike McRaith discusses the vital role insurance plays in people's lives, the progress made by state insurance regulation, and more

Michael McRaith served as Director of the Federal Insurance Office (FIO) from June 2011 to January 2016. As Director of FIO, Mr. McRaith advised the Treasury Secretary on domestic and prudential international insurance matters of importance. Prior to his work at FIO, Mr. McRaith was Director of the Illinois Department of Insurance.

The following is an edited transcript of our conversation at NOLHGA's 2017 Legal Seminar on July 20.—Peter G. Gallanis.

Gallanis: *Going back to the beginning of your time in government in Illinois, from the perspective of 2005 forward, could you briefly describe how the "constitution" of insurance regulation has changed? Particularly in terms of the relative roles and responsibilities of the states, the federal government, and some of the international organizations that are now focusing on insurance.*

McRaith: In 2005, the big issue in the insurance sector was generated by New York Attorney General Spitzer's investigations into contingent commissions and finite reinsurance. These were the first issues I dealt with through the NAIC. As state regulators, we felt challenged, in that other state authorities were imposing on our turf.

We were not entirely confident they knew what they were doing or what they were talking about. We also were confronting the broader, macro-level debate about whether there should be federal regulation. I believe it was Senator Sununu and then Congressman Royce and Congresswoman Bean, from the northern suburbs of Chicago, who were actually proposing legislation to create an optional federal charter.

All that changed, and the point of inflection was the financial crisis. All of a sudden, the insurance sector—which, to some extent, had been a sleepy backwater of financial services—moved front and center thanks to AIG and its role in the crisis. It was also front and center from a political perspective because of the federal taxpayer

contributions and federal role to prevent AIG from collapsing.

What we saw coming out of the crisis then were a couple things. One, a recognition that the insurance sector is an essential part of our financial system, an essential part of our economy. And the federal government needed to understand and appreciate how the industry works, how it's supervised, and how it connects with other parts of the economy. That led to Dodd-Frank.

We also saw, though, at about the same time, that as developed economies were seeing negative to very slow growth, developing economies were exploding. As middle classes were developing in those economies, countries like India, Brazil, and others were looking for insurance and private capital as a way of protecting property and supporting the growth of the middle class—ultimately, supporting the development of consumer economies. We also saw in China—though we've not seen a lot of foreign development there—and some other economies the need for private retirement securities solutions on an incredible scale.

With that, we also see the expansion and the increased emphasis on understanding firms that operate multi-nationally. How are U.S. companies evaluating the priorities of consumers in South America or Northern Africa? How is all that risk assessed and managed by a multi-national firm when those consumers, who are a small part of the broader risk profile of the company, are essential in those markets?

So there is this desire globally to have a deeper understanding of how companies are supervised, how they're operating, their risk profile, and how they manage the risk of consumers who are located around the world. And we've seen, over the last seven years since the crisis, a convergence of the state role, the federal role, and the global role.

I would say, to put a fine point on it, however, that the role of the states has not changed. In fact, to a great extent, because of the work of the Federal Insurance Office and the Federal Reserve, the role of the states has been enhanced, and there is more responsibility now at the state level than ever before.

Gallanis: *Let's focus on one of the very last things you did during your time at FIO, since it touches on a number of the points you just made. I'm referring to the so-called Covered Agreement with the European Union. Could you share with us briefly what the Covered Agreement is and what it does?*

McRaith: Title V of the Dodd-Frank Act, which I expect you all reviewed before the session this morning, provides a unique authority for FIO to negotiate, jointly with the U.S. Trade Representative, an agreement with another jurisdiction relating to prudential aspects of insurance and reinsurance oversight.

It's a very unusual mechanism. There is nothing quite like it in terms of international agreements. It also empowers FIO to preempt states, to the extent that states have laws or regulations that contravene the terms of the Covered Agreement.

A couple key points, and then I'll turn it back to you, Peter. One thing that we wanted to do was exercise every authority under Title V, which we were able to do successfully. My personal view was that if we did that, we'd establish a template that successors can evaluate and react to, as opposed to having to originate.

Looking at the issues in Europe and the potential negative implications for U.S. companies operating in the Solvency II environment, where the U.S. regulatory system was not deemed equivalent—"equivalence" is a term of art in the E.U. under Solvency II—the absence of equivalence means that European supervisors could impose Solvency II capital standards or their own domestic capital governance and reporting requirements. These would be significantly detrimental to U.S. companies operating in the E.U. We also, of course, have had the decades-old development here in the United States of reforming insurance collateral requirements for non-U.S. reinsurers.

Before the financial crisis, we knew a bit about Solvency II and the potential for the equivalence problem. We had long said—I testified in front of Congress on several occasions—that the United States will not undergo the formal equivalence process that the E.U. set up. A number of other countries—Switzerland, Bermuda—have gone through the process to varying degrees. But we're the United States, the largest insurance market in the world by a wide margin, and we were not going to be evaluated by the E.U. as if they had some authority to tell us how we're going to supervise the industry or structure our system.

Our vision was, we could tie these two things together. For the E.U., treatment of reinsurers in the United States was an essential, fundamental point. They had been trying to deal with this for decades. And it was also important for us, given that roughly 90% of third-party reinsurance in the United States goes to a non-U.S. reinsurer. So let's establish a new global paradigm for supervision of a global industry. In exchange for the reinsurance piece, let's address the concerns we have about Solvency II. This led to the Covered Agreement that we delivered to Congress on January 13 of this year.

Gallanis: *It's an issue that has both advocates and critics throughout the industry and in parts of the regulatory world. But let me ask this: To what extent would you say the Covered Agreement either supports or supplants state regulatory provisions in the United States?*

McRaith: The Covered Agreement has drawn some criticism from those who are most concerned about the intervention of the federal government in insurance oversight. The whole point of the agreement is to eliminate that prospect. But we have to recognize that the federal government, through the lifetime of our country and our federalist system, has represented the United States on international and foreign matters. That hasn't changed. The federal government has an essential role in representing the United States internationally.

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IT'S ENTIRELY APPROPRIATE FOR THE LEADERS OF THE DIFFERENT FEDERAL FINANCIAL REGULATORY AUTHORITIES AND THE STATE AUTHORITIES TO HAVE A CONVERSATION ABOUT THE RISKS IN THE SYSTEM...

It is in the best interests of our country that the Treasury Department, with centuries of relationships with the finance ministries and regulators of other countries, be involved in a leadership role globally. That's not a threat to the state system. It's simply a statement of fact. It's also true that the Federal Reserve is the most powerful, influential central bank in the world. And in combination, Treasury and the Federal Reserve provide a lot of power for the United States globally when it comes to insurance matters. This is not to the exclusion of the states; it's to complement and work with the states.

The Covered Agreement contains two pieces: a reinsurance piece and a group supervision piece. On the reinsurance side, we took what the states had already agreed to do and we built upon it. We increased consumer protections in this way. There are a number of financial condition and market conduct provisions of the Covered Agreement that are necessary for reinsurers to receive collateral relief. These were factors to be considered under NAIC provisions, and they are conditions for collateral relief under the Covered Agreement. But the Agreement preserves at the state level the capacity to resolve any questions that come up. It also requires the reinsurer to report to the regulator of the ceding company. Whether it's Commissioner Nickel's company in Wisconsin or Commissioner Jones's company in California, the reinsurer will be reporting to the state supervisor of the ceding company. That's a huge development.

Secondly, we obtained for our reinsurers the same treatment in the E.U. Just as E.U. reinsurers will not be required to establish a commercial presence in the United States or propose collateral, the same is true for U.S. reinsurers in the E.U. Not only did we take what the states were doing for E.U. reinsurers, we took it and made it real for our companies in the E.U. reinsurance market.

On group supervision, we took the practices in which the states are currently engaged, with one exception. We took language from NAIC statements with respect to those provisions and put those into the Covered Agreement, so that the group supervision aspects of the Covered Agreement endorse what the states are already doing. There is one piece—group capital—where we took on a commitment already made by the states to develop regulations. In that sense, we deferred to the states. They can develop group capital regulations as they deem appropriate, and the Agreement gives them five years to do it.

And in exchange for all that, our companies operating in the E.U. are able to do so without complying with Solvency II governance, capital, and reporting requirements, ultimately saving those companies potentially billions of dollars.

Gallanis: *Your team completed the work and finalized the Covered Agreement on January 13. In early July, we heard an announcement from the current administration that it intended to move forward. As part and parcel of that announcement, there were references to clarifications that are yet to be made and policy statements on details of implementation that will be made to clarify and respond to concerns that have been expressed about the Covered Agreement. Do you have any observations about anticipated clarifications or policy statements on implementation?*

McRaith: Well, it is not the least bit surprising that the transition from the Obama to Trump Administration would not be entirely seamless. But in my view—and I've testified twice in front of Congress about this—the document was entirely clear. Having said that, there were roughly 8 to 10 lawyers just on the U.S. delegation who were involved in the drafting, and I include myself in that group. We had E.U. lawyers contributing to the drafting as well, not all of whom were native English speakers. So what is abundantly clear to me has proven less so to others. I do think it's entirely appropriate for questions to be raised. And in my personal view, I completely support the efforts to provide clarity on how the Agreement will be interpreted within the United States.

Gallanis: *Let's step away from the Covered Agreement and loop back to our opening issue on the constitution of insurance regulation. Before the financial crisis, almost all insurance regulatory activity—and for that matter, almost all regulation in the financial services sector, period—was focused on the regulation of individual companies for solvency and how they conducted their*

business. In other words, so-called "prudential regulation" focused on internal aspects of individual companies.

Since the crisis, an additional focus has been placed on preventing and mitigating risks to the overall financial system: so-called "macro-prudential regulation." That was obviously one of the goals of Dodd-Frank, and it was one of the missions assigned to the FSOC and FIO. Based on more than six years of experience with FIO and participating in the FSOC and otherwise, do you have views as to the extent to which the insurance industry and the firms that operate in it are proper subjects for this new, expanded, macro-prudential regulatory view?

McRaith: It was an amazing privilege, as the FIO Director, to serve on the FSOC for almost six years, beginning with Secretary Geithner and then Secretary Lew, and seeing the commitment of the leaders of the federal financial authorities—Secretary Geithner, Chairman Bernanke, and then, of course, Chair Yellen and Secretary Lew and the whole team. The work of the FSOC is absolutely essential, because it's entirely appropriate for the leaders of the different federal financial regulatory authorities and the state authorities to have a conversation about the risks in the system, if the system is exposed, whether there is concern or vulnerability about what's happening, say, when the United States was downgraded, etc.

These are important questions for our financial leadership to discuss together. I did support the designation by the FSOC of the three insurance companies as systemically important. I don't want to comment on any one institution, but I will say that the crisis again demonstrated the importance of the insurance sector in our broader financial system. The sector has $8.5 trillion dollars in assets, just in the United States.

That's not to say everyone has to agree with the designation of individual firms. But I think we should all agree that it's appropriate for the insurance sector to be represented in the conversation by people who understand the market, the products, and the regulation. And to the extent that there is a concern about an individual firm, as a country, we need to be able to talk about that, and we need to be able to do something about that. We learned that through the crisis.

Now, as we move away from the crisis, the group supervision at the state level has been substantially enhanced. It's far greater than it was when I arrived in 2005. The states should receive a lot of credit for that.

Gallanis: *As Illinois Insurance Director, as an officer of the NAIC, and in the time since you've left FIO, I know that you've been deeply engaged on a number of health insurance issues. With efforts apparently still afoot to bring about material changes to the Affordable Care Act, what do you view as the biggest challenges facing the health insurance marketplace and its consumers today? And what do you see as the prospects for addressing those challenges?*

McRaith: This is a subject of great interest and passion for me. I first became a lawyer in 1990, and as a gay man coming out at that time as well, people were dying. Men were dying because of HIV and AIDS, and there was no medication. Eventually, we had medications that allowed people to live, but they couldn't get coverage. I saw this as recently as 2005. A friend died because he didn't have insurance and he couldn't afford medication.

Also, having served on the Board of the American Foundation for Suicide Prevention, roughly 90% of all suicides are the result of a diagnosable and treatable disease. How many of those people would be alive if they'd had care for their mental health challenges, whether it's addiction or depression or something else?

As a country, I think the question we're answering—and not everyone likes how this is going—but the question we're answering is whether all families are entitled to have healthcare for their parents and children and spouses that covers the conditions they confront through no choice of their own. At one firm where I worked before becoming insurance commissioner, we had two partners who were with the firm, not because they loved the practice of law, but because they had to keep their health insurance for their wives who were fighting breast cancer. They could not pursue their passion or their talent or their entrepreneurial spirit because they needed to retain their group health insurance.

I think we have an opportunity as people who understand insurance to weigh in on this conversation. And I strongly encourage you to do that. Health insurers can cover preexisting conditions only if healthy people are also in the system. A bill that removes the individual mandate, however much we might dislike that, destroys the prospect of covering people

I THINK WHAT THE STATES HAVE DONE IN TERMS OF GROUP SUPERVISION IS THE SINGLE BIGGEST ACHIEVEMENT OF THE STATE REGULATORY SYSTEM IN THE LAST 10 YEARS.

with preexisting conditions. As a country, I think we're moving to a place where we are expecting health insurance to cover the conditions that our families confront. What we have not yet determined is how we pay for that.

I have three specific remedies. Very briefly. One, the risk adjustment, risk corridor, and reinsurance pieces need to be fully implemented and funded. We need premium credits for families below 400% of the federal poverty level. And—here's one that health insurers will dislike—we should eliminate the segmentation of the risk pools. There shouldn't be different risk pools for those policies sold on the exchange versus off the exchange. One could argue we should even blend all the risk pools within the companies. That eliminates the volatility, eliminates the segmentation, and allows much greater predictability and stability in terms of pricing.

Gallanis: *One of FIO's other major statutory assignments was conducting a study of the effectiveness of U.S. insurance regulation and identifying any areas that FIO believed could be strengthened. Based on the work that you've done in the regulatory and modernization report, and in updating it in the FIO annual reports, what are you prepared to say about what is being done well in U.S. insurance regulation today and what can be done better?*

McRaith: First of all, with respect to the reports, there are some people who are uncomfortable with the notion of a federal office writing reports about the U.S. insurance sector and its regulation.

The insurance sector in the United States: again, $8.5 trillion in assets, and an essential component of the American promise of economic opportunity and fairness. It allows families to protect property, allows intergenerational transfer of wealth, and allows secure retirements. Insurance is an essential part of our country. It's the fabric of the American promise. And we should not accept that our work and the work of the industry are not important enough to be dealt with at the national level. That can happen without posing a threat to the state regulatory system.

It was always somewhat fascinating to me that we published a report on how to modernize the system and did not call for a federal regulator, except in mortgage insurance. And that was because the mortgage insurers and financial guaranty companies had a role in the crisis through the housing finance system that transcended the insurance sector itself.

But we were criticized by some for being too aggressive in pointing out that the state system could be improved in a number of areas. We have to be able to talk about these things honestly at the national and federal level. I mentioned this earlier—I think what the states have done in terms of group supervision is the single biggest achievement of the state regulatory system in the last 10 years.

But there are areas where the states are deficient, in my view. There's too much deference to state-by-state discretion. That does play into insolvency at times. One concern that's been expressed over the years is that some companies choose what state will be their regulator based on the treatment by that state of their financial condition. Accounting practices vary sometimes state to state. One of the concerns we had was, there should be some multistate oversight not just when a company is troubled, but when a company might receive treatment that would give it an advantage in the marketplace, whether in terms of reserves or portfolio apportionment.

On the consumer side, I think the states, to some extent, are working to understand better how products are priced for consumers. That seems to be an effort undertaken with more or less enthusiasm, depending on the state.

I want to mention cybersecurity, because it's the seminal supervisory issue in every financial service industry. And the insurance sector is, once again, following. The State of New York did a good job, and we know the NAIC is working toward a solution. But cybersecurity is about risk, and that operational risk is part of our lives now. It is not something we're going to solve and then move on from. It is a part of our lives, and the insurance regulatory community at the state level should be as aggressive as possible when it comes to that subject.

Gallanis: *Most of the people in this room deal with the question of troubled U.S. insurers. Companies don't fail very frequently, but when it happens, the regulators have a duty to jump in as quickly as possible and put a company into receivership promptly. The receivers have a responsibility to come up with an effective, cost-efficient plan for liquidating the failed company. The guaranty system has a responsibility to come in and provide the*

AS A COUNTRY, I THINK WE'RE MOVING TO A PLACE WHERE WE ARE EXPECTING HEALTH INSURANCE TO COVER THE CONDITIONS THAT OUR FAMILIES CONFRONT. WHAT WE HAVE NOT YET DETERMINED IS HOW WE PAY FOR THAT.

financial safety net for insurance consumers. From your perspective, how are we doing?

McRaith: I think you're being tested right now in a way that will help you answer that question, by the Penn Treaty case. It's a really fascinating intersection of insurance regulation, receivership, and public policy, as our country has an increasingly desperate need for retirement security and an increasing number of people needing long-term care. The numbers are staggering. Yet we see the contraction of the private long-term care market.

How the states are able to resolve Penn Treaty is a good test case, I think, for the receivership system overall. It will also be interesting to see how that plays out with respect to the life versus health companies and whether there's some sanity that can be brought to that conversation of who's responsible for any guaranty fund liabilities. These are really important tests. And fundamentally, it's tested the state system. Even if there's an agreement at the NAIC level, is there going to be the initiative and the energy to get things done in state capitals to change state laws if needed?

Audience Question: *In our interactions with the federal government and in the FSOC designations of insurers, we have read and heard multiple times a concern about the "run on the bank" scenario. You've served on the FSOC and interacted with these federal regulators. How prominent is that fear? How alive, even today, are those ghosts?*

McRaith: Runnable liabilities are a key consideration when we look at financial stability. They have a profound effect on contagion as well as liquidity, so that's a big consideration. Now, again, I'm not speaking about any individual institution, but that was considered by the FSOC. It's a prominent issue, both at the global level, as we looked at the globally systemically important firms, and then nationally as well.

Here's an interesting question. The states monitor RBC for insurance companies, and I think at roughly 300% RBC, a state can start to take supervisory corrective action. But it's possible that you could have an insurance company with hundreds of billions of dollars in assets. It's far above that 300%. What happens if there is a need for that insurer to dispose of those assets above the 300% in a fire sale or expedited fashion? Does the state have the authority to step in if it goes from 450% to 350%? How many billions of dollars in assets is that, and what effect does that have on the broader financial system? That's a longer answer to your question.

It's an essential consideration, the runnable liabilities, but it's also an interesting dimension from the state regulatory perspective. The supervisor authority triggers at roughly 300%. What happens above that 300% could have a potentially significant effect on the broader financial system, even if it doesn't mean the insurer itself is in crisis.

Audience Question: *In my reading in the national press and in* ***The Wall Street Journal****, there seems to be a sense that, "Okay, we've made it through the crisis. Things are fine now. There's stability in the markets. We need to revisit a lot of these regulations that we thought were necessary and maybe get rid of them." With this sense that everything is fine, what do you see*

as the critical points where we really shouldn't backtrack? What issues should we continue to watch closely in our industries so we don't have another financial meltdown?

McRaith: Let me make the general observation that the insurance industry right now has more wealth than it has ever had in the history of the United States. That is also true for the banking sector. Record profitability over the last number of years raises some questions about the merits of the complaints that we hear.

Now obviously, I come to this with a perspective that the Dodd-Frank Act, by and large, improved the stability of our system and has given our economy a platform to expand, even when the rest of the world's developed economies did not. When Western Europe had flat growth and negative interest rates, the United States was growing. Now, we've heard people say, "We should have been growing at 6%." That's absolutely unreasonable. It's a complete fiction and fabrication. However, it's a moderately decent talking point, I suppose.

Going back to your question, I would say there are three key pieces in terms of financial oversight. One, we need to retain the forum for the leaders of the financial system to meet and speak and assess and have their staffs work together, every day, as happens through the FSOC. Second, we need to preserve the authority to designate individual institutions, whether an insurance company or some other company, as systemically important. Third, we need to preserve the Volcker Rule, which prohibits financial institutions from effectively investing for commercial purposes money that is federally guaranteed. That protects the taxpayers. Those three protect the taxpayers, protect our system, and ultimately protect the institutions.

Audience Question: *My question is related to regulatory modernization. Going back to 2000, ACLI has made regulatory modernization a priority, and at the core of our support for modernization has been support of state standards. With respect to the Covered Agreement, will we see another type of Covered Agreement, a sort of federal standards approach where, with the involvement of the state regulators and the use of state standards, we'll see federal enabling legislation going forward on any number of issues? Or in today's states'-rights Congress, is that really something we won't see much of going forward?*

McRaith: The Covered Agreement, at least as I and we conceived it, was not to establish new, unprecedented standards that, at some metaphysical level, imposed uniformity. We wanted, through the Covered Agreement, to solve real issues in real time, and that's what we did. I don't expect the Covered Agreement mechanism would be used like that in the future. I do think that the United States insurance industry is entitled in many ways to greater uniformity than we currently have, and some modernization. That can be done not as a threat to the states, but to support the work of the states. And the NAIC's attitude toward these kinds of things has changed.

In 2010, we found a sponsor in Congress to introduce a bill that would have made federal law out of the NAIC reinsurance collateral reform proposal. We literally developed a legislative proposal to inform reinsurance collateral. I don't think that would happen today. But I do think that it's a great opportunity for the state system to be integrated with the federal government in a way that ultimately supports the state system. It is 2017. The industry's vastly different from what it used to be. It's changing from the consumer perspective every day. And we, as a country, need to be able to address these issues in a way that improves efficiency for the industry, for consumers, and ultimately for our national economy. ✯

WE PUBLISHED A REPORT ON HOW TO MODERNIZE THE SYSTEM AND DID NOT CALL FOR A FEDERAL REGULATOR... THERE'S TOO MUCH DEFERENCE TO STATE-BY-STATE DISCRETION.

["Ask Again Later" continues from page 1]

She encouraged the regulatory community to take stock of what the New Jersey Department is doing to implement group-wide supervision under its powers as updated by the NAIC's Solvency Modernization Initiative.

Maurer and Commissioner Nickel singled out the guaranty system for praise. "There's no smarter or more experienced group on resolution issues," Nickel said. "We need you to help us understand what you're seeing in the market." Maurer echoed his comments, encouraging the guaranty system to continue to "look at issues and seek solutions from a broader perspective, including federal and international perspectives, while building on the success of our U.S. system in protecting policyholders. That may be more productive than viewing issues in a silo."

The next panel, *Dodd-Frank & Insurance Regulatory Modernization: Legal & Economic Concepts* (moderated by Caryn Glawe of Faegre Baker Daniels), brought a broad perspective of opinions on the Dodd-Frank Act (DFA), in that each panelist questioned the DFA's value, but for different reasons. James H.M. Sprayregen (Kirkland & Ellis) said that the DFA suffered from a malady that afflicts most legislation that follows a crisis. "It was fighting the last war," he said. "I think it was inevitable, but I don't think it was helpful." Douglas Baird (University of Chicago Law School) agreed that the DFA "fought the last war" but added that during that "war," the derivatives book of Lehman Brothers, which was worth billions of dollars, "vaporized when they filed for bankruptcy." In response to this, Title II of the DFA has a mechanism to keep such assets intact when a large company fails. "It's the first problem they solved" with the DFA, he said.

Sprayregen took issue with the requirement that large banks create "living wills" in case of failure, predicting that any plan "will last about one second" in a real failure. Baird pointed out that "the process of doing a living will has forced banks to restructure themselves" and take on more loss-absorption capacity, but he did remind the audience of the Mike Tyson quote, "everyone has a plan until they get punched in the mouth."

Luncheon speaker Anthony Ponce entertained attendees with stories about his **Backseat Rider** *podcast and his decision to leave his job as a Chicago TV reporter to become a Lyft driver and launch his podcast, which involves interviewing his passengers. "Everyone in broadcast news was imitating each other," Ponce explained. "I wanted to tell stories more on my terms, and I wanted to highlight the things that connect us all."*

Patrick Cantilo (Cantilo & Bennett) took issue with the DFA's SIFI designation process, especially how it's been applied to insurance companies. He questioned how the Act would work if two companies, just below SIFI status, were to fail, but he did acknowledge that the DFA "has prompted regulators to be more astute and has forced management of companies to recognize risks and plan for them."

Looking to the next financial crisis, Sprayregen cited Congress's quick action on the TARP fund. "In a pinch, cooler heads will prevail," he said. "We'll figure it out, but I don't think we've done away with bailouts." Cantilo agreed, saying that "the federal government and the financial sector will find the tools to trigger a bailout" even if the Orderly Liquidation Authority in the DFA is repealed. Baird agreed that improvisation would be key, noting that in 2008, no one knew how bad things were at AIG. "The next crisis is going to be something else we don't understand."

Giving attendees an understanding of the DFA's impact on a practical level was the goal of the following panel, *Dodd-Frank & Insurance Regulatory Modernization: Legal & Economic Realities*, moderated by NOLHGA's Bill O'Sullivan. Marshal Auron (KPMG Advisory) explained that "after the crisis, the Fed tried to focus on macro-prudential supervision," which meant that global systemically important banks (GSIBs) welcomed an "army of supervisors" focused on capital management, liquidity management, and resolution planning. "There has been a benefit to the companies," he said. "But it comes at a cost."

At the time Prudential was one of two insurer SIFIs that face that same level of heightened regulation, and Deborah Bello (Prudential Financial and NOLHGA Board Chair) said that "it's almost impossible to estimate the cost" of preparing reports for regulators, which she called "a crushing undertaking." Bello noted that the company hasn't received any feedback from the Fed on resolution and recovery plans filed in 2015 and 2016. "I have never been in a more uncertain situation in terms of how we are regulated."

NAIC CEO Michael Consedine likened the new regulatory framework to "a giant hand sweeping across a chessboard and knocking the pieces to the

ground. We're trying to figure out how this game is played." While he acknowledged the advantages of the Financial Stability Oversight Council (FSOC) created by the DFA ("there is a benefit in having a collection of regulators talking about what's going on out there from a big picture perspective"), he added that "we've long had a problem with SIFI classification."

Consedine and Bello both pointed to an activities-based approach as a better way to identify potentially troublesome companies. "Prudential is interested in exploring activities-based analysis," Bello said. "Size can't be the only determinant of whether a company's failure will have an effect on the economy." Auron noted that regulators are "looking at more than just size," when evaluating GSIBs, with a focus on interconnectedness—the key, in his opinion, to identifying systemic risk. "We've taken a step in the water, but there's a long way to go."

NAIC President and Wisconsin Insurance Commissioner Ted Nickel, Kristine Maurer (New Jersey Department of Banking and Insurance), and moderator Pat Hughes (Faegre Baker Daniels) discussed the challenges facing state regulators.

The Health of Healthcare

Speaking of things that have a long way to go, healthcare reform was discussed by a few panels at the Seminar. With all the uncertainty surrounding the possible repeal or replacement of the Affordable Care Act (ACA)—the Seminar was held just a week before Sen. John McCain (R-AZ) voted thumbs down on the third version of ACA repeal—the *Healthcare & Insurance: Law & Practice in a New Political World* panel (moderated by Susan Voss of American Enterprise Group) explored a wide array of possibilities concerning healthcare in the United States. For instance, if Congress simply cut off funding for the ACA but left the law in place, many people would lose coverage and others would forego regular care, according to Keith Passwater (Anthem). "The net effect would be that costs would go down, but 10 to 20 years later, costs would be much higher," he said. David Meltzer (University of Chicago) added that "one thing we'd see is an increase in bankruptcies."

JoAnn Volk (Georgetown University Center on Health Insurance Reforms) noted that today's discussions about possible changes to the healthcare system are fundamentally different than those that took place before the ACA. "The ACA really did change the debate," she explained. "We now expect people with preexisting conditions to get coverage." She added that covering preexisting conditions makes life easier for early retirees and even entrepreneurs hoping to start their own businesses, as they don't have to worry about a gap in their insurance history.

When asked what would happen if insurers could offer an ACA-compliant plan and scaled-down plans that cover fewer conditions, Passwater replied that "the ACA plan would effectively become a high-risk pool," adding that this is already occurring to some extent. With the scaled-down plans, "you'd see a lot of carriers make their ACA plans as unattractive as possible. You'd see innovation, but not the kind we want."

Asked about ways to improve the healthcare delivery system, Volk said that "there are two relatively quick fixes": funding the ACA reimbursement and reinsurance programs. Meltzer, noting that "we're not going to solve this till we address long-term issues" such as treating high-risk patients, said that "I would start with a Manhattan Project on risk adjustment" to identify these high-risk patients and how to treat them. When asked about any dangers on the horizon, Passwater pointed to possible health insurer insolvencies, and

In a panel moderated by NOLHGA's Bill O'Sullivan, Marshal Auron (KPMG Advisory), Deborah Bello (Prudential Financial and NOLHGA Board Chair), and NAIC CEO Michael Consedine examined the effect the Dodd-Frank Act has had on the financial services marketplace.

Volk mentioned the possible failure of the individual insurance market. Though a small fraction of the total market, its loss would be "devastating."

The next panel, *Risk Corridor Litigation: Class-Action Decisions & Potential Sale of Risk Corridor Receivables*, dealt with the losses insurance companies (both solvent and insolvent) suffered when the United States failed to fund the risk corridor program in the ACA (the risk corridor was part of the ACA stabilization program designed to pay health insurers that experienced greater than expected losses). Moderator Frank O'Loughlin (Lewis Roca Rothgerber Christie) noted that only 12.6% of these obligations were funded in 2014 and 1.6% in 2015 (the government has not yet announced what funding is expected regarding 2016 payments, after which the three-year program ends), which meant that billions of dollars in payments were not made to participating insurers.

Some of these insurers sued the government, and Stephen Swedlow (Quinn Emanuel Urquhart & Sullivan) reported that there are 27 suits in federal claims court—2 class actions and 25 individual actions. Two cases have been decided—one in favor of the government and the other in favor of the plaintiff—and both rulings have been appealed. Swedlow said that the ruling on the appeal (the cases have been consolidated) will go a long way toward determining the fate of the class actions, but that whatever happens, we can expect more legal action. "The next wave of litigation will be the most interesting wave."

Until these cases are resolved, many insurers have large unpaid balances on their books, and "there was wide variation in how companies were recording the balances in 2015," according to Michelle Avery (Veris Consulting). However, some insurance departments determined that companies could record up to 12.6% of these amounts as admitted assets. Anything over that amount can be written off if the company can prove that it's unlikely to ever receive the money.

Filing suit or writing off the payments isn't the only option companies have—the receivable can be monetized in the market at a discount. "Let's liquidate—at least partially—the claim" by selling the rights to the payments to a third party, said David Desser (Juris Capital). By doing so, "you're less invested in the litigation outcome—we're shifting risk." Desser explained that his company, which has purchased a share of one CO-OP's claim for risk corridor payments, doesn't get involved in the litigation—it simply waits for Congress to act or a ruling on the lawsuit.

In the presentation Dodd-Frank & Insurance Regulatory Modernization: Legal & Economic Concepts*, moderator Caryn Glawe (Faegre Baker Daniels—not shown), Douglas Baird (University of Chicago Law School), James H.M. Sprayregen (Kirkland & Ellis), and Patrick Cantilo (Cantilo & Bennett) discussed the pros and (mostly) cons of the Dodd-Frank Act.*

The concept of shifting risk also came up during the *Long Term Care: Developing Legal & Business Issues* panel (moderated by Vince Bodnar, who was with LTCG at the time), which employed a Q&A format because the moderator spent the weeks leading up to the Seminar binge-watching *Game of Thrones*. When asked about discrepancies among states in granting rate increases, Frederick Andersen (Minnesota Department of Commerce) replied that "the NAIC does recognize this as being a problem. I don't think we're ever going to get to a point where it's 100% uniform, but if we can squeeze everyone to the middle, we'll be in a better place."

Asked if any facets of the LTC market are improving, Shawna Meyer (New York Life) said that "we've learned a lot over the past 20 years. The most obvious change is the price point." She added that better claims practices can make a big difference. "The important part is to pay the right claims." Meyer also mentioned the idea of bringing managed care concepts into the LTC arena, with a goal of "educating people to help them avoid future claims." Stephen Serfass (Drinker Biddle & Reath) acknowledged that there could be legal risks in encouraging policyholders to avoid claims, but "the risks are far outweighed by the benefits in our view."

Technology has a huge role to play in cutting costs for insurers and insureds. Serfass said that many insurers are already using a mobile app that confirms a person's location to confirm that caregivers are actually providing care when they say there are. Meyer called it a "win-win for insureds" because they only pay for care they receive. More technology is on the horizon, according to Serfass: "Artificial intelligence is going to make its way in here sooner or later."

All three panelists were skeptical about proposals for companies to shift legacy books of business to other companies, but they expressed great enthusiasm for hybrid LTC products ("there's a lot of innovation there, but there's a lot more innovation to be had," Meyer said) and the future of the LTC market. "It's weird to talk optimistically about LTC," Serfass admitted, but he predicted that one or two strongly rated P&C companies could enter the market soon, and Andersen noted that the debate surrounding the ACA had heightened awareness of (A) how much Medicaid spending goes toward LTC and (B) that this level of spending by the gov-

ernment is unsustainable, which could prompt more people to purchase LTC insurance.

More Things to Be Worried About

Not surprisingly, *Politics & Public Policy in a New Political Environment: The Legal & Legislative Moving Pieces & Why They Matter*—the panel charged with explaining what's going on in Washington and why, which was moderated by Alison Watson (Faegre Baker Daniels)—didn't have a lot of good news for attendees. Melissa Mueller (Capitol Tax Partners) noted that "things are not proceeding rapidly in Washington" (yes, the audience laughed) and added that raising the debt ceiling and passing a government funding bill are "two real obstacles that could come up soon." Douglas Elliott (Oliver Wyman) said that presidents can usually only accomplish two or three major initiatives in their first term and that expectations for the Trump Administration should be scaled back accordingly. He then cautioned that "in Washington, if you have to bet, always bet on nothing happening."

Some things, however, have to happen, and tax reform is high on the list. Briget Polichene (MetLife) identified the issue as crucial for the insurance industry and added that industry representatives are concerned by the process, which has featured no hearings or transparency. With the imperative that any tax cuts be balanced by savings elsewhere, and the prospect of including the savings from the repeal of the ACA looking increasingly slim, "there's plenty to worry about here." Elliott predicted tax cuts rather than true reform, and Mueller noted that "the pressure to have a success will be even greater" as the year winds down.

Polichene pointed out that one big roadblock is that "Congress tends to act only when they have to," adding that the debt ceiling is an issue they must act on. "That's where some big deals could be cut," she said, though she didn't believe that tax reform would be one of them. Another roadblock, of course, is politics as usual—or not usual, as Elliott mentioned. "I have observed a real increase in the tribalization of politics," he said, and the result could be that in December 2017, the question everyone will be asking is, "how come Washington couldn't do a damn thing this year?"

Tax reform is so important that it got its own presentation: *Tax Law Reform—Will It Happen? What Are the Possibilities?* Jodie Curtis (Drinker Biddle & Reath) noted that while tax reform is "the Holy Grail for the vast majority of Republicans," it has never been accomplished in an election year. "The calendar is not the Republicans' friend."

Neither is the current makeup of Congress. "The good news is that everyone agrees the tax code needs to be reformed," Curtis said. "The bad news is that no one agrees how to do it." Even among Republicans, though there's agreement on lower rates and a broader tax base, there's no consensus on key issues like the border adjustment tax—which might explain why there could be as many as five Republican tax plans in the works. Also, since the bill must be revenue neutral, that likely means it will have to call for entitlement cuts. "You probably aren't going to have Democrats come to the table on tax reform."

Curtis explained that at this point, there's no framework for reform. "We are truly on hold till they figure out what that framework will look like," she added. Once it's released, it will become clear which industries are winners and which are losers, and those industries will mobilize accordingly. "The Republicans are going to have to pick among their children," Curtis said.

If there's one thing Democrats and Republicans can agree on, it's that computers will be the downfall of mankind (something anyone who's seen *WarGames* already knows). This year's Seminar included the traditional "scary computers" presentation, entitled *Cybersecurity Risks, Protections & the Path Forward*. Eric Shiffman, an FBI agent on the frontlines of the cyberwars, confirmed the worst fears of everyone in attendance when he explained that the biggest computer problem any company faces isn't a computer at all. "People are your biggest vulnerability," he said, adding that "spearfishing" e-mails (messages designed to look authentic—from a bank or credit card company, for instance) are getting better and better.

All is not doom and gloom, however. Michael Bahar (Eversheds Sutherland) began his comments by saying, "what an enormous opportunity there is for lawyers in the cybersecurity space." He also noted that cyber attacks are "a markedly underinsured threat," so there's a great opportunity for the insurance industry as well.

There's also a great threat. Mark Thibodeaux (Eversheds Sutherland) said that insurers represent "almost the perfect confluence of factors for hackers," since health records contain a great deal of the data that many hackers seek. That's not the only problem companies face, however. "It's not all about data," Bahar explained. "Hackers are also looking to disrupt and destroy." Shiffman agreed, saying that hackers will "hammer away at your site because they think it's fun." He also warned that hackers who created malware that could take over Wi-Fi enabled household devices (what's known as the Internet of Things) posted the code for their malware online. "That's one of the things we're seeing, the open source nature of bad guys and hactivists." And yes, your phones are at risk too.

A successful cybersecurity program starts at the top, according to Bahar. "Get upper management involved," he said. "Leadership sets the tone." It could also be where the buck stops if there's an attack. "Boards of Directors are no longer off the hook from regulators, and the day is coming when they won't be off the hook from directors and officers liability." ✯

Sean M. McKenna is NOLHGA's Director of Communications. All meeting photographs by Robert Levy Photography.

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

estate assets to fund covered claims up to the level of the liquidation ratio, for practical purposes the guaranty associations "top up" asset/liability shortfalls (the difference between the liquidation ratio and 100%) for claims that they cover (see Figure 5, which illustrates guaranty association "top up" funding for covered claims on the left, and in red on the right the remaining amount of claims exceeding guaranty association coverage, and for which asset coverage is unavailable due to the remaining estate asset shortfall—a concept referred to here as "unprotected claims.")

So far, the basic concepts illustrated here apply in all insurer insolvency cases. But as Scott Kosnoff says, when you've seen one insolvency, you've seen one insolvency. Each case presents special wrinkles in terms of potential elements of the problem—or its solution. And while each case is different, ELNY was more different than most.

As previously noted, ELNY had an anomalously low liquidation ratio, coupled with an anomalously high percentage of contracts well in excess of what guaranty associations cover. The low ELNY liquidation ratio (unlikely to reoccur in a future life or annuity case for a variety of reasons) is illustrated conceptually in Figure 6. Figure 7 shows the extent of guaranty association statutory coverage obligations and the allocation of estate assets between guaranty associations (for the contracts that they cover) and the substantial remaining unprotected claims, illustrated again in red.

The comparatively large red block in Figure 7 reflects the effect on ELNY annuity payees (mainly SSA payees) of both the very low ELNY liquidation ratio and the high proportion of ELNY liabilities comprising claims exceeding guaranty association coverage (almost all of which are SSAs).

Had the liquidation ratio been at a more typical level—say, 90%—the relationship of assets to liabilities would look more like Figure 8. Had the percentage of liabilities covered by guaranty associations been more typical of a life/annuity case (at the same liquidation ratio), the illustration might have looked more like Figure 9. Had both those variables (liquidation ratio and percentage of guaranty association–covered liabilities) been more typical, Figure 10 might have been the result.

The ELNY case also involved the very unusual situation of a small (but significant) amount of contractual liabilities to "orphan" policyholders, who were not required under then-applicable law (since changed) to be covered by any guaranty association.

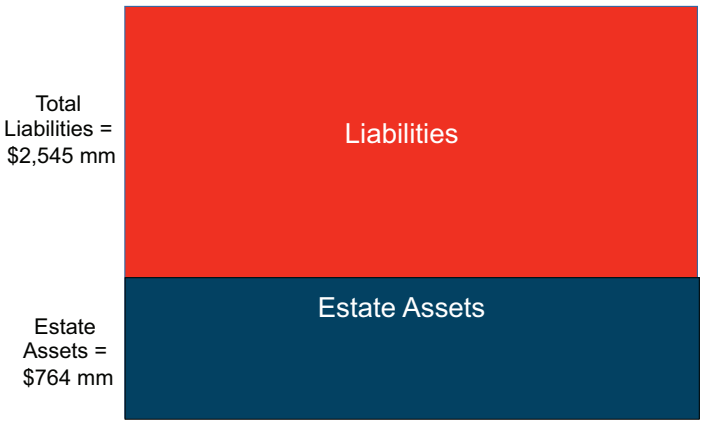

Figure 6. The ELNY estate's low liquidation ratio.

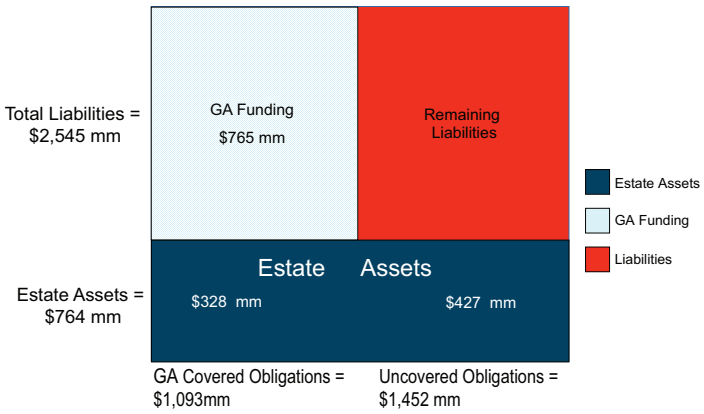

Figure 7. Guaranty association funding and remaining liabilities in the ELNY estate.

Figure 8. Typical liquidation ratio.

Figure 9: ELNY liquidation ratio with typical GA coverage.

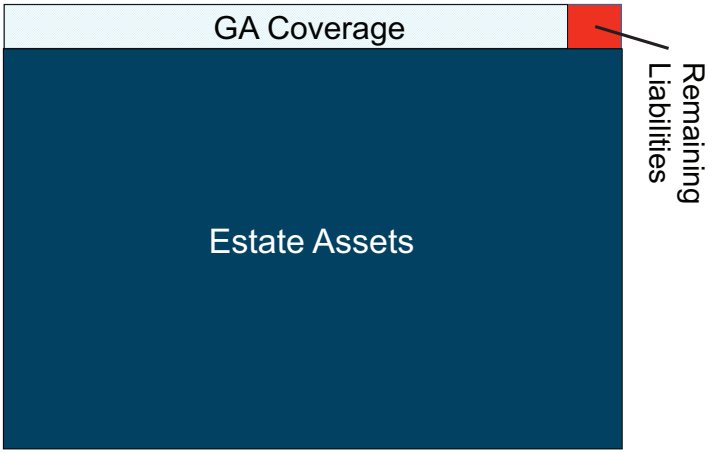

Figure 10. Typical life/annuity insurer liquidation ratio with GA funding.

Figure 11 restates Figure 7, with the red block in the upper right showing the preliminary unprotected claims that initially would have resulted for annuity payees as a consequence of the low liquidation ratio and the high percentage of contracts exceeding guaranty association coverage, exaggerated to a slight extent by the "orphan" policy problem.

No one wanted that outcome. Obviously, the payees facing unprotected claims wanted a better result, but so too did concerned regulators, industry representatives, and NOLHGA's ELNY Task Force. The strong desire by those stakeholders to achieve an outcome for otherwise unprotected claims better than would have been achieved by simply following the law under this highly unusual fact set was itself an important consideration in developing a plan.

Synthesizing Solutions. The challenge, therefore, was to find ways to soften what otherwise might have been a very hard blow for some very vulnerable annuity payees with unprotected claims. That, in turn, required critical consideration of some other factors unique to the ELNY case.

One such factor was that the ELNY resolution plan required an extended runoff (over a period of 50-plus years) by the guaranty associations, primarily because the liabilities could not be economically transferred to another company in an assumption reinsurance transaction (as would have happened with a pool of more traditionally marketable life or annuity contracts).

Instead, guaranty associations and their member companies determined that the runoff would be managed through a nonprofit, tax-exempt special purpose vehicle (Guaranty Association Benefits Company, or GABC) that they would form and control. Guaranty associations chose to pre-fund their financial obligations projected to be needed to support each guaranty association's covered benefits, and the receiver transferred to GABC the assets of the ELNY estate allocable to uncovered benefits. That is, GABC was able to manage and invest roughly $1.5 billion over the runoff period—part of which related to guaranty association–covered claims, and a separate part of which related to uncovered claims.

The extended nature of the runoff under the resolution plan provided both risks and opportunities unique to the ELNY case. The risk was that, over the runoff period, assets invested to support uncovered liabilities might actually decline in value, putting at risk the amount that could be used to pay scheduled (but uncovered) annuity benefits, with the possibility of further increasing the amount of unprotected claims (the red-shaded section in Figures 7 and 11).

The opportunity—supporting one element of the synthesis of a creative resolution plan—was this: Conservative pre-funding by the guaranty associations of their projected runoff obligations for covered claims supported the projection of investment earnings that would exceed the amount required to pay guaranty association statutory obligations. The projected "excess earnings" from the guaranty associations' conservative pre-funding strategy allowed the associations to agree to having GABC apply those excess earnings to fund a specified level of benefits for "orphan" contracts.

In addition, a group of 39 life and annuity issuers organized through the ACLI made a voluntary commitment to guarantee a specified minimum level of coverage for uncovered liabilities (slightly exceeding what was supported by allocable estate assets), regardless of the investment performance for those assets. The same life and annuity insurers guaranteed the sufficiency of the "excess earnings" from guaranty association funding to cover "orphan" contracts. The resulting

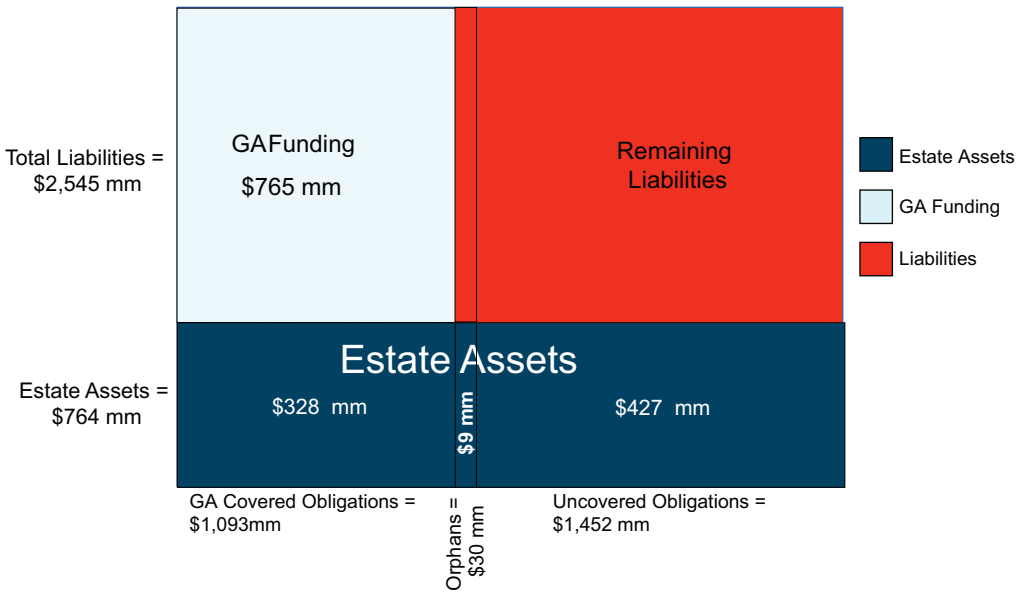

Figure 11. Guaranty association funding and remaining liabilities in the ELNY estate (including "orphan" policies).

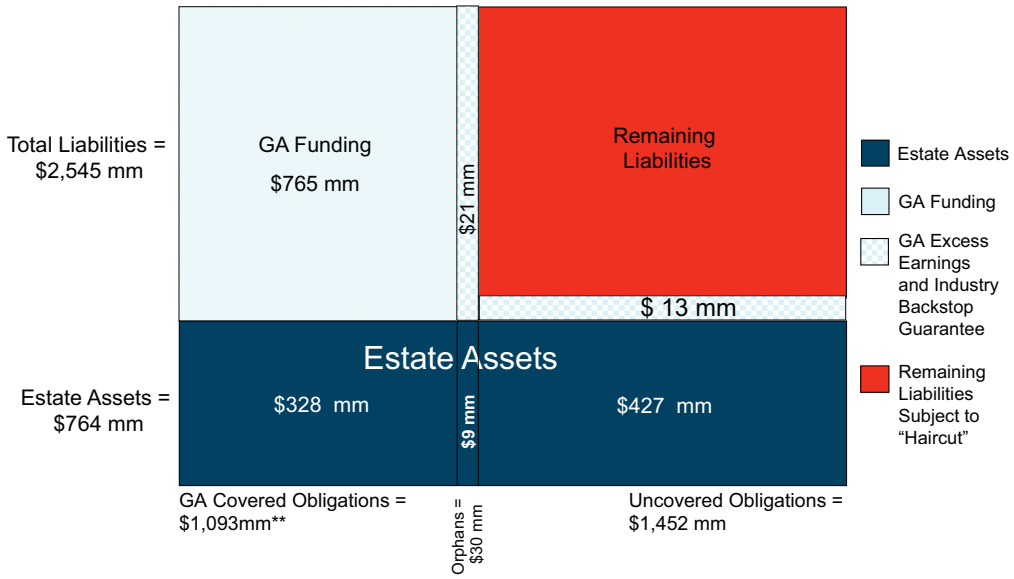

Figure 12. ELNY estate with GA coverage of orphan contracts and industry-backed guaranty of uncovered contract protection.

coverage of orphan contracts and the guarantee of uncovered contract protection are both reflected in Figure 12.

Another special fact in the ELNY case—again, both a challenge and an opportunity in helping to synthesize a creative resolution plan—was the high number of SSAs that ELNY had issued to property and casualty insurers. The intent of the P&C purchasers was that, by funding their obligations (e.g., to insureds or tort victims) with an annuity, they could "defease" their obligations to those parties. In some cases, the P&C insurers either were not expressly released from their underlying liability in connection with the structured settlements or otherwise concluded that they would honor their original settlement-related obligations, not withstanding ELNY's failure. The ELNY resolution plan facilitates the payment by those obligors for the benefit of the payees who otherwise would have received payments under ELNY annuities, and the facilitation of those payments is reflected in Figure 13.

Yet another quirk of the ELNY case was that the NAIC's GA Model Act was amended near the end of the ELNY rehabilitation to increase coverage for individual annuities (such as SSAs) from $100,000 to $250,000 (as applied to the present value of all future annuity payments). But when guaranty associations were triggered by the ELNY liquidation in 2013, not all state legislatures had yet had time to amend their statutes to effect that change in the Model.

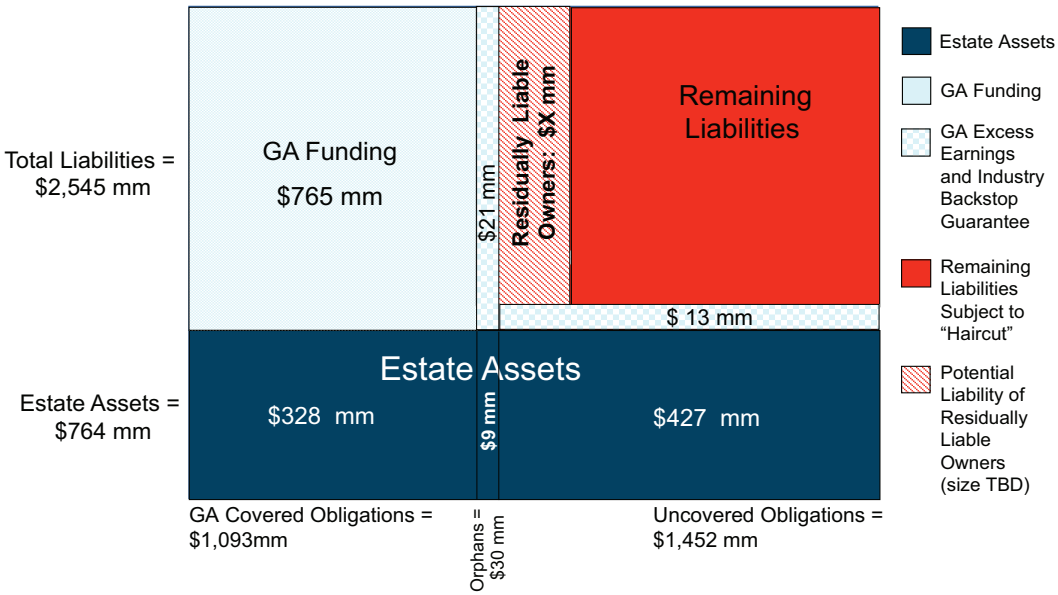

Figure 13. ELNY estate with P&C insurer funding of some SSAs.

Once again, and also voluntarily, a group of 19 companies organized through ACLI agreed to provide an additional guarantee supported by a "supplemental benefits" pool of additional funds to assure that no payee would lose any future annuity payments that had a present value of up to $250,000. In fact, the 19 companies voluntarily over-funded that pool, and the over-funding was made available to cover payments of unprotected claims that otherwise might not be paid.

The effects of the supplemental benefit pool and its over-funding, together with the other plan components previously described, are shown in Figure 14. In sum, these elements of the resolution plan synthesized by the NOLHGA ELNY Task Force and supported by industry stakeholders reduced the amount of otherwise unprotected claims by at least a couple of hundred million dollars.

All those extraordinary elements of the ELNY plan still left the possibility that some payees whose unprotected claims exceeded guaranty association coverage and the other available sources of funding might face significant hardships from benefit reductions. To help address that concern, some ACLI member companies participating in the other extraordinary plan enhancements described above *also* agreed to fund (outside the formal court receivership process) a "hardship fund" of over $100 million, administered by independent experts, that would be applied to defray costs of payees otherwise facing significant personal hardships from potential reduction

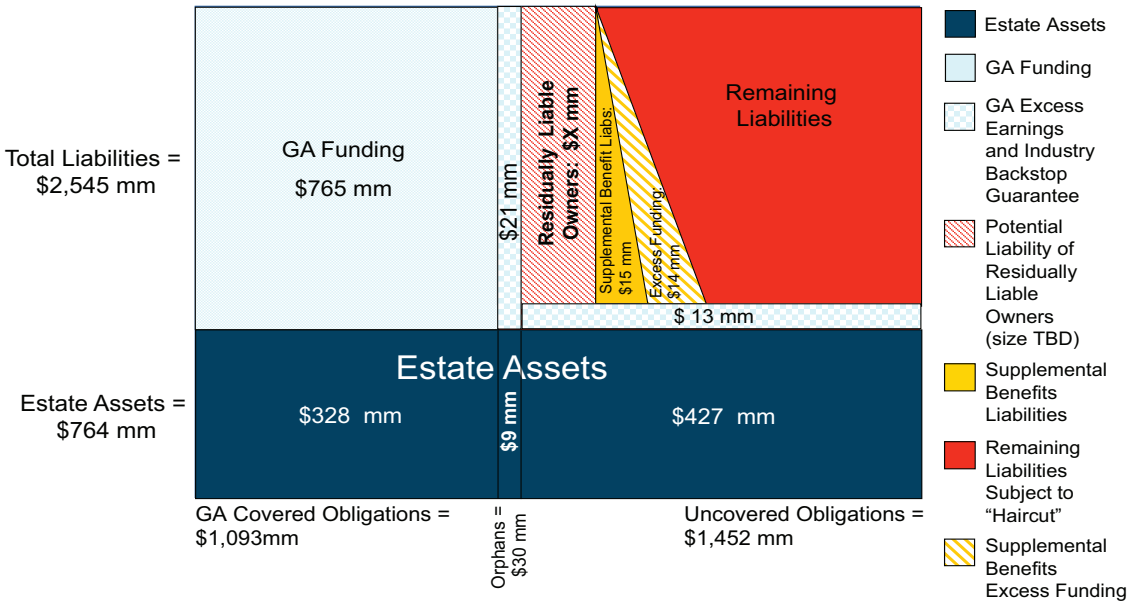

Figure 14. ELNY estate with industry-backed supplemental benefits to match new Model Act coverage level (along with over-funding of those benefits).

of their annuity benefits because of unprotected claims. The application of that hardship fund is illustrated in Figure 15.

Where There's a Will—and a Critical Analytical Process—There's a Way. Everyone involved in the ELNY situation would agree that the unprecedented facts of that case made the development of a resolution plan extraordinarily difficult. All the challenges presented by any nationally significant, complex insolvency were represented in ELNY, along with some additional and unique challenges. Yet some of those unique factors, upon analysis, also presented opportunities for the development of responsive elements of an equally unprecedented resolution plan.

The keys to developing that plan were defining and understanding the problem to be solved; analyzing the important component considerations; and using those component considerations to synthesize and articulate an effective solution. In other words, critical thinking, applied in very practical ways to our particular corner of the real world. ✯

Peter G. Gallanis is President of NOLHGA.

End Notes

1. Liability valuation variables can combine to produce surprising and counterintuitive results, as happened in the ELNY case. In ELNY, liabilities actually *increased* over a long rehabilitation period, even though the company had a closed block of business. This surprising phenomenon was due mainly to the need to ratchet downward valuation assumptions related to investment and reinvestment earnings for the assets held in ELNY to support the liabilities (which were payable according to schedules that did not fluctuate over time).
2. Receivership even of an insolvent company presenting a high liquidation ratio makes eminent sense, because the legal requirement to operate as an insurer is not merely to have assets *equal* to liabilities, but rather to have funding sources that *exceed* liabilities, so as to provide some cushion for adverse events.

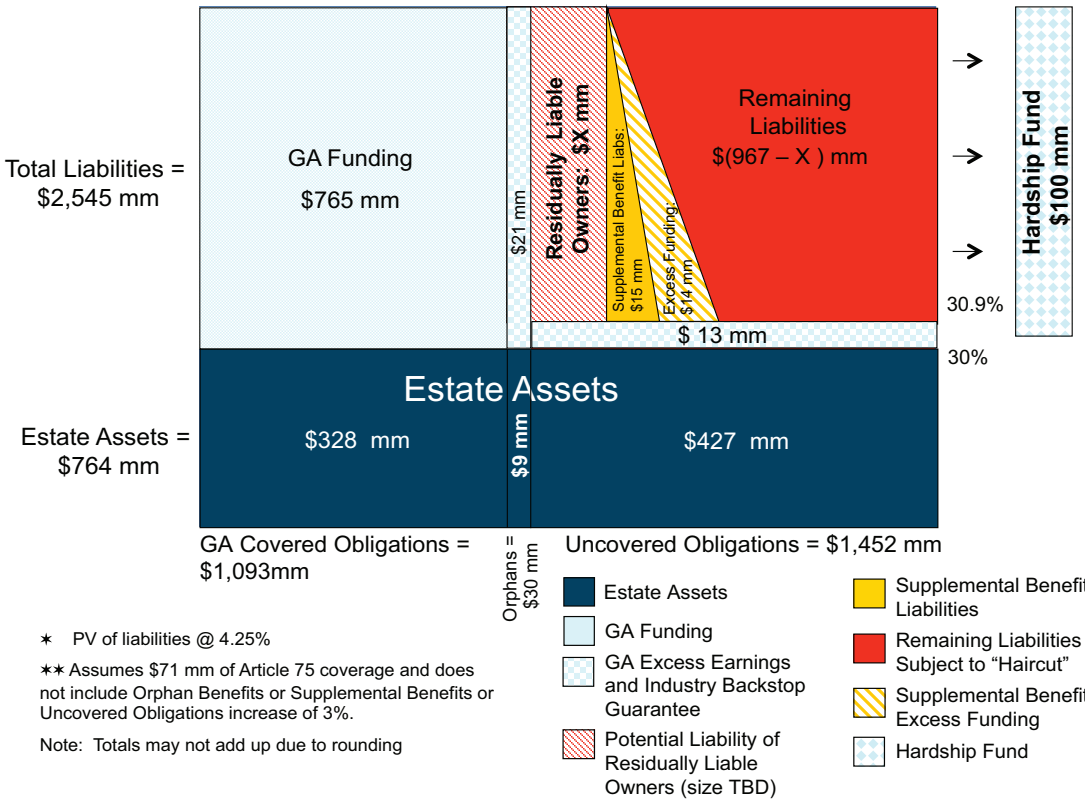

Figure 15. ELNY estate with all funding sources, including Hardship Fund.

NOLHGA Calendar of Events

2017

October 17	**MPC Meeting** **Charleston, South Carolina**
October 18–19	**NOLHGA's 34th Annual Meeting** **Charleston, South Carolina**
December 2–5	NAIC Fall National Meeting Honolulu, Hawaii

2018

January 25	**MPC Meeting** **Newport Beach, California**
March 24–27	NAIC Spring National Meeting Milwaukee, Wisconsin
April 19–20	**MPC Meeting** **Savannah, Georgia**
August 4–7	NAIC Summer National Meeting Boston, Massachusetts
October 17	**MPC Meeting** **Seattle, Washington**
October 18–19	**NOLHGA's 35th Annual Meeting** **Seattle, Washington**
November 15–18	NAIC Fall National Meeting San Francisco, California

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