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NOLHGA Looks to the Future at Annual Meeting

By Sean M. McKenna

David McMahon, NOLHGA's new chairman, captured the mood of the organization's 18th annual meeting in his chairman's address when he said, "When NOLHGA chose the theme 'New Challenges, Steadfast Commitments,' for this conference, we couldn't have known how right we'd be."

The program for the meeting, which was held Oct. 17 and 18 at the Hyatt Regency Tamaya in Santa Ana Pueblo, N.Mex., addressed the main challenges facing the guaranty system, with panel discussions on health insurance insolvencies and optional federal charters. Yet the events of Sept. 11 and their possible repercussions, both for the country as a whole and for the insurance industry, were also on the minds of attendees and speakers alike. As a result, the meeting showcased NOLHGA preparing for a future more challenging than anyone could have foreseen just a few months ago.

Looking Forward & Back

In his outgoing chairman's address, Roger Harbin told the more than 130 attendees at the meeting that he'd hoped for a "quiet, uneventful year" when he took office. However, two issues—the growing number of health insurance insolvencies and what Harbin called "the specter of federal involvement" in the insurance industry—made the year anything but quiet.

In the past year, Harbin said, the Financial Services Modernization Committee was formed to address the optional federal chartering issue; he also noted that the Legal Committee had prepared a report on uniformity in state guaranty laws. With these and other efforts to promote the effectiveness of the state-run guaranty system, Harbin said, "we're having the desired effect of making our point of view known."

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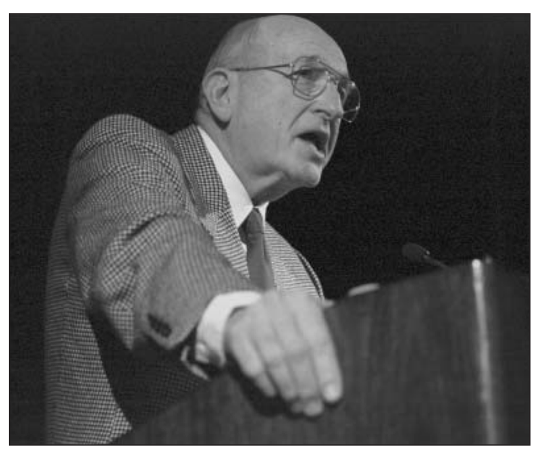

Terri Vaughan (left) presented the NAIC's position on optional federal chartering, and Ron Downing (right) summarized the ACLI's stance on the issue.

PRESIDENT'S COLUMN

The War and Our Guaranty System

By Peter G. Gallanis

I was just finishing the last edition of this column when the news broke concerning the World Trade Center and Pentagon attacks. Much has happened since then. Most significantly, the horror and grief of civilized people everywhere over this assault on innocent members of the world's civilian communities have galvanized public opinion and political leaders across the globe. The civilized world has gone to war against terrorism. It is a new kind of war, with objectives that are much harder to define—and in some ways harder to accomplish—than has been the case in prior wars.

The risks of this war are also harder to define and guard against than those of prior wars. Certain of those risks raise concerns for the insurance guaranty system and those it serves.

The first such concern, for all of us individually and for our system, is the possibility of further terrorist attacks. If office workers in the World Trade Center were targets in this war, then the cold fact is that all civilians and places of business are potential targets.

Hundreds of insurance workers were killed on Sept. 11, and insurance businesses located at and near the World Trade Center were destroyed or badly damaged. Future attacks could destroy or disrupt other insurance businesses, or non-insurance companies in which there is a large concentration of insured risk for a given insurer. Such attacks could result in losses to essential personnel or systems and would produce direct claim losses that could jeopardize the solvency of some insurers, particularly carriers that were encountering difficulties before Sept. 11. Reliance Insurance Co. apparently was pushed over the brink into liquidation by the Sept. 11 atrocities.

The second concern is the risk to the general economy. We were struggling with an incipient recession of uncertain length and severity before this war started. The severe costs of the September attacks, combined with the costs of waging the war, have aggravated the existing economic downturn, causing immediate and serious harm to most businesses and individuals. Consumer confidence is down, equity markets have been off, interest rates are the lowest in generations, home prices have dropped, and unemployment has risen.

> *Hundreds of insurance workers were killed on Sept. 11, and insurance businesses located at and near the World Trade Center were destroyed or badly damaged.*

These economic problems raise some specific worries for the life and health insurance industry. One concern is that, as in prior recessionary periods, claims (particularly disability income claims), policy lapses, and withdrawals are likely to increase. More significantly, insurers will struggle to generate an adequate return on their investment portfolios if interest rates remain low (or drop even further) over a prolonged period. Many companies are now obligated for minimum contractual returns on products, where the guaranteed return is higher than the rates now available for investments in the capital markets.

In this regard, conditions in the United States are not yet as bad as they became for Japanese life insurers in the 1990s, where a somewhat worse "negative spread" environment produced a number of failures by insurers that were household names in Japan. Nonetheless, the domestic trend lines are troubling.

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Additionally, pressure on insurers' investment returns is likely to cause struggling companies to consider investing disproportionately in higher-yielding securities and other instruments, which carry default, prepayment, valuation, and reinvestment risks of the sort that have contributed to a number of prior domestic insolvencies.

A third major concern is the risk of hastily considered political reactions and the unintended consequences they may bring. Shortly after the September attacks, voices within the insurance industry began to call for legislation that would in some fashion cause the federal government to serve as a "reinsurer of last resort" for terrorist losses. The idea has some precedents in England and Israel. Trade groups and political leaders have advanced a number of somewhat detailed, competing proposals.

The logic of the basic concept is simple and appears sound: private-sector insurance has at its core the assessment and management of, and pricing for, the transfer of risks that are predictable and somewhat controllable, whereas terrorist acts are inherently unpredictable and uncontrollable. Accordingly, it is argued, the costs of terrorist attacks on the nation should be borne, at least in part, by the nation as a whole.

As I write, there are differences between key legislators and the administration regarding some details of the proposals, but the informed consensus view is that some version of a federal terrorism reinsurance bill will be enacted before the end of this year. The unanswered political questions at this point relate to how much increased federal oversight of insurance will follow from the federal government's involvement as a terrorism reinsurer, and what the new federal role may portend, in the somewhat longer term, for the future of insurance regulation.

In the early public discussion about federal terrorism reinsurance, some of the key members of the House of Representatives stated that there would be no federal insurance "bailout" without a formal federal oversight presence in the field. As the evolving proposals have come to look less like an industry bailout and to incorporate "sunset" provisions, the calls for direct federal oversight have subsided.

Still, the level of congressional oversight over insurance industry operations has been higher in the past year than at any point since the early 1990s. If the federal government becomes contingently liable for many billions of dollars of terrorism reinsurance risk, that trend likely will accelerate.

The increasing federal focus on insurance since Sept. 11 must also be viewed against the backdrop of the ongoing debate over federal chartering for insurers. In mid-November, the ACLI's Board of Directors authorized ACLI staff to seek introduction in Congress of legislation that would establish optional federal chartering for life insurers. During the past year, the American Bankers Insurance Association, the American Insurance Association, and the ACLI each unveiled legislative proposals for optional federal chartering. While optional federal chartering still faces serious opposition, the federal reinsurance initiative and the likely heightened congressional scrutiny of insurance may be yet another siege advance in the assault upon the citadel of exclusive state jurisdiction for insurance regulation.

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The political risk to the guaranty system lies in the possibility that the mechanism for delivering "safety-net" protection to insurance consumers may receive inadequate attention if the principal legislative battlegrounds for insurance bills involve other topics, such as direct industry financial assistance, tax reform provisions, corporate and product regulatory reforms, class action litigation standards, and tangential social issues. Stated differently, the question of how best to protect insurance consumers against insurer insolvencies may get short shrift if the debate becomes fast and furious on other subjects. If the focus of the legislative debate rests elsewhere, political expediency might be served by an apparently simple resort to an FDIC-style legislative approach to guaranty protection, given the familiarity of that approach to legislators who have had far more experience with banking than with insurance.

Those who have been involved in the guaranty system must lose no opportunity to keep this debate in the foreground. Insurance and banking are different. Bank deposits are essentially commodities. Insurance contracts embody a vastly more complex combination of promises that involve not only insurers' financial commitments, but also their promises to accept the transfer of a variety of risks and to provide an array of services that cannot be fully appreciated by someone who does not have comprehensive experience in the insurance arena.

Simply writing checks cannot solve the problems attending an insurer's failure. If consumers are to be protected, experienced insurance professionals must evaluate the obligations of the failed carrier to its policyholders and see to it that the carrier's various financial and service commitments are kept.

The current life and health guaranty system repeatedly has proven its ability to see that those insurance promises are honored. The consumer has a right to no less. ■

Have an Idea for the NOLHGA Journal?

If you would like to write for the *NOLHGA Journal* or have a suggestion for an article, please contact Sean McKenna at 703.787.4106 or via e-mail at smckenna@nolhga.com.

Guaranty Protection: How Would It Change Under the Optional Federal Charter Proposals?

By William P. O'Sullivan

For the past several years, there has been vigorous debate within insurance circles over the possible federal regulation of insurers. Recent developments suggest that this issue will be the subject of continuing debate and focus, as well as possible legislative action.

One such development is that Congress, in response to the events of Sept. 11, is considering legislation to protect P&C insurers and reinsurers from catastrophic terror-related insurance losses. Based on discussions to date, this legislation could provide for some federal oversight of the affected insurers to protect the government's interests. Some observers believe that a limited provision of federal regulation in this context could pave the way for more-comprehensive federal regulation of insurers in the future.

Another development that portends a continuing focus on federal regulation is the recent decision of the American Council of Life Insurers (ACLI) to seek introduction in Congress of an optional federal charter proposal. In taking this step, the ACLI reaffirmed its support for efforts to improve state regulation but made it clear that it is also committed to a federal alternative.

In light of these developments, and the possibility that federal regulation could be on a legislative fast track in the near future, it is important for guaranty system participants and other interested parties to understand the various optional federal charter proposals and how they might impact the guaranty system.

As a means of furthering that understanding, this article will examine how the guaranty association mechanisms under the federal charter proposals differ from the current system and the potential implications of those differences. To begin, however, the article will provide a brief overview of the guaranty mechanisms provided for under the various federal charter proposals.

Overview of Proposed Federal Charter Guaranty Mechanisms[1]

To date, the ACLI, the American Insurance Association (AIA), and the American Bankers Insurance Association (ABIA) have released proposals for federal charter legislation. Generally speaking, these proposals take two basic approaches to providing guaranty protection for consumers of insolvent insurers.

The ACLI and AIA proposals take a similar approach—both rely on the existing state system to provide guaranty protection for federal- and state-chartered insurers.[2] In contrast, the ABIA proposal creates an entirely new guaranty mechanism based on the FDIC model for protecting deposit holders of failed banks. The ABIA mechanism would cover all federal insurers but only certain state-chartered insurers that are accepted into the program. State-chartered insurers not accepted into the program would remain in the existing state guaranty system.

Comparison of Proposed Guaranty Mechanisms to the Current System

Since the ACLI and AIA proposals both rely on the existing state system, this article will focus on how the ABIA's guaranty system differs from the current life guaranty system.[3] Set out below is an overview of the important differences between the two systems and the possible implications of those differences.

Organization: The ABIA proposal creates a new federal government agency—the National Insurance Guaranty Corporation (NIGC)—to provide guaranty protection for federally chartered insurers and certain state-chartered insurers. The NIGC would presumably be staffed with federal government employees.

In contrast, the existing guaranty system is composed of associations of insurers created under state law. While these associations are not considered part of state government,[4] each works closely with its state's insurance commissioner, who has a supervisory role over the association. However, each association also has a board of directors—consisting largely of industry representatives—that has responsibility for managing and directing the association's activities and operations.

One of the benefits of the current system is that it promotes efficiency by providing the industry—which funds the system and therefore has an incentive to control costs—with direct supervisory responsibility while also recognizing the need for some regulatory involvement.

Purpose: The purpose and activities of the current system are focused on protecting policyholders of insolvent insurers. In contrast, the ABIA's guaranty mechanism (i.e., the NIGC) has a broader mission that includes not only protecting policyholders but also serving as receiver and performing certain regulatory functions.

This broader mission will require more resources than the current system, and it could divert the NIGC from its principal function of protecting policyholders. In addition, by combining guaranty, receiver, and some regulatory functions in the NIGC, the ABIA proposal will forgo valuable checks and balances that exist when these functions are kept separate.

Protection for Policyholders: Under the ABIA proposal, the NIGC's powers to continue coverage are more limited and less specific than those provided to state guaranty associations. However, the NIGC has extensive powers to assist financially troubled insurers, both pre- and post-receivership, by arranging for mergers, acquisitions, and transaction-based solutions. In this regard, the ABIA approach seems to follow the FDIC model for protecting deposit holders of troubled banks.

However, insurance products are very different from bank deposits, in that they often consist of complex, long-term financial obligations with significant service components. Given this fundamental difference, it will not often be possible or desirable to arrange for a quick transactional solution. This is particularly true in cases where a block of insurance is not readily marketable and needs to be worked out over time. In those cases, experienced insurance professionals will need the statutory authority and tools to administer and structure policyholder benefits so that the block can be serviced in contemplation of future disposition.

Industry Role: Under the ABIA proposal, insurance company personnel are ineligible to serve on the board of the NIGC. Moreover, there is no requirement that members of the NIGC board have prior insurance experience. This is in contrast to the current system, where insurance company personnel serving on guaranty association boards have been an invaluable source of expertise and support in protecting policyholders.

...by combining guaranty, receiver, and some regulatory functions in the NIGC, the ABIA proposal will forgo valuable checks and balances that exist when these functions are kept separate.

Allocation of Cost: Under the ABIA proposal, LH&A companies will be assessed to cover all life, health, and annuity products irrespective of the lines of business they write. In contrast, member insurers under the current system are only assessed to fund coverage for the types of products they themselves write. This approach recognizes that there are different types of insurance products and that the benefits and costs of providing insolvency protection differ among the different products.

Funding of Coverage: The ABIA's proposal employs a "pre-funded" assessment system that requires the industry to maintain a large, permanent capital contingency fund. In contrast, the current system uses a post-funded system, where insurers are assessed on an as-needed basis.

There are two potentially negative economic consequences of the ABIA's approach. First, this approach will cause the insurance industry to bear substantially greater up-front assessment costs than it does under the current system. Second, it will divert a significant amount of capital from the private sector, where it could be used for business expansion and other productive purposes. Given the long-term nature of many insurance obligations and the proven ability of the current system to meet its obligations by assessing funds when needed, there are substantial questions about whether the economic costs of a pre-funded system are justified.

In addition, a pre-funded system poses the risk that ready access to large cash deposits will result in expensive "quick fix" solutions to insolvencies. This would be in contrast to the current system's approach, which recognizes the relatively long-term nature of insurance liabilities and emphasizes creative and careful financial planning to achieve efficiencies in protecting policyholders.

Assessment Base: The current life guaranty system provides a single safety-net system with one assessment base consisting of all LH&A insurers. In contrast, the ABIA's proposal would result in two guaranty mechanisms, dividing the assessment base between the NIGC and the state guaranty system. This, in turn, could result in inadequate assessment capacity for both systems. In addition, the admission criteria for state insurers to join the NIGC is based on the financial strength of the applicant; this raises the risk that only the strongest state insurers will be admitted, leaving only the weaker companies in the state system.

Conclusion

The existing life guaranty system has proven itself to be very effective at protecting policyholders in a cost-efficient manner. Since 1988, the system has ensured that insolvent insurers' commitments have been kept on approximately $20 billion of policy obligations with a full-time staff of fewer than 100 persons.

The success of the current system has much to do with the fact that it was specifically designed to protect consumers of insolvent insurers. In the event that Congress decides to adopt an optional federal charter for insurers, it will need to decide whether the existing "custom designed" system should be preserved or whether it should be replaced with an adapted version of a system created for banks. In considering these alternatives, Congress will need to carefully consider the differences and potential implications of the two approaches. ■

William P. O'Sullivan is the senior vice president and general counsel for NOLHGA.

Endnotes

1. A more-detailed overview of these proposals can be found in "Proposals for an Optional Federal Charter: How Do They Provide Guaranty Protection?" in the Fall 2001 issue of the *NOLHGA Journal*.

2. The ACLI's federal charter proposal only applies to companies that write life, annuity, disability, and long-term care business, and thus it principally relies on the existing state life guaranty mechanism to provide insolvency protection for policyholders. Conversely, the AIA proposal only applies to property and casualty companies, and thus it relies on the existing state P&C guaranty mechanism to provide that protection.

3. The ABIA proposal applies to both life, health, and annuity and property and casualty insurers. However, this discussion will cover only those aspects of the ABIA proposal applying to life, health, and annuity guaranty protection. This discussion also assumes the provisions of the current NAIC Life and Health Insurance Guaranty Association Model Act in describing the existing life guaranty system.

4. The Arizona Life & Disability Insurance Guaranty Fund is an exception to this statement.

Arizona Receiver Holds AMS Actuaries Accountable

By Joni L. Forsythe

Mark Tharp, special deputy receiver for AMS Life Insurance Co., takes a proactive stance on asset recovery. As a result of his diligent efforts and the support of the Arizona Department of Insurance and litigation counsel, asset recovery on behalf of the AMS Life estate will likely exceed $30 million. The largest portion of this recovery resulted from his successful pursuit of claims against the company's former actuaries, seemingly breaking new ground in professional liability litigation.

"When I first started thinking about this lawsuit and began discussing it with AMS's lawyers back in 1996, there were a number of people who were skeptical," said Tharp. "The idea of an insurance receiver bringing a lawsuit against an accounting firm for accounting malpractice was daunting enough, but suing two actuarial firms for negligence was unheard of."

Professional Negligence Identified

AMS was an Arizona-domiciled insurer that predominantly wrote and reinsured individual deferred annuities and some limited life policies. The company was licensed in Arizona, Illinois, Indiana, South Dakota, and Texas and had annuity contract holders and policyholders in approximately 40 states. On March 27, 1992, AMS was placed into receivership by order of the Maricopa County Superior Court in Phoenix. The "hole" created by the insolvency of AMS totaled approximately $50 million.

While conducting due diligence, Tharp identified what he believed to be multiple occurrences of professional negligence in connection with the accounting and actuarial services provided to AMS from 1983 to 1991—conduct that he believed contributed significantly to the company's ultimate insolvency.

"I remember discussing a potential lawsuit against the actuaries with Michael Glover of the law firm Glover & Van Cott, with whom I have enjoyed a long and successful relationship," Tharp recalled. "I had a very strong sense of outrage about what the actuaries had done and had failed to do. I went to Michael to see if my intuitive sense of this case had a basis in the law. In short, did we have a case?

"Michael came back to me a week later and said that there was very little guiding case law regarding actuarial liability, but that the concept of professional accountability is well established in the law, and

> *"I had a very strong sense of outrage about what the actuaries had done and had failed to do."*

actuaries were undeniably professionals. Not only did he feel we had a case, as did I, he advised me that it was an important area of professional accountability which had been all but ignored. In consultation with the Arizona Department of Insurance and General Counsel Joe Hennelly of the law firm Hennelly & Steadman, we collectively decided it was time for actuaries to be held accountable for their actions. And so began the litigation."

Demanding Accountability

In 1997, Tharp filed suit alleging professional negligence and negligent misrepresentation against the company's former accountants and actuaries. The defendants included the accounting firm McGladrey and Pullen (former outside auditors for AMS), certain former officers and directors of AMS, and the actuarial firms William M. Buchanan and Associates, Inc., and J. Huell Briscoe and Associates, Inc., as well as certain of their principals and associates.

Almost immediately after the filing of the lawsuit, the McGladrey and Pullen defendants agreed to settle the claims against them for the sum of $5 million. Over the course of the next few years, other claims were settled or dismissed, resulting in additional payments to the AMS estate of $1.1 million.

In December 2000, William M. Buchanan and Associates, including William Buchanan individually and Unified Life Insurance Co., a Texas-domiciled insurer owned at the time by Buchanan, approached the receiver regarding settlement. After considerable negotiations, the "Buchanan Defendants" agreed to pay the receiver $2.25 million in settlement of the claims against them.

After years of hard-fought litigation, more than 100 days of depositions, and extensive settlement negotiations, the case was scheduled for trial in June 2001. The sole remaining defendant group included the actuarial firm J. Huell Briscoe and Associates out of Chicago and two of their actuaries, Jerome Comm and Bruce Jackson. The "Briscoe Defendants" were represented by the Chicago law firm Lord Bissel and Brook, and the AMS receiver was represented by the law firm Glover & Van Cott from Phoenix, with Michael Glover and Joyce Van Cott as the lead attorneys.

The Trial & Verdict

The evidence in this case included the testimony of a number of expert actuarial witnesses.[1] Following a lengthy bench trial that ended on July 13, the judge entered a ruling in favor of the receiver on the issue of liability and requested post-trial briefing on the issue of damages. On Sept. 5, the trial judge entered a verdict outlining his

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findings in the case and determining the liability of the Briscoe defendants to be $17.5 million.

As set forth in the findings of the court, the Briscoe defendants provided virtually all of the actuarial services for AMS Life during the period at issue—including quarterly reserve calculations and year-end certification of reserves—and further provided information for annual statements. The court went on to note that the defendants knew or should have known that AMS Life was totally dependent upon the Briscoe defendants to provide timely and accurate actuarial services, and that their repeated failure to do so was a violation of their professional obligations to AMS Life, the state regulators, and policyholders.

The verdict in this case is believed to be one of the largest awards ever obtained against an actuary or actuarial firm for professional negligence. Considering interest and possible attorneys fees, the judgment amount could exceed $20 million, bringing the total litigation recoveries to more than $30 million. Tharp cautions that there is still some arguing to be done in connection with post-trial objections before the judgment is finalized, and he notes that an appeal is possible.

> *...Tharp has had great success in pursuing asset recovery litigation in other Arizona-based insurance insolvencies.*

Tharp adds, however, that he will continue to press forward and is "confident that at the end of the day, Briscoe will answer for its negligence." The proceeds from the lawsuit, once collected, will be distributed to the guaranty associations that have funded the company's obligations to policyholders.

Teamwork & Support

As Tharp notes, asset recovery litigation like the AMS lawsuit is a team effort that requires commitment, patience, and support, as well as sound judgment and diligent lawyering. "A lawsuit like this would have been impossible to carry out without the support of the receiver, Charles R. Cohen; the Arizona Director of Insurance; and his staff," Tharp said. "I cannot say enough about the support that I and the law firms Glover & Van Cott and Hennelly & Steadman have received from Director Cohen, Deputy Director Sara Begley, and Deputy Receiver Leslie Hess. The trust they placed in us was critical and very much appreciated."

In addition to his work on AMS Life, Tharp has had great success in pursuing asset recovery litigation in other Arizona-based insurance insolvencies. For example, in 1996 Tharp, as special deputy receiver for Farm and Home Life Insurance Co., with Glover & Van Cott as litigation counsel and Joe Hennelly as general counsel, completed five years of litigation against more than 20 defendants, which resulted in cash settlements of $95 million paid to the Farm and Home Estate.

"Litigation like this is expensive to launch and even more expensive to maintain," Tharp said. "If you don't have the support of the receiver and those around you, results like this just don't happen." ■

Joni L. Forsythe is senior counsel for NOLHGA.

Endnotes

1. The primary actuarial expert used by the receiver for AMS was Jerome F. Seaman of Jerome F. Seaman and Associates, Inc., out of Chicago, with consulting assistance from John D. Radek of MMC Enterprise Risk Consulting, Inc., in Chicago. The Briscoe defendants used Robert E. Wilcox (former Utah Insurance Commissioner and current consulting actuary in Salt Lake City, Utah, from the firm of R. E. Wilcox and Co.) and Michael A. Hughes, an actuary with Ernst and Young LLP, in Chicago.

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Harbin's term as chairman also saw the formation of the Health Insurance Issues Committee, which was charged with developing new techniques for the guaranty system to meet the unique challenges of health insurance insolvencies. Harbin praised the committee's recent report, noting that one of the best aspects of the guaranty system is that the industry learns quickly and is able to adapt to changing demands on its resources.

In closing, Harbin said that it was still too early to gauge the effects of the terrorist attacks of Sept. 11 on the insurance industry. He noted that while NOLHGA was unaware of any life and health insurer whose solvency was directly threatened by those events, the early effects would be seen in the reinsurance side of the industry, what he called "the leading indicator of the financial stress in our business." Harbin also noted that if the federal government became involved in reinsurance, it would no doubt wish to regulate the industry rather than simply serve as a reinsurer of last resort.

Different Views on Federal Charters

Fittingly enough, the main presentation on the first day of the meeting concerned federal involvement in the insurance industry. "Perspectives on Optional Federal Charters" began with Terri Vaughan, Ph.D., commissioner of the Iowa Insurance Division and vice president of the NAIC, giving attendees an overview of the NAIC's modernization initiative and its stance on optional federal charters.

According to Vaughan, market forces such as globalization and e-commerce have highlighted the need for streamlining, cost-cutting, and overall modernization in the insurance industry. The NAIC has targeted a number of areas in its modernization initiative, including privacy, producer licensing, speed to market, market conduct, and company licensure.

In the area of producer licensing, Vaughan explained, "we wanted to create a national

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licensing system," complete with more-uniform laws and technical infrastructure. The NAIC has created a national licensing database, and Vaughan feels they've made "remarkable progress."

Vaughan noted that the NAIC has also made strides in its efforts to improve speed to market, but she added that more industry participation is needed. She discussed the NAIC's Coordinated Advertising Rate and Form Review Authority (CARFRA) system, which can approve a filing in 45 days. According to Vaughan, 10 states are participating and three product lines have been approved for review through CARFRA. While two more product lines are expected soon, she said that "the biggest disappointment" with the program was the low number of filings so far.

The bulk of Vaughan's comments centered on optional federal charters and the NAIC's stance on them. She noted that while a move to an FDIC-style system might make sense to some, "there is a significant difference" between the banking and insurance industries. As an example, she pointed out that there are approximately 450,000 consumer complaints about the insurance industry, while the banking industry fields far fewer.

One reason for this disparity, she said, is the complexity of insurance contracts as compared with typical banking transactions. She also noted that the problems faced by consumers can occur at times of crisis, when help is needed quickly. Finally, many of the issues that arise in the insurance industry are by their very nature "hot-button" or political issues that are difficult to resolve.

"State regulation has its problems," Vaughan concluded. "But it also has its strengths." Those strengths, she said, include a history of adapting to the changing needs of consumers and the insurance industry. While implementing changes to state regulation is difficult, Vaughan said, the system's "proven history of protecting consumers" makes improving it preferable to creating a new federal system.

Ron Downing, president and CEO of National Farm Life Insurance Co. and a member of the NOLHGA Board of Directors, presented the ACLI's stance on federal charters with his typical good humor, noting that he was the eighth person asked to make the presentation because the first seven people were smart enough to say no.

He began by going over the history of the ACLI's Regulatory Efficiency and Modernization (REM) Initiative, which began in 1999 when a survey of insurance industry CEOs revealed several inefficiencies in product regulation, producer licensing, and market conduct. The CEOs surveyed thought these inefficiencies created a disadvantage for the insurance industry in an increasingly competitive market.

Speakers received a warm response from the more than 130 attendees at the meeting.

The ACLI's efforts to improve efficiency followed along two tracks. The first track, Downing said, was designed to "improve the state system of insurance regulation." In the product regulation/speed to market field, the ACLI is working to establish what it calls "single point of filing" using CARFRA, an entity with exclusive jurisdiction over product filings. He noted that the ACLI will work with the NAIC to make sure more product types are added to CARFRA and more states participate in the system.

Downing added that uniformity was the ACLI's chief goal in producer licensing and that the ACLI supports uniform adoption of the NAIC's Producer Licensing Model Act, which has been adopted by more than 30 states with minor deviations. However, he noted that some of the larger states—California, Florida, and New York, for example—have not adopted the model act.

In the market conduct field, Downing said the ACLI is moving to streamline the existing market conduct examination system. The group recommends moving to a zone system, similar to that used for financial examinations, that would cut down on overlapping exams performed by individual states and would apply uniform compliance standards.

Track two of the ACLI's modernization efforts involved drafting an optional federal chartering proposal. Downing said the drafting process began in June 2000, and the proposal is available on the ACLI's Web site (www.acli.org). He stressed that charter neutrality was a goal throughout the drafting process and added that the proposal is optional and does not result in deregulation; "the draft would enact a regulatory system at least as strong as we have today," he said.

Echoing Harbin's comments, Downing said that the tragedies of Sept. 11 could result in federal involvement in reinsurance and noted that this "could have regulatory implications." He added, "the absolute worst thing I can imagine is state regulation with federal oversight."

While Vaughan and Downing addressed the pros and cons of federal chartering, Phil O'Connor, Ph.D., president of the Illinois market for AES NewEnergy, Inc., examined the driving forces behind the call for federal involvement in the insurance industry and the possible outcome of such involvement.

According to O'Connor, the main impetus for federal chartering has always been the dissatisfaction of insurers with state regulation. However, insurers have also been wary of federal chartering, fearing that it could be the first step toward a much larger federal presence in the industry; this and other factors have served as obstacles to any change in the state-run system.

However, O'Connor said that changes in the industry, such as trade association support for optional federal chartering and Gramm-Leach-Bliley, have changed the way the industry views federal involvement and legitimized the idea of federal chartering. Efforts to improve state regulation (like those mentioned earlier) have also drawn Congress's attention, he noted, although at this point the pressure seems to be on overall improvement rather than on specific facets of the industry.

O'Connor added that issues outside the chartering debate may drive the debate nonetheless. He pointed to the proliferation of class actions suits, which he said "are really a form of extortion," as an issue that could drive the industry toward federal involvement, since some companies would prefer to operate under federal class action laws.

Federal chartering of life and health insurance "really is the path of least resistance," O'Connor said, since local differences aren't a compelling argument to many in Congress. However, he added that "Congress may drag this one out" by using the issue as a way to generate campaign contributions.

O'Connor listed a number of risks inherent in optional federal chartering, noting that national policies can result in big mistakes, the division of labor between the federal government and the states could be muddled, and the move to a federally regulated system could result in a lack of access for consumers. If a federal system is put in place alongside the state-run system, O'Connor said, "they'll coexist for a while." But he predicted that if a state guaranty fund is unable to cover an insolvency, the federal system would eventually take over.

"Each time an insolvency does occur, we learn again that the true value of our system lies in our readiness and our ability to protect the policyholder," said NOLHGA Chairman David McMahon.

New Challenges & Responsibilities

Peter Gallanis used his president's address to give attendees an overview of the possible short- and long-term implications of the terrorist attacks of Sept. 11. Gallanis addressed the direct impact on the insurance industry (such as the hastening of the Reliance Insurance Co. insolvency) as well as the threat posed by a weakened economy and by the possibility of increased federal involvement in the industry (a summary of Gallanis's speech appears in "The War and Our Guaranty System" on p. 2).

In his chairman's address, David McMahon (VP, associate general counsel, and secretary of GE Financial Assurance/First Colony Life) spoke of the value of the guaranty system in light of the Sept. 11 attacks, saying that "in these uncertain times, NOLHGA and the guaranty system can serve as a rock of certainty." However, he added that those who work in the system have a responsibility to support and improve it.

That support, McMahon said, involves "singing the justly deserved praises of our system" in the discussion of optional federal chartering. He noted that NOLHGA

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Goto, Jackson Complete Board Terms

NOLHGA's 18th Annual Meeting marked the end of the Board of Director terms of Douglas Goto and Jim Jackson. During the Annual Business Session, Roger Harbin made special note of their contributions to the organization and thanked them for their many years of service. He also presented Jackson with a special plaque to commemorate his work on the Board (Goto was unable to attend the meeting).

On accepting the plaque, Jackson called NOLHGA "a great organization to be associated with" and praised the work performed by NOLHGA and its members, saying simply, "they do good things for people who need help."

NOLHGA Annual Meeting...

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and its members are uniquely suited to defend the state-run guaranty system and point out the dangers of abandoning it. He also spoke of the need to "get the word out to state insurance departments and insurance companies about the value of a strong, viable system that can react quickly to an insolvency."

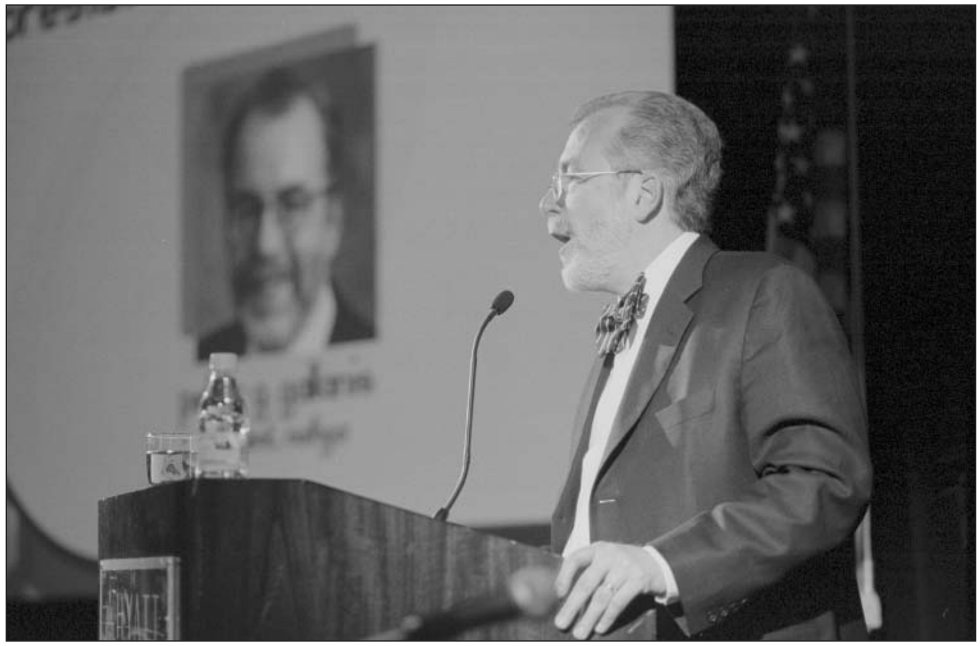
While praising the system, McMahon acknowledged that, "as good as we are, as the system is, we can do better." The drive toward financial services modernization is a challenge and an opportunity, he said, because it's given the industry an opportunity to pinpoint places where it can improve.

One of the primary areas in need of improvement, McMahon said, is uniformity in state laws. "We'd be wise to create uniformity where it doesn't yet exist," he said, pointing to a NOLHGA Legal Committee report that identified five areas in state guaranty laws (who is covered, when coverage starts, what types of contracts are covered, coverage limits, and how assessment provisions are set) where uniformity "could and should be achieved by the adoption of language from the Model Act."

In closing, McMahon reminded attendees of the value of the state-run guaranty system and the chance they have to improve it. "We've got a great system," he said, "and we're in the best position to make it even better."

A Look at the Industry

Dan McCarthy, a principal with the actuarial and consulting firm Milliman USA, gave attendees a broad overview of the trends driving the life and health insurance industry. He began by saying that the industry is named incorrectly.



"The fact is that this system does consumers a great deal of good, and that good is accomplished with an exceptionally low price tag," said NOLHGA President Peter Gallanis.

"It's really the annuity industry in many respects," McCarthy said, noting that annuities have come to dominate the business. He also noted that the industry is consolidating and that more companies are concentrating on single product lines, lessening their stability if a particular product line should run into trouble.

The lack of early warning systems for companies in danger of insolvency makes this trend a dangerous one, in McCarthy's opinion. "For the most part, we are still cleaning up after the fact," he said. He pointed to the increasing separation of asset accumulation and insurance risk in many companies as another troubling trend.

McCarthy borrowed a trick from David Letterman by presenting a top 10 list of risky products. They included:

- **Medical insurance:** Many companies write this and little else, McCarthy said, and he predicted that "we're going to see more companies in trouble" because they don't have other products to balance out medical insurance costs.
- **Long-term care insurance:** The bills on this type of product usually aren't seen till 20 years after it's sold, making it difficult to tell if it's priced correctly. "In every new product line the insurance industry has gone into, in one way or another, we've paid for our education," McCarthy said.
- **Equity-indexed annuities:** The combination of a complex product and no SEC requirements make this product very dangerous, McCarthy said. "If I had to identify the next looming class action suit, I'd pick this one," he added.

Other products that made McCarthy's list included what he called "trick GICs," noncancelable disability income insurance, payout annuities, long-term disability insurance, variable annuities with guaranteed living benefits, term-life insurance with long premium guarantees, and variable annuities.

McCarthy also provided attendees with a top 10 list of industry issues. While traditional issues like regulation and litigation made the list, McCarthy also pointed to the danger of risky investments; "in these times, everyone wants to get an edge," he said, and this can result in ill-advised investment strategies.

This can go hand in hand with another item on the list, needless risk. McCarthy pointed out that risks are often taken, not to support the company, but to generate

Presentations On-line

The PowerPoint presentations given by Phil O'Connor, Ph.D.; Dan McCarthy; and the Health Insurance Insolvencies panel are available in the "Confidential Access" section of the NOLHGA Web site (www.nolhga.com).

additional earnings. If the true nature of these risks isn't understood, significant losses and even insolvencies can result. "That lesson gets learned every decade or so," McCarthy said.

Health Insurance Insolvencies

The meeting ended with a presentation by members of the Health Insurance Issues Committee. Merle Pederson, VP and counsel, Government Relations, for the Principal Financial Group; Dick Klipstein, executive VP and COO of NOLHGA; and Charlie Richardson, a partner with Baker & Daniels, held a panel discussion on ways to improve the handling of health insurance insolvencies.

As the panel noted, these types of insolvencies, which have become more common in the past few years, are fundamentally different than life insurance insolvencies; the pace is quicker, with transactions occurring on a daily basis. Claims must be paid quickly, and there's increased contact with policyholders.

> *"In every new product line the insurance industry has gone into, in one way or another, we've paid for our education," McCarthy said.*

Not surprisingly, the recommendations of the panel (which are contained in a report the committee presented to the Board of Directors) centered on acting quickly. "One of the themes of this presentation is reaching out to regulators early on," Pederson said. "We need to get involved before the guaranty associations are triggered." He also spoke of "how quickly cash bleeds out of these companies if steps aren't taken."

The panel examined in detail what those steps are and how rapidly they must be taken for the guaranty system to do its job successfully. Early involvement by guaranty associations is crucial, as is aggressive coordination with insurance commissioners. Klipstein noted that the NOLHGA due diligence team in these cases should be expanded to include a third-party administrator, a health insurance specialist, and a "best practices" consultant.

The chief goal, according to the panel, is to convince regulators to reach out to the guaranty system as early in the process as possible. "We need to do a better job of informing regulators of who we are, what we do, and how we can help," Pederson said. He also noted the significant political and economic risks regulators face in these insolvencies, especially if claims aren't paid quickly.

In addition to their call for quick intervention on health insurance insolvencies, the Health Insurance Issues Committee prepared a list of steps that should be taken as quickly as possible:

- Complete arrangements for third-party administrators
- Arrange for guaranty association funding of claims
- Cancel cancelable policies (if this is determined to be the best strategy)
- Retain necessary levels of staffing (customer service and claims)
- Develop a communications package for policyholders and providers
- Complete arrangements for key services with PPOs, drug card providers, etc.

The benefits of early intervention, the panel noted, include efficient and cost-effective disposition of the health block, reduced policyholder hardships, early identification of administrative deficiencies in the insurer, and enhanced communication ability, among others.

Pederson added that NOLHGA wants to launch "an aggressive communications plan" to inform regulators of the benefits of early guaranty association involvement and to enhance NOLHGA's credibility as a valuable resource in insolvencies.

The panel discussed 18 recommendations from the committee's report. They included establishing an "on the shelf" arrangement with a third-party administrator that is approved by guaranty associations well before an insolvency, determining the feasibility of pre-arranged rollover offers, producing a report for the regulatory community on the lessons learned in the Centennial and American Chambers insolvencies, and developing a database of regulator, staff, and chief financial examiner contact information. A complete list of the recommendations can be found on the NOLHGA Web site (see "Presentations On-Line," p. 10). ■

Sean M. McKenna is the communications manager for NOLHGA.

Merle Pederson (left), Dick Klipstein (right), and Charlie Richardson (not shown) presented a report from the Health Insurance Issues Committee with recommendations on how to handle health insurance insolvencies more effectively.

Calendar

2002		
January 29–31	**NOLHGA MPC Meeting**	**Savannah, Ga.**
February 5–6	**NOLHGA Board of Directors Meeting**	**Indian Wells, Calif.**
March 16–19	NAIC Spring National Meeting	Reno, Nev.
April 18–19	NCIGF Annual Meeting	New York, N.Y.
May 8–9	**NOLHGA Board of Directors Meeting**	**TBA**
May 20–22	**NOLHGA MPC Meeting**	**Columbus, Ohio**
June 8–11	NAIC Summer National Meeting	Philadelphia, Pa.
June 20–21	Southeastern Regional Guaranty Association	Little Rock, Ark.
August 6–7	**NOLHGA Board of Directors Meeting**	**TBA**
September 7–10	NAIC Fall National Meeting	New Orleans, La.
October 13–15	ACLI Business Solutions 2002 (Annual Conference)	San Diego, Calif.
November 7–8	NCIGF/IAIR Joint Workshop	Henderson, Nev.
December 7–10	NAIC Winter National Meeting	San Diego, Calif.

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