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"Everybody Was Caught Off Guard"

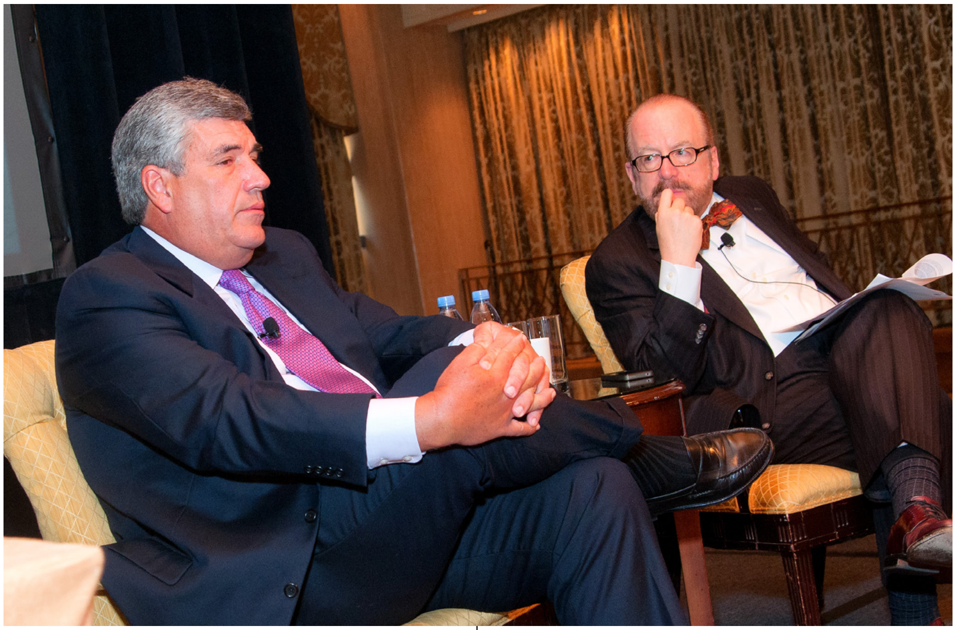
nolhga conversations

Bryan Marsal, the man who oversaw the bankruptcy of Lehman Brothers, discusses what unwinding a SIFI really entails

Bryan Marsal is the co-founder and co-CEO of Alvarez & Marsal (A&M), a leading global professional services firm that provides turnaround management, performance improvement, and business advisory services to clients spanning multiple industry sectors. With three decades of hands-on operational and financial experience, Mr. Marsal has been involved as an adviser or manager in high-profile, large-creditor cases and most recently served for three years as Chief Executive Officer of Lehman Brothers, overseeing the largest bankruptcy in history. (A&M continues to provide interim management support and asset management/recovery services to the estate.) He also served as Chief Restructuring Manager of Arthur Andersen. The following is an edited transcript of our conversation at NOLHGA's 2013 Legal Seminar on July 11.

Peter G. Gallanis

GALLANIS: *Many federal agencies are now involved in implementing a lot of the provisions of the Dodd-Frank bill. And Dodd-Frank, as everybody here knows, is the financial regulatory reform legislation that was passed in the wake of the financial crisis, and in the wake of a broad political consensus that we should avoid, if possible, again being in a situation where the government must choose between either "bailing out" a large, important financial company, or instead seeing a "disorderly bankruptcy" of a large financial institution.*



When the political and pundit classes looked at what happened in the financial crisis, there were two poster children for those scenarios. The poster child for the bailout that we want to avoid and never see happen again was AIG. And the poster child, in the minds of many people, for a disorderly bankruptcy was Lehman Brothers.

Now, you know more about that case than anyone else in the world. Viewed from the perspective of the stakeholders in the Lehman Brothers bankruptcy—creditors, employees, counterparties on various financial arrangements with Lehman—was the bankruptcy process considered generally satisfactory? Was it considered a good outcome, or was it considered a train wreck?

MARSAL: Oh, I think the outcome was a disappointing one for most people in that the kind of losses that were experienced by the Lehman creditors were pretty much unnecessary. The lack of planning by Lehman management and the inconsistency of the United States government resulted in a significant hit to the creditors of Lehman Brothers.

["NOLHGA Conversations" continues on page 11]

IN THIS ISSUE

Does "Big" Mean "Systemically Important?"

As the debates about SIFIs (systemically important financial institutions) and G-SIIs (globally systemically important insurers) wage on, some of the arguments advanced for designating large insurers as SIFIs (or G-SIIs) seem based on little more than the size of the companies in question: "They're so *huge*, they must be SIFIs." A second argument is also sometimes advanced, which is that budding troubles at a major insurer could lead to "run on the bank" behavior at that insurer, and possibly even infect other (presumably healthier) insurers.

Such arguments betray a fundamental misunderstanding, not just of the SIFI designation, but also of the regulatory and resolution mechanisms in place for insurance companies of all sizes, including large companies that do business around the globe.

In this column I would like to respond to some questions of this nature that have been raised about large insurers, how truly "systemically important" they may be, and the challenges they might pose for insurance regulators, receivers, and the guaranty system.

Q. Is there anything about the pure size of a very large U.S. life insurer that would make successful administration of the receivership of such a company operationally infeasible under current insurance resolution processes?

A. Size alone ought not to adversely affect receivership administration under current processes for several reasons. First, large insurer receiverships have been successfully managed before, and many of the same problems arising in an even larger case are problems that have already been successfully addressed. Second, the response systems of receivers and the guaranty system are scalable and readily augmented by the substantial operational and technical resources available within an insurance company itself and from the insurer's network of vendors. Third, the operational and technical resources of receivers and the guaranty system can also be augmented from a deep pool of available external resources (attorneys, actuaries, accountants, investment professionals, management consultants, etc.), as has been done in large bankruptcy cases of both financial and non-financial companies.

Q. Does the complexity of the largest insurers—for example, the centralization of non-insurance company operations outside the operating insurance entities—make the resolution of such companies infeasible under current insurance resolution processes?

A. Resolution of complex entities is always harder than resolution of non-complex entities, but similar challenges have been met in other large receiverships and could be met in even larger cases.

One item that is routinely the subject of regulators' focus as they monitor and plan for the potential failure of a significant insurer is securing access (e.g., contractually or through corporate reorganization) to resources and systems within an insurance holding group necessary for effective resolution of the subsidiary insurers. Even where that cannot be accomplished, insurers generally have some contractual rights to resources and systems that can serve (and have served in prior cases) as the basis for negotiating the continuation or cost-effective replacement of essential support.

More generally, complexity has been a common element of most large insurer failures, and even some smaller cases. Reinsurance is one typical manifestation of complexity issues. For example, Pine Top Insurance Company, a comparatively

Nothing in history supports speculation that troubles at one insurance company tend to provoke runs at other companies, and there is no material reason they should.

small, Illinois-domiciled property/casualty insurer, had a reinsurance and retrocessional network that involved more than 1,200 external counterparties on outbound and inbound reinsurance contracts. Although the ultimate resolution of all those relationships took time, because the nature of the contracts (like insurance contracts generally) did not require full resolution immediately upon liquidation, all the relationships ultimately were satisfactorily resolved.

Q. Are there special problems posed by large companies having overseas subsidiaries and affiliates that may be subject to resolution by foreign authorities in non-U.S. proceedings?

A. Multi-national entities pose various challenges under any form of resolution. One basic problem is that, while some jurisdictions have expressed a degree of openness to the concept of trans-jurisdictional financial *supervision*, many fewer have evinced serious interest in trans-jurisdictional *resolutions*. The established pattern is that entity resolutions occur at the national level. Cooperation accords show some promise, particularly with the leading "host" jurisdictions for financial services companies, but much progress remains to be made in this area.

The one significant life insurance company insolvency involving transnational issues was Confederation Life, which began receivership in 1994. The outcome of that case was quite successful for stakeholders, and agreement was reached on cooperative resolution strategies with the Canadian regulators, receivers, and guaranty system, although it took some time.

Concerns about transnational issues are somewhat mitigated by the fact that most insurance company liabilities (and supporting assets) are confined within separate legal entities in the domiciliary jurisdictions.

Q. Would the current resolution system be able, financially, to meet reasonable consumer expectations of protection in the event of the failure of a very large U.S. insurer?

A. While one can always postulate hypothetical outcomes to the contrary, realistically, the answer is "yes."

Assuming that the failure of the company in question is idiosyncratic—a "stand-alone" failure of that company at a time when the rest of the financial sector is operating relatively normally—then it is reasonable to assume several things, based on historical experience and established regulatory institutions and practices:

- That regulators will have foreseen the company's failure to some extent and done some advance resolution planning.
- That regulatory intervention will have occurred at a time when assets were reasonably close to the level of liabilities.
- That regulators, prospective receivers, and the guaranty system will have made provisions for operational and technical challenges (e.g., the consolidation of subsidiaries and support operations like what was done in the Reliance and Home situations).
- That, if necessary, either the company or the regulator (upon or prior to receivership) will have imposed a stay on voluntary surrenders and withdrawals.
- That an efficient plan will have been made for any necessary or prudent disposition of assets and liabilities.

Under those assumptions, the idiosyncratic failure of even the largest company should be susceptible of resolution with little or no loss to policyholders or other stakeholders (and therefore little or no financial burden on the guaranty system). Even if such a large company failed and assets were not available to cover 100% of liabilities to insurance policyholders (most of which would not be due and owing for some time after failure), the liabilities of the insurer could be stabilized (if necessary) through imposition of a moratorium on voluntary surrenders

The capacity limits of the guaranty system have never been remotely approached by the system's funding requirements—not during the recent financial crisis, nor in prior recessions.

and withdrawals. The guaranty system has aggregate assessment capacity in a given year of more than $10 billion[1] (an amount that "refreshes" each year and that has increased steadily for many years), and the capacity limits of the guaranty system have never been remotely approached by the system's funding requirements—not during the recent financial crisis, nor in prior recessions.

In addition, associations have the authority to borrow against the collateral of future assessments, and many have standing lines of credit with financial institutions. Guaranty associations also from time to time receive funding from significant recoveries on prior insolvencies in which they have creditor claims. Consequently, it is likely that the combination of estate assets and guaranty association funding (from assessments and other sources) would suffice to cover liabilities for the essential insurance promises coming due as a resolution progressed.

On the other hand, a failure of such a company that is caused by some sort of "common shock" to the overall financial system—perhaps accompanied by simultaneous failures of other large insurers—would pose a different set of problems. In that context, it should be recalled from both the recent financial crisis and prior systemic tests of the financial economy that insurers historically have been among the last financial companies to fail. The failures of one or more large insurers in such a period likely would have been preceded by many more failures of large banks, investment banking concerns, mutual funds, hedge funds, and the like. Under those circumstances, absent massive federal support to the financial sector, some level of consumer benefit restrictions or reductions likely would be visited across the financial sector. My personal belief is that the burden would fall least heavily on insurance consumers, since—of all financial institutions—insurers are most likely to be able to fund all or most of their essential commitments to consumers from assets available in their receivership "estates."

Q. Could large blocks of insurance or annuity business be effectively transferred from a very large failing insurer to other insurers?

A. Large blocks of business could be transferred, as evidenced by significant acquisitions of such blocks by Prudential, MetLife, and other carriers, even during the recent financial crisis.

Q. In terms of the effects of the failure of one of the largest U.S. insurers on "external" parties—parties other than consumers and creditors of the company itself—would the costs of guaranty association assessments to protect policyholders of that company be likely to cause the insolvency of other carriers?

A. Guaranty association assessments in such a case are highly unlikely to cause the insolvency of other insurers for several reasons. First, assessments are "capped" in most states at a level of 2% of applicable premium in any year. Second, most states have provisions permitting cost recovery of part or all of the assessments as offsets or reductions of taxes otherwise payable in the state. Finally, a guaranty association has the authority to abate assessments owed by a member company if the payment of an assessment would pose a solvency risk to that member company.

Q. What effects would the failure of such a company have on the assessment capacity of the guaranty system? Wouldn't all the insurance premiums of such a company be removed from the assessment capacity of the guaranty system in future years, thus increasing the burden on other carriers, diminishing the system's ability to respond to future insolvencies, or both?

A. The premiums that would have been written by a large insurer before its receivership do not simply disappear from the guaranty system's assessment base because of the company's receivership. In fact, as soon as the premium-paying business of that company is transferred to one or more healthy companies via assumption reinsurance, the premiums paid to the assuming company would replace (for assessment purposes) the premiums no longer being paid by the company entering liquidation.

Q. Would the insolvency of a very large U.S. life insurer prompt customer "runs" at other insurance companies because of significant benefit reductions at the subject company?

A. That scenario seems unlikely for several reasons.

First, I do not believe it to be possible that consumer insurance or annuity benefits in such an insolvency ever would be cut so significantly (to guaranty association limits or below)

The response systems of receivers and the guaranty system are scalable and readily augmented by the substantial operational and technical resources available within an insurance company itself and from the insurer's network of vendors.

to cause a widespread "run," even at the subject company. When a significant life insurance company fails, it always has substantial assets at the time of failure—often (though not always) in the range of 85% to 95% of liabilities to policyholders (which liabilities themselves mostly are not due and payable at the time of failure). Consequently, even if there were benefit reductions, the reductions would always recognize the amounts covered by the guaranty system and, even as to uncovered contracts (or excess-of-cap portions of contracts), would reflect the ratio of assets to liabilities available in the insolvency estate.

Second, nothing in history supports speculation that troubles at one insurance company tend to provoke runs at other companies, and there is no material reason they should. Life insurance companies in different insurance groups typically have few, if any, financial interconnections. Moreover, contractual features are likely to make most voluntary surrenders and withdrawals financially disadvantageous for the consumer. In addition, the insurance or annuity objective of having acquired the contract in the first place may be partially or entirely thwarted by such action, since it likely will be impossible to acquire comparable protection on comparable terms, particularly after incurring any applicable surrender or withdrawal penalties. Finally, the net effect of such behavior may be beneficial to the balance sheet of the company that issued the contracts.

I understand further from insurance regulators that surrender and withdrawal activity was closely monitored by regulators at all major insurance groups, both during the AIG crisis of September 2008 and during the precipitous stock market decline of early 2009, and I have been advised that in neither case did bad financial news at any company appear to have a substantial impact on voluntary surrenders and withdrawals at other companies.

Finally, because it is fairly well known that insurers tend to be the last financial companies to suffer materially in financial crises, I believe it reasonable to expect that not only would there be little voluntary consumer flight *from* the insurance industry, but rather—at least in a systemic crisis—there might in fact be some flight *to* conservative products offered by financially conservative insurers. There is some anecdotal evidence that this in fact happened during the recent crisis.

Conclusion

No one would welcome the news of financial problems developing within a very large U.S. life insurance company. The good news, though, is that such a development is unlikely to occur in the first place, given the conservative nature of the industry and an effective regulatory regime. However, if a large life insurer were ever to fail, there is ample reason to believe that the current receivership and guaranty system would be able to protect consumers as they have done in the past.

End Note

1. The actual aggregate assessment capacity varies from year to year (usually increasing over time) and is comprised in most years of an amount available for health claims (usually slightly less than half), and amounts available for life and annuity claims. In most states, shortfalls in amounts assessable in the annuity account may be made up from amounts assessable in the life account, and vice versa; neither life nor annuity assessments are available for health claims, nor are health assessments available for life or annuity claims. ✭

Peter G. Gallanis is President of NOLHGA.

DEEP Dish

NOLHGA's 2013 Legal Seminar gets to the bottom of regulatory modernization, new trends in the insurance industry, and a lot more

By Sean M. McKenna

Chicago means different things to different people. Great music. Delicious pizza. Distasteful politics. A great rock band that lost its way in the 1980s. A proud sports tradition that doesn't involve the Cubs. "Hog Butcher for the World."

Once every few years, Chicago also means "the best place to learn about trends in the insurance industry and receivership arena." This was one of those years, as the Windy City played host to NOLHGA's 2013 Legal Seminar. Nearly 200 people (lawyers and those who love them) came to Chicago to hear leaders from industry, the state regulatory community, the federal government, and private practice offer insights into the future of insurance regulation, the likely impact of the Affordable Care Act on the health insurance market, and a host of other issues.

Regulation on the Menu

Regulatory modernization is always a popular item at Legal Seminars, and this year's meeting was no exception. The panel discussion *Regulatory/Receivership Modernization After Dodd-Frank* tackled issues such as systemically important financial institutions (SIFIs), the Dodd-Frank Act's orderly liquidation authority (OLA), and more.

Moderator Charles Richardson (Faegre Baker Daniels) set the stage for the panelists by reminding attendees that any discussion of the impact of the Dodd-Frank Act was in some ways premature, since "many studies and rules mandated by Dodd-Frank are not finished," including the long-awaited report on regulatory modernization from the Federal Insurance Office (FIO).

Douglas Baird (University of Chicago Law School) criticized the Dodd-Frank Act's OLA powers as "essentially fighting the last war" and doing so too slowly: "The activating time for OLA is too long." He added that while the failure of Lehman Brothers "taught us that bankruptcy cannot always handle systemic problems," the next financial crisis "won't be Lehman, and this law won't be much good."

Although SIFI status has already been proposed for a few insurance companies, Cynthia Shoss (Sutherland, Asbill & Brennan) expressed doubt as to whether any insurers merited the designation. "I'm not persuaded we've been shown how or why the financial instability of an insurer could threaten the United States," she said. She expressed hope that a few years from now, those few insurers who may be so designated will have been purged from the SIFI rolls, though she acknowledged that the opposite could happen, with more insurers added.

Shoss also praised the progress made by insurance regulators over the past few years. "Since the financial crisis, the NAIC and state insurance regulators have definitely upped their game," she said, pointing to work done on the Solvency Modernization Initiative and international matters.

John Simonson (FDIC Office of Complex Financial Institutions) praised the Dodd-Frank Act's "living will" requirement for SIFIS, saying that the process has been valuable in highlighting potential problems that might otherwise have been overlooked. "You don't know what you don't know," he explained. "Where can things break down in a failure?"

The keys to any resolution of a complex financial entity, he added, are information and proper planning: "In the new Dodd-Frank world, you've got planning by the company and then the FDIC's planning." That planning is also taking place on the international level, as the FDIC contemplates what could be required to take down an international holding company. "One really big change from the

FDIC's perspective is the dialogue internationally," he said, as the FDIC works with international counterparts to discuss strategies and build relationships before a crisis arises.

Susan Voss (former NAIC President and Iowa Insurance Commissioner) followed up on Simonson's comments when she noted that "there's nothing like a crisis to make regulators work together." Currently, though, "we're sort of in a holding pattern" as regulators wait for the FIO report on regulatory modernization as well as the federal regulations that Richardson alluded to at the start of the presentation. "Let's get the report out and find out what FIO thinks," Voss said. "At the end of the day, the state regulators are going to need the feds for some things, and vice versa."

International Fare

In his remarks at the seminar, FIO Director Michael McRaith indicated that the report on regulatory modernization would be released in the summer or shortly thereafter. He added that "notably, the question is not 'whether,' it's how" insurance regulation needs to be modernized.

Director McRaith also reported on the FIO's international activities, which have focused on the International Association of Insurance Supervisors (IAIS) Common Framework (ComFrame), the Solvency II equivalency assessment of insurance regulation, and other matters. This international focus, he explained, is being driven by market forces, as premium volume in emerging markets is "exploding."

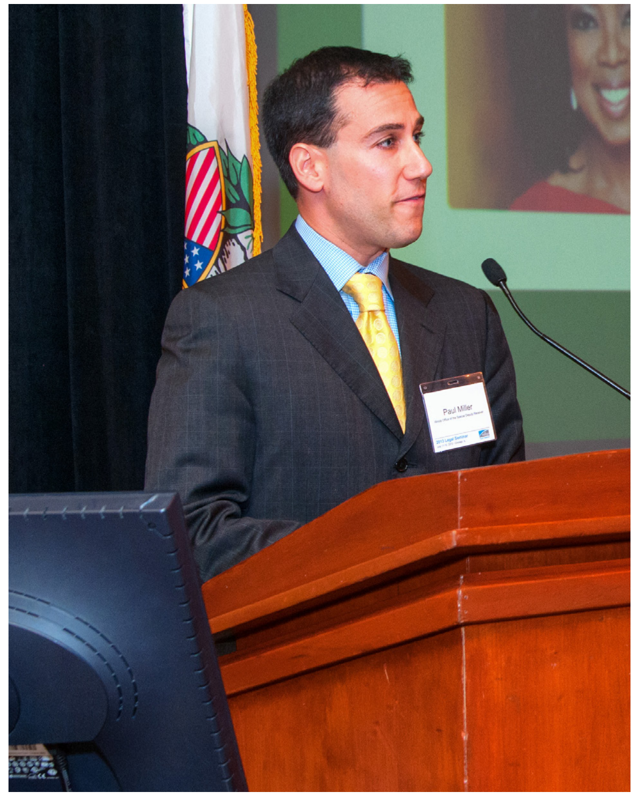
"The world is changing," Director McRaith said. "And in my view, as a country we need to not only be involved in that change. We need to lead that change." In the Solvency II debate about whether the U.S. regulatory structure will be deemed "equivalent" to the Solvency II requirements, the FIO worked to "build a path forward for the EU and U.S. regulatory regimes," eventually negotiating an agreement that it's in both groups' best interests to work together.

Director McRaith also offered his opinion on the debate over ComFrame (a template for the supervision of internationally active insurance groups), saying simply, "ComFrame is inevitable." He added that the work done with the IAIS by both the FIO and state insurance regulators has resulted in significant progress toward a principles-based regulatory approach, but with some specific measurables included in the template.

Director McRaith closed by saying that the failure of a globally significant entity would have such a great impact on so many countries that "these are ultimately not regulatory issues—they're political." Without the participation of political leaders in the relevant countries, he added, no resolution will be possible.

Complicated Recipe

Politics has also been known to play a role in health-care reform, the topic of the panel discussion *Obamacare, Health Insurance, and the Provision of Healthcare Services*. Kim Holland (Blue Cross and Blue Shield Association and a former Oklahoma Insurance Commissioner) reported that "the challenges insurers are facing with the Affordable Care Act are enormous, and they're getting bigger." With open enrollment in the insurance exchanges fewer than 80 days away at the time of the seminar, Holland said that



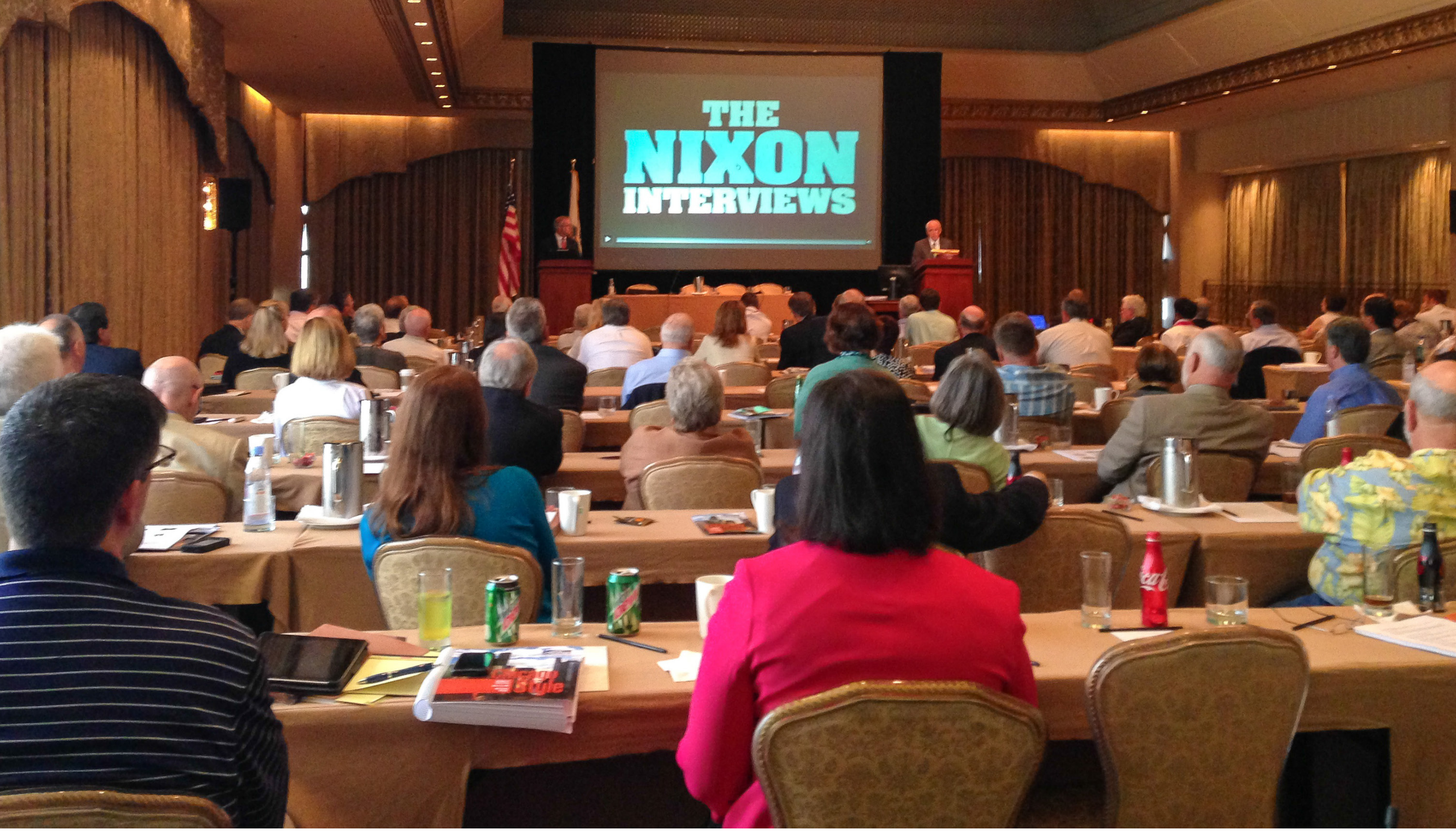
Paul Miller, with the Illinois Office of the Special Deputy Receiver, offered attendees an overview of the fiscal situation in Illinois, which is facing a "crushing pension problem" and increasing labor and health-care costs. He also spoke of recent regulatory successes, notably the Lumbermens Mutual Casualty Company liquidation, which he said offered "a lot of positive take-aways for future receiverships."

the most immediate concerns are operational—companies are working to bring their legacy systems in line with new federal systems that aren't up and running yet. "We have to continue to move forward," she added. "But the closer we get, the rules change."

The key question facing the exchanges, Holland noted, is whether young people will sign up or risk the modest penalty they could pay for not doing so. "They're not buying today," she explained. "Are they going to buy tomorrow when there's a minimal penalty that probably won't be enforced?" Another pressing issue for insurers, she added, is that the federal government will run well over half the state exchanges. "We're facing the reality that we now have a federal regulator," Holland said.

Despite these pressures, the companies have no choice but to move ahead. "Our best approach is to consider this an evolution and not a revolution," Holland said. "We can't survive if we do nothing. The costs are too extraordinary."

Norman G. Tabler Jr. (Faegre Baker Daniels), who previously served as General Counsel for Indiana University Health (a system that encompassed 19 hospitals and 29,000 employees), noted that changes in the health-care market aren't limited to insurers.



Former White House Counsel John Dean and James Robenalt (Thompson Hine) conducted a presentation on how Watergate changed legal ethics.

"Components of the health-care delivery system are rapidly integrating together on the provider side," Tabler said, which is a radical change from the days when hospitals had no relationship with doctors and other groups.

"Providers are taking on more and more risk," Tabler added, by offering to oversee the care of a particular population for a specified amount. The less care that population needs, the better the hospital does financially. "Ideally, the people don't become patients," Tabler said. This change has brought with it a focus on wellness and health management—a more proactive approach than the traditional health-care model.

More and more payers are paying on the basis of the quality of the care and the outcomes of the treatment. This is generally a good development, Tabler said, "but the wildcard in all this is that it depends on compliance by patients. In general, Americans have an abysmal record of patient compliance." Under the Affordable Care Act, however, hospitals will pay a penalty for repeat admissions.

William Lape (R&Q Solutions, LLC) added that there's been a change in how different players approach risk. "Partially because of Obamacare and partially because of market forces, all the payers are trying to get out of the risk-taking business and all the providers are trying to get in," he said. He also noted that an analysis of the health-care system can't focus solely on the role of the federal government, or any one factor. "Health care is not a linear supply chain," he explained. "It's a complex economic matrix. You can't push one part of it without something popping up somewhere else."

Lape added that private equity firms are "lining up" to find ways to make money on health care, and he predicted a change in the way that care will be provided. "You're going to see new products and services, and people are going to be taken care of in a different way," he said, including a focus on less-expensive treatments that still prove effective. He also predicted that most U.S. companies would not take extreme steps to avoid complying with new Affordable Care Act provisions. ""Employers still look at health care as a recruiting tool," he said.

Trouble Brewing?

Private equity was a key theme in another presentation, *Captive Reinsurance, New Equity Investors, and Solvency Concerns*. NOLHGA President Peter Gallanis, who served as moderator, noted the recent report from the New York Department of Financial Services that referred to captive insurers as "shadow insurance" that raised solvency concerns and also called for a moratorium on creating new captives.

David Alberts (Mayer Brown) defended captives, calling them

Legal Seminar Materials

Meeting materials from NOLHGA's 2013 Legal Seminar (slides, background materials, and speaker biographies) can be accessed at www.nolhga.com/2013LSDocs.cfm.

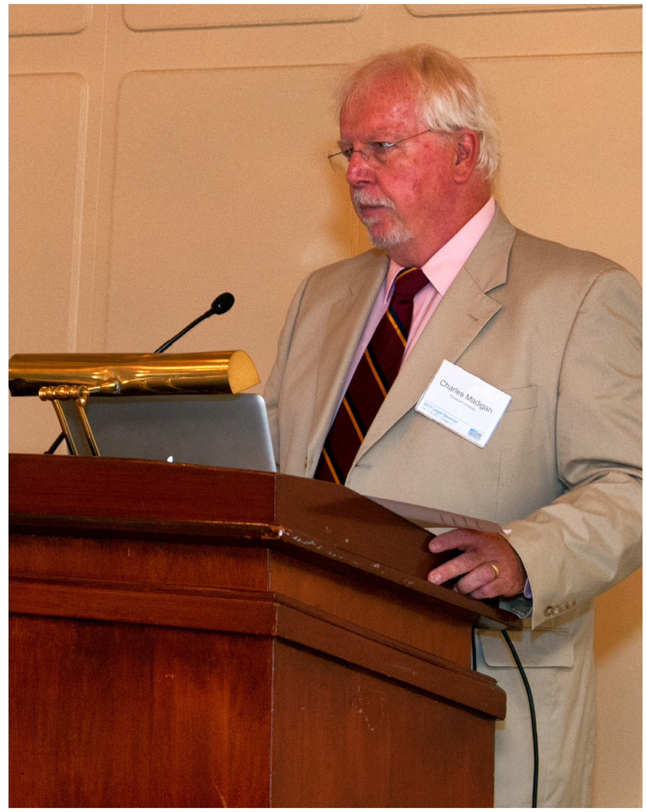
"a significant sector for the life insurance industry," and said that eliminating captives "could exacerbate the solvency concerns" raised in the report. He explained that life insurance companies face redundant reserve requirements, adding that "companies have been pretty aggressive in finding ways to finance these reserves." One such way is the formation of a captive insurance company that takes on one or more blocks of business.

Keith Andruschak (Mayer Brown) said that the use of captives began about 10 to 15 years ago, but the recent financial crisis "took away the market solution to the need to fund this excess reserve portion." Companies are continuing to self-fund their reserves and seek financing for the redundant reserves. "The process brings into the life insurance sector third-party capital commitments that otherwise wouldn't be there."

Christina Urias (Christina Urias Consulting and a former Arizona Insurance Director) disagreed with the New York report's "shadow insurance" charge, saying that state regulators "are very much aware of these captive structures. We know about these. We regulate them. But there are problems." She added that although 35 states host captives, "there's no uniformity" in the laws governing them. The NAIC needs to modify reserving rules and also work on the uniformity issue. "You don't want these new structures to be an avoidance of statutory principles," she said.

When talk turned to the influx of private equity firms into the annuity industry, Jim Mumford (Iowa Insurance Division and a former NOLHGA Board Chair) said that captives and private equity firms are "just another evolution in the insurance world, and you have to look at them with an open and investigative mind."

Mumford reported that the Iowa Insurance Division has spent the past year analyzing the proposed purchase of a domestic insurer by a private equity firm, adding that "the Apollo/Aviva transaction will be a case study at the NAIC." Private equity firms, Mumford noted," say they have better expertise than insurance companies in investments, and they do in certain investments." One area where these deals raise concerns, he added, is with ratings. Lower-rated companies are selling more and more annuities, which could lead to solvency worries.



Luncheon speaker Prof. Charles Madigan recounted the history of the ***Chicago Tribune*** *under the ownership of Colonel McCormick, an eccentric but pioneering leader who "knew what technology was and how to use it before anyone else."*

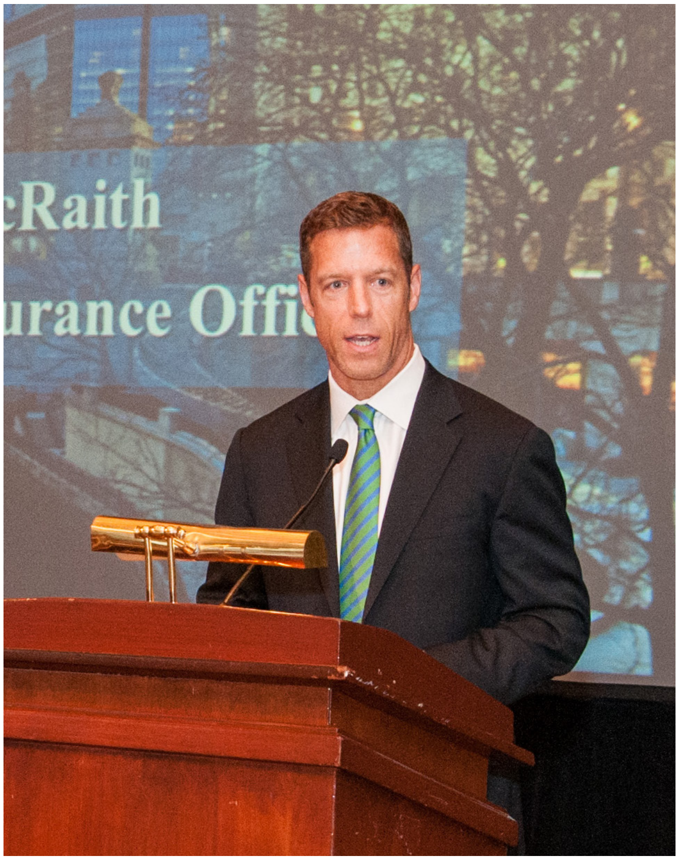
Order in the Court

Insurance companies have worries of their own, of course, and the *Insurance Litigation* presentation addressed two major ones: unclaimed property and cost-of-insurance litigation. Phillip Stano (Sutherland, Asbill & Brennan) gave an overview of the unclaimed property issue, and it wasn't pretty. "We are in a regulatory 'new normal,'" Stano said. "We have regulation by settlement or by litigation." The danger of either, he added, lies in "setting the precedent to establish a new regulatory requirement that has no basis in the law."

Stano said that as many large insurance companies have reached settlements with insurance regulators, regulators and the auditing firms they use to conduct unclaimed property audits are now turning to mid-sized insurers. He added that there are three kinds of insurance companies in America: those that have settled, those that are under audit or litigation, and those that will soon be under audit or litigation. "The states have an incentive to grab more unclaimed property money, knowing that most of it can't be paid to beneficiaries," he explained.

Companies do have some recourse, Stano said, such as entering into voluntary disclosure agreements or requesting remediation (which involves applying auditors' criteria to your own books to see how many matches arise, and how many of those are valid). Companies can also pursue a claims-only approach—limiting the audit to those policies that are due benefits, rather than all policies (which auditors will request). As more and more companies agree to check their records for unclaimed property, Stano said, the requirement to do so could trickle down to other groups. Guaranty associations "are going to run into this issue more and more. It should be on your 'to-do' list when you acquire a company."

Wilson Barmeyer (Sutherland, Asbill & Brennan) provided attendees with a primer on cost-of-insurance (COI) litigation, noting that there are currently more than 20 COI class-action suits. "Companies have built-in discretion to change their rates" if actuarial assumptions prove incorrect, Barmeyer said. "But



FIO Director Michael McRaith

increases create a potential risk of litigation."

The litigation hinges on the contention that companies can only raise rates if mortality projections are off—under this rationale, financial factors cannot be used as a justification for rate increases. Policy language, Barmeyer said, differs on COI and what elements factor into it. "Given the variance in contract language, it's not surprising there have been different judicial outcomes," he added. Some companies have settled suits by agreeing to roll back part of the rate increase or by agreeing not to raise rates for a specified period of time. "Courts are really taking a hard look at rate increases," he said. "Clear contractual language is really key."

The courtroom served as the backdrop for another presentation, *Liquidation Courts/Jurisdictional Issues*. Moderator Joel Glover (Lewis Rocca Rothgerber) set the stage by recounting a case he'd argued years ago in which a debate arose over proper jurisdiction: bankruptcy court or liquidation court?

The Honorable Michael Romero (U.S. Bankruptcy Court), who presided over that case, spoke about the issues judges consider when jurisdictional questions arise. In that case, "we had two courts that conceivably had conflicting goals," he said, since bankruptcy courts and receivership courts have different priority schemes. He detailed the three tests used to determine whether an entity is a domestic insurance company and also described other criteria (such as abstention) used to determine the proper venue for a contested case.

"If there are other creditors outside of policyholders, they're very interested in having the case adjudicated in bankruptcy court," Judge Romero said, citing the policyholder priority in liquidation court. If there are overlapping claims, he added, "there's going to be an interaction between the courts" to determine which rules first.

The Honorable Peter Flynn (Illinois Circuit Court) commented that "the one thing you want to have in a delinquency hearing is one-stop shopping. You can't do that if the hearing can be fragmented among competing jurisdictions." He added that a beneficial side-effect of jurisdictional issues can be the added expertise of another court: "I relish having someone on board who knows what they're doing."

When courts find it necessary to work together, there's a natural comity among judges that helps ease the process, Judge Flynn said. "Communication between judges is extremely effective. I don't know any judge who doesn't have, tattooed on his eyelids, the phrase 'what goes around comes around.'"

That phrase must have slipped Glover's mind when he asked his colleague Cindy Oliver (Lewis Rocca Rothgerber) to join the panel. After beginning her presentation with a few jokes at his expense, Oliver described a recent case in which the former owner of a liquidated insurer filed suit in another state 15 years after liquidation in an attempt to gain control of the assets left in the estate. While that case was dismissed, jurisdictional issues "are sometimes far more complicated," Oliver said.

Adding the Tax

No Legal Seminar would be complete without a look at tax reform and how depressing it is that political leaders can't agree on anything, which made it even more surprising when Evan Migdail (DLA Piper) began his presentation by saying that the Chairs of the two congressional tax writing committees—Rep. Dave Camp (R-MI), who heads the House Ways and Means Committee, and Sen. Max Baucus (D-MT), who heads the Senate Finance Committee—are both intent on simplifying the tax code. They're also both retiring, which is actually a good thing, since it makes them somewhat immune to the political pressures that a campaign can bring.

Even with this encouraging development, Migdail warned attendees not to get their hopes up. "There are enormous impediments to getting this thing done," he said, including the need for bipartisan consensus and the President's apparent lack of interest in the subject. More than that, "tax reform has winners and losers, and no one wants to take responsibility for the losers."

The primary impediment, though, is the "philosophical divide" between Republicans and Democrats. Even though both parties agree on some tax issues, "Democrats absolutely insist tax reform should increase revenues," Migdail said, while Republicans insist it be revenue-neutral. "That divide is enormous."

Guggenheim Partners President Todd Boehly discussed his company's perspective on insurance company acquisitions and some of the risks facing the industry. "We don't think of ourselves as a private equity firm," he said. "We're not short-term focused and we're not concerned with the traditional things that private equity would be concerned about—wanting to sell."

While tax reform is unlikely, the risk to the life insurance industry of taxation of inside buildup and other insurance benefits is still real. "All the issues we care about are seen in one way or another as tax expenditures," Migdail said. Once any reform is proposed and moves out of the committee, it's "memorialized" in that it will most likely be revisited any time Congress needs money. "You have to be vigilant even if you don't think tax reform is likely," he warned. ✯

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

["NOLHGA Conversations" continues from page 1]

Once the bankruptcy occurred, however, I think it was actually a poster child for the way in which a bankruptcy proceeding of a large, complex case should be managed. The judge in question, Judge Peck, recognized that it is not appropriate to dispose of assets in a highly illiquid market. It's a market where the distressed hedge funds will run around and tell you that my return is 20% to 25%; therefore, you've got to give me the property. That kind of a market just didn't make sense for Lehman Brothers in 2008–2009. Instead, we attempted to do our net present value calculation and actually apply more normal discount factors.

As it turned out, we were right. The estate is going to realize in the neighborhood of $70 to $75 billion of recoverable assets from the illiquid assets, as opposed to the $20 billion we had when we started the process in late September 2008.

So I think the bankruptcy result was good. I think the way in which Lehman's management, the U.S. Treasury, and many of the Lehman banks handled the matter resulted in a significant hurt to many of the pension funds and stakeholders in the United States. It was totally unnecessary.

GALLANIS: *When people think about the problems of the Lehman Brothers failure, they sometimes confuse two things. On the one hand, there is the actual bankruptcy proceeding itself, which in the eyes of many bankruptcy and insolvency practitioners, and given the circumstances of the case, turned out reasonably well. But on the other hand, there was the reaction of the financial markets to the news that Lehman Brothers was not going to be rescued in that second week of September 2008.*

Everybody here remembers that the reaction in the financial markets was, across the board, one of surprise, bordering on horror. Stock prices fell, the fear index spiked, liquidity for financial institutions from their liquidity providers pretty much dried up. It was not the reaction that was expected. I think maybe what I'm hearing you say is that the government's decision not to rescue Lehman wasn't what was expected, even by (or especially by) Lehman's own management.

I showed up at 8:30 the next morning, and people with boxes were coming out of the building. I said, "Oh, my God."

MARSAL: No. I was watching Sunday Night Football in my den, and my wife leaves me alone during those periods of insanity. Even the dogs leave me alone. So throughout the evening, we got a couple of phone calls from the board of Lehman. My wife neglected to tell me it was the board of Lehman; I hadn't spoken to Lehman. Finally, one of the members of the board called one of my partners, saying "I'd like to try and get ahold of Marsal. He's not available, and the board is sitting around waiting to talk to him."

So then I called the board. It's about 10:30 or 10:45 Sunday evening, and I had no idea this was going to happen. They said, "We'd like to talk to you about coming in tomorrow and taking over the company." I said, "Okay. Can I ask a few questions before we get into that?" They go, "Sure." I said, "How much planning has gone into this?" And the answer was "This is the first phone call." I said, "Oh, that's kind of tough. How much time do I have?" "Two hours. We're going to be filing before the London markets open."

["NOLHGA Conversations" continues on page 12]

[“NOLHGA Conversations” continues from page 11]

And then I asked the most important question, as you know, to a consultant: “How much cash do we have?” And they said, “None. It’s all been swept by the banks.” So the three most important questions—the planning, timing, and cash—we came up with a goose egg. But being a smart man—I mean a smart consultant—I said “I’ll take the job.”

I showed up at 8:30 the next morning, and people with boxes were coming out of the building. I said, “Oh, my God.” Four days later, all the people, the operating businesses, the building and all the infrastructure of the business were sold to Barclays. So we had $650 billion worth of assets and no people on the fourth day.

Capitalism works because of greed and fear. You take away the fear, don’t be surprised if you get a Lehman.

GALLANIS: *Because they were all gone to Barclays.*

MARSAL: They all went to Barclays. Barclays had 90 days to decide whether or not they wanted to hire the people. Of course, I didn’t know what the hell I was going to do for the 90 days, but we attempted to put a team together, which we did. We put a team together and just attempted to, first and foremost, preserve records. We figured if we had the records, we could track down who owed us money or who we owed money to. And so the records, the accounting system, the infrastructure—that was the first order of business.

It took us about 90 days to get the records squared away. One of the problems that you discover with a global entity is that we had information system centers in the U.K., the U.S., Japan, and then the largest center was in India. Well, what happens in a bankruptcy is that, in many countries throughout Asia and in Europe, if you are out of cash, then the officers and directors of that entity become personally liable. So what happens, if it’s evident that there may not be cash, there’s a panic on the part of the local representation. Either they resign, or they run down, if you would, to the local judge and ask for a receiver. And once a receiver is hired, the walls go up. No information flow goes out of there. It will take you at least three months to get through to people that you’re trying to preserve assets.

So one of the dangers of a global entity is that these walls go up and you really don’t have access to your basic financial information. We didn’t know for 90 days who we owed money to or what assets were ours, what loans were ours, as we tried to reconstruct.

GALLANIS: *If I’m following your narrative, essentially what happened was almost as though Lehman had been “neutron-bombed.” You had the facility. You had some records. You had some systems. But basically you didn’t have any people, so they needed to be replaced. And then on the other hand, Lehman being a very complex international organization, you also were suddenly encountering problems getting at least information and maybe other things from the business centers elsewhere in the world.*

MARSAL: That’s correct. They were under different receivers. The walls went up. Literally, no cooperation until they stabilized their situation, and then and only then would they release assets. I mean we had books and records, but they were as of August 31. So we had the last month in, but we didn’t have beyond that.

GALLANIS: *How did you solve the people problem in the U.S.?*

MARSAL: Well, we ended up bringing in, at the peak, about 600 people; 200 of them came from Alvarez & Marsal. We stripped them out of every available unit we could, because the need was desperate.

And the people who were at Barclays were just given 90 days. We were not party to that agreement. If we had been, we would have had some of the people much sooner. But we then proceeded to recruit from Wall Street, and we recruited from those individuals whom Barclays let go.

We brought our staff down to anywhere from 100 to 75 people within six months, and we backfilled the positions with people from Wall Street or with former Lehman employees.

GALLANIS: *Did Lehman have a big book of derivatives contracts where the counterparties with Lehman were in a position to close them out on short or no notice?*

MARSAL: Lehman had 1.2 million derivative contracts, with a notional value of $39 trillion. That was what the Fed and the Treasury did not understand—the worldwide implications of the derivative book. That was grossly underestimated in terms of the systemic breakdown.

GALLANIS: *I know you could probably talk about this for hours. I’m going to ask you to tell us, if you can, in a minute or two, in general terms, what your approach was to getting your arms around those problems, and then how it turned out for Lehman and the counterparties?*

MARSAL: Well, what Lehman experienced—which is what the members of this audience who are in the derivative business are going to be driven crazy by, ultimately by the FDIC—is that Lehman, like everybody else on Wall Street and every major bank, ran its business like an operating entity. And the operating people really didn’t care what the legal entity structure was; they were indifferent to that.

So what you’d do at the end of the night, you’d stuff a contract where you wanted to stuff a contract for tax purposes or for capital allocation purposes, and the boss of the unit didn’t really care. He left that to somebody else to figure out where that gets allocated. The only problem is that Lehman actually had a matched book…

GALLANIS: *Please tell us what you mean by “matched book.”*

MARSAL: A matched book would be if the Bears were playing the Giants. You bet with the bookie—Lehman—$100 on the Bears, and somebody else bets $100 on the Giants. So the bookie has

They thought there would be an orderly wind-down a la Bear Stearns. And it didn't happen.

both sides of a bet. What's going to happen is the guy who wins is going to get paid the $100, and meanwhile the bookie is going to get his vig, which is 10%.

GALLANIS: *So you're not taking a big credit risk on one side or the other side of the derivative position.*

MARSAL: Well, Lehman didn't, but AIG did.

GALLANIS: *You anticipated my next question. It sounds like the derivatives book at Lehman was very different than the book at AIG.*

MARSAL: It was, but it turned out to be a disaster. Let's say you're a German company and you want to lock up dollars, and then you're a U.S. company and you want to lock up euros. And so you do a million-dollar trade on each side, but you'd say, "Well, I've got a matched book. I'm going to get a fee for providing the service." The only problem is, one contract was booked in the Lehman subsidiary in Germany; the other was booked in the U.S. subsidiary.

So what happened was, there was a complete disregard for the legal entity implications of the business trade. So when the walls went up, Germany did its thing and the U.S. did its thing, so what you had was the worst of both worlds. If you were a receivable, good luck collecting. If you were a payable, you were going to get four times what you should have gotten. You got the worst of all worlds.

So one of the things that you're going to find that's coming down the pike is that when you write a derivatives contract, it's got to be in the same legal entity. To really have a matched book, you have to have both sides of the contract in the same legal entity.

GALLANIS: *On that legal entity point, you mentioned that one challenge when you got in there was that Lehman ran its business the way most people run businesses—by business lines. But the business lines were not lined up with the legal entity lines. That can be harmless while things are going well, but if you hit the wall and there's a need to disentangle all the relationships, the relationships end up getting disentangled on the basis of legal entities.*

MARSAL: Right.

GALLANIS: *Did Lehman have any sort of a break-the-glass plan for what would happen if Mr. Fuld didn't get his so-called "Jamie deal"? {i.e., a federally supported disposition, like the disposition of Bear Stearns to J.P. Morgan, which was and is led by CEO Jamie Dimon.}*

MARSAL: It wasn't even a consideration. There was nobody at Lehman who believed it could happen—and there was no reason to believe it, by the way. I came in and I was baffled. I said, "How can so

["NOLHGA Conversations" continues on page 14]

["NOLHGA Conversations" continues from page 13]

many smart people not have done any planning?" And fundamentally it was because of Bear Stearns. One of the key lessons that comes out of this is that the government must be consistent in its administration. Capitalism works, as long as people understand what the rules are.

In this case, they thought there would be an orderly wind-down a la Bear Stearns. And it didn't happen. So everybody was caught off guard; there was no break-the-glass plan. There was no contingency planning being done.

GALLANIS: *The expectations that were raised by Bear Stearns, and even before that by Northern Rock in England, were that actions would be taken by sovereign governments; and so markets expected that, if a big financial entity got in trouble, the government would be there with money to bail it out. It was a huge shock when that didn't happen with Lehman, and the markets reacted badly to the Lehman bankruptcy filing. Might that market reaction have been a key reason why the AIG bailout took place?*

MARSAL: I think AIG was bailed out because they realized that we were going into the toilet. I mean, the night of Lehman's bankruptcy, Jamie Dimon of J.P. Morgan called a board meeting in which he asked his board if he could withdraw cash so that he could pay the employees. Because he was concerned that in the next week there would be at least four institutions that would be closing their doors, and the last time this happened a bank holiday was declared. When a bank holiday is declared, as the people of Cyprus now know, you can't get money out of the bank.

He was convinced that there was going to be a meltdown of the economic system, and he wanted to see that his employees at least had cash to be able to operate in a credit-less society for a period of time. That's how serious it was that night, if people have any question about it. And his board granted him the right.

GALLANIS: *So Lehman didn't have a break-the-glass plan. And part of what Dodd-Frank will impose on SIFIs, and I think part of what at least some insurance commissioners are going to be expecting in a slightly different way of larger insurance companies, is a living will or a break-the-glass plan or some way of foreseeing how the response should be developed if there are financial problems at a company. I have a sense that, even if only from your personal experience with Lehman and Arthur Andersen, you're becoming a believer in that sort of a planning.*

MARSAL: Well, within degrees, but I think right now the government is overdoing it. When you talk about a living will, there are really two aspects to it. One, the FDIC is asking companies to do an enterprise risk management assessment. Look at your business and say, "Where am I vulnerable?" Do an Honest John on your business; that's actually a pretty healthy exercise. Where am I vulnerable in terms of systems? Where are my operating and legal entities not lining up? How have I been doing on risk management guidelines? For example, Lehman had an asset concentration in real estate; it had a guideline. The board had established this risk management guideline: how much of its assets would be established in real estate. What would be invested in real estate?

When Lehman started to hunt, what happened is the real estate department would say, "We've got to do this deal. We've got to do this deal." So suddenly the risk management guideline on real estate concentration was exceeded. What did Lehman do? Lehman simply adjusted the risk management guideline upward for it. As a board member, you should want to know that, and you should want to understand how we're managing our risk.

The second thing is the contingency plan, which is your road map if in fact a resolution is required. You can do a zillion hypotheticals about this happening or that happening, so that to me is a bit nonsensical. But the first part of the exercise, which is the living will part, I think is pretty doggone useful and in fact would be one that I would say almost every company and every board—forget just about financial institutions—ought to be asking itself.

Your auditors look at your financials, and they tell you whether you're following generally accepted accounting principles. Well, how do you ever assess operating risk? How do you know that management is really operating within the thresholds that you agreed to? And that, I think, is what the FDIC is asking. Are you really managing your risk, or are you just talking about it, like Lehman did?

GALLANIS: *We're in a somewhat different legal and regulatory environment now than the one that we were in as the financial crisis unfolded. The main difference legally is that we now have Dodd-Frank, and we now have a process by which systemically risky companies are supposed to be identified, and that's actually beginning to happen. Dodd-Frank also created a so-called orderly liquidation authority under the supervision and control of the FDIC. Entities that have been designated as SIFIs would be subject to special provisions for the resolution of those entities*

Lehman had 1.2 million derivative contracts, with a notional value of $39 trillion. That was what the Fed and the Treasury did not understand—the worldwide implications of the derivative book.

should they get into trouble.

There was a fairly well-publicized study that the FDIC released about two years ago, analyzing what a resolution of Lehman would have looked like if the Dodd-Frank provisions had been in place before the company hit the wall. Have you had an opportunity to look at that? And I wonder if you've got any comments or observations about the difference that having Dodd-Frank in place might have if you had a Lehman-type failure today.

One of the key lessons that comes out of this is that the government must be consistent in its administration.

MARSAL: I'd say that the resolution tools provided in Dodd-Frank could have significantly improved values: areas like a delay in the ISDA {swaps and derivatives} termination and an assignment of possible derivative contracts, like the fact that immediate liquidity would have been provided, that subordination effectively of subordinated debt in the process. All of those kinds of actions which are included in Dodd-Frank would have helped us in Lehman.

But there's a flawed aspect of the FDIC's report, and that is that decisions in a crisis need to be immediate. You can't go around and talk to three different departments. By the time you get three different departments in Washington to agree to anything, things have moved on. So the speed by which they believe they can move, I don't think is credible.

I also think there's no way sovereign entities are going to cooperate unless we have an international treaty. There's no way it's going to happen. And anyone in the FDIC or in government who believes to the contrary ought to step inside my shoes as I was trying to deal with 34 countries, trying to get them to cooperate, just providing information to me, nothing more than information.

So I think it would help. I think there would have been an improvement in the recovery, but not nearly to the extent that they had indicated in the report.

GALLANIS: *I'm not an expert in this field, but I don't get the sense that we made a lot of progress in having firm treaty direction in how the separate sovereign governments involved would cooperate in the resolution of a multi-jurisdictional financial institution.*

MARSAL: I think there are protocols between the U.S. and the U.K. Which is important. But beyond that, I don't think anything concrete exists.

GALLANIS: *If you could counsel CEOs of large financial companies about specific lessons from the failure of Lehman and other big cases in which you've been involved—things they should take to heart as they think about strategic planning for their own companies' crisis survivability—what do you think might be the most important things you'd suggest to them?*

MARSAL: I think what I would say to them is, if they attend many of the meetings that I have attended, I believe that the banking system as we know it is in a major restructuring mode right now. That is, I think the FDIC has been given an impossible task to avoid government intervention and taxpayer intervention in the event of a failure.

The only solution as I see it is to reduce the level of complexity, which will mean dumbing the banks down. That continues to go on. They will reduce the level of complexity, which means banks will be forced to get out of certain activities that they're doing by virtue of how expensive it's going to be for them to continue in those activities. The marketplace understands that, and as a consequence there's a shadow banking system developing: all kinds of activities. I mean, it's amazing what's happening: companies that are coming in and starting to form, and also hedge funds which are actually offering revolving credit facilities today.

And so I see this kind of activity, and what I would say to you and the people in this audience is, don't fight it. I think it's just a matter of time before the regulators are going to be at your doorstep, asking you about those same activities that they were concerned about before. How are you managing that risk?

So you can fight it, but I think it's kind of pointless, because what's happening is that the banking industry is changing. And as others adopt some of the business activities of those banks, if you believe the FDIC is going to sit on the sidelines and not go monitor that, I think I'll sell you…

GALLANIS: *You've been involved with insurance entities a fair amount over the years, and you appear, at least publicly, to be ramping up even more of a practice than you've had in the past for dealing with insurance company crisis situations and potential insolvencies. Are you seeing a lot of difference between the state of the insurance industry today and the banking industry? And do you think you would face different challenges, working toward the resolution of an insurance entity, compared to other types of institutions?*

MARSAL: Clearly insurance companies, at least in my view, are much more conservative, much better capitalized, and probably much more in tune with risk management than some of the banks. Although at the same time, I thought that about AIG until I saw that they were actually writing naked derivative contracts.

But outside of that, my reaction would be it's a much more conservative group. It's a much better capitalized group. It's probably got a lot less to worry about. But what bothers me today, Peter, is that in an interest rate environment where you're making 1% or 2% on your money, I'm seeing insurance companies and pension funds getting increasingly yield-aggressive. They're under pressure. They've got contracts. They've got guarantees of 5% or 6%. The banks have shifted much of that risk over to this side of the world, and what you're seeing is a yield-desperate lender who is going to

["NOLHGA Conversations" continues on page 16]

["NOLHGA Conversations" continues from page 15]

be taking on greater and greater risks.

So to some extent, maybe the bubble's just kind of moving. Maybe it's just moving. I don't know how you get out of that bind, because I don't know how you deal with these low interest rates today. I don't know how you and many of the people in this audience can meet their guarantee needs or the needs of their policyholders. It's a tough position to be in.

GALLANIS: *So if we hit a situation where we do have a failure of a large institution, if I'm understanding you correctly, you're saying that living wills and orderly liquidation and break-the-glass plans—all of that stuff is fine. But there's nothing that really provides liquidity like liquidity, and that's the answer.*

MARSAL: Well, I think if I was going to advise the U.S., I'd say quit focusing on too big to fail. In the Lehman matter, the creditors lost $150 billion. That's $150 billion of value out of pension funds and savings and what have you. Not one person was held accountable for that.

Maybe this is heresy, but there should be accountability on senior management's part. There should be accountability at a board of directors' level on enterprise risk management. And if that changes, the laws are simplified—meaning if the laws are simplified and if accountability can be introduced at a management level at the banks or at the financial institutions and at a board level—I think you'll clean up this. I don't think it will be too big to fail. Capitalism works because of greed and fear. You take away the fear, don't be surprised if you get a Lehman.

AUDIENCE MEMBER: *What do you like best about your job as CEO? What do you like worst?*

MARSAL: What I do I like best? I love the jazz of the hunt. I mean, I criticize those guys, but I love to solve problems. I do not like the administrative and the politics side of the job, but I do love working on engagements. So when I had people say, "Oh, that must have been tough for you at Lehman?" It was the best experience of my life—the best work experience.

I had a lot of great people. I met a lot of great people from Lehman. We went to battle together, and you know, that was a great experience. ✭

NOLHGA Calendar of Events

2013

October 21	**MPC Meeting** **Manalapan, Florida**
October 22–23	**NOLHGA's 30th Annual Meeting** **Manalapan, Florida**
October 27–29	ACLI Annual Conference New Orleans, Louisiana
December 15–18	NAIC Fall National Meeting Washington, D.C.

2014

January 7–8	**MPC Meeting** **Scottsdale, Arizona**
March 29–April 1	NAIC Spring National Meeting Orlando, Florida
April 8–10	**MPC Meeting** **St. Louis, Missouri**

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