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GUARANTY FUND SYSTEM

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MR. REED P. MILLER: We were looking at a variety of potential topics, all of them focused in the direction of capital adequacy and solvency. One piece that we thought was a very important ingredient, because it tends to be the piece that all insurance companies have to live with in the case of capital inadequacy and insolvency, is the guaranty fund system. We wanted to give, as part of the financial reporting track, each of you the opportunity to hear some thoughts from that particular perspective.

Jack Blaine comes with a trade association/executive/lawyer background, with an extensive background in management of government relations operations and an in-depth knowledge of insurance law and regulation, with emphasis on the life and health insurance side. Jack graduated from the University of Wisconsin law school and spent the majority of his work years with the American Council of Life Insurance in Washington, where he served as vice president and general counsel. That particular stint was from 1968-89. He spent a period of time as the president and chief executive officer of the Reinsurance Association of America and is currently serving as acting president of the National Organization of Life and Health Guaranty Associations (NOLHGA). He will talk to us about the guaranty fund system.

MR. JACK H. BLAINE: I took my job in February 1992, at the request of the board of NOLHGA. I had left the reinsurance association and went into private practice with the law firm of LeBouef, Lamb, Leiby, and MacRae. The NOLHGA board was about to lose its then current president, Edem Sarfaty. The arrangement was that I would come out and run NOLHGA until the end of the year and then either go back to the law firm or continue as acting president, if the board so wished. I am still weighing that decision of whether to stay with NOLHGA or go back to the practice of law. I have to tell you it's really enticing to stay at NOLHGA, even though right now we're under a great deal of stress. We have a very small, woefully inadequate resources office, particularly with all the insolvencies and the activity going on today. But, at the same time, it is a very exciting time for all of us, and the things that we're doing are not only important, but they present different kinds of challenges than I have ever been faced with in my career.

Going back to the Baldwin-United days, which many of you will recall, when we dealt with the first major insolvency since the Depression years, that was a successful venture for the industry. We not only came out with a program and a plan that restored the policyholders to 100%, but we did something that gave the industry, the regulatory system and the guaranty fund system a great deal of credibility. At that time, however, there were maybe even less than 30 states that had insolvency guaranty laws in effect. The problems were different in implementing a large multistate insolvency enhancement, or bailout plan if you will, because of the way in which the guaranty funds were structured at that time.

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That was really the period in which NOLHGA was born, because we were confronted with the situation involving Baldwin-United. You recall there were four or five life companies, subsidiaries, or affiliates, two principle companies in Indiana, and one large company in Arkansas. Indiana had a guaranty fund law in effect at the time. Arkansas did not. Indiana's law covered all policyholders of an insolvent domestic company. All states that had the law would also cover their residents since there was no coverage for the Arkansas company in its domiciliary state. It was a very difficult situation to sort out in terms of where the liabilities were going to fall and how we were going to put the plan together. We organized NOLHGA to bring in the representatives of the existing guaranty associations, to have a place to coordinate their activities, and to come together with unified advice and legal resolution of issues. It has grown since then, as has the whole structure of insolvency guaranty funds.

We now have 50 states and, we hope, the District of Columbia. The bill in the district council has passed, and I believe it's either gone to the mayor, or it may have gone even to Congress for the waiting period for it to go into effect. When it does, we will have a true nationwide system of protection for all policyholders of life and health insurance companies. I guess that's both the good news and the bad news. The good news from the policyholders' standpoint is that they will be protected wherever they happen to reside. They will have a level of protection that, despite what the congressional representatives criticize as being a patchwork web of unstructured laws, is truly relatively uniform, at least in the basic levels of coverage across the country.

One of the difficulties of that system is the fact that while all the states do have a law in effect, they have differing types of laws, not so much because of local differences, although that enters in too, but because of the way the model law that the NAIC developed operates. The original model act dating back to 1970 was based on a 1941 New York law, which is the grandfather of all insolvency guaranty laws. It took the position that the state of domicile should have the responsibility of protecting all policyholders of domestic companies, wherever they reside. That's the way the New York corporation was set up, and that's what we were working with the NAIC to put into the model act. The theory was good and it continues to be good. All the liabilities and all the assets flow to the domicile of the insolvent company. There is one management workout, whether it's an assumption reinsurance sale or otherwise. At least there was that consistency. You were only worried about interpreting one law and implementing one level of benefit plans.

Five years ago, we went to a new model law that tracks residents only; that is, when a company goes insolvent, every state where that company is licensed has this guaranty-fund law triggered. Each of those state guaranty associations has the responsibility of protecting just the residents of its state. We have more states yet to implement that switch from a coverage of all policyholders to a residence-only approach, and that has caused some problems. The NAIC adopted this approach largely because we ran into capacity problems involving Baldwin-United. Estimates were that if Indiana had to pay off all of the liabilities of College Life or University Life -- I've forgotten which -- it would have taken from 40-50 years to do that at a two-percent-a-year assessment. It was obvious that we could not have a system to handle huge insolvencies by using the assessment capacity of only one state. Now we have multiplied that assessment capacity with the residents-only approach, up to roughly $3 billion in an annual assessment capacity for all three of the major accounts. I'll get back to that in a moment.

The model law is set up this way. In every state, the law requires that every licensed company be a member of the association as a condition of doing business. The board of directors of the association is composed of representatives from the industry. Sometimes the insurance commissioner is a member of the board, sometimes he's an ex officio member. It is largely an industry-operated system. The money comes from the industry. It's done on a postinsolvency assessment basis, which is a very fundamental principle in the model law. As funds are needed, assessments are levied against all companies doing business in that state, proportionate to the liabilities in each of three separate accounts: the life insurance account, the health insurance account, and the annuity account.

Now one of the changes made in the most recent version of the model law was to simply set up two accounts. Under the life account, there are both allocated and unallocated annuities. This was done simply to raise money for when you run out of funds in one of the accounts or subaccounts. It also was a compromise to effect coverage in the model law for unallocated annuities. That's another very controversial area that I'll get back to when I talk about Executive Life.

The level of coverage that I talked about being relatively uniform across the country is in the death benefit protection, which is $300,000 on any one life. With not more than two or three exceptions, that death benefit protection is basically the same. There is $100,000 in cash value of life insurance, $100,000 in present value of annuities, $100,000 in health insurance, and then an aggregate cap of $300,000 on any one life for all combinations of those benefits.

The change that was made in the last revision of the model act, with respect to unallocated annuities, was to provide up to $5 million per contract holder on GICs or other unallocated annuities. That was done with a very extensive lobbying effort, both by companies and the industry at that time. I was representing ACLI, which opposed coverage of those products, and some companies that felt differently were supporting their coverage and inclusion in the model law. That debate continues today. As I mentioned, it faces us squarely in the Executive Life Insurance Company rehabilitation plan, and it's coming up in other plans that we're now working on.

The model law's focus is to provide a basic level of protection for most consumers. That's why, at the time, we picked a $300,000 death benefit protection. We felt that was probably more than adequate for the average amount of life insurance coverage in force on any one individual, and similarly with the other limitations that I mentioned. It does not cover plans such as Blue Cross/Blue Shield, except in those states that have opted to bring them in largely because their corporate structure is more akin to commercial insurance companies. It does not cover HMO plans because, again, those are not insured-type plans. They're not subject to the same capital and surplus requirements, reserving, and other requirements an insurance company is. In fact, the NAIC has developed a separate model act for HMO insolvencies. It does not cover fraternals. We have attempted in the various versions of the model law to exclude all separate account products. Originally, that was largely variable annuities and then variable life insurance. Now it would not cover other separate account products, whether they're flexible, or variable, or guaranteed in amount. It does not cover uninsured plans established by employers or other organizations. If there's an excess or stop-loss-type plan in effect, to the extent that that is insured by an insurance company, then it would be covered. The basic uninsured employee benefit plan is not covered under the model law.

One of the principles of the act is that we cover what we assess, or we assess for what is covered. One question recently raised was whether federal employee health benefit associations (FEHBA) plans, are subject to assessment in companies that administer those plans for the federal government. Congress changed the law a couple years ago and put in a preemption that prevents states from imposing any tax or other fees on considerations for FEHBP plans. We've been looking at the situation, and several guaranty funds have been challenged by companies that write FEHBA plans, as to whether they can assess the premiums. The conclusion has been reached that these were probably covered as insured plans, and if we're not permitted to assess the premiums or considerations, then they ought to be excluded. I think the NAIC is probably going to approve that recommendation, and the various states will implement the appropriate amendments.

One of the complications that frequently arises in implementing the guaranty association laws is with respect to the trigger. Senator Metzenbaum, in his recent hearings, and Representative Dingell, in his, have all raised a question as to why the guaranty associations don't do something when a company is first found impaired and before it is put into liquidation. The answer is that the model law, and most states, do not trigger the guaranty association until the company is determined to be insolvent by the court and is ordered liquidated or rehabilitated. One of the reasons for this is to allow orderly plans of rehabilitation by insurance departments and to not bring the guaranty associations in until there is a determination that their support and their assets are going to be needed. It works both ways.

More recently, we're finding that a rehabilitation plan, and one that could be a very successful one, exposes us to the possibility that guaranty associations may be prematurely triggered in some states, and may create liabilities for the guaranty associations when they are not intended.

Again, by way of illustration, you're probably aware that two companies out of the First Capital Holding Corporation are now being subject to hearings. One is in Richmond, Virginia, the Fidelity Bankers rehabilitation plan, and one is in California, First Capital Life Insurance Company's rehabilitation plan. The problem is that in both instances, the commissioner has attempted to effect a plan that will restore all the policyholder benefits to 100% over a three- to five-year workout period, without triggering the guaranty associations. He has avoided obtaining a determination of insolvency in both cases, although that may happen, and also has avoided an order to liquidate those two companies.

Our concern is that the guaranty associations in several states can be triggered short of an order of liquidation. They can be triggered by the commissioner upon finding an impairment of a company. We may be confronted with opt-outs from those plans going to the guaranty association and seeking 100 cents on the dollar tomorrow. In both of those plans, as is common with virtually all rehabilitation plans where a successful buyer is found, you must impose some penalty to prevent the opt-outs from all walking away and, therefore, by definition, destroying any attempt to rehabilitate the company.

We have to wrestle with how we can work with the commissioners, the liquidators, and the rehabilitators to prevent prematurely triggering guaranty funds and, at the same time, protect that rehabilitation plan so that it can go forward and be successful. One of the ways we do that, and this is very key to the model act, is the section that deals with the obligations to act when a company is determined to be insolvent. Essentially, the model act says that the guaranty association shall pay claims -- and this is in the case of a company that's determined to be insolvent -- or assume, guaranty or reinsure, or cause to be assumed guaranteed or reinsured the covered obligations of the insolvent company. The argument goes like this. We don't have to pay 100 cents on the dollar tomorrow if we enter into an arrangement whereby the guaranty associations will provide all policyholders all the benefits that they're entitled to under the law, including the death benefit protection, surrender rights and other, and annuity rights over a plan that's reasonable in duration. That's why at Executive Life, for example, our enhancement plan contemplates that over a five-year period, we will pay fully 100% of all benefits that covered policyholders are entitled to by law, but we will not pay 100 cents on the dollar tomorrow. It benefits both the policyholders and the guaranty funds. We provide flexibility to the insurance commissioner to prepare a plan that doesn't require a fire sale of assets and, at the same time, to restore the company through a growth of assets over time needed to do that, and pay off policyholders at the end of that period.

Now in the interim, death benefits should always be paid in full. There may be instances that don't come to mind, or that I'm not aware of, where that's not the case, but it would be unusual not to pay death benefits and annuities in payout status, up to covered limits. We also have hardship withdrawals for policyholders who need that right or need access to their money for various reasons.

The third point supporting that approach is that we have always sold life insurance and annuities as long-term protection products. Why do you buy life insurance? Well, we all know it is for death protection, and we buy annuities for retirement. We have established that as a public policy in the Congress. We're the only financial product, to my knowledge, that has favorable tax treatment. We think it's entirely consistent with public policy, and it's in the best interest of all of the policyholders that the regulators and guaranty associations be able to do this type of workout program.

Now where are we? How are we doing? Last year, and these figures are still preliminary, but in 1991, we assessed in excess of $470 million. That includes assessments for Executive Life Insurance Company. In fact, we encouraged states to make an assessment in 1991 to use up their capacity last year, even though the money was not called in most cases until this year. That amount of money is far and away the highest amount ever assessed since NOLHGA began keeping track of figures in 1975. For the period of 1975-88, the first 13 years of the guaranty fund assessment tracking, we assessed an aggregate of $1.127 billion, but 73% of $800 million of that has been in the last three years.

Well, going back even a little bit further, up until 1991, health insurance constituted the bulk of the assessments that were levied. Most of you will remember that in the 1980s we had a spate of health insurance companies get into trouble. Through 1990, to illustrate that point, we had $394 million assessed for the accident and health insurance account. Well, we had $128 million for life and $145 million for annuities. In 1991, that turned around when we assessed, as I mentioned, $470 million, $154 million of which was life, $218 million of annuities, and $99 million for health insurance, which probably illustrates the change in the mix of business in companies that now pose the greatest risk of going insolvent. I'm confident that the annuity account will again this year far and away exceed the health insurance account and probably the life insurance account. I think annuities account for about 60% of the liabilities at Executive Life. We had 28 companies go into receivership in 1991, but only six of those companies accounted for $42 billion in assets. The asset figure is based on their last year's annual statement, so it's probably inflated.

The good news is that, as I mentioned, of those six companies, two of them do appear to be on their way to a successful rehabilitation, Fidelity Bankers and First Capital Life. Executive Life, as you know and as I've alluded to, is under a plan of rehabilitation, and we're very much involved with an enhancement plan that I'll talk about in a few minutes. Guaranty Security Life was one of those six companies, and it has presented entirely different problems. Guaranty Security Life came along in 1991 in the same or somewhat similar mode with Executive Life, First Capital, and Fidelity Bankers. They were all very heavy into junk bonds. However, what we're seeing now is not junk bonds. We're seeing commercial real estate. You're all familiar with Mutual Benefit Life and the well-publicized problems that it has had with mortgages and real estate in its portfolio. It's a little bit more difficult than the junk bond problems we were having last year, in that at least with the junk bonds, you had some idea of what the market was. With commercial real estate, I'm told by the people in that business, it's really hard to tell just what the market is if you had a fire sale of those assets. We have a couple more that have gone in the tank in the last six months that also have real estate problems. InterAmerican Life in Chicago is one of them.

I'm going to discuss Executive Life, and then I want to get back to how we are working with some of these problems like Guaranty Security Life, where we do have a difficult asset portfolio problem, and how we hope to work that out in an orderly way. Some of our guaranty association people, and I know others in the industry, asked how we got into this enhancement plan at Executive Life. If you're involved in it and have any sense of the complexities of it, you do have to shake your head. When I went out to NOLHGA in February, I did read through the enhancement plan. Almost from the first paragraph on, it's the most complex document I've ever seen in my life. The substance of it, or the concept of it, is not so hard to understand. Essentially, we brought together the 46 guaranty associations that are involved, and through compromise and negotiation with the commissioner as rehabilitator, we agreed that we would do certain things in exchange for some give-ups on his part. Primarily what we got was the ability, as I mentioned earlier, to work this plan out over five years and defer our liabilities to the end of the workout period. We do have an $81 million payment coming up on July 5, 1992, and we'll have another payment of about that amount due January 31, 1993. The bulk of the liabilities, which are now about $1.9 billion, are deferred to the fifth year. In exchange for being able to defer those liabilities and work with the commissioner in this enhancement plan, we did give up some reductions in guaranty fund coverage that would otherwise have taken place.

California, for example, unlike any other state, has an 80/20 coinsurance provision. It pays only 80% of the covered liability up to the statutory maximum. It also has what we call a haircut on interest-sensitive products, as a number of other states do. The model law provides for a reduction of 200 basis points off of Moody's corporate index, going back and averaged over the four years prior to the date of the rehabilitation, and 300 basis points going forward. California has 600. We agreed to give those up in connection with Executive Life. It's caused a little bit of unhappiness, because it did have an increase in liabilities for the guaranty funds, but we think it was a reasonable compromise to make to effect the plan that ultimately came out. We did maintain the limits on individual state liabilities, the $100,000, $300,000 that I mentioned. There are some differences that are particularly important in the area of unallocated annuities that do come into play.

Basically, the agreement that the commissioner ultimately arrived at with the French, who were the successful bidders for the business, was that they would buy the bonds. It was a bonds-out deal and they paid some $3 billion plus for the bonds on March 5, 1992. Unfortunately, the sale of the bonds and their transfer was not contingent upon closure of the new company by the French, which will assume the assets and liabilities. Almost all of Executive Life Insurance Company will be sold to the company with which we have the deal where we will be enhancing those products, and the guaranty association will fill in the gap over the five-year period that I mentioned.

We are now in the posture of waiting for the court to approve the rehabilitation plan. The judge has been saying he is going to do it any day for the last three or four weeks, and as of yesterday, he had still not approved the rehabilitation plan. This is important because we are supposed to go to closure with Aurora, and the enhancement plan will go into effect on June 30, 1992. That day is, obviously, coming upon us shortly, and it's looking somewhat doubtful that we're going to go closure on June 30. That in itself would not be terribly disastrous, and we may agree to continue our enhancement plan to keep it open for some short period of time after that. From the standpoint of the policyholders, it is not good to be left with that uncertainty as to what they are going to get out of the plan, and how soon they're going to have some access, will be limited, to their funds. We're anxious to get to closure on this and we want to get the deal done.

The French, on the other hand, have some problems, too. You may have read in the press that there's a dispute over the coverage of municipal GICs. These were essentially funding agreements sold to back up municipal bonds. Well, they're not covered in any states by the guaranty associations, and I don't believe anybody contemplates even litigating that issue. It's clear to us. They are a tremendous factor in our liabilities, because the court, Judge Lewin, has ruled that the municipal GICs should be treated in the same class as policyholders. In California, that's a class-five priority, as opposed to a class-six priority for general creditors. That makes an enormous amount of difference since $1.8 billion of liabilities now come into the pool with all the policyholders of the company, and they substantially increase our liabilities between $900 million and $1 billion.

We obviously have a very strong interest in having the court of appeals, where that decision has been taken, overrule Judge Lewin and say these are general creditor obligations and they come out of that class. The court of appeals is not likely to rule on this for quite sometime. In fact, the other day, the case was sent back to Judge Lewin to make another finding. That contingency, and it is a big one, is still hanging out there to be resolved.

The owners of GICs, trustees and pension plan sponsors are challenging guaranty fund coverages in states where there's any question as to their coverage. As I mentioned, the model law does provide coverage for annuities up to $100,000 in present value. We call those allocated annuities. It also provides $5 million per contract holder coverage in the case of unallocated annuities or GICs. The pension plan people at Executive Life are making two arguments. In those states that do not cover, or do not have a specific exclusion for unallocated annuities, they're initially arguing that these are annuities, and just like any other annuity, they're covered up to $100,000 per participant or per account holder. In those states where there is coverage, they're arguing that these are not unallocated because the plan sponsor can tell you from its books and records what each of those account values are, they are really allocated annuities and, again, they get a pass-through protection of $100,000 per participant. The difference in our liabilities is very significant. A $50 million GIC now becomes potentially a $50 million liability, instead of a $5 million or a $1 million liability, in some cases. That issue has yet to go to court, and it has the potential of being litigated in a number of states.

There are other contingency problems, one of which for the French is a major stumbling block, and that's the liquidation value of the company. Judge Lewin initially held that as of the date on which he took Executive Life under receivership, April 11, 1991, the company had a then liquidating value of 55 cents on the dollar. The municipal GIC people are arguing that that's too low. They're looking at present-day values and saying that it really ought to be 60 or 65 cents on the dollar. The French, for good reason, are saying they can't do that. The liabilities go up enormously if you find that the liquidating value is that high. The liquidating value has a great deal of significance in any rehabilitation plan to meet the constitutional test of fair and equitable and due process requirements. Basically, a rehabilitation plan must provide that an opting-out policyholder gets an equitable share of the assets measured by the liquidating value of those assets on the date the company is taken into conservatorship. Fifty-five cents, if that remains the amount, is what people who opt out of Executive Life will get on the first day or the first month. If they stay in the plan, the account value will become 71 cents, based on a projected value of the assets over five years, and we will fill in the 29-cent difference up to the guaranteed fund limits for all policyholders. That's a real thorn and a frequently misunderstood problem. In some states today, Washington state being one, the commissioner and other people are about to go to court and litigate the right of policyholders to get their 100 cents on the dollar and not 55 cents right now. As I mentioned earlier, that's, of course, a problem for us if they should succeed in doing that. Now we're very optimistic that we will go to closure and that the enhancement plan will go into effect. In the meantime, getting there is taking many of our resources and, obviously, much time and effort.

I mentioned that the problem we're seeing in troubled assets has changed from what a year ago was largely a junk bond portfolio to real estate portfolio problems now. We're going to try something different with the Guaranty Security Life Insurance Company in solvency down in Jacksonville, Florida. This company has about $600 million in liabilities, and with a fire sale, the assets are probably worth, at most, around $250 million. For us to sell that business, as we typically do, we would find a buyer and work out an agreement to make up for the asset shortfall, either though an infusion of guaranty fund notes or cash to effect the transaction. For one of this magnitude, for us to find a buyer, we would have to come up with a substantial amount of money to make it attractive for the buyer to take on that business. Rather than do that, we've decided to form a Florida insurance company and assume the liabilities and take over the assets on our own. It is something new. I really don't think the risk is that great. We have the liabilities, in any case, and by doing so, Duff & Phelps and the other people who have assessed the asset portfolio and its potential worth over three years, tell us that we could probably save $60-70 million, at a minimum maybe $30 million. We think it's worth taking the risk to do an orderly disposition of those assets and manage the liabilities over that period of time, perhaps even up to five years. Now the insurance commissioner is not formally signed off, but we have a letter of agreement. There was some premature leak in the press a week ago, but we expect that to go to closure shortly.

If that should work, and I have no reason to doubt that it will work, then we may wish to consider doing something on a broader basis across the country. For example, we've even talked of having a national guaranty reinsurance corporation, something like a resolution trust company, set up by the insurance guaranty system. It could be a parking place for assets and for management of liabilities until we can dispose of the bad assets and maximize their values, and then find a buyer to take over the business. It just makes a great deal of sense, when in today's market if you're inheriting real estate you ought to be able to manage that portfolio and maximize the return to policyholders. It's intriguing and I think it has many possibilities.

We are getting a lot of heat, and I think we will continue to do so, from Congress. I think anytime you have insolvencies of the magnitude of Executive Life or Mutual Benefit Life, with policyholders of that number who don't have access to their cash values, who have uncertainties surrounding their coverages, the congressional representatives will hear about it. They will be concerned, and they will continue to have hearings and they will continue to come up with proposals. You're all familiar, I'm sure, with HR4900, Congressman Dingell's bill introduced about a month or so ago. It won't go anywhere this year, but it's going to get hearings and probably a lot of attention in the next Congress. It not only would set up the optional federal charter for companies that wish to go that route, but it would set up a policyholders' protection act. The National Insurance Protection Corporation (NIPC) would be a prefunded insolvency guaranty fund for all lines of business that could cross-subsidize between property/casualty lines and life and health insurance lines. It would essentially provide the same level of coverage that the model law does. In fact, the draftsmen use a lot of language from the NAIC's model act, but it has a lot of problems in it, just from a technical standpoint, and totally aside from the question of whether the industry really wants to go to both a federal law and a prefunded approach. First of all, with the NIPC approach, the insolvency guaranty fund would only be available for companies that opted for a federal charter, which then raises the question of what it would do to the existing state system. I personally think it would destroy it. I don't see how you could potentially take 80-85% of the assessment base out of the state system and have it survive; certainly, not for very long. I think, too, just simply having that optional federal charter available would become such a competitive factor that it would force a substantial share of the business to go that route. Anyway that's basically where we are today.

MR. JOE E. DAVIS: I'm involved indirectly in the recording of some of the premiums, the deposits, some other things that are allocated and unallocated, and employee spending account (ESAs). Somehow ESAs get in an allocated format. Tell me a little bit about the problems of the system with one company recording the other.

MR. BLAINE: I thought I had that in my notes, and I surely should have. I talked about the different accounts in the model law, the unallocated annuity, the annuity account, and the life and health. In addition, the model law has some peculiar provisions in it. For example, all 403(b) plans, 401 plans, and Section 457 Internal Revenue Code qualified plans that are sold to plans protecting government employees have special provisions. They all get the $100,000 pass-through per participant. I understand most 457 and 401(k) plans are really unallocated. Under the guaranty association law they get special treatment. At the same time, all 403(b) plans are treated for assessment purposes as if they're unallocated, even though most 403(b) plans, some people tell me all, but certainly most, are truly allocated contracts. We have this anomaly in the law and we tried to have everything kind of fall neatly. If it's an allocated annuity, it's assessed as such, and it's treated as such for coverage purposes. Because of these differences in states, we needed to have an assessment data base that would equitably allocate the assessments by account according to the laws in every state for Executive Life. Most states use the three years prior to the date of rehabilitation order. For 1988, 1989 and 1990, we have had to gather from your companies all of your premium information to form the database for determining how we're going to make the assessments in each state. It's an enormous project. Arthur Andersen is running it for us and we've had a lot of problems with it.

One of the major problems we've had with it is in the annuity account area and how the companies account for allocated and unallocated annuities. I came into this very late, but our survey asked that Schedule T information be adjusted to the appropriate accounts. I think Line 1 and 1A also come into effect. The problem is that a number of companies, and some very large companies, account for the deferred annuity considerations in Column 6 of Schedule T, and not in Column 4, where you can argue that it may or may not be appropriate. Because these are allocated annuities, if it's deferred premium until it's drawn down, if it is reported as deposits and other considerations, it doesn't come up or may not come up when we do an assessment on the allocated annuity account. By the same token, on the other side, the unallocated account is not correct. We have tried to correct that by sending out a supplemental survey that asked for an adjustment to sort out all considerations between allocated and unallocated, and we try to keep these straight. There's been a lot of concern about this and, unfortunately, some acrimony has grown up within the industry as to whether companies are cheating, being unfair in reporting annuity considerations, and thus, shifting the burden of their assessments to other companies that are playing by the rules. We're trying to stay out of that debate. We're just trying to get a fair and equitable database as we go forward, and we're about to do a 1991 survey. It has been a real problem. The NAIC has worked with this. I think it has had the longest standing working group in the NAIC. They've been working with Baldwin-United on deposits funds and other considerations, trying to straighten out this reporting.

Some of you were probably involved and knew a lot more than I do, but we do have a new reconciliation exhibit going out with the 1992 statement that will basically track the model law. Then we have an adjustment form that we've prepared with the NAIC that we're asking each state to fill out annually. It will pick up changes in the law so that we are making the appropriate adjustments to track those accounts. It's been a very difficult and controversial subject. All I can say is that we are trying to make this a fair and equitable base. The last thing we need is strife within the industry as to whether companies or competitors are fairly reporting annuity considerations in premiums.

FROM THE FLOOR: I think a lot of these problems aren't really going to stop, but my question is, when you were describing the current legislation, the new model law, you were talking about the assessment being made by states. What happens to policyholders who move from a state where they're covered by a licensed company to a state where that insolvent is no longer licensed?

MR. BLAINE: First of all, with respect to the assessment database, the assessment is made by the state guaranty association in accordance with its laws. We first apportion the liabilities of the insolvent company by state, and then that state knows its liabilities by life, health, and annuity accounts that it assessed based on premiums of its member insurers. That's where the database comes into play. Now Pennsylvania still has the old model law, and Pennsylvania now assesses those companies licensed in Pennsylvania, based on a proration of their business in Pennsylvania. If it's the old model law, the assessment is also proportionate to the business done in other states where that company was licensed. I'm a little rusty on the old model law, but I think we actually went out and looked at each state where that company was licensed to get a proportionate share of the premiums in those states by member companies in Pennsylvania. The theory was, you could have a company domiciled in Pennsylvania, but write 90% of its business in Indiana, and it would be fair to apportion the business among the companies in Pennsylvania, based on their writings in Indiana. It ought to also take into account the other states where the company does business. That's one thing the residents only coverage does. It makes it a little more simple to do the calculation.

Again, under the model law, first of all, the company must not have ever been licensed in that state, and if it was not, then that coverage goes back to the domiciliary state. There actually are three conditions of the state. The guaranty fund in the state of domicile says we will cover nonresidents of Ohio, for example, if the company was never licensed in that other state where there are policyholders, if they have a law similar to the Ohio law that covers residents. Unfortunately, there are about three states that don't have that provision, and Indiana's one, I believe. It's a problem, because until Indiana accepts that, we'll cover nonresidents of an unlicensed company that fall between the cracks. Now I know in Indiana, and in another state, too, where this came up. They have agreed to cover them, so they aren't without coverage. It's a real problem. We need to seal that off and fill that crack.

In response to a question regarding Guaranty Security Life Insurance Company, we'll hire a CEO and the investment management will have to be contracted out with investment advisers. There are employees who are now managing the liabilities. The claims management function is there and ongoing. What we need is a CEO to come in and run the company. We haven't decided yet how to structure the board of directors or the stock in the company. I know we'll have to ask the ACLI to take a seat on the board and have a board of competent, able insurance executives overseeing a CEO. We intend to get somebody who's experienced, maybe a retired CEO, who can run the company and manage it. There is no marketing of new business, so there is not any of that new business concern to worry about.

One of the goals is to get that company out of the hands of the receiver early. Most receivers, especially receivers who work on a contract basis, as opposed to the in-house receivers, insurance departments, don't have a great incentive to wind up the receivership. That's how they're paid. Not only that, but they don't always get good investment advice, and they don't always get good management. The sooner we can get that company out of the hands of the receiver and in the hands of competent, able management, the better. Now the expenses in this case will be borne by the estate assets as opposed to assessing companies, which is how we do it now for our consulting expenses. We just assess that back proportionate to liabilities of the various states. The bottom line is it's the same thing, because every dollar you take out of the state assets of 60, 70, 80, or whatever covered liabilities, come back to the guaranteed funds anyway.

FROM THE FLOOR: Would you care to comment on the premium tax offsets?

MR. BLAINE: Sure. I spent a lot of my life at the ACLI lobbying to get premium tax offsets in various states and in the model bill. I'm not optimistic that we're going to keep them for a long time. When the Executive Life assessments start hitting the state treasuries it may be a problem. One of the reasons we encouraged the state associations to levy assessments in 1991 for Executive Life was to both maximize their ability to get them in in 1991 before they run out of capacity. I think there is also an argument that if the state legislature in 1993 repealed the tax offset, but the assessment was made in 1992, you have perhaps a vested constitutional right that they can't take away from you, even though it's written off over five or seven or ten years. It's hard to be optimistic, quite frankly, with state budgets being what they are and with the enormity of some of the assessments coming down now, but the arguments for a tax offset are equally very persuasive.

FROM THE FLOOR: One of the problems of the guaranty associations is federal income tax. The IRS immediately assesses the claim against the company in settling in excess of what they think they owe. I was vice chairman of the executive committee of the Life Insurance Guaranty Corporation in New York. The IRS has created a phase-three claim, and it would hold the superintendent of the New York Insurance Department personally responsible.

FROM THE FLOOR: I noticed that Executive Life was able to compromise at least one of them. This is a real problem.

MR. BLAINE: It is, indeed. I am not a tax lawyer at all. I know so little about federal income taxes. The one thing I have a great appreciation for is the importance of the deferred acquisition cost (DAC) tax and other income tax impacts on insolvent companies. They really drive the way in which we structure the sale or work out the arrangement that we have. They have a great deal of impact on both the company tax, as well as the policyholder tax and the 1035 exchange rules so that favorable rulings are important. The Treasury has finally come down, I think, on a Baldwin-United request sometime ago. I don't really understand all the tax consequences, but I know it is frequently a stumbling block to achieving what you might think is the optimum way of settling an insolvent company.

FROM THE FLOOR: In the case of Northeastern, what about the fact that the company could be sold because nobody wanted to buy it with this question hanging over its head?

MR. BLAINE: I think the phase-three tax liability now has been eliminated. I don't hear about it anymore. I don't know whether it's eliminated, or maybe it's been resolved in some way, but I remember that from 20 years ago, that is, the acceleration of the phase-three tax liability being a concern.