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A "Crazy" Year—and More to Come

2010 brought the guaranty system the Dodd-Frank Act, the retained-asset account furor, and health-care reform—will 2011 be better?

By Sean M. McKenna

When Incoming NOLHGA Chair John Mathews said "this past year has been pretty crazy for our system" while speaking at the 2010 Annual Meeting, it almost felt like an understatement. The year 2010 saw the guaranty system deal with regulatory reform, the overhaul of the American health-care system, controversy over retained-asset accounts, and several large receiverships. Not to mention the after-effects of the economic crisis of 2008–2009.

Almost 200 guaranty system professionals gathered in Seattle in October to discuss these and other issues, and to get a handle on what had happened during 2010 and what was likely to happen in the future. The forecast for 2011, much like most weather forecasts in Seattle, didn't exactly call for sunny skies.

The Other Washington

Seattle played host to NOLHGA's 2010 Annual Meeting, but much of the attention centered squarely on the Washington on the East Coast, where bills reforming financial services regulation and the health-care system had been signed into law over the last few months. In leading a panel discussion on regulatory reform and other insurance industry issues, Charlie Richardson (a partner with Baker & Daniels) said that passage of the Dodd-Frank Act in July wouldn't end the debate over federal regulation of insurance and the guaranty system. He called the Act "a decision by Congress to defer the question" of who oversees failed insurance companies and predicted that the regulations and federal studies called for in the Act would provide the answer: "The second wave will decide the guaranty system's future."

Richardson noted that the guaranty system did "awfully well" under the Act, which retains the system's role in protecting policyholders. The Act also calls for the new Federal Insurance Office (FIO) to study insurance regulatory modernization—including the performance of the guaranty associations—and Richardson commented that "the FIO is where the action is," even calling the office "a federal platform for the future."

Considering the studies called for in the Act, additional studies planned by the Department of Labor and the Government Accountability Office (GAO), and the stated intention of some members of Congress to revisit the optional federal charter issue, "none of us can afford to be complacent," Richardson said. "NOLHGA has to stay focused and involved in the second chapter of financial services reform. If we're not at the table, we'll be on the menu."

Kimberly Olson Dorgan, the ACLI's Senior Executive Vice President, Public Policy, was also pleased with the outcome of the Dodd-Frank Act, although she

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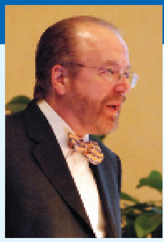

2011: The Shape of Things to Come

When Scoop, my editor, rejected my second idea for this issue's column ("Who Was *REALLY* America's Greatest Athlete: Dick Butkus or Dick the Bruiser?"), he made a suggestion: "Why don't you just do a 'crystal ball' column?" I gave in when he refused to reconsider my first proposal, a comparative evaluation of the lifetime achievements of Georg Solti and George Carlin.

Scoop says that the *Journal's* readers really want some predictions regarding issues significant for insurance regulation, receiverships, and the guaranty system that are likely to emerge in the coming year. You ask, we deliver.

Normally, in preparing such a column, a writer is tempted simply to compile a list of unrelated items that might emerge in any year, in hopes that he might end up right on as many as half of the predicted developments.

An odd feature emerges, though, in trying to generate this year's list: This year's items really are different from those of other years, and they are not at all unrelated. In fact, virtually every significant issue likely to develop this year is significantly related to almost all the others. Moreover, almost all of them share an element of what my friends at the Lloyd's market in London have long referred to as "political risk."

Allow me to group the potential developments into three broad categories—federal matters, state matters, and industry matters. I'll give you the list first, and then consider some interrelationships and shared elements of political risk.

Federal Activity

For the first time in many years, there is no critical insurance legislation pending in Congress. However, the federal health-care reform legislation and the Dodd-Frank Act, both enacted in 2010, touch insurance in a lot of ways that will begin seriously to play out in 2011.

On the health front, the two key issues for 2011 will be efforts within Congress to repeal or defund last year's landmark legislation and efforts in the courts to challenge its constitutionality. Predicting the impact of the legislation on the health insurance industry—even without repeal/defunding efforts or court challenges—is nearly impossible (though accelerated consolidation in the industry is a safe bet). A successful court challenge to the individual mandate element of the legislation could force Congress back to the starting line.

As to life and annuity companies (as well as other types of insurers), the major federal issues of 2011 all will involve various organizational and "rollout" steps called for in Dodd-Frank, involving mostly new agencies and significant regulatory and study projects.

Some new agencies are already up and running, while others are still being organized. The new supervisory regulator, the Financial Stability Oversight Council (FSOC), held its third formal meeting in mid-January 2011, and that body is already neck-deep in projects important to large insurers, including development of Volcker Rule standards, guidelines for asset securitization transactions, and (perhaps most importantly) the designation of systemically important companies.

On the last point, FSOC is now fast-tracking the release of standards by which systemically important companies will be designated. Many observers expect the actual designation of systemically important companies—by name—to follow shortly after the standards are established early this year. Whether any insurance companies are named will be an early signal of how enmeshed the federal government will be in the prudential regulation of insurance entities. My expectation is that at least a couple of insurers will be named, if only for political reasons.

Meanwhile, on the same day that FSOC most recently met, the FDIC's Board convened to approve "interim final" (Beltwayese for "final") rules for the exercise of its "orderly liquidation" resolution authority powers under Dodd-Frank. Dodd-Frank gives the FDIC authority to resolve the financial failures not only of banks, but also of systemically significant non-banking financial institutions, including insurance holding companies (and even insurers, in the unlikely event that an insurer's state regulator fails to take timely action in a crisis). The interim rule provisions are largely consistent with the language of Dodd-Frank and generally steer clear of insurer insolvencies, although the text is ambiguous about the extent of the FDIC's powers regarding the handling of solvent subsidiaries of an insurer within a holding company that is the subject of orderly liquidation. I predict that, moving forward, the FDIC will not be shy about defining the scope of its authority in the resolution of any systemically significant financial entity.

Meanwhile, the Federal Insurance Office (FIO) is gearing up within the Treasury Department, as is the new Office of Financial Research. Dodd-Frank calls for FIO to complete and deliver to Congress by January 2012 a major study on U.S. insurance regulation that could provide impetus for future legislation. In particular, FIO is required to report on (among other things) the feasibility of regulating only some lines of insurance at the federal level (read: life and annuity business); the ability of the federal government to provide robust consumer protections (probably including discussion of a potential federal safety net); and the consequences of subjecting insurance companies to federal resolution, including safety net consequences. What data points will FIO consider in reaching its conclusions?

Other federal government efforts also will be prominent in 2011, including separate reviews by the Government Accountability Office (GAO) of retained-asset accounts and the ability of the state guaranty system to provide adequate protection for annuities used to provide guaranteed lifetime income to consumers in retirement (a topic also being reviewed jointly by Treasury and the Department of Labor).

State Activity

At the state level, important issues that will arise in 2011 involve legislation in individual states, specific insolvencies, and efforts within the NAIC to enhance the process and outcome in receiverships having national significance.

The NAIC approved a new Model Act for life and health insurance guaranty associations in 2009, and key components of the new Model have already been enacted in 28 states—pretty fast take-up for an NAIC model. With a heightened appreciation among Commissioners (and in the industry) regarding the desirability of functionally uniform guaranty association laws, more states are likely to adopt key components of the new Model in 2011.

In addition, the NAIC has embarked on a new project to provide for multi-state monitoring of nationally significant receiverships, aimed at enhancing regulatory strategies and encouraging receivership "best practices." Commissioners supporting this effort hope that it will bring to bear on state receivership activities an element of "peer review" benefits similar to the benefits provided for state financial regulation through the NAIC's very successful Financial Analysis Working Group (FAWG).

A regulatory commitment to functional uniformity and best practices may be particularly timely in 2011, since the year is also likely to bring significant new and prominent insolvency cases. Any significant insolvency is likely to draw attention in the current climate, but even more so if either individual consumers suffer significant uncovered losses or if the regulatory or receivership processes are viewed as having operated poorly.

Industry Concerns

As to industry issues, simply put, company CEOs see an environment (operational, financial, and regulatory) that is changing more rapidly than has ever before been the case, and they will be focused on how best to position their companies in that exceedingly volatile environment.

Health insurers face nothing but extreme volatility for at least the next decade in ways that are almost too numerous to mention, let alone predict. If the 2010 federal legislation remains substantially in place, the general direction of the industry appears to be toward a public utility function, and prior economic models will have to be drastically rewritten. That may be the best case. If the legislation substantially changes (by repeal, amendment, defunding, or judicial invalidation), the tenuous assumptions on which any current predictions are based may vanish, and we might as well then call for the Ouija Boards. For example, what happens if the individual mandate feature of the legislation is invalidated, but the medical loss ratios and coverage mandates remain?

Life and annuity writers face a somewhat different set of issues, including material concerns about the current and future investment climate; changes in tax law; regulatory uncertainty; and expanding the market for insurance and annuity products, especially among retirees.

Interconnections and Political Risk

I said at the outset that these predicted developments for 2011 were not only new and unique to this year, but also that the developments are highly interrelated. We who work in the guaranty system focus most easily on insolvency issues. Let's use the lens of an insolvency case to examine briefly the interrelationships of likely 2011 developments.

If one or more nationally significant insurer insolvencies occur in 2011, and especially if some consumers in such cases are not made whole, the ripple effects on other developments are fairly obvious.

A highly publicized, nationally significant insolvency would provide an example (if only in miniature) for proposals to expand the federal role in both regulating and resolving at least those insurers deemed systemically important. It might also drive down the threshold for deciding what companies are systemically important. Moreover, such an insolvency likely would provide

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INTERVIEW

with a Legend, Part 2

NOLHGA President Peter Gallanis sits down with Wall Street's "go-to lawyer," H. Rodgin Cohen

The following is an edited transcript of Peter Gallanis's interview with H. Rodgin Cohen, Senior Chairman of the leading Wall Street law firm Sullivan & Cromwell LLP, a man one observer has called the "Trauma Surgeon of Wall Street." Part one of our interview, which took place on July 15, 2010, at NOLHGA's 17th Annual Legal Seminar in New York City, addressed some of the better- and lesser-known causes of the financial crisis (see the September 2010 issue of the NOLHGA Journal*). In part two, we continue our discussion of the crisis and also address the Dodd-Frank Act and its likely effect on the financial services industry.*

Gallanis: The leaders of some major investment and commercial banking firms claimed that the declines in the values of their stocks were driven, to a significant extent, by short sellers and by hedge funds engaging in short selling activities. Any thoughts about that?

Cohen: It's an interesting question I had during that period. We had a number of clients who firmly believed it. I must say I had some suspicions, but in this world where almost any misdeed is evidenced somewhere in an e-mail, there's an absence of any smoking gun. There was a lot of smoke, but the absence of any evidence that has been brought to the law enforcement authorities, to the SEC; we went there and there was a lot of sympathy for these institutions, but law enforcement would say quite legitimately, "Show me the smoking gun, and we will pursue it vigorously." There was no gun. It may have been that people couldn't find it, but it wasn't there.

Gallanis: Speaking of hedge funds, it has also sometimes been said that the tremendous growth of hedge funds, along with private equity firms, mortgage finance companies, commercial credit firms, and other entities involved in the "shadow banking system," and perhaps also the lack of regulation of the shadow banking system, contributed significantly to the crisis. What do you think of that?

Cohen: I do believe that the shadow banking system was a major contributor, and there are several problems. One, it simply was not being regulated. There was no knowledge, particularly, about the mortgage banking firms, which sprung up overnight. I have said before, and I really believe, that there is a regulatory corollary to Gresham's Law that bad money drives out good. Bad regulation drives out good regulation, because what happens is one of two events, both of which are bad. If you have a largely unregulated sector, either it forces the regulated sector to lower its standards to meet the competition, or it drives the regulated sector out of the business entirely and more and more is achieved by the unregulated sector. Either event creates the possibility of a serious problem.

So, there were very serious issues with the shadow banking system, and I think the Systemic Risk Council and the concept of systemically significant institutions in the legislation both are designed to deal with that and prevent a repetition.

Gallanis: The SEC recently filed actions concerning controversial transactions that took place during the 2006, 2007, and 2008 period within investment banking firms that are characterized as involving inappropriate or under-disclosed conflicts of interests. Investment banking firms are characterized as having bet against the interests of these banks' own investment advisory clients. It has been alleged in some Senate Banking Committee hearings that this sort of conflict of interest was a major contributing factor to the recent crisis. What are your views on that issue?

Cohen: This is a really important point, and let me try and deal with it on two levels. One, did it contribute to the crisis? I'm not sure I can see, again, much of a correlation. It may have caused some significant losses, but not the type of losses that led to the financial crisis.

I think this is an area where, I'm glad Congress, for the most part, decided not to try and legislate. It is simply too complicated for legislation. But I do think this is an area with a lot of problems, and the financial industry can do itself a lot of good by trying to come together and develop basic principles of how you deal with conflicts. I mean, there are inherent conflicts in financial services. Market making is inevitably a conflict. You're supposed to be on both sides of the market, but there are situations where, perhaps, you shouldn't be market making with certain types of customers.

This is where the industry shouldn't wait for Congress to come back or the regulators or somebody else to do it for them. They really know where the conflicts lay better than anyone else, and they know how they can resolve them without creating a serious financial problem for themselves.

Gallanis: Two more short-answer questions before we round into the home stretch. If you view the crisis as beginning in the subprime mortgage market, were the government-sponsored entities—Fannie and Freddie—significant contributors to the problem?

Cohen: I think the system that involved the GSEs was a significant contributor because there was a repository for too many loans that should never have been made. And again, any one cause, that just is not possible to determine. There were multiple causes. But the virus actually starts with the less-regulated and some poorly regulated financial institutions in the mortgage market. If they had had to keep those mortgages, they would have been out of business very quickly. They would never have been able to develop their business. The GSEs were an available vehicle, in part because of congressional and administrative mandates that they expand the level of home ownership in this country.

Gallanis: A slightly related question. To what extent was the crisis, in your view, exacerbated by the absence of a dedicated federal consumer financial regulatory agency?

Cohen: We now will have a consumer agency. I believe much more in people than in structure. I don't think that's necessarily the structure that is required, but it is one that could be effective. It is understandable why the administration wanted it—there was a total breakdown in protecting consumers in 2008 and 2007, 2006, and 2005. Not that the consumer is totally blameless here, but the concept that you could rely simply on disclosure was a mistake. There needed to be more rules of the road.

Gallanis: Then what I'd like to do in our last segment here is to talk about the regulatory reform legislation that now appears to be only hours away from final passage in the Senate.

The Dodd-Frank legislation would

establish the Financial Stability Oversight Council we discussed a little earlier, as a mechanism to monitor and regulate the buildup of risk in and to the financial system from major financial services institutions. What is your general view on the need for such systemic risk regulation, and what thoughts would you share about the way this concept is addressed in the Dodd-Frank legislation?

Cohen: I think you definitely needed an overseer, and the political situation was such that it had to be a council rather than any single regulator. There is, inevitably, some concern that a council with 10 voting members will be unwieldy, but you do have the Treasury Secretary as the Chairman. And I think this is our best practical shot at having this overarching regulatory scheme.

I think this is very important in another way, which has not been much commented on in the press or by analysts. I'm far from an economist, but all the leading economists seem to agree that using monetary policy to deal with asset bubbles does not work. It's too blunt an instrument and cannot work well. However, no one has suggested yet, to my knowledge, that you can't use regulatory policy as opposed to monetary policy to deal with asset bubbles. And this new council, combined with its new research arm, would have the potential to determine when these bubbles are there and then prevent them from growing to too great a state through regulatory actions, whether it's increased capital, liquidity, or margin. There are a host of regulatory tools to deal with bubbles.

Gallanis: If this structure had been in place in 2005, do you think things would have turned out materially differently?

Cohen: I actually do. As I've said, there are some flaws, but I suspect that, at this point, you would have collected enough information about what was going on in the mortgage market that action could have been taken.

Let me give just one example which I think illustrates this point. It was just the absence of a coordinated effort. There are groups that work together, sponsored by Treasury, on money laundering, filing of suspicious activity reports, and financial fraud. The statistics showing the growth in fraud in the mortgage markets were incredible—almost a straight line up. Nobody put that together, it seems to me, with what was going on in the financial markets. There wasn't the mechanism; people still should have seen it, but there wasn't the structure. Here at least you have the structure.

Gallanis: That's a great point. Another key feature of Dodd-Frank is the creation of a "resolution authority" under which the FDIC would oversee the orderly wind-down of a systemically important financial institution. The objective is to provide a middle ground between disorderly liquidation, as in the case of Lehman Brothers, on the one hand; and an outright bailout, as in the case of AIG. What are your thoughts about the legislation's resolution authority? And again, would it have produced a different outcome than what we saw with Bear Stearns, Lehman, AIG, and possibly some of the other firms that faced failure in the crisis?

Cohen: I think absolutely it would have produced a different outcome. For resolution authority to work, you have to deal with three key and sometimes competing objectives: no taxpayer bailout, no "too big to fail," and minimizing systemic consequences. This resolution authority, I think, combines some of the best elements of the Federal Deposit Insurance Act for dealing with failing banks and the bankruptcy code for dealing with the failing of almost everything else, though obviously not insurers.

And it combines them to produce a resolution system where there will be no bailouts because the funding will come, ultimately, either from the creditors of the failed institution or the largest financial institutions; where "too big to fail" is clearly gone because it is mandated, virtually, that creditors must suffer a loss—and because they got rid of the prefunding concept, which would have just been a honey pot to keep "too big to fail" in place; and where systemic consequences are minimized, again, by this melding. The idea—it's hard to read this into the bill, but it is there—is that there will be an expedited process for resolving claims so money will flow out and you don't go through the problem with an industrial

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bankruptcy of taking many months, even years, to get your money back. A financial system can't stand that.

Gallanis: As I'm sure you know, most of the people in this room are affiliated in one way or another with the insurance industry. What are your thoughts on Dodd-Frank's establishment of a Federal Insurance Office, and how would you say, generally, the insurance industry fared in this round of regulatory reform?

Cohen: I just gave a talk last night to the board of a financial institution. I really didn't want to do this, but I was asked at the end to separate winners and losers. So I said, the winners are the insurers. But I don't think that is accidental. If you look at what happened in 2008, even though the contagion ultimately started to spread to the insurance industry, the insurance industry performed quite well. I understand that there are exceptions, but if you really look at something like AIG, that was an exception, in large part, because it went into areas other than insurance. So the idea of not subjecting the industry to a radically new, or even a substantially new, regulatory scheme seems to me to be absolutely appropriate.

The idea, however, of some form of federal coordination also seems appropriate. Why would you not want to have some degree of coordination? If, however, you really want to see how the insurance industry managed to avoid the traps here, you only have to look—I think it is Exception F to the Volker Rule—where clearly carved out from all the restrictions on proprietary trading and investing in funds is anything that is done in an insurance company's general account.

Gallanis: Speaking of the Volker Rule, Dodd-Frank seeks to limit proprietary trading, at least by commercial banks, and to limit things like derivatives activities and hedge fund investments by the commercial banks. Were activities of that nature major components of the 2008 crisis, and do these restrictions address what you consider to be real and substantial concerns?

Cohen: I think Chairman Volker is so candid that people don't always listen to what he says after he describes his rule. But he acknowledged that there was not a direct connection between proprietary trading or investing in hedge funds and private equity funds by banks. He acknowledged that had not been a cause of the 2008 crisis. Again, there is no real evidence that was a major contributing factor.

I think what he believes and what he has said is that he is worried about that for the future. That may be right, it may be wrong, but you cannot say that the Volker Rule is mandated because of what happened in 2008.

Gallanis: The Dodd-Frank bill purports to put an end to the notion that any financial institution will, in the future, be treated as "too big to fail." Some commentators—for example, former FDIC Chairman William Isaac—say that that's a fantasy: that if we were ever again confronted by panic that threatened our largest financial institutions, government would have no choice but to step in again and prevent those institutions from failing. What do you think about that?

Cohen: You can never predict, totally, the future, and I don't think anybody could say that confronted with a crisis of incredible magnitude, the government would not step in. I think all you can do is what this legislation does, which is to make it extraordinarily difficult for the government to step in. It would, I think, basically take an act of Congress to deal with that. In view of what have proven to be quite accurate misgivings of the members of Congress who voted for TARP—that they would be tarnished for that—I think it would be very tough lifting, particularly if it is for a single financial institution. And what this bill does, it says look, if we've got a crisis throughout the system, we still have the flexibility to go in and help. But for single institutions, it would be very, very difficult the way this bill is written.

Gallanis: You can help sectors, but you can't help companies, basically.

Cohen: Right.

Gallanis: I'm looking for your bottom-line, overall grade for the Dodd-Frank bill. There are widely divergent views about its overall impact. Some people, like Karen Shaw Petrou, believe that this legislation is going to change the face of Wall Street and the banking world dramatically. There are others who say its effect will amount to, as my wife would put it, "A big nothingburger." What is your view of the likely significance of this legislation?

Cohen: I think, and you've got to take the legislation as a whole, that it will make for a less risky financial system. It will make for a safer financial system. It will create increased availability of a wide variety of weapons to deal with a crisis in the future. So, all in all, if you look at its objectives, which should have been to make the system safer, and to deal with a crisis if it occurs, it would get a very high grade in my view.

Where it fails is in what I would call the add-ons. What happened after the administration put its proposals through Congress. And some of this is not written about. Why, for example, was a decision made—I think I know what prompted it—but why, logically, should we have given unlimited insurance on transactional accounts for two years? It makes no sense, and really has an element of "too big to fail." This is something that came in at the last moment.

There are other examples where there seems to be very little logic, including taking away trust preferreds as an ingredient of tier one capital. There is a legitimate philosophical argument that those should not be part of tier one capital for financial institutions. Fine. But you then don't go to 675 financial institutions that issue trust preferred with the clear commitment from the Federal Reserve that this was tier one capital, and say, "Just kidding."

Gallanis: I'd like to thank you for joining us, and I'd like to ask our audience to join me in thanking Rodge Cohen. ✯

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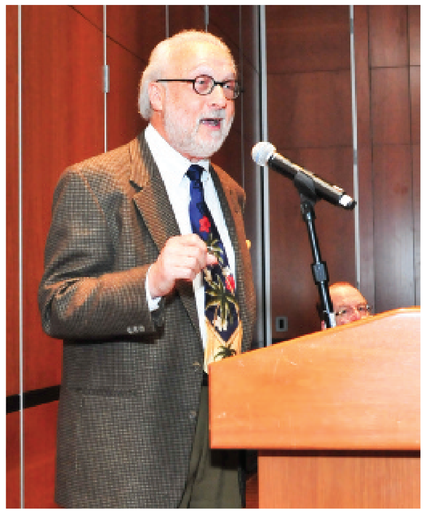
called the bill "bank-centric." Speaking of the FIO, she said the ACLI is "thrilled that we have an office—now we're going to have a place to go to tell our story and raise our concerns." She issued a warning about the FIO's regulatory study and the Financial Stability Oversight Council's review of the Volcker Rule on derivatives trading ("a classic case of unintended consequences—Treasury had no idea how it impacted our industry"), saying "we must be vigilant so we don't end up with double regulation or an over-reach by the federal government."

Dorgan noted that before the economic crisis, one of the ACLI's main goals had been to raise the profile of annuity products in the retirement income sector. That work continues, she said, "but at each step of the way, we are continually met with questions about our backstop." Sen. Kohl (D-Wis.) has called for a GAO study of the guaranty system's treatment of annuities, and Sen. Shelby (D-Ala.) "has voiced reservations about the guaranty funds." These questions—especially about coverage of complex annuity products—will continue, as will questions about disclosure of guaranty association coverage. "We can no longer operate in the shadows," Dorgan said.

One of the major issues addressed in the Dodd-Frank Act was that of systemically risky companies and their potential to take down the entire economy. Professor Martin Grace (James S. Kemper Professor and Associate Director, Center for RM&I Research, Georgia State University) noted that after the economic crisis, "Congress was going crazy about another AIG lurking in the market." His research, however, indicated that AIG's many activities outside traditional insurance made it an outlier, and that no other insurance companies could be considered systemically risky. This being the case, he said, "I was relieved there wasn't a blanket call for federal regulation of insurance."

Borrowing a phrase from NAIC CEO Terri Vaughan, Professor Grace predicted that the first head of the FIO "will set a tone that will last a long time." He added that the FIO's study of ways to modernize insurance regulation could yield federal regulation of parts of the industry—perhaps by making the federal charter obligatory rather than optional.

Joel Feldman, a Partner with Sidley Austin LLP, spoke at length about an issue that had recently appeared on many politicians' radar screens, thanks to heavy media coverage: retained-asset accounts (RAAs). He began by saying, "I don't think I've ever seen an issue with a greater gap between truth and reality in the way the press has treated it."



Luncheon speaker Robert Spector entertained attendees with anecdotes about Seattle-based Nordstrom's legendary dedication to customer service, saying "everything Nordstrom's does is through the lens of the customer" and encouraging audience members to foster the same approach in their organizations.

As he traced the history of RAAs from the 1980s to the present, Feldman noted that "there's great variation in the industry on what is disclosed" to policyholders. There have been a number of RAA class-action suits filed against insurance companies, he added, but "the legal challenges have been largely if not entirely unsuccessful." Despite this, he predicted that the media firestorm surrounding the accounts would result in more lawsuits, more investigations by state Attorneys General and/or Insurance Commissioners, and more regulation.

"Disclosure is the arena where this issue will play out," Feldman said, citing interest rates, ability to liquidate the entire account, and guaranty association coverage as items that might see enhanced disclosure regulations. "But at the end of the day, you're going to see minimal changes in these products."

Then-NAIC President Jane Cline also addressed the RAA issue, saying that the organization was indeed looking at refining the disclosure process. She added that the accounts are protected by state guaranty associations, "but the reporters have chosen not to address that fact." She also mentioned that West Virginia, where she serves as Insurance Commissioner, has received one complaint about RAAs in the last 10 years.

Her department (as well as the NAIC) is hearing a good bit more about health-care reform—she estimated they receive 10 to 20 calls a week. At the time of her speech, the NAIC was working on medical loss ratio (MLR) recommendations to be passed on to the Department of Health and Human Services, and Commissioner Cline commented on the importance of setting the right ratio: "It's a real concern for us, since it can cause significant destabilization in the marketplace and could cause solvency concerns."

Brave New Health-Care World

Health-care reform was also the topic of a panel discussion moderated by NOLHGA Board member Lee Douglass (Senior Vice President, Law and Governmental Relations, and Corporate Secretary for Arkansas Blue Cross and Blue Shield). During a sometimes animated discussion, Washington Insurance Commissioner Mike Kreidler and Illinois Insurance Director Mike McRaith talked about the "brave new world" of health care and what it would mean to consumers.

Both regulators predicted increased competition once the law goes into effect in 2014. By then, "you'll start to see companies jockeying for position and more choice for consumers," Commissioner Kreidler said. Both also agreed that the MLR issue will be challenging for some companies. "We'll see some companies exit the market" thanks to MLRs, Director McRaith predicted.

Despite this, McRaith said, changes are necessary. "The business model for health insurance is changing whether the industry accepts it or not. It's an archaic model."

No Shortage of Challenges

NOLHGA's incoming and outgoing Chairs both predicted a tumultuous future for the guaranty system in their Annual Meeting addresses, urging members to work together and embrace the prospect of change if the system is to survive. Outgoing Chair Steve Lobell said that "exceptional organizations perform exceptionally well in times of great difficulties" and praised the guaranty associations for rising to meet the many challenges they've faced: "The sustained excellence you've exhibited over the past year has astounded me."

Lobell added that this excellence needs to be sustained even further. "The guaranty system as we know it is very much in play," he said. "Outstanding performance under great stress is the best way I know to demonstrate our worth and secure our future survival. To sustain the level of performance we've achieved so far, we have to stay united."

Incoming Chair John Mathews rattled off a laundry list of challenges facing the system, including the Dodd-Frank Act, large receiverships, and the retained-asset account furor. Enactment of the regulations and studies called for in Dodd-Frank "is going to be huge for us," he said. "We need to keep working with our friends at NCIGF to make the case for our state-based guaranty system." The system, he explained, could be harmed both by those who wish to replace it and by those who simply don't understand how it operates.

Large receiverships also pose a threat to the guaranty associations, even if they fulfill their obligations perfectly. "We can do our jobs and still be subject to collateral damage because of what others have done or not done," Mathews said. "When people don't get the coverage they expect, regardless of what the law provides, there is likely to be a backlash."

As the system faces these and other challenges, Mathews added, members must be open to "the opportunity to bring about positive change to improve the system." He cited functional uniformity as a prime example of what can and should be done. "We've made great strides in the past two years, but there's more to be done," he said. "There's more to uniformity than just benefit limits. The industry will keep developing new products, and we need to find a way to achieve functional uniformity when coverage decisions are not easy to make."

The New Board Member Orientation Program and Major Insolvencies/Rehabilitations Briefing were well-attended and well-received by guaranty association board members and administrators.

Both he and Commissioner Kreidler objected to the contention that the new law was a first step toward a single-payer system. Director McRaith said that reform efforts were aimed at saving the private marketplace, and Commissioner Kreidler insisted that "we're going to build on the private market."

Commissioner Kreidler expects a number of rate increases between now and 2014, and he expressed concern that consumers might be led to believe that the increases are due to health-care reform. He added that companies "have an obligation" to make it clear that this isn't the case. "If they send out letters that blur those edges, I'm going to be on them like a blanket," he said. "I'll take the heat for approving a justified rate increase, but by heaven, the industry has to do its part too."

Economic & Industry Insights

Paul Kasriel, Senior Vice President and Chief Economist of The Northern Trust Company, opened his presentation on the economy by noting that "the past recession was the deepest and longest in the post-war era. The recovery is also the weakest in the post-war era." He added that while recessions typically take their greatest toll on Main Street, in the most recent recession, "both Main Street and Wall Street took it on the chin."

In examining why the recovery is progressing so slowly, Kasriel pointed to the tightening in bank credit. When an individual lends money to another, he explained, the increase in one person's ability to spend is offset by a decrease in the other's. "The banking system is different," he said. "It can create credit, and when it does, the recipients of that credit can spend and no one has to cut back." The lack of bank credit is thus depriving the economy of a needed stimulus.

Despite the Fed's slashing of interest rates to spur the economy, "bank credit in the first half of this year failed to respond," Kasriel said. "A lot of it ended up as idle cash reserves on the books of banks." He believes banks are concerned about future capital adequacy, thanks to fears of large losses on commercial real estate and an increase in required capital ratios by U.S. and international regulators. Despite these fears, he added, "the banking system is now starting to create credit, and banks appear to be easing their lending terms." These are encouraging signs, but Kasriel expects the slow recovery to remain slow.

The insurance sector weathered the financial crisis quite well, but Brad Smith, Chairman of Milliman, said that some regulations made things more difficult for insurers. "Excessive reserves and capital standards made a bad situation even worse," he said. Smith testified before the NAIC about loosening capital standards to fend off what he called "artificial insolvencies"—companies that are economically sound but are perceived to be weak.

Most insolvencies, Smith said, result from asset problems or product design flaws, which he believes are related. "Policyholder behavior is the weak link," he explained. "We don't have a good handle on that," particularly where it relates to lapse-supported products. He explained

Seattle Snapshots

Images from NOLHGA's 2010 Annual Meeting.

that a 1% change in the lapse rate of a long-term-care product can reduce the profit margin by 8% over the life of the product. Underestimation of policyholder behavior in the pricing process can be extremely costly, he said: “Agents and policyholders know a good product when they see it.”

Tom Marra, President and CEO of Symetra Financial Corporation, gave attendees his insights into how the industry as a whole is behaving. “I think everyone is still de-risking” after the financial crisis, he said, and companies remain worried about low interest rates: “Earnings are going to be dampened because of the margin squeeze.”

Companies are building up their surplus as they reduce their risk, Marra added, so merger and acquisition activity could increase in the near future. While sales are down (“companies need to do a little bit of back to basics”), Marra remains bullish on the future of the industry. “Life insurance is viewed again as pretty stable,” he said. “Analysts are looking more favorably on the industry.” ✯

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

A Night to Remember

Dinner at Canlis was one of the highlights of the Annual Meeting.

["The Shape of Things to Come" continues from page 3]

fodder for the pending FIO study and for inquiries by the GAO and various congressional committees, to the point where it might significantly affect the results of those studies and inquiries. A call to extend the jurisdiction of the new Consumer Financial Protection Bureau to insurance transactions might arise.

Adverse publicity from such a case might also focus attention at the state level on state-to-state differences in laws, procedures, and systems, and likely would focus particular attention on any performance shortcomings that could be tied to losses by consumers. To the extent that state regulators, legislators, and the NAIC make progress on some fronts before any such insolvency develops (e.g., by setting up a FAWG-like process for major receiverships or succeeding in having NAIC models adopted by the states), that progress would provide some defense for the current state system for resolving insurance company failures. But state regulators need to be concerned that significant adverse publicity from an insolvency will affect perceptions about the adequacy of state regulation, especially in Washington.

As in prior cases of nationally significant insolvencies, the insurance industry will be challenged to respond. At a minimum, insurers will be expected to support fully the delivery of guaranty association benefits to all consumers having guaranty association coverage. Some may call on the industry to do even more. In that case, an industry already facing substantial challenges and uncertainties would have to decide the extent to which the industry's reputation and relations with external constituencies would justify heroic measures.

Additionally, the industry—which historically has been a strong defender of the guaranty system—would carefully assess the implications of such a case for its future support of the current system (versus some alternative). I do not take for granted industry support for the current guaranty system. Rather, I believe industry will support the system to the precise extent that industry believes the system supports consumer confidence in insurance products. The best way for guaranty associations to foster ongoing industry support for their work will be to continue to satisfy the reasonable expectations of consumers whose insurers have failed. ✯

Peter G. Gallanis is President of NOLHGA.

NOLHGA Calendar of Events

2011

March 26–29	NAIC Spring National Meeting Austin, Texas
April 4–6	**MPC Meeting San Antonio, Texas**
July 19–20	**MPC Meeting San Francisco, California**
July 21–22	**NOLHGA's 19th Annual Legal Seminar San Francisco, California**
August 29– September 1	NAIC Summer National Meeting Philadelphia, Pennsylvania
September 7–9	**MPC Meeting Reston, Virginia**
October 10	**MPC Meeting Chicago, Illinois**
October 11–12	**NOLHGA's 28th Annual Meeting Chicago, Illinois**
October 16–18	ACLI Annual Conference Orlando, Florida
November 3–6	NAIC Fall National Meeting Washington, DC

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