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Midtown Memories

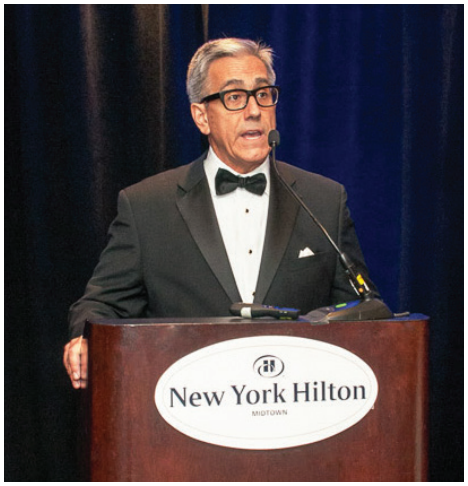
NOLHGA's Legal Seminar tackles regulatory reform, the health insurance market, "shadow insurance," and more—

with style

By Sean M. McKenna

New York City's Fashion Week isn't usually held in July, but this year was different. NOLHGA's 2014 Legal Seminar came to town, and designer eyewear, Savile Row suits, and a tuxedo-clad host joined with a sparkling speaker program to create the most stylish event ever for the guaranty community. Almost 200 people came to New York to get a behind-the-scenes look at the financial crisis from Wall Street legend Harvey Miller (see page 4) and to learn about the shifting regulatory landscape, the continuing disruptions to the health insurance market, the role of annuities in retirement planning, and even the role of costume design in wildly popular shows such as *Saturday Night Live* and *House of Cards*.

They did not leave disappointed.



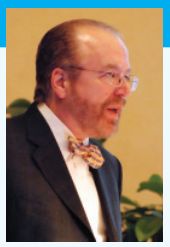
Legal Seminar host Charles Richardson (Faegre Baker Daniels) added some flair to the proceedings with his stylish eyewear and ensemble.

Regulation Nation

One of the key themes of this year's seminar was the way insurance regulation is changing, and a panel moderated by Charles Richardson (Faegre Baker Daniels) took a look at how these changes were playing out domestically. "The scope of federal regulation of insurance is expanding day by day," said Ricardo

["Midtown Memories" continues on page 18]

IN THIS ISSUE



Insurers, Systemic Risk, and the Debate Over Regulatory and Resolution Policy

This column is the first of a two-part discussion; the conclusion will follow in the next issue of the NOLHGA Journal.

Insurance regulation, receiverships, and the safety net often are central topics in discussions of proposals to change or "reform" the architecture of financial regulation. Some elements of the regulatory reform conversation (e.g., federal vs. state regulation) are hardy perennials—they have been debated for decades. Others (e.g., whether insurers can pose "systemic" financial risks, and if so, what to do about it) became part of the discussion after the recent financial crisis.

While events like the NOLHGA Legal Seminar (discussed elsewhere in this issue) do a good job of gathering opinion leaders to plumb these topics together in real time, such discussions seldom can be memorialized in comprehensive written records.

For that reason, anyone seriously interested in these topics should welcome the publication of the new book, *Modernizing Insurance Regulation* (John H. Biggs and Matthew P. Richardson, editors; Wiley 2014). The book includes a number of serious and significant papers from leading academic, regulatory, professional, and industry authorities who, between them, discuss broadly and deeply almost every aspect of the contemporary debates about how the regulation and resolution of insurance entities might be improved, based on current thinking and the lessons of the recent financial crisis.

Journal readers may be particularly interested in Chapter 11, "Policyholder Protection in the Wake of the Financial Crisis," in which I attempt to offer the most comprehensive and current account in print today of the structure, operations, capabilities, and track record of the guaranty system.[1] (I hasten to note that I and the other authors have received and will receive no compensation from sales of this book.)

The book is the written record of an important conference on insurance regulatory reform held at New York University's Stern School of Business in 2012. The presenters captured the state of discussions on most important issues in the field from various perspectives, and with well-developed and substantiated offerings. On a variety of topics, disagreements among different presenters were profound, but few positions were advanced without thoughtful supporting arguments.

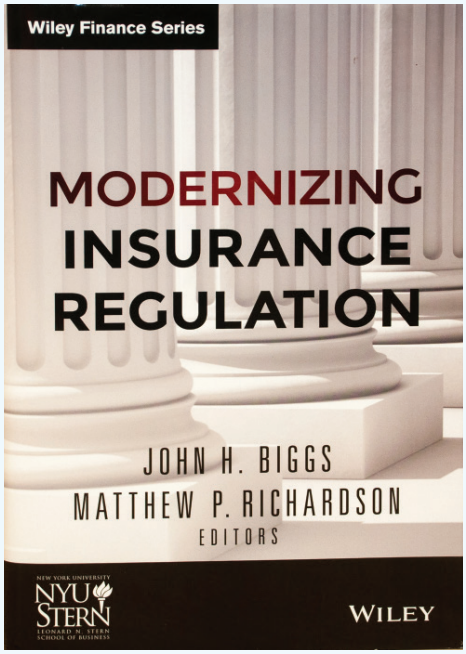
On one topic, all speakers agreed: U.S. insurance companies in general, and life insurers in particular, play a key part in the success of the American economy. This point was made initially by keynote speaker and ACLI President and CEO Dirk Kempthorne and was revisited in different ways by various other speakers. In particular, Gov. Kempthorne emphasizes in the written version of his remarks both the critical importance of insurance products in protecting the economic security of consumers and the stabilizing economic role of the industry's long-term investments in American business.

Gov. Kempthorne makes the important point (considered in different ways by other symposium participants) that the business model of life insurers is a fundamentally different business model than that of banks. Banks are, by their basic nature, in the business of taking short-term, demand deposits—a core element of their funding—and making long-term loans that in many cases are relatively illiquid and vulnerable to developing weaknesses in the real economy.

The basic nature of life insurers, by contrast, is making what are mostly long-term promises to support the long-range financial security of their customers, while insurers invest premium

dollars mainly in longer-dated, conservative, and relatively liquid investments that support the insurers' ability to fulfill those promises as and when they mature over an extended period.

Because of the core differences between the banking and life insurance business models, banks, by their basic nature, are much more susceptible to disintermediation risk than life insurers. Sound prudential regulation must provide for that difference by prescribing standards for, e.g., capital and liquidity that take into account the core business model of the regulated entity, rather than imposing upon insurers regulatory strictures designed for the banking business model. Not to put too fine a point on it, but one size does *not* fit all.



Lessons from the Crisis

Beyond their agreement on the important role of insurers in protecting consumers and investing in the economy, seminar participants (the chapter authors in this volume) diverge substantially in their views on today's key insurance regulatory issues. Points of disagreement include, among others, (i) whether the current U.S. insurance regulatory architecture can adequately supervise the modern insurance industry and, if not, whether that architecture should be radically changed; (ii) the extent to which major insurers pose systemic risk for the financial economy, and, if so, how that risk should be managed; and (iii) whether today's institutions for resolving the failure of significant insurers (including specifically the guaranty system) meet the needs of stakeholders, and, if not, whether those institutions should be replaced by a federal backstop—and with it, a federal prudential insurance regulator.

The recurring debate over federal vs. state regulation was joined by several of the contributing authors, most notably TIAA-CREF CEO Roger Ferguson and former NAIC CEO Terri Vaughan.

Mr. Ferguson ably advocates a federal chartering option, noting that a federal charter would be particularly helpful in reducing the costs, delays, and inefficiencies from multi-state regulatory compliance for a national writer.

Dr. Vaughan acknowledges that state-based regulation entails some inefficiencies, but emphasizes the successes states have made (through the NAIC and otherwise) in reducing such inefficiencies. She also notes the exceedingly strong track record of successful insurer solvency regulation. Vaughan contends that that strong track record has resulted in substantial part from collaboration and cooperation among the states in identifying and remediating solvency issues—in most cases before such issues erupted into crises for insurance companies.

Both Vaughan and Gov. Kempthorne note that insolvencies among state-regulated insurers were almost nonexistent during the financial crisis, whereas the (arguably) more efficiently regulated banking sector saw hundreds of failures in the same period.

In light of the September 2008 problems of AIG, former New York Superintendent of Insurance Eric Dinallo—a sometime visiting professor at the NYU Stern School—uses his paper to explore the lessons of the AIG case for the issues explored by the Stern conference. Dinallo was directly and deeply involved in the AIG crisis, as the lead regulator of some key entities in the AIG family and a key member of the NAIC's multistate AIG response team.

In brief, while Dinallo recognizes that key AIG business decisions made at the holding company level (particularly the development of the risky credit default swap (CDS) enterprise at the AIG Financial Products division (AIG-FP), and to some extent the uniquely risky corporate-wide securities lending program directed from the holding company) may have posed systemic financial risks, those problems were not, in his view, attributable to state insurance regulation.

Rather, Dinallo notes that federal law forbade insurance regulators from regulating credit default swaps, and that AIG had a federal regulator responsible for regulating the firm at the holding company level. He further notes that the problems with AIG's disastrously anomalous securities lending program were identified by state insurance regulators prior to the financial crisis and were in the process of being remediated before the remediation process was overtaken by the events of the crisis generally—and specifically by the AIG rating agency downgrades and related financial pressure (from CDS collateral posting requirements, among other reasons) in the AIG-FP derivatives portfolio.

Dinallo also makes the same observation that former Federal Reserve Chair Ben Bernanke made to Congress: That the core insurance businesses of AIG were fundamentally healthy, though serious problems obviously developed at the holding company level—particularly the risk overhang that grew over several years from the AIG-FP CDS book.

Dinallo goes further to say that it was the value that remained within the regulated insurance entities as of September 2008 that made a successful federal resolution of AIG possible. In his view, the fact that state regulation had successfully controlled the insurance liabilities of the subsidiaries and protected the invested asset portfolios of those entities gave the federal government a solid foundation that ultimately led to the federal

["President's Column" continues on page 14]

NOLHGA Conversations

"People Don't Want to Face Failure"

Harvey Miller discusses the Lehman Brothers bankruptcy, the challenges in unwinding a multinational company, and how Dodd-Frank doesn't really end "too big to fail"

Harvey Miller is a Partner in the New York City–based international law firm of Weil, Gotshal & Manges, LLP, where he created and developed the firm's Business Finance & Restructuring Department specializing in reorganizing distressed business entities and representing creditors, investors, and purchasers of distressed businesses and assets. From September 2002 to March 2007, he was a Managing Director and a Vice Chairman of Greenhill & Co., LLC, an international investment banking firm. The following is an edited transcript of our conversation at NOLHGA's 2014 Legal Seminar on July 17. — Peter G. Gallanis

Gallanis: *A fair number of the folks in this room attended our Legal Seminar last year, and we had a conversation like this with someone you know quite well, Bryan Marsal from Alvarez & Marsal. He began his remarks with a funny story about how he was sitting in his den on the evening of Sunday, September 14, 2008, and how he had put in place standing instructions to the family that he was absolutely not to be disturbed by anyone during his football games. The phone kept ringing that night, but no one could reach Bryan. Finally one of his partners—a friend of the family—persuaded Bryan's wife that this was a call that Bryan really had to take. During the same hours when Bryan was trying to sit in his room undisturbed watching football, what was happening in your life?*

Miller: Well, that was the fateful weekend that started on the 12th of September, when all the heads of Wall Street firms—I used to call them the heads of the families—were called down to the Federal Reserve Bank in New York to decide what should be done with Lehman Brothers. It was a horrific weekend, because it started out on Saturday with an issue of whether Lehman could be bridged to some transaction. Officers from Lehman were being interrogated about the financial condition of Lehman, and how big was the hole that had to be filled. The presumed operating model was, going back to 1998 when Long-Term Capital Management failed, would that kind of event destabilize the markets? At that time, as a possible merger partner or acquirer, the Fed took an aggres-

sive position, and ultimately the Street bailed out LTCM. That was the model. At the same time the LTCM solution was being considered, Lehman was pursuing Bank of America, and Barclays as the second in line.

The negotiations went on all day Saturday, and basically there was a handshake at close to midnight of that day with Barclays. Bank of America had disappeared. It was sort of funny, because sometime during that day, John Thain, who was the CEO of Merrill Lynch, was sitting at the table where Bart McDade was being examined about Lehman, and he later testified in other subsequent hearings that as he was sitting there he came to the conclusion, I am going to be sitting in that seat in two weeks: Merrill is next. He closed his attaché case, got up, and said, "Gentlemen, you'll have to excuse me." He left. He stood on the street corner outside of the Federal Reserve building and called Ken Lewis, CEO of Bank of America, and that's when they made the deal for Bank of America to acquire Merrill. I've always said the stockholders should send a case of champagne to John Thain every Christmas, because he got, I think, $29 a share. If you waited three days, Ken Lewis could have had Merrill for virtually nothing.

So that was the end of Saturday. I believe Dick Fuld thought there was a deal with Barclays. I had only gotten involved on the prior Thursday, and it was all very secretive. Nobody was to know. You couldn't talk to anybody, because confidence is the whole game on the Street. If the Street loses confidence, that's the end of it, because the credit facilities just dry up.

On Sunday, September 14, 2008, we were called down to the Federal Reserve building. We got down there, and the paparazzi were all around the entrance photographing anyone wearing a suit. We were taken up to this room, and as we were going in, the head of Citibank and the head of J.P. Morgan were leaving. I said, "That's not a good sign." There were six of us, and there must have been 40-plus people on the other side of the table. The conversation generally was, what are we going to do with Lehman? Everybody said, "Well, last night we thought there was going to be a deal." We were told that at that point the Treasury Department had decided that there would be no financial assistance to Lehman. The statement was: "Not one dime." That came as sort of a shock, because, frankly, we went down there with the feeling that we're just going down for a conference, we're going to do some housekeeping, and then there would be an arrangement with Barclays.

What had happened during the night was that the Financial Services Authority in the UK had come to the conclusion that this was a very risky transaction for Barclays, and that Barclays was not in the greatest financial condition. Therefore, Barclays could not go ahead with this without having a stockholders meeting. That would take some time, even on an accelerated basis. So there was a need to bridge Lehman to that transaction. Alistair Darling, who was the Chancellor of the Exchequer, told Secretary Paulson that the UK could not bail out a U.S. firm without the United States participating. Secretary Paulson allegedly responded that, "The Treasury and the federal government are not going to participate." Darling basically said, "If that's so, we're not going to contribute anything to this."

So sometime during the morning that message got back to that room, and the conversation changed. Finally sometime during the day the Fed said, "We have come to a conclusion, and the

conclusion is that Lehman has to go into bankruptcy." That came as a shock to us, and we kept saying, "Could you explain to us the rationale?" The answer was, "None of your business. We made the decision, and you should live by it." Well, we kept saying we need some rationale, it's a public corporation. Finally they said, "Well, we're going to caucus." Since there were only six of us, we said, "Well, we'll go out of the room." They said, "No, we'll leave," and these 40-plus people got up and walked out of the room. We thought we were making a little bit of headway, that they were actually caucusing. They were gone for about 45 minutes.

If you've ever been in the Federal Reserve building downtown, it's a strange place. If you walk into the wrong hallway, you get captured by federal guards because they think you're trying to get to the basement where the gold is. So a partner of mine and I, we were walking around and we got captured and they took us back and restricted us to the conference room. The 40-odd people came back in, and the general counsel of the Fed said, "No to your request, we've made a decision. You've got to go back and get your board, and you've got to tell your board to authorize the filing of a bankruptcy petition." We said, "Have you really considered the consequences of this? It's going to be Armageddon out there in the marketplace." They said, "We've done all the work we want to do."

Again we asked, "Could you at least tell us what you're planning on doing?" Same phrase: "None of your business." Finally—I guess we looked like we were desperate—they said, in effect, "We have decided how we're going to calm the markets down. We have three press releases that we're going to issue, and once the market reviews the releases it'll be very quiet. The way we see it, the first day of the bankruptcy will be very newsworthy, a lot of comment; the second day will slow down; and by mid-week people will have forgotten."

I believe there was a gross misassumption made. This is all in hindsight, but I believe the Treasury and the Fed came to a conclusion after Bear Stearns, which occurred in March of that year, that the market was preparing for Lehman's demise. Various hedge fund managers had made speeches that Lehman was insolvent. So I believe that Secretary Paulson firmly believed that the market was ready for Lehman's demise.

Actually, the facts indicated the exact converse. What was going on in the marketplace was, "Look, they saved Bear Stearns, they're certainly not going to let Lehman go down." There was no preparation for a Lehman bankruptcy. Nobody in the federal government had advised anybody in the international community what action was going to be taken. The next day after the bankruptcy petition, Christine LaGarde called Secretary Paulson—this is on tape—and she said, "Hank, what have you done?" The international community had no knowledge of the Treasury's position and the potential demise of Lehman.

So they were going on that assumption, and they finally said, "You have to go back to Lehman." The Board of Directors of Lehman was in the headquarters building, because they thought they were there to approve a transaction with Barclays. So when we came back and announced what the government wanted, there was total shock, and a great deal of dismay.

Lehman convened a board meeting, and a very strange thing happened during the meeting. In the middle of the meeting, Dick Fuld's assistant came in and said, "The Chairman of the SEC is on the phone, and he would like to speak to you." Dick got on the phone, and the Chairman of the SEC said, "We would like to address the board." Now, I've been in a lot of board meetings, and I've never seen that happen before.

It was the general counsel of the Federal Reserve Bank of New York and the Chairman of the SEC. We patched them into the board meeting, and we arranged that only directors would speak—no lawyers, no financial advisors. Chris Cox, the SEC Chairman, made a plea about how important it was for Lehman to go into bankruptcy. One of the directors, a very active director, said, "Look, I don't want all the legalisms, I don't want all the rationales. I want to know, are you directing us to pass a resolution to put Lehman into bankruptcy?" There was a long pause, and then the general counsel of the Fed said, "I think we have to caucus, so we're getting off the phone."

That went on for 10 minutes, and then they came back and said, "No, we're not issuing a direction." They repeated what they said. The same director said, "You're not answering my question. Are you directing us to pass a resolution that Lehman should go into bankruptcy?" They responded, "We have to caucus again," and they left again. Another 10 minutes went by, and they came back and they said, "No, we are not issuing a direction. We think it's a question of business judgment for the board. But we made the government's preference very explicit at the

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meetings earlier in the day at the Federal Reserve." That was their final statement. They got off the phone.

Now, you can't imagine what it was like in the headquarters building on Seventh Avenue. People were running in and out of the building trying to retrieve their personal belongings, because they were afraid the building was going to be locked down.

Gallanis: *This is still Sunday night?*

Miller: This was Sunday night. It was getting pretty late. Security had completely disappeared, and people were milling around on the various floors that Lehman had at 745 Seventh Avenue. It was just pandemonium. I'll always remember—there was a man standing outside the front door dressed like a Viking, with his big spear and a big sign: "Down With Wall Street!"

Going back, once the call with the government ended, the issue was, "What do we do now?" Lehman had absolutely no money. There was no money to open up the next day, and without money it would be horrific for the markets and the public. The Fed was willing to open the discount window just for the Lehman Brothers Inc. broker-dealer, provided that Lehman would provide adequate collateral security. It was a big advantage to keep the broker-dealer open because that would allow customers to get their accounts out, and to keep some sense of stability. The other problem was London. The London office of Lehman, or "LBIE" as they called it, was a very, very big operation. Under English law, directors can have personal liability once a public entity is insolvent.

Gallanis: *If the company trades while insolvent.*

Miller: Yes. There are potential criminal penalties, and there certainly are civil penalties. So they were getting very anxious. Because the way Lehman functioned was on a strict holding company structure; every day the cash was swept up to Lehman, the holding company/parent, and the next morning it was disbursed as needed. During Sunday evening there wasn't any cash in London. The LBIE directors were very anxious—how were they going to open up on Monday? The directors had hired counsel in London, and the calls kept coming in, "What are we supposed to do?"

There's a bankruptcy process in England called administration, and the LBIE directors had decided that LBIE had to go into administration. Well, if they went into administration the whole organization, the whole structure, would and did collapse.

So ultimately the board decided it had no alternative but to initiate a Chapter 11 case in the United States. The Fed had no alternative but to file. The Fed had said, "We want you to file by midnight." Which was impossible. Nothing had been prepared. In fact, when I was first called, I was told not to say anything to anybody, including my wife. We basically had very little information. But it was necessary to get a petition filed before the opening of the market. So it was referred to as the skinniest Chapter 11 petition ever filed in the history of the United States.

Gallanis: *Well, you didn't have a lot of lead time.*

Miller: No. Fortunately you can file electronically, so we did at 2:00 a.m. At the first hearing the next day somebody said, "This is the worst-planned Chapter 11 case I've ever seen." And I said, "No, you're wrong. It was not planned at all."

Sometime that Sunday night somebody said, "Well, what are we going to do tomorrow?" I mean, it was real pandemonium. We said, "Well, you really need one of the restructuring experts to come in, and to bring staff." Bryan Marsal's name came up—I had worked with Bryan for a long time—and the phone calls were made. Bryan, as you know, unfortunately is a football enthusiast who was unable to make the team at Michigan State and compensated by avid watching. The story he told you last year is true. He locks himself in that room on Sunday evenings with the TV set.

Bryan was called, and some of the Alvarez & Marsal people came over immediately that Sunday night. Bryan showed up on Monday. It was still pandemonium, because there was no money. The effect of the filing in London was even worse than New York, because what happened in London was that PricewaterhouseCoopers was appointed as the administrator: two partners from PwC. They went to the headquarters in London, and they looked in the bank account and found that there was no money in the bank account. They got nervous—questioning whether PwC would get paid, and there was no money for employees. So they fired everybody, and they closed the office.

When they did that, they closed down the computer system. When they closed down the computer system, it all evapo-

rated. The books and records basically disappeared at that point. It was a very integrated system; it worked very well while the entity was operating. And when it was shut down, it went blank.

I guess it was about 7:30 in the morning when Barclays called and said, "We don't want to take over all of Lehman, but we're still interested in assets, and we'd like to acquire the Lehman North American capital markets business." A meeting was arranged. You have to understand that everybody was up all night; people hadn't slept since Sunday morning. So a meeting was established for around 8:00 in the morning. From 8:00 till about 10:30, people kept drifting in. We were sitting in a conference room up there on the executive floor, and Barclays's position was they would be interested in acquiring the North American capital markets business, but only as a going concern, which meant the transaction would have to be consummated very quickly.

We were already in bankruptcy. The world was going into a panic; the markets were going crazy; and Barclays basically said, "If we can't get this in a day or two, we're not interested." Well, we had a long conversation. You can't do anything in bankruptcy in a day or two, basically. Certainly not in 2008. The world has changed a bit. We had conversations that day, and toward the afternoon we said, "The fastest we could possibly do this, and it would be basically a miracle, is five days." Now, what we're talking about is selling major assets in five days with thousands upon thousands of creditors all over the world who would have to be notified. Doing that was almost an impossible task, but we had done the impossible before—so why not now!

We focused on this particular provision in the Bankruptcy Code, which has now become very popular, that provided for 363(b) sales. We reached an agreement with Barclays that if we could do this sale and have it approved by Friday of that week they would go forward. But it was a very fluid situation. We didn't know the total value of the assets, which was diminishing every day. The commodities exchanges were threatening to close Lehman down. But we said, we'll take a chance. We went to court the next day to get the bankruptcy court to set a hearing to approve the terms and conditions of sale—the procedural aspects.

In the interim, a creditors' committee was being appointed. We had a hearing on Wednesday the 17th to approve the procedures. We went to court that day, and there must have been a hundred people in the courtroom objecting. The e-mails were coming into the court fast and furious and asserting that it was a violation of due process and inappropriate and so on, and there was a long argument. We went into the courtroom, and basically I said to the judge, "We're not asking for any substantive relief, all we want you to do is set down the procedures." The judge said, "Well, when do you want to have the sale hearing?" I said Friday—this was Wednesday afternoon—and he said, "Oh, really."

We had the procedural hearing. It went from 2:00 to about 8:30 that night, and he finally determined, in effect, "Look, I'm not saying I'm going to approve the sale. There's no substantive relief here. We're going to have the hearing on Friday. You don't have to file written objections; you can come to court orally or by phone. You can file your objections by e-mail." This was on a telephone network, and there were three courtrooms full of people. The judge said, "Right up to the hearing date, you can file your objections through e-mail." Well, the next day the negotiations were going on feverishly. The asset purchase agreement was changing by the moment. On Wednesday the Chicago Mercantile closed down Lehman, and that cost about $2 billion. So the assets were disappearing very rapidly, and the sale was becoming more and more tenuous.

The sale hearing started Friday afternoon, and it was a madhouse in the courthouse. It was televised throughout the courthouse in the different courtrooms where people were sitting. The asset purchase agreement was changing as we were on the way to the courthouse, in the courthouse, so we didn't have a final asset purchase agreement when the hearing was about to start. We advised the audience of certain changes, and then the judge came out. The hearing started at about a quarter to four. It lasted till midnight. It went during that time period without any breaks. There were a lot of objections. The judge had very good control. Our people were getting very nervous.

> The disorderly effect of Lehman was that nobody realized how interconnected Lehman was, or how big Lehman was.

It was an evidentiary hearing, and we had hired Lazard as financial advisors from an investment banking standpoint. The president of Lehman testified. At the end of the hearing, the bankruptcy judge said, "Give me two minutes," and went into his chambers. He came back, and he dictated his opinion into the record. Basically, he said that after reviewing all the facts and circumstances, he felt there was no other alternative but to approve the sale. But it was much longer than that. When he finished—it's now midnight—I've never seen this before, but the entire audience got up like a Broadway show and applauded for the judge. The judge said, "I am prepared to stay around for another hour or so."

Gallanis: *For more applause.*

Miller: More applause, no! It was to sign the order that required a bit of wordsmith-

ing in light of the hearing. I thought, well, this is great. We got this done, tomorrow we'll have a signed asset purchase agreement and a sale hearing. It did not work that way. It got very complicated. We did not have a signed asset purchase agreement and a sale closing. It occurred just before the market opened, and Barclays was advised that title to 745 Seventh Avenue had passed to it. We had spent the entire weekend renegotiating this agreement, because the values were disappearing. We had to deal with the creditors' committee, the trustee appointed by SIPC for LBI, the broker/dealer, as well as Barclays. We were all over the Weil conference center. People were sleeping on the floor, food was all over the place. You had Barclays in one place, and you had the creditors' committee in another place, and you had banks in another place.

At 3:00 or 4:00 in the morning on Monday, the chief negotiator for Barclays came in and said, "There's no deal, we're pulling out." They were having a controversy with J.P. Morgan over some securities. We said, "You can't do that. We've got to stay here until there is a deal." We got the Fed and the Treasury on the phone. It was a very funny conference, because they were in Washington, and the speakers were in the ceiling, and you heard this distant voice like the voice from Hell saying, "You have to do this deal."

So finally it got down to just before the market opened, the deal was signed and the sale consummated. But what had happened was the values had gone down. We couldn't tell exactly what we were selling anymore, because things were disappearing. So basically Barclays got the North American capital markets business for $250,000, which was a good faith payment to the broker-dealer. But we did some fantastic things there, because by keeping LBI, the broker-dealer, functioning, some $92 billion was disbursed to public customers in that week. The customers got out. We persuaded the SEC and we persuaded SIPC that this was the way to go. That took some persuading.

You know, people talk about Lehman being a very disorderly bankruptcy. It really wasn't. It was very in character for a bankruptcy case. The stockholders got wiped out, the creditors took haircuts that Dodd-Frank intends to occur. The disorderly effect of Lehman was that nobody realized how interconnected Lehman was, or how big Lehman was. I think that from the government standpoint, they kept thinking of Bear Stearns. Bear Stearns was a domestic operation basically.

Gallanis: *And very New York–oriented.*

Miller: Very New York–oriented, very little international involvement. Lehman was a huge international operation. What really happened was that the lack of international cooperation created the disorder. Because, in almost every situation, local creditors go for local assets. And that's what happened. So within 24 hours we had, if I remember correctly, almost 60 foreign proceedings—receivers, administrators all over the world. They closed down all those offices.

Gallanis: *I think that's when serious discussions began about enhancing international financial regulation of financial institutions. Shortly after the beginning of the financial crisis, one of the comments that I often heard, and you probably heard it too, was that it might be possible to regulate such institutions internationally, but resolutions of failed legal entities are always going to happen at the local jurisdictional level.*

Miller: Well, certainly in 2008 the attitude was that we are sovereigns; we have our own laws, and we're going to protect our own creditors. As the crisis developed and it became very clear that we now live in a world that's much smaller, and much more interconnected in the financial sense, ultimately there has to be some way to deal with entities that operate internationally. When you think about it, take even a General Electric, 50% of its operations—or more—are overseas. In 2008 there was no international cooperation at all.

Gallanis: *So in the Lehman case, you had a crisis that was really not foreseen either by the domestic regulatory authorities or by some of the foreign players that you'd mentioned.*

Miller: When you say not foreseen, I think you have to add something to that: self-interested blindness. Lehman was a very financially sensitive organization. Lehman was vastly overleveraged. I mean, if you allow entities to be at 55 to 1 on average at the end of a reporting period, think about in the middle of that reporting period. It may have been 70 to 1.

They were overleveraged because they had gone from being a conduit for investments to a holder. Lehman invested very heavily in the subprime market and in other real estate. So when you say not foreseen,

my conclusion is that all of the facts and all the evidence were there, but nobody wanted to pay attention. There's the committee that was appointed to inquire into the crisis, the Financial Crisis Inquiry Commission. If you read the report that was filed by the FCIC and you look at the exhibits, in the summer of 2008 and after Bear Stearns, there are e-mails and reports basically stating, "We have a real problem with Lehman." In fact there's one e-mail that says, "It's not a question of if Lehman's going into bankruptcy, it's only a question of when," or something like that.

And then you had a dispute between the SEC and the Fed: Who regulates Lehman? At the SEC, Chris Cox took the position that the SEC does not regulate Lehman. Well, here's the Chairman of the SEC, with no recollection that the four largest investment banks had submitted to the jurisdiction of the SEC. At some point, I think it was in the end of June, somebody down at the New York Fed said, "Well, we can't think of anything to do, so just let it ride." To me, that's a failure of regulation.

Gallanis: *You are on record as saying that in making the decision to allow Lehman to fail, the involved federal authorities made a major policy mistake.*

Miller: Yes.

Gallanis: *Because of the spillover effects, the loss of confidence in the market?*

Miller: The prediction of the group down at the Fed, as I said, was that Monday would be a tough day, Tuesday wouldn't be so bad, and Wednesday would be fine. But by Wednesday of that week, the commercial paper market disappeared. Companies like General Electric—this was when they finally really got the attention of the Fed—were calling Secretary Paulson and saying, "We don't have any cash." The U.S. and others have developed a business philosophy that nobody keeps cash; every dollar's got to earn money. So GE and other companies go to the commercial paper market to get their cash. Well, that market was, essentially, closed on Wednesday.

Giant U.S. companies were basically saying to the Treasury, "On our projections, we will run out of cash in two or three weeks. We won't be able to make payroll." That's a real disaster. The situation came within millimeters of becoming a Depression way beyond the 1930s.

Gallanis: *I think we were a lot closer to a horrible situation than many people now acknowledge. But there was some concern that, by taking some of the steps that were taken after Lehman was allowed to go into bankruptcy—particularly the rescue of AIG, but also some of the capital infusions into the banks, some of the other steps—that by responding in those ways to the problems of large financial institutions, a major moral hazard problem was created. An expectation was raised that, when companies get into trouble in the future, government rescue plans will save them. That expectation, in turn, is predicted to encourage management of big firms to take undue risks.*

And the record between March 2008 and the rescue of Bear Stearns and mid-September and the bankruptcy of Lehman suggests that the management of Lehman was operating on the assumption that if the firm truly hit the skids, there would be another bailout deal like the Bear Stearns deal. That mindset didn't exist only at Lehman; the potential acquirers of Lehman and other troubled firms were holding out for what was being called a "Jamie deal" after Jamie Dimon of J.P. Morgan, who led the March acquisition of Bear Stearns with government support.

What is your reaction to the concern that providing government support for a failing entity like a Lehman or another big financial institution exacerbates the problem of people taking risks because they view the government as their backstop—as the entity that will step in and cure any mistakes from excess risk-taking?

Miller: Well, you're raising the whole issue of "too big to fail" and the role of government, or the role of institutions. If you go back into history, intervention in a financial crisis is historical. If you go back to the 19th Century and the railroads, like everything else we do, we overdo it. After the Civil War, everybody wanted to build a railroad from the East Coast to the West Coast. The theory was, if you build it, they'll come. Nobody took into account that everybody was building it. So you had the Northern Pacific, the Southern Pacific, the Central Pacific, and so on. They didn't take into account competition. They did projections and said, "We're going to complete the railroad at a certain date." Of course they never did it. When it came to service their debt, they couldn't.

This was a crisis. Railroads were very important to the economy. The government intervened; it gave them the land free, the right of way. But J.P. Morgan stepped in too. By providing cash they restructured the railroads, and that became the reorganization paradigm. Then as you went forward into the 20th Century, every time there was a crisis such as in the early part of the century, J.P. Morgan got together with his colleagues on Wall Street and they put in the cash to stabilize the market.

In the bigger organizations, the iconic companies of this country, nobody wants to bring bad news to the CEO. So things start to get shunted aside.

Gallanis: *The Knickerbocker Trust panic of 1907 and that sort of thing.*

Miller: Yes. And in 1910, Mr. Morgan recognized that every crisis was getting bigger, with the result that the private sector would not be able to be the savior. So you got the Federal Reserve Act of 1913. The Federal Reserve Bank was supposed to be regulating credit. Then you move forward, and as recently as the 1970s, when the New York Stock Exchange got into trouble—member firms got into trouble because the Exchange was expanding, the member organizations were borrowing a lot of money and they began to fail. Well, the Exchange stepped up and created what they called the special trust fund to bail out all customers.

There's always been intervention. If you think about it, Lockheed got into trouble at one point, and the government came in and made a loan to Lockheed because it manufactured fighter planes and it was very important to have fighter planes. There's also the first Chrysler bailout. The question is, what is the government supposed to do when there's a crisis looming that could destabilize the economy? I believe there is an obligation to do something to prevent chaos and total disorder.

But you've got to tie that in, Peter, with regulation. We were living in a period—which I call the Greenspan era—of deregulating with absolute confidence in free markets. The market will regulate itself. Well, as Bryan Marsal said here last year, there are two driving forces in life: greed and fear. As Bryan said, when fear dissipates, greed takes over. If you don't have reasonable regulation, and instead you have free markets with total self-regulation, it doesn't work. It has never worked. So you have to have rational, reasonable regulation. Not overburdening regulation, but you need some regulation.

The SEC had a staff of four attorneys who were on the Lehman premises every single day following the failure of Bear Stearns. Things were getting worse every month, but no recognition or action. Now, you look at Dodd-Frank and Title I, you need somebody who has the ability to say, "You should get out of the real estate business. You've got to sell that, and if you don't sell it we're going to take action." At the New York Stock Exchange, when I was special counsel there, if a company went into capital violation and you did not replenish your capital, you got suspended. You have to have some regulatory body that has the power to stop something before it becomes a crisis.

Gallanis: *A cop on the beat who knows what's going on.*

Miller: Yes. Theoretically, Dodd-Frank is supposed to do that in Title I. Dodd-Frank is…some people have described it as an aggravated assault on the English language. It almost defies comprehension. Barney Frank said Congress operates basically on money. Notwithstanding what the Supreme Court may opine, and while money stimulates things, every once in a while an event occurs that makes Congress think about policy. That occurred in 2008, and for about a day and a half there was no partisan politics, because most people in Congress recognized how bad the crisis was.

You have to think about this in context. Chairman Bernanke and Secretary Paulson are walking to the White House to report to President Bush, to tell him what was happening. Paulson's cell phone rings, and the other party says, "It's Nancy Pelosi. We'd like to know what's going on." Paulson says, "Well, we're on our way to see the President." She says, "Well, the leaders of Congress would like to have a presentation." Paulson says, "When would you like it?" She says, "How about Monday?" He replies, "That's too late." Tomorrow morning, I think he said, or something like that. I think this was Thursday.

This is all on tape, by the way. There's a video. They're in Speaker Pelosi's conference room, and it holds about 40 people. All the leaders are there. Paulson, Bernanke, Geithner, and Chris Cox are on the way over. Paulson says to Bernanke—this is not on the tape—but he says, "When I get up there they're going to kill me. They hate me on the Hill." He looks at Bernanke and says, "You know what? You're a professor; you tell them what's happening." They walk into the conference room, there are no social niceties or anything, and Paulson says, "We're here because we have a crisis," or words to that effect. He takes out his two-and-a-half page proposed legislation, and he says, "You must pass this. If you don't pass it, we won't have a financial system in two days. Chairman Bernanke's going to tell you about it." He did. You could hear on this video, a gasp. Senator Dodd said, "You're kidding us." Paulson said, "No." That's how close they were. And, of course, that bill didn't pass, and that created another crisis.

Gallanis: *After Lehman, and after the first failure of the assistance bill, in both instances the Dow dropped somewhere between 500 and 1,000 points in minutes.*

Miller: It was funny, because after Lehman went into bankruptcy, the next morning, I think it was 8:00 in the morn-

ing, Secretary Paulson was having a press conference in Washington. He had gotten e-mails from a few senators congratulating him, saying he did the right thing. He walked into this press conference beaming with self-satisfaction. We were watching it on TV—and after a very bad weekend, everybody was worn out. Paulson steps up to the lectern, and he has this big smile on his face, and he says, "I hope everybody had a good weekend." He really thought he had done the right thing.

After he finished his presentation, he left, and on the steps of the Treasury building the Deputy Secretary or some other senior officer was standing there, and as Paulson walked up the steps he said words to the effect that, "We have a really big problem. This is running out of control." That's when Paulson did a 180-degree turn. After a review of the deteriorating situation, he allegedly said, "We've got to get remedial legislation passed."

Gallanis: *Within hours of that moment, they also had to decide what to do with AIG.*

Miller: I did not see them, but I am persuaded that AIG's people were in the Federal Reserve Bank building as we were leaving that night, because the government persons were running to another meeting. Sunday night was becoming horrific for the government representatives.

They recognized—this is hindsight again—that if AIG went down, Goldman and others were gone, and that was a real crisis. They just recognized, if we don't do something, we don't have a viable economy. It became an issue of global survival for financial markets.

Gallanis: *With the time we have left, I'd like to get into several of the points that have already come out in the Lehman story. First, you've indicated that you thought letting Lehman fail was a mistake, and that we need to do a better job thinking about when it makes sense to provide assistance to troubled major companies and also about how better to regulate them. My big picture question is, are we in a better place now in terms of legal and regulatory structures than we were in 2007 and 2008?*

Let's start with Title 1 of Dodd-Frank, which establishes our first real macroprudential regulatory structure with the creation of the Financial Stability Oversight Council, this college of regulators who are responsible for identifying systemic risk and systemically risky institutions. One of the complaints sometimes raised about Title I is that in FSOC you've got this group of regulators who are basically the same regulators who were regulating the Lehmans and the AIGs and the others, and they didn't catch the problems then. How are they going to catch them now? Is there something about operating through this council and doing the things that Dodd-Frank asks the council to do that gives you hope that we're going to achieve better regulatory outcomes?

Miller: I would say this: Dodd-Frank is a good faith effort on curing the problems. Is it wholly successful? The answer is no. I believe there are about 280-odd regulations that were supposed to have been passed months ago that have not yet been passed. Only 50% of the over-500 intended rules and regulations have been put into effect. What Dodd-Frank does is give the regulators more oversight, and it spells out that oversight. What it also has done is force institutions that are in the SIFI classification to look at themselves through the living wills provision. Is that going to be totally effective? Probably not, because nobody likes to draft a plan of how we're going to be dismantled; that's a very tough project.

Gallanis: *I think you've handled more big bankruptcies than any other lawyer in the United States. In how many of those cases did you go into a situation where senior management of the company had done a lot of advance thinking and advance planning of what they would do when the company failed?*

Miller: This is a very strange kind of a world I live in. You know, there are three stages to life: one, you're very young; two, you're middle aged; and then finally you're wonderful. I'm in the wonderful stage, so I can say all these things. People don't want to face failure. And in the bigger organizations, the iconic companies of this country, nobody wants to bring bad news to the CEO. So things start to get shunted aside. Then at some point there's an event that brings it to the attention of senior management.

I would say that 15 or 20 years ago, there was much more planning for disaster than today. Today, it's the last thing you want to think about—particularly financial entities. There isn't very much planning for failure. But sometimes there's an event. For example, in the Texaco case you had a situation where Pennzoil had obtained a humungous judgment against Texaco of $11 billion, and this is in 1985. In those days there was no insurance company or

The question is, what is the government supposed to do when there's a crisis looming that could destabilize the economy? I believe there is an obligation to do something to prevent chaos and total disorder. But you've got to tie that in with regulation.

My conclusion is that all of the facts and all the evidence were there, but nobody wanted to pay attention.

syndicate that would bond that amount. If you couldn't bond the judgment, that meant that Pennzoil could execute on it. There was a lot of legal work done to try to stop that, and Texaco was able to get an injunction. During the period the injunction was outstanding, Texaco really planned for the possibility of bankruptcy. The company restructured itself so that all the operating companies were outside of the bankruptcy. When Texaco actually went into bankruptcy, it was just a holding company and two financial companies. Essentially all operations—refineries, exploration, etc.—were not affected.

Gallanis: *It was a single point of entry.*

Miller: Well, I wouldn't go that far. I have great reservations about the single point of entry. But let me just add, I think Title I has the bones for effective regulation.

Gallanis: *Let's talk about Title II, which really contemplates how we go about resolving large and complex financial entities that fail. In the whole resolution strategy, there are several parts. There's the orderly liquidation authority, the Orderly Liquidation Fund mechanism to provide some liquidity for the FDIC as the liquidating entity. That's begun to be implemented through the FDIC's proposal for single point of entry.*

There have also been some changes to the authority of the Federal Reserve under Section 13(3) of the Federal Reserve Act, which is the lender-of-last resort authority that was used in several cases through the crisis to provide assistance for financial entities that otherwise would have failed. That authority has been severely truncated by Dodd-Frank. But on the other hand we have the Orderly Liquidation Fund that's been provided to the FDIC. If I understand your earlier points, sometimes when key companies or sectors fail, there is a social need and a governmental responsibility to make sure they don't fail in a way that harms the general public. Is Title II of Dodd-Frank an improvement over what we had before?

Miller: I doubt it. If the objective is to avoid the use of taxpayer money in rescuing or bailing out these entities, I doubt that it works. The concept of the FDIC as receiver—forming a bridge company, and then the bridge company keeping the operating units operating—requires cash. It needs liquidity. Where does that liquidity come from? If you looked at Lehman, there was no liquidity at the holding company.

And to say that you could be able to go to the private sector and raise money by pledging the assets? That's not going to work. The assets are already tainted. There's nothing in Title II that really tells you where the liquidity is coming from. The Orderly Liquidation Fund doesn't have the money now. Ultimately, when you look at Title II, it's the Treasury that's the backup.

I have great reservations about it. I also have great reservations about the FDIC as the receiver. The FDIC was very effective in the 1980s in the energy crisis; when a bank failed, they would go in on a Friday night, there would be a contract of acquisition by another bank, and Monday morning the deposits would have been moved and the bank opened up under the acquirer's name without affecting depositors. Moving deposits is not a problem. Dealing with derivatives and all kinds of very opaque, difficult, and esoteric financial instruments or securities is very different. The FDIC did not have the staff to do that. And I still don't think they have the staff to do that. It's a typical bureaucracy.

Gallanis: *Was that decision really a case of Congress looking around at the available federal entities and lighting upon the one that then was in the highest repute?*

Miller: Yes. It was the only one that really did any restructuring of that kind. But this is different. I once said in 2009 when I was testifying that a representative of the FDIC would not know a derivative if it hit him in the face. Think about it. To this day, there are still about 150 people working at Lehman unwinding derivatives.

Gallanis: *If I understand Dodd-Frank correctly, the major thrust of the Act is looking at systemic risk predominantly within the boundaries of the United States. With the failure of a Lehman, and certainly with the failure hypothetically of an AIG or a GE or any of a number of other multinationals that we can think of, how far does Dodd-Frank move us—or how far have we otherwise moved—in the direction of creating structures and lines of communication that might allow us to deal better with an internationally complex company like Lehman?*

Miller: Well, the big hole in Dodd-Frank is that it has no provision for binding international agreements. There is one provision that essentially encourages the FDIC to work out arrangements with foreign countries, and there's been some progress made with the UK, but not very much beyond that. Until you can get a binding international arrangement, as our world becomes smaller and more interconnected, this is going to remain a problem. You're not going to be able to stop local creditors from getting a receiver or administrator appointed and grabbing the assets. That's a very big problem under Dodd-Frank. ★

["President's Column" continues from page 3]

support effort being a profitable undertaking by the government, contrary to the expectations of almost all commentators in 2008 and 2009.

Dinallo makes an additional important observation: That the strong credit rating of AIG—at the parent company level—was in part illusory because of the fundamental fact that the assets of its regulated insurance companies were not available to satisfy liabilities of AIG's non-insurance affiliates (e.g., AIG-FP). Under the law of New York and every other U.S. jurisdiction, insurance company assets are "ring-fenced" and only available to satisfy insurance company liabilities.

In September 2008, when AIG-FP found itself unable to meet collateral posting requirements for its CDS contracts, the fact that substantial solid assets resided in the insurance subs was of no help to AIG-FP, which was not a regulated insurer. But those same insurer assets were available to satisfy the insurance promises of the regulated subsidiaries. In fact, Dinallo contends that, even had the parent failed utterly (i.e., had there been no federal rescue), the insurer subs had enough assets to satisfy all insurance commitments to consumers.

Runs on the Bank

The book has no fewer than four chapters separately exploring the question of what systemic risk (if any) is posed by the insurance industry: one by a team of research economists at the Chicago Federal Reserve Bank, and three by academics. All four papers are detailed and financially technical, but there are some basic points of agreement, as well as some differing opinions.

None of the four papers suggests any reason for believing that traditional property and casualty insurance is likely ever to be a source of material risk for the financial system or the real economy. Moreover, all four papers suggest that "traditional" insurance (described somewhat differently by different authors)—whether life and health or property/casualty—is unlikely to be a source of systemic risk from any U.S. insurer.

On the other hand, all four authors to some extent share the view that systemic risk can arise to the extent that insurance entities engage in material amounts of "non-traditional/non-insurance" activities, such as the CDS program conducted at AIG-FP or the uniquely risky securities lending program run on a corporate-wide basis by the AIG holding company. The authors cite no evidence that any American insurer is or has been materially engaged in those types of activities, except for AIG itself (as that entity existed before the financial crisis; AIG today is a significantly different company). The authors also suggest that systemic risk may be generated by monoline credit insurance entities (financial guarantors and mortgage insurers).

In the latest of a series of monographs, economist Anna Paulson of the Chicago Federal Reserve Bank and several of her Chicago Fed team members attempt to analyze the vulnerability of the U.S. life insurance industry to systemic shocks, particularly sharp declines in asset valuations and sharp increases in policyholder redemptions.

Dinallo also makes the same observation that former Federal Reserve Chair Ben Bernanke made to Congress: That the core insurance businesses of AIG were fundamentally healthy.

The paper begins by contrasting the generally understood business models of banking and life insurance. The authors observe that banks are by their nature inherently susceptible to "runs" because their essential business is to fund themselves with highly liquid demand deposits (over 70% of bank liabilities) and to use those funds borrowed from depositors to invest in illiquid, opaque, and difficult-to-value loans (over 50% of bank assets). The risk "overhang" created by demand deposit funding, on the one hand, and long-term, illiquid investments, on the other, creates a risk of "disintermediation," whether because depositors are concerned about the risk of bank failures (as during the Great Depression) or because funds in demand deposits can be redeployed in higher-yielding non-bank investments (as during the early 1980s, when bank and S&L depositors shifted funds from depository institutions to the then-new money market mutual funds).

By contrast, the traditional model of life insurers is to invest premiums for long-term contracts providing financial security (life insurance and annuities) in conservative corporate and government bonds, which tend to be liquid, transparent, and easy to value. Said differently, banks rely on highly liquid, demand deposits to fund illiquid, long-term investments, while traditional insurance business makes long-term, illiquid or "sticky"

A key conclusion of the authors—supported by other researchers in the field cited in their paper—is that generally insurers are "victims rather than propagators of systemic risk events."

promises to consumers that are backed by conservative, long-duration investments.

The authors explain that systemic disintermediation risk can arise to the extent that consumer runs compel a financial institution to liquidate significant amounts of assets to meet demand commitments from funding sources (e.g., withdrawals from savings or checking accounts). If an institution either has a large buffer of liquid assets, or if its liabilities to funding sources are unlikely to be the subject of widespread, imminent repayment demands, then the level of systemic disintermediation or "run" risk is comparatively low.

The question addressed by the authors is, to what extent are modern U.S. life insurers really immune to such "run" risks by virtue of the nature of their contractual liabilities to consumers and the nature of their invested assets?

The authors analyze the liquidity of industry-wide general account investment portfolios and observe that (as of year-end 2012) almost 75% of assets were invested in bonds. They project that, across the industry, a severe credit event (defined as a five-year low in invested asset market values) would result in a 5.7% balance sheet loss to the industry—not good news, but nothing close to a catastrophe, given the generally long-term nature of insurer liabilities and the fact that, for most asset devaluation scenarios, there would be offsetting gains from decreases in policyholder liabilities (due to the interest rate increases that would precipitate asset value declines).

Although the authors acknowledge that life insurer liabilities in general remain much less liquid—"stickier"—than bank demand deposit accounts, they offer some research findings suggesting a slight industry-wide trend recently toward more liquid insurer liabilities. They point particularly to guaranteed investment contracts (GICs) and deferred annuities with little or no remaining surrender penalties as products that cause some life companies to be more prone to "run" risks than other products.

The most interesting element of the Fed paper involves the effort by the authors to model how financially exposed life insurers would be to widespread efforts by policyholders to pursue surrenders or withdrawals on their accounts. For this purpose, the authors hypothesize both a "moderate" and an "extreme" run-on-the-bank stress scenario. They acknowledge that their assumptions are extreme and very remote: For the "moderate" case, they assume that 10% of life contract cash values would be withdrawn; 50% of annuity values of contracts with penalties would be surrendered; and 100% of annuities without penalties would be surrendered. For the extreme case, the corresponding figures assumed are 20%, 100%, and 100%, respectively. (These outcomes, even in the "moderate" case, are much higher than seen in any U.S. insurer insolvency to date, and assume—contrary to all experience—that no moratorium would be imposed on surrenders or withdrawals by an insurance receiver.)

Even based on these assumptions—which the authors describe as extreme and only remote possibilities—the liquid assets alone of the industry (without resort to the customary receiver's moratorium on voluntary surrenders and without reliance on less liquid assets, which are also available for workouts or receiverships) are projected to cover 109% of all "runnable liabilities" in the "moderate" stress case and 79% of such liabilities in the extreme case.

In other words, even in very extreme stress circumstances, the ability of the life insurance industry in general to withstand an unprecedentedly high surrender scenario is sustainable from the liquid investments held in the industry. That conclusion is entirely in accord with the actual experience of the industry during the recent financial crisis, when (i) actual surrender activity was in fact low; and (ii) no large (or even mid-sized) insurers were significantly challenged in meeting all obligations to consumers, whether those obligations were from conventional and scheduled benefit payments or voluntary surrenders or withdrawals.

Propagators or Victims?

The book's second article on systemic risk, by Temple professors J. David Cummins and Mary A. Weiss, explores whether evidence or modeling supports the notion that systemic risk is associated with the insurance industry; and, if so, the nature of that association, in general and by type of insurer and insur-

ance activity (examining both the lines of traditional insurance offered and "core" versus "non-core" insurance activities).

The inquiry is important, the authors note, particularly in light of the assignment given by Congress to FSOC in the Dodd-Frank Act (DFA) to identify risks to the financial stability of the United States that could arise from the activities of large, interconnected bank holding companies or nonbank financial companies.

The largely statistical analysis of the paper concludes that while *non-core* activities like issuing credit default swaps and financial guaranties are strongly associated with systemic risk, *core* activities of insurers in general are not materially associated with systemic risk.

A key conclusion of the authors—supported by other researchers in the field cited in their paper—is that generally insurers are "victims rather than propagators of systemic risk events."

The authors then offer some reflections on how regulation could be modernized in light of the lessons of the financial crisis. They note in particular concerns arising during the crisis over complex financial entities, some of them related to insurance, that operate through multiple subsidiary or affiliated companies that may be located in different states or different countries.

In that connection, the authors review insurance regulatory changes that have developed in the United States since the crisis, including NAIC holding company regulation enhancements and the development of structures for international insurance regulatory cooperation and consultation.

The authors conclude by warning that stricter regulation isn't necessarily better regulation—that economic harm to stakeholders can follow as much from over-regulation as from under-regulation. They suggest that regulatory requirements should be tailored to the risk circumstances of regulated entities and, for insurers, would best be devised so as to complement existing state regulation, "…keeping in mind that under the existing U.S. state regulatory framework, insurers fared well through the crisis; new regulation should not fix what is not broken."

A third paper by NYU Stern School professors Viral V. Acharya and Matthew Richardson similarly examines on the basis of a different statistical analysis whether the insurance industry is systemically risky. The authors find what they consider to be at least some statistical support for the notion that insurers can either be sources or victims of systemic risk.

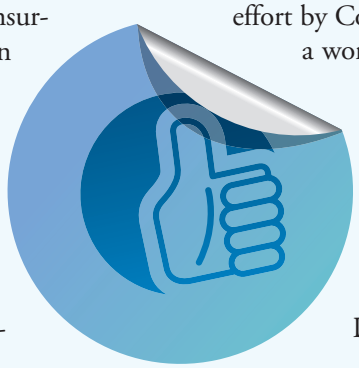
Their statistical argument appears to be much stronger, again, for firms engaged in financial activities other than traditional insurance business (such as issuing CDS contracts or financial guaranties) than for traditional insurers. In addition, the analytical model is based on patterns of equity trading and credit derivatives issued on insurance entities and appears to ignore the fact that regulatory ring-fencing of operating insurance company assets (and the reservation of those assets for policyholder liabilities) makes equity and derivative prices for insurers much less relevant measures of an insurer's stability than would be true for other financial services providers. (As readers of this periodical know, in some notable cases insurance holding companies have actually filed for bankruptcy without policyholders of the subsidiary operating insurers ever losing a penny.)

To be sure, declines in insurance holding company equity prices and market-perceived concerns for holding company creditworthiness may reduce the level of investment activity of the holding company, but that seemingly bespeaks more the extent to which the overall enterprise is affected by systemic risk than a source of such risk.

Designating SIFIs

The final systemic risk paper is from Scott Harrington, a Wharton School professor and member of the Federal Advisory Committee on Insurance. Harrington focuses on designation and supervision under the DFA of systemically important nonbank financial institutions (SIFIs).

He writes that a fundamental policy challenge of the financial crisis is how to reduce the likelihood and severity of future crises while avoiding overly restrictive rules for financial institutions that could lessen the availability of (or increase prices for) valuable financial services. He describes the DFA as a good faith effort by Congress to address that challenge, and he provides a working explanation of the SIFI designation process at FSOC.



Harrington notes that the extension of DFA oversight authority to insurance entities was driven by the problems at AIG, whose public perception as "an insurance company" made that extension politically inevitable.

That said, Harrington observes (as does Dinallo) that, notwithstanding the non-traditional

Even in very extreme stress circumstances, the ability of the life insurance industry in general to withstand an unprecedentedly high surrender scenario is sustainable from the liquid investments held in the industry.

Harrington also finds that designating additional insurers as SIFIs would produce at most modest benefits, compared to the potential direct and indirect costs.

financial activities initiated outside the regulated insurance subsidiaries (AIG-FP's credit default swaps and the corporate-wide AIG securities lending program), there clearly was enough capital within the AIG insurance subsidiaries (at least on an aggregated basis) to meet all of the AIG insurers' traditional insurance obligations.

Harrington also notes briefly the regulation of AIG at the holding company level by the federal Office of Thrift Supervision (later terminated by the DFA) and the substantial role of the federal government in rescuing AIG (and its counterparties) at the height of the crisis in September 2008. Because of the prominent role of AIG in the crisis, the details of the federal rescue, and public reaction to some aspects of AIG in the wake of its rescue, Harrington concludes that the eventual designation of AIG as a SIFI was a foregone conclusion.

After reviewing the research and analysis done in the field, Harrington considers the issues of (i) regulatory and compliance costs and undesirable market disruptions from an insurer's SIFI designation; (ii) the design of capital requirements for insurer SIFIs; and (iii) whether designating insurers as SIFIs could reduce market discipline by appearing to protect designated insurers with an implicit promise of future federal rescues because they are "too big to fail."

Harrington finds that qualitative analyses (his own and those of others) generally have concluded that core insurance activities pose little or no systemic risk, and that quantitative analyses and modeling have provided no compelling evidence to the contrary. That is, the research to date suggests that traditional insurance generates little if any systemic risk, especially compared with the banking sector, which in crisis circumstances poses a much greater systemic threat. He also finds that designating additional insurers as SIFIs would produce at most modest benefits, compared to the potential direct and indirect costs.

Harrington urges that any enhanced regulation of insurer SIFI capital, leverage, and other matters should be designed with reference to the specific operations and risks of the particular designated entities, and he suggests that any enhanced capital requirements should be based upon the existing NAIC and state standards that have been developed and employed with great success (much as was suggested in the Cummins and Weiss paper).

Harrington's concluding observations center on unintended consequence risks of designating an insurance entity as a SIFI. He notes as one potential risk the likelihood that implied federal protection of a SIFI entity as "too big to fail" may distort competition with other companies in the market by reducing the cost of capital to the SIFI firm and helping it attract risk-sensitive business. In addition, he notes that market discipline (the practice of individual consumers and financial institutions considering the financial strength of an insurer when making insurance product selections) may be considerably weakened if a SIFI insurer is viewed as implicitly backed by the federal government.

Harrington observes that the U.S. insurance industry traditionally has been marked by strong market discipline from policyholders, bondholders, intermediaries, and rating agencies, among others. He notes as well that the current structures and scope of state guaranty association protection reduce moral hazard and promote market discipline, an effect that might be undermined by a series of SIFI designations of insurance firms and the signal that such designations might send to the marketplace.

So, while at the margins a variety of academic, professional, and economic experts have slightly different views about whether insurers theoretically *could* pose systemic risk, they appear to agree broadly that traditional insurance activities *in practice* pose little if any risk; that insurers for that reason fared comparatively well in the financial crisis; and that other sectors (such as traditional and "shadow" banking) appear to be much greater potential sources of systemic risk than the insurance sector.

From the standpoint of this periodical's readers, an important question remains: Do the lessons of the financial crisis and subsequent analyses of insurer riskiness suggest that the United States needs a different system for resolving financially troubled insurers and protecting consumers (and possibly others) from the consequences of an insurer failure? The Stern symposium and the book that followed from it, *Modernizing Insurance Regulation*, have provided a highly controversial proposal for answering that question, which we will examine in the next issue of the *NOLHGA Journal*. ✯

Peter G. Gallanis is President of NOLHGA.

End Note

1. In part to "level-set" discussions about the life and health guaranty system, NOLHGA has published and twice updated a "white paper" discussing in detail how regulators, receivers, and the guaranty system address the resolution of troubled life and health insurers and the track record capabilities of the system. The first version of that white paper was prepared for the American Bar Association National Institute on Insurer Insolvency in New York in June 2009. The second version was delivered as written testimony to the Financial Services Committee of the U.S. House of Representatives for a hearing in November 2011. The third version first appears as Chapter 11 of the book being reviewed, and a free-standing version of it is now being prepared.

["Midtown Memories" continues from page 1]

Anzaldua (MetLife), who added that the question facing the industry was how federal regulators would interact with their state counterparts.

New Jersey Commissioner Ken Kobylowski, whose department oversees Prudential (which has been designated a systemically important financial institution (SIFI) and a globally systemic important insurer (G-SII)) has some experience in that area. "I hate to use the words guinea pig," he said, "but we've been at the forefront of working with federal regulators." Noting the oft-repeated line that banking is not insurance, he added that "it's clear to me the federal regulators understand these differences."

Talk quickly turned to the Dodd-Frank Act, and Aaron Klein (Bipartisan Policy Center) began by saying "the myth that Dodd-Frank didn't touch insurance companies just isn't true." The Act, he said, was designed to turn bank regulators into financial sector regulators—the question is, can they oversee insurance effectively? He believes so, adding that "I'm pretty optimistic" about the Act's orderly resolution authority process. Anzaldua wasn't so sure, saying "I'm concerned the FDIC doesn't have enough insurance expertise."

All the panelists agreed that the Financial Stability Oversight Council (FSOC) created by the Act has some work to do. Klein criticized the $50 billion threshold for non-bank SIFI consideration (it's too low) and also said, "the transparency of the SIFI process has been sorely lacking." Anzaldua picked up on that thread, adding that "we should all be troubled that the insurance experts on FSOC wrote such eloquent dissents" when the council designated Prudential a SIFI. The "run on the bank" premise they used to justify the designation, he added, "is not realistic, and the analysis of why that event creates systemic risk is unsupported by the evidence."

Commissioner Kobylowski singled out another creation of the Act, the Federal Insurance Office (FIO), for possibly overstepping its charter. "I hope FIO doesn't think the international arena is its space alone," he said. "I disagree with that 100%." He also warned that changes in international regulation, with FIO and other non-regulators representing U.S. interests at the International Association of Insurance Supervisors (IAIS) and other bodies, might be moving too quickly. "U.S. regulators need to be engaged, but I'm not sure if, at the end of the day, the IAIS knows what we're going to do with all these standards," he said. "And I think that's a fundamental problem."

By a fortuitous coincidence, the very next panel at the seminar, moderated by NOLHGA President Peter Gallanis, focused on changes in international regulation. In discussing the prog-

The next step, Sharma added, is determining how to replace these vital services. "That is the bit of the analysis that is sorely lacking."

ress made in the international arena, Paul Sharma (Alvarez & Marsal), who headed a body at the IAIS that developed the G-SII criteria, said that "the first and most significant thing that's been accomplished is the designation of G-SIIs." In layman's terms, he explained, a G-SII is a company that does something extremely important for the global economy that would be difficult to replace if the company in question were to fail. The next step, Sharma added, is determining how to replace these vital services. "That is the bit of the analysis that is sorely lacking."

John Nolan (FIO) noted that FIO "has been very active on G-SIIs and capital standards" in its work with the IAIS. He added that these are long-term projects. "This is at the early stages," Nolan said. "There are years of consultation and testing before implementation."

Ann Kappler (Prudential Financial) explained that as a traditional insurer that's been designated both a SIFI and a G-SII, Prudential deals with state, federal, and international regulators—a process she likened to "playing three-dimensional chess." She noted that "G-SIIs are dominated by European insurance entities, and the regulators are too," adding that there's a "really strong push" to match the proposed Solvency II regulations. "Who is speaking for the U.S. interests?" Kappler asked, noting that even with the FIO, NAIC, and Federal Reserve participating in the IAIS process, "it's not clear that having a lot of entities at the IAIS is doing us any good."

Actor and award-winning costume designer Tom Broecker (with moderator Bess Gallanis) entertained luncheon attendees with his stories of the perils of live TV and the role clothes can play in storytelling.

Asked why G-SIIs were designated before there was a plan in place for how they should be regulated, Sharma replied that "you couldn't perfect these policy responses without knowing the types of firms they'll apply to." He added that this process allows companies a say in developing these new policies and also gives them additional time to prepare for them.

Echoing a comment Anzaldua made earlier, Kappler said that the problem with the SIFI designation process is that "it places a burden on FSOC to make predictive judgments" based on a scenario that's never occurred. Sharma followed by saying that companies might want to get used to that sort of regulation. "Regulatory decisions are becoming much less predictable on the basis of published materials," he said. "Regulators are claiming discretion, and it's causing problems for the regulated."

The panel discussion on the health insurance market featured Sally McCarty (Georgetown University Center on Health Insurance Reforms), Professor Timothy Jost (Washington & Lee University School of Law), and Candy Gallaher (AHIP) (not shown).

Some say the health insurance market knows a thing or two about dealing with changing regulations, and a panel on health insurance issues led by Lee Douglass (Arkansas Blue Cross and Blue Shield) proved this to be the case. In noting the effects of the Affordable Care Act (ACA) on the market, Sally McCarty (Georgetown University Center on Health Insurance Reforms) cited a *New England Journal of Medicine* study reporting that 20 million people had gained coverage through the ACA through various channels (exchanges, Medicaid, or private insurance). Early reports also indicate that exchange enrollees have a high rate of seeking care for serious or chronic illnesses.

McCarty added that at this point, people can find data to support any stance on the ACA. "It's too early to draw any conclusions," she said. "I think it's going to be a year or two before you can get good data."

Vermont Insurance Commissioner Susan Donegan (left), Laura Bazer (Moody's Investors Service), and Peter Schaefer (Hannover Life Re) discussed captive insurers and their impact on the industry.

Professor Timothy Jost (Washington & Lee University School of Law) noted that "one persistent concern about ACA implementation is its effect on markets. Adverse selection is a very real threat to insurers." He added that changes in the rules governing implementation, along with problems at the federal exchange and several state exchanges, make it difficult to gauge the long-term effects of the Act on insurers. "ACA participation is a risky business for insurers," he said. "But at this point, the risk seems manageable."

As with most discussions of the ACA, this bit of good news was followed almost immediately by bad news. Candy Gallaher (America's Health Insurance Plans) told attendees that if they thought the exchanges had a tough time getting up and running, they haven't seen anything yet. "There's another crucial funnel point that's going to cause more clogging, and we don't see a fix for it yet." The new clog is called the Hub, which verifies every applicant's eligibility for premium subsidies. According to Gallaher, the Hub can't handle batch processing, so nine million applications will be run through one at a time.

It's likely to be a confusing time for applicants, and Gallaher expressed doubt that the government will be ready for the flood of calls likely to come its way. "The federal call center wasn't up to the job before, and they're not up to the job now," she said.

This challenge to ACA implementation is joined by a host of others, including many court cases seeking to block various parts of the Act. Professor Jost noted that the case seeking to block subsidies because of the Act's wording that these subsidies can only be provided to those who use an exchange "established by the state" could bring down the entire Act. A ruling in favor of the plaintiffs (which was issued shortly after the seminar and is now on appeal) "would be devastating," he said, explaining that it would leave the market reforms called for in the Act in place while eliminating the subsidies and individual mandate. "That would essentially mean the collapse of the individual health insurance market in 37 states."

Shadows & Death

Another seminar panel, moderated by David Alberts (Mayer Brown), dealt with a practice that threatens the entire insurance industry (according to a report issued by the New York Department of Financial Services): "shadow insurance," which is what the report called captive insurers. Most of the panelists didn't view the practice of establishing captives with the same degree of alarm, although they did say it's not without risk.

Peter Schaefer (Hannover Life Reassurance Company of America) began by noting the value of captives to insurers and policyholders. "There's a clear connection between the savings that come out of the captives and the benefit to consumers," he said. Banning the use of captives would only increase the price of insurance products and thus the number of under-insured consumers in America. He added, however, that the differing laws governing captives among the states, as well as the varying levels of transparency, are causes of concern. "The ACLI would like to see more transparency among the regulators," he said.

Vermont Commissioner Susan Donegan is one of those regulators, and she echoed Schaefer's call for more uniformity and transparency. Vermont has a thriving captives industry, and the Department of Financial Regulation recently issued a bulletin on best practices for captive regulation. "We want to have standards to give certainty to the industry and to show that we as regulators can come together."

Commissioner Donegan added that "as commissioners, we have several camps of thought" on captives, ranging from her belief that they're a valuable tool if regulated properly to New York Superintendent Lawsky's belief that there should be a moratorium against them. She noted that his call for a moratorium was not adopted by the NAIC.

Laura Bazer (Moody's Investors

"We believe that in a stress situation, those assets are unlikely to be available to the ceding companies."

Service) told attendees that Moody's does consider the use of captives when it analyzes companies. "The ratings are relative, one company compared to another," she said, and all other things being equal, a company that does not use captives would be considered stronger financially than one that does. Bazer said that captives provided $400 billion of reserve credit to the industry in Moody's most recent analysis and added that they'd prefer to see traditional third-party reinsurers take on that risk.

"We believe that policyholders and creditors are at greater risk of loss because of the dependence on captives," Bazer explained, saying that risk doesn't truly leave the company in a captive structure and that regulations for captives are looser than those for traditional insurance companies. "We believe that in a stress situation, those assets are unlikely to be available to the ceding companies."

Schaefer, who (not surprisingly) agreed that third-party reinsurers are a better way to go, predicted that the widespread adoption of principle-based reserving (PBR) would lessen the reliance on captives. Commissioner Donegan agreed, saying "I think the path to PBR adoption in the states is inevitable." She added that PBR adoption will likely become part of the NAIC's accreditation process for state insurance departments.

A panel on insurance litigation revealed that the effects of the New York Department's report on "shadow insurance" weren't felt only by regulators—the legal world reacted as well, according to Sandra Hauser (Dentons). While Superintendent Lawsky didn't get much traction in the NAIC with his call for a moratorium on captives, "the plaintiffs' bar seized upon the report." In a case filed in New York, *Yale et al. v. AXA Life Insurance Company*, the plaintiffs sued the company for using "shadow insurance" to misrepresent its financial condition.

"You might wonder, where's the injury?" Hauser asked. "The plaintiffs' position is that there doesn't need to be an injury." Instead, the plaintiffs' attorneys, who are seeking class certification for the suit, have argued that a statutory penalty can be levied upon the company and shared by the class members. AXA has asked that the suit be dismissed, but Hauser warned attendees that "cases focusing on this kind of disclosure are going to be out there. We're going to see litigation regarding a company's financial stability."

We go now from shadows to death, in this case the Death Master File (DMF) and the recently minted "duty" that insurance companies are under to search the file for unreported deaths. Phillip Stano (Sutherland Asbill & Brennan) gave an update on litigation in this arena and, strangely enough, had some good news to report. In *Andrews v. Nationwide*, the Ohio Court of Appeals ruled that there's no duty to search the DMF. "*Andrews* did not make new case law, but it was the court ruling what everyone's been saying," Stano said. A ruling in another case, *Feingold v. John Hancock*, matched that in *Andrews*. "We still don't have a body of case law, but we have a trend."

Stano added that many regulators have been reluctant to clarify this and other unclaimed property issues, preferring to

Josh Gotbaum (PBGC), Wisconsin Insurance Commissioner Ted Nickel, Birny Birnbaum (Center for Economic Justice), and Vince Bodnar (Towers Watson) addressed pensions, retirement annuities, and LTC insurance in their panel on senior issues.

let the auditing firms conducting the inquiries take the lead. Nevertheless, he takes some encouragement in the recent trend in the rulings, and in the law itself. "This is not rocket science," he said. "The law is on the side of the insurance industry."

Jury Duty, Getting Older & Other Bummers

The law may be on the side of the insurance industry, but a presentation on juror perceptions of big business by Johanna Carrane and Christina Ouska of JuryScope made it clear that jurors sure aren't—not at first, anyway.

Any insurance company that finds itself in a courtroom should be aware that most jurors believe that "there's probably been some wrong done" if a case even makes it to trial, Carrane said. Perhaps more disturbing, "well over one-third of jurors believe their role is not necessarily to right a wrong, but to send a message to a wrongdoer." This, coupled with the bias many jurors have against big business in general (a bias, Ouska noted, that many of them aren't even aware they have), spells trouble for the industry in jury trials.

In addition to these hurdles, "the jury doesn't really understand insurance," Ouska said. "They have a vague understanding of what they've been through." In other words, jurors take their own experience with insurance—be it life, health, auto, etc.—and believe that all insurance companies operate the way their company did.

The good news, Carrane said, is that "jurors take their roles ridiculously seriously." She and Ouska offered a number of tips on weeding our potentially troublesome jurors in the *voir dire* process, but the key to success in the courtroom, Carrane said, is educating jurors on how the industry operates and on the specifics of the case while avoiding jargon and acronyms that will just confuse them even more. "Give the jury a reason to care," she added. "They want to be able to feel that they did the right thing."

Doing the right thing was the main topic of the presentation by Josh Gotbaum (Pension Benefit Guaranty Corporation) in a panel on senior issues hosted by Peter Gallanis (NOLHGA). Gotbaum noted that the needs of retirees are changing faster than the plans that serve them, adding that "unless there are changes, millions of people will be impoverished in retirement. But they won't know it till it's too late."

Gotbaum told attendees that while most private sector workers have no pension plan, the idea that pensions are a thing of the past is a myth. He noted that 75 million people are in defined-benefit plans, 36 million of them active workers. "There are still some things out there worth preserving," he said, while acknowledging that many companies are getting out of the pension business. "The buzzword is de-risking," he said, adding that "the reputable way is to use annuities. However, sadly, an increasing number of companies are doing lump sums." While this is often a bad move for retirees, who usually can't hope to match the returns they'd get from an annuity, Gotbaum noted that government policy actually makes it easier for companies to offer lump sums rather than annuities.

Gotbaum offered a variety of suggestions to improve the retirement market, such as encouraging the offering of hybrid plans that offer lifetime income options, allowing more flexibility in the retirement plans currently offered, and auto-enrollment in 401(k) and other plans. On a more basic note, he said, "we need to stop saying 'plan' and start saying 'save.'" The time to act, he stressed, is now. "This is coming. This is a major problem. What we do today will make or break retirement."

Wisconsin Commissioner Ted Nickel talked about the challenges facing regulators as the retirement market grows and changes. "We've seen the increased need for annuities now that pension plans are declining," he said, adding that insurance departments are doing their best to keep up with new products as well as suitability concerns and other issues and are working with the industry to do so. The twin concerns of regulators, he explained, are solvency and consumer protection.

"The buzzword is de-risking," Gotbaum said, adding that "the reputable way is to use annuities. However, sadly, an increasing number of companies are doing lump sums."

Birny Birnbaum (Center for Economic Justice) came at the regulatory issue from the consumer protection side. He promised attendees that he would try not to be too controversial before warning that the "massive shift" the industry has made from spreading mortality risk to creating investment returns presents dangers to consumers and the economy. "Bad products create systemic risk, even if the companies that sell them are not systemic," he said.

Birnbaum singled out contingent deferred annuities (CDAs) as a product that "results in fee harvesting rather than retirement security" and encourages consumers to seek out the riskiest investments for

the highest returns. "These products don't spread risk, they consolidate it," Birnbaum said, adding that in his opinion, "guaranty fund coverage should not extend to products offering investment guarantees."

Vince Bodnar (Towers Watson) provided a comprehensive overview of another area of intense interest to retirees: long-term care (LTC). "The need for LTC insurance is still there," he said. "Medicaid is becoming the primary way people are funding their LTC needs, and this is unsustainable."

Tracing the history of the LTC market, Bodnar said that "in 2004, we saw sales collapse" due to new regulatory requirements. The industry also became aware that people who bought LTC policies "kept them a lot longer than we thought." Companies are seeing very poor performance from their older products, he added.

Looking to the future, Bodnar predicted that the Baby Boomers are going to screw up LTC the way they've screwed up everything else (maybe not in so many words). "Baby Boomers have changed everything about society, and they're going to change how we receive LTC" he said, explaining that the Boomers simply won't settle for the old ways of receiving care and will demand new ones. The rise in assisted living facilities, and even assisted living facility cruise ships, is one sign of this changing market. Unfortunately, current products aren't priced to handle this level of care.

As the market has transformed to meet the needs of the Boomers (who are less risk averse and less interested in wealth transfer than the generations that preceded them), we're seeing the rise of what Bodnar called "LTC 2.0 products" such as annuity combos—annuities that offer an LTC benefit. "There's room for LTC 3.0, but there's a lot of regulatory resistance," he explained, adding that there's still cause for optimism. "I think innovation is really going to open up the market in the future."

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Teamwork & Taxes

In a panel discussion on single-state insolvencies, moderator Joel Glover (Lewis Roca Rothgerber) led participants through a spirited discussion of the challenges these smaller cases pose—until the panelists seized control of the panel and acted as their own moderator.

Before all control was lost, Lynda Loomis (Ohio Department of Insurance) said that one of the keys for everyone involved is having advance notice of an impending insolvency. "One of the things that's important to all of us is early warning," she said. "As a receiver, sometimes you don't get much notice at all." That notice is important, she added, because it's vital to learn as much as you can about the company and to sit down with the financial examiner—if you can. "It's crucial to have contact with the financial examiner who examined the company," she explained. "But it's not always possible."

Another benefit of early warning is that it allows you to identify key employees. "They know where the bodies are buried and where the hot files are," said Mike Marchman (Georgia Life & Health Insurance Guaranty Association). Retaining these key people is also important, because "you're not going to be able to bring in a whole team like in a multi-state insolvency," added Andrea Bowers (South Carolina Life & Accident & Health Insurance Guaranty Association).

With fewer resources at hand, it's vital for the guaranty association and the receiver to work together closely. Steve Durish (Ohio Life & Health Insurance Guaranty Association) noted that guaranty associations and receivers often split up duties, and Loomis agreed: "As long as you're working toward the same goal, I don't think anyone is going to quibble over who does what."

Guaranty association administrators are sometimes called on to act as the receiver in a single-state insolvency, and the arrangement doesn't present as many difficulties as you might expect. "I don't think it's a conflict of interest as much as a confluence of interest," said Marchman. "My board actually thought it was a great idea." Bowers agreed and pointed to the bottom line as one reason the arrangement works. "I think it's saved us a lot of money, and I think it's saved the state a lot of money."

In these smaller cases, as in larger ones, consumers only care about one thing. "If you're getting calls, they don't care if you're the receiver or the guaranty association," Durish said. "They want to know if their claim's getting paid."

Local politics, as well as local press, can play a role in the receivership. Loomis noted that the liquidator gets bad publicity in the state. "The liquidator pulled the plug and ended all those jobs," she said. "You have to give some early consideration to how you're going to minimize the damage." Bowers agreed, saying, "very early in the receivership, I issue a press release. When you're going to lose jobs, you have to let

people know what's going on and who's in charge."

No one's quite sure what's going on in Washington these days, but one thing we do know is that Congress is once again taking a run at simplifying the U.S. tax code, and Scott Lenz (New York Life) briefed attendees on what Congress has planned and on how big a hit the insurance industry would take if those plans ever come to fruition. The answer: a big one.

Johanna Carrane and Christina Ouska of JuryScope discussed the problems large corporations can face in the courtroom.

Lenz explained that the latest tax reform efforts are aimed at lowering corporate taxes ("doing business in the United States is more expensive that it is in the rest of the world," he noted) and bringing the tax code in line with how business operates today. "The nature of our economy has made it easier to be mobile and move to the cheapest place to do business," he said. "The tax rules have really not caught up with that."

With that in mind, the proposed tax code lowers the corporate tax rate from 35% to 25%. However, "with rates coming down, the base needs to be broadened to keep up with things from a revenue standpoint," Lenz said. That means changing how overseas entities are taxed. It also means changing how financial products are taxed, which is not good news for the insurance industry.

"We have three or four very significant proposals aimed right at us," Lenz said, mentioning a proposal to use a much higher discount rate in calculating reserves as well as another that effectively eliminates the dividends received deduction for assets in variable annuities. "Congress needs the money, and they have chosen to come at us a little harder than at other industries." ✭

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

NOLHGA Calendar of Events

2015

January 13–15	**MPC Meeting Clearwater, Florida**
March 29–April 1	NAIC Spring National Meeting Orlando, Florida
April 7–9	**MPC Meeting Austin, Texas**
July 21–22	**MPC Meeting San Francisco, California**
July 23–24	**NOLHGA's 23rd Legal Seminar San Francisco, California**
August 14–17	NAIC Summer National Meeting Chicago, Illinois
October 11–13	ACLI Annual Conference Chicago, Illinois
October 27	**MPC Meeting Baltimore, Maryland**
October 28–29	**NOLHGA's 32nd Annual Meeting Baltimore, Maryland**
November 19–22	NAIC Fall National Meeting Washington, D.C.

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