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"I Don't Think That Federal Regulation Is Inevitable"

Wisconsin Commissioner Sean Dilweg talks about the strengths of state regulation and the potential downside of a systemic risk regulator

Sean Dilweg was appointed Commissioner of Insurance for the State of Wisconsin on January 1, 2007. The Office of the Commissioner of Insurance regulates the business of insurance in Wisconsin and is responsible for examining industry financial practices and market conduct, licensing agents, reviewing policy forms for compliance with state legislation, investigating consumer complaints, and providing consumer information.

Prior to this appointment, Commissioner Dilweg served as the Executive Assistant to the Secretary of the Wisconsin Department of Administration from 2003 to 2006. In addition to managing key agency activities, including external communications, tribal negotiations, and state finances, he advised the Secretary of the Department of Administration and Governor Jim Doyle on legislative and policy matters.

Commissioner Dilweg currently serves on the NAIC's Senior Issues (B) Task Force, Life Insurance and Annuities (A) Committee, Indexed Annuities (A) Working Group, and Consumer Connections (D) Working Group. He also spoke at NOLHGA's 2009 Legal Seminar.

This interview was conducted in late July 2009.

Where do you see the life industry at this point in the economic cycle? What strengths have been demonstrated? What weaknesses remain?

Obviously, as commissioners we've been very involved, even as it goes back to the capital and surplus relief debate, as the financial crisis occurred. Overall, the life industry has weathered this financial crisis very well. That line of insurance is obviously invested in a variety of assets, so the stress of the stock market going down 40% has hit them in a variety of ways.

So, how do we handle and interpret what an asset may be valued at, especially as you wrestle with how the rating agencies have changed their view on some of these assets? That's an ongoing debate among the commissioners. But I would say overall, life insurance has come out on top as far as a financial product.

I do have concerns as we look at variable annuities and the guarantees behind some of those and how they're being stressed. But overall, the strength of the industry shows the strength of state-based regulation, which has protected consumers.

What did the Wisconsin Department do to respond to the economic downturn of the past few years?

Wisconsin has had a unique experience with this financial crisis. It was really both New York and Wisconsin that had to wrestle with bond insurers. The second-largest bond insurer in the country is domiciled here in Wisconsin, and we also have the largest mortgage insurer. So we've come

["Commissioner Dilweg" continues on page 11]

In a sense, the bond insurer was the canary in the coal mine for the financial crisis, because they were stressed a good eight months before the collapse of the financial markets in September 2008.

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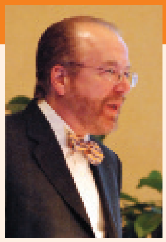

Life Insurance Consumers and the Economic Crisis of 2008–2009

As I write in mid-August, the economic "green shoots" of which Fed Chairman Ben Bernanke spoke in the spring seem to be blossoming into the start of an economic recovery. Commercial credit appears to be recovering; the U.S. equity markets have just finished their strongest month since 2002; home sales are picking up in many markets; and various other economic indicators and indices have either begun to reverse long declines or have dramatically reduced their rate of fall. In short, a consensus is developing, based on not a little evidence, that the long recession is ending and that we are now beginning some sort of recovery.

To be sure, not all economic experts share the view that a recovery has begun, and of those who do believe, many doubt that the recovery will be long or strong. Unemployment remains a serious problem, concerns persist about both residential and commercial real estate, and there may be (as suggested recently in the *Financial Times*) "unexploded ordnance …litter[ing] the financial landscape." Still, the view is growing that we may be past the most dangerous part of the crisis that began in earnest at the end of last summer and continued through the early spring of 2009.

I sometimes wonder whether the economic crisis of 2008–2009 will be looked back upon by historians and psychologists as a study in the development of societal anxiety. If that happens, I hope someone brings to bear the tools of "public choice" analysis to examine how—and more important, why—certain actors in society contributed to that anxiety.

"Public choice" theory is widely associated with the "Virginia School" of economics and with 1986 Nobel laureate James M. Buchanan of George Mason University. The theory attempts to explain, among other things, how public decision-making contrary to the general interest often follows from rational economic decisions made by actors within the political system and those who interact with the political system.

For example, an elected zoning official may know that the approval of a large development is opposed by a majority of his constituents, but he may be moved to approve the project out of a desire for campaign contributions or other forms of support from interested developers, contractors, labor unions, and the like. In economic terms, the diffuse unhappiness among the general electorate about a "yes" vote on the development may have less negative value to the official than the positive value of concentrated contributions, endorsements, and active campaign support.

Never Waste a Crisis

In the context of the current economic crisis, the public choice explanation of how policy develops can also be seen in the comment by President Obama's Chief of Staff, Rahm Emanuel, that one should "never allow a crisis to go to waste," meaning in no small measure that generalized public fear and anxiety have a value that can be harnessed to make possible policy initiatives that (because of costs or other negative long-term implications) could never be implemented in times of calm reflection.

To be fair to Emanuel, few political actors of *any* stripe, and few who deal with the political process from the outside, view crises much differently. As a senior official at a conservative think tank told me during what many will always call "AIG Week" (the week beginning Sunday, September 14, 2008, when AIG teetered on the brink of bankruptcy before a federal rescue), "Any time there is a major crisis, you can hear the sound of file drawers opening all over Washington." Moments of crisis inevitably inspire opportunists (many of them well-meaning) to trot out old proposals that normally would gain no traction. Similarly, when the formerly unthinkable (e.g., the failure of AIG) is at hand, many previously unmarketable notions may plausibly be advanced.

Those inspired by rational self interest not to "waste a crisis" include, besides politicians, those who lobby politicians for governmental assistance or relief. They also include others whose standing or livelihood depends on marketing the belief that they are sources of truth, wisdom, and good advice in threatening times. This category includes some journalists, who might hope for front page stories, advancement, and recognition in stories about a crisis. It also includes "think

We have seen from political officials a long string of policy responses to the current economic crisis, many of which are well-intended and some of which make sense.

tank" scholars and "consumer advocates" who might hope for contributions, grants, and increased influence from speaking loudly and often about elements of a crisis.

So we have seen from political officials a long string of policy responses to the current economic crisis, many of which are well-intended and some of which make sense. Likewise, we have seen a number of stories from journalists and opinion pieces from bloggers and consumer advocates focusing on various elements of the economic crisis.

Notice, however, that the one narrative that is of no use in advancing a new policy proposal, furthering a journalistic career, or increasing contributions to "think tanks" or consumer advocacy organizations is this: "*There's nothing to panic about here.*" Stories predicting the impending demise of Western civilization appear above the fold on page one. As they put it in the television news business, "If it bleeds, it leads." Stories noting the absence of fires today, if they appear at all, are between the obituary and religion pages. A public choice theorist might say that it is economically rational—especially in a crisis—for many whose business is influencing societal attitudes to go long on worry and short on calm.

The Supposed Insurance "Crisis"

This phenomenon is easy to see when one looks back at public discussions of the insurance industry—especially the life industry—during the recent crisis. For example, there is the basic tack taken in almost every news story about AIG. Reference is made, almost universally, to "failed insurance giant AIG," and columnists proceed to lump the insurance industry in with other business sectors full of companies that either have failed or have survived only due to federal financial assistance. All this, even though the predominant cause of AIG's challenges was entirely unrelated to insurance activities, and even though a grand total of two insurance companies out of the thousands doing business in the United States ultimately accepted TARP assistance from the Treasury.

Similarly, the blogosphere has been full of accounts of the impending demise of the insurance industry, and even assertions that the economy has been causing failures of insurers left and right. A reporter at one national paper—possibly trying to get out in front of the journalistic competition with what he anticipated might turn into a big story—wrote a series of articles earlier this year questioning the strength of the life industry and the ability of regulators and the insurance safety net to protect consumers.

The ultimate questions aimed at by such comments are these: Should consumers have deep concerns about their life insurers, and could the life and health guaranty system protect consumers if the current economic crisis were to worsen again, resulting in the failures of several major, national companies?

["Economic Crisis" continues on page 15]

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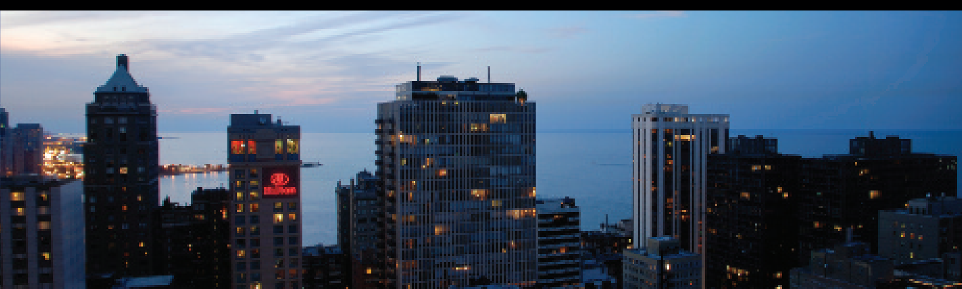
Tough Town, To

Facing a troubled economy and possible regulatory upheaval, NOLHGA's 2009 Legal Seminar

By Sean M. McKenna



In a city known for bruising politics and soul-crushing baseball, more than 200 members of the guaranty system community (a Legal Seminar attendance record) came to Chicago in early July to discuss how the insurance industry and guaranty system safety net will navigate an economic recession, increased attention from Congress and the Administration, and the very real possibility of a host of new regulators with at least a finger or two in the insurance pie. They departed the two-day Legal Seminar intrigued or confused by exhibits at a nearby art museum but armed with insights into the regulatory debate on Capitol Hill, when the recession might end, and how ready the guaranty associations are to meet the near- and long-term challenges they face.

Regulation Nation

With the Obama Administration releasing its proposal for financial services regulatory reform a few weeks before the Legal Seminar, it's no surprise that insurance regulation was on the minds and BlackBerries of attendees and speakers alike. Dr. Terri Vaughan, Chief Executive Officer of the NAIC, noted that since the economic crisis began, "we have seen a parade of financial regulators admitting that they made significant mistakes" on issues such as credit-default swaps and loosening leverage requirements. These types of mistakes, she added, often arise from regulatory forbearance (failure to take prompt action) and regulatory capture (when regulators become overly sympathetic to those they regulate).

With these forces constantly at play in the regulatory arena, Dr. Vaughan said, "we need to let go of the idea of a single, omniscient regulator." In other words, any new regulatory structure must take into account the simple fact that regulators, even good ones, make mistakes. "To counter these problems, you need a system of checks and balances—multiple sets of regulatory eyes" she explained. "Who watches the regulators?"

In state insurance regulation, Dr. Vaughan emphasized, the regulators watch each other and serve to temper any moves toward regulatory forbearance or capture. This "system of oversight

ough Times

the insurance industry and guaranty system meet in Chicago for

and peer review," she said, performed well in the current economic crisis: "The fact that the insurance industry looks good today compared with other sectors is not just an accident." This being the case, the NAIC feels that state regulators should be incorporated into any new system of insurance regulation.

Dr. Terri Vaughan, CEO of the NAIC

Dr. Vaughan admitted that the system of checks and balances "can be a source of great frustration" when it is employed inefficiently, and she said that the NAIC is open to the idea of Congress spurring the NAIC and its members along in its modernization efforts by setting standards: "There's a new willingness to engage with the federal government to solve some of these problems."

In a panel discussion on the insurance regulatory debate, Charlie Richardson (Baker & Daniels) made it clear that Congress and the Administration are also displaying a new willingness—some might say eagerness—to engage in a top-to-bottom review of the regulation of insurance. He noted that while the Administration's proposal does not call for an optional federal charter, "much of the language of the proposal is broad enough that insurance could be swept in." In fact, one of the duties of the proposed Office of National Insurance (ONI) within the Treasury Department is to "modernize and improve" the current system of insurance regulation along six principles, including systemic risk regulation, consistent consumer protections, and increased national uniformity.

Richardson said that the guaranty system will not escape efforts to modernize and improve insurance regulation and warned that "the guaranty association story is still not completely understood by some in Congress." The guaranty system community, he added, "will have to GOST—get our stuff together" and make the case persuasively that the state-based safety net can adapt to any national regulatory regime; after all, it has protected consumers well for four decades.

Dr. Vaughan, pulling double duty as a solo speaker and a panel participant, made the point that "much of the discussion going on in Washington is being driven by concerns about banking," adding that Rep. Barney Frank (D-Mass.), who chairs the House Financial Services Committee, has said that insurance is not at the top of his agenda. There's also an intense focus on eliminating or minimizing systemic risk, but Dr. Vaughan said, "I can't think of a single insurance company that's so big we couldn't handle it failing." She added that AIG's insurance subsidiaries by themselves pose no systemic risk.

The NAIC's emphasis as the regulatory debate moves forward, Dr. Vaughan concluded, was to maintain the organization's focus on consumer protection as the Administration and Congress evaluate proposed additional regulatory bodies such as the Financial Services Oversight Council and the Consumer Financial Protection Agency: "Let's find a better model that builds on the strengths of the current system."

Nat Shapo (Katten Muchin Rosenman LLP) did not share Dr. Vaughan's enthusiasm for building on the existing state system of regulation. While acknowledging that an optional federal charter is "not the silver bullet catalyst for regulatory change," he added that "the state system is not the best way to get to the goals" for insurance regulation spelled out in the Administration's proposal.

Shapo raised doubts about the creation of the ONI—"It's quite a thing to build a bureaucracy from scratch," he said—but he added that the states have "systemic issues" that will prevent them from achieving uniformity and other goals set by the Administration. "The states can't achieve those goals on their own," he said. "You have a classic collective action problem" in which each state will do what it deems best.

Alison Watson (Northwestern Mutual Life Insurance Company) began her comments by noting that the efforts under the Gramm-Leach-Bliley Act to establish a regulatory framework for financial services included complete deference to the functional regulators by the federal government. Under the Obama Administration's proposal, she said, "the deference between the federal and functional regulator is virtually eliminated."

Watson described her view of Rep. Frank's top priorities: the Consumer Financial Protection Agency, tightening regulation on derivatives, executive compensation, and systemic risk regulation. She echoed Dr. Vaughan's comment that insurance is not on the Chairman's "short list" of priorities and predicted that we won't see the creation of the ONI in this session of Congress, saying that a focus on other issues will crowd it out.

Watson noted that while nostalgia is only natural in an industry facing the kind of upheaval the insurance industry faces—"What do we want? We want to go back to our college years," she joked—there's no place for it in today's

The Downfall of Civilization

According to Joel Telpner (Mayer Brown), "right after subprime, derivatives have been blamed for the downfall of Western civilization." This is despite, or perhaps because of, the fact that a large number of people don't understand what a derivative is.

Telpner and Ken Wylie (Sidley Austin) did their best to demystify derivatives, especially credit-default swaps, and the first lesson is that derivatives are big business with a capital B. The derivative market in 2008 was valued at roughly $62 trillion dollars, Wylie said, which is four times larger than the American economy. "Did I forget to mention that they're not regulated?" he added, although that statement won't be accurate for long.

Telpner defined a derivative as "fundamentally an instrument that can be used to identify and quantify risk and move it from one party to another." In the example he used, a person buys a $100 bond and then buys credit protection in case the bond goes into default. That, in essence, is a credit-default swap.

Is it insurance? Insurance policies have measurable loss and insurable interest, but credit-default swaps don't necessarily have these components. Telpner explained that you don't need to actually own a bond to buy a credit-default swap, and the payment if the bond goes into default is the same no matter what you paid for the bond in the first place (if you paid for it).

As derivatives became increasingly popular, Telpner said, "it was difficult for regulators to even understand what was in the market." That should change, he added, because there's a movement to make the derivative market more transparent. Under proposed federal oversight of the market, all participants will have to report their derivative exposure to regulators, and there will be much more significant margin requirements.

political and economic environment. "Our industry and our economy have fundamentally changed," she said. "We've got our work cut out for us."

The Business of America

The fundamental changes in the economy were the topic of the presentation by Dr. Randall Kroszner (University of Chicago), who served as a Governor of

Dr. Randall Kroszner (University of Chicago)

the Federal Reserve System from March 2006 to January 2009 and before that as the key economic advisor to the Bush Administration. Dr. Kroszner shared his "ringside seat" perspective on the financial meltdown of 2008 and stressed that the Federal Reserve faced an unprecedented global shutdown of the financial markets. "So some of the responses had to be things we'd never seen before either," he said.

Pointing to the subprime meltdown and highly leveraged lending, Dr. Kroszner blamed much of the economic crisis on "a truly worldwide breakdown of risk management principles." He criticized "excessive reliance" on ratings agencies, which "failed miserably" in assessing the risk in some of the new, highly complex structured debt instruments. "You really need to do your own due diligence," he added. "People have to trust but verify."

An Alternative Approach

"My friends in the legal community are very fond of receiverships," said Illinois Insurance Director Michael McRaith in a Legal Seminar presentation on ways to avoid receiverships. The Illinois department is overseeing the solvent runoff of Kemper Insurance Companies (the largest runoff in United States history), and McRaith emphasized that "effective and persistent communication" with all involved parties is key to a successful runoff. He added that it might be necessary to replace company leadership, since overseeing a runoff is quite different than running a traditional company.

The key question in deciding whether to pursue a runoff as opposed to a liquidation is whether the commercial marketplace can treat consumers as well as a receiver. Provided the runoff plan has policyholder protection as a priority, McRaith says the answer is yes: "That commercial dynamic can serve customers ultimately better than a receivership."

Former South Carolina Director Eleanor Kitzman (Goldman Sachs) said that "for a commissioner, it's a very bad thing to have to take a company down" due to its effect on the state's consumers. In evaluating whether to run off a company's business, she added, it helps to get in as early as possible. "Ideally, the management will be coming to you," she said. "No matter how good your examiners are, you're looking in the rearview mirror."

Kitzman also stressed that wishful thinking has no place in the decision. "You have to be very realistic in your assessment of each company," she said, since some companies won't have enough value on the books for the commercial market to be interested. "You have to be able to triage the situation," she added. "And you have to be creative in your approach."

Former New York Insurance Superintendent Gregory Serio (Park Strategies) gave attendees his insights into the intricacies of such a runoff—he is a trustee for the Senior Health Care Oversight Trust in Pennsylvania, which is overseeing the runoff of Conseco Senior Health Insurance Company's long-term-care business. He noted that the trustees removed the Chief Executive Officer from the company to "create as much daylight between us and Conseco as possible" and that the company was being operated "as an independent and freestanding organization."

Serio agreed with the other panelists that the runoff process gave regulators more flexibility than the judicial review of a receivership—he pointed out that the company would pursue rate increases, which would be impossible in a liquidation. He also noted that with a runoff, "the guaranty funds are not seen as the first stop, but as the last stop, if at all." He added that an ongoing dialogue with the guaranty associations is "absolutely crucial" for the success of this effort, and he sounded bullish on its prospects. "I think we have a new conservation paradigm afoot here," he concluded.

Luncheon speaker Paul Green spoke about Chicago's political history and explained how President Obama embodies both the "hard-nosed toughness" and the "idealistic reform movement" that are the twin themes of Chicago politics.

In response to the crisis, the Federal Reserve "took a very proactive approach," Dr. Kroszner said, in contrast to its actions in the 1930s. He added that the emergency powers granted to the Fed in the 1930s required a supermajority of five or more Governors to be used. Since there were only five Governors when the 2008 crisis hit, each move made by the Fed had to be unanimously approved. "It was really quite heart-pounding," he said of the Sunday meetings in which the Fed had to take extraordinary actions before the markets opened on Monday.

Looking to the future, Dr. Kroszner predicted that unemployment will peak in the mid-10% range. "The markets are still fragile," he explained. "I think it's foolhardy to say we're done" with the crisis. He pointed to the housing market as the "key to overall stabilization, especially in the United States," and said that he expects most housing markets to settle down by the end of 2009 or early 2010.

Dr. Kroszner didn't hold out much hope for the Obama Administration's stimulus package. "The impact will be too much, too late," he said. "And there's going to be a real issue down the line of how this will be paid for." He played it safe in commenting on proposed regulatory reform, saying that "the devil's in the details" and noting of the Consumer Financial Protection Agency, "there's a big chance for it to be very harmful."

The goal of regulatory reform, he added, should be to make the market safer and more robust. "We want to avoid the system-wide risk we've seen," he said, so that a company can fail without taking the economy down with it. This can't be achieved by creating a single systemic risk regulator: "Markets move very quickly," he said, and one regulator can't foresee every threat.

The threat to the insurance industry posed by the drying up of the capital markets was the main focus of a panel entitled *Capital and Crisis*. Laura Bazer (Moody's Investors Service) noted that her agency had downgraded more than 25 companies in the past six months and predicted that the negative outlook for the insurance industry would last into 2010. Pressures on the industry include investment losses, the impact of the weak equity market on variable annuities, and limited capital market access. "The capital markets have been pretty much closed until recently," she said.

Bazer added that the industry's strong credit profile—including a high level of regulatory capital—is expected to soften the pressure. "If you have to go into a recession, it's good to start at 400% RBC," she said.

Bruce Ferguson of the ACLI followed up on Bazer's comments, saying that the state of the capital markets in the fall of 2008 led the organization to seek regulatory changes from the NAIC on what the ACLI felt were "overly conservative" standards that led to companies under-reporting assets. The NAIC decided against making any changes in 2008, but many states granted the changes under permitted practices. Ferguson said that while the reporting standards "have served this industry and our policyholders well," regulators need to find a way to adjust these standards on a timely basis to adapt to changing economic conditions.

Wisconsin Insurance Commissioner Sean Dilweg offered a regulator's view of the situation, noting that the Wisconsin department granted permitted practices to some of its domestic companies but also stressed that those assets be slated for claims rather than dividends or other uses.

Commissioner Dilweg made the case that state regulation, while slow at times, is working, and he

pointed to the strength of the insurance industry as proof. He also warned of the dangers inherent in a systemic risk regulator, saying that it's not difficult to imagine such a regulator ordering that money meant to pay claims be moved to prop up a holding company, thus weakening policyholder protection if an insolvency occurs.

George Nichols (New York Life Insurance Company) called the capital relief debate "not the prettiest thing I've ever seen—not our finest hour," but he added that based on the comments of his fellow panelists and others at the seminar, "you should walk away pretty optimistic about the long-term viability of the life insurance industry."

The hallmark of state regulation, Nichols added, is solvency regulation, and "that has served us well." Despite this, he did have some suggestions for change. He called RBC standards "outdated" and advocated a more sophisticated approach to evaluating companies' solvency. "My fear is that we're looking at it from a piecemeal perspective and not a comprehensive perspective," he said.

Nichols then turned his perspective on the guaranty associations, saying that "I think it's important that we address uniformity from a process standpoint and a coverage standpoint." The guaranty system needs to be prepared to explain why the industry shouldn't be served by an FDIC-style system, he said, arguing that the current system addresses moral hazard in a way the FDIC does not. The fundamental question, he added, is simple: "Should we create a national guaranty system?" If our answer is no, "we're going to have to deal with marketing or defining what our system is for the average consumer."

The Safety Net at Work

Defining the guaranty system—and how it performs its role—was the goal of two panels at the Legal Seminar. In one, James Stinson (Sidley Austin) reviewed the fundamentals of receivership law, detailing the options a regulator has in dealing with a troubled insurance company. These options range from corrective orders to a court-ordered receivership—"literally changing the locks on the doors," Stinson said—with liquidation being the final option.

Kevin Griffith (Baker & Daniels) examined the special problems presented by a life or annuity insolvency, noting that "in a life insolvency, we almost always see some form of liquidity problem." He added that "we're seeing a big increase in Federal Home Bank Loan transactions" with life companies, which tie up a good deal of assets in illiquid ventures.

Peter Gallanis (NOLHGA) addressed the most basic of all policyholder questions: "Are life and annuity contract owners secure" if their company fails? The answer to this question, he said, lies in the way the guaranty system safety net responds to insolvencies. The financial capacity of the system—almost $9 billion annually at last count—won't be called on to "fill the hole" of an insolvency in one year. Instead, the obligations of a failed insurer stretch out for years and even decades, and so too do the costs of the guaranty associations that meet these obligations.

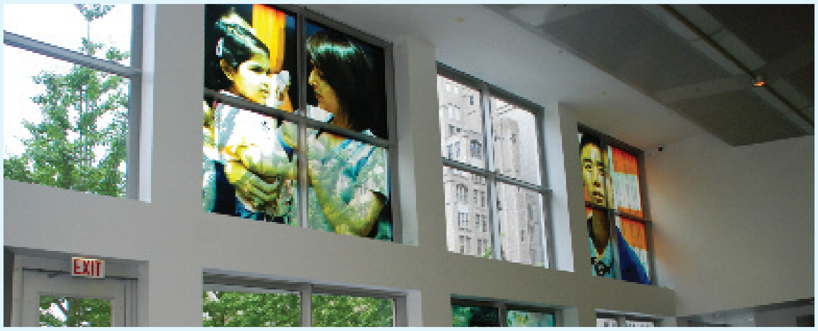
In addition, thanks to the conservative regulation of insurance companies by state regulators, "when you get into difficult times, there's more money in the cupboard than you'd think there'd be," Gallanis said—sometimes 85 to 95 cents on the dollar. NOLHGA has engaged in "stress tests" to gauge the system's ability to respond to the failure of one or more large insurers, and the associations' ability to spread costs out over a number of years means that the system has a firm answer to the question of whether it's ready. "When you look at the numbers and kick the tires," Gallanis said, "the answer is clearly yes."

The system's ability to meet the demands of even the most challenging insolvency was further illustrated in a mock board meeting presentation featuring Candie Kinch (Idaho guaranty association), Pam Olsen (Nebraska guaranty association), Joel Glover (Rothgerber, Johnson & Lyons) and Kevin Griffith (Baker & Daniels). In the presentation, the "board" and its legal consultants reviewed the critical agreements—joint and common interest, early access, liquidation trust, etc.—that guaranty associations use in handling insolvencies. The presentation also explored how confidentiality agreements affect guaranty association board members. ✯

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

Pictures at an Exhibition

Chicago's Museum of Contemporary Art played host to NOLHGA's 2009 Legal Seminar Welcome Reception.



["Commissioner Dilweg" continues from page 1]
at this financial crisis through the lens of the stresses placed on our monoline insurers, and that really started in the fall of 2007.

That's given us specific insights, especially on the bond insurance side, as they wrapped a lot of these financial products, such as CDOs and CDOs squared, and had these agreements with a variety of counterparties ranging from Society General to Citigroup. In a sense, the bond insurer was the canary in the coal mine for the financial crisis, because they were stressed a good eight months before the collapse of the financial markets in September 2008.

So it better prepared me as a commissioner for all the issues the rest of the insurers were facing—understanding some of the securitized assets that they may have had investments in, and understanding what reserves are there to back up the claims that may be increasing. So it's given us a specific insight into the stresses on the economy.

We have had a slight uptick in our permitted practices, like a number of other states, and we've had to monitor more companies across all lines as assets degrade. We had the life industry asking for relief on a variety of fronts. We had what happened with AIG. So Wisconsin really approached the capital and surplus relief issue by asking, "Why should the policyholder suffer from some of the decisions the company made during the financial crisis?" That's why, as we and our fellow regulators looked at permitted practices, the goal was to sequester the relief so it benefitted the policyholder—or didn't hurt the policyholder—and would not go toward dividends going out to shareholders or things of that nature.

So the experience gave me a clearer view of how to navigate the capital and surplus issue. Obviously, we have a number of the reserving requirements—there are nine or so points we're still examining on the NAIC level.

What did the insurance regulatory community do by way of a concerted, national response to the economic downturn?
Our response, to me, shows the strength of the state-based system. On insurance, what the consumer should know is that not only do you have the guaranty funds backing everything up—and as we know, the guaranty funds are not taxpayer dollars, which is important—but you have 50 different sets of eyes looking at each problem. And you're all equal. As commissioners or superintendents or directors, we all have our own hammers and our own views of a company even as we give deference to the domestic regulator.

The goal of statutory accounting is, if you had to pay all your claims today, could you do it? We're not working through Ponzi schemes here in insurance. This isn't a cash-in, cash-out operation. This is, can you pay all your claims today? That lens has to be there every day, and that's how we have to look at our companies.

I think on the federal side, you had a regulatory system that was dysfunctional, that wasn't communicating. You didn't have that council of peers even talking with each other, whether it be the Federal Reserve, Office of Thrift Supervision, or Securities and Exchange Commission. You saw agencies get involved more in turf battles, and a lighter touch on regulation than what I've seen on the state side. So ultimately, while the state-based system does not offer the efficiency of a single point of contact, it's one that does protect the consumer and provide more checks and balances than a central federal regulator.

I think the state insurance regulator should continue to be the portal or gateway for the federal government as they deal with some of these systemic issues.

I would hate to see the reserves set aside on the insurance company side for claims to be tapped by a systemic federal regulator to bail out a financial services division of a company.

What is the role of regulatory forbearance and the permitted practice exceptions you mentioned to otherwise applicable regulatory requirements in this kind of environment?

Permitted practices allow the states to look at how the companies account for a variety of issues. The big issue last year was the deferred tax asset. When you think about a deferred tax asset, if you have a company that's going to continue having income, they're going to be able to realize the deferred tax asset. That's a simple decision. The question is how you then account for that, how you carry it forward, under what length of years.

Where the deferred tax asset starts getting dicey is when you have to determine if it's an empty asset. If you're getting into a liquidation situation, a deferred tax asset is not a building you can sell, it's not a property that you own. So it becomes less valuable. So how is that accounted for in a statutory snapshot?

Of course, any state can refuse to provide a permitted practice. Another state can say, "That's nice, but I'd like to see this company's annual statement without the deferred tax asset and see how solvent they are." Any state can check another state, and the systems are set up to have those conversations so that all the states can understand why the permitted practice was given.

Permitted practices are given for a variety of reasons. They average probably 30 to 40 a year. With the financial crisis, I think we were upwards of 80, so it shows a doubling of permitted practices. But it's meant to be there to handle the stresses on the companies and the specific issues the companies have.

Keeping with this issue, how transparent should regulatory decision-making be in this sort of environment? Is there such a thing as too much regulatory transparency?

I felt the capital and surplus relief process was transparent. In general, you have to be concerned about competition and confidentiality as you look at, for instance, RBC. That's a number, but it's not a transparent number. If you were to show that transparently, you would be giving insight into a company that could potentially hurt it and benefit its competitors. So you need to find that line to show the external mark—here are the assets the company has, here's the claims-paying ability.

It all comes down to the claims-paying ability, so the consumer knows that when they take out that contract, which is just a piece of paper, that the company will be there to pay it. Especially with life insurance, you're looking over a much longer view than a six-month auto insurance policy or something like that.

Has your department been tracking the progress of the long-term-care component of the marketplace recently? Does Wisconsin have any special observations about that business?

Wisconsin was late to come to long-term care. We had a lot of questions about it—this obviously predates me. But we have been heavily involved in the long-term-care issue. On the Senior Issues Task Force at the NAIC, while we chaired it we coordinated with the D Committee to survey all the companies—we got about 80% of the market share and reported on 58 data points on what's going on in the market. I've testified a number of times to Congress on long-term care.

We have pushed, and I expect adoption in September, for a rule to provide consumers with an independent review of long-term-care decisions. Once all the states have the independent review option, consumers will have more power to look into their company's decision on whether their assisted daily living activities meet that qualification for the long-term-care product.

We've always talked about not buying long-term care in a vacuum. It should be a piece of your overall retirement puzzle. It's not right for everybody—you may be better off with other investment products or annuities. That's what Wisconsin and most commissioners tend to highlight.

It's only been around 30 years, which is relatively new because the claims start rolling in 10 to 15 years after people buy the product. A lot of early issuances were underfunded. We solved, through our Model Act process, a lot of the problems the initial long-term-care products had. It's something that we're monitoring closely and staying involved in on a national level.

My Senator, Sen. Herb Kohl, is head of the Special Committee on Aging and is looking at provisions to start standardizing the terms in long-term care and getting more accountability into the product for consumers. We continue to stay involved in it.

Is an increasing federal insurance regulatory role—of some form—inevitable? If so, what should be the ongoing role of state regulation?

I don't think that federal regulation of insurance is inevitable. So with that view, the question is, how have we worked under the current financial stresses? And frankly, I turn to how well we worked on the AIG situation. I know proponents of federal regulation argue that's a reason for federal regulation, but frankly, my counterparts in New York, Pennsylvania, and Texas really stepped up and became the voice to the federal regulators as to how the insurance side of AIG was doing.

In my view, that's how the process should continue. I would hate to see the reserves set aside on the insurance company side for claims to be tapped by a systemic federal regulator to bail out a financial services division of a company. Insurance typically doesn't have a run on the bank, and if you have a holding company in a systemically significant company with not only insurance but banking beneath it, the potential for a run on the bank is there on the financial services side.

On the insurance side, these are contracts that we've spent a lot of time on to make sure the money is there. So you can envision getting into arguments with the systemic regulator: "This contract isn't due for 30 years, so let's use the money over in the financial services division that's rupturing because it invested in the subprime mortgage market."

That's basically what the federal government is doing with Social Security—they're operating the government off the Social Security funds, saying, "The people aren't going to cash in for another 30 years." I'm not comforted by the federal government's approach to financial services. I think there's a long history there—we've all heard it, from the savings and loan crisis to periodic crises on the federal government side that we on the state side seem to have avoided.

So I think the state insurance regulator should continue to be the portal or gateway for the federal government as they deal with some of these systemic issues. Wisconsin chairs the NAIC's Financial Analysis Working Group, or FAWG, which looks at troubled insurance companies. We communicate with the New York Federal Reserve almost monthly. We have confidentiality agreements with them. We communicate with Treasury and with the Federal Housing Finance Agency on our monolines. And other states do the same. So there's nothing prohibiting states from talking to our federal counterparts. And I think that should continue.

Would that continue through something like the proposed Office of National Insurance, which would act as a federal clearinghouse for this kind of information?

That's one thought that's out there. I get concerned that the federal side might preempt the state side—it's one thing to be a clearinghouse and another thing to have authority over reinsurance collateral, things like that, which I think was entertained in the proposal last year. We spent a lot of time educating our federal counterparts in the spring of 2008 on bond insurance and its role in the marketplace, and having better-educated federal regulators of other financial products is helpful.

You mentioned at NOLHGA's Legal Seminar that the Wall Street media are not conducive to taking a long-term view of the crisis and possible solutions. How does this play out, and how does it affect efforts to reform financial services regulation?

I don't envy my counterpart in New York because of the media market in which he has to function. The Wall Street media, to their credit, are very granular, but they have a very short view of the issues at hand. I parallel it to when Brett Favre played for the Green Bay Packers—there were endless stories about could he throw, how much Vicodin was he taking, where did he eat dinner? It's very similar to sports media.

It stems from investors making daily decisions on stocks. I understand the media's role there, but it's not conducive to a long-term view. I benefit from Wisconsin being home to one of the largest mutual

I think on the federal side, you had a regulatory system that was dysfunctional, that wasn't communicating.

companies—Northwestern Mutual—and the largest fraternal insurer, Thrivent Financial. And they have a much longer view of this financial crisis, and I think a much healthier view, than those companies that are forced to live with the Wall Street media day by day. That's why you saw the actions taken by the SEC on short selling and other similar steps to try to control the synergies between the Wall Street media and investors.

You touched on this earlier, but how are "toxic assets" affecting the insurance industry and its policyholders? What are state regulators doing about it?

The toxic asset issue continues to affect the economy. I've had specific insight into it through my bond insurer. The concern is that you have banks that have not valued these toxic assets—the subprime mortgages; the longer, securitized auto loans; and securitized credit card balances. That was really the goal of the original TARP program, to spend money to value those assets so you'd know that the CDO that Citigroup holds is worth 20 cents, 40 cents, 60 cents—at least you'd know the value of it.

Until those are written down, you're going to have to deal with even more unique financial products, such as re-REMICs, which basically turn these assets into a good bank/bad bank internally, as far as I can tell. These all create challenges for insurance regulators. Any company might have some money invested in these assets. It's not going to be a majority—there are restrictions there. But you still have to place value on them.

So then what you get, and this has been talked about, is this hangover effect, kind of what Japan faced with what was termed the zombie banks. How did they resolve the value of those assets? As we wrestle with the value of these assets on the insurance side—it's not been as much of a problem as on the banking side—these are the challenges we face.

You said at the Legal Seminar that the current economic environment is an opportunity for state guaranty associations to tell people what we do. What do policyholders need to know about guaranty associations?

This is the first time I've had the chairman of my insurance committee asking about guaranty associations—what do they do, what is their role, how are they constructed? These are questions that probably hadn't been asked for 10 or 15 years here in Wisconsin. And then you had the consumers asking what is there to guarantee my annuity?

So I think it is a good time—I understand the moral hazard of advertising guaranty funds on specific products—but as far as educating the policymakers and general public as a whole on the role of the guaranty funds, I think there's a huge opportunity right now that each guaranty fund should be taking in each state.

Has your department encountered any misconceptions about the guaranty system, or is there simply a general lack of knowledge about the associations?

It's more a general lack of knowledge. The consumers view it as the FDIC, and the policymakers don't realize the strength and the legal backbone of the guaranty funds. I go back to one of my original points, which is that in the end, there are no taxpayer dollars involved in the funds. I think that's a huge plus that consumers and policymakers should know.

In your opinion, how well is the state-based guaranty system performing its role? Are there any changes you'd like to see in the guaranty associations?

We benefit in Wisconsin from having one board for all of our lines. It's a positive—it gives me and others one place to turn. So I would make that suggestion for other states.

I think efforts to find common guaranty coverage levels—be it $300,000 or $100,000, depending on the product—are also helpful, so that as a consumer, as you're crossing state lines you still have the same guaranty. Those two fronts would be helpful. ✮

["Economic Crisis" continues from page 3]

Most commentators who have raised such questions appear unacquainted with the relevant facts and history. As a great Democrat once said, "Let's look at the record."

Since the start of 2008, we have seen, among other events, the virtual disappearance of the investment banking industry as previously known; the government seizure of over 100 banks and thrifts (including quite recently the fifth-largest bank failure in U.S. history); the conservatorship of Fannie Mae and Freddie Mac; the collapse of Bear Stearns and the bankruptcy of Lehman Brothers; the closing of many hedge funds; and the bankruptcies of Chrysler and GM. Against that backdrop and in the same period, it is noteworthy that precisely *zero* life insurance companies have entered liquidation as a consequence of the economic crisis.[1] To be sure, even in good economic times, some companies do fail as the inevitable result of competition and management issues, and some life insurers ultimately may be liquidated before a recovery truly takes hold. But the record shows clearly that the life insurance industry has so far weathered this economic storm better than almost any other sector of the economy.

The Guaranty System & the Four Pillars

On the question of whether the guaranty system is able to protect consumers in the event of a major increase in insolvency activity, the answer from history is clear: The system has *already* proven its ability to do precisely that, responding successfully to the insolvencies of three major national companies (Mutual Benefit, Executive Life, and Confederation Life) in the early 1990s while also handling the contemporaneous failures of several dozen small to mid-sized companies.

Even aside from that significant track record, were the economy to worsen again, life industry consumers should take comfort from four critically important and related facts.

First, as a consequence of strong regulation, rating agency requirements, and a conservative business culture, life companies reserve against economic downturns more carefully than virtually any other financial entities. Their reported assets tend to be discounted, their liability estimates tend to be redundant, and they do not engage in the sort of financial leverage that proved so risky for the investment banking industry. As a consequence, when a life company fails, typically the shortfall of assets to liabilities ranges roughly from 5% to 15%—a much smaller shortfall than in conventional business bankruptcies. The substantial assets usually remaining in a life company upon liquidation are available to satisfy the company's obligations to policyholders. That means that the failure of a life company with, say, $1 billion of policyholder liabilities (assuming for illustration purposes that all liabilities are covered by guaranty associations) does not produce a need for $1 billion of new funding to protect policyholders; rather, the amount needed typically would range from $50 million to $150 million.

> Life insurers are not banks, and their obligations are completely different from bank deposit accounts.

Second, life insurers are not banks, and their obligations are completely different from bank deposit accounts. When a company writing life and annuity business fails, its obligations to policyholders, unlike bank "demand" deposits, are not all due on the date of liquidation. To the contrary, most essential liabilities to policyholders (e.g., death benefit payments and scheduled annuity installment payouts) will not come due for years, decades, or even generations after a life company's liquidation date. Using the same example as before, the requirement to fund that $50 million to $150 million can (if necessary) be spread out over the period during which obligations to policyholders come due. It is primarily for that reason that a large, pre-funded insolvency "war chest" (like that normally maintained by the FDIC) is not needed to respond to insurer insolvencies.

Third, insurance liquidation statutes in all states afford claims in respect of insurance policies an *absolute priority* over claims of general and subordinated creditors. Policyholders must be paid first and in full from assets remaining in the failed insurer (which, as noted, are usually substantial) before lower-ranking creditors may be paid anything. There have been cases, some recent, where a life insurer has been insolvent on a balance sheet basis but nonetheless able to make full and timely payments of all policyholder claims from the insurer's assets—all because of that absolute priority rule.

Finally, the financial capacity of the life and health insurance guaranty system is quite substantial, particularly considered in light of the preceding three points. An individual state guaranty association typically is authorized to assess in any given year up to 2% of the annualized industry premiums within the state for covered business. In theory, the 52 guaranty associations that serve the United States (one for each state, plus Puerto Rico and the District of Columbia) could assess an aggregate of $8.8 billion in the current year, or almost $90 billion over the next 10 years (conservatively assuming the assessment caps, which have steadily risen over the years, were to remain level). To put that in perspective, the entire net assessments collected by the guaranty system over the past 20 years (the costs to the system for protecting policyholders) total roughly $5 billion—an amount significantly less than the system's assessment capacity for just the *current* year, and much less than what could be assessed (if necessary) over the next 5 or 10 years.

Nothing to Panic About

None of the foregoing is intended to minimize the effects of a very significant recession, both for consumers and for the life industry. Life insurers, like all individuals and businesses with investment portfolios, have seen meaningful declines in the values of their invested assets. By all means, and now more than ever, consumers should pay careful attention to the financial strength of their insurers. The fact remains, however, that life insurance and annuity products are still secure and valuable choices for inclusion in any sound personal financial plan.

Stated another way, and regardless of what some may feel motivated to say elsewhere, in truth there is nothing to panic about here. ✯

Peter G. Gallanis is President of NOLHGA.

End Note

1. Two life companies have entered rehabilitation during that period, but the receivers to date have not concluded that liquidation is appropriate. Two other companies entered liquidation because of irregular transactions by company management entirely unrelated to the economic crisis.

It is noteworthy that precisely zero life insurance companies have entered liquidation as a consequence of the economic crisis.

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NOLHGA Calendar of Events

2009

Sept. 21–23	IAIR Fall Meeting Washington, DC
Sept. 21–24	NAIC Fall National Meeting Washington, DC
October 12	**MPC Meeting Washington, DC**
October 13–14	**NOLHGA's 26th Annual Meeting Washington, DC**
October 18–20	ACLI Annual Conference Chicago, Illinois
December 5–8	IAIR Winter Meeting San Francisco, California
December 5–8	NAIC Winter National Meeting San Francisco, California