Volume X, Number 2 | May 2004

nolhga journal

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

Lessons for a New Century

The Centennial insolvency teaches us quite a bit about how to handle a national health insolvency

By Dan Watkins & Charlie Richardson

Health company insolvencies are a *real* pain. No insurance insolvency is easy, but health insolvencies can instantly present an array of policyholder, financial, political, and publicity challenges almost unmatched in their complexity and time sensitivity. They also cry out for a very high level of communication and cooperation among the receiver and guaranty associations to protect insureds.

We, along with many others in the Kansas Insurance Department and the guaranty system, learned this lesson—sometimes the hard way—as a result of the Centennial Life insolvency that started in 1998. Because Centennial was the most significant national health insolvency tackled by NOLHGA and its member associations, NOLHGA's Centennial Life Task Force and the 49 affected guaranty associations faced an array of complicated legal, financial, and administrative issues that had not been faced before—or, if they had, not to that magnitude.

As Centennial wraps up after five years, we'd like to share some thoughts—lessons learned, if you will. We've provided some background on the insolvency (old news for those who worked on the Centennial Life Task Force—see p. 11) before sharing, or perhaps preaching, our views on what it takes to deal effectively with health insolvencies like Centennial.

In a nutshell, we believe that the key organizing principle behind delivering health benefits to policyholders must be early and continuous sharing of reliable information between the receiver and the guaranty system. This sharing enables both camps to figure out the best alternatives to protect insureds quickly, consistent with the economic facts of life, the receivership and guaranty association statutes, and industry best practices.

Centennial Basics

Centennial was headquartered in Lenexa, Kans. Prior to rehabilitation in 1998, the company was licensed in all states except Maine, New York, and Rhode Island; it was also licensed in the District of Columbia and had previously been licensed in Puerto Rico. The stock of Centennial was owned by a Kansas holding company, which was in turn owned by an individual (20 percent) and a Delaware holding company (80 percent) owned by a different individual. Another affiliate owned Centennial's home office building and rented it to Centennial.

Centennial's convention blank as of December 31, 1996, showed assets of approximately $117 million, surplus of approximately $28 million (including $25 million in surplus notes), and net premium of $93 million. The bulk of Centennial's business was group A&H (predominantly major medical coverage, which accounted for more than 90 percent of the premium and approximately 44 percent of the liabilities) and group LTD (less than 10 percent of the premium and approximately 55 percent of the liabilities), although Centennial did have very small blocks of life and annuity business (1 percent). The group A&H business, in turn, came in two large pieces: home office–administered health business and TPA-administered health business, which had been ceded to Centennial by another company.

Centennial was placed in rehabilitation by the court in Topeka, Kans., on February 4, 1998, and in liquidation on May 27, 1998. The Kansas Insurance Commissioner served as receiver. Centennial was one of the first insolvencies (after Consumers United) where policies were not canceled prior to the date of liquidation.

Why Centennial Went Down

Centennial did not lack for legal and financial problems. The situation was in critical mode from the outset, with several issues confronting the regulator:

- Losses averaging $2 million per month in the last half of 1997 and early 1998.

["Lessons" continues on page 9]

IN THIS ISSUE

1 Lessons for a New Century
2 President's Column
4 An Interview with N.J. Insurance Commissioner Holly Bakke
12 Calendar

"NOLHGA" As a Verb: The Nature of Our Guaranty

Over the past several years, various people have commented on differences between the safety net mechanism provided for bank depositors through the FDIC and the national safety net for life and health insurance consumers provided by the state-based guaranty associations working together through NOLHGA. In those comments people sometimes note that the FDIC is a large government agency with a big building on Seventeenth Street in Washington, approximately 5,300 employees, and an annual budget of over $1.1 billion, while the facilities and staff of our guaranty system are comparatively quite modest.

NOLHGA's headquarters occupy a small part of one floor in a fairly unassuming office building in Herndon, Va., where currently 14 staff members serve NOLHGA's 52 member associations. Even aggregating all those who work for the individual member associations with NOLHGA's staff, the system includes fewer than 150 permanent full-time-equivalent staffers, most of them spending their workdays in office space no more physically impressive than the Herndon offices of NOLHGA. In short, there is nothing about the state guaranty system that looks or feels much like a large federal bureaucracy.

But it misses the point to say that the insurance guaranty system is not so constituted as to dazzle anyone from the standpoint of physical facilities and sheer manpower. The achievements and capabilities of the guaranty system are not visible from a static perspective. The system can only be clearly perceived by viewing it in action.

Hitting the Deck Running

The best way to view the guaranty system in action is to observe the work done by our insolvency task forces—work that is really our *raison d'etre*. These groups are assembled quickly when a life insurer insolvency looms, and from the time they are activated until the time policyholders are provided a "safe, sound, warm, dry home" (usually in the form of a new insurance carrier), the watchwords of our task forces are "move it forward and get it done right."

Forward progress in protecting consumers of an insolvent life carrier is the product of a series of steps taken by the insolvency task force in cooperation with the domiciliary regulator and receiver. In the cases where consumers have been most effectively protected, the leadership of our system (usually including the Members' Participation Council (MPC) chair, the domiciliary guaranty association executive director, and the NOLHGA president) engaged in a series of pre-liquidation meetings with the domiciliary commissioner and key DOI staff, and with the special deputy receiver where one had been identified. By "hitting the deck running" at these meetings, we developed the clearest possible preliminary picture of the company's in-force business, the assets available to support a potential assumption transaction (or other response strategy), and any special problems posed either by the company's assets or liabilities or by current conditions in the industry and the capital markets.

When an insolvency appears likely, our standard practice is to form an insolvency task force comprising representatives of the domiciliary guaranty association and a cross-section of other guaranty associations whose residents are policyholders of the subject company. The chair of the task force is the representative of one of its member associations, and from its formation until policyholders' contracts have been assumed by a new carrier, the task force works with a team of consultants (usually including lawyers, actuaries, and financial experts) and NOLHGA staff toward the goal of an effective guaranty system response.

The daily work of the task force is to analyze in depth the challenges that need to be met in the specific insolvency and to develop a proposed response strategy to meet the statutory obligations of each of the affected guaranty associations (which together comprise the MPC for that insolvency—a group that may be significantly larger than the states participating in the task force). In the end, it is the prerogative of each individual guaranty association whether to accept the proposed strategy, so a key consideration of the task force is to develop a strategy that is, as nearly as possible, universally acceptable to the affected associations. In nearly all cases, that is precisely what occurs.

In fact, over the past 20 or so years, NOLHGA's members have responded effectively to more than 150 life and health insurer insolvencies. In the multi-state insolvencies handled through NOLHGA, the guaranty associations have guaranteed more than $20.1 billion, and their member insurers have contributed more than $5.5 billion of assessments to protect policyholders.

Scientific Method

There is no "cookbook" for responding to insurer insolvencies. Each case is different, and the key aspects of the insurance marketplace and the capital markets are always changing the backdrop against which response strategies must be crafted. What is constant across all of our insolvency task forces is the pursuit of a proven process toward the goal of policyholder protection.

This process—the action steps toward the goal—involves something very much like the "scientific method." Our task forces first strive to collect relevant data such as policy forms, records of the in-force business, distribution information, and unusual aspects of the company's insurance liabilities. They also collect information about assets of the company—bond investments, real estate mortgages, and other holdings—and any unusual aspects of those assets that may be relevant in the formation of a response strategy.

Data in hand, the task force develops hypotheses regarding potential approaches that can effectively meet obligations to policyholders while also protecting the capacity of the system for use in future insolvencies. From among these competing hypotheses, the task force crafts a recommendation for a response strategy that is then presented to all affected guaranty associations for their consideration, comment, and assent.

The Value of Participation

An entirely intentional byproduct of this process is that it factors into the job of problem-solving—the development of the response strate-

e Dynamic System

gy—a variety of different perspectives and experiences that can be critical to reaching the best answer. For example, in recent years we have seen several failures of health carriers that wrote business in multiple states. The "feedback loops" provided through the task force and MPC processes have resulted in invaluable contributions to the team effort by several key member association executive directors with considerable experience in health claim administration and third-party administrator issues (including, but not limited to, Mark Femal of Wisconsin, Bart Boles of Texas, Mike Marchman of Georgia, and Dan Orth of Illinois).

More recently, we have faced the challenge of how best to transfer significant blocks of annuity business in a market that has a lower-than-normal appetite for such business. William Falck of Florida, Art Dummer of Utah, and Frank Gartland of Ohio have been among many who rolled up their sleeves and made substantive contributions to the development of some new lines of analysis and response approaches.

A second intentional byproduct of the process is to ensure consideration of the interests of all the major stakeholders in the guaranty system. The insolvency task forces themselves are designed to represent the membership at large, but in the end each member association must pass on the task force's recommendations. In the course of making their decisions, individual guaranty associations are guided by their boards of directors, whose members represent the domestic industry that pays the costs of an insolvency response; each association also accounts to its domiciliary insurance regulator. Additionally, the overall response strategy developed for an insolvency by the guaranty system is discussed along the way with the company's receiver, and the receiver's comments are taken very seriously in finalizing the guaranty associations' plans.

The Lessons of History

One subsidiary goal in each insolvency is to distill and preserve the lessons of that insolvency for use in future similar situations. We typically accomplish that by a "lessons learned" report that is presented by the insolvency task force to the MPC as a whole. Other lessons are shared through NOLHGA legal seminars and in reports given to the National Association of Insurance Commissioners and to the industry.

In the end, the guaranty system is not a marble palace in Washington, nor is it a standing army of bureaucrats. It's not a thing, a place, or even a team, so much as it is a dynamic process designed to produce optimal results for insurance policyholders in need.

And that is as it should be. In the contemporary business world, organizational achievement isn't about bricks and mortar or staff headcounts, but rather about what an organization achieves to accomplish its mission. From its inception, the focus of the guaranty system has been on delivering specified protections to policyholders in an effective and cost-efficient manner. The process continues to meet its goals, notwithstanding a constantly changing set of challenges and a continually evolving business environment. ✯

Peter G. Gallanis is president of NOLHGA.

21st annual meeting

October 26–27, 2004 | Las Vegas, Nev.

NOLHGA's 21st Annual Meeting

October 26–27, 2004

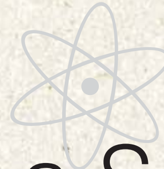
Four Seasons Hotel

Las Vegas

Las Vegas, Nevada

Insolvencies Are Not a Science

They're an Art



New Jersey Insurance Commissioner Holly Bakke talks about the need for improved communication and coordination in the insolvency process

Holly C. Bakke was sworn in as commissioner of the New Jersey Department of Banking and Insurance in March 2002. From 1989 to February 2002, she served as executive director of the New Jersey Property-Liability Insurance Guaranty Association, the New Jersey Surplus Lines Insurance Guaranty Fund, and the New Jersey Medical Malpractice Reinsurance Association. Prior to that, she served as special deputy commissioner of insurance litigation practices for the New Jersey Department of Insurance. In 2003, she was selected to chair the National Association of Insurance Commissioner's (NAIC's) Coordinating with State Guaranty Associations Working Group.

How did the Coordinating with State Guaranty Associations Working Group come about?

The NAIC is truly a national system of state-based regulation. That has to be across the board, and the insolvency process is certainly one of the things that regulators are engaged in. I think you have an obligation to work with all the people in the insolvency system so that it's effective, it's efficient, and it works for policyholders and claimants. And the only way you can do that is coordination.

Was there a perceived lack of coordination that brought this about, or was there just a feeling that things could be done better?

That's an interesting question. I think the problem is this. There will always be some estates that are managed better than others. The ones that you hear about, like everything else in life, are the ones that are problematic. So to a degree the problem was real, and to a degree the problem was a perceived problem. But the reality is that as a commissioner working toward a national system of state-based regulation, perception becomes as important as substance. You want to make sure that this aspect of the system is working smoothly.

Why do you think you were chosen to head up the project?

My background is in guaranty funds, and I was very involved in the insolvency process. So I think it's probably because I have a background in that area. It's also an area that's of interest to me. And probably one that no one else wants to tackle!

So you have the ability to see things from both sides of the equation.

Now I do. And if I had to pick one thing that has changed my point of view about how I did my guaranty fund job before, it's this project. I'm much more conscious of two things: first, the balance the regulator is always making between the obligations to creditors of the estate and to the policyholders. If a company is in trouble, where do you draw the line? At some point, if you keep a company alive longer than it's supposed to be, it's to the detriment of creditors and policyholders.

On the other hand, if you move too quickly you miss an opportunity to protect policyholders and claimants. So striking that balance—I think I now appreciate how difficult that is more than I did when I was on the guaranty side.

What's also striking to me are two other factors tied to what I've learned. One, guaranty associations do not appreciate how proactive a department can be during the administrative supervision phase, which is confidential. And a lot of times, there's a sense that a department is not taking action. And it's that balancing again—if we were to tell the world that we were taking administrative action, it would compromise the viability of the company. So people don't think we're doing anything. They wonder how aggressive we're being. And I promise you, during administrative supervision—speaking only for New Jersey—we are very aggressive.

But it's under the radar?

It has to be. But that's very difficult, and it's where the second-guessing comes in.

I think the other thing I've learned is the necessity of making a solvent runoff an important option in your continuum as you look at a company. To me, when you look at a solvent run-off, it is the ultimate because policyholders get their full range of benefits, you don't have to hire a receiver, and you don't have to expend money. You can let it run off. Now, it's not an option in all cases, but I've tried to make it that last question I ask myself. Can we do this? Can we make it a solvent runoff? I know that we've had some bad experiences with them nationwide. Look at The Home Insurance Companies, which were supposed to be funded as a solvent runoff. Didn't happen. So I guess we need better tools for looking at the viability of a solvent runoff.

On the other hand, if I can get there, it allows the company to meet its obligations—and that's ultimately what you want—without incurring the additional costs attendant to a receivership.

Can you tell me a bit about the working group's activities?

First, I'd like to say that I'm very fortunate, because the people on the task force bring incredible years of experience. There are at least three initiatives they're committing time to that I want to share with you.

One certainly is the white paper. The NAIC has often been criticized for not moving rapidly enough. Well, this is a group that has said, "That's not something we buy into. As part of a national system of state-based regulation, we need to get the coordination white paper out there." They've done it in a very short period of time, and I think it will be an incredibly useful work product.

The other thing is GRID—the Global Receivership Information Database. This group is seeking to help commissioners understand the relationship between receiverships and premiums. That's not a connection that was always made. That is, if you're getting distributions from estates, you don't need to have such a large "fill in the blank"—some states are premium tax offset states, some are surcharge states, and in some states it goes into premiums. What we've said to the commissioners is, "If you get these distributions from your receiverships, you're going to lower premium tax offsets. If it's part of your premium, you're going to be able to lower premiums, because you're not going to have your public paying for the guaranty association system—you're going to be getting the money from the receivership."

It's been a tremendous effort on the part of every state to get that information into the database. How many estates do we have that are open? How much money is available for distribution? How many estates have funds out there that can be used as early access for guaranty associations? And I think we made the link for the commissioners that receiverships aren't just "dead" things—they connect to what policyholders are paying in your state, and that's why you have an incentive to close receiverships and get the money distributed. I think that made a difference.

Also, because some guaranty associations are running out of money, like in Alaska, if we do more timely distributions, you're going to have fewer guaranty associations running up against their caps for assessments.

The third initiative is a joint one with NOLHGA, the International Association of Insurance Receivers (IAIR), the National Conference of Insurance Guaranty Funds (NCIGF), and now the NAIC, which is funding it. And it's training materials for judges.

In the judicial system, if they have not identified a judge who has routinely—or ever—handled a receivership, it goes to a judge who has no background. And we needed to develop a way to provide that information so that it's objective. It's not telling one side of the story—we have the regulators, the receivers, and the guaranty associations. So we give judges the tools they need to ask the right questions.

It's going to be a CD-ROM package to go out to judges assigned to an insolvency. We're in the very preliminary stages of meeting with the judges, because they're critical. We'd like to tell them what we think is important, but we want judges to tell us, "As a judge, that's not important. Here's what we need to know."

What topics does the white paper cover?

The white paper looks at all aspects of the receivership process and the role that each entity plays in that process. For example, when do you involve the guaranty association when you know there's a troubled company? Do you wait till it's insolvent? If you do, then maybe the association can't be as prepared as it could have been had you talked to them before the declaration of insolvency. When do you bring the receiver on board, and when does the receiver start talking to the guaranty association? What about confidentiality concerns?

What about reinsurance contracts? That's another thing. The receiver is responsible for collecting the reinsurance. There have been a lot of concerns over whether they're getting the information they need from the guaranty associations on a timely basis to maximize their collections. It's obviously in the guaranty associations' interests, you would think, to get that information in there to maximize the collections and get the money distributed back out. So if you can identify what the interests are, you can really identify who needs to be doing what.

What we tried to do is look at each stage in the process and identify things that we should be revisiting, things that work, and maybe new things we haven't thought of that we might want to try. And the white paper, I hope, provides a blueprint. We want it to be a "living document," where we build provisions in there to make changes, recognizing that not all estates are alike. You can't have a cookie-cutter approach, which is why coordination is so critical. Because if we treat it as if it's a rigid system where only A, B, and C can happen, this isn't going to work. There's a big difference between an estate that has good information and one that has poor information.

You mentioned the NCIGF. Is your working group looking at coordinating with property and casualty guaranty funds as well, or only life and health associations?

Life and health and property and casualty.

["Bakke" continues on page 6]

The reality is that as a commissioner working toward a national system of state-based regulation, perception becomes as important as substance.

Are you taking two tracks because they're different areas?

No. I think at this juncture, what we've done is say, "There are fundamental steps in the process." And we haven't really decided to deviate. It's not a flowchart approach.

What role have NOLHGA and the state guaranty associations played in the efforts of the working group?

They've been tremendous. Representatives from NOLHGA and the NCIGF have worked on all aspects on the projects I've talked about.

There's no way you can talk about an insolvency system without talking to the people who are working with the policyholders. The receiver is going to handle the creditors, and that's one story to be told. But the other story is about the policyholders. There's a lot of information there. I've been trying to do this without great success, but I'm a real believer in the idea that guaranty associations should have to do an analysis of all the medical malpractice carriers, for example, that went under in the last few years, to explain what they found in those files.

Don't forget, in most guaranty association statutes, there's a prevention and detection provision. I'm very big on the prevention part. What can we learn from their experience that will help us prevent future insolvencies? That's a real big deal for me.

It's clear that even if we're not focusing on prevention, these are the people on the front lines. You want to talk to the guaranty association people who are dealing with the policyholders. We should listen very closely to what they're saying.

The policyholder doesn't understand the receiver. The receiver isn't really helping them resolve their claim. When they file their proof of claim, the department doesn't touch the person. The department transfers the call to the guaranty association. So the ultimate measure of our success with the policyholder, in many respects, is what the guaranty association has done.

What's the current status of the working group's efforts?

The white paper should be ready for final review in June. That's our goal. The judicial training project is underway—as I said, we're having our first meeting with judges. And again, that's an IAIR, NCIGF, and NOLHGA effort. It's important to recognize the involvement of each of those groups.

With GRID, we're doing our last update now, and then we're going to hand it over to the NAIC. Because we'll have done everything we can do to make it current, and we can say that this is a good starting place for information about the status of these insolvencies. The question at our next meeting in June, when we hand it over, will be how we get people to update it. Because this hasn't been done for years, and now we're almost current.

I think the committee's appropriate discussion is, what do we do now? We're looking at enhancing GRID to facilitate the proof of claim process and other things that have to do with technology. That's being handled by the NAIC's Internet Group. If we can simplify the proof of claim process with automation, that would be wonderful.

What are some of the main stumbling blocks in regulatory community/guaranty system coordination identified by your group so far?

I wish we could say that we identified something new. I think issues about coordination and communication have always existed, but two things have changed. Certainly, the need to be a national system of state-based regulation—you can't have that unless there's communication and coordination.

We have national solvency standards—measures for the financial stability of estates. What hasn't necessarily followed from these national standards are standards concerning what we consider when we move a company toward insolvency and when we involve the guaranty associations. As I mentioned before, do we need a declaration of insolvency and a liquidation order before we can talk to guaranty associations?

So there's no standard for the timing of guaranty association involvement?

Actually, we're not looking for a standard. We know that estates are not "one size fits all." But if you were going to do a checklist of what you should consider in the process, you'd want to ask yourself, as a regulator, "Do I need to get the guaranty associations involved early in this estate?" There's no one right answer as to yes or no—or if yes, when, and if no, why?

In my opinion, you would almost want people to have, in their own minds, a checklist that addresses when to share information, with whom, and why. So that the policyholders and claimants are getting the results they deserve.

What's the other major change?

This isn't happening on the life and health side—although maybe your time is coming—but on the property and casualty side, because of the Reliance insolvency, there's greater scrutiny of how we manage these estates. And I think it's very hard, if you're a receiver and you look at submissions from guaranty associations, when you can't compare. You look and say, "How can 50 states have such different experiences with the same claims case load?"

I have to tell you, we did a very good job with Reliance. There haven't been articles in the paper where people have been angry or frustrated, because the guaranty fund system stepped up to the plate. And that's great.

But the situation has shined a light on the guaranty fund community. They have not only the NAIC Model Act for guaranty funds but also the NCIGF Model Act, and the NCIGF is working very hard to make sure that proper procedures are more uniform on the guaranty fund side. I think we as regulators have to recognize that and help them get there. And a lot of that requires legislative changes. So from where I sit, it's certainly an important piece to say, "Not only are we subject to this review because people are looking at national issues with insurance concerning state regulation, but we're also being looked at because we're more on the front page with the word 'insolvency' and Reliance."

On the guaranty association side, as a regulator, I would want to promote the uniformity needed to have a true national system of state-based regulation.

So the ultimate measure of our success with the policyholder, in many respects, is what the guaranty association has done.

So from a regulatory standpoint, enhanced uniformity among the guaranty associations would make for a smoother process?

Quite frankly, when you say "a national system of state-based regulation," I think it does two things. It tells the world it's a national system, which offers a degree of predictability. But it also says that what needs to be unique will be unique at the state level, where we're providing these services directly. And that's really the process we're engaging in right now. What are those things that have to be the overlay that creates that predictability nationwide? And on the other hand, how do we maintain the services that are unique?

I'll give you an example. Let's talk about losses. I don't have a lot of experience here with hurricane losses. Florida does. And to a certain degree, how you train and organize—how guaranty associations do what they do—reflects where they are and the type of losses they're going to be handling.

Even on the receivership side, if you were to look at how receiverships report information on the current assets available and uncollected reinsurance receivables, there's not a lot of uniformity there. That's why GRID is so important. So it's really on the regulators' side, as the liquidator or the receiver, to say, "We recognize that as part of a national system, there has to be a degree of transparency in terms of these estates." And on the guaranty association side, as a regulator, I would want to promote the uniformity needed to have a true national system of state-based regulation.

In looking at past insolvencies, have you found any root causes for why coordination breaks down?

Yes, and I think the root cause is that for a long time, people drew black and white lines and said, "This side is the white side and this side is the black side, and there's no gray." And the reality is that insolvencies are not a science. They're an art. You can't draw a line that says we will always do X or we'll never do Y. It's a conversation, and it's one that should start before administrative supervision, when you're looking at a company.

For instance, and we've already had this happen in New Jersey, take a company that is very healthy. Yet they have actuarial reports that say, if we don't change, this is where we're going to end up—insolvent. I don't know that we listened to the company then to understand the implications of what they were saying.

In other words, you can have a company that's healthy, but when they look down the road, they themselves see some problems. And that's taken us to a new place, at least in New Jersey. And that's corporate governance.

I happen to be the commissioner of banking and insurance. I want to thank the banking community and Julie Bowler, the Massachusetts Commissioner of Insurance, for all they've taught me about the importance of corporate governance. You asked me earlier what I've learned in my old job and my new position. If I had to pick the one new thing that I've learned, it would be the importance of corporate governance.

As regulators, we tend to interact with management. We don't engage boards in discussions. If we're doing this well and doing it right, we have to explicitly recognize that the boards run the companies. They hire the management. The management works for the board—the board doesn't work for the management.

That's simple to say, but in reality, I as a regulator—until I got caught up in understanding corporate governance—would have continued to think just about management. I credit the banking side because state banking commissioners—and I think there are only four of us who are both banking and insurance—have routinely met with banks' boards of directors. So my banking division taught me a great deal about what should be included in a program of corporate governance. Commissioner Bowler taught me a great deal about how she started this with insurance companies and how she's meeting with her domestics. We're now doing this, and it's critical.

Why? Because hopefully, you're preventing an insolvency. If the company is in difficulty, you're going to be able to detect it sooner. And if you need to take it down because it can't get financially healthy, the board is not going to oppose it because they'll understand how they got there.

Are you meeting with all your domestic insurers, or just ones with "red flags?"

We're going to go through every domestic, but we're starting out with the ones that may have more issues than others. And the questions are really basic. We send the boards the financial exams that we do, but we've never talked to them about them. I'm sure they get them in the mail and say, "That's nice." Now we're going to ask them if they opened the cover. We're going to start sending them market conduct exams—we never did that before. We're going to be looking at the head of the audit committee and asking if he or she understands the responsibilities undertaken as head of the committee. We don't want a board to be so disconnected, where management isn't giving them a fair picture of the financial position of the company.

Is this a result of Sarbanes-Oxley?

Sarbanes-Oxley and everything that's been going on have certainly raised a red flag about why this is good to do. But as I said, once I got into this, knowing that banking has been doing it for years, I asked myself the question: "How could I not do this?"

Is Sarbanes-Oxley an impetus? Yes. But I think it's simply the right thing to do.

As far as these coordination problems between guaranty associations and the regulatory community, you mentioned that one factor was the "black and white" mindset. Are there any structural or built-in obstacles to overcome as well?

I've yet to see an obstacle that I don't believe can be overcome, so understand that you're talking to something of a Pollyanna.

Let's just focus on confidentiality. A lot of people have expressed concerns that if you bring guaranty associations in too early, you won't be able to maintain the confidentiality of what the department is looking

at. I simply disagree. There's been a long history of confidentiality agreements that the NCIGF coordinating committees have entered into with insurance departments to talk about insolvencies early on. The problem is that a lot of other states don't know about this and don't know how well these agreements work. People tend to manage by example, so what you need to do is get the information out there. There are ways to get around this, and a confidentiality agreement is certainly one of them.

So I think any problems are a combination of both factors—structural and mindset. Confidentiality is a real issue, but the mindset is, do you stop and say, "I can't do it because of confidentiality," or do you say, "I can figure out a way to do two things—ensure the confidentiality but also foster the communication necessary to make this a smooth insolvency process."

In your opinion, why is enhanced coordination between regulators and guaranty associations important?

We work, quite frankly, for the public, and it's our obligation to make this system work for policyholders, claimants, and, if the company is insolvent, creditors. That's what we do.

Who does a lack of coordination harm the most—regulators, guaranty associations, or policyholders?

A lack of coordination hurts everyone, but ultimately, the people harmed are the policyholders and the other creditors against the estate. And I think that has to be first and foremost in our minds. All of us are working for the policyholder.

If you pick that common thread, the one thing that should pull us all together—regulators, receivers, and guaranty associations—whatever your role in this process, it's all about the policyholder. And that common thread should be the tie that binds.

Can you cite some practical examples of cases where early coordination helped consumers, or cases where earlier and more effective coordination could have improved the administration of the insolvency?

I'll give you a few examples, but not by specific estate or line of business. If you're looking at a private-passenger auto company that becomes insolvent, one of the things that we have to remember is that people have cars in garages being repaired, and they can't get them out. If you don't intervene early and work with the guaranty fund, the phone is going to ring off the hook at the fund—and they're not going to have an answer. So you need to talk about the early transmittal of files and data that help them answer those immediate questions. Another example is workers' compensation benefits. You obviously want them to continue.

On the life and health side, you know how sensitive it is for people when you're talking about health insurance. Life policies are a different matter—they're not as immediate. But where the insolvency involves these immediate concerns, if you're not talking to your guaranty association ahead of time, then they can't perform the service to the policyholders. To me, that's the best example: Where early intervention means early communication with the guaranty community—life and health or property and casualty, whatever it takes—to take care of those immediate situations where people are unnerved and terrified because they don't understand what's happening to them.

Does that tie back into what you mentioned earlier as far as the greater scrutiny of the system?

Of course. The worst thing that can happen is for someone on workers' comp to be waiting for their check, and it doesn't come. Or someone who has their health care interrupted and can't get a referral or whatever they need. As I said, the life situation isn't usually as urgent. But on the health-care side, that's where the scrutiny is.

Has the working group encountered any resistance from guaranty funds or associations or insurance departments that don't feel the need to change how they perform their duties?

There's an old saying that goes something like, "I don't object to change until it applies to me." Everyone loves change until they have to change. All of us are comfortable with what we know and our current frame of reference. When you extend beyond your current frame of reference, there's a risk you take, because you don't understand all the implications. And you can never understand all the implications of making that change. So there has to be a willingness to do it. And that's where I would encourage everybody looking at this process to say, "We can't refuse to take the next step in the process just because it's not perfect." There's nothing I'm aware of that's ever been perfect. But if you're scared to make a change because you're worried about what might go wrong, that means you're never going to have the opportunity to do those things that will make the system better.

So there should never be any thought that a process, the process of change, is anything other than evolutionary. It just keeps evolving over time. This can't ever be a "do or die" paper on coordination. There's never going to be a one-size-fits-all document. Each insolvency is going to present new challenges, and this project is really about building the fundamental underpinnings. If people communicate and coordinate, then the necessary changes are going to happen and the process will continue to evolve. It's only when people don't want to communicate and coordinate that you get stuck.

So if you wait for everything to be perfect before you change, you'll never change.

Clearly, you're going to do an analysis, and if the bad outweighs the good you're going to reconsider making that change. But if you've done that analysis and you find yourself only talking about the unknown, it suggests that you experiment. Try a pilot program or a test period. Do something on a limited basis.

This is off the topic, but the Northeast Zone of the NAIC is taking on a project where we're going to try to admit companies in the zone. So if one state admits the company, the zone does. We're working on this project because we want to show that as a zone, we can do it.

When I talk to people about their willingness to change, my main point is that you're not just going to make this change tomorrow. What you're making is a commitment to ongoing change to make sure that the system reflects the current state of the problem. To me, this is about putting tools in place—communication and coordination—to allow the system to adjust on an as-needed basis.

And it's the role of the working group to do the analysis you mentioned and recommend the ideas that pass the test?

Exactly. And that's not to say that something shouldn't be changed six months from now. Just because it's in the paper, it doesn't mean that you don't change it if it doesn't work. It's a living document. ✯

["Lessons" continues from page 1]

- Disputes with AXA Re, Centennial's A&H reinsurer and surplus note guarantor, that led to AXA withholding payment of reinsurance claims starting in June 1997. This was followed by major litigation initiated by Centennial and its holding company against AXA in federal court in Kansas in October 1997.
- Disputes with Universe Life Insurance Company, in rehabilitation (then liquidation) in Idaho, over a rescinded health policy block transfer; these disputes led to major litigation in Idaho and Kansas federal and state courts.
- Severe cash shortages, brought on by the business losses, AXA Re's withholding of reinsurance obligations, and, ultimately, a restraining order in the Universe litigation freezing the few remaining assets of the company.

Centennial's high losses in 1997 and 1998 reflected development on materially understated reserves. The understatements were due to unrealistic expectations and unreasonably optimistic assumptions about loss ratios, caused principally by inadequate analysis of trends in claims experience and reliance on poor pricing determinations from 1993 through 1997. In other words, by 1997 the company was headed full speed toward a train wreck and management was in denial about how fast the train was traveling.

During supervision, management and the regulators attempted to identify suitable investors or purchasers—always a challenge in individual and small group health. These efforts yielded few fruits, so the receiver entered into a management agreement in early 1998 with American Chambers Life Insurance Company (an Ohio insurer that ultimately went into liquidation itself in 2000). American Chambers and its affiliates replaced Centennial's management and provided interim management of Centennial's operations. American Chambers also accepted 100 percent of the risk on new health business written by Centennial after March 1, 1998, and offered guarantee issue replacement health policies to Centennial's home-office policyholders (the TPA-administered small group block had guarantee issue protection under the Health Insurance Portability and Accountability Act of 1996, or HIPAA).

The receiver tried to settle the AXA Re disputes during rehabilitation and thereby replenish Centennial's increasingly empty treasury. Centennial's holding company, which was a party to the litigation, scuttled settlement discussions. In February 1998, Universe Life Insurance Company obtained a $9.5 million judgment against Centennial in Idaho District Court, subject to offsets that were not yet litigated. Universe then proceeded to attempt collection on its judgment.

On April 21, the receiver filed a liquidation petition with the Kansas court stating that rehabilitation was not possible. A liquidation order followed a month later.

A Host of Challenges

Why was Centennial so complicated, and what made finding a solution so difficult? Like the problems besetting the insurer, there's no shortage of answers to these questions:

- The need to compile sufficient information for the receiver and guaranty associations to decide whether to terminate (i.e., cancel) benefits under Centennial's group A&H coverages and, if so, on what terms. The American Chambers rollover moved about half the home-office business, and the TPAs moved a portion of the other business, but each guaranty association had to decide what steps it wished to take on the remaining business for which the association had the legal prerogative to terminate benefits. All that was coupled with the need to analyze—for the first time—the legal and administrative parameters of health policy cancellation in this post-HIPAA environment.

["Lessons" continues on page 10]

About the Authors

Dan Watkins is an attorney in Lawrence, Kans. He specializes as a receiver for troubled insurance companies and has worked with the Kansas Insurance Department and Kansas courts as special deputy receiver in eight life and health, property and casualty, and workers compensation rehabilitations and insolvencies, of which the Centennial Life Insurance Company liquidation was the most prominent. Watkins is designated as a Certified Insurance Receiver—Multiple Lines by the International Association of Insurance Receivers (IAIR). He also serves on the IAIR Board of Directors.

Charlie Richardson is a partner in the Washington, D.C., office of the law firm Baker & Daniels and chairs the firm's Insurance and Financial Services Team. He has represented NOLHGA as its legal counsel in several insolvencies since 1990 (including Centennial Life) and has also served as NOLHGA's Project Manager on two insolvencies. Mr. Richardson is a member of NOLHGA's Legal Committee and chairs the 2004 Guaranty System Summit Planning Committee. He is a former director of IAIR, the Federation of Regulatory Counsel, and two insurance companies and is a qualified independent assessor of the Insurance Marketplace Standards Association. He is a frequent speaker on insurance topics around the country.

["Lessons" continues from page 9]

- Time-sensitive health business with a 90,000 claim payment backlog exacerbated by a large and complex set of more than 130 different health coverages, each with numerous policy options.
- LTD business where the insureds were depending on monthly disability checks, qualifying as hardship situations if checks were delayed.
- A liquidation estate with virtually no cash on the liquidation order date and no ability to pay the large backlog of claims.
- Questions concerning a reinsurance trust, whose assets were restricted.
- The complexity of Centennial's contractual arrangements and the difficulty of "getting one's arms around" the myriad systems and operational aspects of the business.
- A boatload of pending serious litigation and legal disputes that threatened to tax if not deplete seriously the receiver's personnel resources during liquidation.
- The need to consider and implement health policy administration mechanics and operations when the claim-processing capabilities of the guaranty system had not yet been tested in a major health insolvency.
- The need to evaluate carefully the reliability of existing policy-handling, claim-handling, and other administrative systems at Centennial, given recommendations that the best—or least worst—and only realistic alternative was to leave the policy administration in place rather than move it to an outside TPA.

Cleaning Up the Mess

At this point in 2004, we can report on the end of the story without going into too much detail on how the receiver steered the ship through the insolvency storm. Everyone should simply know the following key points.

- Massive and hard-fought litigation with reinsurers, former management and owners, reinsurance brokers, auditors, a fronting company, Universe Life Insurance Company, and others has been concluded, bringing into the estate approximately $70 million in recoveries.
- Trust accounts and state deposits were recovered, along with premium receipts, interest on investments, and other assets; this brought in another $35 million.
- Administrative expenses of the receiver and the guaranty associations (including claim and litigation expenses and association due diligence expenses) were approximately $25 million, with policyholder-level claims of approximately $80 million.
- Guaranty associations received periodic early access distributions from the estate; to date, these distributions total 97 percent of policyholder-level claims. A final distribution will bring the associations very close to 100 percent recovery of all administrative expenses and policy claim payments.

What Have We Learned?

As a company is headed into receivership and, hopefully, well before a liquidation order is entered, *job one from day one* is getting an accurate picture of the troubled company's financial situation so that decisions can be made quickly about what comes next. From the life and health guaranty associations' standpoint, that means identifying the potential association-covered liabilities if (but, as is almost always the case, when) the company ends up in liquidation. NOLHGA's members have to plan how they will satisfy covered obligations if (when) an order of liquidation with a finding of insolvency is eventually entered by the supervising court. The sooner that liquidation contingency planning occurs, the better for policyholders.

Typically, the guaranty associations want to find the best way to continue the policyholders' coverage after liquidation, subject to applicable guaranty coverage limitations. That means they need reliable information about insureds' residency and any TPA and trust arrangements, data to calculate policy limits and interest rate rollbacks and roll forwards, information about reinsurance, etc. But when it comes to

The key organizing principle behind delivering health benefits to policyholders must be early and continuous sharing of reliable information between the receiver and the guaranty system.

health coverages, the associations also have to face HIPAA and policy cancellation issues while focusing on claim backlogs and periodic claim payment requirements. That means working out joint investigation/information sharing arrangements between the receiver and the NOLHGA task force. Such arrangements must provide the associations with copies of all policy and contract forms and related financial/actuarial data, plus information about any claim backlog.

In the Centennial insolvency, cooperation on all these issues started early and continued nonstop, and NOLHGA's task force and its legal, actuarial, and financial consultants played a critical role. The receiver was very open to the insight, assistance, and cooperation the NOLHGA team brought to the table at the initial meeting in March 1998, in serious working meetings leading up to the liquidation order, during the early claims crunch, and at every major decision point along the way. Thanks to this openness, the due diligence and early commitment of major resources by NOLHGA and the guaranty associations had a high benefit-to-cost ratio.

Bottom line, here are the key things we learned:

Communication & Coordination. As with so many other areas of insolvency practice, communication and coordination among the receiver and the guaranty associations leading up to the entry of a liquidation order are very important in a health insolvency. The short-term nature of the health policy obligations calls for quick communications with policyholders/claimants on policy service and claims handling to prevent massive confusion—even panic—among policyholders, claimants, providers, regulators, and others. The receiver and the guaranty associations have to be on the same planning and communication page so that the stage is set for a thorough examination of the situation once the initial communications have stabilized it.

Avoiding Negativity. Health insolvencies bring a potential for claimant complaints and negative publicity that does not exist in virtually any other type of insolvency. The best (and perhaps only) way to mitigate that potential is to have sound communications with all interest groups—including regulators, who are on the receiving end of complaints—and to make timely (or nearly so) claim payments. The proof is in the pudding, and the pudding is money going to claimants on a regular basis.

Handling Claims. One goal should be to minimize the number of changes to pre-insolvency policy service and claim-handling procedures so that policyholders and claimants do not suffer unnecessary confusion or disruption of service. Significant administrative changes can cause communication headaches and repetitive claim-handling steps that contribute to payment delays. Creation of a system for handling disputed (or appealed) health claims is also important. That system might include putting disputed claims at the end of the line, adjudicating those claims only as hardships, or setting up a separate mechanism to deal with them on a current basis that will not interrupt the handling of original claims.

External Relationships. The administration of health business is almost always more complex and difficult than anyone thinks at the beginning of the process, which usually leads to an underestimation of the time required. It is very important that the receiver and the guaranty associations evaluate the insolvent company's external relationships with discount service providers, drug card providers, etc. This may require a negotiation of pre-insolvency fees for those discount service providers and some kind of post-insolvency guarantees to them. Continuing the best of these relationships will save significant administrative and, more importantly, claim costs.

Follow the Money. Given the amount of guaranty association money being disbursed periodically to claimants, a NOLHGA task force must consider an outside audit/quality control process to give comfort to the associations. These insolvencies are unlike a typical closing of a life/annuity reinsurance transaction, where the task force's consultants provide pre-closing assurances on the correctness of each association's share of the funding. In a health or LTD insolvency where no transfer of obligations is feasible, guaranty associations are required, in essence, to fund their obligations every single month that the insolvency is open! The associations writing the checks need a basis upon which to conclude that the process is producing reliable data.

The Right Servicing Agent. A task force must carefully weigh the pros and cons of having the receiver act as the guaranty associations' servicing agent for policy and claim handling, including whether or not the receiver can deliver dependable service over the long haul (in Centennial, the receiver had an administrative agreement with an outside insurance company, American Chambers, already in place). As part of that evaluation, the task force and its consultants should critically evaluate, possibly with the help of an independent advisor, the systems aspects of the insolvent company's policy service and claim-handling capability. It is wise to have an outside claims auditor make recommendations to the task force before a decision on a servicing agent is made.

The quality of the systems support is key, and usually it cannot be improved much in the short

The Centennial Life Task Force

Members
Mark H. Femal (Wisconsin): Chair
Linda Becker (Kansas)
Bart A. Boles (Texas)
Andrea H. Bowers (South Carolina)
T. Randolph Cox Jr. (West Virginia)
William E. Falck (Florida)
Michael C. Marchman (Georgia)
Richard W. Klipstein (NOLHGA Staff)

Consultants
Actuarial: Milliman USA
Financial: BWT Consulting
Legal: Baker & Daniels

term. If existing systems at the insolvent company are unsatisfactory, it is unlikely the receiver will be able to make them much better. A reality check of the receiver's staff's expertise in financial, legal, and manpower areas is important. It makes a big difference if the receiver is open to and cooperates with this evaluation, rather than taking a defensive stance.

Proper Timing. A task force should also weigh the pros and cons of an early liquidation order and guaranty association trigger (including the transfer of post-liquidation premiums to associations) versus a later liquidation order and trigger that will give the receiver and the guaranty associations more planning time concerning policy cancellation and other issues. In Centennial, the premium income in the month between the application for liquidation and the court's order provided the estate with its only available cash for administration of the estate.

The Right Message. In a health insolvency, communication is key when it comes to the insured/claimant constituencies, as well as state regulators who may be involved. The servicing agent, whether the receiver or an outside TPA, should receive clear instructions from the task force on what should be said and not said about guaranty association involvement, procedures, limits, coverage, etc. In Centennial, the receiver and NOLHGA both signed off on all the notices the receiver sent to insureds, medical providers, discount service providers, drug card providers, and others.

Health insolvencies demand that the receiver and guaranty associations be on the same page from beginning to end. It takes constant communication and information sharing to deliver benefits to insureds in a timely, efficient way. This must start well *before* a liquidation order is entered—perhaps even before receivership—using confidentiality agreements to facilitate the process. To us, that's the main lesson learned from the Centennial Life insolvency, and we invite others in the receivership and guaranty system communities to add their two cents in future issues of the *NOLHGA Journal*. ✯

NOLHGA Journal
Vol. X, No. 2 | May 2004

The *NOLHGA Journal* is a publication of the National Organization of Life and Health Insurance Guaranty Associations dedicated to examining issues affecting the life and health insurance guaranty system.
Copyright © 2004
All Rights Reserved.
Reproduction in whole or part is authorized with permission from:
NOLHGA
13873 Park Center Road, Suite 329
Herndon, VA 20171
TEL: 703.481.5206
FAX: 703.481.5209
Editor: Sean M. McKenna
E-mail: smckenna@nolhga.com

The views expressed herein are those of the authors and do not necessarily reflect those of NOLHGA or its members.

2004 NOLHGA Calendar of Events

Date	Event
May 24	**State Guaranty Association Board Chairs' Conference** **Reston, Va.**
May 25–26	**NOLHGA MPC Meeting** **Reston, Va.**
June 12–15	NAIC Summer National Meeting San Francisco, Calif.
July 20–21	**NOLHGA MPC Meeting** **Seattle, Wash.**
July 22–23	**NOLHGA's 2004 Guaranty System Summit** **Seattle, Wash.**
August 10–11	**NOLHGA Board Meeting** **Reston, Va.**
September 11–14	NAIC Fall National Meeting Anchorage, Alaska
October 10–12	ACLI Annual Conference Chicago, Ill.
October 25	**NOLHGA MPC Meeting** **Las Vegas, Nev.**
October 26–27	**NOLHGA's 21st Annual Meeting** **Las Vegas, Nev.**
November 4–5	NCIGF/IAIR Joint Workshop San Diego, Calif.
December 4–7	NAIC Winter National Meeting New Orleans, La.