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JOINT WORKING GROUP OF THE LIFE INSURANCE AND ANNUITIES (A) COMMITTEE AND THE MARKET CONDUCT AND CONSUMER AFFAIRS (D) COMMITTEE ON RETAINED ASSET ACCOUNTS

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Testimony of NOLHGA President Peter G. Gallanis

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 Mr. Gallanis' 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.

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 one percent 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. GAs 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 GAs cannot reasonably be interpreted any other way. No other conclusion is plausible: not by a GA, 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 GAs 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 GAs to cover death benefits to contract beneficiaries in Sections 3A(1), 3B(1), and 3C(2)(a)(i). And it requires GAs 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 GA 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 GA 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 GAs 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 GAs. 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 GAs 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 GA “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 GAs, and the ability of the GAs to assess quickly, taken together, are the reason that GAs 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.