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TESTIMONY FOR THE RECORD

OF

THE NATIONAL ORGANIZATION OF LIFE AND HEALTH INSURANCE GUARANTY ASSOCIATIONS

BEFORE THE

HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON INSURANCE, HOUSING AND COMMUNITY OPPORTUNITY

HEARING ENTITLED

"INSURANCE OVERSIGHT AND LEGISLATIVE PROPOSALS"

NOVEMBER 16, 2011

The National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) is pleased to submit these comments in response to the invitation of the Subcommittee Chair. NOLHGA's 52 members are the guaranty associations (sometimes called "GAs") formed by the 50 states, Puerto Rico, and the District of Columbia to provide protection for consumers facing financial harm from the failure of a life or health insurance company. NOLHGA's members, along with the state property and casualty insurance guaranty funds belonging to the National Conference of Insurance Guaranty Funds (NCIGF), have provided a nationwide insolvency "safety net" for American insurance consumers since the 1970s.

The objective of this written testimony is to provide the Subcommittee with an overview of the life and health insurance guaranty system and its operations, history, and ability to protect consumers—even in a challenging economic environment. NCIGF is concurrently submitting parallel testimony on the property and casualty insurance guaranty system.

THE LIFE AND HEALTH INSURANCE GUARANTY SYSTEM TODAY

From its inception in the early 1970s, the life and health insurance guaranty system has evolved into an effective national network that has fully performed its obligations to provide protection to consumers. The system has protected consumers in 80 insolvencies of insurers who wrote business in multiple states, and in another 326 instances where smaller single-state or regional

carriers failed.[1] In those cases, the system has protected, in the aggregate, more than 2.8 million policyholders, and it has guaranteed policyholder values in an aggregate amount of about $25 billion.

Although the recent financial crisis laid waste to a number of financial service providers of many kinds, operating insurance companies stood up well to the many challenges of the period: Only 13 life and health insurers (8 life and 5 health) were placed in liquidation from January 1, 2008, through November 16, 2011, with aggregate liabilities to policyholders of about $900 million.[2] And while the insurance industry has fared comparatively well through the crisis, the guaranty system's financial and operational resources are greater now than they have ever before been, supporting the conclusion that the system can and would protect consumers in a challenging future financial environment, as it has done in the past.

Development of the Current Life and Health Insurance Guaranty System

There was no organized national consumer insurance safety net before the early 1970s, but by then a consensus had developed that such a system was needed. As a result, insurance regulators, legislators, and the industry developed guaranty association model legislation (the "Model Act"[3]) that states adopted widely in the 1970s and 1980s as the foundation of the current guaranty system.[4]

By 1991, life and health insurance guaranty associations had been established by the legislatures of all 52 of NOLHGA's current member jurisdictions.

NOLHGA was formed by the guaranty associations in 1983 to provide a process, facilities, and staff to coordinate and support the activities of the member guaranty associations, particularly in connection with the insolvencies of insurers writing business in multiple states.

How Guaranty Associations Work

Insurance guaranty associations provide protection to consumers; they do not provide rescue or "bailout" financing for financially troubled companies. The fundamental responsibility of an insurance guaranty association is to assure the provision of insurance protection to consumers, up to a statutorily established maximum level of guaranteed protection, once the duties of the guaranty association have been "triggered" by a judicial determination that an insurer is insolvent and should be liquidated.[5]

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[1] Also included in the larger number are some cases where failed property and casualty insurers wrote a small amount of health insurance, and where the insolvency case triggered obligations of both property and casualty guaranty funds and some life and health guaranty associations.
[2] Compare, for example, the initial bank and bond debt of Lehman Brothers alone, which was reported on the first day of Lehman's bankruptcy as totaling approximately $765 *billion.*
[3] *See* NAIC Life and Health Insurance Guaranty Association Model Act ("Model Act").
[4] The development of the consensus favoring the guaranty system, the related model legislation, and enactment of the model legislation in the states are summarized in *The U.S. Guaranty Association Concept at 25: A Quarter Century Assessment*, Christopher J. Wilcox, 14 J. of Ins. Reg. 370 (Spring 1996).
[5] Certain conditions must exist in order for a guaranty association to have statutory responsibility to consumers. For example, in general the insured must be a "covered person" (*see* Model Act Section 3A); the contract under which

A working understanding of how guaranty associations protect consumers thus requires first a working understanding of the insurance receivership process.

The Conduct of Insurance Receiverships

Domestic U.S. insurance companies are excluded from the definition of "debtor" under the U.S. bankruptcy code, and thus their financial failure is resolved outside of the federal bankruptcy process.[6] Rather, an insurer receivership is an insolvency proceeding conducted in a state court of the state where the insurer is chartered and primarily regulated (the "domiciliary state").

Under the laws of most states, the receivership is commenced by the filing of a petition by the state's attorney general on the relation of the state's insurance commissioner, who is appointed statutory receiver if the court grants the petition.

Receiverships are of several different types. For example, in Illinois (and many other states), the mildest form of receivership is "conservation," under which the insurance commissioner is appointed conservator for purposes of securing the finances and records of the company, thus protecting the status quo pending a determination of whether a more serious form of receivership is required. If serious solvency concerns are raised, a company can be placed into "rehabilitation," where the commissioner, as rehabilitator, is expected to develop and propose to the court a rehabilitation plan aimed at addressing the causes for concern about the company. If a company is financially troubled and cannot be rehabilitated, the commissioner petitions for "liquidation," under which the commissioner is appointed liquidator and directed to marshal the assets of the failed company, evaluate claims against it, and distribute the assets to those with valid claims in the manner specified in the state's receivership law.[7]

Three aspects of the insurance receivership process are particularly relevant to how guaranty associations protect consumers.

First, insurance receivership judicial proceedings, like bankruptcy cases, generally provide for notice to and participation by creditors on material issues. While the development of a resolution plan for a failed insurer usually is proposed in the first instance by the domiciliary commissioner as receiver, this is done with knowledge that affected creditors will have opportunities to comment upon or object to all or part of the proposal.

Second, state receivership laws generally confer priority creditor status on claims against the "estate" of the failed insurer that arise from the insurer's direct policies of insurance. Since receiverships follow an "absolute priority rule," all claims at the insurance policy level must be paid *in full* before any payments may be made on lower-ranking claims, such as general creditor claims, claims in respect of subordinated financing, or equity claims.

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the insured seeks coverage from the guaranty association must be a "covered contract" (*see* Model Act Section 3B(1)); the failed insurer must have been a "member insurer" of the guaranty association (*see* Model Act Sections 3B(1) and 5(L)); and no coverage "exclusions" must apply to the insured's claim for coverage (*see* Model Act Section 3B(2)). These conditions are routinely satisfied in cases involving typical insolvent insurers that wrote traditional consumer lines of life or health insurance.

[6] *See* Bankruptcy Code, 11 U.S.C §§ 109(b) and (d), preventing domestic insurance companies from qualifying as "debtors" under Chapter 7 and Chapter 11 bankruptcy.

[7] *See, e.g.,* 215 ILCS 5/187 *et seq.*

Third, guaranty associations are subrogated to the claims of the insurance policy owners that the associations protect; that is, after protecting the consumers, the associations step into the shoes of those policyholders as creditors of the insolvent insurer at the (preferred) policyholder creditor level.[8] In effect, the associations are responsible—within coverage limits—for the entire amount of covered policy liabilities to consumers, but if the estate has significant assets when the insurer is placed in liquidation, the associations' subrogation claims to those assets effectively become part of the associations' financing. If the consumer has a claim exceeding association coverage limits, that "over limits" portion of her claim is *entirely* dependent on the availability of estate assets.

Viewed another way, since the obligation of a guaranty association is to assure that consumers are completely protected *up to* the association's limit of coverage, the amount of assets that can be marshaled by the receiver are critically important not only to the guaranty associations and those paying the associations' costs (by reducing the expense of providing coverage within the associations' limits), but also to policyholders with large claims (by maximizing the assets available to cover any portion of a policyholder's over-limits claim). Accordingly, the comparative success of a receivership—and how well (or badly) policyholders with over-limits claims and other stakeholders fare in the receivership—is primarily a question of whether the receiver marshals assets covering a significant percentage of policy-level liabilities. (For a more detailed discussion of this issue, see Appendix A – The Critical Role of "Prompt Corrective Action.")

As a consequence of the three receivership aspects described above, the activities and interests of insurance receivers and the guaranty system are closely inter-related, a fact recognized widely among state regulators and receivers.[9]

The Operations of the Guaranty System in a Receivership

Once a guaranty association is triggered by a judicial determination that an insurer is insolvent and should be liquidated, the association has two principal sets of duties to consumers. First, the guaranty association must pay, up to coverage limits, any claims that are or become ripe for payment. Second, as to contracts that the failed insurer had no right to cancel prospectively (e.g., annuities, most non-term life insurance contracts, and some types of health insurance contracts), the guaranty association must guaranty, assume, or reinsure the continuing insurance coverage. In other words, the association must make sure that the coverage continues, as long as the consumer pays any required premium.

Regarding the first set of obligations—payment of "ripe" claims—the duties of life and health guaranty associations are substantially similar to those of property and casualty guaranty funds. The function of the triggered guaranty association is to process, adjudicate, and pay claims coming due in much the same way that the insurer would have done, had it not failed.

However, because non-cancellable contracts, such as life and annuity contracts, are purchased to cover an extended period of time for contract terms and premiums that are often permanently established at the inception of the contract (unlike, for instance, property and casualty coverage,

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[8] *See* Model Act Section 8K.

[9] *See generally,* "Communication and Coordination Among Regulators, Receivers, and Guaranty Associations: An Approach to a National State Based System," NAIC (2005).

which is purchased annually and may be subject to annual re-pricing, re-underwriting, contract term changes, or even cancellation by either party), the policy owner has an investment or "equity" interest that cannot be fully protected unless the contract is, in effect, kept in force. For example, a policyholder might have been in good health when she purchased a life policy 10 years before the insurer entered liquidation, but at the time the insurer failed, her health might have deteriorated to the point where she might be unable to purchase replacement coverage on similar terms, or at any price.

Consequently, for the "safety net" to work regarding non-cancellable contracts, the guaranty association must assure the continuing covered benefits promised by the contract on the terms originally agreed between the policyholder and the (now-failed) insurer. This is often accomplished by the negotiation of an arrangement known as an "assumption reinsurance" transaction. In such a transaction, a healthy carrier agrees to assume all or part of the policy liabilities of the failed insurer in exchange for a transfer of assets to support the liabilities—assets that are usually provided in part by the receiver from the estate of the insurer, and in part by guaranty associations. In other cases, guaranty associations simply assume the covered liabilities of the insolvent insurer for whatever period is required for the liabilities to run off. A combination of both approaches can also occur, in which the guaranty associations assume the covered liabilities for some period of time, after which a healthy carrier takes over the liabilities via assumption.

Coordination of Guaranty Association Responses

Guaranty association coverage responsibilities under current law are determined by the residence of the covered person: A covered person is protected by the guaranty association of the jurisdiction where the person resides, even though the insurer whose liquidation triggers the association's coverage responsibility may be domiciled in a different jurisdiction.

In some cases, an insurer may be licensed to do business only in its state of domicile and may only sell contracts to individuals in that state. If such a company fails, that state's guaranty association provides all of the available guaranty association coverage.

In many other cases, a failed insurer may have been licensed in (and may have contracts with residents of) many states, in which case coordination of the coverage responses of multiple guaranty associations is necessary. The guaranty associations effect that coordination through NOLHGA and its processes, with the result that the receiver and potential assuming carriers can deal with a single point of contact and contracting instead of having to engage in multiple discussions, negotiations, and contracts with a variety of different associations. That said, and though the process is essentially invisible from a consumer standpoint, the protection afforded each contract owner and the related funding for that consumer's protection always come from the guaranty association of the jurisdiction where the contract owner is deemed a resident.

NOLHGA's offices are in Herndon, Virginia, where a permanent full-time staff of 15 insurance, finance, MIS, and legal professionals and administrative staff members support the work of the member guaranty associations. Its management is overseen by a 13-member board of directors, and all significant decisions regarding major insolvencies are made by NOLHGA's member guaranty associations.

Guaranty Association Powers and Duties

Each guaranty association is a creature of statute whose powers and duties are established by legislation adopted in its state. Since all guaranty association enabling laws are drawn from the Model Act, many of the provisions are similar or identical from state to state, though there are some differences. In some cases, the differences exist because the state insurance commissioners have amended the Model Act several times since it was first promulgated, with the result that there is usually a time lag of several years before most states' legislatures will have had an opportunity to consider updating their guaranty associations' enabling statutes in light of Model Act changes. For example, the Model Act was amended in 2009 to (among other things) raise the coverage limit for annuities from $100,000 to $250,000. To date, the laws of 35 jurisdictions cover annuities to a limit of $250,000 or more and other states are considering amendments to that effect, but some states currently are still at the old $100,000 coverage limit. (For more detail on guaranty association coverage limits as of October 2010, please refer to the brochure, "The Nation's Safety Net," which accompanies this testimony.)

All insurers licensed to market covered lines of business in a jurisdiction are obliged to be members of the guaranty association of that jurisdiction. The costs of covering consumers and of operating the association that are not provided from assets of an insolvent carrier or any ongoing premiums in respect of contracts continued by the association are financed by assessments payable by member companies. Those assessments are levied in proportion to the insurers' market shares within the jurisdiction and are subject to an assessment cap each year (typically 2% of an insurer's gross premium in the assessed line of business—life, health, or annuity).

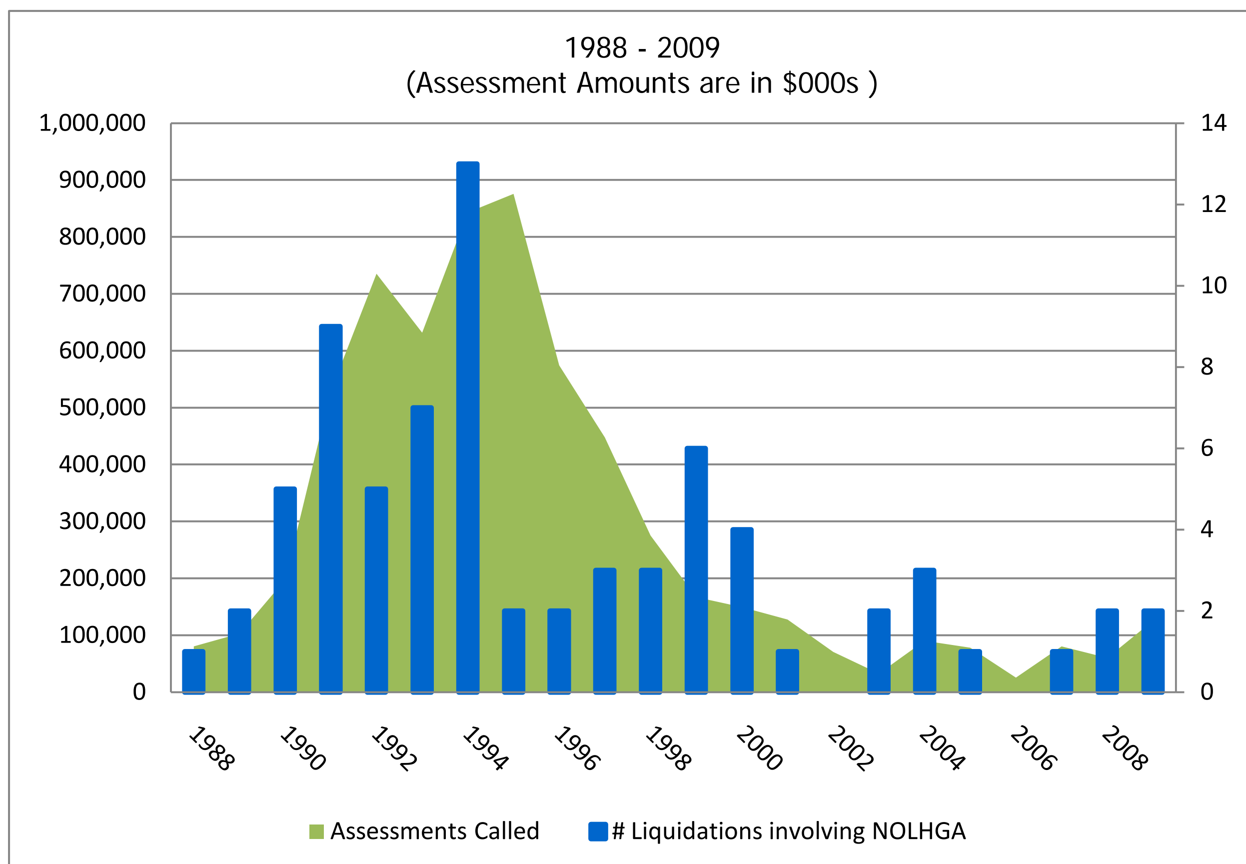
Under Section 13 of the Model Act, a state's legislature has the option of providing a "premium tax offset" to association members for portions of the assessments a member pays to that association to provide guaranty association protection for consumers. Many state legislatures have provided such premium tax offsets, in recognition of the practical difficulties preventing a member from recovering assessment expenses from any other source.

Each guaranty association is subject to regulatory supervision and examination by the insurance commissioner of its jurisdiction, and its responsibilities are prescribed by its enabling statute and by a plan of operation approved by the insurance commissioner. Operations are governed by a board of directors elected by the membership in accordance with the enabling legislation, plan of operations, and bylaws of the association.

Daily operations of guaranty associations are primarily the responsibility of an executive director, sometimes referred to as an "administrator," engaged on behalf of the association by its board of directors. Depending on the activity level of the associations, the administrators may supervise staff of varying sizes; the administrators also typically oversee work done for the associations by counsel or other professional advisors.

Historical Insolvency Performance of the Life and Health Insurance Guaranty Associations

Guaranty associations have protected consumers in 80 multi-state insolvencies coordinated through NOLHGA. In addition, they have protected consumers in approximately 326 smaller or single-state insolvencies in which NOLHGA was not directly involved. Set forth below is a chart displaying by year the frequency and cost (by assessments "called," or collected from guaranty associations' member insurers) of the 74 insolvencies from 1988–2009 coordinated through NOLHGA:



As the chart suggests, insolvencies have tended to increase and decrease—both in frequency and severity—in apparent "waves" or cycles that bear some relationship to broader economic and financial trends.

For example, the chart shows a marked increase in the frequency and cost of insurer failures in the first half of the 1990s, when the U.S. economy was emerging from a general recession and the financial sector was also still feeling the consequences of negative developments in the commercial real estate and corporate high-yield bond markets. A number of the more significant life company insolvencies in this period were precipitated by significant deteriorations in real estate or bond investments.

Interestingly, the recent financial crisis—which saw the failure of nearly 400 commercial banks and thrifts, several major investment banking firms and hedge funds, finance companies,

government-sponsored housing entities, and other firms—resulted in very few liquidations of operating life and health insurers. Of the 13 life and health companies that entered liquidation since January 1, 2008, almost all were comparatively tiny regional writers; none were remotely "systemically important;" and their aggregate liabilities to policyholders were approximately $900 million—compared to, for example, the initial general creditor liability of Lehman Brothers alone, which was reported at the start of its bankruptcy filing as being approximately $765 *billion.*

There are several reasons why the effect of the recent recession on the insurance industry and its consumers has been relatively mild. One reason is that standards for evaluating and managing investment and underwriting risk (by companies, their actuaries, regulators, and insurance rating agencies) have become considerably more sophisticated than they were in the years prior to the early-1990s recession. Another reason is that the methods and systems U.S. insurance regulators have employed in monitoring and responding to financial solvency concerns at operating insurance companies have become significantly more effective than they were in prior periods.

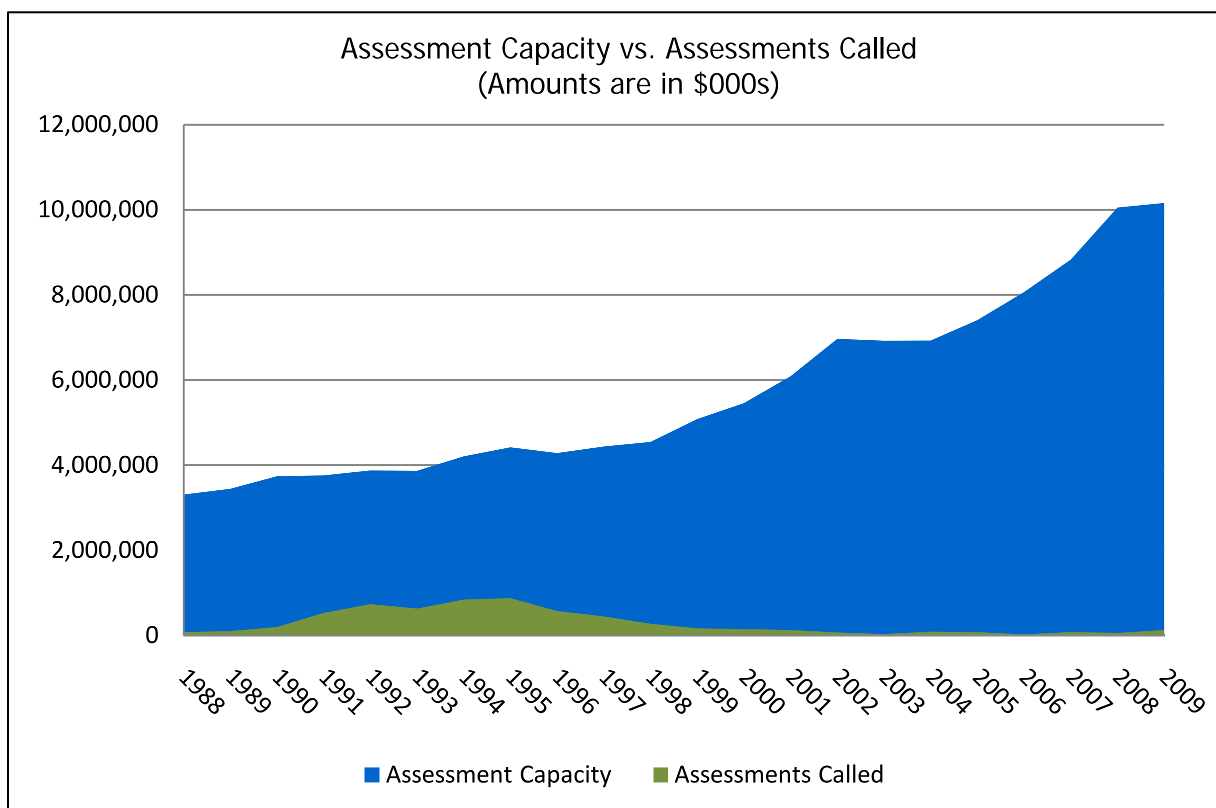
Ability of the Life and Health Insurance Guaranty System to Protect Consumers in Challenging Economic Environments

The experience of the recent financial crisis understandably has led people to inquire whether the insurance guaranty system has the financial ability to protect consumers if, for example, several major insurers were to fail simultaneously. Those who have reviewed the available evidence have been able to conclude both that the system has in fact met that challenge in the past, and that it could do so if necessary in the future.

Historical Performance

While the current recession has caused the liquidation of relatively few operating insurers, that was not true of the last significant U.S. recession. As a consequence of the recession in the early 1990s, a total of nearly 40 life and health carriers were liquidated, and their resolutions were addressed simultaneously by NOLHGA and its member guaranty associations. Three insurers ranking among the top 25 writers in the U.S. market were among those liquidation cases. Yet even in the worst years of that period, the costs to the guaranty system of protecting consumers (sometimes referred to as "assessments called," i.e., collected from member insurers) did not remotely approach the theoretical maximum annual assessment capacity of the life and health insurance guaranty system, as illustrated in the following chart[10]:

[10] The chart depicts the actual assessments collected from association member companies by year, charted against the aggregate theoretical maximum assessment capacity for all lines of insurance for all of NOLHGA's 52 member guaranty associations. The entire theoretical maximum capacity may not be available for a particular insolvency, since each individual guaranty association generally covers only residents of its jurisdiction, so that—in theory—an individual association could meet its annual capacity limit before satisfying all of its obligations. In practice, even individual association "caps" are seldom approached in an insolvency, and in the rare cases when they are, associations have the ability to borrow against the security of future assessments to meet current needs. Furthermore, insolvencies of life and annuity carriers generally tend to produce a relatively normal distribution of policyholders by state, with the result that association funding needs generally line up relatively well with association capacity, further minimizing the impact of what otherwise might be viewed as a "silo" issue.



Current and Projected Financial Ability

As depicted in the foregoing chart, the maximum annual assessment capacity of the life and health guaranty system now slightly exceeds $10 billion. That amount "refreshes" each year, meaning that, for a two-year period (at the same maximum capacity), the total available to protect policyholders would be $20 billion, and so on. By comparison, the total net assessments, from the inception of the guaranty system to date, required to provide all life and health guaranty protection—guarantying obligations on almost $25 billion of policyholder obligations for about 2.8 million policyholders—has been roughly $5.3 billion. In other words, the current year's assessment capacity, by itself, is almost twice the total net costs that have been required to protect consumers since the beginning of the system decades ago.

The ability of the guaranty system to respond in challenging times is not, however, limited to its annual assessment capacity. This is true for several reasons.

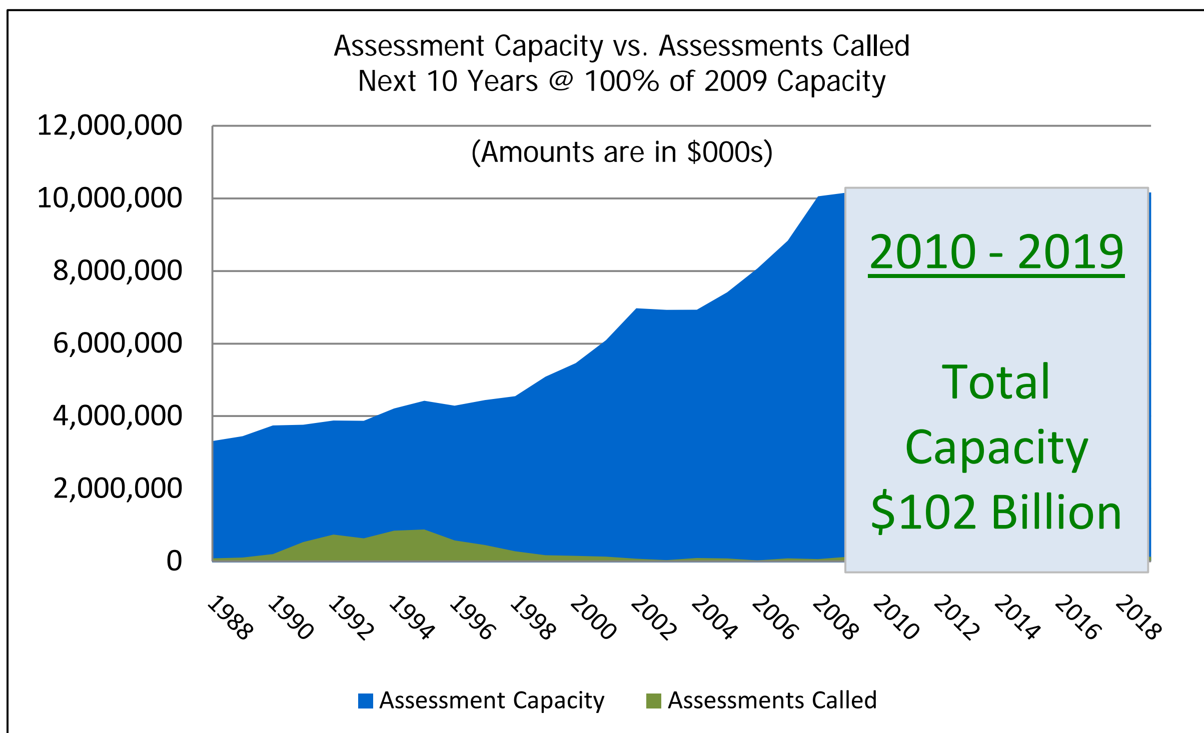
First, the liabilities of a troubled insurance company do not all come due on the date that an insurer enters liquidation; for a typical insurer, many or most of its liabilities will not come due until years, decades, or even generations after the company fails. For that reason, much less liquidity is required to meet the covered liabilities of a failing insurer than in the case of, for example, an FDIC-insured bank, whose consumer liabilities primarily consist of deposits contractually available to the consumer on demand.

Second, most life insurer insolvencies involve only small shortfalls of assets versus liabilities. The shortfalls are seldom more than 15% in larger cases and are more typically in the range of 5% to 10%. As a consequence, the need that must be funded currently by the guaranty

associations when the company fails is reduced to the extent that estate assets are available to the receiver in devising a resolution plan to protect policyholders. If the solvency problem is identified early by the regulator and prompt and effective regulatory intervention takes place, the cost of the insolvency is minimized—both for guaranty associations (and their funding sources) and for policyholders with claims exceeding guaranty association "caps." (For further discussion of this point, see Appendix A – The Critical Role of "Prompt Corrective Action.")

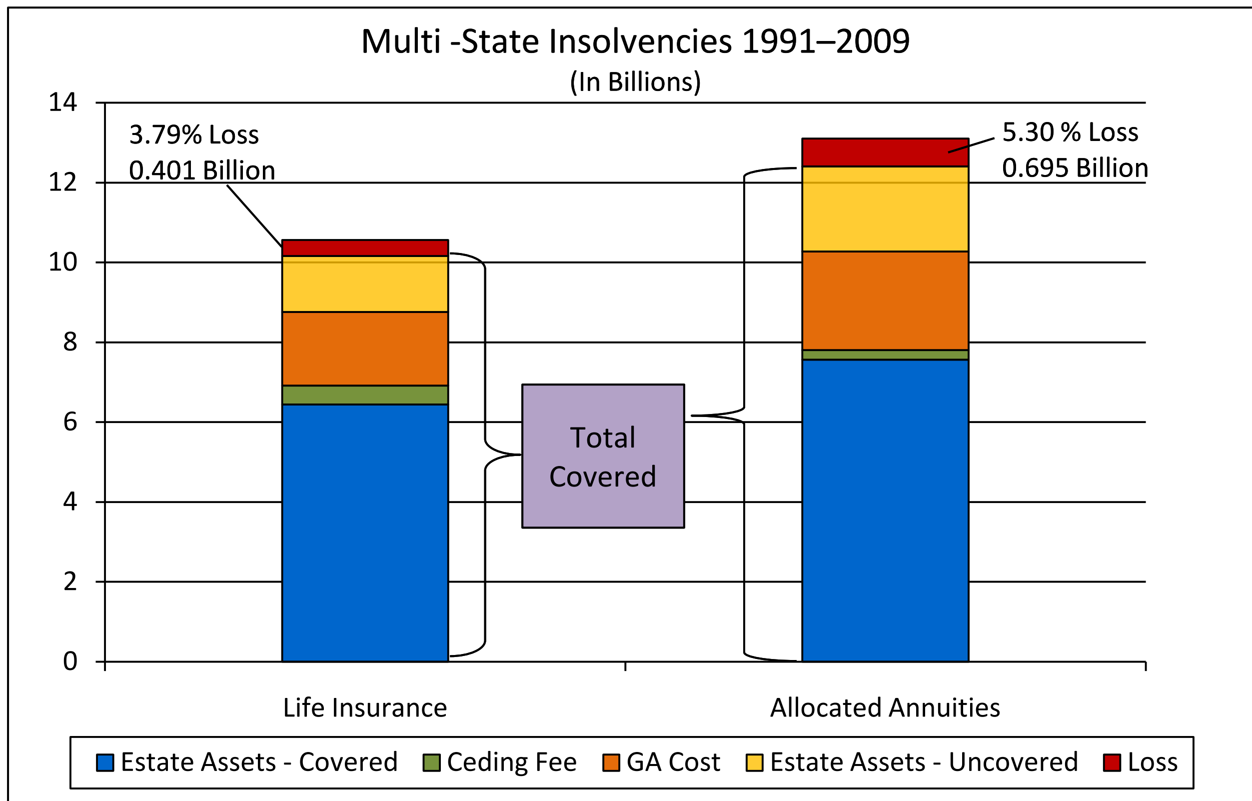
Third, even a financial crisis of unprecedented proportions, involving insurers with unusually large shortfalls of assets to liabilities, could be addressed by utilizing the assessment capacity of guaranty associations that would develop in the years following the initiation of receivership proceedings. Because a significant proportion of the insurers' liabilities would mature in future years, a resolution plan could provide for the "runoff" of those liabilities (i.e., payment of the liabilities from the receivership estate, "topped up" or enhanced as necessary by guaranty associations, over the years in which the liabilities would by their terms mature). Such a runoff would only be paid from the assessment capacity of the guaranty associations in the years in which the payments would be made—not all in the year in which the receiverships commenced. In addition, associations have the ability to borrow today against future assessment capacity, in the event a liquidity need might arise. Accordingly, an appropriate yardstick for the financial ability of the guaranty system to perform its mission is not the maximum assessment capacity of the system in the year a crisis arises, but rather the aggregate capacity of the system over the projected runoff period.

The point is illustrated in the following chart, which assumes, for illustrative purposes, that capacity would remain level for the next 10 years, producing an aggregate maximum financial capacity of more than $100 billion.



Average Recoveries by Policyholders

One final point should be noted regarding the protection that has been achieved for policyholders in prior life insurer insolvencies. Because of factors noted above—particularly the protections afforded through the guaranty system, the generally conservative nature of insurance company investments, and the effectiveness usually demonstrated by regulators in intervening promptly when life insurers face financial difficulties—actual losses typically suffered by consumers with life policy and annuity claims against insolvent carriers have on average been modest. The point is illustrated by the following chart, which shows that, after application of "estate" assets to both the claims covered by guaranty associations and those policy claims exceeding coverage limits (or otherwise not covered), average recoveries have exceeded 96% on life claims and 94% on annuity claims.[11]



[11] The figures in the chart reflect only multi-state life insurer liquidations in which NOLHGA was involved. A small number of health insurance insolvencies in which the companies wrote residual life and annuity business have been excluded, as has one life insurer liquidation for which we do not possess reliable financial data. The figures are based on guaranty association records, financial information provided by receivers, and estimates on recoveries on "above coverage limits" amounts derived from guaranty association recoveries of their subrogation claims. The figures do not reflect the time value of money.

Conclusion

The recent financial crisis, like other adverse financial periods before it, has challenged both individuals and institutions. Fortunately, the insurance industry has weathered the storm rather well and continues to meet its commitments to consumers. In the few instances when life or health insurers have failed, the life and health insurance guaranty system has ably discharged its mission to protect consumers. It stands ready to do so in the future.

We welcome the opportunity to provide any further information that may be required by the Subcommittee; please direct questions to:

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APPENDIX A

THE CRITICAL ROLE OF "PROMPT CORRECTIVE ACTION"

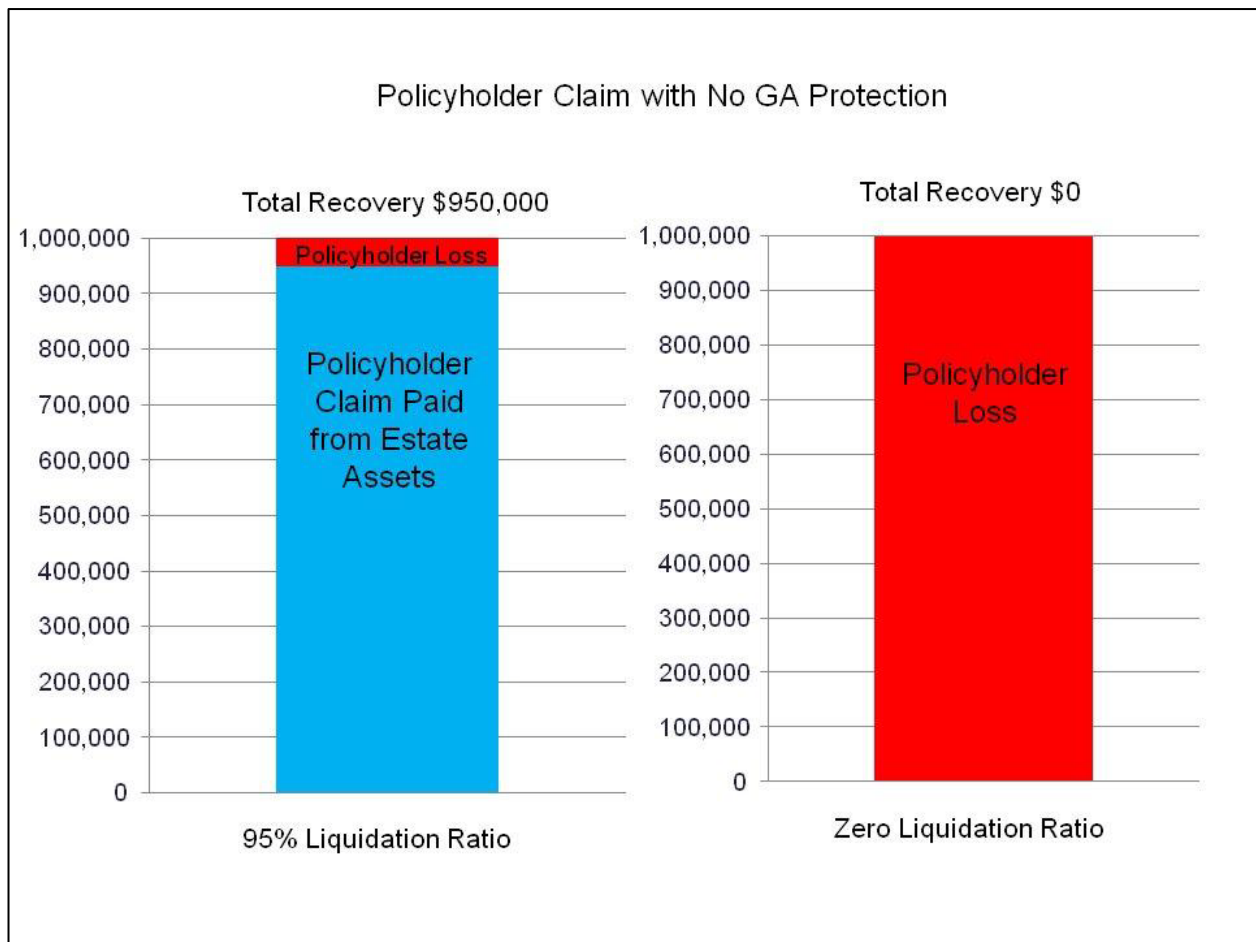
It is a common misunderstanding that policyholder recoveries in insurance liquidations are limited to guaranty association coverage limits or "caps." The truth is that whether a policyholder recovers all or most of her claim *above* guaranty association caps depends significantly on whether regulatory intervention occurs before the failed company's assets have been substantially dissipated, and whether assets are effectively protected and marshaled in the company's receivership**.**

This is a subtle but critical misunderstanding suffered even by financially sophisticated people who do not often work with insurer insolvencies and the guaranty system.

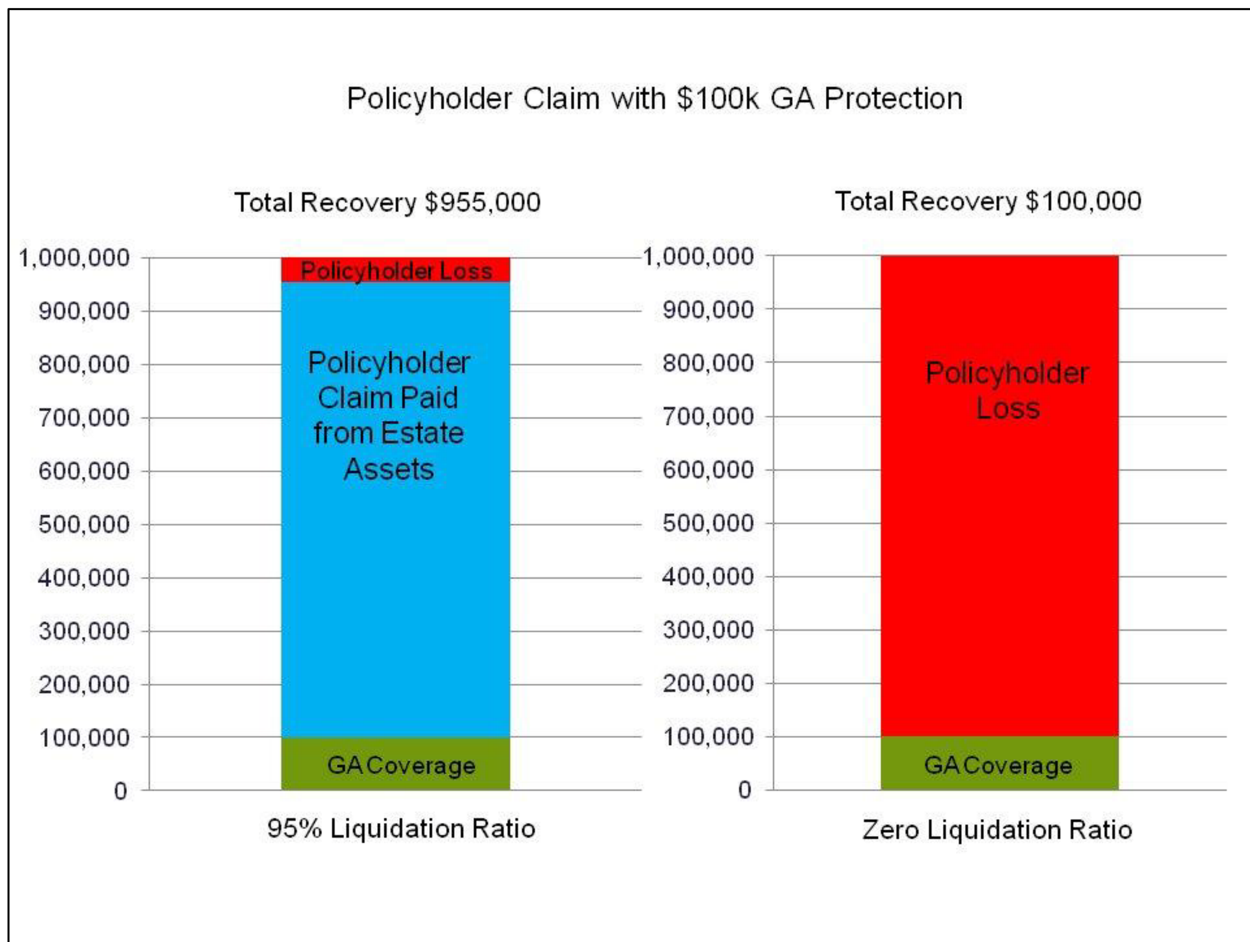
Policyholders with claims against their insolvent insurer in excess of guaranty association caps have a priority claim against the insurer's assets for the excess amount. That excess claim ranks *pari passu* with all other claims at the policyholder level. For that reason, a policyholder can—and often does—recover most or all of her claim in the insolvency, *even above* the level covered by guaranty associations. The point can be seen in the following illustrations.

Imagine an insolvency in which a policyholder has a claim of $1 million, and suppose further that there was no guaranty association to provide a financial safety net. What would the policyholder recover? The answer: It depends on the level of assets available in the insolvency estate, compared to the amount of the policy-level liabilities. This relationship is sometimes expressed as a *liquidation ratio,* or the number of "cents on the dollar" available for distribution to policy-level claimants.

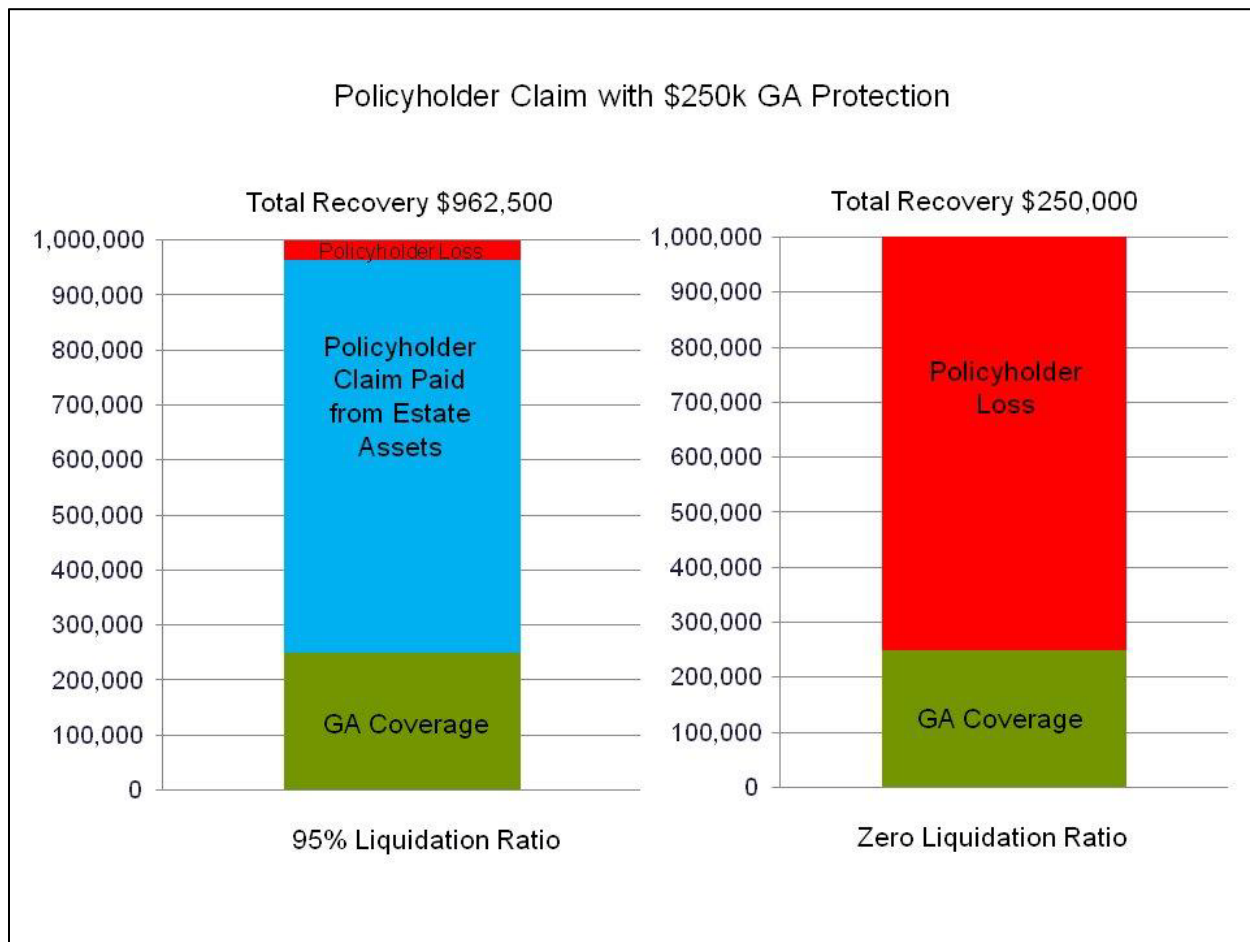
Consider the outcomes illustrated in the following chart. If the estate has 95 cents on the dollar available—a 95% liquidation ratio—the policyholder will recover $950,000 on that $1 million claim, even with no guaranty association protection. On the other hand, if the estate has zero cents on the dollar available at the policyholder level, the policyholder will recover nothing.



Now imagine that the policyholder has the same claim for $1 million and resides in a state where guaranty association coverage is $100,000. Consider the outcomes illustrated in the next chart. In this case the policyholder will recover (from the guaranty association) 100% of the claim up to $100,000, and she will recover on the rest of her claim an amount determined by multiplying the excess claim (here, $900,000) by the liquidation ratio for the insolvency. If the insolvency estate marshals 95 cents on the dollar for policyholder claims—which is a bit lower than average for life insurance claims in insolvencies—that policyholder will end up with a total of $955,000 on her $1 million claim: $100,000 from the guaranty association and $855,000 (95% of $900,000) in respect of her excess policyholder claim. On the other hand, if the estate marshals zero cents on the dollar, the policyholder's total recovery is limited to the $100,000 that will be paid by the guaranty association.

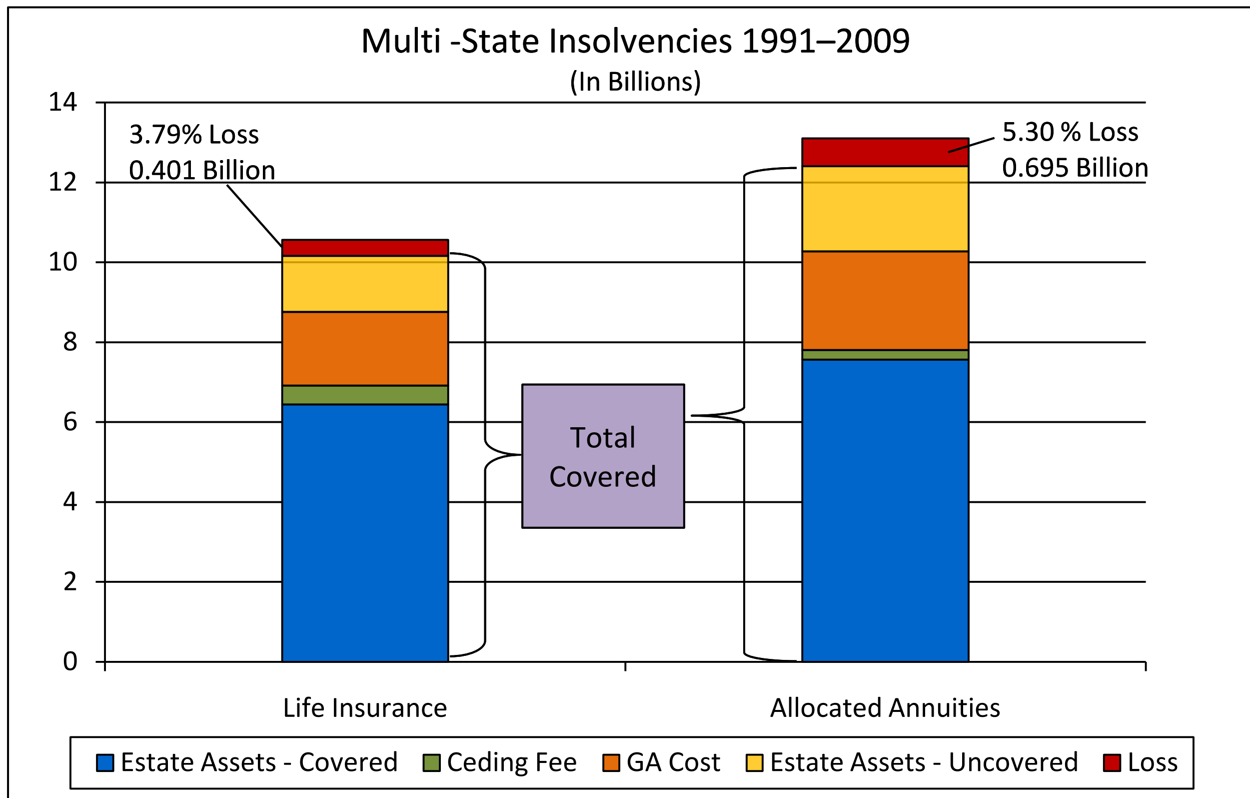


Imagine next a slightly different set of facts, illustrated in the next chart. Suppose the policyholder resides in a state with a $250,000 guaranty association "cap." In the first hypothetical outcome in this series of examples—a liquidation ratio of 95% —the policyholder's total recovery then would be $962,500 ($250,000 from the guaranty association and $712,500 from her excess claim): a modest increase of only $7,500 over what she would have received with guaranty association coverage to $100,000, even though the guaranty association "cap" is two-and-one-half times larger. But in the second hypothetical outcome—with a liquidation percentage of zero—the total policyholder recovery is still only $250,000. That is to say that a very large loss—$750,000—is borne by the policyholder, even with much more guaranty association coverage than in the prior case.



A guaranty association's coverage limit or "cap" does set a "floor" for policyholder recoveries, no matter what else happens in the receivership case. But as the foregoing illustrations demonstrate, the much more important factor—at least for policyholder claims significantly in excess of caps—is the liquidation ratio achieved in the insolvency. How many cents on the dollar is the receiver able to pay on policy-level claims?

On that score, the historical averages are significant. In the insolvencies of the past 20 years, claims on life policies have been paid, on average, at a level of 96.21 cents on the dollar. Claims on annuity contracts have been paid, on average, at 94.70 cents on the dollar.



In other words, in most (though unfortunately not all) life and annuity insolvency cases, the vast majority of policyholders have been made nearly whole, *regardless* of the guaranty association "caps" in their states. The obvious conclusion is that regulators, working with receivers and guaranty associations, have done an effective job of delivering real policyholder protection over the past two decades.

Prospectively, the key is to make sure that such outcomes (or better) are achieved in the future.

Experts in handling insolvencies of regulated entities—not just insurers, but other types of financial firms as well—have long recognized that the keys are, first, spotting financial problems early; and then acting promptly, decisively, and effectively to keep a bad situation from getting worse.

Spotting problems promptly is a function of financial supervision, and much of the success in delivering good receivership outcomes to policyholders over the past 20 years is a direct result of better financial supervision. In this sense, "financial supervision" is intended broadly to include assessments by companies of their own risks, risk-spotting by markets and insurance rating agencies, and better risk standards and evaluations by insurance regulators.

Beyond that, the recent financial crisis and attendant policy debates about regulatory reform have cast a bright light on the significance of effective resolutions of failing financial companies. Even if regulatory financial supervision is good, the regulated firm's stakeholders can still be harmed significantly by ineffective resolution of the failed company.

The two things critical to a successful resolution are early intervention—invoking the liquidation process at a time when the assets of the failed company have not yet been substantially dissipated—and professional execution of a resolution strategy that marshals the assets of the failed firm as effectively as possible and maximizes their prompt application to proven creditors' claims as directed by law. In the world of banking resolutions, these concepts are sometimes referred to, respectively, as "prompt corrective action" and "least cost resolution."