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GUARANTEE FUNDS

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- What are they and how are they operated?
- Why and how did they develop historically?
- What are the more recent developments?
- What are the advantages and disadvantages of these funds?
- Are changes needed to keep these funds viable?

MR. FRANK W. SPEED: I am with the Canadian Life and Health Insurance Association and am your moderator for this panel.

There has been a lot of discussion lately about the subject of insurance company insolvencies. Some of the discussion is centered around ways to prevent insolvencies and some is related to what to do when an insolvency occurs.

Other panel discussions at these meetings dealt with the first part of this subject: How are insolvencies prevented? We heard about the idea of strengthening the role of the valuation actuary, giving him greater responsibility for insuring the continued financial soundness of an insurance company, and we heard about the idea of statutory minimum continuing capital and surplus requirements. But no preventive measure is going to be 100 percent effective. Thus we are faced with demands by regulators for a safety net for companies that, despite the best preventive measures, do go into insolvency, and that of course leads us to discussion of guarantee funds.

I know that in Canada, it's probably safe to say that they there is not a great deal of enthusiasm for the idea of the guarantee fund within the

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industry. In the United States (U.S.), my impression is that the industry has come to accept guarantee funds as a way of life and, perhaps, does not view them negatively. Our panelists may want to comment about that. In any event, the concern in the U.S. seems to be whether or not the existing guarantee fund system could handle a major insolvency, such as that of the Baldwin-United Insurers. As you will hear very shortly, some changes are felt to be necessary.

This discussion will deal exclusively with the situation in the U.S., because Canadians are in an early stage of thinking about guarantee funds and hoping to benefit from the U.S. experience. We are fortunate today to have on our panel, two people who perhaps know as much or more about this particular subject as anybody in the U.S. Before I introduce our panelists however, and in view of the fact that the discussion is going to be solely about the U.S. situation, it occurred to me that some of you might be interested in just a capsule picture of where things stand in Canada.

To put the Canadian scene in perspective, there have been only two life insurance company failures in Canada in the last forty years--more than forty years. These were small provincially incorporated regional companies and the provinces stepped in to provide a guarantee to the policyholders. There have been three or four casualty insurance company failures in the last few years, perhaps a dozen trust company failures and one domestic bank came precariously close to failure.

In any event, the Federal Department of Insurance in Canada has been floating the idea of a guarantee fund for a number of years. Last year the provincial authorities, particularly those in Ontario, began to insist upon the establishment of guarantee funds. Initially both the life and health and the casualty industries resisted the idea, but last year the casualty industry decided that it would look into the matter. In January of this year, it came up with a comprehensive proposal for a guarantee fund for casualty insurance excluding certain specialized lines of business. Now, this proposal was for the incorporation of a company under existing law. It would not require any new legislation and therefore could be put into effect fairly quickly. One might say that the regulators are pressing for implementation of a guarantee fund in 1986, which I think is a bit optimistic.

The life and health insurance industry has different problems than the casualty insurance industry because of the longer-term contract guarantees. However, the life and health insurance industry did, in August of last year, form a task force to look into the question of establishing a guarantee fund. That task force formed a number of subcommittees to look at things like legislative standards for solvency testing, coverage limits, exposure and legal matters associated with establishing a guarantee fund.

In a related area, the Canadian Life and Health Insurance Association is carefully examining some proposals for continuing minimum capital and surplus requirements. In fact, the proposals are from Dr. Allan Brender. Some of you may have heard about those yesterday.

I want to make one final comment, and that is about public perceptions. Despite the impressive record of safety of the life insurance companies in Canada, and despite the rather unfortunate publicity that the trust companies have received of late because of failures, the public still perceives life insurance companies as being less secure than either trust companies or banks, according to the industry's recent survey. In these days when the different financial institutions are offering very similar products, registered retirement savings plan (RRSP) products for example, this public perception may be important. So that is a capsule picture of what is happening in Canada.

Now I would like to introduce our panelists. We were very fortunate to have with us two guests who have traveled quite long ways to share their experiences and knowledge with us, and we are greatly indebted to them for doing so.

Mr. Ernest R. Porter is a member of the American Academy of Actuaries and is a Fellow of the Life Management Institute; he is very much involved in industry activities.

Mr. Anthony Harris is a member of the Texas Bar Association, a member of the NAIC Liquidator Task Force and of the Baldwin-United Workout Group of the Executive Committee of the NAIC.

In this panel discussion, we are going to have each member make a short presentation. Then we are going to give them an opportunity to talk to each other or to challenge each other. In the first part, Mr. Porter is going to provide a brief history of guarantee funds in the U.S. He is going to talk about the development of the funds, about the purpose of the National Organization of Life and Health Guarantee Associations (NOLHGA), and about the ACLI discussions of possible alternatives to guarantee funds. Mr. Harris is then going to discuss his experiences with insolvencies. Afterwards, we will give them an opportunity to talk to each other.

Mr. Porter is then going to discuss the proposed changes in the NAIC model legislation and about the Baldwin-United situation. Following this, Mr. Harris is going to discuss the environment in which these changes arose.

MR. ERNEST R. PORTER: Perhaps aside from the Treasury Department's new simplified tax law that is going to be introduced to Congress this year, the subject of insolvencies is probably the most talked about issue by insurance executives, at least in the U.S. Not only is there concern, but there is confusion, indecision and vast differences of opinion as to how to preserve our industry and our image.

When I was first asked to come here and talk to you on this topic, it never occurred to me that we should go back to the basics and talk about the background of guarantee associations, because actuaries should know all these things. But as Mr. Speed said, some of you in Canada do not know much about guarantee funds, and some of you in the audience from U.S. companies may also not be familiar with the guarantee associations.

I am going to give you a very brief historical sketch of the U.S. experience with guarantee associations and present a conceptual look, if you will, at how they operate on the insolvency scene.

Also, in the time available, I am going to cover a couple of areas that are just starting to become issues, one is NOLHGA and the other is this new guarantee law.

Washington State, after New York, had the first guarantee law in the country. Its guarantee association was the first ever to pay a claim. So those of us working there at the time walked on a lot of fresh snow. We created some new directions for guarantee funds.

In the U.S., there are guarantee funds for both property and casualty and life companies. To the extent that both can write health insurance, there is an overlap that has caused some confusion. I am going to talk about the life side only, and its attendant health coverage.

The very first law was enacted in New York in 1941, but because it covered only domestic companies it had very little impact nationally. It was in the mid to late 1960s when regulatory attention on insolvency matters started to peak and, finally, in December of 1969, the first model law was endorsed by the NAIC. Very shortly thereafter, the Washington State law was enacted and it was different from the model law in two very important ways. One was that it was triggered on liquidation, not on rehabilitation, and that remains an unresolved issue. Another element (this was contested up to the Supreme Court where it was supported by a nine to zero decision) was that it provided coverage for a company that was insolvent before the law was enacted, before it became effective. Those were the differences that people worked with in Washington State.

In general however, the guarantee laws do not provide for these exceptions to the model. These characteristics are common:

1. They provide by law that all companies licensed in the state are manditorily members of the guarantee association.

2. Assessments are made on a post-insolvency basis rather than on a prepayment plan such as the FDIC or FSLIC. (We will talk a little bit more about that later on.)

3. Guarantee associations are governed by a board of directors elected by the member companies.

4. The association is granted special statutory legal immunities, which is very important. Incidentally, one thing I'm concerned about as this valuation actuary role matures, both in the U.S. and Canada, is liability. Perhaps some sort of statutory immunity could be built in to provide security for actuaries. I can imagine how there could be a fall guy, under certain circumstances. In any event, the guarantee associations have immunity.

5. The statutorily required membership and associated guarantees of coverage cannot be used in advertisement or as a sales tool. This is a very different situation than for FDIC banks. They advertise FDIC membership in all media.

6. In many states, the law provides for an offset against premium taxes.

Now, there are many other unique provisions, but this should be sufficient background to follow the ideas presented later. I want to note one thing, however, that there is no federal involvement in this scheme of policyholder protection, none at all! To date, this system has been able to handle all the insolvencies that have come up in the U.S. Earlier there was talk about having two insolvencies in Canada in forty years. There was twice that many in the state of Washington in the last ten years, so the U.S. system has managed many insolvencies.

When the Baldwin-United monster appeared on the horizon, two things happened:

1. The guarantee associations themselves were confronted with the need for coordination.

2. The industry leaders suddenly became aware of the tremendous potential liability that their companies faced.

So today, companies are very intensely deliberating the issues of prevention and management of insolvencies.

If time permits, we can discuss the Baldwin-United situation in more detail later on, to further illustrate the insolvency issues I am talking about. For now, I would like to talk to you briefly about the matter of guarantee needs on a national basis.

How many of you have ever, before you walked into this room, heard of NOLHGA? Anybody? One or two people? NOLHGA is an acronym that stands for the National Organization of Life and Health Guarantee Associations. It was formed only a year ago last December, by thirteen state life and health guarantee associations that perceived a need for greater coordination and collective action through a separate national organization that would reflect their special function and unique status.

Today, all thirty-five guarantee associations in the U.S. are members of NOLHGA. Membership will certainly grow as more states enact guarantee laws. NOLHGA was formed for several reasons, let me enumerate:

1. To encourage and facilitate cooperation and coordination among the various state life and health insurance associations--this would help to achieve efficiencies for the member companies, for the regulators and for the insured public.

2. To provide a national interstate clearing house for the discussion and resolution of issues and problems related to the operations of the state associations.

3. To disseminate information which assists state associations in their administration of the laws they operate under.

It is also expected that we will analyze information, and provide assistance to members in such areas as administration and claims disposition as well as on measures designed for prevention and detection of life and health company insolvencies.

We further anticipate acting as the agent of our member associations on specific issues, as they direct us. In fact, we are heavily involved in those right now with Baldwin-United.

Another reason for NOLHGA's existence is to participate in the litigation of insolvency matters. This week we on the NOLHGA staff were asked to prepare an amicus curiae brief in Oklahoma on a special situation. So we will be involved, nationally, in supporting individual associations because what happens in one area is just bound to eventually spill over into another.

One last primary reason for our existence is to establish and maintain liaison with the NAIC and with the individual state regulatory authorities. There isn't total unanimity within the NAIC within the boards of the life and health trade associations or among other interested parties on matters that pertain strictly to insolvencies.

Now obviously we aren't able to fulfill all those objectives today. That's a big chore for such a short period of time and with such limited finances that we have available to us. But hopefully, those of us here today will be able to comment further on this potential.

Please keep it in mind that NOLHGA is entirely separate from insurance company trade associations. Our members are the associations themselves, not the member companies. This distinction allows us to recognize and reflect the guarantee association's legal status and to enable the NOLHGA organization to provide the necessary services.

Since life and health association insurers are members of the state guarantee associations by law, and since the guarantee associations have (this is very important) statutory immunity from liability claims arising from their operations, NOLHGA is an efficient vehicle for enabling collective and coordinated action on common problems without burdening any segment of the industry with the expense of, or the exposure to, the liabilities a company association, or even a committee, might bear. Thus, NOLHGA should be able to act as an agent for the members in securing common counsel and administrative services, particularly in cases where the members are required to take action with respect to insurers engaged in multistate operations. This is another area of our Baldwin-United involvement.

These functions are especially pertinent when the state of domicile of an insolvent insurer has no guarantee association, and they are equally as pertinent under the terms of a new law we are going to talk about in a second.

In spite of its infancy, NOLHGA has provided a useful service to the industry. Its task force members formulated the basic premise of the Baldwin-United bail out. At the very first board meeting the NOLHGA staff ever attended with Merrill Lynch Prudential Bache, we became instant experts in Baldwin-United. In fact, now that a number of guarantee associations around the U.S. are starting up in response to the Baldwin-United situation and because Baldwin-United is not yet in liquidation, another task force was created. This group of people is charged with the preparation of recommendations on how to coordinate these various states on releases and on other facets of that very complex problem.

Last November NOLHGA held its first seminar for regulators, liquidators, rehabilitators and association members. That meeting was held to an overflow crowd that expressed intense interest and a good response to our program.

It should go without saying that the total portrait of insolvency in the U.S. is really quite frightening. In fact, it has become a multinational concern. Last March, I was asked to come to Canada to meet with a number of Canadian CEOs and industry officers to provide them with an overview of the U.S. experience. I think that if this coordination is continued, it will be extremely valuable to both countries.

Another thing that happened after the Baldwin-United problem surfaced, and I mentioned this earlier, was a sudden increase in insurance-industry awareness of the value, or perhaps I should say vulnerability, of guarantee associations.

The ACLI created a task force to focus on the insolvencies and their effect on the industry. This task force was manned by more than a dozen top CEOs in the U.S. It was chaired by Mr. John Creedon, President of Metropolitan Life Insurance Company, the lead company in the Baldwin-United situation.

They split off into two working groups, one directed towards prevention and the other to look at alternatives to the present system of state guarantee funds.

Needless to say, a tremendous amount of time, effort and money was devoted to travel and meetings in devising an effective approach to this tough issue. And by the way, that group included top actuarial talent.

I am not going to be able to go into any substantial detail in this forum today, but let me give you a snap shot of this matter as it stands today:

1. On the prevention side, some very difficult issues were faced: how to regulate bad management, how to face up to weak regulation, how to manage the quality of assets. I have to tell you that these problems were not solved, they are still hanging. Nevertheless, certain recommendations came out of this working group and were presented to the ACLI Board last month. Those were essentially these five things:

(a) There needs to be further development and improvement of the Insurance Regulatory Information System (IRIS) now used by the NAIC to develop the early warning ratios. Observations were that it is a good sound system, but a tardy one.

(b) There needs to be a way to mandate reporting to the IRIS system, because the companies that need monitoring the most are the ones that are not reporting to it.

(c) While much discourse has yet to go on regarding the role of the valuation actuary, that specialty is increasingly looked to for solving some of these intangible management and quality of asset valuation problems. I don't know where that is going to end up, but I will tell you that there was almost a total resistance to having state regulation of quality of assets. It was discussed, put in, taken out; and I think there is going to be pretty much of an unanimous feeling across the country that regulators should not be substituting their judgment for what are and are not appropriate assets within the guidelines that are imposed by code.

(d) There was agreement that the examination system has to be strengthened along the lines of the Bell-Budd report. This is a fairly recent report, based at least in part on the McKingsey Report that the NAIC authorized a few years ago.

(e) Then there is a need for more frequent and effective methods of financial reporting.

So, those are the things on the prevention side.

2. Now with respect to the management of existing and future insolvencies, some very unique things have developed. An attempt was made to make a case for an industry-funded private reinsurance company to automatically reinsure the insolvent business as it came about, and thus, protect the policyholders that way. In effect then, this would replace guarantee associations as we know them today. This proposal was suggested to be a prefunded plan with rates based on the quality of risk, and they ran into some buzzsaws there. How do you determine the quality of management of one company versus the other, the quality of regulation, and the quality of bringing the asset valuation into focus? All of these things indicate that risk-related premiums are very hard to come by in this area. However, that was the part of the proposal that ran into a lot of snags, and now this suggestion is currently being reconsidered. Let me enumerate some of the obstacles:

(a) Compulsory participation; how does one get compulsory participation in one reinsurance company around the whole U.S. without federal mandate?

(b) Antitrust; it is a very big issue, if the reinsurance company is operated by the companies.

(c) Rate regulation; this will go outside of the state supervisory sphere, and into a new ball park.

(d) Federal involvement; nobody wants this, well I shouldn't say that. There are some who do, but the vast majority don't want federal involvement if the state system can be preserved.

(e) Premium tax offset; that would go by the wayside if there was a private institution outside of the state sphere of regulation.

(f) Immunity; there would be no more immunity as we know it today.

(g) Funding; this is always an issue.

(h) Politics; that always raises its ugly head.

So those are some of the mountains that have to be climbed.

In the final analysis, a new task force was formed. As I understand it, this task force will look at ways of improving the existing system because the alternative looks pretty formidable.

This concludes the first portion of my presentation. It has been a very brief overview of what's happened over time and how the industry has faced up to some of the current issues. A little later, I will come back and we'll talk about the new law and the Baldwin-United debacle.

MR. ANTHONY G. HARRIS: Two months ago, I left the Texas Department of Insurance where I had been for twelve years, dealing with insolvencies. For the last seven or eight years I was the Liquidator Receiver, the person who is designated to deliver the bad news, take the company over, pay the losses and bring the causes of action. I was never met with smiles while I was there. What I would like to discuss today is what an insolvency is, from my 20/20 hindsight perspective.

I found some common factors that point out certain vulnerabilities within an organization. Initially, these dealt with life and A&H problems, not with P&C problems. That is the way I am going to approach this discussion. Initially, the company had a product that was very successful, a tremendous amount of cash flow was generated (if you compare it to the preceding year). The company suddenly got a little spark and doubled its cash flow, because it had hit upon a new and different product idea. It was an extraordinary product for what that company sold. It introduced a certain imbalance in the administrative area of the company, which made it very hard to deal with, aside from the lots of money coming in later.

The circumstance of going from an average-size company to finding the golden goose is exactly what happened in the Baldwin-United case. It went from about a $700 million company to a $5 billion company in two years. It literally shook to pieces from an administrative standpoint. It didn't know whose money was in, when they sent it in, or what their addresses were. Fueling this cash flow was a relaxation of underwriting guidelines, so that another portion of the company became affected by the new product experience.

The next factor is something that I found in every company I was involved with at the Texas Department. Let me give you an idea of the number of companies I am talking about. I left the Department in April, and from September of 1984 to the following April 1st, there were nineteen insolvencies in Texas. A majority of those were property and casualty companies, but I never found anything that was different in a situation on the life side. Universally, there was a collapse of the administrative section's record-keeping ability.

Many times, this occurred during EDP changes or conversions. What would happen was that the company would begin to be overwhelmed administratively and say: "Let's get a bigger EDP system or a bigger computer, or make a conversion, or get a large third-party administrator, or something like that." At the time records were needed the most, company management was denied them because of this "hiccup," if you will.

There was always a strong influence on management from the marketing section. From an insolvency standpoint, this is a very sensitive subject because private industry must sell its product or it is not in business. But, looking back over one-year or six-month horizons, there is an interesting interplay between the marketing, management and actuarial factions. In the situations I have seen, the marketing people always won. What that means is that to continue the cash flow the company had become accustomed to, and probably depended on, the marketing people won. The company couldn't sell its product unless it could give a benefit. Then it had to write the benefit.

What happens next? There was a situation in San Antonio with a company in which the marketing arm of the company by-passed management and opened up a direct dialogue with consulting actuaries. The consulting actuaries never got a true picture of the company's situation because the marketing people didn't want to have high rates. They didn't want to have real rates. What they wanted to do was sell the product and get the commission. Thus, the marketing area came to direct the course of the company.

In the situation where the wagon is going down the hill, and the wheels start to shake, that is the moment when the actuary can come in, evaluate the rates and make the adjustments. But this is when the record-keeping situation becomes critical, and often at this moment in time, there are no records, or the records are late, wrong, or can't be found, and the system can't respond to the increase in losses.

This is as much a cause of insolvency as anything else: the contract, the product itself guarantees the rate for too long a period after some experience developed. The system is dependent on each one of its parts working in unison to be able to maintain the solvency of the company. And as the wagon starts going down hill and it starts shaking, these parts become isolated from each other and there can't be a consensual resolution of a situation with rising losses and no rising rates.

One of the first things I learned as a regulator was that there are no bad risks, there are only bad rates. I still hold this view. So then, what do the managers do? Well, they have several general options, one of which is to turn it over to the lawyers and let them fight it out, whatever that might mean. It can suddenly become a large claims litigation situation. The lawyers end up giving a negative impression of the company, not necessarily because the claim is not payable, but because a lawsuit is filed. Now, the policyholder has to go hire a lawyer, file a lawsuit, not get paid--and then the complaints really start. The complaints start coming into the commissioner. When a complaint comes into the commissioner, any commissioner, a different light goes on. These are the people he is pledged to protect, so he sends off an inquiry.

Well, if a company can't pay its client, or it is paying yesterday's losses with today's premiums, then it starts paying on the cases where there are official complaints and just gets further behind. Then schedule examinations occurs and the rest of it is history.

One important aspect of this, though, is that at this moment, at the time the claims become late in payment or litigation is instituted, the agents start catching a lot of heat from the policyholders. The agents are the ones who placed them with this company, so there aren't any renewals. Thus when a big cash need is projected, the renewals cease and there is a cash-flow disruption. These instances are exceptional, but I think we can learn from the exceptions.

There is a responsibility that whoever signs the annual statement saying that the reserves are okay has a public duty, and the actuary fulfills that public duty in a very special way. It's viewed by the regulators that actuaries have that special relationship. I just want you in the audience to remember that.

MR. SPEED: Would you gentlemen like to question each other, or comment on what each other said?

MR. HARRIS: The only thing I would like to say is what Mr. Porter said earlier, and that is that I think NOLHGA is the perfect answer to continuing state regulation and avoiding federal involvement. When I first became involved in insolvencies, nobody cared about them. Now everybody cares about them, every business failure is a media event. I think what Mr. Porter is doing, what the NOLHGA people are doing, is a giant step forward compared to the way things were before.

MR. PORTER: Let me add to that. There are a lot of things I didn't cover in my comments. One of them was this reinsurance company idea. In the early stages of discussion of this, even without the support of NOLHGA, I suggested that if a reinsurance function was the way to go, then it shouldn't be organized as a private operation. It should come under the umbrella of NOLHGA, mainly to preserve the state's presence there, to preserve the input of the commissioners on guarantee funds, immunities, tax offsets, and a number of other things that would go by the wayside if there were a privately-run national reinsurance company. I think that concept is still being studied, but to come under a different umbrella than originally proposed.

Mr. Harris, I would just like to ask, of the nineteen companies that failed in Texas, how many were life?

MR. HARRIS: Two.

MR. PORTER: Two? So we are in the right business.

MR. HARRIS: All the rest were P&C companies, but virtually every insolvency between 1980 and September of 1984 had been a life company.

MR. SPEED: Okay, Mr. Porter would you like to talk about the change in the NAIC law?

MR. PORTER: Let me talk about this new model law. I think it's a cornerstone of whether or not we are going to be able to control and prevent insolvencies in the future. Obviously, it goes hand-in-glove with NOLHGA's future, and with building on the state system. Hopefully, at the upcoming NAIC meeting, the NAIC will finally endorse the exposure draft we have.

I don't know how familiar you are with the current law, but suffice it to say that over the last three years, some eight different drafts to modify that law have been prepared. Finally, last summer, the NAIC accepted a study draft. Since then, NAIC working groups, representatives of the ACLI and representatives of the Health Insurance Association have been trying to find some kind of compromise to bring very divergent objectives together. At last December's NAIC meeting, it did accept a document as an exposure draft. Briefly now, let me tell you the major concepts of this exposure draft, and highlight the major conceptual changes it would make:

1. Each state guarantee association will be responsible for its residents only. This differs from the current model under which the state of domicile of the insolvent insurer is responsible for the policyholders no matter where they reside.

This does several things. It increases capacity because the annual 2 percent of premium limitation has to cover resident policyholders only, rather than, as in the case of a domiciliary insolvency, all policyholders. It also puts pressure on states that don't have a guarantee fund to enact one, and that's the biggest Achilles' heel in the whole scheme of things right now, as far as I am concerned.

It also makes the tax offset a more likely possibility since the amount of the assessment will be kept to a minimum. All the tax offsets will be available under the new law where they are not currently, because they are controlled by the state of domicile.

The new law will definitely establish which law prevails, thus eliminating disputes between the states and any dispute within a state as to which guarantee association should actually levy an assessment.

2. Limitations would be placed on guarantee associations' liabilities. Here we are talking about interest-sensitive products and this is designed to eliminate a liability for excess interest which might be unreasonable or might even be unobtainable. In effect, it's designed to reflect the market rate of the insured crediting rates less one percentage point.

   Another limitation on liability regards accident and health policies. The liability for claims under existing policies are limited:

   (a) for group cases, to six months or the renewal date, if it's earlier;

   (b) for individual accident and health policies, to twelve months or an earlier renewal date;

   (c) for noncancellable policies a substitute coverage or, upon approval of the commissioner, a reissue to another policy is permitted at a different premium rate. However, if there is an increase in premium, it has to be approved by the courts. And, I might just say from personal experience, modification of a policy in an insolvency, if you want to sell it, if you want to get rid of the business, is absolutely imperative. We've done this on two or three occasions and it allowed us to rectify the rate inadequacies, or the benefit deficiencies, that were brought about by bad management or poor actuarial work or whatever, if there is such a thing.

3. The assessments will be based only on products that are covered by the act. Now, let me explain that. Under the current law, life and health and annuity policies are covered. With the fast pace of change in new products today, it is felt necessary that products which are not covered are clearly spelled out. Among the exclusions are the accumulation-type fund products such as guaranteed interest contracts (GIC) and deposit administration funds. Of course, any annuities that would be purchased out of those funds would be covered, but they are not in the nature of insurance contracts and this is a battle that may be lost. There has been a lot of discussion lately about everything the act is to cover in an insurance company's portfolio. So there is going to be a tough battle, one that is waging now.

4. A very important concept, and in my mind one of the most important, is that under the new model, the guarantee funds would be triggered upon insolvency and liquidation, like the State of Washington Law that I mentioned earlier. Right now, funds are being triggered by criterion used with Baldwin-United, and it is

> not even in liquidation. It may very well be that nobody knows what its liability is, if there is any. Two or three years ago, the UNEC was so heavily impaired (on a disability income issue) that some of the guarantee funds were triggered. After getting through a ten-year rehabilitation program, I asked the Commissioner, who at the time was Mr. Peter Hudson: "Are you going back to the guarantee funds before you turn the company over to the stockholders again?" And he said: "That will kill our rehabilitation program." But in the new law, that safeguard is there, because some of the regulators have faced up to the fact that the time to handle an insolvency is when it is actually in liquidation, not when it is in rehabilitation.

However, we are having a very difficult time with that. Some of the commissioners have insisted that (in the interest of consumerism) in an emergency for a death or medical claim, guarantee funds for a company should be triggered upon rehabilitation. In any event, I think there is agreement on the safeguard that the guarantee associations must be paid back before the company can be turned back over to the owners or otherwise resume business. That's one of those losses someone can take to make a profit. A compromise, I guess.

Now there are two more concepts that should be mentioned briefly. One is that the premium tax offset is still optional and most companies don't go for that, but that's in the new bill. The other is that it is now proposed to require a disclosure statement of the guarantee coverage. While the NAIC wanted this disclosure statement to be given to all policyholders, I think they have been persuaded that it is to be applicable prospectively only.

Those are the major differences, but I think it is fair to say that the industry still is not totally satisfied with this exposure draft. At the NAIC task force meeting in Williamsburg in March, some substantial changes were presented. It was suggested that the mandatory triggering upon impairment be limited to foreign companies, since the commissioner of a domestic company already has the power to order liquidation in his state. There were also some changes suggested to more clearly define the coverages that will not be included under the new law.

It was felt too that a six month continuation on group insurance might really be too long because if there were rate inadequacies, some tremendous losses could be suffered in six months. So I think that is going to be massaged a little bit more.

Also with respect to the interest rate for the liability, there is a suggestion that we go to a Moody's minus 2 percent to set up the reserve liability, as opposed to 1 percent under some general market rate.

Lastly, the industry wants some assurance that the guarantee laws cannot be used as a selling point, particularly with respect to the proposed disclosure. The thinking is that disclosure, as it is now, should be available only upon request.

So we have to see how those things come out. That is a broad overview of the new law and some of the changes that we hope will be helpful in trying to prevent and control the insolvencies.

Let me tell you now about this Baldwin-United situation, not only because of it's magnitude but also because of the potential involvement or, perhaps, I should say, lack of involvement of the guarantee associations across the U.S.

Once again, there are so many facets of this problem I am not going to address them all. However, the highlights and some very recent developments as I understand them, can be summed up this way. Originally, it was estimated that the ultimate liability to the industry in those states that have had guarantee funds would range somewhere between $400 million and $800 million. Now those are pretty staggering sums, and they shook up a lot of people. It is no wonder they suddenly became aware of what they were facing.

You may recall that the fundamental reason for Baldwin's demise was the lack of marketable value of certain affiliated assets in the various company portfolios. This may have been aggravated by poor record keeping and all that sort of thing, but basically when a company didn't have the assets to cover liabilities, it was a candidate for Mr. Harris' former liquidating unit. That is what was involved.

It was calculated that the nonaffiliated assets were sufficient to cover only an assured rate of interest of 5.5 percent. Since the guaranteed rate for those SPDAs, on the average, was about 7.5 percent and the value of the affiliated assets were very questionable, there was about a 2 percent shortfall. It is a lot more complex than that, but I am just going to leave it there for this discussion. So in a very simplistic way, this 2 percent shortfall was what represented a good part of this huge potential liability.

Now earlier I mentioned that a NOLHGA task force developed a bail-out plan, now called an enhancement plan. The industry then, very quickly in support of this, committed $50 million in an attempt to minimize the guarantee fund liabilities because those were so big.

Today it appears that the industry is in a positive position and the most encouraging posture since this ugly financial thing surfaced. All parties are eager to settle since their reputations and the soundness of the business as well as its dollars are at stake.

Several material and significant developments have occurred in recent weeks. Some of them as recent as a week ago. One is that the rehabilitators and Baldwin-United have agreed to transfer funds to the rehabilitators on affiliated assets. Now there are certain conditions on this transfer, and it isn't 100 percent certain, but it does represent about $170 million.

In the settlement of a class action suit in New York, which represents 56 percent of all of the Baldwin-United annuitants, the brokers agreed to contribute $140 million. So let me just present the situation to you in a nutshell, as it is right now.

First of all the estimated $400 million tax involvement of Baldwin-United has to be resolved with the Internal Revenue Service. There are two kinds of tax involvements here. There is an historical tax that goes with the companies and the bankruptcy and then there is a transfer tax that must be avoided for the affiliated assets, when they are transferred over to Metropolitan, or whoever is going to manage those. So those have to be resolved and that's a big cloud hanging on the horizon. If that could be resolved, and if the insurance industry will permit about $14.8 million of its original $50 million committed to cover the liability for the policyholders (that bought from insurance agents, not from brokers), allowing that to be distributed over this 56 percent of the policyholders, then total releases from future guarantee association liability for that 56 percent will be given. Incidentally, this group of policyholders in the class action suit possesses policies that were sold by brokers, not agents. In other words, any potential liability from those policyholders can be walked away from. That is kind of a sure thing.

Since it is a class action suit, with no single individual opting in and out, it will be handled by a negative enrollment or a negative approval. So, I would say that for $14.5 million, we can get rid of 60 percent of this potential $400-800 million liability, and I think that is awfully encouraging.

I will mention one more step and that is: if this so-called global enhancement plan is put into effect by December 31, 1985, then all the monies I have been talking about will be committed to this program as opposed to being spread over the class action group. Then plans can proceed as scheduled. Either one or both of those will go a long way in helping bring the Baldwin-United thing back into a manageable situation. Some possibilities are even better than those I have stated, because of the other brokers that sold Baldwin-United policies. About 14 percent of the policyholders are still brokerage-related. If those brokers would come into the class action suit, which is permitted under the terms of the settlement, then for roughly another $4 million up to 70 percent of the Baldwin-United policyholders might release liability from the guarantee fund. That would be very helpful, however, there is no guarantee that is going to happen.

A lot of bridges have yet to be crossed, but at least we are one step closer to managing what may have been the biggest financial disaster ever to appear in this country.

MR. HARRIS: I will make some brief comments on the environment in which these issues are going to be decided. Is there life after Baldwin? I am not sure. I think the question is whether state regulation is effective as it is or whether insurance should be regulated by the federal government.

The only comment I have about that is that the largest political force I've witnessed in my lifetime has been consumerism. The policyholders expect to get what they buy. Nothing more, nothing less. This gives me great problems about not revealing what the guarantee fund limitations are, because when one buys a $1 million policy, no one says that the limit in the state is only $300,000. If the company should go insolvent, or if the person should be put into the hospital, then $100,000 is the limit on any health benefits. The difference in the last fifteen years is that the public has become very politically aware. They have become very politically sophisticated. When they feel that they do not get what they bargained for, and what they paid for--they didn't set the rates or something of that nature--the first thing they do is call their commissioner, the second thing they do is call their legislators.

I think the examples of the near bank failure in Chicago that almost busted the FDIC, and the Ohio and Maryland situations with the FSLIC, illustrate that every business failure is a media event. So if you are going to protect the integrity of your industry, you cannot be on the six o'clock news every night. Now there would not have been a problem in any of those examples if there had been time to pay. But there wasn't. Neighbors saw each other camped out in front of S&Ls and they said: "Well, I am going to get down there too, and get all my money out, because Joe's down there and he may know something I don't know." Well, there isn't much public confidence demonstrated when an institution has to be closed to keep a run on the bank from occurring.

So I think that's the bottom line--how does one maintain the public's confidence in the industry? Just a minute ago we heard about what the contributions of the guarantee funds were going to be. The taxpayers are going to be paying all this, because the companies are going to be receiving tax offsets. In my home state, the legislators are going to have to go into special sessions to see about raising taxes, and they don't just get taxes because somebody messed up someplace. So, the whole regulatory process is going to be reviewed.

The whole idea of the industry's participation in the regulatory process is going to be reviewed, in which the role of the actuary is very important. If a company files an annual statement and there is not an actuarial signature attesting to those reserves, a different light goes on.

The legislators are now interested in what is causing these insolvencies. Then we have our attorney general friends all over the country who have discovered that the way to become governor is to be a consumer protection advocate. With that comes deceptive trade practices legislation, which was one of the big problems in the Baldwin workout with that state's attorney general. He kept saying: "Look, it says right here it is a guaranteed 7.5 percent return on your money, yet there is not enough money in there to guarantee it, so what does guaranteed mean?" Well, guaranteed means something different to us in the insurance industry than it does to the public. When they see guaranteed, they think it is guaranteed. So what's happening is a redefinition of the role of the regulatory people, especially the commissioner and the guarantee funds. I do think that the political forum is the place to balance equities, and see if we can keep the confidence of the public.

DR. ALLAN BRENDER: I have two questions for Mr. Porter. With respect to rewriting policies, if there was some sort of failure, one of my concerns would be the question of changing policies from participating to nonparticipating, getting people out from under high premiums because the dividends would probably disappear as well. My second question is that I think I also understood you to say that under this model bill, GIC type contracts accumulation earnings wouldn't be covered, is that right?

MR. PORTER: That's some of the thinking right now.

DR. BRENDER: I must say I am surprised, in view of the remarks about what seems to be have caused a lot of these insolvencies. I assume that the experience of rapid inflow of money came mostly from these kinds of products. In view of what I think was Baldwin-United's mix of business, which is a lot of this kind of stuff, and the fact that these kinds of products really compete with deposits from other kinds of financial institutions, some of which in fact do have deposit insurance, I think this is probably the biggest omission. From the public point of view, the omission almost invalidates a lot of the purpose of having a guarantee fund. I am frankly mystified as to how the industry would put up any guarantee fund and not cover this kind of thing.

MR. PORTER: Let me respond to the last question first, and say that, I think there is some fear in the U.S. that these funds are so huge they are more in the nature of a savings account, or a certificate of deposit or something of that nature, and they are not really insurance related. I think we are going to have a tough time on those issues. But I think the effort is to say that this is really not an insurance product and, since we are supporting our own risk-related products, it shouldn't be included. I don't know how its going to come out. I can see both sides of the picture, except that the dollars are so big on the GICs that they overwhelm some of the other kinds of products.

Let me talk for a second about par and nonpar because I actually did that once. As a guarantee association, one of the things you don't want to do is to run an insurance company, which is what you might have to do if you don't find some way to get someone else to take over the risks involved. In one particular case, we went to the court and said: "Please make these par contracts nonpar." It was the only way we could find a buyer to take it over. Otherwise who would buy a policy if they had to, theoretically, distribute all the profits that they might make out of it just to back up the policyholders? Let me tell you the results, because those are about nine years old now. We did not have a single complaint from a policyholder, most of that business has persisted at an exceptionally high level. The carrier who took over that business is happy and the guarantee association had to continue to tap the rest of the industry to administer a pool for the last nine years. I would do it again, because it was the only feasible way out of a very difficult situation. The other time that we changed contracts was when we had some noncancellable contracts. This was before the new act. We went to the court and said: "We don't want to discriminate against anybody, but make them collectively renewable, will you?" They did that, and we had reasonably good success. And not much policyholder complaint.

DR. BRENDER: In changing from par to nonpar, were the premiums reduced?

MR. PORTER: No.

DR. BRENDER: Were there still no complaints?

MR. PORTER: There were not.

MR. GARY CORBETT: Mr. Porter, I wasn't quite sure about one of the changes you mentioned in the new model law. What products would be covered under the assessment base?

MR. PORTER: Mr. Harris might be more familiar with this than I am, but the model act is going to try to spell out the kinds of contracts that are not covered, so that it will cover just basic life, health and annuity products.

MR. CORBETT: Is it intended to keep the different classes so that, like right now, there is A, B and C? You've got life insurance, you've got health insurance and you've got annuities. For instance, the Baldwin assessment base is the annuity base and not the life insurance base. Isn't that approximately correct?

MR. PORTER: I think so. I also think it goes back to this other issue of trying to weed out those that are not really insurance contracts. That could cause a real headache to the industry, but that is the best answer I can give you right now.

MR. HARRIS: I will add that 90 percent of Baldwin's business was in these contracts, and there had not been a lot of annuitization at the time. I think that one of the great wonders of the regulators, and also honors of the guarantee funds, was that they never raised the defense that the Baldwin problem is not insurance. The guarantee funds had a capacity of about $110 million a year. When the problem first arose, it appeared to be taking all the affiliated investments, about a $900 million insolvency. So they would have filled up the capacity of all the guarantee funds in the U.S. for nine years. And we have the problem worked out reasonably without having to do all that.

MR. PORTER: Let me make one more comment. First, in the Baldwin business, its life and health business was solid. It was sold off to purify the issue and to bring what profits there were back in to minimize the liability. One of the things to be very afraid of is that somebody, some lawyer, is going to come up with the concept that guaranteed issues, I mean guaranteed interest, is really the bail-out level. If you think that won't cause an expansion of the industry's potential liability, it is horrifying to think of what would happen if we had to pay 11 instead of 7.5 percent.

MR. CORBETT: My concern relates to the problem of subdividing these product lines. As I understand it, the Baldwin base is the annuity base of companies, and not their life insurance base or their health insurance base. I find it rather unfair to tap into that annuity assessment base, and I will use a hypothetical situation to explain myself. Consider companies that are writing only immediate annuities with no cash value guarantees which incidentally was the thing that triggered the Baldwin-United action. It's not the annuitization twenty or thirty years out, it's the use of guaranteed cash value products with no market value adjustments. I question whether a company that's selling an immediate annuity with no current cash out, or a deferred annuity that has full-market value protection, should be any more liable for an assessment on that product than any other insurance company selling life insurance, health insurance or anything else. I don't see them as two similar products. I don't see the financial risk as being at all similar between immediate annuities, for instance, and cash value deferred annuities.

My second comment is that the NAIC is addressing the vital problem that so many of these things are triggered by the need for guaranteed cash values. If companies instead were able to issue with nonforfeiture values, that did not have to be paid in cash, you could forestall, at least as history would tell us, a number of these Baldwin situations.

MR. HARRIS: That is a good idea for the future, but we can't change the rules after the fact. You can for the future.

MR. TONY WILLIAMS: I'm with Johnson and Higgins. I have a question for Mr. Harris. I have become involved in one of the insolvencies in Canada recently, and know a couple of things in addition to his list of common features. They are the deterioration of the relationship between the company, the regulators and reinsurance agreements, which add very little value to the company. Are these common?

MR. HARRIS: Yes, very much so. One of the things that I might add to that is the public relations problem in an insolvency. A lot of people especially in a health insolvency when discharged from a hospital and their claims haven't been paid, become very concerned (particularly elderly people) that they won't be readmitted. That becomes a great big public relations problem. What you might do is contact the hospitals and tell them that they are covered in the future and also contact the policyholders and explain, that in the U.S., they have ongoing coverage until it's dealt with in some way. They have a lot of concerns that are human concerns, and not business concerns.

MR. PORTER: One element we haven't mentioned is reinsurance. It often plays a big role in financial insolvencies. Look at the Iowa State Travelers. That is a 103 year-old company that went down the tubes to the tune of $14 million in fifty-three days. Primarily, this happened because its reinsurer had no substance at all, had no means of guaranteeing what it said it was going to guarantee. Of course, you have the same kind of problem with offshore companies, where carriers are going more often, for whatever reasons they might have. There is no control over them, so reinsurance can be a major factor.