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Crystal Ball Time

Members of the guaranty community give their predictions for 2009

Mark-to-Market No More?

Eugene Choate, Immediate Past Chair, NOLHGA Board of Directors

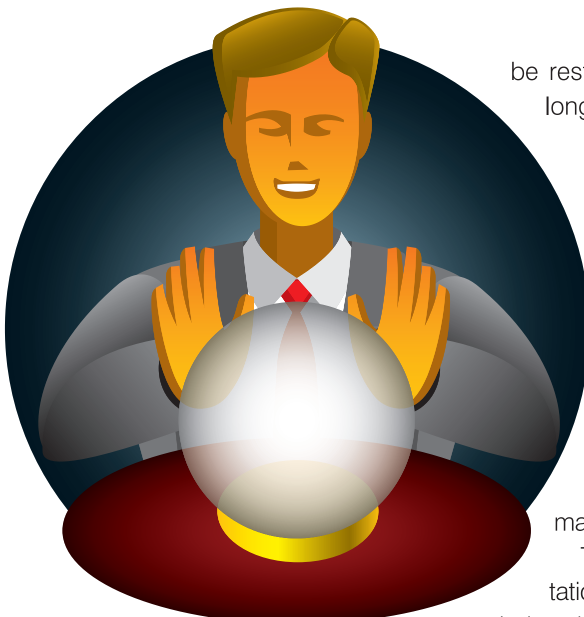
I see the most critical issue being whether the NAIC will consider the ACLI's request to change the mark-to-market rule on investments. We could be faced with a number of insolvencies as a result of the impact of this rule and the effects of the slow economy.

We will probably see the market reopen upward in the next three to five months and then see another downturn, much like what happened in the 1974 and 1982 recessions. With the new administration having to handle the financial crises, we probably will not see anything from them on new oversight for two to three years. Other than this, our industry should continue to prosper and perform well. We at NOLHGA are well prepared to handle those companies that may need our help on solvency issues.

Fighting the Next War

Robert F. Ewald
Former Chair of NOLHGA's Disposition Committee

In planning for the future, let's all be mindful of the lessons learned by military planners, who have historically planned for the next war based on the strategy and tactics of the last one. That is the box we are trying to think outside of as we address the following issues (in no particular order).



Balance Sheet Asset Valuations

Asset valuations, troublesome in the past, now become critical. The Financial Accounting Standards Board and its European equivalent rulings are so demanding of "mark to market" principles that even more insolvencies can be expected if these rulings are followed explicitly.

On the one hand, presentation of the fair market value of assets is required by those who regulate, if they are to do their jobs responsibly. And investors need to know the value of their investments. On the other hand, with asset values rapidly deteriorating under current conditions, there is reason *not* to "mark to market" when many of these assets arguably will be restored to more reasonable values long before they are needed.

J.P. Morgan reports that TARP continues to expand the definition of "financial institution," with some insurance companies having bought small thrifts so they can qualify as depository institutions. The SEC is allowing more transactions to be designated as "forced" or "distressed" and is allowing assets to be designated as "inactive" so as to avoid marking to market.

There are also methods of presentation that can be revealing without being destructive. Notes to financial statements have served such a purpose for generations. If "fair market value" is not on the balance sheet, such values can be presented with reasonable commentary in the "Notes to Financials" part of a report.

National Regulation

Rep. Dingell, a proponent of national insurance regulation, has been replaced as Chair of the Energy and Commerce Committee. Does this mean the issue will be put on the back burner, or will the increased clamor for better regulation

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The Lessons of History

The following is adapted from the President's Address given at NOLHGA's 25th Annual Meeting in October 2008.

Today I want to focus on the some of the challenges and prospects before the guaranty system, given the mission we are going to be expected to perform.

On an anniversary occasion, it's especially appropriate to consider the future in light of the lessons of history. We got some very valuable and practical historical observations during the terrific panel discussion yesterday afternoon: lessons about *our* history in our guaranty system, presented by four individuals who, along with many others, were critical players in the system's development.

Of course, our system operates in a larger economic, social, and political environment, and it may be useful to think about the lessons of history that can be drawn from that broader context.

Eight years into a new century may be enough time to reach some preliminary conclusions about trends that may matter in the years that follow. So let's look at the first eight years of that century and see what they tell us.

In that span we saw a Republican in the White House—one prone to foreign adventurism and not a little moralizing on various issues. Immigration policy and the effects of new immigrants on the economy were hotly disputed. Foreign conflicts, recent and potential, were on everyone's minds, as were emerging international military and economic powers. Big businesses were consolidating into bigger businesses, causing many to worry about excessive concentrations of corporate power. Some cheered the investigations and prosecutions of leaders in the insurance and financial services world that were led by a brilliant young prosecutor who then went on to become Governor of New York, before winning a very *different* kind of fame. New technologies, especially in communications, were bringing the world closer together than it had ever before been—and those same technologies were permitting facts and rumors about financial problems to spread more quickly and broadly than ever before.

Most significantly, a long period of U.S. business and economic growth and expansion was suddenly challenged by a major financial crisis that brought an abrupt, startling, and ignominious end to companies that previously had been household names and pillars of the financial world. Our country's foremost financier, one of the richest men in the world, stepped forward in a risky effort to respond to the crisis. The financial problems raised a raft of questions about the adequacy of government regulation and the viability of social safety nets.

Some of you may have imagined that the President of whom I spoke is George W. Bush; that the crusading attorney and Governor is Eliot Spitzer; that the technologies are computers and the Internet; that the market crisis is the current situation involving subprime mortgages, Bear Stearns, Fannie Mae and Freddie Mac, Lehman Brothers, AIG, Washington Mutual, and the rest; and that the leading financier is Warren Buffett.

Actually, those aren't the cases I'm talking about at all.

In fact, the President I had in mind was Theodore Roosevelt, and the crusading prosecutor and Governor was Charles Evans Hughes (whose leadership of the Armstrong Committee affected the insurance industry far more than anything ever done by Eliot Spitzer). The technologies to which I alluded were the telegraph, telephone, and railroad systems; the market crash was the great "Panic of 1907" (the subject and title of an excellent book that I commend to your attention); and the financier who was the hero in the 1907 Panic was J. P. Morgan.

When History Rhymes

Why talk about things that happened over 100 years ago when we have seen instances of very similar behavior in just the past few months? Because it illustrates that, when it comes to people investing their money with major institutions, similar situations—and reactions to such situations—arise over and over again. Those recurring situations are clues to how we must look at our job. The situations may not present themselves in each cycle of history in precisely the same way: People change and technologies change. But, as Mark Twain observed, while history may not precisely *repeat* itself, it certainly does tend to *rhyme*. Let's look at some of the recurring rhymes.

Good times lull large groups of people, including investors, consumers, and even many "experts," into a false sense of economic security, which results in imprudent or risky decision-making. The consequence often is a "bubble economy," the subject of which may be tulip bulbs, shares in the South Seas Trading Company, railroad or Internet stocks, or—in this latest case—suburban homes.

Most people are reluctant to recognize the existence of a bubble economy, and they tend to resent being told that the bursting of the bubble may be imminent. Federal Reserve Chairman Alan Greenspan was widely criticized for predicting the bursting of the high-tech stock bubble in the late 1990s, and others were similarly criticized for predicting the bursting of the housing bubble just a couple of years ago.

In growing economies where it appears difficult to *lose* money, lots of incompetent or dishonest people will offer great returns on consumers' investments, and the naïve—and even some who may seem sophisticated—invariably take the bait. Bubble economies, like Ponzi schemes, are situations where the success of an investment by person A depends on the timely appearance of a person B, who is a "greater fool" than person A, to take out person A's investment. It's a mathematical necessity that at some unexpected point, the music will stop, the bubble will burst, and there will be no person B—no greater fool—left to absolve person A of what now, in hindsight, proves *not* to have been a "sure thing," but rather a very risky outlay of capital.

Well-run businesses often survive the bursting of even the most hyper-inflated bubbles, but some businesses or individuals that were simply riding the bubble, without the appropriate expertise or capital cushion, inevitably fail, as do some good firms that changed proven business models to try to take advantage of the bubble economy.

And *that*—the failure of a business—is what invariably brings citizens to the intersection of *their* street and *our* street: to the intersection of Wall and Main, as we've often heard it put lately.

What Should Be Done?

Four questions generally arise in connection with the failure of a financial services business:

1. What will be done to protect the consumers who put out money in exchange for a promise from that failed business?
2. What should be done for the commercial entities that traded with that business?
3. What should be done for the failed business itself?
4. What should be done to protect society from the failure of that business, or the failure of others like it?

We're hearing all four of those questions today, with a frequency and intensity only present at times when the general economy is very threatened. The first question—what should be done for consumers—hits us directly where we live; I'll come back to it, and it will be the principal focus of what I have to say.

The second question—what to do about commercial ventures that trade with the failed company—is normally the province of ordinary bankruptcy law and similar state creditors' rights regimes, such as the insurance receivership statutes. The usual answer is that the law will provide an orderly process through which those commercial trading partners—sometimes called "counterparties"—can assert their rights to be paid some amount from the remaining assets of the failed venture. In rare instances, there is a demand for a different answer, and we'll come back to that.

The third question—what should be done for the failed venture itself—is normally answered with a straightforward "nothing." The essence of free competition in the marketplace is that inefficient and uncompetitive ventures fail and disappear. The possibility of failure itself is a motivating force in driving labor and capital to be deployed with maximum efficiency, to the general benefit of the entire marketplace. Without that aspect of "creative destruction" (as economists describe it), you can't have the full benefit of innovation, development, progress, and true competition in pricing and performance. So the social and legal response to the fact that a firm fails is typically—and in normal times—a heartfelt, "We're sorry for you, but we wish you the very best of luck in your next venture."

Even when a number of financial services firms fail, as in a normal recession, the general societal attitude is that this is just an industry "shakeout" or "realignment" and that no extraordinary steps need be taken to save the various failed firms, or for that matter the commercial counterparties that did business with them.

In rare circumstances, though, conditions of fragility or vulnerability in the financial markets are seen as so threatening to the economic circumstances of us all—to the "real" economy, as opposed to just the financial markets—that we get to the fourth question: What should be done to protect *society* from the effects of a failed business or group of businesses in a critical sector of the economy like financial services?

Thankfully, this question—how to respond to perceived *systemic* risk—is seldom seriously asked and seldom answered. In a major way, we've seen the question addressed within the U.S. economy three times in the last century or so. The first

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such instance was in connection with the Panic of 1907. In that case, the inability of the private banking system to respond promptly to the panic led to the creation of our Federal Reserve System. The second instance was the Great Depression and the series of governmental responses to it from the Hoover and FDR administrations.

Most recently, of course, we saw Congress struggle in early October with how best to protect society from the current financial crisis. Most observers recognize that what Congress gave us was not the final answer to that question, but rather just a first installment. For better or worse, Congress and the states will consider many, many more governmental responses to the current crisis before we reach an eventual economic recovery.

When government responds to systemic threats from a financial crisis as serious as the current crisis, truly radical solutions are considered and sometimes implemented.

Radical Responses

When government responds to systemic threats from a financial crisis as serious as the current crisis, truly radical solutions are considered and sometimes implemented. By "radical" I mean what the word originally meant—changes that reach down to the very roots of how the financial system is regulated and organized. So, for example, in the 1907 Panic, one major governmental response was the creation of the Federal Reserve, our first truly national banking system. In its time, that was a revolutionary, radical response. The Great Depression elicited a whole raft of programs and policies that significantly altered American economic operations, radically and in some cases forever. One such program relevant to our business was the FDIC, which was created in 1933.

The current crisis brought forth not only the $700 billion T.A.R.P. rescue mechanism, but also the nationalization of Fannie Mae and Freddie Mac, which was almost unthinkable a year ago; the government takeover of the largest insurance holding company in the world, AIG; and the *de facto* elimination of the investment banking industry, at least in the form we have known it for many years. All those changes were fundamental, radical alterations to the prior landscape, and many of them were brought about almost overnight in response to perceived emergency circumstances.

Radical solutions are pursued in connection with the fourth question confronted in times like these: what to do to protect society as a whole against the risks of systemic financial failure. But such radical solutions to systemic financial risk—those we've seen so far, and those yet to come, proposals that may not yet even be on someone's drawing board—tend *not* to be limited just to this question. Rather, they tend to be broadly based, omnibus packages that invariably affect how the other three questions are answered as well. They address the systemic economic risks, but in addition—either as intended outcomes or as collateral effects—they have a significant impact on whether and how the failing company, counterparties, and consumers are protected.

You'll see exactly what I mean if we consider a couple of examples, all of which were primarily aimed at answering question 4 (protecting against systemic risks) but involved to some degree the other questions. The Bear Stearns response, for example, not only addressed question 4, but also extensively involved the protection of the Bear Stearns counterparties (question 2). The Fannie/Freddie takeover did address question 4, but besides also addressing the protection of counterparties (question 2), it protected in addition Fannie and Freddie themselves—question 3 in our matrix. And the governmental responses to the banking crisis within the Great Depression and to the S&L crisis of the late 1980s aimed at protecting the economic system, but also had at least as much to do with the protection of the ultimate consumer—question 1. I note for your particular attention that, in the S&L crisis 20 years ago, Congress simply decided to put the old FSLIC—the S&L consumer safety net—completely out of business and turned its mission over to the FDIC.

All of the foregoing is to say that in every case of perceived systemic financial risk, a mentality of near panic grips a significant portion of the population, and elected representatives hear about it. This in turn results in a political scramble to respond, and the responses can easily become overbroad and carry negative unintended consequences. It's precisely at moments like that when our system is at its greatest political risk.

Welcome Attention

At times like that, when the troubles of the financial system have people worrying about their insurance companies and their retirements—as we saw at the height of the AIG crisis on September 15 and 16—we *know* people are going to come looking for us. It's worse than pointless and counterproductive to try to hide. We need to stride out to meet those people—to let them know we're here, and what we do and don't do. The insurance consumer safety net provided by our guaranty system is *not* the area about which people need to worry. We have their insurance "backs"—and by the way, we provide that protection without putting the federal taxpayer at risk.

We found out during the AIG crisis that most people didn't know that we have their backs. More *do* know that now. It's possible that, before long, the issue will not be a near-miss like AIG, but an actual insolvency of a company of some size. Unlike a particular politician, I am *not* predicting such an insolvency or claiming that I know of one in the offing: I most certainly do not. However, in the current climate, it could happen.

And if it does happen, there are four things that we simply have to deliver if we in this guaranty system want to keep providing this service—if we wish not to go the way of the old FSLIC.

We need to be *quick*; we need to be *clear*; we need to be *decisive*; and we need to be *courageous*.

We must be *quick* because the greatest lesson of the current economic crisis is that solvency problems for a company are likely to emerge very, very quickly. Once the news is out, the world will be turning to us for answers. Information and money now move literally at the speed of light. We will be expected to move almost as quickly.

We must be *clear,* because the biggest driver of a panic is uncertainty. If people don't know the extent to which they are protected—by the guaranty system and by the regulatory system—they will conclude that they are completely at risk and react entirely from fear. Panicked reactions by consumers make a successful resolution of an insurer's problems difficult and perhaps impossible, and in many cases such panicked reactions are also contrary to the best interests of the consumers.

We must be *decisive* because a financial crisis is almost by definition a deteriorating situation, and the longer it takes to make a decision, the fewer and smaller are the building blocks from which a resolution plan can be crafted. In a crisis, undue delay amounts to assured destruction; it is not an option.

Finally, we must be *courageous*. The very need to respond quickly, clearly, and decisively means that we will need to make significant commitments that take us outside of our comfort zones. While, in a perfect world, we might want to defer making a commitment until we have that last 93-page legal memorandum, the results of those 1,000 stochastic scenarios, or an investment analysis of the smallest item on a company's balance sheet, we're not likely to be able to wait for those things. We're going to have to make important decisions based in material respects primarily on judgment, experience, and our sense of what is right—and what is reasonably expected of us by our constituencies.

The AIG crisis taught us and others a lesson. In fact, what I expect we knew intuitively before has now been proven definitively to others. That lesson is that, even in a world where there might be no insurer insolvencies at all, this guaranty system delivers solid, demonstrable value for consumers and for their insurance companies. AIG was perceived to be in mortal danger; insurance consumers were in a near panic; and unwise action by panicked consumers would have hurt those consumers and threatened the AIG insurance subsidiaries. Along with the regulators, we in this system put in a herculean effort to let consumers know that they had reasons to stay calm and not be stampeded by fear. Thousands of people are now better off as a result of the hard work all of you devoted to protecting that most precious resource, confidence.

Warren Buffett likes to say that it takes decades to build a good reputation but only seconds to destroy one. So far, we've invested a lot in building a very good reputation for our system, and our reputation—and the confidence we communicate to others—has continued to pay great dividends. But we can't now drop our standards, even for a second. The challenge is before us, but I know it's one we will meet. ✯

> In every case of perceived systemic financial risk, a mentality of near panic grips a significant portion of the population, and elected representatives hear about it.

Peter G. Gallanis is President of NOLHGA.

Changing Landscape

Talk of the economic crisis and what it means for the guaranty system dominates NOLHGA's 2008 Annual Meeting

By Sean M. McKenna

The celebration of NOLHGA's 25th anniversary took place in October 2008 in Jackson Hole, Wyoming. There, in one of the most beautiful places in the country, NOLHGA's members gathered to survey one of the bleakest and most depressing economic landscapes anyone could recall. Just a few days after the economic turmoil of "Black September," speakers and attendees alike tried to make sense of the eco-

nomic downturn, the federal government's efforts at jumpstarting the economy, and what all of it might mean for the future of the guaranty system.

Welcoming speaker Ken Vines, Commissioner of the Wyoming Insurance Department, set the tone for the meeting by noting "the challenging and somewhat frightening time in our history" and praising the work of the life and health insurance guaranty associations. "The very existence of the guaranty associations helps calm the policyholders," he said, explaining that his department—like the associations themselves—had received many calls from policyholders concerned about their insurance in the wake of AIG receiving billions in assistance from the federal government.

"I hope you never lose sight of the fact that you help consumers," he added. "They're the ultimate beneficiaries of your work, and the guaranty system can be very proud of that."

The question on many people's minds, of course, was how the turmoil in the economy would affect the associations' ability to continue their good work.

Mondays & Financial Tornadoes

Two presentations at the meeting addressed the economic crisis, and both offered attendees a ray or two of hope. Dennis Johnson, President and CEO of United Heritage Financial Group, focused on the credit and equity market implications for life and health insurers, beginning with a sequence of increasingly depressing newspaper headlines to remind everyone what had occurred over the past month—the fall of Lehman Brothers, the rescue of AIG, the Dow dipping under 10,000 (which sounds pretty good these days), and other financial calamities.

"I've gotten to where I hate Monday mornings," Johnson said. "Every Monday, it seems like there's somebody working on Wall Street or in Washington or both who's going to disrupt my life as it affects our portfolio or your portfolio."

Johnson summed up the economic carnage by asking and answering a question that's still being asked today. "Is this the worst credit crisis since the Great Depression?" he asked. "The answer is yes, far and away. Is this the worst economic crisis since the Great Depression? The answer is no. An economic crisis is different." He went on to illustrate that difference with a series of pictures from the Great Depression—a vivid reminder of the massive unemployment and hardships suffered at that time.

Johnson detailed the causes of the credit crisis, pointing first to the subprime mortgage meltdown and the bursting of the housing bubble. Rising foreclosures, he said, mean that in 2009, "one out of every three homes in the United States will be owned by a bank." He also criticized "the onerous requirements of fair value accounting" and heaped scorn on short sellers, adding that "we as an industry should be very concerned that the SEC did not do a lot about short selling" before putting a stop to the practice on September 18.

"To me, this feels like 1982," Johnson said, "the worst recession we've had since the Great Depression." That time of economic turmoil, he added, led to NOLHGA's creation in 1983, and he sees new regulation on the horizon for the industry. "More regulation on all levels will make it harder to do business," he said.

Dennis Johnson, President and CEO of United Heritage Financial Group

Despite this, Johnson assured the audience that the future is not all bleak. "I think the forward look, the outlook, should be stable or positive for our industry," he said, noting that new bond investments will have a higher spread and risk premium than just six months earlier. "Finally, we're going to get paid for that risk premium," he added. "Once

» Spotlight on Health Care

Mila Kofman, Superintendent of the Maine Bureau of Insurance, provided attendees with insight and some troubling information concerning the 47 million Americans who lack health insurance. She noted that taxpayers end up paying for the care these people receive and that overall, America spends more on health coverage per capita than any other industrialized nation.

"This tells me that we're generous, but it also tells me that we may have some inefficiencies in our system and that we can do it better," Kofman said. As an example, she cited a report showing that many Americans skip doctor visits or needed drugs because of the cost of these services. "I frankly think it's un-American what we allow to happen on our watch," she said. "We can do much better."

There are some promising signs, according to Kofman. Whereas the insurance and pharmaceutical industries weren't active players in the last attempt to reform health care (in the 1990s), "now, they all want to be at the table. And to see real reforms, we're going to need everyone at the table willing to give and take." In addition, both presidential candidates made health-care reform an important part of their campaigns.

Despite this, Kofman said that in light of the economic crisis, "I don't think we're going to see major health-care reform next year." She did predict that some incremental reforms may be in the offing. In particular, she cited the Small Business Health Options Program (SHOP) legislation introduced in April 2008, which is designed to help small businesses and the self-employed obtain health insurance.

The NOLHGA Turns 25 *panel featured (from left) Doug Goto, Bill Fisher, Joe Morris, Roger Harbin, and Nick Latrenta.*

all of this washes through, I think we in the life insurance industry will have a positive outlook because we'll actually have a chance to have higher earnings."

Bob Baur, Chief Global Economist for Principal Global Investors, also offered hope for the future, but only after looking to the past for the causes of the financial crisis. According to Baur, for the last year and half, "there's been a financial tornado stalking the U.S. economic and investment landscape, wreaking havoc on everything in its path." The question is, where did it come from?

Baur attributed the economic boom and bust to "unprecedented changes that have gone on in the global economy," and he cited four driving forces—lowering trade barriers, deregulation, opening closed economies, and the technology and communications revolution. All of these combined to create what he calls "a supply shock that swept around the world"—a huge increase in goods and production. Low inflation kept prices down, which "led to an excess of cash, a flood of liquidity just sloshing around the world economy."

Baur called the period from 2001 to 2007 "the greatest global economic boom in the history of mankind," but he added that "the only problem with booms is that imbalances are created—they contain the seeds of their own destruction, and this one was no different." Emerging markets kept their exchange rates low to foster exports, which helped drive a consumption culture in the United States. "Because interest rates were low and credit was cheap and easily available, individuals were encouraged to take risks," Baur said. "And we did," buying second homes, third cars, etc.

The low interest rates also encouraged investors to take more risks: "That's why money was pouring into these mortgage- and asset-backed securities, because of the few extra basis points of yield they promised." Consumers and industries had overextended themselves, Baur said, and when the housing bubble burst and the credit crunch hit, "like a giant Ponzi scheme, it all came crashing down."

What comes after the crash? "We favor more of a 'muddle through' scenario," Baur said, "but not everything is doom and gloom." He pointed to "a very flexible and innovative U.S. economy" that can adapt to changing conditions and cited "a fundamental transformation that is happening in the U.S. economy—away from one that is totally centered on consumer spending and toward one that we think is being led by exports." These exports are services rather than goods—entertainment, medical and engineering services, and even fast food restaurants.

The View from Mars

Both the future and the economic crisis played a large role in *NOLHGA Turns 25: The Lessons of History*, a presentation that featured panelists Bill Fisher (a consultant and former Corporate Vice President and Associate General Counsel with Massachusetts Mutual Life Insurance Company), Doug Goto (Executive Vice President of Pacific Guardian Life Insurance Company), Roger Harbin (Executive Vice President and COO with Symetra Financial Corporation), and Nick Latrenta (Senior Chief Counsel with Metropolitan Life Insurance Company).

Moderator Joe Morris (a Partner with the law firm Morris & De La Rosa) played the role of the outsider, providing a "report from Mars," as he put it, on the state of the guaranty system by quizzing the panelists—all of whom are current or former state guaranty association Board Chairs and former NOLHGA Board Chairs—on the creation of NOLHGA, its role through the years, and the challenges it has faced and will face in the future.

NOLHGA was founded in 1983, a year after the failure of the Baldwin-United companies taxed the capacities of the existing state guaranty associations and highlighted the need for a central coordinating body. "It's a little bit uncanny how our organization was born out of crisis, and here we are 25 years later, and some would say we're in crisis again," Latrenta observed. As the conversation moved from Baldwin-United to Executive Life Insurance Company of California (ELIC), Mutual Benefit, and other insolvencies of the 1990s, a few key themes emerged that have as much relevance for the system today as they did 10, 20, or 25 years ago.

One recurrent theme was the balance the guaranty system must strike between ensuring confidence in the insurance industry while minimizing the risk of moral hazard that a safety net necessarily

Building Community & an Outsider's Perspective

In their addresses at NOLHGA's 25th Annual Meeting, Outgoing Chair Gene Choate and Incoming Chair Chris Kelly took different approaches to the same goal—preparing the guaranty system for the future.

Choate explained that upon being named NOLHGA Board Chair, "I was intent on breaking down any barriers, real or perceived, that stood between the Board and the membership." As part of this effort, the Board now invites a few guaranty association Board chairs and their administrators to each Board meeting to open up the lines of communication and "break through any mystery" surrounding the NOLHGA Board.

The program has been a great success for everyone involved, Choate said. The guaranty association members get a better feel for how the NOLHGA Board operates, and the Board learns firsthand about the major issues confronting the associations.

Federal regulation is one such issue for all associations. "We are facing the prospect of a new regulatory regime, and we're going to have to figure out how we would fit into that puzzle," Choate said. While the guaranty system can certainly adapt to a federal regulator, the associations will have to do just that—adapt. "It's a safe bet that some tweaks are in our future," he explained, citing issues such as uniformity and the use of best practices.

Choate concluded by saying that he's confident that the system is up to the challenge of adapting to whatever changes come its way. "When called upon," he said, "we can act in concert to achieve great things."

Kelly began his speech by noting that he's a relative newcomer to the guaranty system and explaining how this might serve the system well. "One thing I will bring to my role as NOLHGA's Chair is a fresh set of eyes and a willingness to respectfully challenge the status quo," he said.

Kelly promised to use his outsider's perspective to foster open and honest debate about the system and how it can best ready itself for the future. The biggest challenge the system faces, Kelly went on to say, is "the balancing act we play between honoring the statutory authority of our state associations while striving to produce a more efficient and effective guaranty system." The issue, he added, is one of priorities: "We have to decide what's most important to us—guarding our state prerogatives or reaching reasonable compromise to be part of a guaranty system that can survive the approaching regulatory wave." If we cling to the former, he said, "we risk losing our relevance and our place at the table in any discussion of the future of the safety net under federal regulation."

Kelly pointed out that the guaranty system still enjoys support from the insurance industry, on both an operational and philosophical basis. "We're cost-effective and remarkably efficient," he said. "We also share with the industry a commitment to the safety net concept—one that rescues policyholders within reasonable limits, without providing a blank check that would increase moral hazard for the industry as a whole."

That support will grow even stronger, Kelly said, if the guaranty system demonstrates that it is serious about addressing uniformity and other issues: "If we can show that the current system is moving in the right direction and is superior to any alternatives, we can maintain and even strengthen the industry support we enjoy today."

creates. "The issue of moral hazard is one that has troubled the industry from the very beginning about guaranty associations," Harbin said. "Somehow, we have to have a regulatory safety net system that protects consumers, because they need to be protected, but without causing the opportunity for companies to disregard sound, safe operations."

Goto spoke of the difficulties this balance presents to companies. "It's difficult to be at a home office and sign assessment checks that are related to the actions of former competitors, but it's a premium we pay as an industry to maintain the confidence of the consumers in our sector," he said. "When something happens, especially if it's not resolved, the flow of new business and the retention of blocks of business we have in place are threatened, and the absolute health of our industry is in jeopardy."

Confidence in the industry, while necessary, carries a risk of its own. "One of the things we have to be careful about in building confidence is that we don't create an expectation that we cannot meet," Fisher pointed out. In this sense, the seemingly inevitable comparisons between the guaranty system and the FDIC can be dangerous. The FDIC "is a Friday to Monday operation," Fisher said, and that speed can and perhaps will be expected of the guaranty system, even though the challenges guaranty associations face are quite different than those faced by the FDIC.

Annuities are a prime example, Fisher said: "In the minds of consumers, annuities are often equated with bank products. We may find, as we have annuity failures, that there will be a greater expectation that they be handled much more like a bank failure than like an insurance failure." Goto pointed out that this pressure already exists. When the FDIC temporarily increased its coverage limits, some associations received questions asking when they would increase their own limits.

Latrenta added that, with the guaranty system and all financial services regulation sure to come under scrutiny in the next year or two, "in my nightmare sce-

Magician Bill Herz kept the audience entertained—and busy, bringing many of them onstage to help with the show.

nario, in the middle of that discussion, you have a mega-failure. Our history is that it takes three or four years to take care of mega-failures. We'll be in a world of hurt if that happens."

Not surprisingly, uniformity was also a prime discussion topic, with the focus not simply on different benefit levels or policy coverage, but also on the way that guaranty statutes are interpreted. "There has been disparity amongst the associations in terms of the interpretations of sometimes identical laws" and among states with differing laws, Fisher said, "and we will continue to grapple with this issue."

Harbin zeroed in on the danger to the system. "I think there's a fantastic grandstanding moment out there for some member of Congress who has relatives who buy policies in multiple states," he said. "Suddenly a company fails, and his niece gets $100,000 coverage, his nephew gets $500,000, and his daughter gets zero because they live in different states. That's going to be a moment for the press."

Fisher pointed out that uniformity will always be a challenge in a system based on state associations, because tension can arise between a Board's duty to the system as a whole and to the state association it represents. In Goto's opinion, it's an issue the system must address now. "We have to become vigorous advocates of uniformity," he said. "That's not a role that all of us have been comfortable with, but clearly, the lack of uniformity is our Achilles heel."

The panelists agreed that the cost-effectiveness of the guaranty system and its performance through the years are positives that must be highlighted in any discussion of the system's future. The task now is to craft those and other arguments. "We're going to see lots more questions coming, and we're going to have to have simple, clear, and concise answers," Harbin said. "We need to get that down almost to a sound-bite level, because we are going to be inundated with questions about who we are and what we do."

The Need for Speed

Sound bites and other media matters were addressed in the meeting's final presentation, *Next on **60 Minutes**—Communications Challenges for the Guaranty System*. Charlie Richardson (a Partner with Baker & Daniels) and Diane Tomb (Senior Advisor with B&D Consulting) stressed that the rise of the 24/7 news media means that the guaranty system can't afford to wait for a large insolvency to occur before developing a media strategy.

"Does anyone think that 'let me get back to you after our Coverage Committee meets in a couple of weeks' will cut it with Lou Dobbs?" Richardson asked. "Given the speed with which federal regulators have reacted to this crisis generally, and AIG specifically, the insurance insolvency and guaranty systems are going to be in for constant timing comparisons from here on out."

The good news, Richardson said, is that the guaranty system enjoys a solid reputation among many decision makers. "You're seen as insolvency consumer protection studs in many quarters" on Capitol Hill, he explained, but that doesn't make the system immune to criticism. "We have to face words that make us cringe," he added, rattling off a list of possible attacks on the system—whether it can withstand one or more large insolvencies, lack of uniformity in coverage and benefit levels, whether the industry should control the safety net mechanism, etc.

The best way to face these criticisms, Tomb said, is with a coordinated campaign. "We need to be thoughtful and strategic about how we get the guaranty association message out there," she said. "We need to clearly define what the guaranty associations are and their place in the marketplace, and we need to build our goodwill and tell our story as we anticipate the turbulent times before us." Above all, this means having answers at our fingertips and responding quickly to any attack or request for information.

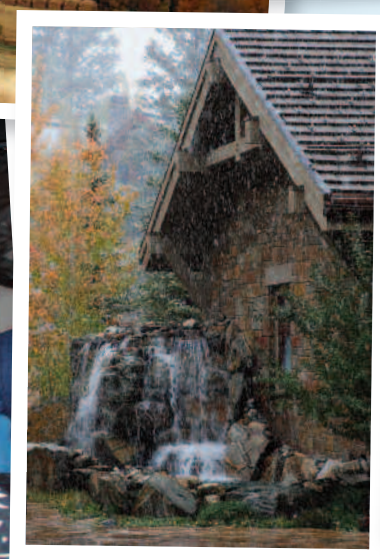
Tomb also pointed out what viewers of the presidential and vice-presidential debates had learned well—the question you answer doesn't have to be the question you're asked. "You shouldn't feel that you have to answer every single question," she said. "If you have something better that you want to say, this is your opportunity to get it out there."

Every encounter with the media is just that, Tomb added—an opportunity to advance the cause of the guaranty system. And not just with the reporter. In doing an interview of any kind, Tomb said, "remember, that individual is really just a vehicle to reach a lot of other folks." ✯

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

Worth a Thousand Words

Faces and sights from NOLHGA's 25th Annual Meeting in Jackson Hole, Wyoming.



["Crystal Ball Time" continues from page 1]

generally bring it to the fore? What would the consequences of national regulation be? With the industry itself divided on the question, NOLHGA's role needs to be clearly defined.

Relations with Regulators

Early in our history, and for some extended time, the guaranty system and NOLHGA were regarded by regulators as nuisances that impeded the discharge of their duties. Much has been accomplished toward better relationships with regulators in recent years, but this is still a vital concern. Much of the responsibility for these regulator relationships lies with the individual associations, but NOLHGA must find improved means of contributing to the betterment of relations.

Public Perceptions

We have always been careful to stay out of the public eye, and probably should under ordinary circumstances. However, current economic conditions require that we step forward publicly to inform insureds and potential buyers of insurance of our existence and our history of having provided billions in benefits. Knowledge of our presence should be reassuring to prospective buyers of insurance products and those who already own them.

Guaranty System Performance

The guaranty system has no control over when or in what circumstance it will be called upon to exercise its function. If regulators act too quickly, insurers that might have recovered are put in receivership. If regulators procrastinate or don't recognize the problem, greater losses occur and more people are hurt. We have always been reluctant to be involved in the process of identifying potential insolvencies—to do so could lead to the salvation of a competitor of some of our member insurers. Surely there is a middle path of cooperation and consultation that could prevent insolvency and make use of the knowledge and skills we have.

Perhaps because my experience includes managing virtually every aspect of life and health insurance company operations, it has always concerned me that too many of our association administrators have had little if any experience in insurance company operations. We have many fine lawyers and actuaries, but very few who understand operations. A NOLHGA-sponsored educational program for administrators with some focus on operational issues could be very useful.

Inside NOLHGA

While navel gazing is not recommended, would it not be helpful to examine the NOLHGA culture? How do the officers and staff perceive the NOLHGA role (beyond the usual mission statement)? What are our individual attitudes toward the many NOLHGA constituencies (including our colleagues)? Not what they are normally thought to be, but our honest daily attitudes? How do these fit with what we profess? How do they fit with what we think these constituencies want? Do we know what these constituencies want?

NOLHGA, of necessity, devotes a lot of time to negotiating. The key to good negotiation is knowledge of the needs and desires of those with whom we are negotiating, and finding ways to respond to those needs and desires. Do we truly understand them?

Consumer Focused

Janis B. Funk
Executive Director, Indiana Life & Health Insurance Guaranty Association
Member, NOLHGA Board of Directors

When looking to topics that will impact the life and health insurance guaranty association community in 2009, I believe that consumers will call us with more questions about the maximum we will pay and how we will cover some of the more complicated products that exist in the marketplace. In addition, press reports on the security and stability of the insurance industry overall will "feed" these concerns and calls from the owners of particularly life, annuity, and long-term-care products. The challenges for 2009 are (please note that these thoughts are those of the author only and are not intended to represent the ideas, thoughts, or issues of the Indiana Life & Health Insurance Guaranty Association or its members):

Coverage

Questions on policy types and language that the system has not addressed recently, or ever. Examples are variable products and/or variable products with guarantees, products that look like certificates of deposit but are annuities, and long-term-care contracts with policy provisions and/or statutory language that mandate coverage provisions. Consistency among guaranty associations as they interpret similar statutory language will also need discussion among the guaranty system.

Guaranty association coverage limits. Consumer questions on annuity limits are the most common questions we receive at this point: "Why isn't the same amount guaranteed at the bank as is guaranteed by the guaranty funds? When will the guaranty associations increase their limits to equal those of banks?"

For life and annuity products, we regularly receive questions on how to maximize guaranty association coverage: "If I have multiple contracts in one company, do I have guaranty association coverage up to the limit for each contract? Do I have to buy products from multiple companies to maximize my guaranty association coverage?"

Consumer Awareness

Consumers are increasingly concerned about the reliability of the life and annuity products they purchase, and they're becoming more aware of guaranty associations. Their concerns are impacted by articles in the press, and the sense is that the guaranty association (not the Department of Insurance) can provide all the answers on regulation and financial analysis needed to assure these consumers on their products. There seems to be a need for more information geared to consumers on the role of the Departments of Insurance in financial monitoring of companies and what the guaranty associations do.

Impaired Insurers

Many guaranty associations have provisions in their statutes for dealing with "impaired insurers," but most have no experience in interpreting these provisions. As a system we should consider common elements to discuss with our Boards if (when) we are asked to take action with respect to an impaired insurer.

Staffing

What is the impact of staff members no longer reviewing claims but instead spending significant portions of their day answering questions from concerned consumers on products we have not seen and for which we don't have "ready" answers on guaranty coverage? This leaves consumers frustrated—since we won't "just give them an answer"—and staff frustrated because they are regularly dealing with unhappy and difficult callers. It also affects the time available for staff to work on understanding the newer products and how they might be covered by our statutes.

Opportunities for Improvement

J. Chris Kelly
Chair, NOLHGA Board of Directors

The coming year may well be the most pivotal year in NOLHGA's short but distinguished history. Recent economic and financial market events have put significant pressure on the life insurance industry as well as our competitors in banking, brokerage, and asset management. While the industry as a whole remains well capitalized

We must also be open to recognizing our own opportunities for improvement, to create our own urgency about making the system more consistent among the states and across the entire country.

— J. Chris Kelly

and financially strong, there seems little doubt that this pressure will take its toll on some life insurers. Those whose capital, liquidity, or product risk profiles make them more vulnerable may fail, and their policyholders will need the expertise and protection that our national safety net provides.

The crisis has also renewed calls for a fresh look at the current financial services regulatory structure, including our current state-based form of insurance regulation. These calls come with a renewed sense of urgency, significant political momentum, and a perspective that financial services regulation today is too patchwork and functionally focused.

As the current state-based form of insurance regulation is evaluated by Congress and the new administration, so too will our national life insurance safety net for policyholders. We should not be reluctant to advocate for the demonstrable effectiveness and efficiency of NOLHGA and the member associations. We must also be open to recognizing our own opportunities for improvement, to create our own urgency about making the system more consistent among the states and across the entire country. Our stakeholders are watching, and the clock is ticking.

Time to Shine

Steven S. Lobell
Vice Chair, NOLHGA Board of Directors

It was just a short time ago that the NOLHGA Board and staff were discussing NOLHGA's role in an environment that seemed to have the potential for a comparatively prolonged period of reduced insolvency activity. While NOLHGA's insolvency workload has picked up somewhat in the last year, what has really changed since that time is the level of pessimism and uncertainty that now prevails in global and U.S. financial markets. So far, the life insurance industry has avoided the chaos suffered by investment and commercial banks. However, life insurance companies will soon be filing their annual statements—at which time the ratings agencies, financial press, and public will begin to get a better picture of the damage wrought on insurance companies' balance sheets.

Times of great turmoil present wonderful opportunities for organizations to prove their worth by demonstrating to their various constituencies their ability to ably perform their mission when the chips are down. The goodwill and credibility generated from high performance at the right time can last many years.

Hopefully, no life insurance companies will prove to be casualties of the economic meltdown. However, now is a great time for all of us to pull together and demonstrate our capabilities for all to see.

New Year, New Name?

James W. Rhodes
Executive Director, Oklahoma Life & Health Insurance Guaranty Association
Chair, NOLHGA Legal Committee

Donning my Carnac the Magnificent turban and peering into future—I briefly toyed with the idea of an elaborate gag involving envelopes that had been hermetically sealed and kept on Funk & Wagnalls's porch since noon—I see challenges in four major areas:

Health Insurance

No surprise here. The health insurance industry has been in a Darwinian death spiral for years, and we can surely expect the less-fit companies to continue to land on our plate in 2009 and beyond.

Long-term Care

Again, no surprise, especially with the recent entry of an order of rehabilitation for Penn Treaty. We have had little experience with these types of contracts, and they raise some new issues for us in a variety of areas.

Life & Annuity

Still no surprise. If history is any guide, the grim economic environment and toxic investment climate are bound to take their toll on insurers with long-term obligations. The question is, will heightened state regulation and RBC requirements soften the eventual impact? I think the answer is probably a little, but…

Name Change

Tackling the above three challenges will raise NOLHGA's public profile and increase scrutiny from state and federal lawmakers. Prior to Peter Gallanis's testimony before the Senate Commerce Committee in October 2009, Chairman John Rockefeller will gruffly observe: "NOLHGA, huh? That's a strange name. Are you guys Russian or something?"

At the 2009 Annual Meeting, the NOLHGA membership will vote to change the organization's name to the "friendlier" sounding American Apple Pie Organization for the Protection of Widows, Orphans and Puppies of America, thenceforth to be known by the more euphonious acronym AAPOPWOPA. Carnac has spoken!

Feds on the March

Charles T. Richardson
Partner, Baker & Daniels

We've long known there would be an extensive debate over so-called insurance reform and optional federal charters. After all, the conventional wisdom is that Congress doesn't usually act on economic legislation unless there is consensus *or* a crisis. We now have a crisis that may have just shortened the time for a debate over the shape of the insurance regulatory marketplace.

My crystal ball may be no better than yours, but here are some predictions.

- There will be more hearings in both the Senate and the House on insurance regulation as a part of Congress's review of the whole financial services sector and the "systemic risk" it faces. Proposals will take shape over the next 60 days as congressional scrutiny intensifies after the inauguration with introduced legislation on the systemic risk issues first. The increased Democrat majorities could be searching for sweeping reforms across the economy, with an even more comprehensive bill for financial services by late summer. We're now in a regulate mode, *not* deregulate. I think we also might see a special joint House/Senate committee to push a financial services regulation overhaul.

- A regulatory crackdown on markets for credit default swaps and mortgage-backed securities looks likely, along with a restructuring of agencies that regulate banks and Wall Street firms such as Goldman Sachs and Morgan Stanley. Of course, any drive to strengthen regulation and close business tax loopholes would be constrained by the federal budget deficit, a weak economy, and a myriad of interests opposed to changing the status quo.
- As a part of the debates to come, consumer protections will be important in the Democrat-controlled Congress. We heard that loud and clear in 2008 hearings, and you'll hear it again in the context of taxpayer protection and consumer protection going hand in hand. The insurance companies that want federal financial support and/or federal regulation should be prepared for a regulatory regime that may look different than the one in the optional federal charter bills introduced so far.
- The feeling in the House on the Democratic side of the aisle is more likely to sound like a life-only or life-first regime for optional federal chartering, assuming optional federal charters are even in the short-term mix now. Some Democrats have expressed doubts about optional federal charters for property/casualty companies since that could mean rate and form deregulation.
- The Treasury's whole competitiveness review of banking, securities, *and* insurance announced in its March 2008 Blueprint, coupled with the $700 billion TARP rescue plan and $800 billion consumer credit plan (not to mention the stimulus plan), has set the stage for a shift in policy in favor of some kind of overarching federal role, particularly if insurance companies are allowed to participate more in the second half of Treasury's capital purchase program. Treasury has so far said insurers can participate in TARP if they have a federal regulatory link, such as a thrift charter or a bank holding company charter. Over 20 do, but more are applying. The GAO report and the Group of 30 report, both released in January, are going to be considered along with Treasury's Blueprint as starting points in Congress's consideration of financial services reform.
- My prediction is that, at a minimum and soon, there will be discussion of a new Office of Insurance Information within Treasury to feed the federal government's need for reliable information about this sector of the economy. From there, we'll need to see Congress's appetite for biting off more as it considers some kind of systemic regulator for all financial services, including large insurance holding companies. And some in Congress will be saying that federal insurance regulation or oversight, at least for the large companies with systemic implications or federal support like AIG, should *not* be optional.
- Count on ever more insurance industry consolidation in the face of our economic woes and the ever more important search by companies for capital to stay alive. The state of the credit markets makes deals difficult to pull off, but that doesn't mean that companies won't be accelerating the search for business affiliations.
- Finally, I still think a relevant question is whether the current division among the industry and regulators can eventually be bridged, and powerful opponents of most federal regulation—like NAMIC, the Big I, the NAIC, and state government leaders—can be mollified in the face of Congress's intent to *do something*. Opponents of federal regulation will be a big part of the debate even in this environment, and warnings about the sweep of federal regulation will be heard. After all, the state-regulated insurance industry has fared better in the economic crisis than federally regulated banking and securities industries. ✪

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NOLHGA Calendar of Events

2009

March 15–18	IAIR Spring Meetings San Diego, California
March 15–18	NAIC Spring National Meeting San Diego, California
April 15–17	**MPC Meeting Oklahoma City, Oklahoma**
May 6–7	NCIGF Annual Meeting Oklahoma City, Oklahoma
June 13–16	IAIR Summer Meetings Minneapolis, Minnesota
June 13–16	NAIC Summer National Meeting Minneapolis, Minnesota
July 7–10	**MPC Meeting & Legal Seminar Chicago, Illinois**
Sept. 21–24	IAIR Fall Meetings Washington, DC
Sept. 21–24	NAIC Fall National Meeting Washington, DC
Oct. 12–14	**MPC Meeting & Annual Meeting Washington, DC**