Volume XVI, Number 3 | September 2010

nolhga journal

A Publication of the National Organization of Life and Health Insurance Guaranty Associations

The End of the Beginning

The financial services regulatory reform bill more or less leaves the guaranty system alone—but this is no time to relax

By Charles T. Richardson

The 13-month debate over financial services modernization finally ended on July 21, 2010, with a Rose Garden signing ceremony. The Dodd-Frank Wall Street Reform and Consumer Protection Act (*http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/conference_report_FINAL.pdf*) is now law.

President Obama unveiled his financial services modernization plan to much fanfare in June 2009. From that point forward the debate in the House and Senate was wide open and at points controversial, with the votes largely along party lines. But the Administration and congressional Democrats now have legislation that looks a lot like the plan unveiled in 2009 to deal with the aftermath of the Great Recession as we head into the midterm elections.

How We Got Here

The House jumped on the regulatory reform bandwagon first, with hearings throughout the summer and fall of 2009 led by House Financial Services Committee Chairman Barney Frank (D-Mass.). After the House's passage of a financial reform bill in December (by a vote of 223-202), the Senate finally got moving in March 2010, with a new bill introduced by Senator Chris Dodd (D-Conn.) on March 15 and a party-line Senate Banking Committee (chaired by Senator Dodd) vote a week later after a rip-roaring 20 minutes of debate. The Congress was coming off the uber-contentious health-care fight, so the Republicans on the Senate Committee decided to hold their fire for the floor. At any rate, the Senate floor debate started a month later. On May 20, the full Senate adopted its version of financial services reform by a vote of 59-39. Four Republicans voted yes, two Democrats voted no. Otherwise, it was a party-line vote.

Forty-three conferees—31 from the House and 12 from the Senate—took up the final debate in June over how to reconcile the House and Senate bills on financial regulatory reform. After a few wild weeks and a 20-hour marathon session that ended at 5:39 a.m. on June 25, House and Senate conferees agreed (by a vote of 27-16) on sweeping legislation that will change the way banks and other financial companies are regulated. On June 29, the conferees reconvened to strip out a $19 billion bank tax to win some Republican votes. On June 30, the House voted 237-192 to adopt the conference report; the Senate did the same on July 15 by a vote of 60-39.

The Dodd-Frank Wall Street Reform and Consumer Protection Act reached the President's desk weighing in at over 2,300 pages. It creates a new system for regulating large, interconnected bank holding companies and nonbank financial companies whose financial distress

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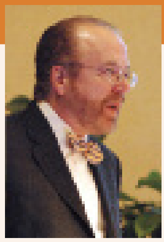


GA Coverage of RAAs

On August 15, 2010, NOLHGA President Peter G. Gallanis was invited to address the NAIC's Joint Working Group of the Life Insurance and Annuities (A) Committee and the Market Conduct and Consumer Affairs (D) Committee on Retained-Asset Accounts. Mr. Gallanis testified that retained-asset accounts used as a means of paying life insurance policy death benefits are and have been protected by the state life and health insurance guaranty associations. The following is adapted from his testimony.

I'd like to begin by thanking the co-chairs and members of the Working Group for this opportunity to testify. My name is Peter Gallanis, and for the last 11 years it has been my honor and privilege to serve as President of the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA). Before joining NOLHGA, I served as the insurance receiver for the State of Illinois. While I worked at the receiver's office, I also taught the course in Insurance Law for eight years at the DePaul University College of Law in Chicago. Before that, I had been a financial services lawyer in private practice in Chicago since 1978.

NOLHGA, on behalf of its 52 member guaranty associations or "GAs," coordinates the protection of consumers upon the liquidation of multistate life and health insurers. NOLHGA's membership has acted in approximately 100 insolvency cases over the past two decades or so, providing in each case prompt and full protection of all covered policies within statutory limits of guaranty association protection. NOLHGA's membership has stood behind and guaranteed more than $10 billion of life contracts issued by insolvent insurers and more than $12 billion of annuity contracts. That protection was provided for approximately 2.4 million insurance consumers.

The Working Group asked me to report today on the insolvency-related issues that bear on "retained-asset accounts," or "RAAs." Here are what seem to be the most important considerations:

First and foremost, life insurers in general tend to be among the safest and most conservatively managed and regulated of all financial services institutions. Over the past 20 years, only about 20 companies having more than a few life policies in force have entered liquidation. Of those, only three had life insurance liabilities in excess of $1 billion. Again, that's over a 20-year period. Compare that to the hundreds of banks and thrifts, some much larger, that have failed just since the start of 2008.

Second, because of the financially conservative ways in which life insurance companies operate and are regulated, in the rare cases when life insurers have failed, the shortfall of assets to liabilities historically has tended to be quite small. On average, even life policy claims *above* guaranty association limits have recovered over 96 cents on the dollar in liquidation proceedings. Stated differently, when a life insurer enters liquidation, it usually does so with substantial assets and substantial liquidity.

Third, in marked contrast to bank failures, the liabilities of a life insurer entering liquidation are for the most part *not* due and owing when the company fails. Most liabilities—such as payout annuities, death benefits promised to people who are likely to live another 30 years, and the like—will not be due and owing until years, decades, or even generations after the liquidation proceedings commence. Put another way, the liquidity demands for a life company entering liquidation tend to be low, compared to, for example, those at a bank, where liabilities predominantly comprise demand accounts.

This is not the first time the NAIC has taken a very close look at RAAs in general, and at guaranty association protection of RAAs in particular.

Fourth, while RAAs in fact *are* demand accounts, they tend to make up only a tiny fraction of the policyholder liabilities of most life insurers. I looked yesterday at the financial report of one of our largest life companies, and the amounts in its RAAs accounted for less than two-tenths of 1% of the face amount of its life insurance policies now in force. RAAs in and of themselves tend to be such a small part of a life insurer's overall book of business that neither earnings on, nor activity within, RAAs are likely to have any material impact on an insurer. RAAs, in and of themselves, clearly are *not* an industry-wide solvency concern.

Fifth, this is not the first time the NAIC has taken a very close look at RAAs in general, and at guaranty association protection of RAAs in particular. Back in 1993, when these accounts were not widely known, some insurance commissioners asked the NAIC to study them. An active working group of the NAIC's Life Insurance (A) Committee then looked at many of the same issues being considered again today. One question specifically raised back then was the extent to which guaranty associations cover RAAs. At the request of that working group, NOLHGA delivered written and oral testimony asserting unequivocally that guaranty associations not only do cover RAAs, but noting also that they had in fact done so. ACLI submitted written and oral testimony from the life industry to the same effect. The minutes of the working group state clearly that *all* members of the working group—the insurance regulators closely studying the issue—received and reviewed NOLHGA's written submissions; that *all* working group members were satisfied that the issue of guaranty association coverage was "resolved"; and that any concerns about guaranty association coverage had been "laid to rest." That was in November and December of 1993, and the working group member states that unanimously reached that conclusion and reported it to (A) Committee included Texas, Washington, Vermont, and Oregon, which chaired. And so, guaranty associations in fact covered RAAs before 1993 and have continued to do so since then.

Members of this Working Group might ask, as Milton Friedman liked to say, "That's all well and good in practice, but how does it work in *theory*?"

That brings me to my sixth point. Guaranty associations concluded that they were required to cover RAAs, even before the 1993 working group review, for the simple reason that the statutes establishing and governing the guaranty associations cannot reasonably be interpreted any other way. No other conclusion is plausible: not by a guaranty association, not by a regulator, not by a creditor, not by an interested third party, and not by a court. Indeed, it's hard rationally to envision who would even challenge that conclusion, since the guaranty associations themselves would be attempting to pay beneficiaries up to limits, and any attempts by estate creditors to increase their recovery from estate assets would not depend on whether or to what extent the guaranty associations have statutory coverage obligations for these RAAs.

All states, the District of Columbia, and Puerto Rico have enacted guaranty association statutes based on the NAIC's Life and Health Insurance Guaranty Association Model Act. The Model Act contains a statutory rule of construction, of the type often relied upon by courts, requiring that the Act be construed to effect the purpose of protecting covered persons under covered policies. See Model Act Section 4 and Section 2. The Model Act requires guaranty associations to cover death benefits to contract beneficiaries in Sections 3A(1), 3B(1), and 3C(2)(a)(i). And it requires associations to pay on "supplemental contracts" to life contracts in Section 3B(1), with "supplemental contracts" being defined in Section 5W as *any* "written agreement entered into for the distribution of proceeds under a life, health or annuity policy or contract." That's precisely what an RAA does. Now, recall the Model Act's own internal rule of construction requiring that it be construed to effect the purpose of protecting covered persons under covered policies. With that in mind, under what possible, reasonable construction can it plausibly be argued that a guaranty association does *not* have the obligation to cover death benefits—which are clearly covered—when those are held pursuant to an agreement establishing an RAA—which is clearly "an agreement entered into for the distribution of proceeds under a life contract" and therefore also a clearly covered "supplemental contract?"

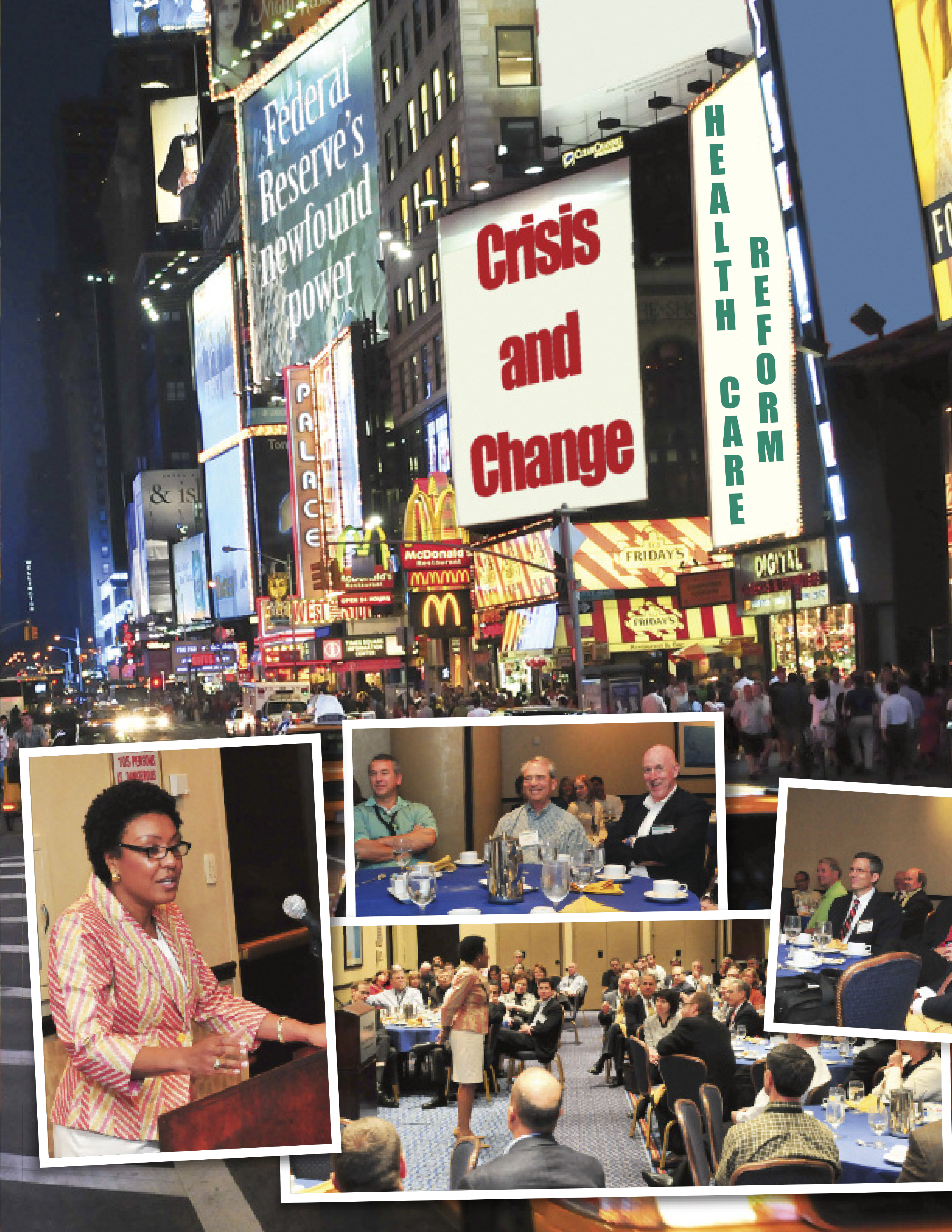
Seventh, the notion that guaranty association coverage may vanish just because explanatory documents say an RAA beneficiary is a "creditor" of the insurance company is fatally flawed as a matter of law. Once a life insurer becomes obligated to pay a death benefit, basic hornbook law says that the beneficiary is *always* legally a "creditor" of the insurance company, and this is true regardless of whether an RAA is used. The RAA does not change what was *already* a debtor/creditor relationship. Guaranty associations are obliged *by law* to cover death benefits under life insurance policies. They are obliged *by law* to cover death benefits that are paid through supplemental contracts. By statutory definition, this obligation extends to RAAs. In addition, beneficiaries do not need any "special relationship" with their insurer to receive guaranty association coverage—they simply need to be owed a death benefit under an insurance policy or under a contract entered into to satisfy a death benefit obligation (such as an RAA). Either way, the guaranty associations cover. Period.

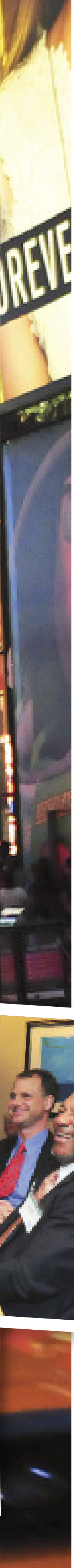
Finally, and as most members of this Working Group already know, there is no serious question that the life and health guaranty system has more than enough financial resources to honor statutory obligations in respect of RAAs or any other obligations covered by guaranty associations. The current aggregate annual assessment capacity of the life and health insurance guaranty system is about $10 billion dollars—and the assessment capacity is refreshed each and every year. That means that, at current levels, about $100 billion would be available if needed over the next 10 years. Barring an end-of-the-world scenario, nothing remotely near that will ever be needed. The most the system has ever needed to collect through assessments in a given year—even in the midst of the worst insolvency cycle ever seen—was about $1 billion: nowhere close to the system's annual financial capacity then, and a tenth what it is now. The entire net amount of assessments needed to protect consumers dating back to the *inception* of the national life and health guaranty system totals about $5 billion—roughly half the system's financial capacity for the current year alone.

And while capital capacity thus is not an issue, neither is liquidity. In addition to significant funds that guaranty associations have on hand and can collect promptly through assessments, recall that when life insurers fail, they typically have on hand very substantial assets. That is why, as noted before, even *uncovered* life policy benefits (for example, policy claims in excess of guaranty association "caps") on average have received over 96 cents on the dollar in life insurer liquidations. Those assets within the estate of the typical failed company, the assets on hand at the guaranty associations, and the ability of the associations to assess quickly, taken together, are the reason that guaranty associations have always been able to provide full and immediate protection for covered benefits, as they will continue to do in the future.

I apologize to the Working Group and its co-chairs for speaking at such length, but a lot of confusion has developed recently around the topics I have tried here to clarify. I know that it is critically important that both this Working Group and the public learn the truth and understand that retained-asset accounts are protected by the life and health insurance guaranty associations. To that end, I would be happy to address, now or later, any questions the Working Group may have. Thank you very much for the opportunity to testify today. ✯

Peter G. Gallanis is President of NOLHGA.


Crisis and Change
HEALTH CARE REFORM
Federal Reserve's newfound power
PALACE
McDonald's
FRIDAY'S
DIGITAL



New York State of Mind

NOLHGA takes a recession, reform, and receiverships and puts on a show in Times Square

With a theme like "crisis and change," it's no surprise that NOLHGA's 2010 Legal Seminar played to a packed house (more than 170 attendees made their way to New York City in July). After all, there's plenty of both going on in the insurance industry and the guaranty system, as Seminar Planning Committee Chair Joel Glover (Rothgerber Johnson & Lyons) noted in his opening remarks.

The program reflected the theme perfectly, with presentations on the likely effects of the Dodd-Frank Act, the future of health-care reform, the causes and effects of the Great Recession (see "Interview with a Legend" on p. 10), and more. And the performers (OK, lawyers) delivered on the promise of the program, with performances that were at times humorous, pugnacious, and downright off-the-wall.

Former Georgia Chief Justice Leah Ward Sears mixed humor and insight in her luncheon address, using a story about a car trip in her youth to encourage attendees to "pull over every once in a while to reflect and think on things lasting." She also remarked that "judges are generalists, not specialists," advising the lawyers in attendance not to bury judges under arguments laden with industry jargon.

Regulation Takes Center Stage

The issue of financial services reform dominated the summer, and the seminar was no exception. Moderator Charlie Richardson (Baker & Daniels) kicked off a panel discussion on the reform act's effect on the economy and the financial services sector by observing that the Dodd-Frank Act created "a new federal focus to all things insurance." Did he somehow foresee the coming furor and promised congressional hearings looking into retained-asset accounts? It's hard to say, but perhaps worth noting that "retained-asset accounts" is (very nearly) an anagram of "Charles T. Richardson."

Brian Gardner (Keefe, Bruyette & Woods) noted that "you can't just look at the Act in a vacuum—we're in a reg-

By Sean M. McKenna

New York Superintendent of Insurance James Wrynn welcomed attendees and spoke about the rapidly changing insurance industry, noting that "the insurance marketplace is global and is becoming more global every day." He added that his department is working to enhance the city's image as a financial center; these efforts could include reopening the New York Insurance Exchange.

ulatory cycle." He added that this cycle of increased regulation would continue even if Republicans take over Congress in the next elections, though the nature of the regulations would change.

As for the Act itself, he was lukewarm. "There's some good stuff in this bill, but there's a lot to knock in it," he said, especially the absence of any action on Fannie Mae and Freddie Mac. He also expressed concern about the Federal Reserve's newfound power to break up institutions that pose systemic risk. "When a regulator gets a new power," he said, "they want to use it quickly and decisively" to show how it will be employed in the future. The question is, what company will it be used on?

Douglas Elliott (Brookings Institute) described himself as "quite a strong supporter of the Dodd-Frank Act and the Administration's goal." He noted that President Obama faced the same choice as President Roosevelt during the Great Depression—scrapping capitalism or trying to fix it. In both cases, he said, the presidents made the right choice by attempting to improve regulation instead of revamping the economy.

In Elliott's opinion, one of the causes of the financial crisis was that over a 25-year boom period, "we got lax. Risk wasn't scary enough, and we became not careful enough." The Act does signal "the expansion of the perimeter of what's being regulated," he said, and he admitted that the Consumer Financial Protection Bureau (CFPB) "scares me a little bit" because no one knows what it's going to do. He also raised doubts about the Financial Stability Oversight Council and its ability to head off another financial bubble; he noted that "bubbles are exceedingly popular" up until the moment they burst.

Michael Krimminger (FDIC) zeroed in on the "too big to fail" issue, saying that "it was critical that we create a resolution process" for such companies "to squeeze out some of the moral hazard." He added that "bankruptcy will be the default mode" in the resolution of too-big-to-fail institutions.

Krimminger expressed confidence that the Oversight Council "can have a very significant role" in preventing systemic risk if its chairperson is willing to challenge other regulators, while admitting that "we would have preferred a stronger oversight role." He also noted the CFPB will need to focus on areas that to this point haven't been regulated, rather than targeting "sitting ducks" that already have extensive oversight.

In a lively but never violent question and answer session, Elliott said that regulators didn't distinguish themselves in reaction to the economic bubbles of 2007 and 2008. "There were mistakes made by virtually everybody across the board," he said. "If Dodd-Frank had been in place a few years ago, we would have had a much less severe crisis."

All three panelists expressed concern about too-big-to-fail companies. Krimminger noted that under the new Act, "there will be no authority to provide TARP, to provide cash infusions" to a failing company. Elliott agreed, asking what the government would do if we faced a situation where the choices were another TARP program or a recession.

When asked if consumers should be confident with the new Act in place, Gardner replied, "I hope they're not overly confident. People have to be careful of falling into this false sense of security that the regulators will take care of everything." Elliott answered that "over time, this will make the world somewhat safer."

What About Insurance?

Talk turned from the economy to what really interested people—LeBron James joining the Miami Heat—in a panel discussion exploring the impact of financial services regulatory reform on the insurance industry (James was really only mentioned in passing). Moderator Scott Kosnoff (Baker & Daniels) led a spirited debate touching on systemic risk, the role of insurance in the Dodd-Frank Act,

and the strengths of the guaranty system.

While it was suggested in the earlier panel that insurance emerged relatively unscathed in the regulatory reform debate, Thomas Sullivan (Connecticut Insurance Commissioner) said that "we were brought into Dodd-Frank more than we would have liked." He also criticized the Act for "creating another layer of too big to fail—why do we need a new layer of bureaucracy?"

Nicholas Latrenta (MetLife) called the Act "essentially a bank-centric proposal," adding that "the nuances and complexities of the insurance business weren't taken into account." He noted that his company could fall under the dreaded banner of being "systemically significant," although no one at this point is really sure what that would mean. Ernest Patrikis (White & Case) suggested that it would mean "a life full of rude awakenings"—enhanced regulation, federal supervision, getting to know bank examiners on a first-name basis, etc.

In discussing the new Federal Insurance Office (FIO), Latrenta expressed uncertainty about its ultimate impact, calling it "something that in the future could turn out to be enormously positive for the insurance industry—maybe." He added that it would fill a void on Capitol Hill, where there's a lack of insurance expertise, but Sullivan disagreed: "This notion that no one in Washington knows insurance, I think it's a bunch of garbage. I dismiss it out of hand."

Sullivan said the key would be how the FIO exercises its power: "If needed, we will challenge the authority of that office" to protect consumers. Patrikis agreed with Latrenta that Washington is largely devoid of insurance knowledge and suggested that federal preemption by the FIO would not be much of a concern.

The FIO is charged with studying the feasibility of bringing insurance insolvencies into the federal resolution

(From left to right) Charlie Richardson, Brian Gardner, Douglas Elliott, and Michael Krimminger debate the merits of the Dodd-Frank Act.

Commissioner Susan Voss, Daniel Evans Jr., and Lindy Hinman discuss the health-care reform bill.

Scott Kosnoff, Commissioner Thomas Sullivan, Nick Latrenta, and Ernie Patrikis discuss the likely impact of the Dodd-Frank Act on the insurance industry.

Tad Rhodes (center) brings a little Big Apple Circus atmosphere to the Legal Seminar. Frank O'Loughlin (left) and Bill O'Sullivan (right) chose not to follow suit, or nose.

authority, and Latrenta said that it's "absolutely critical" to this study that the differences between banking and insurance be made clear. He acknowledged the need to determine if the current receivership process can be improved, but he warned that "I don't think it's going to be easy to create a markedly better system." Patrikis remarked that the new resolution authority "is a horror in its own right," saying it's designed to punish companies and shareholders.

Sullivan stressed that "the structure that's really working is FAWG"—the NAIC's Financial Analysis Working Group, which tracks troubled companies and critiques the actions of local regulators. "FAWG provides a check and balance to ensure that state regulators are doing their jobs," he said. "It's inherent accountability."

Asked to suggest improvements to the current guaranty system, Latrenta called for uniform benefit limits, while Patrikis said "I think very highly of the system. I don't see a lot of need for change." Sullivan praised the benefits of early intervention by regulators and guaranty associations, noting that "the spirit of cooperation is pretty strong."

The Doctor Is In

Cooperation isn't the first word that springs to mind when discussing the new health-care reform bill, but the members of a panel discussion on the bill's likely effects on the industry (moderated by Charles Gullickson of the South Dakota Life & Health Insurance Guaranty Association) complemented each other exceedingly well in a presentation that made it clear that the prospects for the bill's success, as the panelists view them, aren't necessarily healthy.

Susan Voss (Iowa Insurance Commissioner) expressed grave doubts about whether The Affordable Health Care Act would truly make health care affordable. "Until we change some of the habits of consumers, I believe we'll see rates go up for some time," she said, noting that "we're adding the sickest of the sick" to the insurance rolls. Daniel Evans Jr. (Clarian Health Partners) agreed, saying "demographics and utilization will eat us alive."

Lindy Hinman (America's Health Insurance Plans) said that her organization is "focusing heavily on the implementation phase" in 2014, when much of the bill goes into effect. She warned that "the bill does not address underlying costs drivers," a theme echoed by Evans and Voss.

"This is a cultural issue as well as a financial issue," Evans said. "The mistake society has made is not caring about how much the other guy spends. Everybody is trying to push the risk on to somebody else." He described the reform bill as a "huge opportunity lost" because lawmakers had an opportunity to address rising costs but failed to do so in the end. Voss agreed, saying "we stink in the red zone. We get down to the 20-yard line, but we can't punch it in."

The prognosis was not all bad, however. When asked if there are any good aspects of the legislation, Voss drew laughs by replying, "Finally somebody passed something. I think that's pretty amazing." Evans added that many of the studies called for in the bill could be beneficial, especially those on comparative effectiveness. Hinman agreed, saying "the comparative effectiveness piece is potentially groundbreaking" because it could help "build a better evidence base" to identify effective treatments, as well as wasteful ones.

Evans predicted that we will see rationing of health care, but not on an official basis. "It will not happen by law," he said, "but you can ration by high cost. I believe we're going to have de facto rationing." Voss predicted that the rate review provisions will take some of the heat off state regulators, who have performed this duty in the past. "We've been taken to task for something we really did a good job on," she explained, and federal review will make the process, and its difficulties, more obvious to critics.

Evans wrapped things up with a warning to the industry. "You need to do a better job of explaining how you do business," he said, adding that the industry has allowed politicians to paint insurance companies as the bad guys. There's a natural tension between those who want to insure everyone and the business model of insurers, he noted, and if that model isn't explained better, "the health insurance industry, as we know it, will be federalized."

Outside the Box

Other presentations took a look at guaranty system operations from a fresh perspective. Kevin Griffith (Baker & Daniels) led a discussion of prepackaged bankruptcy plans, evaluating whether "prepacks" might work in the insolvency resolution arena. Lee Attanasio (Sidley Austin) explained that the goal of these plans is the same as in any corporate bankruptcy proceeding. "A prepackaged plan is designed to do most of the legwork before you even file for bankruptcy," he said. "The key benefits are that you save time and, by definition, you save money."

Jeff Liebmann (Sidley Austin) noted that the goal of a corporate bankruptcy is to keep the company as a going concern, "a fundamentally different goal than the receivership process." A receiver, he explained, is not concerned with maintaining the company that's been declared insolvent: "A lot if it doesn't work and doesn't fit."

Griffith did his best to marry prepacks with the receivership process, suggesting that it might be possible to devise a prepack designed to protect policyholders and not the company itself. He admitted, however, that the idea is "fraught with problems" due to the difficulty of moving the business to protect policyholders without somehow damaging confidence in what would still be an active company.

Joel Glover (Rothgerber Johnson & Lyons) moderated a panel examining risk management for guaranty association board members. Glover began by noting that the statutory immunity granted to board members is "extraordinarily powerful language" that has been upheld by the courts. There are exceptions to every rule, however, and Micky Cowan (Watkins Ludlam Winter & Stennis) walked attendees through a lawsuit filed against the board members of the Mississippi "Windpool," a state-sponsored group of insurance companies similar to a guaranty association.

The Windpool board members were sued by other members of the organization for breaching fiduciary duty and negligence. In effect, they were charged with acting in the best interests of their companies and not the organization's members. The board members eventually prevailed in what proved to be a costly process, and Cowan stressed that their victory was largely due to accurate documentation of their decision-making process, reliance on professional experts, and making their meetings open to member companies.

Carol Zacharias (Ace North America) offered advice on directors and officers insurance, noting that today's policies cover a great deal more than earlier policies did. "It's really not D&O insurance," she said. "It's sort of an all-risk policy." Even if such policies are customarily offered to all board members, she emphasized the importance of actually reading your policy: "You're the only person representing you."

In a presentation that was part MTV (when they played videos) and part Carrot Top (when he was funny), Tad Rhodes of the Oklahoma Life & Health Insurance Guaranty Association and NOLHGA's Bill O'Sullivan conducted a Point/Counterpoint debate on some of the most significant legal issues facing the guaranty system. Ably assisted by moderator Frank O'Loughlin (Rothgerber Johnson & Lyons), Rhodes and O'Sullivan discussed the merits of lengthy rehabilitations, paying agent commissions during rehabilitation, and other topics—first making it very clear that the views they espoused might not be their own, or anyone else's.

Singing the praises of lengthy rehabilitations, Rhodes argued that "the rehabilitation court has very broad powers. Once you enter liquidation, everything is set in stone." O'Sullivan deftly parried, maintaining that "if a company is insolvent, the best place for it is liquidation," which comes with the priority statute, prohibition against preferences, etc. He also noted that if the rehabilitation goes badly, the guaranty associations are left "to pick up the pieces."

O'Sullivan also took a stand against paying agent commissions during rehabilitation, saying that such commissions are a general creditor–level claim and so should not be paid: "It's a drain on the cash at the expense of policyholders and the guaranty associations."

This seemingly innocent argument drove Rhodes over the edge. "I haven't seen someone this upset about rehab since Amy Winehouse," he said as the video to the song played behind him and the image of Winehouse traumatized attendees. Rhodes argued that failing to pay commissions will lead agents to churn the business. "If you're trying to rehabilitate the company, that's just the kiss of death," he said, turning to prop comedy by donning a red clown nose. The audience, perhaps frightened of what might happen if they disagreed, applauded. ✪

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

INTERVIEW

with a Legend

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

The following is an edited transcript of my interview with H. Rodgin Cohen, Senior Chairman of the leading Wall Street law firm Sullivan & Cromwell LLP, a man one observer has called the "Trauma Surgeon of Wall Street." In part one of our interview, which took place on July 15, 2010, at NOLHGA's 17th Annual Legal Seminar in New York City, we discuss some of the better- and lesser-known causes of the financial crisis.

Gallanis: The recent financial crisis is sometimes described by people as a "black swan" event—something that had never been seen before and couldn't have been predicted from any of the historical precedents.

But we had failures of major banks before IndyMac and Washington Mutual failed. And we had seen failures of hedge funds, such as Long-Term Capital Management. We had seen big investment banks fail before Bear Stearns did, and we've had bad recessions and depressions before—The Great Depression, what we saw in the early 1970s, the early 1980s, the S&L crisis, the Latin American and Asian debt crises, the dot-com bubble bursting, and so forth.

So as a matter of historical context, what, if anything, was really so different about the financial crisis of 2008?

Cohen: Let's begin by comparing what happened in 2008, particularly in the fall, to periods subsequent to the Great Depression. There were serious problems. There was the Russian Debt Crisis. There was Long-Term Capital Management, and Drexel, and Continental Bank. You can go on and on, but these tended to be isolated events: either an individual company or a relatively limited geographic area.

What happened in the fall of 2008 was what I call true financial contagion—where no one would deal with anyone else, where the underlying creditworthiness of an institution was irrelevant because everyone was unwilling to trust any other institution. And so you had absolute gridlock in our financial markets. And the threat of a true domino-type effect with one institution falling and taking with it another, and another, and another.

Now, that actually does happen in the Depression, as a climate of fear overtook depositors at banks. But the key difference is, we were talking about much smaller institutions and a very different, far less interconnected financial system. That, I think, is where this event is really distinguishable from what happened subsequent to the Great Depression, the 1929 to 1933 period.

You started, and I think quite properly, with history. What almost nobody has written about is this great change that was made—the original TARP proposal was to take out bad assets, but it ultimately involved capital injections. That is *exactly* what was done in the 1930s. It was capital injections, and hopefully people learned and actually read some of the papers that were written about what happened at that time because the two programs, the Reconstruction Finance Corporation and TARP, are actually quite similar.

Gallanis: Very interesting. In the days after the Lehman bankruptcy in mid-September 2008, and after the initial rescue of AIG, with the Reserve money market fund having just "broken the buck," the stock of Morgan Stanley and Goldman Sachs in free fall, and interbank lending drying up, Treasury Secretary Paulson and Fed Chairman Bernanke met with some leaders in Congress to propose the initial, three-page TARP plan. At that time, Chairman Bernanke told Congress that he, as an academic scholar of the Great Depression, was convinced that if Congress didn't act very promptly, and I'm quoting now, "and act in a big way, you can expect another Great Depression, and this time it's going to be far, far worse."

From what you were able to see and what you were hearing from people working on Wall Street, was Chairman Bernanke's statement an exaggeration, or had the degree of panic in the financial markets really reached that point?

Cohen: Oh, I think Chairman Bernanke was absolutely correct. The tragedy is that we didn't do some of the things that were done in the fall of 2008 six months earlier. But I don't think he could have gone to Congress at that point in time with Treasury Secretary Paulson and said, "The sky is falling." They would have been regarded too much as Chicken Little. Only at that point {in September} could they have really gone when there was so much clear evidence. But I have no question that there was no exaggeration and that we weren't just talking about a financial problem or an economic problem. Had Congress not acted, I think we could have very likely seen the type of societal and political upheaval we really saw in the 1930s.

Gallanis: There is much debate about the causes and contributing factors for this crisis. One piece of conventional wisdom is that the crisis itself was predominantly the result of excessive deregulation—although there certainly are people, like Peter Wallison, who contend that few industries at the time were more regulated than the banking sector. Do you view the crisis as having been caused primarily by deregulation?

Cohen: In my view, absolutely not. You try and look at cause and effect. Everyone seems to point to the partial repeal of Glass-Steagall. Actually, Glass-Steagall had two significant elements. One was restricting what banks and depositories could do, and the other restricted what affiliates of depositories could do. What was done in 1999 was only to remove the restrictions on the latter, the affiliates. The restrictions on the depositories themselves remained in place. But this is what the critics of deregulation point to.

Now, take that and layer that against the failures and near-failures of major institutions. Bear Stearns had nothing to do with the repeal of Glass-Steagall. It was an investment bank before; it was an investment bank after. IndyMac had nothing to do with Glass-Steagall. It was a bloated thrift. Washington Mutual? Nothing to do with Glass-Steagall. AIG? Fannie and Freddie? You go on and on and on. You cannot find, with possibly one exception, a single correlation between the repeal of Glass-Steagall and the failure or near-failure of an institution.

I think there were certainly serious flaws in the regulatory scheme, but that can't be traced back to what happened in 1999.

Gallanis: Let's stay on Gramm-Leach-Bliley and its partial repeal of Glass-Steagall as an arguable factor in the crisis and its resolution. I've even heard it contended that, without Gramm-Leach-Bliley, some of the resolution steps that were taken—for example, the resolution of the Bear Stearns situation, or the resolution of the crisis at Merrill Lynch—would have been impossible.

Cohen: That is a very good point. That also raises a serious question about one of the provisions in the financial reform legislation, which would prohibit large acquisitions. The rescues of Bear Stearns and Merrill would have been impossible had this legislation been in effect in early 2008.

Gallanis: Let's do a little more probing of conventional wisdom. There is also a view that the resolution steps pursued by the Treasury and the Fed in 2008 involved too much ad hoc and inconsistent decision making. For example, saving Bear Stearns and then letting Lehman fail, and then saving AIG. Wiping out preferred stock in some institutions while protecting it in others. Or as you mentioned yourself, initially pitching the TARP program as an asset-purchase mechanism and then ultimately using it as a capital-infusion mechanism. Are these fair criticisms of the people at Treasury and the Fed who were involved in the rescue efforts, or do they perhaps fail to take into account the time and circumstances?

Cohen: I find it very difficult to criticize what were admittedly ad hoc responses to a series of rapidly evolving, unprecedented crises. It would have been ideal if some group of wise men had been sitting around for 20 years and had that sort of red-covered pamphlet in their desk which says "what happens if such and such and such occurs, how will we respond?" But that's providing far too much credit to anybody's ability to predict the future. I think, in fact, the ad hoc nature of what happened is reason to commend rather than condemn the governmental people responsible, because in most of these cases, the ad hoc solutions worked.

Even in Lehman, which has been criticized, including by me—I think that it was a mistake to let Lehman fail—but the government, I think, really tried diligently to prevent the failure. I think it ran out of time. Another day, two days, so that there could have been better coordination between the British and U.S. governments with respect to Barclays's bid, and I think it could have gotten there. But these were always "when do the markets open in Asia" crises.

Gallanis: I've also heard it suggested that if Lehman had not been allowed to fail, and if the consequences of the failure had not, therefore, been visible to all, a rescue of AIG wouldn't have been politically possible, and TARP wouldn't have been politically possible.

Cohen: That's one of the great mysteries. Would the government have been willing to salvage AIG? I have some doubts, frankly. So, it's just one of these ironies of history, but we will never really know. I don't think anybody sat around—you made a very astute observation a few moments ago about the Reserve Fund. I am fairly confident that no one in the government, and frankly, no one in the private sector, said if Lehman goes, the largest money market fund will go the next day. That's the danger in not overreacting. You want to get it just right, but in a true crisis atmosphere, I would rather take the risk of overreacting because, again, it is just so difficult to predict the outcome of a cataclysmic event.

Gallanis: Further visiting the question of causes or contributing factors, I'd like to ask for your perspective on how important several different issues were in the development of the crisis. I'm going to run down a list and ask if you would give me your reaction to each of these as a major or minor factor, perhaps with a brief explanation of your thoughts. Let me start with this: excessive leverage (or inadequate capitalization) in major financial institutions.

Cohen: I would say that this, if you want to rank them, is probably the single most important factor, but with a caveat that a crisis of this incredible magnitude had to have multiple causes, and if you try and come up with simplistic solutions based on a single cause, it just isn't going to work.

I would also say that leverage was not restricted to financial institutions. We have overleveraging at the consumer level, at a number of businesses, and at the governmental level. So, it was leverage in the system as a whole as well as the financial institutions.

Gallanis: What about just the sheer size of financial institutions and the extent to which market share seems to be increasingly consumed by three or four or five of the biggest players, compared to their relative shares of the market 10 or 20 years ago?

Cohen: This is a more difficult one. Again, I try and look at what is the correlation? If it were truly size, then it's very difficult to explain a number of events. First of all, of the major financial

What happened in the fall of 2008 was what I call true financial contagion—where no one would deal with anyone else, where the underlying creditworthiness of an institution was irrelevant because everyone was unwilling to trust any other institution.

institutions, some of them did well. If it were just size, then we wouldn't have had these hundreds and hundreds of smaller banks failing. If you look at the countries around the world where the banks did, perhaps, the best, those tended to be the countries where the banking systems were absolutely the most concentrated, such as Canada and Australia.

Now, I think there are other reasons. It's not just that they are concentrated, but for the same reason you can't just say size is responsible for what happened.

Gallanis: What about the degree of financial interconnectedness of major American and global financial services firms?

Cohen: I think that clearly is a problem, because it creates this almost unbearable pressure for "too big to fail." Because if you let one institution go down, you have no idea what other institutions will go as well, how they will be affected. I think we, hopefully, learned a lesson about the danger of interconnectedness and the dangers of "too big to fail." I am actually optimistic that we have this largely solved in the legislation. I think the new resolution procedure, which is very difficult to understand and read, does give the FDIC the authority to resolve firms, and I think the FDIC intends to use the authority to resolve them in such a way that interconnectedness is not an inseparable obstacle again.

Gallanis: What about the inability of functional regulators who are focused on particular, functional segments of the financial services marketplace to stay on top of increasingly complex, multi-functional financial services conglomerates?

Cohen: I think that was a factor. If one wants to criticize Gramm-Leach-Bliley, it would be more for the political compromise which led to silo regulation of financial institutions. But again, I think the new legislation has this about right, with the Federal Reserve as the supervisor of the institutions which are the most likely to be in this multi-faceted category. In addition, with the new Systemic Risk Council, you have a second layer of oversight. So this was a problem, and it seems to me, the legislation is clearly responsive.

Gallanis: The topic of executive compensation probably provoked more sales of torches and pitchforks than anything else about this crisis—particularly the bonus system at the investment banking firms. Was this a major cause of the problem?

Cohen: This has to be a contributing factor. The idea that it was "heads, I win, and tails, I walk away and still win" just doesn't make sense. I don't want to sound like a cheerleader here for the legislation because there are flaws in it, but I think the administration and regulators have it about right to focus on incentive compensation and the need to better calibrate risk and reward, and to make sure that incentive compensation is measured over a prolonged period of time, so that short-term gain, long-term loss never again happens as a factor in compensation schemes.

I don't regard this as a leading factor, but it's hard to argue that it didn't contribute.

Gallanis: The prevalence of complex and structured investment vehicles—straight mortgage-backed bond transactions, collateralized debt obligations, "CDOs squared" and the like—these products were an aspect of the financial services landscape in 2008 that was very different than anything seen before. To what extent was the emergence of the complex and structured investment sector of the marketplace a contributing factor in the crisis?

Cohen: It is and was a contributing factor, but again, I don't want to exaggerate it. Many of these instruments, they have very complicated names and I think sometimes they are sold based on their complexity. It gives them an aura. But most of them, stripped down, are actually fairly simple. It's a group of mortgages or bets on mortgages, and if housing prices go up, everybody is going to be fine. And if they decline, there is likely going to be a disaster. Really, the fundamental aspects were fairly simple.

To me, the far greater issue, far greater, was the explosion of the credit default swap market, which really happened under the noses of—maybe that's unfair, let's say without the knowledge of—the regulatory apparatus. When you look back, Chairman Bernanke is criticized for a speech that he made, I think, in 2007 where he said, "The fallout could be contained from the subprime mortgage market." He was right—if it had been just the subprime mortgage market. The problem is that this market effectively had been leveraged 10 to 20 times throughout the financial system through the writing of credit default swaps and other synthetics, and the regulatory community was simply unaware of what was going on. They had an idea, but I don't think they were even close to guessing at the magnitude. ✯

Part II of this interview will appear in the next issue of the NOLHGA Journal*.*

["The End of the Beginning" continues from page 1]

or failure could threaten the financial stability of the United States. There is a whole range of banking, insurance, derivative, reinsurance, surplus lines, and consumer protection provisions and studies.

Oversight & Resolution Authority

Large, interconnected financial companies that are systemically significant will be identified by a Financial Stability Oversight Council chaired by the Treasury Secretary (Title 1, Subtitle A). (This could include insurance companies and insurance holding companies, although most observers contend that few, if any, insurers are systemically significant.) Once identified, these large financial companies will be subject to stringent regulation by the Federal Reserve Board.

The legislation also creates a new mechanism for liquidating systemically significant financial companies whose failure could destabilize the economy (Title II). While the FDIC will be appointed receiver of and liquidate most types of financial companies, insolvent insurers (including any that are systemically significant) will remain subject to state receivership and guaranty association processes. The only exception would be if the domestic state fails to act quickly enough and the FDIC's "backup authority" kicks in (Title II, Sec. 203(e)(1-3)), in which case the domestic state would have 60 days to act. In a late-breaking turn of events, the conferees gave the newly formed Federal Insurance Office (rather than state insurance regulators) a vote in triggering authority for orderly liquidation when a financial company or its largest subsidiary is an insurance company (Title II, Sec. 203(a)(1)(C)).

Resolution of systemically significant financial companies will be funded by a post-liquidation resolution fund. If any insurers are tapped to contribute to this fund, they will get a credit for guaranty fund assessments already paid (Title II, Sec. 210(o)(4)(B)(iv)). This resolution fund is separate from the $19 billion tax that the legislation originally levied on large financial institutions, including insurers, with assets under management of more than $50 billion; that tax was stripped out of the bill on June 29.

Even though insurer insolvencies will be conducted under state law, the FDIC could be appointed receiver of certain subsidiaries of an insurance company if they are in default or in danger of default, their failure would have a significant adverse effect on the U.S. economy, and certain other criteria are met. That outcome probably should not concern receivers or guaranty associations, since such subsidiaries would be unlikely to have any value that could be used for policyholder protection.

Federal Insurance Office

The legislation also establishes a Federal Insurance Office (FIO) in the Department of the Treasury with limited authority over all lines of insurance other than health insurance (Title V, Subtitle A). This new office will give a new federal focus to all things insurance. Among other responsibilities, the FIO will monitor the insurance industry for regulatory gaps that could lead to systemic risk.

The FIO will also recommend to the Financial Stability Oversight Council those insurance companies that the FIO believes should be subject to regulation as nonbank financial companies by the Federal Reserve Board. Both the director of the FIO and a state insurance commissioner will have non-voting seats on the Council. The FIO will be authorized to gather (or in some cases, subpoena) data from insurers and their affiliates for these and other purposes, but only after coordinating with federal agencies and state regulators and determining that the informa-

The legislation requires the FIO Director to conduct a study on how to improve and modernize insurance regulation.

The Bottom Line

Under the Dodd-Frank Act, the guaranty system's existing role in protecting policyholders will remain intact—for now. But potential trouble spots loom. Here are the key "takeaways" from the Act.

- Large, interconnected financial companies that are systemically significant will be subject to oversight by the Federal Reserve Board. This could include insurance companies and insurance holding companies, although most observers contend that few (if any) insurers are systemically significant. FDIC will resolve systemically significant financial companies *other than* insurance companies.
- All insurance companies (including any that are systemically significant) will remain subject to state insurance insolvency laws.
- The guaranty system's existing role in protecting policyholders will remain intact.
- The newly created Federal Insurance Office will study the possibility of subjecting insolvent insurance companies to a federal resolution authority, including its impact on the guaranty system.

tion may not be obtained from those or other publicly available sources.

The legislation requires the FIO Director to conduct a study on how to improve and modernize insurance regulation, the results of which will be reported to Congress no later than January 2012 (Title V, Subtitle A, Sec. 502(a)). As part of the study, the FIO is charged with examining the potential consequences of subjecting insurance companies to a *federal* resolution authority, including the effects of any federal resolution authority on (A) the operation of state insurance guaranty fund/association systems, including the loss of guaranty fund/association coverage if an insurance company is subject to a federal resolution authority; and (B) policyholder protection, including the loss of the priority status of policyholder claims over other unsecured general creditor claims.

So when it comes to insurance company receiverships, the financial reform legislation maintains the status quo—but opens the door for big changes in the future as the federal microscope potentially gets focused on the guaranty function in the study to come. Keep in mind, this is just one of over 60 studies—68 to be exact—required by the Dodd-Frank Act on a whole raft of subjects.

Other Key Elements

The Act establishes a Consumer Financial Protection Bureau within the Federal Reserve, with the authority to write consumer protection rules and enforce those rules on banks and nonbank financial companies but not on the business of insurance or even auto dealers, for that matter (Title X). Any regulations passed by the bureau could be overruled if financial regulators vote to do so by a two-to-one margin. State consumer protection agencies would be allowed to enforce stricter consumer protection rules on national banks as long as the state regulation did not adversely interfere with the banks' ability to do business. State attorneys general are empowered to enforce rules established by the bureau.

The Act requires large banks and nonbank financial firms to increase and maintain capital standards, as included in the Senate bill via an amendment by Sen. Susan Collins (R-Maine) (Title VI). Banks with less than $15 billion in assets can keep their current capital standards, and large banks have up to five years to meet these requirements.

One area of considerable dispute between the House and Senate was the inclusion of the "Volcker Rule," a ban on proprietary trading by depository institutions named after former Federal Reserve Chairman Paul Volcker. Senators Carl Levin (D-Mich.) and Jeff Merkley (D-Ore.) pushed for stringent bans on hedge fund and private equity investment by depository banks, while Republicans argued that proprietary trading did not cause the 2008 financial crisis and thus should not be considered. Ultimately, regulators were instructed to write regulations limiting proprietary trading and banks were limited on certain forms of speculation, but banks were also allowed to invest up to 3% of equity in hedge and equity funds (Title VI).

Also receiving significant pushback was legislation by Sen. Blanche Lincoln (D-Ark.) dealing with derivatives (Title VII). Lincoln's strict requirement that all federally insured depository institutions spin off any swap-dealing operations was softened at the eleventh hour to allow for some swaps dealing, such as derivatives that hedge an institution's risk. The Act also requires that most derivatives be traded through exchanges and clearinghouses to increase accountability.

Also, of interest to the insurance industry, indexed annuities were exempted from Securities and Exchange Commission oversight; that authority was transferred to state insurance regulators (Title IX).

The Act streamlines the nonadmitted insurance markets by giving policyholders' home states the sole authority to collect premium taxes on and regulate multistate insurance policies for nonadmitted policies and by providing commercial purchasers easier access to the surplus lines insurance market (Title V, Subtitle B, Part I).

The Act also grants a reinsurer's home state sole regulatory authority over the reinsurer's financial solvency and authority to recognize financial statement credit for a company's reinsurance transactions. The reinsurer's home state also has governing authority over any contractual issues and preemptory power over any other state laws that interfere with contractually agreed-to arbitration (Title V, Subtitle B, Part II).

What's Next?

All in all, insurance receivers and guaranty funds and associations fare awfully well under the new legislation as the new day dawns. But that new day will bring a fresh look across a political and regulatory spectrum that is now both state and federal. As noted earlier, the legislation requires the new FIO Director to conduct a study on how to improve and modernize insurance regulation, the results of which will be reported to Congress no later than January 2012. So when it comes to insurance company receiverships, the financial reform legislation maintains the status quo—at least temporarily.

We've noted in the past the optional federal charter proposal of Reps. Bean and Royce, and we need to monitor its future development. Both sponsors are influential members, and they are support-

So when it comes to insurance company receiverships, the financial reform legislation maintains the status quo—but opens the door for big changes in the future.

ed politically by powerful industry champions of federal charters. But anything like that is far off and probably within the examination/investigation charge of the new FIO. However, Chairman Barney Frank said in July that the federal charter issue would be on the House Financial Services Committee agenda in 2011.

That second wave of insurance examination as a part of a new insurance presence in the federal government is where our receivership and guaranty association risks may be greatest. The spotlight will be on the guaranty system as never before when the FIO is up and running—and looking for things to examine. In addition to the FIO study, Senator Herb Kohl (D-Wis.), Chair of the Senate's Special Committee on Aging, has asked the U.S. Government Accountability Office (GAO) to conduct a review of how current regulatory structures ensure that institutions that sell annuities will be able to meet their financial commitments and the types of state guarantee funds that exist to protect purchasers of annuities. The review would include how the funds are structured, how they are monitored, and the circumstances under which they have been used to compensate owners of annuities.

For both the FIO and GAO studies, many state regulators and guaranty association members will certainly be asked, or even compelled, to give input. The federal camel's nose and humps will be under the heretofore state-regulated insurance tent, no doubt about it. You will be investigated—because Congress has now said it wants that done.

There are plenty of things that all players in the insurance industry need to do in the next year to make sure the next phases of regulatory reform do not produce a bad result for guaranty associations and the policyholders they serve. A new federal regulatory structure is sure to adopt the "trust our words but verify our actions" mantra of Ronald Reagan. The key this year and last was that the Congress and Administration not do something as part of its systemic risk/resolution authority review that puts at risk insurance consumer protections, guaranty association coverage, and the walling off of an insurance company's assets for policyholders/guaranty associations. Ditto the next Congress and Administration, and the next…and the next. ✯

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NOLHGA Calendar of Events

2010

October 4	**MPC Meeting** **Seattle, Washington**
October 5–6	**NOLHGA's 27th Annual Meeting** **Seattle, Washington**
October 17–19	ACLI Annual Conference Baltimore, Maryland
October 18–21	NAIC Fall National Meeting Orlando, Florida

2011

January 10–12	**MPC Meeting** **Coral Gables, Florida**
March 26–29	NAIC Spring National Meeting Austin, Texas
April 4–6	**MPC Meeting** **San Antonio, Texas**
August 29– September 1	NAIC Summer National Meeting Philadelphia, Pennsylvania
October 16–18	ACLI Annual Conference Orlando, Florida
November 3–6	NAIC Fall National Meeting Washington, DC

NOLHGA Journal
Vol. XVI, No. 3 | September 2010

The *NOLHGA Journal* is a publication of the National Organization of Life and Health Insurance Guaranty Associations dedicated to examining issues affecting the life and health insurance guaranty system.

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