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ACTUARIAL SOLUTIONS TO THE LIFE AND HEALTH GUARANTY FUND PROBLEMS

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Recorder:	KENNETH D. THIEME

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- o Brief description of present Casualty Association structure
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MR. HOWARD H. KAYTON: There are basically seven features of our Guaranty Fund, or Guaranty Association, system:

1. It is mandatory. All companies must be members of the Guaranty Association.

2. Assessments are made on a postinsolvency basis, i.e., there is no prefunding.

3. In many states, there is an offset of the assessment against future premium taxes.

4. Each association is run by a Board of Directors elected by the member companies.

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** Mr. Washburn, not a member of the Society, is Director of Insurance for the State of Illinois.

5. Membership in the Guaranty Association, and the guaranties provided, cannot be advertised by the insurance companies.

6. Each state's association protects all policyholders of domiciled insurance companies and, if an insurer that fails is domiciled in a state having no Guaranty Association, it also protects the residents of its own state.

7. The risks are divided into life, health, and annuities, both for protection and assessments. Therefore, a health company going under, if it sells just health insurance, has little impact on the life or annuity companies.

The present form of the Guaranty Association model bill presents many interesting and illogical problems. We are hopeful that by presenting this panel, actuaries will become more involved in these issues and develop a more logical approach.

Director John E. Washburn heads the NAIC task force that is most responsible for promoting the passage of the proposed Guaranty Association model bill. He has been in the Illinois government since 1970. In 1983, after serving three years as Director of the Governor's legislative office, he was appointed Director of Insurance.

MR. JOHN E. WASHBURN: To understand some of the shapings of Guaranty Funds, there are three basic tenets to remember:

1. It is absolutely repugnant to an insurance company to pay claims of a competitor out of the insurance company's hard-earned surplus. This is especially so when that competitor may have gotten its policyholders by underpricing the product in order to "steal" policyholders from the company now having to pay the claims.

2. Guaranty Funds take the pressure of policing the marketplace away from the regulator. In that light, Guaranty Funds may be counterproductive to good solvency regulation.

3. Insurance is a product of trust. It is an intangible product until claim payments are made. Insurance is a financial service much like banks or savings and loans, and as such, both good public policy and good public relations will not allow the policyholder to be harmed by mismanagement or fraud. There has to be a mechanism for his protection. The providers in the marketplace will pay for this protection. Such public protection becomes mandated by law and, along with this, comes attention to regulation. In other words, if you are going to protect the policyholder, we, as regulators, are going to look at the regulation that is doing it. So, if state regulation of insurance is going to be a viable entity, then state guaranty laws are needed. If the federal government becomes involved in the Guaranty Fund mechanism, it will also become involved in the regulations. Therefore, there is an attempt to make sure there is a state protection for policyholders.

SOLUTIONS TO THE LIFE AND HEALTH GUARANTY FUND PROBLEMS

The conflicting tenets of having to take care of your opponent's policyholder while at the same time remembering there is a public policy and a good public relations aspect have helped shape the current Guaranty Fund bills. Because of this, we have a Guaranty Fund system that works, but not perfectly.

In going through the history of Guaranty Funds, it is important to talk about both property-casualty and life, because much of what came about in the life industry came about because of a property-casualty Guaranty Fund system that already existed. The property-casualty Guaranty Fund legislation was passed in almost all the states very quickly because the federal government told the states that if they didn't create one, the federal government would. The only way to save state regulation was to make sure there was passage in all the states. What evolved was an NAIC model, based on the postassessment principle, which was then passed by the states.

The model bill was based on the concept that, in property-casualty, you did not have to have a continuation in coverage. The coverage in force usually ceased within 60 days of the insolvency, with the claim payments being made by the Guaranty Fund. There would be a post-insolvency assessment, where both claims and assessments were usually broken into two or three categories. One category would be personal lines auto, the second category may be all other, or there might be two other categories, workers' compensation and all other. New York had a prefunding concept on its entire Guaranty Fund, while all other states were postassessment.

To insure that only unsophisticated buyers were being assisted and to keep the process manageable, a cap was put on the amount of claim to be paid. In many states, to further encourage diligence on the part of the Commissioner, a tax offset was added. In other words, the companies could offset whatever they paid in assessments against their premium taxes. To make sure too much strain wasn't placed on the marketplace, a cap was placed on assessments equal to 2 percent of premium. Basing the assessment on premium made sense for the property-casualty industry. The clear expectation when these bills passed was that most insolvencies would be small specialty carriers, usually auto, resulting in a small hit to the Guaranty Funds.

The life Guaranty Fund did not have the national impetus from the federal government. It evolved, over a period of several years, after the property-casualty bill had been passed at the NAIC level. The concept behind the life Guaranty Fund was different than property-casualty because it was a different type of product. Both life insurance and accident and health (A&H) insurance are products needing some continuation in coverage, partly because the policyholder has an expectation of that continuation when he buys the product. Also, the policyholder's circumstances may have changed to such a degree that he could no longer get the product if his company went insolvent.

Because of these differences, a different structure from that used for property-casualty was needed. There was concern that you could not achieve continuation of coverage if the block of business was chopped up among various states. The general thought was to reinsure or sell the block of policies to an existing carrier. It was not thought that the Guaranty Fund would stay in the business of insurance. To reinsure the block or sell it, the block of business had to be kept together. Thus, the state of domicile of the troubled company would assume responsibility for all policies. The assessment would be on a state-wide basis according to the type of business sold, but there would still be a cap on assessments. Again, because the assessment in the property-casualty model was based on premium income, the life model was based on premium income. The assessment would be based on the amount of premium income the prior year, and there would be a state cap.

As the life company has a limited ability to raise its prices to recoup assessments, the tax offset was thought to be much more important in the life bill. Because of both the tax offset and the cap, there was a thought that there was going to be some problems in capacity.

The model got adopted in 1975 and passed in many states because, in those days, it was difficult to imagine a life insurance company going insolvent. The products were conservatively priced. The annuities were retirement products; they were not sold as tax-deferred investments. Finally, the high rates of medical cost inflation had not really hit. Therefore, the likely scenario for insolvency would be a small company which could be handled by reinsurance or merger. The Guaranty Fund would insure industry help in terms of reinsurance or the sale of the block, and the tax offset would take care of any major problems that were out there for the companies. Again, you had caps on the amount of payments that could be made, because it was the small, unsophisticated investor you wanted to protect. Also, you had a cap on the assessment to make sure you did not have market destruction. Last but not least, you could not advertise the Guaranty Fund because that was considered abusive.

The insolvencies in the 1970s and 1980s have resulted in recognizing the problems with the models that were adopted. In the property-casualty industry, the bill was too inclusive. The property-casualty industry came out with new types of products that were basically sold to sophisticated buyers, especially products like financial guaranty insurance. The big push with financial guaranty insurance on the property-casualty side has caused everybody to take another look at Guaranty Funds, as it became apparent that they were providing protection to the sophisticated buyer. This was an unintended result.

The other problem with the insolvencies in the 1970s and 1980s was that they were no longer small specialty carriers. There were large multi-line insurance companies going under. There was a problem with capacity. In other words, could the Guaranty Funds actually take care of the problem? There is always a thought that if the Guaranty Fund does fail, you will never be able to resurrect the state Guaranty Fund system. If the Fund ever comes up badly short, there would be such a public outcry, that it would have to go on a federal level. So there is a new examination of the property-casualty area to see if there is enough capacity and to see whether the products covered are the correct products.

In the life area there has also been a change. The industry has changed the types of products it sells. There is more competition and, therefore, greater risk. The industry is adjusting to the higher interest rates and high, uneven rates of medical cost inflation. And last but not least, reinsurance and mergers did not work. In Wisconsin, Reliable Life & Casualty Insurance Company went insolvent. It had a block of noncancelable A&H business which was badly underpriced. The premiums were very deficient but could not be changed according to the terms of the Guaranty Fund. In Delaware, Tara Life went insolvent. It was a Delaware company that sold on a national basis.

With the cap on assessments depending on Delaware premium income, the Delaware fund was unable to take care of either the Delaware policyholders or the national policyholders. There was a real capacity problem because of Tara Life. Baldwin United was a real shock to the system. First, there were some capacity problems with Baldwin United. There were Indiana companies and an Arkansas company. The Indiana companies would strain the Guaranty Fund for the next 80 years. The Arkansas company did not have a Guaranty Fund, so basically the other states' Guaranty Funds would have to take over. Also, the product involved with Baldwin United was the single premium deferred annuity (SPDA). The expectation of the buyers was very different. There was a great sentiment in the life insurance industry that it should not be bearing the whole burden for a product that was essentially sold as an investment product by brokers. In Illinois, we had the Georgetown Life insolvency which, because it sold many lines of insurance, presented great difficulty in determining its assessment base. A significant concern of the Illinois legislature was that the majority of payments went to out-of-state citizens.

A final problem with the life model is that it was not accepted in all the states. Only 35 states have adopted it. When the model first was adopted, there was a general belief among both the commissioners and the industry that it was never going to be needed. Therefore, there wasn't a major push to adopt the model. There was not a strong sense that you had to have one; it was good public relations, but it wasn't something that had to be done. While the industry saw a need for the model, states with small domestic life insurance industries actually discouraged passage of the bill.

If the other states that had large domestic life insurance industries passed the model, the small states would be protected. As states got in trouble with their own budgets, the general assemblies began to look at off-budget items. A conflict arose over the tax offset provisions in the life model, as the industry thought the tax offset provisions were essential, but the legislatures did not like to see this source of revenue reduced.

All of these concerns led to the NAIC looking at the models early in 1984. The American Council of Life Insurance (ACLI) and the Health Insurance Association of America (HIAA) came out with a model revision for the life industry, and submitted it to the NAIC in June 1984. The regulators sat down in August to figure out what they thought should be in the model. There were some major differences between the NAIC's position on a revised model and that submitted by the ACLI. A series of discussions occurred through December, when the NAIC circulated a draft model. Following are some of the key provisions of this model:

1. The new Guaranty Fund would take care of the policyholder who resided in the state. This solved several different problems. It increased the capacity to take care of your own state's policyholders. The 2 percent limitation on assessments based on premium volume still existed, but if the state only had to worry about the policyholders in its own state, this limitation on assessments caused less of a problem. It increased the capacity nationwide because each state had that 2 percent capacity. Therefore, the capacity problems caused by a nationwide company were addressed. it was better public policy in light of the tax offset, in that it would literally save the tax offset in some states. It simplified the assessment base, and it encouraged the other states to pass the model act.

2. On all A&H policies, the thought was to pay the claims incurred under the old contract but for continuation of coverage to be under a new contract with standard coverages and standard rates. This is different from the old model where the Guaranty Fund literally stepped into the shoes of the company. These changes should make it easier to sell off these blocks.

3. On interest-sensitive products, because of the Baldwin United and Georgetown insolvencies, it was evident there was a need to look both retrospectively and prospectively at the interest rate credited that the Guaranty Fund would be responsible for. Retrospectively, they could go back four years and look at the Moody's index and use these figures as the rate the Guaranty Fund would be responsible for. The difference between this index rate, and what the company promised the policyholder, would still be a claim against the Guaranty Fund, but it probably would not be paid 100 percent. On a prospective basis, if the policyholder wanted to keep the policy in force, the interest rate to be credited would also be based on the Moody's index. This allowed protection for both the Guaranty Fund and the policyholder.

4. The assessments would be based on a three-year average of premium income rather than just the preceding year's premium.

5. Since there was not going to be universal protection for everything promised by the company, there needed to be disclosure at the time of delivery of the product.

This model bill contained provisions for a life account, an accident and health account, and an annuity account. A major question, which became evident in December 1984, was what should be included in the annuity account. To be more specific, the question was, "Are you going to include guaranteed investment contracts (GICs) in the annuity account?" The ACLI's position was that GICs should be excluded. Many companies, however, felt GICs should be included. These companies argued that, in some cases, the only difference between what was called a GIC and what was called an SPDA was the name. Also, they argued, there is a public perception problem. If a company goes insolvent, and some policyholders get paid and others don't, you need to address why you appear to have discriminated against a certain type of policyholder.

In June of 1985, the NAIC adopted a policy that GICs would be included. The question then became whether there would be three or four accounts. Would GICs be included in the general annuity account, or would a fourth account be established just for GICs. This is especially important in terms of the assessment base.

If GICs were to be included, the assessment base would be quite a bit higher for all the annuity products, but of course, the exposure would also be higher. It would also change who was going to have to pay for the assessments. This issue is still not resolved. The ACLI reaffirmed its position that GICs should not be included at all, and that position limited the ACLIs ability to determine whether three or four accounts would be a better approach. At the NAIC meeting in Syracuse, the vote was to have just three accounts, but have a cap on GICs.

The issue of what to do with GICs is complex. There is the issue of fairness. Are the purchasers of GICs sophisticated or unsophisticated policyholders? If sophisticated, is the intent of the Guaranty Fund to protect such policyholders? Another issue is the effect on the capacity of the system. If GICs are excluded, what happens to assessment capacity? If included and capped, what should the assessment limit be? My suspicion is that there will be more discussions on this topic by the NAIC.

On the property-casualty side, there were fewer problems to deal with as the system has worked well in the past. There will be some changes where it appears we were protecting only sophisticated buyers. These include excluding captives and some financial guaranty products.

In both cases we are going to adopt a model bill December 1985. On both models one of the major questions for the next couple of years is whether our assessment will be enough to take care of the capacity needed for the Guaranty Funds.

MR. IAN M. ROLLAND: My job is to recap what is going on in the ACLI with respect to this subject.

Prior to September 1984, Guaranty Funds and insolvencies weren't a major issue before the leadership of the ACLI. But then the Baldwin United insolvency got everybody's attention. At that time, we were trying to put together an enhancement program for Baldwin United and were in the process of trying to enroll chief executive officers (CEOs) in an effort to enhance annuity benefits for the Baldwin policyholders.

Specifically, we were asking those CEOs to put up their company's money voluntarily to establish a $50 million industry fund.

As you can imagine they didn't participate enthusiastically. In the process, they expressed a number of concerns about the existing Guaranty Fund system. I would add emphasis to Mr. Washburn's comment that most CEOs in the industry simply don't understand why they should be putting up their company's hard-earned money to bail out a competitor who they feel has acted irresponsibly in the marketplace. Furthermore, they find it difficult to understand why they should be helping a regulatory system that may not have done its job in connection with that particular insolvency.

These were the concerns among the CEOs who were asked to participate in the Baldwin United deal. Their concern was that we do something to assure that similar insolvencies don't happen in the future. So, as is typical, a committee was formed to deal with this issue.

The committee of CEOs represented a broad cross-section of life insurance companies under the leadership of John Creedon, CEO of Metropolitan Life. The group was divided into two subcommittees.

The first subcommittee, of which I was the chairman, was to study ways to prevent insolvencies. Our subcommittee immediately realized that insolvencies are, for the most part, created by bad management practices; i.e., either management that is incompetent or management that is purposely trying to defraud. It is almost impossible to select out in advance the good managements from the bad managements, so a Guaranty Fund system that would prevent insolvencies is probably impossible to achieve.

Our subcommittee looked at a number of ideas and came up with five proposals, which were ultimately adopted by the ACLI Board:

1. Participation by companies in the NAIC's Insurance Regulatory Information System (IRIS) should be made mandatory. This is a data base maintained by the NAIC, which provides information for a number of tests that can be run on companies. The attempt is to flag, in advance, companies that are headed for trouble. Our subcommittee was quite impressed with the IRIS system. We were impressed with the kinds of tests that could be run from that information.

2. We should support improvements of the IRIS system that the NAIC was trying to bring about.

3. We should support the position of the valuation actuary. The committee studied the concept of the valuation actuary. CEOs are not terribly anxious to have an actuary with even more independence than he now has, trying to tell the CEOs what to do or second-guess their actions. It is important and significant that this subcommittee, and ultimately the ACLI Board, supported the concept of the valuation actuary as a useful tool in preventing insolvencies. It viewed the valuation actuary as a person on the

inside, who could determine up front, or prevent, actions which might ultimately end in insolvency. The subcommittee recommended that a special ACLI task force be established to further develop the idea of the valuation actuary and how it would function in an insurance company. This is in process.

4. The implementation of the Bell-Budd recommendations was encouraged. The Bell-Budd recommendations were the result of a study of the NAIC examination systems carried on a number of years ago. The name comes from Commissioner Bell of Kansas and Edward H. Budd, CEO of the Travelers, who chaired the committee. These recommendations involve some substantial modifications in the examination system which could be useful in preventing insolvencies.

5. We looked at the proposals for mandatory filing of quarterly financial statements by all insurance companies. There was some feeling that more frequent reporting could be a device to prevent insolvencies. We supported the idea that quarterly reporting should continue on just the targeted basis, aimed at companies having potential problems. I also said that if that reporting was to become mandatory it needed to be less burdensome than was being proposed.

These ideas were adopted, and although they will not prevent insolvencies altogether, I think they will be useful in flagging them a bit earlier.

The second subcommittee was a working group on reinsurance and other alternatives under the chairmanship of John Fisher. It was to look into other alternatives to the existing Guaranty Fund system. It looked at an alternative possibly being a private, or public-private, mutual property-casualty insurer to indemnify against losses because of insolvency. This insurer would be federally chartered and would be a replacement for the present Guaranty Fund system. This proposal was discussed at length but did not receive much support. I think this proposal faltered on the idea of federal chartering of the insurer, and the potential for federal intervention in the regulation of our business.

What has emerged, as a potential alternative to the present system, is a system of insurance that would be an enhancement to the present Guaranty Fund system. That is, the creation of a private, or public-private, mutual property-casualty reinsurer to provide catastrophic coverage if Guaranty Fund resources are exhausted. This reinsurance would come into play with respect to a particular Guaranty Fund if the limits and caps in that Guaranty Fund are exhausted by a particular insolvency. This reinsurance company would pay claims through the Guaranty Fund system, so it would be built on the present system.

This concept has a number of advantages:

1. It continues the present state regulatory system for solvency protection.

2. It provides backup protection for the Guaranty Funds that exhaust their assessment capabilities.

3. It concentrates resources on the states where the problems are the most severe. The idea was that this insurer would build up a fund of about $500 million that could be brought to bear in particular state situations.

4. It eliminates pressure for increased assessments or for the removal of the tax offsets. There was also the thought that, with this reinsurance facility in place, the industry could make a case for reducing the present cap on assessment from 2 percent of premiums to maybe 1 percent of premiums and, therefore, reduce the exposure to assessment under the basic Guaranty Fund system.

There are also some disadvantages to this proposal:

1. Potential antitrust problems.

2. There are many who think this is still a form of prefunding, which is almost universally opposed in the industry. The industry does not like the idea of setting aside money up front to deal with a later insolvency.

3. There is a feeling that this system would take the pressure off the regulators with respect to their job of trying to prevent insolvencies.

4. There is also a feeling that this would result in a fund of money that could be raided by legislatures for other purposes.

5. This, of course, would continue all the problems of the current Guaranty Fund system because it would remain in effect.

This proposal is still on the table at the ACLI, but it has not been adopted. It remains a proposal before the committee that is receiving further study.

Since the subcommittee on solvency prevention had found no magic answers and felt that the present system doesn't work all that badly, the committee decided to appoint a third subcommittee to look at the present Guaranty Fund system and come up with any ideas for improving that system. That subcommittee developed a number of proposals, which again have not yet been adopted by the ACLI Board, but have at least been discussed at the Board level:

1. We looked at the current Guaranty Fund laws and simply indicated that the changes being considered currently by the NAIC should be supported.

2. We examined the activities of a new group called the National Organization of Life and Health Guaranty Association (NOLHGA). It was brought into existence to deal with some of the coordination problems surrounding the Baldwin United situation. It has

been a useful forum in which Guaranty Funds can communicate. It was our view that NOLHGA was a useful organization and should be expanded and used more effectively and vigorously in connection with any Guaranty Fund issues.

3. We also recommended offsets against any future Guaranty Fund assessments for companies that voluntarily participate in bailouts or enhancements of insolvent companies. In the Baldwin United situation, we had companies putting up a fund of $50 million voluntarily to enhance benefits for Baldwin United policyholders.

4. One of the real gaps in the present system is that 15 or so states have no Guaranty Funds. It was our view that all states should be encouraged to adopt Guaranty Funds. We felt that the proposals currently before the NAIC, under which the Guaranty Fund would have responsibility for only the residents of that state, would be a useful device in pressuring the other 15 states into adopting their own funds. If they don't adopt a fund under this new system, their residents will have no protection.

We also heard an interesting proposal that might be called another alternative to the present system. Under this proposal, companies would set aside a fund for future insolvencies. Funds would be set aside on an ongoing basis, as a percentage of premiums. This fund would be identified as a liability on companies' statutory financial statements, and there would be an identified pool of assets which back up that particular liability. This proposal was received by our subcommittee, discussed extensively, voted on, and got a four to four vote; so you can see that quite a difference of opinion exists on this topic. As a result it was not submitted to the Board. The concept here is that assessments under Guaranty Funds are an inevitability in insolvencies, and companies need to put aside money for that purpose. In other words, companies should reflect on an ongoing basis the liability that is really there. Another advantage some see under this proposal is that it gets money from all companies, even those that would ultimately become insolvent. Those who oppose this idea still see it as a preassessment idea. Opponents also feel it could lead to Guaranty Funds becoming an alternative to efficient regulation. Proponents of this plan feel it helps deal with the lack of capacity in the present system, while those who oppose this proposal feel there is not a demonstrated lack of capacity in the life system at this time.

The Baldwin United situation triggered all of this exploration. In some quarters, the Baldwin United situation is being viewed as evidence that the present system doesn't work. I think the contrary. The Baldwin United situation may be some evidence that the present system isn't all that bad. The present system forced the industry to do something about that situation. We were looking at liabilities that could have been in the hundreds of millions of dollars, and that got everybody's attention. We got together and worked on it, and I think the industry is going to come out of that effort with a solution that is better than might have been the case had there been a fund of money available to be paid out immediately upon the announcement of that insolvency. So while the present system isn't perfect, it did force the industry to deal with difficult situations, and I think we came out quite well. Some improvements in the present system are necessary, and we are going to push for those improvements. A lot of us simply feel that drastic changes are not needed.

MR. DONALD J. MATTHEWS: I would like to focus on this challenge from a policyholder or customer point of view.

One of the challenges facing your industry today is developing an insurance mechanism that would provide almost instant relief to your policyholders in the event of a major insolvency or financial impairment. This mechanism should be compatible with, not a substitute for, the state regulatory process. It would be perceived to offer protection similar to Federal Deposit Insurance Corporation (FDIC) insurance. In other words, a bridge is needed to cover the time span between the initial exposure to loss or failure on the part of the company and the ultimate disposition of the failed company's assets. I see a definite need for the life industry to be able to offer its policyholders what the banking and securities industries offer their customers. The life industry, the banking industry, the securities industry, or if you will, the financial services community is becoming more competitive, and the lines are becoming less defined between these groups as they compete for the consumer's dollar.

The federal agencies that insure public deposits have brought remarkable stability to the financial sector. Between the crash of 1929 and 1934, the year the FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC) were created, approximately 50 percent of all banks and 25 percent of all savings and loans (S&Ls) failed. In recent times, the failure rate of banks and S&Ls has averaged about 1 percent a year.

Why is there a need for deposit insurance? Deposit insurance protects the financial system from the domino effects of financial failure. Such a failure can have serious consequences, such as a strong contraction of the money supply, if the public, through fear and loss of confidence, were to make a run on the banks. Deposit insurance protects the small unsophisticated depositor from losing his money in the event of bank failure. This is a parallel situation to the small unsophisticated buyer of GICs.

Deposit insurance also provides financial credibility for financial institutions like smaller banks. Some depositors believe that larger institutions are much safer than smaller ones, and without deposit insurance, those smaller institutions may not stay in business. An example of this is the recent run on the Ohio and Maryland thrifts which did not have the benefit of federally insured deposits. The FSLIC was created to reestablish public confidence in S&Ls so that they could continue to have funds available to make mortgage loans.

I am sure you are aware of the FDIC insurance limit of $100,000 per depositor account. In the event of a bank failure, the FDIC acts quickly to protect depositors by either arranging a merger with another institution or reimbursing the depositor to the insured limit. The FDIC is usually designated to act as a receiver for the failed bank and assumes the task of liquidating the bank's assets and settling its debts, including claims for deposits of that insured limit.

Prior to the failure of the Continental Illinois Bank, the Federal Deposit Insurance Fund was valued in excess of $15 million. The additions to this fund come from two sources: insurance premiums from insured banks and interest income on the fund. Banks' annual insurance premiums are approximately 1/12 of 1 percent of deposits. The FDIC uses these premiums to pay its expenses (including any insurance claims from failed banks), and to maintain an adequate reserve fund. After providing for operating expenses, losses, and necessary additions to the reserve fund, the FDIC is required to refund 60 percent of its remaining funds to the insured banks. In recent years, the net cost of FDIC insurance has been less than 1/25 of 1 percent of the insured bank's total deposits.

As with any insurance operation, the FDIC reserve fund is the first line of defense in the event of any failure. Unlike private insurance, FDIC also possesses a unique second line of defense, a $3 billion credit from the U.S. Treasury. In some ways, the FDIC approach to insurability is similar to that used in the life insurance industry. Each bank must initially demonstrate an acceptable level of financial health in order to qualify for the coverage. The FDIC also requires frequent check-ups, in the form of bank examinations as a condition of continued coverage. This need to reexamine insured banks arises because deposit insurance itself may encourage the bank to take a greater risk.

In 1970, Congress passed the Securities Investor Protection Act, which brought about the formation of the Securities Investor Protection Corporation (SIPC). SIPC is neither a government agency nor a regulated authority. It is a nonprofit membership corporation funded by its members who are securities broker-dealers. Its purpose is to protect customers of these broker-dealers from losses, thereby promoting confidence in the securities market. If a member firm fails financially and is unable to meet is obligations to its customer, SIPC provides certain protection for the clients of the failed firm. SIPC has a seven-member Board of Directors, five of whom are appointed by the President of the United States. Of these five, two representatives are from the general public, and three are from the securities industry. Rounding out the Board is one member designated by the Secretary of Treasury, with the other member coming from the Federal Reserve Board. The Securities and Exchange Commission (SEC) is the federal agency charged with overseeing the activities of SIPC. If a member firm fails, SIPC may ask a federal court to appoint a trustee to liquidate the firm. The trustee and SIPC may arrange to have some or all of the customer's accounts transferred to another member broker-dealer. The accounts that are transferred may deal with the new firm, or may subsequently transfer their accounts to a firm of their own choosing. In those instances where a simple transfer is not feasible, the customers receive all the securities registered in their name. They then receive, on a pro rate basis, all remaining customer cash and securities held by the failed firm. In the event the customer still has a claim after such distribution, SIPC will pay up to $100,000 for cash losses and up to $500,000 per account for all losses.

Generally most customers can expect final settlement in a matter of months. Monies required to satisfy customer claims, after all available cash and securities have been distributed, is advanced from the special SIPC fund maintained for that purpose. The primary source of money for this fund is an assessment collected from each of the member broker-dealers. The annual premium is 1/4 of 1 percent of the member firm's annual revenue. In emergency situations, where the fund is inadequate, SIPC also may borrow up to $1 billion from the U.S. Treasury. Under these circumstances, SIPC must present a plan to the SEC outlining a feasible repayment schedule. If the SEC determines industry assessments would satisfactorily repay the loan, it has the ability to surcharge all equity transactions on a fee basis, not to exceed 1/50 of 1 percent.

In addition to this quasi-private industry safety net, excess SIPC insurance is available from the private casualty market for those firms who satisfy certain underwriting requirements. Some of the larger broker-dealer firms have been able to secure this coverage at an amount of up to $10 million per customer account. This is over and above the $500,000 from SIPC. The premium for this coverage is paid annually and costs well into the hundreds of thousands of dollars a year.

To satisfy individual investors' concerns for safety, the private sector is busily augmenting the federal government's insurance mechanism. Banks and insurance companies are providing more private guaranties to mortgages, municipal bonds, and a host of other financial transactions. To the borrower or the investor, the financial guaranty is similar to renting someone else's credit rating and, in the process, reduces the cost of financing even after paying the fee or premium to the guarantor.

Property-casualty insurance companies are relative newcomers to this financial-guaranty marketplace. The financial-guaranty instrument has evolved from the traditional surety bond. In a way, these guaranties are similar to bank letters of credit, with one major difference: most financial-guaranty products guarantee the payment of principal and interest in the event of default, but are not subject to acceleration. Thus the guaranty is satisfied over the life of the original debt or financial obligation. This critical difference contrasts with the traditional property-casualty claims-paying method. Financial guaranties are designed to add stability and security to a sound financial transaction which can already stand on its own merits but, with the added support of this guaranty, can be either more marketable or more cost effective.

A major concern of insurers and reinsurers who write financial-guaranty insurance is the exposure to catastrophic loss. Severity, rather than frequency, is the order of the day. As a result, the financial-guaranty insurer must increasingly rely on reinsurance to protect his own exposure to catastrophic loss. Generally, reinsurers are cautious players in this market. With the recent losses in the mortgage-guaranty market, such as Ticor, and with the shrinking capacity in the traditional casualty market, the outlook for additional reinsurance support for financial-guaranty insurance is very bleak.

Finally, the value of the financial-guaranty product is only as good as the balance sheet and claims-paying rating of the insurance company issuing the guaranty. As of June 1985 there were only fourteen property-casualty insurance companies with a Standard & Poor's triple-A claims-paying rating.

Because of these factors, it is not realistic to assume the financial-guaranty market can offer any serious capacity to the life insurance industry to cover such catastrophic losses as a Baldwin United. The life insurance industry's response to that crisis, though commendable, was nonetheless "damage control." In addition, it has been a long and drawn out process, one that is yet to be completed. A more permanent remedy is needed, one that parallels the safety net approach available to the banking and securities industries. Whatever form it takes, at a minimum, this safety net should supplement the existing state Guaranty Fund mechanisms. However, it should be able to respond to catastrophic events with speed and efficiency, thus insuring the policyholder's confidence in this system. Through organizations such as NOLHGA, you may have a vehicle that can deal with a national problem or crisis. With a little imagination and creativity a safety net could be designed along the lines of FDIC or SIPC insurance protection, which will provide your policyholders with a fair and adequate relief in the event of a major financial failure within your industry.

MR. KAYTON: Mr. Rolland, since the risk that we are talking about seems to be more related to the investment risk, hence to the reserves, is there any possibility that a future solution (such as the ones considered by your committees) will be based on this type of approach?

MR. ROLLAND: You could probably make the theoretical case that the assessments under the Guaranty Funds should be related to the risk. In fact, there's some initial thought that maybe it should be related to some of the kinds of factors that we're now saying should be in minimum surplus formulas. Minimum surplus formulas are an attempt to measure the kind of risk a company takes. That is probably too complicated. To change from the present system of assessments based on premiums, to something else, would create a controversy in the industry. Those that determine they would be disadvantaged would be fighting it, while those on the other side would be supporting it. Politically, it is not going to be possible to move very far from where we currently are, even though theoretically it may make some sense. The present system is simple; companies can understand it; they can determine their exposure to assessments fairly easy; and that is probably going to be the determining factor rather than the theory.

MR. EDWARD H. FRIEND: It's clear to me that the reason the insurance industry has decided not to go the FDIC and FSLIC route is the avoidance of the federal regulation, and that is truly a commendable objective. The question is whether the private sector can do this by itself. It would seem that three problems stand in the way of a non-federal safety net solution. First, we have to overcome the poor management risk, and that's a severe concern. Second, there is the question as to whether financial guaranties are indeed insurable risks. Third is the trend toward self-insurance.

We've heard nothing about assessments to self-insurers who exacerbate the problem through the reinsurers who would have to protect the variations over the expected level. Prefunding, as Mr. Rolland has suggested, could lead to problems of tapping of that fund. Actuarial funding relating to risk just won't work. The Pension Benefit Guaranty Corporation has tried this in the pension area. It has looked at this problem of risk assessments, but the issues are too severe. The big and safe insurance companies would pay less than their share and probably are the ones that are going to be looked to for most of the protection.

In my opinion, the answer is in financial reporting with a regular and diligent overview of what the insurance companies are indeed doing so that there is an early whistle blown. Perhaps the disavowal of coverage in the event those measurements are not met is a solution. The threat of disavowal, if made public, could greatly endanger the insurance companies issuing new policies. There clearly is a problem with the definition of insolvency in such an approach. Probably half the insurance companies in the country were technically insolvent in the last decade for reasons that are obvious. However, disclosure and frequent financial review could very well be the seeds of solving the problem.

MR. MATTHEWS: To qualify for the SIPC insurance, you've got to agree to constant surveillance (monthly and quarterly focus reports). Prior to SIPC, the New York Stock Exchange, which was a private-industry membership group, policed its members and still does. Therefore, I think you can have a combination of insurability and surveillance. If you get the insurance, it's like getting a triple-A rating in that you become vulnerable. Any time a corporation gets downgraded from an A or a Aa bond rating to a Baa, all kinds of problems arise for that company. It's a potent weapon to say you have insurance now, but if you don't pass muster under that surveillance process, you could lose the right to that insurance. So I think the combination of the two could work.

From a financial point of view, we have been involved in industry situations where, without prefunding (either a letter of credit or whatever), a backstop line of credit with many bank institutions is put together to supply a source of credit, up to even hundreds of millions of dollars. So you could create a source of credit to make initial payments and then let the Guaranty Fund mechanism deal with the remaining claims, on the basis of either the existing mechanisms or ones that are modified.

MR. WASHBURN: In no case does anyone think that a Guaranty Fund is going to solve your problems of adequate regulation. We're always trying to somehow get a little bit better, in terms of how we look at the companies, what's backing them up, and how we examine what's going on out there. I'm trying to understand exactly what the taking away of protection would do to me as a regulator. What do you do to the policyholders, who bought policies earlier when it was a protected company, and suddenly find themselves out in the cold because the company has changed its method of doing business?

There is a difference between life and property-casualty companies. In the property-casualty field, we've had companies that go down within a year. This makes it difficult to do a good analysis, because most of the analysis looks at the past and extrapolates that forward. Now we're having to change the way that we look at companies within that one-year time frame. In the life industry, we're trying to look at what happens to the assets as changes happen in the marketplace that companies have no control over. Both of those things are affecting how we're looking at the regulation aspect.

MR. GARY CORBETT: A program has been mentioned for deferred annuities that's essentially got certain elements of coinsurance. By that, I am referring to going back to some lower level of credited interest rate where the promised interest rates were too high. Is there any thought of extending that in the life insurance area at all? I know it's a little more difficult, but could some elements of coinsurance be introduced where overly competitive products are being sold?

MR. WASHBURN: It will happen on all interest-sensitive products (e.g., universal life), but it would not be based on the premium as much as on the crediting rate that was given out by the company.

MR. ROLLAND: It's interesting to see that there is a broad perception that interest-sensitive products are inherently more risky than our traditional products. I can understand that perception, but I have a hard time believing that it is really the case. I think a lot of the same decisions go into pricing traditional products. A mutual company dividend is not that much different from the crediting of excess interest on a universal life contract. When mutual company actuaries set their dividends, they can make mistakes just like stock company actuaries can with their products. It is my perception that bad management, given enough time, could run any company into the ground. I believe it's not so much a matter of what products you're selling, but a question of how you manage them. Essentially, the risks in all of our products are very similar.

MR. MATTHEWS: A look at the banking or savings and loan industry may support that. Their products are totally interest sensitive. Those companies that got too aggressive, or were badly managed, and failed to match long-term commitments to short-term cost of money, got in deep trouble. I agree that just because a product is interest sensitive doesn't make it a special case. Good management will still prevail.

MR. WASHBURN: The theory behind looking at the interest-sensitive products was not to determine how management acted. The theory was to at least put some form of caveat emptor into the buying decision of the policyholder. In other words, the policyholder should take a second look at a product if it seems too good to be true, rather than just assume he's got ultimate protection over everything. We have found that, in some insurance companies, it is difficult even to find out what they base their decisions on. The basic thought behind the retrospective look at crediting rates on interest-sensitive products was to put an element of alertness in the marketplace that may not exist if the policyholder thinks there is complete Guaranty Fund coverage. Indeed, when Baldwin United policies were sold by some of the brokers, potential policyholders were told that there was no problem with the high crediting rate because they were completely guaranteed by Guaranty Funds.

MR. KAYTON: Which was, of course, illegal.

MR. WASHBURN: It was illegal, but it's not something you're going to be able to saddle the policyholder with.

MR. WALTER S. RUGLAND: One of the things that troubles me is the "cliff" nature of our insolvency definition. The whole Guaranty Fund concept is based on the notion that the statutory measure of solvency has a basis of substance, and I don't think that's true. It was pointed out in the presentation that this probably isn't true, because we assume we can rehabilitate any company we declare is insolvent. So it seems to me we should figure out a way to get rid of the "cliff" and figure out when we're going downhill and when we get to the bottom.

Probably the key is professional responsibility. However, as soon as we latch onto that approach as one that has viability, we have to change a lot of traditional directions. One of those directions that I continually see popping up is that we have regulators and our profession searching to find more safe harbors. Safe harbors, to some extent, conflict with professional responsibility as it applies to the solvency situation.

Whenever there seems to be a need for a company to be stronger, we tell it that it needs to set up more reserves, which in the long run is going to tend to make it weaker, based on most solvency definitions. As we move to professional responsibility, one of the roles of the industry is to convince the regulators that the responsibility for establishing the reserves belongs to management and the actuarial profession, and the responsibility of regulators is to review the appropriateness of the work done by those parties. Regulators as they are structured today, are not equipped, across the country, to be able to do that. One of the thrusts that I hope can be pursued, given we can move that responsibility to management, is to establish an adequately staffed review process on a national basis of the reserves that have been established in the financial reports.

MR. ROLLAND: A lot of the motivation behind the idea of the valuation actuary is to place a good deal of responsibility on an actuary, internally, to make these kinds of judgments. One of the concerns that we dealt with in this study, which arose out of the Baldwin United problems, is the issue of matching assets and liabilities, which we hadn't heard of five years ago. Now, however, it is a critical issue. We're saying, how do you make sure there is a reasonable match of assets and liabilities, or what do you do to make sure the quality of assets a company is investing in is adequate for its business, so it can pay off its obligations as they come due? There are some who think we should regulate the matching process but also say it should be regulated just for the companies that are in trouble. They do not want the process to apply to themselves. They don't want the regulator looking over their shoulders when they are investing.

The solution we came up with was the valuation actuary--an actuary who will make judgments not only about reserves but also about matching assets and liabilities and maybe even about the quality of assets. Our view was we didn't want the NAIC or the insurance commissioners doing that. We wanted it done on a self-regulatory basis through our own people, working at our own companies. We expect we have enough professionalism and independence to be able to do it.

MR. KAYTON: Mr. Washburn, would you see the valuation actuary approach as giving you more confidence and possibly eliminating the need for Guaranty Associations?

MR. WASHBURN: I don't think the valuation actuary approach would necessarily eliminate the need for Guaranty Associations because, in fact, you could still have a problem where you'd need protection. In Illinois, we like the idea of having a professional valuation actuary. We are one of five states that has a CPA audit rule that says a CPA has to file an annual independent audit. If he sees trouble, he's got to tell us. We've had a couple of companies brought to our attention by the CPA. The whole thought of good regulation is something we have to strive for. The Guaranty Funds are not an end in them- selves; you will still need some fail-safe mechanism beyond the funds.

MR. FRIEND: I'd like to clarify my intent with respect to my earlier observation in the disavowal of protection. The disavowal would be with respect to new policyholders. It should be required that the insurance company advise any policyholder purchasing coverage from that point forward that he is not covered by this program. You would essentially be putting the insurance company in a position of not having a good standing with respect to future sales, and it would be forced then to strengthen itself to avoid losing future sales.

MR. WASHBURN: The usual reaction of the Department is that, if you don't think a company should be selling, you don't let them sell. You don't allow them to sell with a caveat. If I didn't think that a company deserved to have the protection of Guaranty Funds, it would be difficult for me to let them sell policies, relying on the policyholder's ability to understand what it means to not have Guaranty Fund protection.

MR. FRIEND: I want to make a second point in connection with the valuation actuary. One of my concerns has been the question of the quality of securities and the frequency of the review by the valuation actuary. The annual review is different from a continual review, and things can go bad in twelve months.

MR. WASHBURN: In Illinois we are looking at how the assets would be managed under different marketplace scenarios and in event of liquidation. Also we're asking how you would respond to marketplace changes in the assets. We're fortunate because we've got an actuary on staff. A lot of states do not have that luxury.

I also have a comment on this "brink of liquidation" question raised earlier. We have built into the life Guaranty Fund model an ability to rehabilitate. This is to cover the situation where you don't think it is yet appropriate to liquidate a company. There may be an opportunity for rehabilitation, with the Guaranty Fund paying the claims while the company sets itself up in a different mode. But then the rehabilitated company has to reimburse the Guaranty Fund before becoming active again.

DR. ALLAN BRENDER. With respect to new-money products, it seems you're competing largely with deposit-taking institutions. But they can advertise being a member of FDIC, so why shouldn't an insurance company be able to advertise that it has insurance of some kind? It's the same business. Also, you're talking about putting some kind of limits on new money-products. It seems to me the consumer is not getting the same deal as provided by FDIC and somehow will have to be advised of that.

Would participating policyholders be treated any differently than non-participating policyholders in the event of a failure? Participating policyholders will have been paying significantly higher premiums for essentially the same coverage, but probably in the event of a failure wouldn't get any of the dividend benefits if the policies were continued.

MR. WASHBURN: We've tried to address the issue of participating versus nonparticipating policyholders under the existing model. The Guaranty Fund literally steps into the shoes of the company and pays on the same basis for all policyholders. There is no discrimination.

Many companies did not want the small companies to be able to advertise their participation in a Guaranty Fund, because they felt they would go a little wild with the advertising.

DR. BRENDER: Why can a savings and loan company make such a claim?

MR. MATTHEWS: If you borrow from the experience of the financial community, surveillance, proper discipline, and the ability to act quickly overhangs any management. However, that doesn't stop outside people. In fact, some of these savings and loans and some of the insurance companies that have been acquired by financial types don't follow the traditional disciplines and professionalism of your industry. The concern about their taking advantage of an industry super safety net is a legitimate one.

MR. KAYTON: Mr. Matthews, you heard before that the proposed model bill has limitations on interest credited to interest-sensitive products, both retrospectively and prospectively. Is there any attempt within the FDIC system or within the banking community to put in similar limits for their products? For example, what if an S&L were to offer 15 percent interest guaranteed for the next five years?

MR. MATTHEWS: Historically there were no limits. Look at certificates of deposit (CDs). You could see some institutions, whether S&Ls or smaller banks, offering rates of 12.5 or 13 percent, and advertising that they were "FDIC Insured." These jumbo CDs were termed "hot money." So the Federal Reserve cracked down and said that in the event of failure, if it's determined that the depositor owning a CD was one of these "hot money" or so-called sophisticated investors, then the FDIC was going to limit payment to $100,000 regardless of how many CDs the depositor bought. These are the only steps I know to place limitations on the FDIC or FSLIC coverage.

MR. KAYTON: But, was there attempt to limit the prior interest credits?

MR. MATTHEWS: No, there have been no limitations on the prior interest. But we should not forget the so-called unsophisticated buyer. People put their life savings in uninsured thrifts and just assumed the institution would make good on its commitment with their money. That's the underlying issue in terms of where I come from, on the consumer's side. You've got to first protect the consumer if you want to have an industry that is highly regarded and well-disciplined.

MR. KAYTON: Mr. Washburn, if this model bill is adopted by the NAIC, what's the likelihood that it will be law in fifty states by one or two years from now?

MR. WASHBURN: There is a growing awareness in the states that do not have a model bill that they need one. There have been some national companies that failed in states not having a Guaranty Fund (Iowa Travelers was one). This created a growing awareness of the need for not only a Guaranty Fund but for one that works. What we've tried to do is put together a model bill that can be passed in all the states, which conforms to what everybody thinks a Guaranty Fund ought to do.

MR. MATTHEWS: As an observer, I'm impressed with the people who are working on the problem. Here is Mr. Rolland, a busy CEO of a major insurance holding company, working on an industry task force to solve this problem. There is John Creedon of the Metropolitan, Mr. Washburn, a Director of Insurance, and others providing this kind of leadership. The awareness and the sensitivity is very high, and that's a strong indication that a solution will be found.

MR. ROLLAND. I don't think we need drastic changes in where we are. The things happening now are generally very positive. The fact that insurance company managements are more aware and concerned about this issue is a real plus because they'll take an interest in it. This industry has to support quality regulation. The issue of bad management in insurance companies is a regulatory issue, too.

The higher the quality of our regulators, the better the chance we'll have of dealing with it.

As we look at some of the other industries, the experiences are instructive, but life insurance is a bit different. The property-casualty area needs funds immediately to pay claims. In the S&L business, these are savings deposits the people need on an immediate basis to take care of financial needs. We have got to recognize our business as longer term. It was evident in Baldwin United that we have more time to work these things out. There are some hardships along the way which have to be recognized, but there is more time to work out the problems of a life insurance insolvency, and that's a plus for us. We've got to construct our system of Guaranty Funds with this in mind.