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GUARANTY FUNDS

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- o Historical perspective on guaranty funds
- o Recently activated state guaranty funds
- o What alternatives are available?
- o What could cause the system to break down?
- o Should guarantee funds exist?

MR. LARRY M. GORSKI: The guaranty fund system for life companies has been in existence for about ten years. Until the Baldwin-United failure, insolvencies were, for the most part, handled by the system. The Baldwin-United failure changed that. Questions about the capacity of the system, coverage of certain types of products and making good on irresponsible promises of the management of insolvent companies were raised. Much activity has taken place at the NAIC level to address these issues.

Our panelists are extremely well-equipped to discuss the agenda items for this open forum. Ms. Susan Dew is an attorney for the law firm of Lord, Bissell & Brook. Prior to her current position, she was an attorney with the Illinois

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Department of Insurance. She was very active in dealing with insolvencies in Illinois and as a primary drafter of the proposed NAIC model life guaranty fund bill. She will address the history of life guaranty funds and the problems encountered by them.

Our next speaker will be Mr. Ernie Porter. Ernie is a past director of the ACLI, past chairman of the National Organization of Life and Health Guaranty Associations (NOLHGA), and president of Washington Mutual Service Corporation. He is one of the few actuaries that I know of who is actively involved in guaranty funds. He will speak to the role of NOLHGA in the development of the new NAIC model bill. Our final speaker is John (Cal) Winter. Cal is a Fellow of the Society of Actuaries and is senior vice president of John Alden Life Insurance Company. Cal has been actively dealing with some of the key issues of the proposed NAIC model. He will present his views on the capacity and coverage issues.

MS. SUSAN E. DEW: Prior to the mid-1970s, few life insurers writing traditional whole-life-type policies were dissolved as insolvent, leaving beneficiaries with unpaid claims. Rather, when life insurers got into financial difficulties, receivers and judges frequently devised plans to limit policy loan rights, reduce cash values, reduce crediting rates, or otherwise draw out the time in which companies could meet their obligations. In other words, the policyholders "refinanced" the company by involuntarily foregoing certain policy rights to access cash from the company. The company used the extra income generated to meet these reduced liabilities. Occasionally, blocks of business were "sold" to other insurers with either temporary or permanent liens placed on the policies. The effect as to policyholders was essentially the same, except they gained the advantage of being in a more viable insurance company for the future. If there were sufficient assets to meet death claims on a timely basis, there were few complaints in these situations.

The alternative to these contract modifications would have been to liquidate the company. A pro rata share of assets would then be paid to policyholders based on their policy cash values or unpaid claims as of the date of liquidation. When the policyholders received these funds, many could use the cash to purchase similar coverage elsewhere. Older persons or those who had become

uninsurable since the purchase of the original policy often did not have the option to purchase other coverage. The liquidation of individual health insurance policies, which were neither guaranteed renewable or non-cancellable, presented even more problems to policyholders. The cash values of these policies were negligible, and cancellation of the contracts imposed a double hardship on policyholders. Because the policies had little economic value, the funds paid from the Company were small and alternative coverage was usually unavailable to persons who needed the coverage most. Luckily, there have been few actual life insurance company insolvencies. The cost to consumers has, thus, not been remarkable.

I. PROPERTY AND CASUALTY GUARANTY FUNDS IN THE 1960s

In marked contrast, the property and casualty automobile insurer insolvencies in the 1960s has significant impact on individual insureds who suddenly found themselves with no insurance and possibly facing undefended claims and unpaid judgments. While many of these auto insurer insolvencies were single-state or regional, enough of them occurred to give rise to the perception, at least, of a "national" problem. The situation was so important that federal legislation was offered to create a federal property and casualty guaranty fund.

The NAIC opposed the federal legislation as an unnecessary intrusion by the federal government in the regulation of the business of insurance which states could properly handle. A model bill was prepared and quickly passed in some form by most states. The salient features provided for guaranty fund coverage to policyholders or claimants residing in the state of the guaranty fund for claims up to a fixed amount, generally $50,000 to $100,000. Coverage was usually continued by statute for a short period, for instance 30 days, after the entry of the order of liquidation to allow policyholders time to take over the defense of cases in suit, and it was often in their best interest to do so. Many guaranty funds covered unearned premium claims, too. The essence of the guaranty fund was to allow for timely claim payments by the fund to consumers, and to let the guaranty fund wait to receive distributions from the insolvent company. Frequently, these would not be made for five years or so, and then the payout was always less than 100% of the amount due.

The costs of the guaranty fund are met through assessments against insurers doing business in each state where the insolvent insurer did business. Most states have at least two accounts for assessment purposes. One is usually automobile insurance, and the other includes other insurance lines covered by the guaranty fund act -- e.g. homeowners, workers' compensation, professional liability, and assorted commercial lines. Authorized insurers are assessed based on a formula, usually in proportion to their market share of premiums written in the state during the prior year. When the model legislation was drafted, automobile insurers' insolvencies were the ones which were of the greatest importance, little concern was given then to the equities of combining all other lines together in a single account.

Guaranty funds operate independently of each other although there usually are statutory provisions prohibiting a claimant from claiming against more than one guaranty fund or stacking recoveries. In the late 1970s, with the insolvency of Reserve Insurance Company, which wrote commercial lines on a national basis, an industry group, the National Committee on Insurance Guaranty Funds (NCIGF), geared up to coordinate efforts, assist funds with unusual problems, and determine which funds should pay in the case of multi-state corporate claimants. In the 1980s large non-automobile insurer insolvencies are common in addition to smaller, local automobile insurer insolvencies. In light of these changing circumstances, changes to the model have been adopted and others are being considered.

II. LIFE AND HEALTH GUARANTY FUND MODEL.

The "success" in passing the Property and Casualty Guaranty Fund Model probably prompted the NAIC interest in developing a companion life guaranty fund more than did an occasional insolvency or the threat of federal interference. This was a rare instance when legislation was actually prepared in anticipation of a problem rather than in response to one. However, the life insurance industry was strongly opposed to even the drafting of a model. The industry argued that guaranty funds would provide "reinsurance" for mismanaged companies or would encourage poor business practices. It was perceived that the stockholders of these mismanaged companies would benefit too at the expense of the

policyholders and stockholders of well-managed insurers who would be obliged to pay assessments.

Ignoring the industry's position, the NAIC had the support staff prepare a bill using the property and casualty model as a starting point. Key differences between the nature of the business written and the duration of the contracts sold, however, necessitated significant differences in the models. As explained, the need to provide a continuation of coverage for most lines of business written by life insurers was important. In order to more easily accomplish this, the model was drafted so that the guaranty fund in the state where the troubled insurer was domiciled would provide guaranty fund protection for all policyholders nationwide.

Life guaranty funds were more than just claim payers. The guaranty funds were authorized to make loans or guarantees to impaired insurers, presumably with the expectation that insolvency could be averted. The option to take such action was given to the fund, but it has been rarely used, if ever. In order to fulfill its primary function, when an insurer is declared insolvent, the guaranty fund must either "assume" the policies and provide continuing coverage and policyholder services through the association, or it can cause the policies to be reinsured to another insurer. This is usually done by using some assets from the insolvent insurer, if available, and by adding amounts contributed from the guaranty fund.

Under certain circumstances, the guaranty fund can request that temporary moratoriums be imposed on cash surrenders or permanent policy liens be attached. These features are both carryovers from the days when there were no life "insolvencies," only reduced policy values. The drafting comments for this section indicate that in certain economic situations, provisions like these might be necessary in order to maintain the financial integrity of the other insurers doing business in this state which would be obliged to pay the guaranty fund assessments. Unfortunately, the model provides only vague guidelines for when liens or moratoriums could or should be used.

In the event that there is no guaranty fund in the state of domicile of the troubled insurer, guaranty funds in other states where the insurer did business

would be activated at an order of liquidation. Again, each such guaranty fund would be responsible for paying unpaid claims and providing continuation of coverage, but for local residents only. Obviously, it was intended that eventually only one fund would be activated per insolvency after each state had adopted the model bill.

Since the early 1970s some 35 states have passed the NAIC Model Life and Health Guaranty Association Act. California and New York are two major states that have been unable or unwilling to adopt the model, although New York does have a fund of sorts which provides some protection for New York residents only and has recently improved that protection to conform with the new NAIC model.

Despite the evidence provided by the insurance industry that life insurers do not become insolvent and that guaranty funds will merely encourage mismanagement, many life insurance companies have been ordered into liquidation on the basis of insolvency in the past several years. The costs to the policyholders of these insurers would have been significant, but for the protection provided by guaranty funds. Perhaps because of the multi-state impact of these insolvencies, the weaknesses and costs of the life guaranty fund systems have been more open to public view and comment.

III. LIFE AND HEALTH GUARANTY FUNDS IN PRACTICE

Some of the lessons of these recent insolvencies are worth reviewing in order to understand the transition from the theoretical to practical application of the law. Most of these life insurers got into financial difficulties because of accident and health insurance business not traditional life insurance products, but even that trend is rapidly changing.

The insolvency of Reliable Life and Casualty Insurance Company in Wisconsin in 1981 caused the activation of the Wisconsin Security Fund to provide protection for policyholders nationwide. The problem book of business here proved to be noncancellable Medicare supplement policies for which the fund was unable to raise rates or reduce benefits. Therefore, the fund was obliged to perpetuate the insurers' poor pricing practices until insureds cancelled coverage.

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The insolvency of Iowa State Travelers Mutual Assurance Company, a long-time direct market company, came as a surprise to many in 1983. A surprise because up to two years prior, it had received an A rating from Best's and the demise of the company was rather rapid. In the absence of an Iowa guaranty fund, some 30 funds in other states were activated on behalf of their local residents. There was initial confusion about the obligation of coverage by guaranty funds in light of the fact that the Iowa's liquidator had cancelled all policies. Also, the liquidator petitioned to reinsure certain life policies using special reserves to fund the transfer. Some guaranty funds objected to this transfer based on a preferential use of assets. In the end the liquidator's petition was allowed, and guaranty funds were not permitted to take advantage of the liquidator's cancellations. Claims were paid and policies continued as required by the guaranty funds.

In comparison to the size and cost of Iowa State Travelers, Tara Life Insurance Company in Delaware was a small insolvency in a state which had a guaranty fund. Once again, the problem policies were accident and health ones. The insolvency of approximately $10 million was not especially large for a company doing business in some 12 states, but the assessment available based on the Delaware premium volume for accident and health policies written in the prior year was not sufficient to meet the amounts necessary to fund a reinsurance transfer. Eventually, claims were paid and a new carrier was secured, but the delays and uncertainties were frustrating to policyholders and disappointing to regulators.

Georgetown Life Insurance Company was ordered into liquidation later in 1983. The Illinois Guaranty Association was activated to protect policyholders in 12 states where the insurer had done business. The premium volume in Illinois was sufficient to provide an adequate assessment base to handle the insolvency. Here for the first time the business which likely caused the insolvency was single-premium deferred annuities (SPDAs) with short term guaranteed interest rates above market. Regulators and insurance industry officials alike wanted to see how these policies would be handled in light of other large annuity writers which were experiencing financial difficulties in mid-1983. The Guaranty Association agreed to cover the policies written by Georgetown, and these were eventually reinsured to another carrier.

The final blow of sorts, or at least the near-insolvency that makes all other insolvencies pale in comparison, was The Baldwin-United Companies. Here it seems as if all of the weaknesses of the life and health guaranty association system came to light instantly. The saga of these companies is well known to anyone interested enough to have followed the drama that had occurred in various courts and has been reported in all of the journals. However it is valuable to consider the new twist that Baldwin-United added to the history of guaranty associations. There were scores of policyholders residing in all 50 states. There were two direct writing companies, one in Arkansas and one in Indiana. Arkansas did not have a guaranty fund, which triggered the guaranty funds in the other 35 states that did have them. Indiana had a guaranty fund, but had an assessment base that would take an estimated 80-100 years to pay off the obligation. The financial problems of the insurers were caused by the sale of SPDAs with high interest rates guaranteed for a relatively long period of time. The wide-spread use of marketing and sales of these policies by stock brokerage houses raised new questions about coverage of these products by insurance guaranty associations. The legal difficulties and complexities of the Baldwin-United holding company system meant that an ordinary liquidation of the insurers would not be possible. Thus, the potential exposure to guaranty funds, without access to assets from the insurers, was estimated at $4 billion and growing daily.

IV. OPPORTUNITY TO CHANGE LIFE GUARANTY FUND SYSTEM

Since the early 1980s, life insurance insolvencies of all types and varieties have put the model to the test. In most instances policyholders were eventually protected under the law, but notable weaknesses in the design of the model have surfaced. Many states are dissatisfied with the gaps in the system due to less than 100% passage of the model. Many states are concerned over the capacity of one guaranty fund to handle a nationwide insolvency. Those frustrations are heightened in states with tax offset provisions. Many states allow the member companies of the life guaranty association to offset the payments made through assessments over several years. These payments are offset against premium taxes, income taxes, valuation fees, or other fees paid to the state. This meant taxpayers in the domicile state of the insolvent company, assuming that state has a guaranty association, were effectively

funding the benefits for policyholders in other states. Without having guaranty funds in every state, the possibility of reciprocal payments were questionable. Others have merely been aggravated by the difficulties in using a model tailored from a property and casualty mold when the interest sensitive products being sold by life insurers today are so different from those which were sold at the time the original life model was prepared.

All of these circumstances combined to provide the inspiration to both the regulators and the insurance industry to make important changes to the model. The changes did not come easily. The insurance industry started first and worked for a year and a half, struggling through eight drafts. The regulators then reviewed the work product and immediately rejected some of the industry's provisions which undercut policyholder protections.

Then the negotiations began in earnest. After another year and a half, a new model was approved by the NAIC in December 1985. Each guaranty association will now cover local residents only as long as the insolvent insurer was authorized to do business in that state. The primary responsibilities of the guaranty associations will begin with an order of liquidation against an insolvent insurer. However, some claims may be paid by the guaranty association earlier after the entry of an order of rehabilitation.

The guaranty association will no longer be responsible for continuing coverage on the same basis as written by the insurer. Reinsuring policies to other insurers will still be encouraged. Accumulated values on interest-sensitive products may be reduced when the insolvent insurer was crediting rates above statutorily defined market rates. Other policy changes may be permitted so that guaranty associations can provide coverage on a going-forward basis and on a more actuarially sound basis.

V. CONCLUSIONS

One thing that is clear is that coordination of the affected guaranty associations under the new model will be crucial. It remains to be seen if such continuous cooperation can be achieved insolvency after insolvency. But if it works, policyholders should be better served by local guaranty associations.

States can be more flexible as to the details under the new model, and many local considerations can be accommodated without doing harm to the network that has been created under the new system. Also, industry members paying assessments should be a little more comfortable about the protections for which they are paying.

MR. ERNEST R. PORTER: I understand that originally this portion of your program was scheduled to discuss, "Recent Activation of State Guaranty Funds," but, with Larry's permission, I suggested that, other than a scare tactic, this would serve no real purpose. In fact, the creation of apprehension about our system is not the message I want to give you at all; rather, my message is that the system we have is the best one designed so far and that there are means of providing adequate capacity even under the most unlikely circumstances.

First, let me set the stage stating that my comments are only from the perspective of life and health guaranty funds, and assuring you that I have been associated with State Guaranty Funds for the past 13 years; primarily to assist in controlling them, not as an advocate of any bail-out mechanism.

A student of insolvencies that have occurred in the United States will quickly observe that, almost without exception, insolvencies occur for one of three reasons:

1. Poor management;

2. Fraud;

3. Weak or ineffective regulation.

These are, indeed, the most difficult kinds of problems to cope with that could be conceived.

The American Council of Life Insurance, almost concurrently with the emergency of the Baldwin-United deficit and the threatening of a huge shortfall in the Charter situation, became extremely concerned. Some of the best insurance minds in the country were gathered to support a task force of CEOs who were

charged with looking for alternatives to the existing system and to find ways to help in the prevention of future catastrophies. The end result was that a viable alternative to the existing system was not found.

Virtually no CEO supported a federal system -- no one advocated a pre-assessment plan, and interest was non-existent to opening the doors to any scheme which would involve regulation in the management decision process, including the determination of the quality of assets.

During this exercise, it was candidly pointed out that we have never had an insolvency in our industry that has not been adequately resolved. Even within the last 60 days, the Wall Street Journal has carried articles pointing out that the FDIC now controls more than 80% of the stock of Continental Bank of Illinois and will likely exercise its option to acquire the rest. On top of this, the FSLIC has asked for nearly $23 billion to help bolster its dwindling insurance fund.

The federal government has never had to bail out one dollar for the life insurance industry, including the billion dollar potential for Baldwin-United.

On the prevention side, the very difficult issues that I mentioned earlier -- poor management; fraud, need for regulatory improvement and asset management -- were so intangible that detailed specific solutions were not readily apparent; however, efforts are proceeding to work more closely with the National Association of Insurance Commissioners (NAIC) through the further development of the Insurance Regulatory Information System (IRIS) and the strengthening of the examination procedure.

In a recent speech before the Society of Financial Examiners, Commissioner Josephine Driscoll of Oregon, who is currently the President of the NAIC and the first female ever to hold that post, concurred that prevention was better than a cure, but than when looking at our industry, as a whole, there was bad news.

The Examiner Team Report to the Examination Oversight Task Force of the NAIC indicated that it had reviewed in depth, the annual statements of 1,120

companies. The Examiner Team's observations revealed that in its opinion, 234 (9.7%) property and casualty companies and 192 (9.8%) life companies were in need of immediate regulatory attention indicating that current operations threatened their short term survival. An additional 267 (11%) P&C companies and 130 (6.5%) of the life companies were found to need targeted regulatory attention to address their long term financial well being.

While in some eyes this may seem frightening, to me it presents a glimmer of hope for the regulatory portion of the formula.

Commissioner Driscoll asked that I bring a message to you. In her mind, the members of the actuarial society have a real obligation to the public, to the industry, and to their company to be conservative in the valuation of liabilities and to persuade their clients and companies to take responsible positions regarding product profitability and rate making. Further, she asked me to relate to you, specifically, and I quote, "Your reputation is on the line."

If there is merit to my observations as to the major causes for insolvencies, the commissioner's message might point out that the actuary is often the scapegoat even when inappropriate management or less than prompt regulation is the fundamental factor.

This reminds me of the story of the actuary who advised his president that, if the company persisted in selling a product as it had been, it would lose $100 million by year end. After the annual statement was out, the president called for the actuary and said, "We lost $100 million on this product -- you're fired." The actuary responded, "But, I told you that we would lose $100 million; don't you remember I even pounded on your desk when I said it?" The boss replied, "Yes, but you didn't pound long enough or hard enough."

Perhaps this illustrates, in part, the future role of the valuation actuary.

If indeed, the actual prevention of insolvencies is the important element to contend with in the years ahead, why then shouldn't guaranty funds play a key role in this effort?

After all, since insurance is, and will continue to be, state regulated, guaranty funds are close to and have the best line of communication to their state commissioner. In many instances, he is actually a member of the board itself. Furthermore, our business is a rather small community, and the likelihood that financial problems are brewing should be better known locally than anyplace else.

Prevention, in my view, is a number one priority. It is probably true that an individual guaranty association has a limitation on its ability to act when a multistate insolvency occurs. But, it is in those instances that the National Organization of Life and Health Guaranty Associations (NOLHGA) becomes a positive influence.

NOLHGA is a new influence on the guaranty scene. When the Baldwin-United monster appeared on the horizon, it became instantly apparent that the various state funds were confronted with a need for coordination. At the beginning of 1984, 13 states got together to form a separate national organization that would reflect the special function and unique status of the guaranty associations.

Today, all 39 of the guaranty associations in the country, with the sole exception of the newly formed Mississippi Association are members or have committed to join.

Only a few months ago, NOLHGA was completely unknown. In an amazingly short time span, it became a necessary ingredient to solving the demands put on the life and health industry by insolvencies.

Of course, Baldwin-United was the major stimulus for this recognition, but Iowa State Travelers, certain activities in Oklahoma, action by the Internal Revenue Service, and other insolvency matters, like the new model guaranty law, were also important factors.

Note, if you will, as I wind down to the conclusion of my remarks, the part that NOLHGA has played so far in just the Baldwin-United stream of events.

At our first board meeting in February 1984, we were confronted with the proposed bail-out plans of Merrill Lynch and Prudential Bache. We promptly appointed a technical task force which shortly thereafter developed the concept of the enhancement plan that has become the ultimate basis for the final settlement of the Baldwin-United insolvency.

Inasmuch as the state guaranty laws are not exactly the same, nor are they administered uniformly, it became apparent that, if the Baldwin-United solution was to be successfully pursued, a cooperative effort was necessary. Consequently, a Baldwin-United coordinating task force was appointed to confront the myriad of issues to be identified and to prepare an in-depth analysis of the guaranty funds involvement at all levels. From this effort came a complex state level pattern settlement plan which addressed the dozens of complicated problems facing the public, the regulators, the rehabilitators, and the guaranty associations themselves.

All during this time period. NOLHGA attorneys were monitoring and participating in the New York class action suit between the policyholders and brokers. At the conclusion of this action, which, by the way, resolved close to 65% of the outstanding policyholder liability of Baldwin-United, NOLHGA took the responsibility for and coordinated the thousands of releases that were needed to be signed and filed.

We also arranged for optional representation for the third party broker suits that popped up during the Baldwin-United episode.

Even after Phase I was concluded, it was necessary for NOLHGA to hire actuarial expertise in order to independently evaluate the merit of the competitive proposals of Metropolitan Life and Sun Life to acquire the Baldwin-United annuities; thus, expediting the conclusion of Phase II.

Many other matters were handled as well by NOLHGA for the benefit of the various state guaranty funds. For example, we are now trying to foil attempts by the IRS and state governments to gain priority access over the policyholders to the assets of insolvent companies, and we have also prepared *amicus curiae* briefs to protect guaranty associations in other instances.

In summary, there is no question but that the current system for guaranteeing the policyholders of our industry and their benefits in the event of insolvency has stood up to the test. There is also no question but that it can be improved.

We know that it is impossible to avoid all insolvencies in the future, but we should, at least, move as effectively as possible, to minimize their impact. In fact, NOLHGA is now exploring means to achieve this, without suffering the many disadvantages of a pre-assessment plan.

In my way of thinking, when the final details outlining the future course of the valuation actuary are completed, the job of the guaranty associations across the country will become much easier.

The "Achilles heel" of the current system is the failure of all the states to adopt responsible guaranty laws. Prompt passage of the new model guaranty law that was recently approved by the NAIC is just about a must if we are to experience ultimate policyholder protection.

If my discussion with you leaves no other message, I hope that it will be to lobby intensely for enactment of the new model guaranty law when it comes before your legislature.

There is a bright spot on the guaranty scene, and I am proud to have been a part of its infancy.

MR. JOHN C. WINTER, III: I got involved in the guaranty issue a little bit later than all the rest. I was serving as chief financial officer for John Alden Life, and we were starting to look at what we should be accruing for the Baldwin-United insolvency. It looked like maybe $400 million was what the industry was going to have to put in conjunction with the stockbrokers. Stockbrokers were maybe going to do $200 million of that, and we had, according to Best, about a half of percent of premium in 1982 which was the assessment base for annuities. So our assessment looked like a $1 million figure, which was kind of eye opening since we had a $20 million profit plan for 1985. Then I examined the industry enhancement plan which looked like it might be able to

supercede the guaranty funds, and John Alden's figure was $4 million not $1 million. That got my attention. Guaranty funds were no longer a theoretical sort of interest, and I've been involved in the issue ever since. The $4 million had to do with current assessment base under the current guaranty law, but some of the issues caused me to be involved in the new law as well. Essentially there were two problems that caused the discrepancy. One had to do with the quality of the assessment data in the annual statement blank. The other had to do with really what was an annuity.

Let me begin by saying there is no such thing as a nonpartisan industry committee. Those of us who lobbied stock and mutual company perspectives for TEFRA are well aware of why this should be so.

The story behind the drafting of the new model guaranty fund law is no different. In many respects, it is a marked improvement on the law that it replaces. But it was drafted largely by individuals who serve as full-time governmental relations representatives for their companies. It is naive to assume these individuals were not at least mindful of how particular provisions would effect their employers.

The major controversy under the proposed new law involves the annuity fund assessment base. At issue is how and whether unallocated funding agreements, Guaranteed Investment Contracts (GICs) and Deferred Annuity Contracts (DACs) are to be covered.

The new law has a choice of funds. The reason for that is to try to make the assessment somewhat fair, to assess companies only to the extent that they sold like products in a state. The previous law had three funds. It had life, health insurance and annuities. It separated out health insurance because property/casualty companies may have written them as well, and you wanted to be able to bill both of them for a health problem. Life and annuity were essentially different.

The new law proposes four funds. The current "preferred" choice is that GICs and DACs are to be separated from other annuities into a fourth assessment account. Coverage and assessment base limits in this account are $5 million

per contract owner. The model bill mentions that a three account approach (all annuities together), a two account approach (life and all annuities together) or outright exclusion of GICs and DACs should also be considered based on state assessment capacity. A state-by-state annuity assessment capacity study is currently being conducted to see what capacity is in each state so the states can describe how many funds they want to have.

Larry offered both sides a chance to outline the arguments on whether or not GICs or DACs should be covered. Due to conflicts only I was able to show, I agreed to at least mention the other side's arguments.

For those of you unfamiliar with them. GICs and DACs are a lot like deferred annuities. They have a deferral period during which deposits are accumulated at guaranteed rates of interest. They have settlement options under which the accumulation can be used to purchase annuity benefits for members of the employee group named in the application. GIC and DAC policy forms are generally filed with and approved by state insurance departments under annuity regulations. The SEC safe harbor exempts GIC and DAC contracts from registration provided they are regulated as insurance; GIC and DAC writers usually claim that their general account GIC and DAC contracts are so exempted.

My company feels that GICs and DACs are, in fact, annuities, and should be covered under a single undivided annuity guaranty fund account. We also feel that for GICs and DACs the maximum benefit limit of $100,000 should be applied per covered individual rather than per contract owner. If a benefit plan trustee buys a CD rather than a GIC or DAC, the FDIC and FSLIC $100,000 coverage limits are applied per covered individual rather than per contract. Our industry generally prefers state regulation to federal regulation. As we seek to defend our preference, we should keep federal government standards for similar guaranty fund programs in mind.

Really this controversy had a lot to do with what various companies look to pay under a future Baldwin-United based on what their portfolio of annuities was. To be fair, my company has no GICs and DACs, and we feel like they really ought to be in the assessment base. Industrywide they are half of annuity premiums.

It means a great deal if an annuity company goes insolvent whether or not it is in the assessment base.

The NAIC Guaranty Fund task force was assisted by the ACLI in appointing the industry advisory committee which prepared the first draft of the new guaranty fund law. While capacity was a major issue, there unfortunately were no actuaries on the initial advisory committee. Over 3/4 of the companies represented wrote GICs and DACs, versus only 174 companies out of 2,000 companies in the industry based on a 1984 Illinois Insurance Department survey.

The initial guaranty fund bill drafted by the advisory committee exempted GICs and DACs from coverage. The reasons advanced included the following arguments:

FIRST ARGUMENT

During their accumulation phase, GICs and DACs are not annuities because there are no specifically identifiable natural persons named as annuitants.

From my company's perspective, one has to wonder at the relevance of an individual being specifically named prior to a settlement option being elected. And the advisory committee was careful to limit the "not an annuity" argument to the guaranty fund issue. Nobody wished to advance the "not an annuity" argument for SEC purposes.

SECOND ARGUMENT

GICs and DACs are not covered under existing guaranty fund laws.

This argument in fact, has been made by various guaranty fund boards in making Baldwin-United assessments. Coincidentally, many members of the boards making this argument are on the industry advisory committee. In Indiana and Minnesota this guaranty fund board position is being legally contested by my company among others, we have won the initial regulatory hearings in both states. In both states we expect the guaranty fund board to appeal our initial victories.

THIRD ARGUMENT

Guaranty funds are meant to cover "the little guy" and not sophisticated investors like the purchasers of GICs and DACs.

This argument has a lot of merit. Those advancing it would ask, "How can I ask a state legislator to give a premium tax offset to provide benefits for General Motors and IBM?" For defined benefit plans, where employers are responsible for investment losses and Pension Benefit Guaranty Corporation (PBGC) coverage is provided, insurance guaranty fund coverage doesn't seem to make any sense.

For defined contribution plans, 401K plans, deferred compensation plans, etc., however, there is no PBGC coverage, and the employer is not responsible for making up investment losses. The balance sheets of many employers wouldn't allow them to make up shortfalls even if they wanted to. Here "little people" would be hurt by not having guaranty fund coverage.

FOURTH ARGUMENT

There is sufficient assessment capacity to make the annuity guaranty fund work without including GICs and DACs.

This may, in fact, be so. But the first ever actuarial survey of state-by-state industry capacity is still being run. The claim is therefore being made in advance of having any valid statistical data to support it. Deciding coverage based upon assessment base requirements rather than protection requirements is a "tail wagging the dog" type of decision.

So, there you have an overview of how the sides are drawn. As you may have guessed from the "preferred" four fund approach, my company's side hasn't done quite as well in the fight as we would like. A large Illinois survey showed that nationwide GICs and DACs represented about 50% of all annuity premiums. At a smaller company such as my own, getting involved in industry issues usually takes more time than most of us can afford. But when the new guaranty fund law is considered by your state's legislature, think carefully before you shrug off the issues as somebody else's problem.

OPEN FORUM

MR. GORSKI: That concludes the presentation portion of our program. We have time for just a few questions.

MR. ARTHUR C. CRAGOE: I have a couple of questions about insolvency prevention. I'm not naive enough to believe that I'm going to get out of an assessment, but I'd like to prevent as much as possible. How can guaranty associations and/or regulators accomplish insolvency prevention measures under current laws? That's one question. The other is do you believe that a valuation actuary concept as it's currently understood would have been effective if it had been in place in preventing insolvency so far? And if so, how?

MR. PORTER: Let me start with the valuation actuary question. I'm going to assume that all valuation actuaries are honest, that they don't fall into the fraudulent section. If I don't assume that then I can't answer your question. But assuming that valuation actuaries are, indeed, fulfilling the purposes as I understand it, I think they could have saved a number of the insolvencies that I have been confronted with. I'm bothered a little bit if the valuation actuary isn't independent of management and works for management. But assuming that he has enough guts to stand up and point out the facts in which he sees them, I do feel that the valuation actuary is going to be extremely important.

The valuation actuary may be even more important in areas in which actuaries never were involved, such as the valuation of asset management.

MR. GORSKI: I've been involved in several insolvencies. In two particular cases, the valuation actuary either would have eliminated insolvency or would have reduced the extent of it. If he had not acted, I think it would be very easy to prove the case he should have and hopefully he wouldn't be an actuary anymore. So I think it can be an effective tool in some cases.

MR. WINTER: I think the valuation actuary role, if we can make it work out right, should help a lot on insolvencies. It will probably have a lot to do with how we as a group act to support people who are having a problem. Often when a company starts to get into trouble, at first the facts are fuzzy. Obviously, if it's unmistakable that you are going to go bankrupt, it's easy to

sign an opinion to that extent, but it's probably irrelevant because by that time everybody knows. But early on you may have a suspicion that things are starting to go wrong. It's difficult to do something like raise your claim reserves a million dollars if you're already short on the plan. You have a suspicion that this is where things are going, but you're not quite sure. I guess my feeling is that, for the valuation actuary concept to work, we in the Society are going to run what in effect amounts to a confession service or least an anonymous service. We may get into situations where somebody feels there is a problem, but they are not sure. They need some backup and are worried about what's going to happen when management then hires a consulting actuary who comes up with another point of view. It's going to be interesting while we learn what we as a Society need to do to support this individual.