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WHAT CAN WE LEARN FROM COMPANY FAILURES?

Interviewer: CHARLES CARROLL
Interviewee: DWIGHT K. BARTLETT, III
WILLIS B. HOWARD, JR.

This interview will examine the background and reasons leading to recent Canadian and U.S. company failures and attempt to draw some lessons. Areas to be covered include the impact on consumer confidence, as well as the roles of management, actuaries, rating agencies, and regulators.

MR. CHARLES CARROLL: If the old saying is true that experience is the best teacher, then the answer to the question posed by the title of session, What can we learn from company failures? must be "a great deal." During the period from 1990 to the present, there were at least 34 life insurance company failures in the U.S. and Canada. Many of these were very large companies, which is probably the most unusual aspect of this period of the history of life insurance company failures in the U.S. and in Canada. The three mega failures were Executive Life, Mutual Benefit, and Confederation, but many other very significant companies failed during this period.

Our panel should draw out some of these lessons. As you can see from the program, this session is to be conducted in an interview format. I have never attended an interview session at the Society meetings, much less conducted one, so if you will bear with me while I get used to this format, we should master it.

I have conceptualized this interview format as the actuarial analog to the "Larry King Live" show in which the interviewer poses very controversial and difficult questions to a panel. Bill Howard is senior vice president and actuary of the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA). Bill has considerable experience in how the industry and NOLHGA have dealt with companies once they have failed. Bill and I have worked together closely on one of the significant recent failures, Kentucky Central Life Insurance Company.

My other guest is Dwight Bartlett. Dwight has had a distinguished career in top executive positions at companies such as Monumental Life and Mutual of America. He is currently the insurance commissioner of Maryland. He has been in that position for two and one-half years. Dwight will speak on some of these issues from the regulator's perspective.

Continuing with the "Larry King Live" analogy, we will have our phone-in section of the program, otherwise known as questions from the audience, and we are reserving a significant part of our time for that. I have some questions, however, that I would like to pose in my role as interviewer.

Dwight, as you review the history of companies that have failed, particularly those that have failed from 1990 to the present, do you see any patterns that have developed in terms of the circumstances underlying those failures?

MR. DWIGHT K. BARTLETT, III: Every failure has its own unique circumstances. There are probably some common aspects, but I don't claim to have studied in

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enormous depth each of these failures. But during my consulting days, before I became commissioner, I did play a minor role in the development of the rehabilitation plans for several of them. As everybody knows, the problem at Executive Life was junk bonds. But I don't think it was just junk bonds. An overly aggressive management wanted that company to grow more rapidly than was prudent. Executive Life had become, by a wide margin, the largest life insurance company in the country that had been founded in the post-World War II era. I was well aware of that because the company in New York of which I was president, Mutual of America, was the second largest and now presumably is the largest, with the demise of Executive Life.

Mutual Benefit and Fidelity Mutual had real-estate-related problems. Guarantee Security Life was more the result of a management that was dedicated to the notion of getting as much out of the company for their personal benefit as possible. I know less about several of the other prominent failures, such as Kentucky Central and so on.

MR. CARROLL: Bill, do you have a comment on that one?

MR. WILLIS B. HOWARD, JR.: I think Dwight put his finger on it. The chief cause for most of these was bad, or rapacious, management. That may be exhibited by poor investments in junk bonds or real estate, but bad management is a key, but it is not the only one. Let me quote Tom Gallagher, who then was Florida's insurance commissioner, in his 1992 testimony before a U.S. Senate Committee talking about Guarantee Security Life:

My initial conclusion is that Guarantee Security was almost from the beginning a massive fraud, aided and abetted by blue-ribbon brokers and licensed professionals motivated by their own self-interest. The fraud of Guarantee was a carefully-orchestrated bank robbery, but the thieves disguised themselves with the help of accountants, brokers, and lawyers rather than wearing silk-stockings masks. They operated like early 20th century barons, cloaking their thievery in the guise of a sound business organization.

So it's not all just bad management. Some of it, at least in Commissioner Gallagher's opinion, was thievery.

MR. CARROLL: In both of your comments, there are some common themes: junk bonds, rapacious management, and fraud. As you look, Dwight, at the tools that you have available to you as regulator, how do you match those tools up with those particular reasons underlying these failures? How do you prevent these things from recurring?

MR. BARTLETT: This is an opportunity for me to put in a plug for state regulation versus federal regulation. Maryland is probably an average sized state in terms of the size of our domestic insurance industry. I regulate a little more than 100 domestic insurance companies of all types: life and health companies, property/casualty companies, and HMOs. There's no question that the physical presence or proximity of the domestic industry to me and my staff allows me to observe those companies infinitely better than federal regulators in Washington could do. They are trying to regulate an insurance industry across the country with many thousands of companies.

We do rely on additional tools. The regular triennial examinations are basic. New risk-based capital (RBC) requirements are going to come into effect in Maryland. I

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think we were the first state to pass the RBC model law effective beginning in 1997. We also have the valuation actuary's requirement for cash-flow testing. None of these tools is perfect. I've observed that in the case of Executive Life, for example, just weeks before the company was taken over by the California department, a major actuarial firm had done a cash-flow test that indicated the company was not in imminent danger of failure. And yet, just weeks later, it did fail because of a run on the bank.

We also do desk audits every quarter. Our domestic companies are required to file quarterly statements in addition to annual statements. My staff does review those quarterly statements with a good deal of care. It's a combination of a kind of closeness and a hands-on relationship with our domestic industry, along with the traditional tools.

MR. CARROLL: Bill, I'm going to turn to you at this point with a question related to oversight. Guarantee Security appears to be one instance in which even if you had RBC, for example, it might not have worked because as I understand it, there was a scheme to turn the portfolio around just at about the time of the annual statement filing. Could any regulatory tools help address a situation such as that?

MR. HOWARD: Not in the case of Guarantee Security. The receiver alleged that the Guarantee Security management sold their junk bonds on December 31 of each year and bought them back on January 1. There was a \$100 million settlement on a lawsuit brought by the Florida commissioner against the brokerage firm, the company's auditors, and a law firm. With all due respect to the insurance departments everywhere and certainly to Dwight, bad management and crooks tend to outwit good regulations and regulators every time. You may remember that when you were studying for the actuarial exams, somebody said that no sooner does a student find a sharper knife for solving actuarial examinations than the examination committee serves a tougher cut of meat. I think no sooner do we get a better regulation, such as RBC, which I think is excellent, than somebody will figure out a way to defeat it just by outright crookedness.

MR. CARROLL: How about other tools that might be needed, or do you think at this point that we have enough in the arsenal?

MR. BARTLETT: As time goes along, I'm sure we will become increasingly sophisticated in devising new tools. I don't disagree entirely with what Bill has said, but I don't think the situation is quite as bad as he's implied. I do think that the closeness in geographic distance and other ways that I have as a regulator allow early warning signs of problems. We have this accreditation process for insurance departments in which the NAIC accredits each department, if it qualifies for accreditation, and turns to each department's ability to adequately monitor the solvency standard of its domestic insurance industry. For example, three years ago the Maryland department was a very weak department with inadequate human resources. The accreditation program has forced Maryland, as well as many other states, to substantially beef up its program.

There is no substitute for competent people in regulation. Incompetent people are not going to sense the problems; competent people will sense the problems. We have now, for example, in the Maryland department, three FSAs, if I can count myself among that group, and one ACAS. This is an important step forward, and I appreciate the

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contribution that the profession has made through the Societies and the Academy to help us beef up the quality and quantity of the people we have on our staff. But the accreditation program was key in that process.

MR. CARROLL: Let me suggest a follow-up question on what the actuarial profession can do to try to avoid these problems. You mentioned strengthening the personnel in the regulatory function. Is there something the Society ought to be doing in that respect? Are there other things that the Society or Academy should be doing?

MR. BARTLETT: There are a number of things that they are already doing. I was chair of the Academy's Committee of Actuarial Public Service for a number of years, and that committee continues to function. It makes recommendations to the Academy and the Societies to help support actuaries in regulation, in terms of making continued education more accessible to the actuaries who work in regulation; for example, the SOA waives one meeting fee per year to any actuary in regulation who wants to attend a meeting.

Since it was started seven or eight years ago, that committee also has worked hard to upgrade the image of actuaries in regulation. There was a period of time years ago, and I was guilty of this, too, when members of the profession tended to look down their noses at actuaries in regulation as being people who couldn't cut it in the private sector. I'm not sure that attitude has entirely disappeared, but I think there's been major progress. I think that actuaries who work in regulation tend to feel less like second-class citizens as members of the profession. The work that's being done by the Academy and the other national organizations to fully integrate actuaries in the profession is a key part in strengthening the ability of state insurance commissioners to regulate their domestic insurance industry.

MR. CARROLL: It has often occurred to me that the legal profession has done a much better job of creating a career path for top individuals in their profession through the regulatory agencies. In the legal profession, experience in certain regulatory agencies is thought of as a stepping stone to private practice.

Statutory accounting historically has been thought of as a bulwark against insolvency. Its pervasive conservatism has apparently served the industry quite well over a long period of time. Is that still true from your point of view? Are some of the recent insolvencies due in part to the limitations of statutory accounting?

MR. BARTLETT: Statutory accounting has to be adapted to changing circumstances and has to be combined with other monitoring tools that we've already mentioned: RBC, cash-flow testing, and so on. It also has to be combined with new legal tools. For example, in Maryland and in most other states now, a law on the books says that I don't have to wait until a company is insolvent or fails its RBC test. When I determine that a company is being managed in a hazardous manner, I can go into that company quietly and sit down with the management and tell them that, in my judgment, the company is being managed in a hazardous fashion and that appropriate steps must be taken to turn that situation around before it becomes insolvent or fails the RBC test. I have actually done that in several small property and casualty companies since I became commissioner.

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But I do get concerned, frankly, because I think statutory accounting, when combined with these other tools and other statutory powers that I have, is in the best interest of the industry and the industry's policyholders and consumers. So I do get worried when I see this emerging trend toward substituting modified GAAP for statutory accounting. I hate to see us throw out the baby with the bath water because I think statutory accounting has worked well or would have worked well if some of these other tools had existed at the time that some of the insolvencies took place.

MR. CARROLL: Rating agencies and their ratings are one of the aspects in the industry that has changed very dramatically during this period of time, partly in the reaction to recent failures. The rating agencies are being much tougher in their ratings and are changing companies' ratings more frequently. Is this a positive or negative development from the point of view of preventing failures?

MR. BARTLETT: It is useful to us in that it provides an independent view to supplement our own work of what a company's financial condition is. If we determine the company is in good shape but a rating agency raises questions about the company, there is no question that we are apt to pay more attention or investigate the matter with considerably more care.

MR. CARROLL: How about a look into the future? Are there new things on the horizon or unseen dangers that could cause failures in the future that you are particularly concerned about?

MR. BARTLETT: I'm concerned with the trend of insurance, life insurance in particular, which has been going on for a number of years now, which manifests itself in different ways, and annuity products being sold more and more as commodities and not as services. I think this trend will be aggravated as banks get more and more into the insurance field. We've seen the actions of the controller of the currency in the recent Variable Annuity Life Insurance Company (VALIC) Supreme Court decision, which will encourage banks to become more and more aggressive in the insurance field, certainly in the marketing of insurance. But I don't suppose you could say that in itself is bad, other than the fact that it creates a more intensely competitive environment for life insurance companies and may lead management to make riskier decisions in product pricing.

But then, of course, there's the specter of banks actually getting into the underwriting of insurance. Who will regulate the underwriting of insurance by banks? That's still an open question. I'm on record with our congressional representatives for Maryland in Washington as not opposing the banks entering into the marketing of life insurance, but strongly affirming the principle that, whatever the insurance activities of banks may be, these activities should, in fact, be regulated by state government and not federal government. I do get concerned. I think that many people thought that, as a result of the November 1994 elections, the specter of federal regulation, as opposed to state regulation, was going to recede back into the woodwork. I see quite the contrary. I think the danger of federal regulation superseding in some important ways state regulation has actually been aggravated simply because the threat has become, in some respects, more subtle than it might have been when Representative John D. Dingell (D-MI) was chair of the House of Representatives' committee that dealt with this problem and was directly attacking state regulation. The attack is not that direct on

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state regulation, but it's in more subtle ways to introduce the notion of federal regulation into the field of insurance.

MR. CARROLL: Some observers have asserted that the existence of deposit insurance was one of the major causes of the great number of failures among the thrift industry. Does the existence of life insurance guaranty funds pose a similar risk? And if not, why not?

MR. HOWARD: It may not be because there are limitations on the degree to which insurance companies may publicize the existence of guaranty funds. Section 19 of the NAIC Life and Health Insurance Guaranty Association Model Act (titled "Prohibited Advertisement of Insurance Guaranty Association Act in Insurance Sales; Notices to Policyholders") says that no advertisement may use the existence of the Insurance Guaranty Association for the purpose of sales, solicitation, or inducement to purchase any form of insurance covered by the Life and Health Insurance Guaranty Association Act.

MR. CARROLL: But I think the existence and nature of guaranty fund coverage is fairly well known among the professional agent community, particularly because many of them sold policies issued by these failed companies. Is there any way to prevent that knowledge from filtering through to the consumer?

MR. HOWARD: Probably not. I can remember that when I bought my first life insurance policy more than 30 years ago, it was implied to me that I didn't have to worry about my insurance policy. Even if something happened to my insurance company, another insurance company would take over the policy. This was long before the existence of guaranty associations.

MR. CARROLL: In fact, that was probably before the modern system even existed. When we were just talking about the causes of company failures, it occurred to me that a common theme has been asset problems, whether they be real-estate- or junk-bond-related, depending on the particular company. Do you think that most companies fail for asset reasons as opposed to mispricing or liability side problems?

MR. HOWARD: Since 1990, there have been no failures due to the right-hand side of the balance sheet. Before 1990, a number of health insurance companies failed and some of these failures were due to inadequate underwriting or pricing.

MR. CARROLL: Regulators are often caught in a catch-22 situation with troubled companies. If they indicate concern over a company's solvency, it can actually become a self-fulfilling prophecy. But letting a situation slide too long can make the situation considerably worse when remedial action is taken. In your experience, how have these situations worked out, and do you see any trends occurring one way or the other?

MR. HOWARD: The regulators, like the rating agencies, walk a fine line. I heard a Duff & Phelps representative address the 1994 NOLHGA annual meeting, and he put it succinctly: none of the rating agencies wants to be either the first or the last to downgrade a company. The regulator is even in a more critical position. If he or she moves too quickly and puts the company into rehabilitation, he runs the risk of litigation by shareholders, assuming it is a stock company. There's no good

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mechanism to minimize the asset shortfall in some recent failures, such as Summit National Life and Investors Equity, in which the gap between liabilities and assets was nearly 90%. The story is not over yet on Confederation Life, the largest insolvency in North America, but the timing of that takedown may turn out to be about right. The preliminary indications are that the total cost to the industry may not be too bad for a company so large.

MR. BARTLETT: Although I haven't investigated this myself directly, I know that some people have suggested that had there not been a run on the bank, both Executive Life and Mutual Benefit might have muddled through. The regulator is in a very ticklish situation in that if he moves prematurely, he can make a bad situation worse. That's why I think the statutory powers that I referred to earlier, in terms of my ability to move in on a company quietly and tell management that, in my judgment, the company is being run in a hazardous fashion and that the company must take corrective action, are so terribly important. I intend to, when appropriate, use that power aggressively in Maryland to avoid a company being publicly in a position that would encourage a run on the bank.

MR. CARROLL: Bill, the guaranty funds have provided valuable support for companies after they have failed; for example, by providing liquid funds to back policyholder values and by taking back an interest in various illiquid assets, such as real estate. Do you see any possibility of the guaranty funds moving in to provide financial support before a company actually gets to the point of liquidation?

MR. HOWARD: It's possible under the model act, Charles, but currently guaranty associations do not provide support for companies. Guaranty associations provide a safety net for policyholders of failed companies. The guaranty associations are triggered by a court's liquidation order with the finding of insolvency. Although the model act provides that the guaranty associations may lend money to insurance companies that are impaired but not insolvent, voluntary triggering, in my opinion, would be political dynamite.

What company, having lost business to a competitor that promised higher returns than it could actually generate, would like to be assessed by the guaranty associations to lend money to rehabilitate that now-impaired competitor? There's no incentive for a guaranty association to preempt action by the regulator. Why should the regulator not take down an impaired company and impose a moratorium to prevent or stop a run on the bank and permit the guaranty associations to move the policyholders to a solid company, thus relieving the policyholders of uncertainty? The guaranty associations, harsh as this may sound, don't care if a company fails. They care if policyholders get coverage, and they typically cannot provide coverage until triggered.

MR. CARROLL: Several initiatives are in place trying to supplant or modify the current state-based legal structure for handling rehabilitations and liquidations of insurance companies. For example, there is a proposal for state compacts that would modify the system, and there are people who say that we would be better served putting insurance company failures into the federal bankruptcy system where there are many more tools in place for the liquidator or rehabilitator to handle a problem. What's your view on these, Bill?

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MR. HOWARD: I'd ask you what evidence you have to support that. I don't see any. In my opinion, the key is for the insurance commissioner in the state of domicile of an impaired company to move quickly to bring to bear the resources with the ability to deal with the issues. Dwight mentioned that he has the ability to go informally into a company, and if that works, that's fine. But it is important that when a commissioner puts a company into rehabilitation, he must move decisively to get the right resources there to take care of the policyholders.

MR. CARROLL: One of Bill's roles happens to be valuation actuary for Guaranty Reinsurance Corporation, which is a guaranty-association-controlled life insurance company. Bill, as valuation actuary for that company, what keeps you awake at night regarding risks to that company's financial health?

MR. HOWARD: Guaranty Reinsurance Corporation (GRC) was formed to manage the assets and liabilities of Guarantee Security for five years. The plan is for GRC to maximize the value of the subsidiaries, including a regional airline and an amusement park, maximize the value of their junk bond holdings, and then sell the block of business to a solid company. Guarantee Security became insolvent in 1991, the same year that Mutual Benefit and Executive Life became insolvent. The combined shortfall from the 1991 insolvencies was more than \$3 billion, which strained the assessment capacity of the industry.

The plan for Guarantee Security called for a 25% moratorium surrender charge in 1993, grading off 5% a year, grading off to zero in 1998. With that background, let me answer your question with a question. Assume your company has only single-premium deferred annuities (SPDAs) and single-premium whole life acquired from an insolvent company in 1993. Current liabilities are about \$600 million. The policies have the moratorium surrender charge just described. There are no provisions for market value adjustments. The aggregate contractual surrender charges by 1998 will be close to zero. For 20 points, what surrender rate should the company assume for 1998 and later years? What is the duration of these liabilities? What should be the duration of the assets? What should the investment strategy be? Why? If a company were to buy this block, when would it want to buy, and would the buyer want assets in cash or assets whose duration approximately matched that of the liabilities? I haven't found anyone yet who can answer the question while standing on one foot.

MR. CARROLL: I think you have some excellent questions in there, Bill. Actually, this is a trick question because Bill asked me the same question twice, and I gave him a different answer both times, so I guess he's looking for the third version of my answer. I said I would want to have the investments pretty much as cash at that magical date and I'll stick with that answer.

Apropos of the question about the state-based system for handling rehabilitations, it does appear, if you look at experience with rehabilitations, that at least they have been taking somewhat less time than they used to. Less time means less expense and more certainty for the policyholders. Generally, I think it's quite a positive development from all sides. What lessons have we learned that have enabled us to get these things cleaned up faster than they were earlier on?

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MR. HOWARD: I think employing the right resources. There's a tendency perhaps for the lawyers to become too involved in these and for the business people to not get involved early enough to reach agreement on the best plan for disposing of the assets and moving the policies to a safe home. You were the chief financial advisor to a regulator in a major insolvency. How would you answer that?

MR. CARROLL: For one thing, if we did it again, I know we would do it much better. You do learn from these processes. I think coordination of all the affected parties, including the guaranty associations, early in the process is probably one of the key aspects. Also, having good executive management of the failed company is very important. Usually when these companies are taken over, the old management, by definition, is gone, and the handling of the rehabilitation requires a very skillful and forceful executive to manage the whole process, one who understands the business and legal aspects. That is a key success factor.

MR. HOWARD: I've only been doing this work for a little more than two years. I've been an actuary for more than 30 years. Doing actuarial work by solving financial problems and doing guaranty association work adds two additional dimensions: the legal and political dimensions. The political dimension is the more challenging. An insurance commissioner may be under severe political pressure to maintain jobs and a company buying services in his state; that is one of the realities of the process. I would add that from the current system it works, and it works well.

MR. MICHAEL E. MATEJA: I have an observation that goes back to the first question that was raised about the effectiveness of regulation. It has been my observation that the industry grew and prospered in times of relative stability, and that dates back to my entry in the business in about 1959. Things somehow got out of hand. The pace of change that the industry was confronted with accelerated and literally reached unprecedented proportions. There are several dimensions of that; interest rates would be the most telling one. In 1979 they spurted up, and all kinds of problems followed.

It has always been distressing to me that statutory accounting never addressed mismatch risk, and it was a sobering experience to me to be an actuary pricing products and performing valuations oblivious to one of the major risks that we now recognize insurance companies have to deal with. This whole problem of stability versus rapid change was in effect thrust upon the industry with a whole plethora of new assets that we had never even heard about a few years ago, such as collateralized mortgage obligations (CMOs). Books have been written about the varieties of CMOs that are out there. There are offerings that have hundreds of tranches with different duration and convexity characteristics.

I put all of that in the context of statutory accounting, and statutory accounting looks much the way I saw it and learned it back 30 years ago. I wonder if statutory accounting is capable of dealing with the kind of problems that we will have to deal with in the future. If you make the assumption that there is stability ahead, it will probably work. If there is volatility, I doubt it.

Another observation is that the reserve methodology in place today is much the same one that I learned in Part 4B. We do have cash-flow testing in place. But at the time

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RBC was adopted, I was saying that I think we have the cart before the horse. We need RBC reserves because the RBC mechanism was, in effect, an admission that our ability to measure statutory surplus was not very good, that we needed to take the surplus under statutory accounting and say, "We're going to throw that out and replace it with some other construct here that we choose to call RBC." Reserves are 95% more or less of the liabilities of a company, and I don't think we necessarily have those right.

We need to do many things to prepare for what I would call a 21st century in which regulation is truly effective. It's probably a Herculean task and I don't know where it starts and ends, but we have some work ahead, and I would like to see what Commissioner Bartlett has to offer in response to that.

MR. BARTLETT: Just to reemphasize what I said before, I do not think statutory accounting in itself, in the absence of the tools that have been developed, such as cash-flow testing and so on, would be adequate anymore. I think certainly the most important development is the concept of the valuation actuary. Regardless of whatever statutory standards are, the actuary has to certify the adequacy of the reserves to mature the contracts; laws and regulations can't do the job. We have to make the people who have the responsibility of the companies discharge that responsibility competently, and as responsible professionals.

MR. MATEJA: I need to add one other postscript. The failure with reserve methodology today is that it penalizes you if you are a sinner. If you're an above-average risk taker, then I, as a valuation actuary, have to do something that will increase the reserves to appropriately recognize the risk. But if I choose to be a saint and run my company with modest risk, I get no credit. The methodology is sound, but there is no incentive for a company to be what I would call a prudent manager in a low-risk mode. I get tarred with the same brush as the worst of my brethren. Somehow we need to have a mechanism that will reflect the fact that I choose to be a very conservative manager in terms of how I take risk. I'll get rewarded for that by having a lower standard of reserves relative to a manager running a company who, by design, chooses to take higher risk and then appropriately recognizes that in the valuation methodology and prices for it.

MR. CARROLL: Isn't RBC an attempt, admittedly an imperfect attempt, to do exactly what you're asking for?

MR. MATEJA: No, RBC is a floor and it only increases. I don't get any credit if I'm a prudent manager. In other words, I start with a simple bit of logic that says that current capital or current surplus as developed by statutory accounting is not a perfect measure of risk. Let's redo it. We're going to take stock of all these things, and the only thing that happens as a result of that is that you will somehow increase the surplus as the result of that measurement process. If I were the most conservative insurance manager around and I could demonstrate that I could operate with a combination of reserves and surplus that was say, 5% lower than what I have, I have no option to do that. This is probably a disservice to the insurance-buying public because somehow, there is an opportunity here to reward companies that choose to be what I would call prudent risktakers by saying, in effect, "By right of the management choices that you have made, you can operate with a lower level of reserves."

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MR. CARROLL: If you can convince the rating agencies that you are a prudent risk taker, presumably they will reward you with a better rating, which is a very valuable thing in the market today.

MR. MATEJA: That's part of it. I think some of the companies that are carrying the higher ratings from the commercial rating services are, in effect, being able to demonstrate that they have very conservative investment postures, and that is probably the key point in what's driving their ratings. I just want to challenge the premise that statutory accounting is OK. I submit that it's been the same accounting system fundamentally that I learned 30 years ago. It has served us well, and it will probably continue to serve us well in periods of stability. If we are assured of stability going forward, then it will probably serve.

I don't expect that to be the case. There are other surprises out there on the horizon, and those are the ones that we somehow need to prepare for. Ultimately, I am a believer in market mechanisms and in positioning the regulation to give managements and markets an opportunity to choose as to how they want to manage their companies.

MR. JOE E. DAVIS: You strongly support the continuing state regulation of insurance companies. Did you have the same view when you were a company actuary years ago trying to get a policy approved in many different states, working with market conduct examiners in which each one has his or her little peculiarities regarding advertising, and so forth? You can make that a yes or no if you like, or you can expand on it.

MR. BARTLETT: As president of the company that did business in all 50 states and the District of Columbia, I became as frustrated as any other company president would when trying to deal with that many jurisdictions. I think the NAIC recognizes those problems and is moving aggressively to help address those problems. I think the agent licensing process, which is a problem for multistate companies, will be drastically reformed in the next few years. The NAIC is also supporting a project to allow for electronic filing of policy forms and rates, which should address, to some extent, the problems. But that's always going to be the price to be paid; that is, the difficulties of dealing with so many jurisdictions as an offset to what I think are the clear benefits and advantages of having regulators who are close to and familiar with the companies that they regulate.

MR. DAVIS: My more serious question is about the examination process. It is very expensive. My experience has been that the process continues today in the same style it did 25 years ago in which the focus is on the liability side. They're adding up every reserve. They're checking the debits and credits in the system. And they're spending very little time on the asset side. I would prefer them to come in and focus on the major issues. Look at the assets, maybe spot-check some other things, and then get on out, rather than camping out for months.

MR. BARTLETT: Let me first comment on the expense. I wonder how that expense compares with the expense of the audit done by the outside auditing firm. I suspect that the audit costs substantially more than the examination by the insurance department. But the examination process, partly driven by the accreditation process, has drastically changed in recent years to accomplish exactly what you have suggested needed to be accomplished. A whole new policy and procedures manual for financial

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examinations was developed by a committee of the NAIC. I don't claim that manual to be perfect, and I'm sure it will be revised from time to time, but I would invite you to look at that manual. If you have any suggestions about how to further improve that manual, believe me, we in regulation do not want to be an excessive burden on the industry. As long as I'm commissioner, I'm dedicated to producing an environment that is not intrusive and that is not excessively burdensome on the industry. I think a healthy insurance industry is in the benefit of the consumers in the long run. To the extent that you see problems in our examination process, I want to hear about those problems.

MR. FREDERICK S. TOWNSEND, JR.: I'd like to express one additional concern about statutory accounting. At the time they were taken over, the failed companies of the 1990s did not have a negative net worth. They were reporting substantial positive surplus positions, and they presumably were taken over because of a run on the bank. When the major junk bond players—Executive Life, First Capital, and Fidelity Bankers Life—were taken over, Executive Life had \$500 million in surplus, and Fidelity Bankers and First Capital each had more than \$100 million in surplus. But each of those three companies was allowed to carry junk bonds at book value, some of which were obviously impaired, and there could have been a permanent breakdown in value because of those impairments. When Confederation Life and Mutual Benefit were taken over, they had large positive surpluses. Four months before it was taken over, Confederation reported surplus of \$900 million. One month and one-half after it was taken over, Mutual Benefit reported statutory surplus of \$450 million. Both of those companies were carrying some real estate mortgage investments at book value, and I think some of those investments were obviously permanently impaired.

There should be some mechanism to let regulators move in earlier and force companies to write down asset values to market value in which the market values are lower not because of interest rate changes, but because of credit risk. If that was done, I think these situations would be recognized earlier and would force managements to react to their problems earlier.

MR. JEREMY STARR: The NAIC is now going through a process to look into recodifying statutory accounting. This is sort of a two-part question, both for you, Commissioner, and for Bill. Do you see that as a way of enhancing the potential for the regulator to monitor the stability of the company? Certain things in the codification process seem as if they are going to lower the surplus of companies, such as EDP equipment and that kind of thing. Do you think that is a benefit? The other half of the question for Bill is, Is NOLHGA looking at the codification process and putting in its comments as to ways that it thinks things could be improved?

MR. BARTLETT: I'm not personally involved in that project for codification of statutory accounting, but it seems to me that certainly one of the benefits is to adjust the kinds of problems that were brought up earlier about the difficulty of companies doing business in the majority of or in all the states. Different rules in different states can make it burdensome. This is an effort among other things to eliminate those differences that ought to reduce that burden.

MR. HOWARD: Until recently, NOLHGA has just in the last few weeks been inundated with some of these 34 insolvencies that Charles enumerated. With a number

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of these insolvencies closed, we can turn some of our resources to such things as you talked about. For example, the financial and accounting vice president for NOLHGA, Paul Peterson, recommended to the NAIC that guaranty association promissory notes be carried as a miscellaneous noninvestment receivable. In this manner, RBC, the asset valuation reserve, and the interest maintenance reserve will not have an effect on an assuming company. As we get out from under this huge load of insolvencies from the early 1990s, we'll be able to do some planning.

