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Higher Education

NOLHGA's 13th Annual Legal Seminar reaches new heights

By Sean M. McKenna

At NOLHGA's 13th Annual Legal Seminar, when NOLHGA Legal Committee Chair Chuck Gullickson said, "I have found the whole experience to be rewarding and challenging," he was not talking about climbing a flight of stairs at the high-altitude Stein Eriksen Lodge in Park City, Utah. But with the lodge a lofty 8,200 feet above sea level, he could have been.

Gullickson—who was talking about his involvement in the guaranty system—could also have been talking about the seminar itself. Over the course of two days (August 18 and 19, 2005), he and more than 135 other attendees were treated to a fascinating look at some of the main issues confronting the guaranty system, such as the investigations by Eliot Spitzer, regulatory reform, the potential pitfalls of litigation, and the status of the U.S. healthcare industry.

Add in an appearance by one of the most powerful Republican senators (see "The Nomination Game," p. 15) and some memorable one-liners from Legal Seminar Planning Committee Chair Dave Perry, and it's safe to say that the seminar truly took attendees' breath away. Although the altitude might have had something to do with that too.

The Spitzer Effect

The seminar's first panel, *Contingent Fees, Finite Reinsurance, and Eliot Spitzer, Oh My!*, looked at the fallout from various investigations into insurance industry practices led by New York Attorney General Eliot Spitzer. John P. Fielding (Collier Shannon Scott), whose firm acts as legislative counsel for the Council of Insurance Agents & Brokers (CIAB), noted that contingent commissions bring the issue—or appearance—of conflict of interest into play. "The concern is that contingent commissions provide an incentive for brokers to place business not in the best interests of the client," he said. As with any issue based on appearances, he added, "this is hard to prove."

Fielding pointed out that the contingent commission issue had been identified by the Risk and Insurance Management Society in the late 1990s; the group expressed concern that clients were unaware of these commissions, and the CIAB issued a directive on disclosure. The Spitzer investigation of 2004 brought a good deal more attention to the subject, prompting both the National Association of Insurance Commissioners (NAIC) and the National Conference of Insurance Legislators (NCOIL) to issue model disclosure policies. While "Congress...really hasn't done much" in regard to the commissions, Fielding said, eight states have enacted legislation or regulations regarding disclosure. Larger states such as California, Illinois, and New York—what Fielding called "the big hitters"—are not among them.

According to Fielding, "we're seeing changes in compensation practices," with many large brokers announcing that they are no longer accepting contingent commissions. Fielding called it "a new landscape" and added that in audits of brokers, "one of the things we've talked about a lot is transparency and disclosure of these practices." He predicted even greater transparency in the future.

Kenneth R. Wylie (Sidley Austin Brown & Wood) rattled off a number of Spitzer's investigation targets—stock analysts, mutual funds, and the insurance indus-

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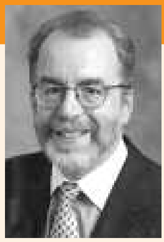

Insurer Insolvency Trends

Researchers in the field of insurer insolvency have always been confronted by a fundamental data problem. Because insurance regulation (and the receivership process for domiciliary companies) is conducted separately by the 50 American states—under separate state statutes, regulations, and processes—the states are the only authoritative repositories of receivership data. Both the quantity and quality of data maintained by states vary, and historically there has been no central repository, at the NAIC or elsewhere, in which data has been effectively accumulated and organized.[1]

The lack of credible national data impedes rational debate about how consumers can be better protected from insolvencies. Without hard facts about the scope, nature, magnitude, and causes of insolvencies, identifying areas of needed systemic improvement is difficult.

Fortunately, some independent experts have provided some quite valuable data on the topic, and none more so than the A.M. Best Company, which accurately describes itself as "the oldest, most widely recognized, full-service rating agency specializing in the insurance industry." In 1991, Best published a comprehensive study of the characteristics and causes of 372 property/casualty insurer insolvencies that occurred from 1969 through 1990. In 1992, Best followed with a similar comprehensive study of 380 life/health insurer insolvencies that took place from 1976 through 1991.

The 1991 and 1992 Best studies were immediately accepted and relied upon by policymakers and researchers as the most authoritative national data sources in the field. However, with the passage of considerable time since the issuance of those reports, the data grew stale, and the reports obviously did not speak to the significant developments in American insurer insolvencies in the ensuing years.

Thus the publication by A.M. Best in December 2004 of a completely new update to the 1992 life/health insolvency study (following Best's May 2004 update to the 1991 property/casualty study) was welcomed by all serious students of insurer insolvencies. Many *NOLHGA Journal* readers attended the 2005 NOLHGA Legal Seminar (reported upon elsewhere in this issue) and heard an excellent summary of the new life/health study from Best's Managing Senior Financial Analyst Stephanie Guethlein McElroy, with related comments from Pacific Life Chairman and CEO Tom Sutton and NOLHGA Chair Ron Downing.

A.M. Best must be applauded for the publication of an exhaustively thorough, serious, and objective overview of the past three-plus decades of American insurance company insolvencies. The newly updated studies continue, and indeed advance, the level of professional analysis reflected in the original studies. The new reports are well-organized, exceedingly user-friendly, and full of helpful graphics that illustrate in quick pictures many of the key findings in the studies. Like the predecessor versions, the new studies will be fundamental sources for those in and out of government who consider insurance regulatory policy.

An initial review of the two new studies suggests that insurers are living in the best of times and the worst of times, as the studies essentially portray a tale of two industries. On the one hand, insolvencies—measured both by number and by cost—are at a near all-time high in the property/casualty segment of the industry. On the other hand, insolvencies in the life and health insurance segment are at a near all-time low, both in number and cost. A closer look at the studies reveals both some interesting trends and some cautionary comments about the future.

The commonplace observation among insolvency specialists is that property/casualty company failures predominantly are caused by problems on the liability side of the balance sheet, whereas life company failures are predominantly caused by problems on the asset side.[2]

The new A.M. Best studies generally support that conventional wisdom, with an important qualification about the future discussed below. On the property/casualty side, the Best researchers conclude that, for the period 1991–2002, 48.6% of property/casualty impairments were caused primarily by deficient loss reserves, with the related factors of catastrophe losses and rapid growth being the primary causes of an additional 19.9% of insolvencies.[3] By contrast, "overstated assets" are said to be the primary cause of only 5.1% of the 1991–2002 property/casualty company failures.

By comparison, asset problems appear to play a significantly larger contributing role for insolvencies on the life/health side, though some parallels to the property/casualty experience also exist. (Inadequate pricing and rapid growth—comparable to the "deficient reserves/rapid growth" categories in the property/casualty study—were cited as primary causes of 38% of life/health insolvencies from 1992 to 2002, though the Best study also notes that almost 75% of the failures attributed to inadequate pricing and rapid growth were among companies primarily writing accident and health coverages rather than traditional life insurance and annuities.[4])

However, the life/health study identifies as primary causes of 45% of recent failures "investment problems," "alleged fraud" (such as the asset looting cases of Thunor/Frankel and National Heritage), "affiliate problems" (largely investment issues), and "reinsurance failure" (again, largely investment- and looting-related). Fifteen percent of recent life/health failures were attributed primarily to "miscellaneous" causes.

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The new life/health insolvency study is perhaps most helpful for the extent to which it illustrates relationships between the economic and regulatory climate and insolvencies. In this regard, most (though not all) of the associations are valuable not because they are surprising, but because of the rich support data A.M. Best musters for conclusions that many may have already reached on the basis of intuition.

For example, though many would suspect that life/health company insolvencies would increase with downturns in the overall economy, it is another thing altogether to see detailed charts such as Exhibit 6 in the new study relating the actual incidence of insolvencies to the ebbs and flows of various economic indices. Other charts and associated text reveal in detail the historical relationships of premium growth and industry-wide, after-tax profit margins to insolvency patterns.

The study also provides some more general, but still fascinatingly detailed, statistics illustrating the changes in product mix within the industry since 1976, showing graphically how the life sector has moved away from traditional life insurance business toward a broader range of financial security products and services and how that shift may be affecting the profitability of insurers.

One particularly interesting subject of the new life/health report is a historical breakdown of the investment mix within the industry. Exhibit 18, for example, is a chart that appears to show that insurer investments in mortgages and real estate have now declined to less than one-third of 1975 levels (when they comprised 38% of industry investments). The following exhibit, charting mortgage loan delinquencies since 1982, shows why the high concentration of direct mortgage investments in the early 1990s, coupled with high default rates in that period, placed great (and sometimes fatal) stress on some insurers. The good news on that score is that current mortgage defaults are approaching historically low levels. However, that news is somewhat tempered by the discussion in the accompanying text about how companies have largely replaced the direct mortgage investments of the 1970s and 1980s with investments in collateralized mortgage obligations (CMOs) and other "bond-like" investments that carry with them new risks of their own. The study also observes that, from 1995 to 2002, company investments in non-investment-grade bonds had increased to levels equivalent to those of 1991.

Another interesting focus of the study—updating work done in the original study—deals with the relationship between state regulatory efforts and insolvencies. The findings are too detailed to relate in the space available, but they can be fairly read to say, in essence, that regulatory success in detecting and preventing insolvencies has more to do with the quality of the regulatory effort than the amount of money spent on regulation by a particular insurance department.

The study also summarizes some of the common characteristics of companies that have failed, concluding (again, not surprisingly, though with ample supporting data) that failed life/health companies tend to fall on the smaller and younger side of the national distribution of insurers; that stock companies tend to fail more frequently than mutuals; and that companies writing primarily accident and health business are much more prone to fail than companies predominantly writing annuities, with traditional life writers falling in between those two sectors.

In presenting an outlook for future life/health company impairments, the new study generally concludes that the near-term prospects are for flat or negligible growth in the overall number of impairments, with a decrease in life company failures likely to be offset by an increase in failures by smaller medical and long-term-care writers. The study notes, on the positive side, that factors working to prevent insolvencies include an improving investment climate, better industry and regulatory cost modeling and risk mitigation systems, and stronger corporate governance.

On the negative side, the study expresses concerns regarding inadequate pricing in some lines; limits on the availability of reinsurance to spread companies' risks; increasing use of alternative investments like asset-backed securities (like CMOs), credit derivatives, and other structured products; and liquidity pressures from fixed and variable annuity guaranties. The last of those enumerated risk factors suggests that, for annuity writers (which generally are among the larger companies in the industry), the traditional assumption that financial problems are most likely to develop on the asset side of the balance sheet may need to be revisited.

Taken as a whole, the new A.M. Best insolvency studies are fascinating reading for all who have even a passing interest in the subject of insurance. If you have not had the chance to review them yet, I suggest that you do. You will most certainly hear these studies discussed, cited, and relied upon in future discussions about insurance regulatory policy. ✯

Peter G. Gallanis is president of NOLHGA.

End Notes

1. During the past several years, under the leadership of former New Jersey Insurance Commissioner Holly Bakke, steps have been taken at the NAIC to establish and populate a "Global Receivership Information Database" (GRID) for the purpose of developing a basic master database of critical national receivership data. An effort to compile a similar NAIC database was debated in the early 1990s, but the proposal was not then endorsed by the NAIC's Receivership and Insolvency Task Force.
2. Failed health insurers, depending on the types of coverages written, in many ways resemble economically property/casualty companies involved in "short-tail" lines of business, such as non-standard automobile insurance or long-haul trucking coverages.
3. Interestingly, the study concludes that no property/casualty company failures were primarily caused by reinsurance failure. The first study concluded that almost 7% of the property/casualty failures from 1969 to 1990 were caused by reinsurance failures. This factor was a key focus of the Dingell Subcommittee's famous "Failed Promises" report in 1990 and related congressional hearings.
4. My principal suggestion for improving the Best life/health study in the future would be to distinguish more clearly between life and annuity writers, on the one hand, and accident and health writers, on the other, particularly in the chapter on causes of insolvencies.

The Next Wave

NOLHGA's 22nd Annual Meeting looks to the future—and the links

By Sean M. McKenna

NOLHGA's annual meeting has been called (by NOLHGA, at least) "the premier event for the guaranty system" because it brings together all the constituents of the system—guaranty association administrators and board members, executives from member life and health insurance companies, state insurance commissioners and other regulators, and lawyers and consultants from various related fields—and gives them the perfect opportunity to network and discuss the prominent issues of the day.

The question is, how do we bring all these people and their sometimes disparate interests together? The answer, in a word: golf.

Actually, it's a little trickier than that.

Something for Everyone

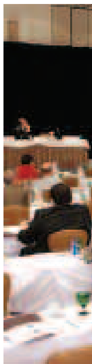
The old saying "give the people what they want" is a good description of the goal and challenge of meeting planning. The best meetings have an informative program that meets the needs and serves the interests of all attendees. This can be particularly difficult for a meeting like NOLHGA's Annual Meeting, which attracts people from many different fields.

Fortunately, the program for October's Annual Meeting succeeds admirably in touching all the bases—guaranty system issues, industry and economic forecasts, regulatory changes, and, last but not least, sports.

Great Guest Speaker: In a departure from past years' practice, NOLHGA will not have a political "talking head" as its guest speaker. Instead, famed sportswriter and broadcaster Frank Deford will speak at the Welcome Luncheon on October 25. Deford is the senior writer at *Sports Illustrated* and is the author of 14 books. He serves as a commentator every Wednesday on *Morning Edition* on National Public Radio and is also a regular correspondent on the HBO show *Real Sports with Bryant Gumbel*. *The Sporting News* has described him as "the most influential sports voice among members of the print media," and the magazine *GQ* has called him "the world's greatest sportswriter."

GA Board Member Forum: With a list of potential topics including attracting new board members, corporate governance, a guaranty association board's relationship with NOLHGA, and company expectations of the board, NOLHGA's 2005 State Guaranty Association Board Member Forum will be invaluable to anyone interested in the pressing issues facing associations across the country. The forum will feature a panel of distinguished association board members: moderator Christopher L. Chandler, vice president, government affairs, for Prudential Insurance Company of America; Alexis L. Berg, vice president and general counsel for Colonial Penn Life Insurance Company; Stephen E. Rahn, vice president of The Lincoln National Life Insurance Company; and Frank A. Sutherland Jr., vice president and insurance counsel, Jefferson-Pilot Life Insurance Company.

Industry Insight: Annual Meeting attendees will be treated to presentations by two industry leaders: Dennis R. Glass, president and



Meeting at a Glance
NOLHGA's 22nd Annual Meeting
October 25–26, 2005
Hilton Head Island, S.C.

Meeting Web Page:
www.nolhga.com/2005annualmeeting.cfm
Hotel: The Westin Resort, Hilton Head Island
843.681.400
www.westinhiltonhead.com
Room Rate: $185/night
Registration
Members: $550
Nonmembers: $725
Guests: $125 (includes attendance at welcome luncheon, reception, and breakfast)
Registration Deadline: October 10, 2005

MPC Meeting
An MPC meeting will be held on Monday, October 24, to update members on the latest insolvency activity. The meeting will feature lunch and an evening reception, and all Annual Meeting attendees are encouraged to attend (there is no registration fee for the MPC meeting). More information on the meeting can be found on the Annual Meeting Web page (www.nolhga.com/2005annualmeeting.cfm).

CEO of Jefferson-Pilot Corporation, and Thomas M. Marra, president and COO of Hartford Life, Inc.

Regulatory Reform: In addition to welcoming remarks from South Carolina Director of Insurance Eleanor Kitzman, Maine Superintendent of Insurance and NAIC President-elect Alessandro Iuppa will speak on the progress of the NAIC's regulatory modernization/reform efforts. Arkansas Insurance Commissioner Julie Benafield Bowman will also speak.

Economic Forecast: NOLHGA's Annual Meeting will once again present an expert outlook on the U.S. economy and its likely impact on the insurance industry. This year's forecast will be presented by Nick Sargen, senior vice president and chief investment officer of the Western & Southern Financial Group.

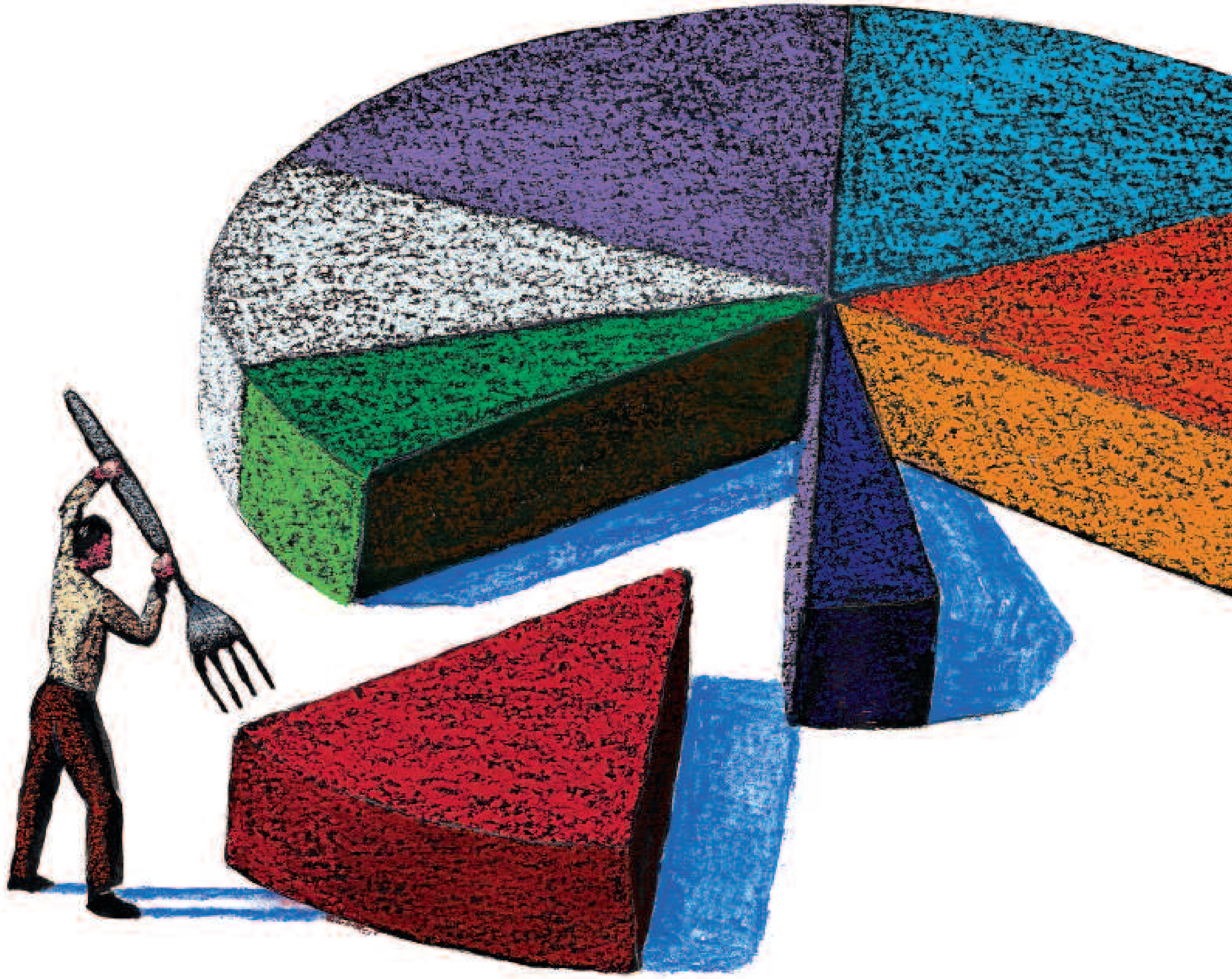
And a Little More

In addition to the speakers mentioned above, NOLHGA's 22nd Annual Meeting also boasts a fantastic host hotel—The Westin Resort, Hilton Head Island in Hilton Head Island, S.C. The Westin offers its guests white-sand beaches, championship golf courses, tennis courts, fine dining, and a host of activities either on-site or a short trip away. Guests will also be treated to a fun-filled reception, with entertainment arranged by the South Carolina Life & Accident & Health Insurance Guaranty Association.

With an outstanding speaker lineup, a beautiful host site, and the best opportunity available to network with fellow members of the guaranty community, NOLHGA's 22nd Annual Meeting truly is the premier event for the guaranty system.

But just to be on the safe side, we made sure there's golf as well. ✪

Sean M. McKenna is NOLHGA's director of communications.



A Separate Piece?

NOLHGA and the ACLI have joined forces to address the coverage and assessment implications of separate account products

By William P. O'Sullivan

In the business world, change can be a powerful ally or a ruthless and relentless foe. For organizations with the vision and foresight to adapt to new circumstances, change is often the catalyst for creativity, innovation, growth, and enhanced profits. Conversely, organizations that fail to keep pace with change risk not only being out of touch but also out of business.

While guaranty associations are not "business organizations" in the traditional sense of the term, they too must adapt to change. Given their statutory role of protecting policyholders, there are many types of changes that can potentially impact guaranty association operations. These changes typically are ones that have broad ramifications for the insurance industry as a whole, and they can arise from economic, financial, market, legal, and regulatory developments.

One specific area of "industry change" that can have a major impact on guaranty associations is the area of product development. Since guaranty associations generally "stand behind" the obligations in insurance contracts, they must be able to adapt to changes in the insurance product marketplace. More specifically, guaranty associations must be familiar with and capable of addressing the application of their statutory obligations to the evolving nature of insurance products. Since there can be significant pressure to meet consumer

Given their "variable" nature, separate account products were commonly viewed as being excluded from guaranty association coverage…

demands quickly at the outset of an insolvency, guaranty associations are best positioned if they are familiar with new product innovations before encountering them in an actual insolvency.

Recognizing this, the American Council of Life Insurers (ACLI) and NOLHGA recently joined forces to examine the evolving nature of separate account products. Specifically, the purpose of this collaboration was to determine whether guaranty associations might have coverage obligations in respect of separate account products that incorporate substantial insurer guarantees and, if so, how these products should be treated for guaranty association assessment purposes. This article will provide an overview of the two organizations' work in this area and the results of those efforts to date.

Background on Separate Account Products

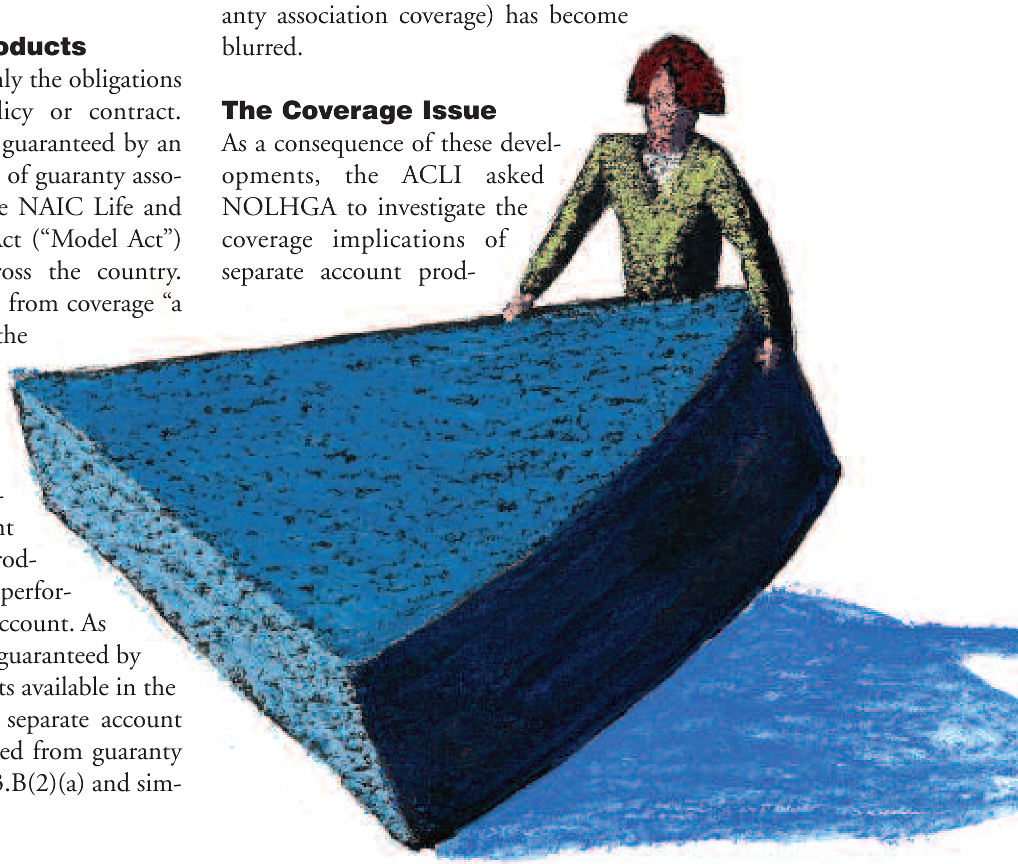
Generally speaking, guaranty associations cover only the obligations of an insurer contained in an insurance policy or contract. Conversely, policy or contract terms that are not guaranteed by an insurer are excluded from coverage. This principle of guaranty association coverage has a statutory basis in both the NAIC Life and Health Insurance Guaranty Association Model Act ("Model Act") and the various guaranty association laws across the country. Specifically, Model Act Section 3.B(2)(a) excludes from coverage "a portion of a policy or contract not guaranteed by the insurer, or under which the risk is borne by the policy or contract holder." This provision, or its substantial equivalent, has been adopted in virtually all states.

Historically, annuity contracts and life insurance policies issued by an insurer's separate account were considered to be "variable." That is, these products provided benefits that depended upon the performance of investments made through the separate account. As a consequence, the policy owner's rights were not guaranteed by the insurer but rather were determined by the assets available in the separate account. Given their "variable" nature, separate account products were commonly viewed as being excluded from guaranty association coverage based on Model Act Section 3.B(2)(a) and similar provisions in state law.

In response to consumer demand, insurers began offering separate account life insurance and annuity contracts with benefits guaranteed by the insurer's general account. Initially, these guaranteed benefits were fairly limited and covered the payment of a death benefit equal to the amount the contract holder paid into the contract. Over time, separate account products evolved to provide more substantial general account guarantees. These guarantees include enhanced death benefit payments and so-called "living benefit" guarantees that provide minimum income benefits, guaranteed minimum accumulation benefits, and guaranteed payout floors. With the advent of these more substantial guarantees, the historic distinction between fixed products (which were traditionally viewed as being eligible for guaranty association coverage) and variable products (which were traditionally viewed as being excluded from guaranty association coverage) has become blurred.

The Coverage Issue

As a consequence of these developments, the ACLI asked NOLHGA to investigate the coverage implications of separate account prod-



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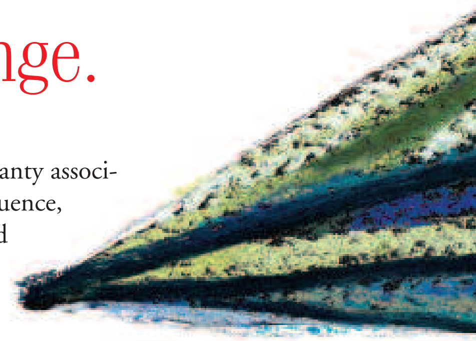


ucts with general account guarantees. In response, NOLHGA did an extensive review of separate account annuity contracts and life insurance policies for the purpose of obtaining a thorough understanding of these products, including how they are documented; what legal relationships they entail; how they are regulated; and what obligations, if any, they impose on an insurer's general account. Following the completion of this review, NOLHGA then conducted an analysis of the Model Act and its legislative history to determine how guaranteed separate account products might be treated for coverage purposes.

In considering the coverage issue, NOLHGA focused on two issues: (1) is a separate account product a "covered policy" as defined in the Model Act; and (2) if it is a "covered policy," is it subject to one of the coverage exclusions contained in the Model Act? Based on this review, NOLHGA's findings were as follows:

- Allocated annuity contracts and life insurance policies issued by a member insurer through a separate account meet the definition of "covered policy" under the Model Act, subject to applicable limits and exclusions on coverage.
- There is no per se coverage exclusion under the Model Act for policies or contracts merely because they are issued through a separate account.
- Model Act Section 3.B(2)(a) applies to separate account products; however, it would not necessarily result in these products being completely excluded from coverage. Rather, the application of this section would result in the exclusion of only *the portions* of the separate account policy or contract that were non-guaranteed by the insurer or under which the risk was borne by the contract holder.

In summary, NOLHGA concluded that separate account annuities and life insurance policies with insurer-guaranteed benefits would be treated as covered policies under the Model Act to the extent of the insurer guarantees, subject to applicable limitations and exclusions.[1]

The Assessment Issue

Guaranty associations raise funds to protect policyholders by assessing their member insurers for a proportionate share of the funds required to provide coverage benefits. Since separate account products historically were viewed as uncovered contracts, they also were viewed as being excluded from guaranty association assessments. This is so because under guaranty association law, assessments generally follow coverage, meaning that only insurance products eligible for coverage are subject to guaranty association assessment. As a consequence, there currently is no established method or practice for assessing annuities or life insurance policies issued through a member insurer's separate account.

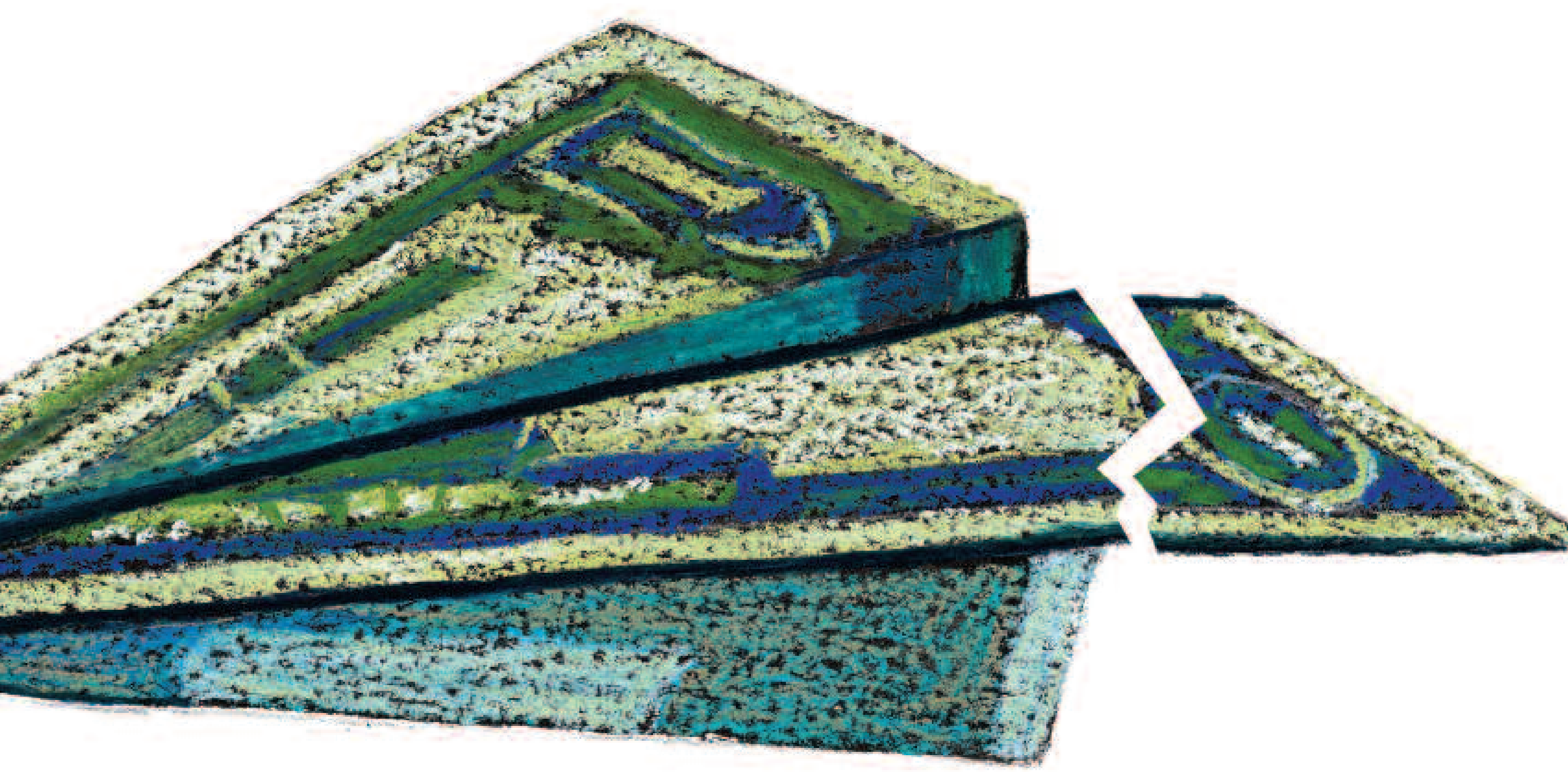
Recognizing that the potential coverage of separate account products would give rise to questions about assessment, NOLHGA and the ACLI formed a Joint Working Group of industry and guaranty association representatives to consider the possible assessment of these products. Specifically, the group was asked to create a method of assessment for variable life and annuity contracts that contain general account guarantees.

Since guaranty associations potentially could be called on to provide coverage for these products in the "next insolvency," the objective was to develop an assessment methodology that could be implemented relatively quickly. As a result, the group focused on solutions that (1) would be consistent with the current Model Act and applicable state law, (2) would rely on information reasonably available in the current form of insurers' statutory financial statements, and (3) would not require substantial changes to reporting forms used for guaranty association assessment purposes. These criteria, in effect, became the group's litmus test for evaluating various alternatives for resolving the assessment issue.

With respect to achieving the above-mentioned criteria, the Working Group was required to develop an approach that would be consistent with the existing system for guaranty association assessments. That system is principally a function of guaranty association law and the NAIC Annual Statement Blank. Under current law, member insurers generally are obligated to pay guaranty association assessments on the basis of their premium receipts on covered lines of business. As a consequence, insurers are obligated to report "assessable premiums" for each covered line of business for each state in which they do business. The reporting of assessable premiums is accomplished through an exhibit to the NAIC Statement Blank (the "Reporting Form") specifically designed for that purpose.

The Proposed Solution to the Assessment Issue

Following a lengthy review process that included consideration of various alternatives, the Joint Working Group focused on using certain fees paid to the insurer's general account as the "assessable pre-



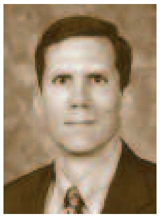
mium" for separate account products. Specifically, these fees are the compensation that the separate account pays the general account for providing guarantees in respect of variable life and annuity contracts ("SA fees").

Since the SA fees represent the "premium" that an insurer's general account charges for the "covered" guarantees it provides to separate account products, the Joint Working Group concluded that its recommended approach was consistent with the current premium-based assessment system. The group also concluded that insurer annual financial statements already contain sufficient information to track SA fees for assessment purposes and that only minor modifications would need to be made to capture SA fees in the NAIC Reporting Form used by insurers to report assessable premium. As a consequence, the Joint Working Group concluded that the SA fee–based approach met the key criteria for an assessment methodology that could be implemented relatively quickly.

The group also tested the SA fee assessment methodology using hypothetical insolvency scenarios. On the basis of those hypothetical results, the group concluded that the SA fee approach was reasonably consistent with the fair allocation of the guaranty association assessment burden among companies that write covered lines of business.

For the above reasons, the Joint Working Group concluded that SA fees should be used as the basis for assessing separate account life insurance and annuity contracts. Earlier this year, the group recommended the SA fee approach to the ACLI, NOLHGA, and various insurers that write separate account business. While the approach engendered questions and healthy discussion among these groups, ultimately no objections were made to taking this approach. In June 2005, the ACLI Board formally considered the Joint Working Group's recommendation and voted to adopt a resolution endorsing the group's recommendation for using SA fees.

The next step in this project is to present the SA fee approach to the NAIC and to obtain the NAIC's approval to incorporate the SA fee methodology into the NAIC Reporting Forms used to report assessable premium. The current plan is to present the SA fee methodology to the NAIC during 2005 and to seek the modification of the applicable NAIC forms for the 2006 year-end reporting period. ✪



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

End Note

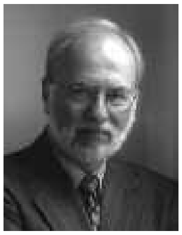
1. This statement is not intended to be determinative of the availability of coverage in any particular instance. Whether any specific contract is covered and to what extent are issues that can only be resolved by the applicable guaranty association based on a review of the particular contract and the provisions of its guaranty association act.

NOLHGA did an extensive review of separate account annuity contracts and life insurance policies for the purpose of obtaining a thorough understanding of these products…

National & International Views

In part two of our interview, D.C. Insurance Commissioner Mirel discusses the need for a national standard for life insurance regulation and why the international community finds U.S. insurance regulation "incomprehensible"

Lawrence H. Mirel was appointed Commissioner of Insurance and Securities Regulation for the District of Columbia in July 1999. Banking regulation was added to his responsibilities in March 2004, and he now heads the Department of Insurance, Securities and Banking (DISB). Since his appointment, Commissioner Mirel has focused on improving the speed and efficiency of regulation to better protect policyholders and to attract financial services activities to the District. The DISB has become a national leader in the use of technology in the regulatory process and now handles virtually all licensing and financial information electronically.



Lawrence Mirel, D.C. Commissioner of Insurance and Securities Regulation

Commissioner Mirel plays an active role in the National Association of Insurance Commissioners (NAIC), where he is a strong advocate for harmonizing regulatory standards and promoting cooperation among state regulators to provide easier and less-expensive access to U.S. markets by national and international insurers. Mirel serves as chair of the NAIC/Industry Liaison Committee; the International Regulatory Cooperation working group of the International Insurance Relations Committee; and the Class Action Litigation working group, which is studying the impact on regulatory authority of large class-action lawsuits. He serves on numerous other NAIC committees and was also named chairman of the board of the NAIC's System for Electronic Rates and Forms Filing (SERFF).

Commissioner Mirel recently announced his resignation from the DISB effective September 30, 2005.

Part one of this interview appeared in the May 2005 issue of the *NOLHGA Journal.*

Q. *As head of the District's Department of Insurance, Securities and Banking, you oversee banking as well as insurance. Banking has a state/federal regulatory structure—would a similar structure work for insurance or just life insurance?*

A. I've only had banking here for about a year, so I'm still learning my way. The banking department was just combined with us in 2004—it had been a separate agency. But I have to tell you, from what I've seen, I'm no fan of dual regulation. It does not make things easier. In fact, it makes them more complicated.

I understand why life insurers in particular want some kind of a uniform national standard, and in my view they ought to have it. It does not require dual regulation, and it does not require a federal regulator. I think it's possible to give life insurance companies an opportunity to operate nationwide with a single regulator, and that single regulator ought to be their domestic state regulator. Deference, as I mentioned earlier [*Editor's Note: The concept of deference—agreements among commissioners to defer to the domestic state regulator whenever possible—was discussed in part one of this interview*].

The dual chartering system gets very complicated. There's always the issue of whether the federal government regulation preempts state authority. There are battles going on all over the place now. There's a recent lawsuit that's been filed against us here in the District by State Farm.

State Farm is an insurance company, but it owns a bank. It wants State Farm insurance agents to be able to sell the bank products without getting permission from state bank regulators. And it got a ruling from the Federal Office of Thrift Supervision, or OTS, saying they could do that. This preempts all kinds of rules that states apply. State Farm knows that, and they're unsure enough themselves about the ruling by the OTS that they want to test it in court. To do that, they've filed suit against the District of Columbia and also against Ohio. They're trying to get a court to say whether the OTS ruling of preemption is valid. Now, that shows you the kinds of problems you get when you have a dual system of regulation. Where does the federal responsibility end and the state responsibility pick up? It's never clear, and it's a constant source of friction and battles and fights. I just don't think that's necessary. I think it can be avoided. The Europeans have figured out a way to do it, and we ought to be able to do it.

Q. *So you believe that life insurers should have the "uniform national standard" you spoke of. You just don't see a need for a federal regulator or dual regulation.*

A. That's right. I can even give you a way it can be done. Some years ago, Congress passed a risk retention law, and that law says that if you're qualified as a risk retention organization, you don't have to be licensed anywhere but in your domestic jurisdiction. It's a limited program, but I think it has enormous potential because that could be the answer. Congress could easily extend that to all kinds of insurance.

Q. *So the company would be licensed in one state, with other states trusting that state's regulation.*

A. Sure. But it's not entirely a matter of trust. The NAIC goes to great lengths to accredit these insurance departments, and I think in many ways that's their most valuable function. But what's the point of accreditation if you're not going to give the state deference?

Q. *It's been suggested that life insurance and annuity products are more like interstate commerce in that insureds can move anywhere in the country and take the policies with them, unlike auto and homeowners*

I think it's possible to give life insurance companies an opportunity to operate nationwide with a single regulator, and that single regulator ought to be their domestic state regulator.

insurance. Do these differences suggest that the life industry is more like other financial services products and should be regulated at the federal level, and P&C is more appropriately regulated by the states?

A. I think such an argument can be made, but I've also heard similar arguments made by USAA, which is a personal auto insurer that insures primarily military people. Many of them move around all the time, as many Americans do. And any time a USAA policyholder gets transferred to another base, they have to get another policy because of different laws. That doesn't make a lot of sense, in my view. So I think the argument is stronger for uniformity for life insurance, annuities, and similar kinds of products, but the argument is there for P&C products as well. I think they ought to be more uniform. Health insurance is another area that drives me crazy, especially here in the District. All our health insurance companies operate in the District, Maryland, and Virginia. The laws are different in each jurisdiction, the products are different, and the approval of the products is different.

Q. *Some have expressed concern that life insurance and annuity products take far longer to gain regulatory approval than comparable banking and securities products, putting the life industry at a significant competitive disadvantage. What's your response to this?*

A. It is a competitive disadvantage, but life and annuity products also have some competitive advantages—some very important tax benefits that competing banks and securities operations don't have. So it cuts both ways. They are not entirely without advantages. When life insurance is seen as a way to protect the family against the premature death of a wage earner, there's a good argument that it should have some tax-favored treatment. But that's not how life insurance is sold anymore. It's sold as an investment product, and the reason it sells is that it has tax advantages. If they want to be like the other competing products, maybe they want to give up those tax advantages.

That said, when it comes to approvals and things like that, we can and should do better.

Q. *Your work with the NAIC has a strong international focus. How do overseas companies view the current regulatory debate?*

A. Overseas companies think that our method of regulation in the United States is absolutely incomprehensible—and I tend to agree with them. My views are based on the fact that I think insurance is truly an interstate and in fact international commodity. It's a global market now. And we have to learn from the way the business is being regulated elsewhere. That's why I'm so interested in the international stuff. There's a lot going on out there.

The United States is way ahead of everybody else when it comes to regulation. There's no doubt about it. We've been at it longer, and we're more deeply into it than anyone else. But there are a lot of people out there who do things better than we do, and we ought to learn from them.

I'll give you an example. I was in London a couple of years ago talking to the Financial Services Authority about my deference idea. And I suggested that we could work that out between the District and the U.K.: "If you will accept District-licensed insurers in the U.K., maybe we'll accept U.K.-licensed insurers in the District." It's obviously funny—they're thousands of times our size, and it wouldn't do U.K. companies a heck of a lot of good just to be able to be licensed in the District.

But the answer I got really surprised me. They said, "We would not require District-licensed companies to be licensed in the U.K. They can sell here." They had no license requirement. They don't require it at all, so the notion of some kind a reciprocal arrangement didn't mean anything to them. In the U.K., they regulate things by the producers. It's my understanding, and I hope I'm right, that they treat all companies the way we treat surplus lines writers.

Q. *So they're baffled by what's going on?*

A. They're baffled, and they're annoyed by it. In some ways, they find that it's anti-competitive. There are various ways to try to cope with it. Some buy American companies that are already licensed in all the jurisdictions. Some of them try to get licensed in a few jurisdictions and operate throughout the country, but you can't—you need to be licensed in every jurisdiction. And that they simply don't understand. They don't see why it's necessary.

Q. *How do you see regulatory reform efforts by the NAIC and Congress affecting the guaranty system, if at all?*

A. Now you're getting into an area that's really not my expertise. The

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guaranty system is one of the things the United States does better than the Europeans, or anybody else. Nobody else has a system like it. I think it's very valuable, despite its flaws, and we have to find a way to preserve it and make it work better.

What it does is give us the luxury of allowing companies to fail, which means we don't have to over-regulate. If we can say that we're protecting all the policyholders, then we don't have to worry about protecting the company. You don't want companies to fail, and you want to make sure that they do things according to the law, but it's not the same kind of catastrophe it would be if there were no guaranty system. Some countries, European and Asian, just simply refuse to let any companies fail. And that means they have to over-regulate. We don't have to do that because we have the guaranty funds. And I think that's a good idea.

Q. *You said the guaranty system is valuable despite its flaws. What are those flaws, in your opinion?*

A. It doesn't apply to every product, and maybe it shouldn't. But there are questions of reach and coverage. There are jurisdictional limits that are difficult. Having a guaranty fund means something different here in the District than it does in California in terms of the depth of the program. You're really getting me into areas where I'm not an expert, but I think there are ways to improve it and protect it. It's not a universal system by any means.

Q. *Any other issues you've been tracking?*

A. The only thing I can think of is terrorism risk. I think that we have not yet found the answer to dealing with terrorism risk. I've never liked the Terrorism Risk Insurance Act (TRIA) very much. The only thing you can say for TRIA is that it may be—may be—better than not having anything. But it just is not a good system, and there should be better ways to do that. Ways that are fairer and spread the very large but unlikely risk further than is done now.

I'm saying this to you in part because I'm the commissioner in the District of Columbia, which has been hit hard with this. Our people here get charged very high premiums for terrorism risk if they can even get coverage. In some areas, like workers comp, some large private employers find it virtually impossible to obtain coverage in the voluntary market and have gone into the residual plan. And that's based on the theory that Washington must be a target because it's the nation's capital. Yet there's not very much evidence for that. The attacks that took place occurred in New York and Virginia, not here.

If you look at the pattern of terrorism attacks around the world—and I've seen this analyzed in some detail—fewer than 6% of terrorist targets have been government facilities. Yet that's all we have in the District. We don't have the large congregations of people or the chemical plants or power plants. No airports or seaports. None of those things people think of as attractive targets for terrorists. But we and New York City pay the highest premiums in the country.

There's got to be a better, fairer way of dealing with the risk. Eventually, the federal government is going to have to back it up, but the federal role could be very minor if there could just be laws that allow the industry to put together some kind of pooling arrangement or similar comprehensive system. I think of things like the Catastrophe Reserve System that Florida came up with for wind storms. That seems to be working really well. Wind storms are more predictable than terrorism, but that concept appeals to me.

I know TRIA is set to expire at the end of this year. I hope that before then, we'll be able to come up with something better. The industry should come up with something better, but the industry has done very little that I can see in the three years since TRIA was passed. And that's why I think it's unlikely that Congress is going to extend it.

It's hard when you're out in Kansas or in Oregon to get the feeling for what's happening here in Washington. But I live with it every day, and I just know that Congress was reluctant to enact TRIA in the first place—the president sort of bludgeoned them into passing it, and they did it as a temporary measure until such time as the industry could come up with a better plan. That's why they limited it to three years. Well, three years are up, and there's nothing on the horizon except the industry pleading to extend it. And I really think Congress is going to say no, and we're going to have to find something else. ✯

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try—and concluded that "clearly, Spitzer is taking on the bastion of capitalism." He noted that a Fitch Ratings 2004 report cited finite reinsurance as a probable topic of investigation for Spitzer, and subpoenas from Spitzer and the Securities and Exchange Commission (SEC) came in 2004.

One of the challenges with finite risk reinsurance, Wylie explained, is that it is an incredibly complicated field. Essentially, it involves insurance or reinsurance in which the primary element of risk is a financial risk rather than an underwriting one. If there is no transfer of risk or no chance for the reinsurer to realize a loss, these transactions cannot be considered reinsurance.

Wylie predicted a good deal of activity in the investigations into finite risk reinsurance. He added that the groups doing the investigating, such as the SEC and the FBI, "don't trust the insurance industry—they're very cynical." While the investigations are moving slowly—mainly because the issues involved are so complex—he believes more charges will be brought.

The final presenter on the panel, Erin Toll of the Colorado Division of Insurance, is quite familiar with investigations into complex areas of the insurance industry, having uncovered a real estate kickback scheme involving captive title reinsurance in Colorado. Her investigation—and the $24 million settlement she reached with one of the title companies—brought the issue national attention, and she shared with attendees her thoughts on what sorts of behavior are likely to cause regulators to sit up and take notice.

Toll cited some of the "red flags" that caught her attention when she sent out interrogatories on captive title reinsurance—a field she was unfamiliar with at the time—to reinsurers in her state. The first warning sign came when she heard back from large national law firms rather than local regulatory attorneys. Then "everybody asked for an extension," she said, even though the interrogatory contained only 10 questions. One company claimed it was impossible to answer the question of whether the reinsurance company had ever paid a claim. When the firms did reply, Toll said, "they buried me in documents—I had probably 15 feet of documents in my office." Not surprisingly, all of this prompted her to dig deeper.

Luncheon speaker Myles Rademan entertained attendees with a stream of anecdotes recounting how Park City partnered with Salt Lake City to help host the 2002 Winter Olympics.

State & Federal Regulatory Reform

Two presentations dug considerably deeper into the topic of regulatory reform and what it might mean for the insurance industry and the guaranty system. In *Insurance Regulatory Reform: A Federal Perspective*, Catherine England (Marymount University) and Wayne A. Abernathy (American Bankers Association) presented contrasting views on the impact of an optional federal insurance charter.

England, author of *Federal Insurance Chartering: The Devil's in the Details* (which is available at www.cei.org/gencon/025,04358.cfm), examined what a dual-charter system similar to the one banking employs would mean for the guaranty system. She began by stating that the banking system will serve as a touchstone for Congress if it considers a dual-charter system because Congress is so familiar with banking. The possibility of a federal insurance charter, she said, raises "potentially very politically sensitive" questions about issues such as market conduct and consumer protection. Based on her analysis, guarantees for federally chartered insurance companies could be handled by three mechanisms: separate state and federal guaranty systems,

Overheard at the Seminar

Opening Remarks
"If the optional federal chartering issue were a dog, it would now be middle-aged."
Chuck Gullickson: South Dakota Life & Health Insurance Guaranty Association

Straight Talk on Social Security
"I am not sanguine about anything good coming out of this."
Pamela F. Olson: Skadden, Arps

Insurance Runoff Plans: An Alternative to Receivership?
"The only reason the receivership system survives is its lack of transparency."
James W. Schacht: PricewaterhouseCoopers
"It's not really clear that insureds and claimants are better off [in a runoff]."
Kevin D. Harris: National Conference of Insurance Guaranty Funds

Discovering, Litigating, and Collecting Fraud Claims
"Any fraud, no matter how large, has the potential to be larger."
C. Philip Curley: Robinson, Curley & Clayton
"If there's no penalty for causing an insolvency, they're going to do it again."
Fred A. Buck: Buck & Associates
"Almost every lawyer and accounting type they engaged—either directly or through the bad guys—was crooked."
Fredric Marro: NHL Deputy Receiver

Health Insurance: Is the System Broken?
"There's a lot of inefficiency, a lot of unnecessary medicine going on out there."
Janice E. Castro: Northwestern University
"I'm not sure we have any realistic idea of our expectations of the American health-care system."
L. Carl Volpe, Ph.D.: WellPoint, Inc.
"The system is broken if insurance companies are paying [to treat] toe fungus."
Stephen D. Neeleman, M.D.: HealthEquity, Inc.

Why We Should Care About Long-Term Care
"I'm here to tell you, as an industry advocate, we don't want to throw the baby out with the bathwater."
Peter Goldstein: Long Term Care Group
"There aren't enough examiners or staff people to deal with all the complaints coming in [about LTC]."
Commissioner Jorge Gomez: Wisconsin Insurance Department
"We quickly learned that long-term care is very different than other policies. The need for immediate processing of these claims is amplified."
Linda Becker: Kansas Life & Health Insurance Guaranty Association

Life Industry Solvency Issues and Developing Trends
"We continue to see liquidity pressure on both fixed- and variable-annuity companies."
Stephanie Guethlein McElroy: A.M. Best Company

a federal guaranty system for all insurers, or the current state-run system.

In expressing her doubts about the "separate systems" approach, England noted that in the banking system, "the federal government has been able to increasingly trump state regulation as time goes on." Touching on the current guaranty system, she pointed out that Congress would not like the idea of policyholders of a failed company receiving different amounts of coverage in different states, which could raise the specter of federal standards for state-based guaranty associations. England also implied that once established, federal regulation of insurance would inevitably come to dominate state regulation. "If I'm the NAIC, I'd never want federal regulation," she said. "But as we know, Congress doesn't always ask the states."

Abernathy looked far more favorably on a dual-charter insurance system, saying that "our system of insurance regulation is archaic" and claiming that an optional federal charter is vital for the industry's success. He called the nation's banking system "one of the financial wonders of the world" and praised the system's ability to encourage innovation in regulation at both the state and federal levels. "What you have, in effect, is competition in regulation," he said, adding that he has seen no "race to the bottom" in banking regulation—a possibility some opponents of the optional federal charter have raised should insurance follow the same path.

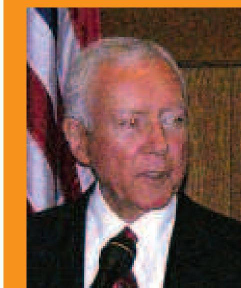
Abernathy said he believed the optional federal charter is an idea "whose time is coming, but maybe has not arrived." He pointed out that major changes to the financial services industry can take decades if not centuries and said that "the impact of introducing regulatory competition to the insurance industry will be huge, profound, and long-lasting." Massive changes like this don't come easily to the federal government—instead, he explained, they are usually caused either by a major economic calamity or a marketplace change or evolution that is later ratified by the government. He predicted that the calamity route would be the path to an optional federal charter, although he couldn't be sure what the calamity would be. "It's hard to predict which element of archaic supervision will bring this bad event about," he explained.

It's safe to say that the next speaker, NAIC President and Pennsylvania Insurance Commissioner M. Diane Koken, disagreed with Abernathy about the archaic nature of today's insurance regulation. In her presentation, *Insurance Regulatory Reform: The NAIC/State Perspective*, she laid out the NAIC's stance that state regulation can "readily respond to the consumers' needs as well as the changes that occur in the environment." While acknowledging that "there are improvements needed in what we do," she maintained that "the states are on-time and on-target" in making these changes.

The goal of the NAIC's modernization efforts, Koken explained, is to create uniformity among the states where it is needed and to establish harmony among them where differences in state regulatory practices are necessary. She reiterated the group's opposition to the draft of the State Modernization and Regulatory Transparency (SMART) Act, saying that "we cannot support any legislation that proposes federal preemption or loss of state authority." She also pointed to the progress the NAIC has made in its Interstate Compact and System for Electronic Rates and Forms Filing (SERFF) initiatives, as well as the work the organization has done on corporate governance regulation and on a new receivership model act.

The Nomination Game

Keynote speaker Sen. Orrin G. Hatch (R-Utah) gave Legal Seminar attendees an inside look at the activity surrounding the nomination of Justice John Roberts to the U.S. Supreme Court (Sen. Hatch spoke before Roberts was nominated as Chief Justice). Saying that "there's little or no excuse for what's happening in the nomination process," he decried the "modern slandering and libeling of nominees" that he said began when Justice Rehnquist was nominated as Chief Justice. "We're hitting an all-time low with Roberts," he added, pointing to recent attacks on Roberts's views on violence against abortion clinics.



Keynote speaker Sen. Orrin G. Hatch (R-Utah)

Sen. Hatch addressed the Senate's role in the confirmation process, stating that the Senate's advice and consent role "has always meant a vote up or down" and that he does not believe in filibustering Democratic or Republican nominees to the high court. He added that he had recommended Justices Breyer and Ginsburg to President Clinton before their nominations.

The senator predicted that it would be difficult for Democrats to filibuster the Roberts nomination and said that if a filibuster is mounted, he would support the "constitutional option" (also known as the "nuclear option") to change Senate rules to prevent the filibuster from continuing.

Sen. Hatch also spoke on the increasing polarization in the nation's capital and throughout the country, laying some of the blame on the media (although he had kind words for FOX News) and on the Supreme Court. The court, he said, had ruled on several social issues—including abortion—that should have been decided by legislatures. In his opinion, the rulings have polarized the country more than any legislative actions would have. He also attacked the "brutal infighting" going on in Washington and praised the value of bipartisan efforts. Noting that he had worked on bills with Democratic senators such as Ted Kennedy (D-Mass.) and Joe Lieberman (D-Conn.), he said, "if Kennedy and Hatch can get together, anybody can get together."

To Sue, or Not to Sue

The seminar moved from regulation to litigation with a panel discussion entitled *The Upsides (and Downsides) of Litigation*. NOLHGA Senior Vice President and General Counsel William P. O'Sullivan began the presentation by highlighting the vital role litigation plays in insolvency practice. "Litigation is a pervasive, inevitable part of what we do as insolvency practitioners," he said. "You could say the entire receivership process itself is a type of litigation." O'Sullivan also pointed out that litigation has a huge impact on the success of insolvency management, with asset recoveries benefiting policyholders and legal precedents affecting how future insolvencies will be handled.

Jacqueline Rixen (The Law Offices of Jacqueline Rixen) gave a detailed account of the evolution and workings of the Texas "special master" system for insolvencies, explaining that it was created out of a desire for more-consistent handling of insolvency

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cases and that it has resulted in a highly efficient process (for more on the Texas system, see "Insolvencies, Texas Style," in the September 2004 *NOLHGA Journal*). James W. Rhodes (Kerr, Irvine, Rhodes & Ables; Oklahoma Life & Health Insurance Guaranty Association) also provided an overview of relevant insolvency litigation over the past year.

Joel A. Glover (Rothgerber, Johnson & Lyons) addressed the issue of discovery, saying "it is dull and dreary and boring—and probably the most important thing that goes on in litigation." To give attendees an idea of the scope that discovery can entail, he mentioned that NOLHGA and the affected guaranty associations produced 220,000 pages of documents in discovery from litigation related to the Executive Life Insurance Company insolvency. He also reminded everyone that the insolvency took place in 1991, before the advent of e-mail, Blackberries, and other electronic messaging devices. He invited attendees to "imagine Executive Life discovery in an insolvency today" and then introduced an expert in computer forensic investigations to help them do just that.

Michael Horwith (Niwot Consulting) explained that computers are far better at retaining information than people—even information that a user has deleted from the computer. "You should assume that everything you've ever done on your laptop is still there," he said. In fact, the average laptop computer has 75,000 to 100,000 items retrieved in a forensic analysis.

Horwith explained that when a file is deleted from a computer, all that is really deleted is the link to the location of that file on the computer's hard drive. The information is still there, waiting for someone like him to perform a forensic analysis on it and retrieve the data (which is sometimes fragmented but still retrievable). "The only really secure way to get rid of information on your computer is a sledgehammer," he said, although he did mention some programs called "software shredders" that can wipe a hard drive clean to varying degrees.

The biggest risk with electronic data, he said, is that people are often quite careless when e-mailing others. "People will write stuff they would never say," he added. "If you don't want it [discovered], don't write it." ✯

Sean M. McKenna is NOLHGA's director of communications. All photographs by Kenneth L. Bullock.

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NOLHGA Calendar of Events

2005

October 9–11	ACLI Annual Conference Washington, D.C.
October 24	**MPC Meeting** **Hilton Head Island, S.C.**
October 25–26	**NOLHGA's 22nd Annual Meeting** **Hilton Head Island, S.C.**
December 3–4	IAIR Roundtable and Meetings Chicago, Ill.
December 3–6	NAIC Winter National Meeting Chicago, Ill.

2006

February 20–22	**MPC Meeting** **Phoenix, Ariz.**
March 4–7	NAIC Spring National Meeting Orlando, Fla.
May 22–24	**MPC Meeting** **Indianapolis, Ind.**
June 10–13	NAIC Summer National Meeting Washington, D.C.
August 1–2	**MPC Meeting** **Baltimore, Md.**
August 3–4	**NOLHGA's 14th Annual Legal Seminar** **Baltimore, Md.**
September 9–12	NAIC Fall National Meeting St. Louis, Mo.