

# **NOLHGA, the Life and Health Insurance Guaranty System, and the Financial Crisis of 2008–2009**

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## **NOLHGA, THE LIFE AND HEALTH INSURANCE GUARANTY SYSTEM, AND THE FINANCIAL CRISIS OF 2008-2009**

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**Introduction.** Since the early 1970s, life, annuity, and health insurance consumers have received protection against the financial risk of the insolvency of their insurer from guaranty associations (GAs) in their states of residence.<sup>1</sup> Fifty-two guaranty associations (for the 50 states, Puerto Rico, and the District of Columbia) coordinate consumer protection in major insolvencies (those involving multiple states) through their membership in the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA), a not-for-profit corporation organized in 1983. NOLHGA's members have protected consumers in many life and health company failures, including roughly 75 multi-state insolvency cases.

The purpose of this paper is to discuss briefly the mission of the life guaranty system (Part I); the development of the guaranty system in the context of U.S. insurer insolvency resolutions (Part II); the operations of the guaranty system when insurers fail (Part III); and the financial capacity of the guaranty system (Part IV).

Participants in the 2009 ABA/TIPS program have a particular interest in the “next level” of receiverships and the use of run-off techniques in today’s very challenging economic environment. Among other things, this paper addresses the extensive use of run-off concepts in prior multi-state life insurer insolvency cases and the potential use of GA-supported runoffs, should the current economic crisis cause the insolvency of one or more nationally significant insurers. Conventional run-off techniques have long been a basic option in the guaranty system’s “playbook.”<sup>2</sup>

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<sup>1</sup>Reflecting the essential separation of the life and health insurance industry from the property and casualty insurance industry, property/casualty consumers are protected by a separate network of guaranty funds coordinated through the National Conference of Insurance Guaranty Funds (NCIGF). Unless otherwise specified, references herein to “GAs” or the “guaranty system” are to the life and health GAs, acting independently or through NOLHGA.

<sup>2</sup> During the planning of this program, the author learned – somewhat to his surprise – that he has developed a reputation in some quarters as being critical of the use of run-off techniques in receiverships. To the contrary, the author is fully supportive of run-offs in the sense that the concept conventionally has been used, although he has criticized the use of the term “run-off” to describe some very unconventional (continued . . .)

## **I.      The Guaranty System's Mission.**

The core mission of NOLHGA and its member GAs is to assure that consumers receive at least a statutorily prescribed base level of financial protection when a life or health insurance company fails. That protection may be achieved either by transferring to a healthy insurer the failed company's business in force or by supporting the run-off of that business.

## **II.     Historical Development of the Guaranty System and Insurer Insolvency Resolutions.**

*History of Life Insurance Failures in the U.S.* Life insurer failures have occasionally occurred throughout the history of the U.S. life insurance industry. Because insurance has historically been regulated by the states rather than by the federal government, insurance company failures have been governed by state insolvency procedures rather than by federal bankruptcy law. For reasons discussed herein, insurance consumers have often been better shielded from harm in state insurance insolvency proceedings than creditors have been in bankruptcies or other types of receivership proceedings.

Until the early 1970s, there was no widespread “safety net” to protect insurance consumers when an insurer failed. Consumers became creditors of the failed insurer in an insolvency proceeding, and when they made claims against the “estate” of the insurer for policy benefits, they could experience delays or reductions in payment of their claims. They were also at risk as to the amount of any payment that would eventually be received. That is, they faced risks regarding both timing (whether the insurer’s estate would have the *liquidity* to pay obligations to consumers as they came due), and amount (whether the *credit* of the insurer would recover so that the insurance estate’s assets would be sufficient to satisfy policy liabilities).

In addition, consumers often confronted the need to replace in the marketplace what amounted to defaulted “permanent” policies of the failed insurer.<sup>3</sup> Consumers

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and troubling proposals. See, e.g., Gallanis, *The “New Runoff”: Threat or Menace?* XIII NOLHGA Journal No. 1, p.2 (January 2007).

<sup>3</sup> The risk mentioned here relates only to “permanent” insurance, and not all insurance policies are permanent. Property and casualty policies are generally renewable and re-priced each year, and are cancellable either by the insurer or by the insured as each year’s policy term expires. The same is true of many types of health insurance policies (e.g., group health insurance policies). To the extent policies are “reset” each year, the replacement risk is minimal or nonexistent, since such contracts can generally be replaced on reasonable terms in the marketplace. The primary consumer risk in such cases is the loss of prepaid installments of premium for the year in which the insurer becomes insolvent (sometimes called (continued . . .)

attempting to replace such policies usually faced, at a minimum, higher premiums, since they would be older than when they purchased the original policies. In some cases, changes in consumers' health since they purchased the original policies rendered them uninsurable at any premium level.

*The Creation of the Guaranty System.* By the early 1970s there was a national consensus that life, annuity, and health consumers should be protected against three major insolvency risks: delays in payment of claims (liquidity risks), uncertainty as to the amounts of any payments received (credit risks), and the risks and costs of replacing the insurer's defaulted permanent policies (replacement risks). (A similar consensus also then formed regarding protection of property/casualty consumers, leading to the development of the property/casualty guaranty funds.)

That consensus led the National Association of Insurance Commissioners (NAIC) to develop the 1971 Life and Health Insurance Guaranty Association Model Act (Model Act). The NAIC has amended and updated the Model Act several times, and it serves as the statutory foundation for the legislation in 52 jurisdictions creating the GAs that are members of NOLHGA. Each state's version of the Model Act created a GA within the state as a specially chartered, not-for-profit legal entity with the power and responsibility to protect consumers against the liquidity, credit, and policy replacement risks posed by a life or health insurer insolvency. Each GA's membership includes all the insurance companies licensed to write covered lines of business in the state. Those "member insurers" bear the costs of protecting consumers in proportion to their market shares in the state.<sup>4</sup>

The emergence of the insurance guaranty systems (life and health and property/casualty) in the 1970s and 1980s was timely. Until the 1980s, insolvencies of major, national insurers had been rare. Beginning in the 1980s and continuing into the early 1990s, several notable insurer failures took place. These included property/casualty carriers Reserve Insurance Company, Mission Insurance Company, and Transit Casualty Company. The first major life company failure in over a generation was that of Baldwin-United in 1983. Baldwin-United's failure was followed by a string of life and health company failures in the early 1990s, including major insurers Executive Life Insurance Company (1991), Mutual Benefit Life Insurance Company (1991), and Confederation Life Insurance Company (1994), along with a number of smaller companies. The number and severity of life and health insurer insolvencies declined after the mid-1990s, and there have been no failures of nationally significant life carriers since the insolvency of Confederation Life in 1994. Exhibit 1 contains a list of life and health insurance companies doing business in multiple states that have failed since 1987, together with a chart illustrating the distribution of company failures by year.

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"unearned premium claims"), a risk that is now covered both by property/casualty guaranty funds and by life and health GAs.

<sup>4</sup> Some state GA enabling laws permit member companies to recoup some of the costs of supporting the guaranty system through various state tax offset provisions.

*Lessons Learned from Insolvency Experiences.* The life industry and its financial and actuarial consultants, the life insurance ratings agencies, and state insurance regulators learned some important lessons from the company failures of the late 1980s and early 1990s. One involved the need for more-sophisticated systems to measure insurance and investment risk in life insurers, which in turn led to the development and refinement of risk-based capital testing. Another lesson was the need for coordinated, sophisticated, national regulatory consultation regarding troubled companies doing business nationally. Other lessons involved the need for skilled, professional leadership of, and stakeholder participation in, the processes to resolve insolvencies of nationally significant insurers.

*Recent Life Insolvency Experience.* These lessons have resulted in an industry that now appears better prepared than others to withstand national economic challenges. Despite the effects of the economic situation of the past 18 months on investment banks, commercial banks and thrifts, hedge funds, credit unions, “monolines,” and government-sponsored mortgage entities, not a single life insurer has had to be liquidated since the start of 2008 as a consequence of the economic downturn.<sup>5</sup>

Life company failures since the early 1990s have generally resulted in favorable outcomes because of some basic attributes of life insurer insolvencies described below in Part III; the increasing use of “prompt corrective action” approaches by regulators; and increasingly professional, transparent, and participatory insolvency resolutions. A “favorable outcome” in this sense means one involving very small shortfalls of assets versus liabilities and a very high percentage of returns on policyholder claims in the “estate” of the failed insurer. These points are addressed further in Part III.

The existence of a guaranty system providing a safety net against policyholder losses from company insolvencies appears to have helped shore up consumer confidence in the life industry in the current economic climate. As discussed in Part IV, however, some media reports have questioned the financial capacity of the guaranty system to withstand an unprecedented financial crisis.

While the actual financial capacity of the guaranty system is quite substantial, it is not unlimited. As discussed below in Part IV, a completely unprecedented, worst-case crisis for the life industry could in theory challenge the liquidity of the guaranty system, but even in that event the system would still have strategies available to protect consumers.

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<sup>5</sup> AIG, though often described as “the world’s largest insurance company,” is a diversified conglomerate whose financial crisis peaked in September 2008, largely as a consequence of derivatives transactions in its Financial Products Division. Regulators report that the insurance subsidiaries remain healthy, although some AIG life subsidiaries apparently experienced problems in 2008 stemming from non-traditional “securities lending” programs. Aside from AIG, the one multi-state life insolvency in 2008 appears to have resulted entirely from management looting, and the one multi-state health insolvency appears to have resulted from litigation losses. Two multi-state life companies entered rehabilitation proceedings in the first six months of 2009, but neither has entered liquidation.

### **III. How the Guaranty System Operates Within the Insolvency Resolution Process.**

In the banking system, the FDIC has two roles: it provides a safety net for banking consumers, and it regulates (indirectly and sometimes directly). By contrast, the insurance guaranty system’s consumer safety net is separate and apart from the regulation of active insurers. Nonetheless, NOLHGA and its member guaranty associations coordinate their activities closely with the operations of insurance regulators and receivers.

*The Nature of U.S. Insurance Receiverships.* U.S. insurance companies are expressly excluded from the definition of a “debtor” under the federal Bankruptcy Code. As a consequence, a failed insurance company does not enter bankruptcy, but rather is placed in receivership by the insurance regulator of the state that granted the insurer’s charter. The receivership proceeding is conducted according to the state’s insurance receivership statute, which in every state bears some resemblance to bankruptcy law. The proceeding is conducted before a state judge, and the insurance commissioner of the “domiciliary state” serves as the statutory receiver of the company.

Insurance receivership laws vary somewhat from state to state, but all have provisions for three basic levels of receivership. The first (and least severe) is often described as “conservation.” Conservation is a process in which the insurance commissioner, as conservator, maintains the status quo (e.g., custody of records and assets) while determining the seriousness of the insurer’s problems. If the conservator is satisfied that any significant problems have been addressed, the company can be released from conservation. If not, the company may proceed to either of the more severe forms of receivership.

The next most severe form is “rehabilitation,” in which the commissioner, as rehabilitator, is vested with title to the company’s assets and control of company operations. Rehabilitation is in some ways analogous to a Chapter 11 bankruptcy reorganization. The objective, if possible, is to develop a court-approved plan of rehabilitation intended to address the problems that made the receivership necessary. The outcome may be the eventual release of the company from rehabilitation, or it may be the most severe form of receivership, “liquidation.”

Liquidation is analogous to a Chapter 7 liquidating bankruptcy. The commissioner, as liquidator, is charged with responsibility for marshaling the assets of the insurer, evaluating the claims of policyholders and other creditors against the insurer, and distributing the marshaled assets to approved claimants in the manner prescribed by the state’s receivership law.

*The Role of GAs in Receiverships.* Under the Model Act as adopted in the states, NOLHGA’s member GAs become actively involved in an insurer insolvency resolution when their obligations to consumers are “triggered” by an order of the receivership court placing the insurance company into liquidation and finding it to be insolvent.

*GA Coverage Obligations.* Once triggered, a GA becomes responsible for protecting contracts covered under its enabling statute, at least to the lower of (i) the contract’s limit of coverage; or (ii) the limit of coverage or “cap” set forth in the GA’s enabling statute. Virtually all of the enabling statutes provide coverage for each covered contract at least to the cap levels set forth in the Model Act; the legislatures of some states have chosen to provide higher GA caps for some lines of business than those in the Model Act. The coverage caps for the different GAs are graphically illustrated in the brochure included as Exhibit 2, *The Nation’s Safety Net*.<sup>6</sup>

In general, all traditional consumer-oriented life and annuity contracts that are guaranteed by a life insurance company are covered by GAs, subject to coverage limits. Under the Model Act, life insurance death benefits are covered to a cap of \$300,000, and cash values are covered to \$100,000; annuities guaranteed by the insurer (fixed annuities and guaranties attached to certain variable annuities) are covered to a cap of \$250,000;<sup>7</sup> and health benefits, depending on the type of contract, are covered to between \$100,000 and \$500,000. (See Exhibit 2 for further details.) Guaranty associations do not cover contractual benefits that are not guaranteed by the insurer, or as to which the consumer has agreed to bear market risks (e.g., fluctuations in the value of variable annuity portfolios that are not the subject of insurer guaranties).

*Flexibility in Manner of Satisfying GA Obligations.* The enabling statutes provide GAs some flexibility in how to deliver mandated protections to consumers,<sup>8</sup> including the power to tailor a resolution plan to achieve a “least cost resolution” while also preserving guaranty system financial capacity when it may be prudent to do so. The GAs’ core obligations are to make payments due on covered contracts and to continue coverage on those contracts on substantially the same terms as those extended to consumers by the failed insurer. By meeting those obligations, GAs relieve consumers of the liquidity, credit, and replacement risks they otherwise would face from the insolvency of their insurers.

*The Role of NOLHGA.* NOLHGA was formed in 1983 to provide a mechanism through which multiple GAs could act in concert to craft a single, national insolvency response plan for multi-state insolvency cases. NOLHGA, which is based in Herndon, VA, has a small staff of insurance, legal, and administrative personnel who support the coordinated activities of the life insurance guaranty system.

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<sup>6</sup> On March 17, 2009 the NAIC amended the Model Act to change the coverage cap for annuities from \$100,000 to \$250,000 and to establish a new \$300,000 cap for long-term care and disability insurance coverage. In anticipation of that change, some state legislatures had already begun the process of amending their GA enabling statutes to implement the new, higher limits of GA coverage.

<sup>7</sup> This is the cap commencing March 17, 2009; the prior limit was \$100,000. (See preceding footnote.)

<sup>8</sup> The Model Act, in language adopted in virtually all state GA enabling statutes, provides that when a “member insurer” is deemed “insolvent,” the consumer protection options open to the GA are to “guaranty, assume or reinsure, or cause to be guaranteed, assumed or reinsured, the policies or contracts of the insolvent insurer.” Model Act 8(B)(1)(a)(i).

In most life insurer insolvencies, GAs deliver protections to resident consumers through one of two types of resolution strategies – assumption reinsurance transactions or “enhancement plans” in which the GAs provide financial support for the conventional run-off of the policies of the insolvent insurer. In either case, contracts effecting the strategy are executed by NOLHGA and affirmed by each of the GAs participating in the resolution.

*Assumption Reinsurance Transactions.* Particularly in smaller insolvencies (or in periods when insolvencies are few and isolated), a resolution plan may involve the transfer of the in-force obligations of the failed insurer to a healthy insurer. The new carrier agrees to assume these liabilities (in what is commonly known as an “assumption reinsurance” transaction) in exchange for a transfer of assets from the estate of the failed insurer plus the GAs’ payment of an amount that satisfies the obligations of GAs to their resident consumers. In an assumption reinsurance transaction, the GAs usually bear the costs of protecting consumers at the time the transaction closes; in other words, the GAs pay at the “front end” all of the costs they will ever bear for protecting consumers in such a resolution plan.

*Enhancement Plans in Extended Run-offs.* Alternatively, GAs may participate in a resolution plan in which they supply enhancing funds to the assets of the insolvency estate, and apply those enhancing funds as needed over time (years or even decades) to pay insurance and annuity obligations as the insolvent insurer’s obligations come due over an extended run-off period. By participating in such an enhancement plan, rather than an assumption reinsurance transaction, GAs can defer having to fund their obligations to consumers until the time when those obligations actually mature. Enhancement plans have been used in a number of insolvency cases, particularly when the size of the case or concerns about maximizing the financial capacity of the guaranty system appeared to justify such a strategy.

In either case (an assumption reinsurance agreement or enhancement plan), GA funds are combined with available assets from the estate to finance the costs of protecting consumers.

*The Significance of Estate Assets.* Two other aspects of life insurer insolvencies are important in this connection. First, most life insurer insolvencies involve only small shortfalls of assets versus liabilities. The shortfalls are seldom more than 15% in larger cases, and are more typically in the range of 5% to 10%. Second, under the insurance receivership statutes of all states, when estate assets are distributed, policyholders have an absolute priority over the lower-ranking claims of general creditors and subordinated creditors. As discussed in Part IV, these two facts, combined with GAs’ ability to utilize enhancement plans to spread their obligations over a multi-year run-off, permit GAs to respond to peak years of insolvency activity (historically concentrated in a couple of bad years within a much longer cycle of relative calm) by spreading their resolution costs over a much longer period. In effect, GAs are able to defer their need for financing to

match the maturity of payment obligations on covered insurance and annuity contracts.<sup>9</sup> In this way the guaranty system is able to avoid the outcome of “drowning in a stream having an average depth of nine inches.”

*GAs Protect Consumers, Not Failed Insurers.* The core responsibility of GAs is to protect consumers whose insurers have failed – not the insurers. Stated differently, GAs were not created to “bail out” financially troubled insurance companies, but rather to assure that individual consumers receive a base level of financial protection during their insurers’ insolvency resolution process.<sup>10</sup>

#### **IV. Guaranty System Financing and Capacity Considerations.**

The guaranty system relies upon a combination of financing sources and resolution techniques to deliver protection for consumers. A clear picture of the financial capacity of the system requires an understanding of those sources and resolution techniques.

*Estate Assets Provide Significant Resolution Plan Financing.* Life insurer resolution plans employ the insolvent insurer’s remaining assets as the *first* level of financing used to protect all insurance consumers pro rata – both for consumer benefits covered by GAs and for insurance benefits that GAs do not cover (e.g., policy or annuity benefits in excess of GA “caps”).

Additionally, as noted above, U.S. insurance receivership laws give policy-level claims priority over all other claims against an insolvent insurer’s assets (aside from receivership administrative costs). This priority (requiring policy-level claims to be paid first, and in full, before any payment of general creditors’ or subordinated claims) boosts the financial resources available for the resolution plan. Moreover, the conservative nature of life insurance investing, strong regulation, and rating agency pressure usually make the “shortfall” of assets to liabilities relatively small for failed life insurers – particularly for larger, diversified insurers. Except in the cases of a few small life companies where management “looted” the insurers’ assets, shortfalls in excess of 25% of policy liabilities are almost unheard of; shortfalls in the range of 5% to 10% are more typical.

*Resolution Plan Financing from GAs.* Even with the funding from estate assets, additional funds from the guaranty system are often critical to the success of a resolution plan. The guaranty system’s funds “bridge the gap” between the total GA-covered

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<sup>9</sup> GAs also have statutory authority to borrow money against the pledge of future assessments.

<sup>10</sup> The Model Act (Section 8(A)(2)) and the enabling statutes for most GAs do permit a GA to lend funds to an “impaired” insurer chartered by the GA’s state. (An “impaired” insurer is one under regulatory supervision or control but for whom GA coverage has not been triggered by a judicial order of liquidation with a finding of insolvency.) To date that provision has rarely been used.

obligations and the estate assets allocable to meet those obligations. Simply stated, GAs must cover that gap for the consumers they are charged to protect.<sup>11</sup>

*GA Assessment Funding from Member Companies.* The most significant source of GA funding is through assessments that GAs collect from the insurance industry. Each GA is authorized by its enabling statute to assess and collect, from insurance companies writing covered lines of business in the state (the GA’s “member insurers”), the amount needed to satisfy the GA’s obligations to policyholders. Member insurers are obliged to pay those assessments, which are allocated ratably in accordance with their market shares, as a condition to maintaining their authority to write business in the state. For that reason, collection of GA assessments has never been a problem for the guaranty system. The Model Act limits the amount that can be assessed to any company in a given year to 2% of insurers’ recent average annual premiums. (A few state GA enabling statutes have assessment “cap” provisions that are greater or less than the Model Act’s 2% cap.)

*Distributions to GAs from Prior Insolvencies.* Another source of GA funding is “dividend” distributions to GAs from insurance receiverships in which GAs previously have advanced funds to protect consumers. The source of these dividend distributions may include (i) the realization over time of value from the sale of distressed assets in the portfolio of a failed insurer; or (ii) judgments or settlements eventually obtained by the receiver against insiders or consultants who bore responsibility for the failure of the company.

*Post-Insolvency Funding.* Unlike the FDIC, the insurance guaranty mechanism does not involve a pre-funded “war chest” available in advance of a particular insolvency. Rather, the funding structure may be described as a post-insolvency funding system, in which assessments are collected only when they are needed to help pay the costs of insurance benefits coming due to consumers. The advantage of this approach is that capital is not removed from the industry prior to the need for such capital, and consumers are not required to pay in advance (through higher premiums) for funds that may never be needed to protect other consumers in an insolvency.<sup>12</sup>

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<sup>11</sup> Technically, the GAs are responsible for the *entire* amount of a consumer’s GA-covered benefits. Under the Model Act and state GA enabling statutes, however, to the extent a GA provides protection, it is “subrogated” to the consumer’s claim as a creditor of the insolvent insurer, and the GA is entitled to pro rata access to the assets of the failed insurer to satisfy its subrogation claim. Thus, if an insolvent insurer’s estate has zero assets (as in the rare case where all assets have been looted by management), the GAs are responsible for paying 100% of covered benefits. But if the insurer has available assets to cover a portion (say, 90%) of policy-level claims, the GAs are for practical purposes responsible to pay the remaining portion (10%) of covered benefits, with the balance being “financed” from estate assets applied to satisfy the GA’s subrogation claims.

<sup>12</sup> While GAs are not formally pre-funded in the sense that the FDIC is, most GAs have made recoveries over the years from the estates of insolvent insurers after assessing the life industry for the cost of providing protection to insolvent insurers’ policyholders. As a result, most GAs today have significant “cash on hand” providing at least a modest operating reserve that can be brought to bear immediately in response to one or more new insolvencies.

The disadvantage of a post-insolvency funding system is obviously the lack of ready funds in advance of a funding need. For an insurance safety net, however, this is not the disadvantage that it might seem.

The historical justification for FDIC pre-funding is the need to support full access to bank savings and checking accounts, which are presumed to be demand obligations of the insured institution that must be fully liquid to satisfy the essential promise to the consumer reflected in the banking relationship. Insurance and annuity products, by contrast, are in essence commitments to deliver funding upon specified events (e.g., the death of an insured under a life policy) or pursuant to a scheduled need (e.g., installment obligations payable under a fixed annuity contract). Unlike a demand account, many insurance obligations do not become due and payable to consumers until years after an insurer's failure.

To provide an effective banking safety net, it is necessary for the FDIC to replace cash (of the failed bank) with cash from the FDIC at the moment the bank fails. By contrast, the insurance guaranty system, by protecting not only against liquidity and credit risks, but also against insurance replacement risks, meets its obligations to consumers in a different way that is appropriate to the nature of an insurance contract, by replacing insurance with insurance.

*Maximum Guaranty System Assessment Capacity.* The theoretical maximum of assessments that may be collected across the guaranty system in a given year can be roughly calculated by applying each state's "assessment cap" to the total of the currently assessable premiums within the state, and adding those amounts for all 52 GAs. That exercise generates a theoretical national assessment maximum for the current year of approximately \$8.8 billion, including about \$4.7 billion regarding life and annuity premiums (generally available only to cover consumer benefits for life and annuity business) and \$4.1 billion regarding health premiums (generally available only to cover health benefits).<sup>13</sup>

*Measuring the Guaranty System's Ability to Respond.* The current economic situation has caused various media outlets to publish stories about the potential failures of life insurance companies. Some of those stories have briefly addressed the guaranty system, but few have done so in detail, and none have done so accurately. Some stories have described the guaranty system as having "capital" of \$8 billion or \$9 billion; others

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<sup>13</sup> The theoretical maximum so calculated is a useful "rule of thumb," but it has limitations. GA capacity is further constrained by at least three "silo" factors. The first is that a single GA's capacity is not available to satisfy obligations of another GA. Second, as noted in the text, most GAs follow the Model Act provisions limiting the use of life and annuity assessments to the provision of life and annuity coverage, and health assessments to the provision of health coverage. Finally, a GA may assess to cover only the costs of protecting its own residents, and some failed insurers may have unusually high or low concentrations of business in particular states. Insolvencies of relatively large life and annuity writers do, however, tend to follow a relatively normal distribution that matches GA coverage costs fairly closely with the states where assessable premium is collected. In other words, assessment capacity is generally distributed among states in a pattern similar to the costs of providing GA protection.

have described the total capacity of the system as being limited to \$8 billion or \$9 billion. The stories then typically compare the cited amounts to the total liabilities of life insurers, and conclude or imply that the capacity of the guaranty system is inadequate to protect consumers.

Such assertions are incomplete and unsound for two important reasons.

*Accounting for Estate Assets.* The first reason is that such assertions fail to account for the very significant extent to which the costs of protecting life insurance consumers are almost always paid from assets that remain with the insurer after it has entered liquidation proceedings. For example, if an insurer with \$10 billion of in-force business (all GA-covered) were to fail this year and be the subject of a GA-supported assumption reinsurance transaction, also effected this year, the cost to the guaranty system would not be \$10 billion. Rather, it would be the *net* amount remaining after subtracting from \$10 billion the available assets in the insurer's "estate." If the insurer had (not atypically) 90 cents available to cover every dollar of policyholder liability, the costs to the guaranty system would be \$1 billion, not \$10 billion.<sup>14</sup>

*Accounting for the Ability of GAs to Match Funding Requirements with Maturing Insurer Obligations over an Extended Run-Off Period.* The second reason is that such assertions fail to recognize that, in major insolvencies, the guaranty system is likely to employ an enhancement plan to spread the cost of protecting consumers across the period of years over which the insolvent insurers' obligations to consumers mature. Such a run-off enhancement plan decreases the extent to which the guaranty system's assessment capacity is depleted for any one year by a particular insolvency. Another way to express this point is to view the relevant "capacity" measure for the guaranty system *not* as the assessment capacity for the current year alone, but rather as the cumulative assessment capacity for the years across which consumer benefits would be covered by GAs. For some types of life or annuity contracts, the delivery of such benefits may span a run-off period of decades or even generations.

To be sure, the assessment base for each future year into which the cost of resolving a current-year insolvency would thus be shifted would also need to be available to pay GA costs for other insolvencies – whether insolvencies arising in that future year or from other, prior years. The point is still important, though, because of the cyclical nature of insolvencies and the relative steadiness – and historically steady increases – in the overall assessment capacity of the guaranty system. Historically, the guaranty system's aggregate assessment capacity for most years has far exceeded the amount needed to protect consumers. That point is graphically illustrated by group Exhibit 3, which shows the total assessment capacity of the guaranty system each year (in the aggregate and by

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<sup>14</sup> Additionally, for many types of business transferred in assumption reinsurance transactions, the acquiring company will pay a significant "ceding commission" in recognition of the cost of acquiring such a block of contracts. Such ceding commissions can further reduce the net guaranty system cost of protecting consumers.

separate lines of business), compared to the total funds actually collected from GA member companies to pay for the delivery of covered benefits to consumers.

*Guaranty System Capacity in the Current Economic Crisis.* The question really being asked, though, by those who have written about the potential effects of the economic crisis on the insurance industry and the guaranty system, is whether the guaranty system is capable of protecting consumers if the current economic crisis continues to grow worse. To state the question somewhat differently, could the guaranty system meet its obligations if the crisis resulted in the simultaneous failure of several nationally significant insurers?

The answer from historical experience is “yes.” During the last major wave of life insurer insolvencies in the early 1990s, the guaranty system protected all consumers to whom it had responsibilities when confronted with the simultaneous resolutions of three nationally significant insurer failures (Executive Life Insurance Company, Mutual Benefit Life Insurance Company, and Confederation Life Insurance Company), plus a number of failures involving middle-tier and smaller companies. At no time – not even in the most expensive years – did the cost of protecting consumers even remotely approach the assessment capacity of the guaranty system. (See Exhibit 3.)

In the current environment, NOLHGA expects that the guaranty system will be able to meet obligations to all consumers under any reasonably foreseeable developments. Still, responsible questions may be asked about what is reasonably possible. For that reason, NOLHGA is currently involved in a “stress test” analysis project supported by the life actuarial resources of Towers Perrin/Tillinghast and insurance insolvency expertise from the law firm Baker & Daniels.

Preliminary results of the stress test analysis indicate that the financial capacity of the guaranty system for 2009 *standing alone* – without “shifting” any of the costs of major insolvencies into future years, as would commonly be done through an enhancement plan (see discussion above) – should be sufficient to support guaranty system assumption reinsurance resolutions of several nationally significant insolvencies effected entirely within 2009, depending on the assumptions used for stress test modeling. But assuming (as would likely be the case) that the resolution plan would spread the costs to the guaranty system over the extended runoff period when insurance obligations to consumers would mature (e.g., death benefit payments, installments on annuities) through an enhancement plan, it can be demonstrated clearly that the assessment capacity of today’s guaranty system could handle the simultaneous failures of a number of nationally significant insurers.

Still, if the economy were to worsen to “near meltdown” conditions, it is at least theoretically possible that the costs of paying maturing obligations to consumers in the current period could strain or exceed the liquidity of the system. Under such a worst-case scenario, one alternative for protecting consumers might be a borrowing by the guaranty system, through conventional or extraordinary channels, secured by a pledge of some portion of the future assessments that would be collected by GAs. Assuming that the

current nationwide assessment base of the guaranty system would remain flat for the period of the next 10 years (Exhibit 4A), the potential collateral stream for such a borrowing would aggregate approximately \$88 billion. Assuming alternatively that the current assessment base would drop by 20% and not recover at all for a period of 10 years, the potential collateral stream would still aggregate \$71 billion.

## **Conclusions**

Insurance consumers have for decades benefitted from a robust system of insolvency protection provided by life and health insurance guaranty associations coordinated through NOLHGA. The system is experienced, well financed, and armed with legal and financial tools that permit the system to manage successfully virtually any foreseeable economic scenario. Even in the event of a “1,000 year flood” affecting the life insurance industry, the ability of the system to make use of the assets of insolvent insurers in conjunction with GA assessments; to spread resolution costs over the long run-off period when consumer benefits would mature; and to borrow against the future assessment capacity of the system, should serve as a solid foundation for protecting consumers.

## **Further Questions**

Any additional questions or requests for data or information should be directed to:

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# Liquidations Involving NOLHGA

74 Life and Health Insurance Companies

1987 - 2009

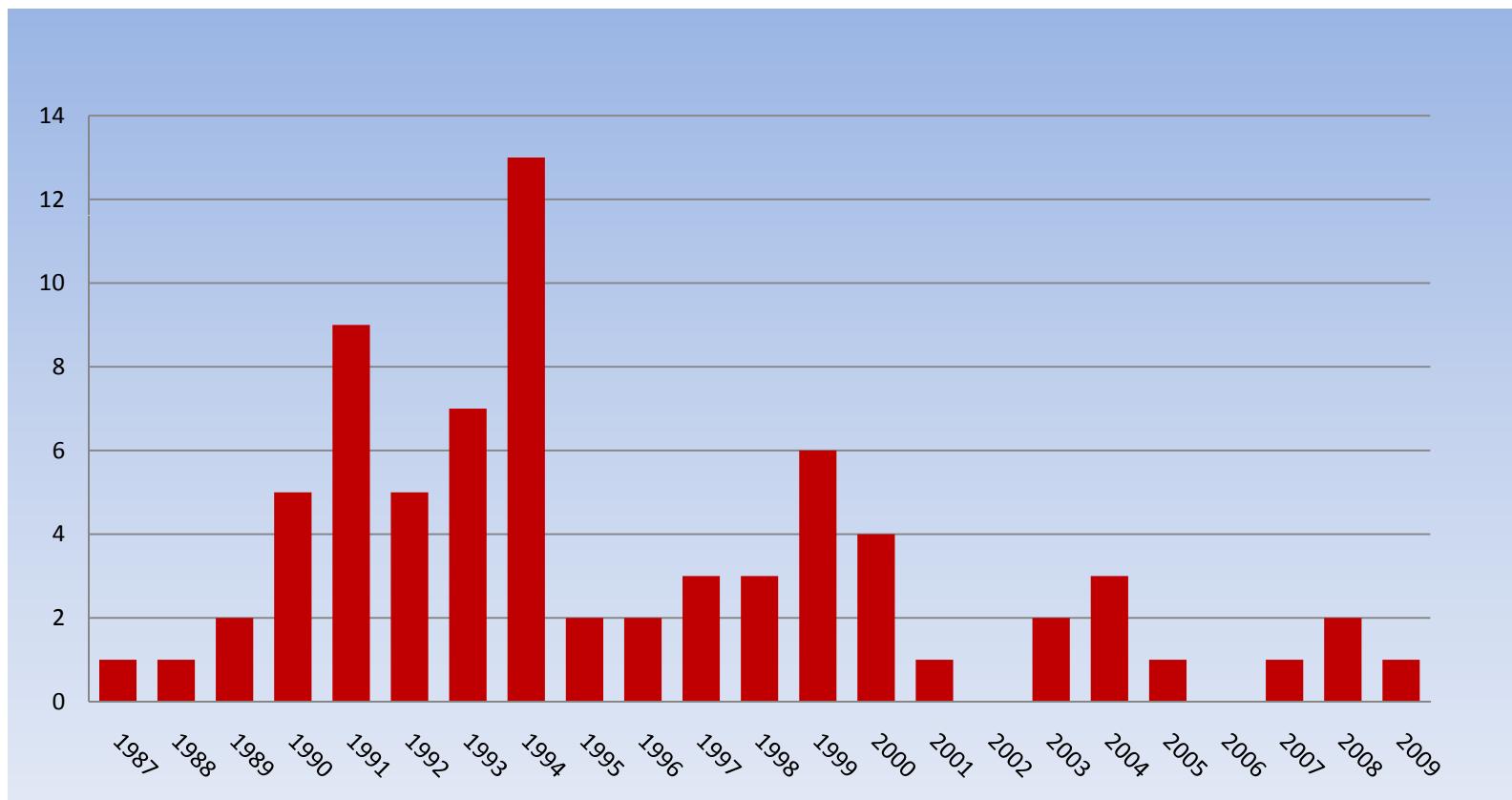


Exhibit 1A



# NOLHGA Involvement

## List of Life and Health Insurance Company Liquidations

1987 - 2009

<u>Liquidation Year</u>	<u>Company Name</u>	<u>Liquidation Year</u>	<u>Company Name</u>
1 1987	Farm & Ranch Life Insurance Company	38 1994	Kentucky Central Life Insurance Company
2 1988	Lumbermens Life Insurance Company	39 1994	Old Colony Life Insurance Company
3 1989	Associated Life Insurance Company	40 1994	Pacific Standard Life Insurance Company
4 1989	Amalgamated Labor Life Insurance Company	41 1994	Summit National Life Insurance Company
5 1990	Cadillac Insurance Company	42 1994	Corporate Life Insurance Company
6 1990	American Independence Life Insurance Company	43 1994	United Republic Life Insurance Company
7 1990	Life of Indiana Insurance Company	44 1995	National Heritage Life Insurance Company
8 1990	American Protectors Insurance Company	45 1995	Supreme Life Insurance Company of America
9 1990	Great Lakes American Life Insurance Company	46 1996	Coastal States Life Insurance Company
10 1991	Executive Life Insurance Company	47 1996	National American Life Insurance Co of Pennsylvania
11 1991	George Washington Life Insurance Company	48 1997	American Life Assurance Corporation
12 1991	Inter-American Insurance Company of Illinois	49 1997	American Western Life Insurance Company
13 1991	Midwest Life Insurance Company	50 1997	First National Life Insurance Company
14 1991	Mutual Security Life Insurance Company	51 1998	American Standard Life & Accident Insurance Company
15 1991	Life Assurance Company of Pennsylvania	52 1998	Centennial Life Insurance Company
16 1991	Underwriters Life Insurance Company	53 1998	Universe Life Insurance Company
17 1991	Legacy Life Insurance Company	54 1999	Family Guaranty Life Insurance Company
18 1991	Lincolnwood National Life Insurance Company	55 1999	First National Life Insurance Company of America
19 1992	AMS Life Insurance Company	56 1999	Franklin American Life Insurance Company
20 1992	Diamond Benefits Life Ins Co/Life Assurance Co of PA	57 1999	Franklin Protective Life Insurance Company
21 1992	Fidelity Bankers Life Insurance Company	58 1999	International Financial Services Life Insurance Company
22 1992	Guarantee Security Life Insurance Company	59 1999	Statesman National Life Insurance Company
23 1992	Old Faithful Life Insurance Company	60 2000	American Chambers Life Insurance Company
24 1993	American Integrity Insurance Company	61 2000	Bankers Commercial Life Insurance Company
25 1993	Andrew Jackson Life Insurance Company	62 2000	Farmers and Ranchers Life Insurance Company
26 1993	Investment Life Insurance Company of America	63 2000	National Affiliated Investors Life Insurance Company
27 1993	Mutual Benefit Life Insurance Company	64 2001	Reliance Insurance Company
28 1993	New Jersey Life Insurance Company	65 2003	Legion Insurance Company
29 1993	Unison International Life Insurance Company	66 2003	Villanova Insurance Company
30 1993	Atlantic and Pacific Life Insurance Company of America	67 2004	Life & Health Insurance Company of America
31 1994	Alabama Life Insurance Company	68 2004	London Pacific Life & Annuity Company
32 1994	American Educators Life Insurance Company	69 2004	Old Southwest Life Insurance Company
33 1994	Confederation Life Insurance Company (CLIC)	70 2005	States General Life Insurance Company
34 1994	Consolidated National Life Insurance Company	71 2007	Benicorp Insurance Company
35 1994	Consumers United Insurance Company	72 2008	Lincoln Memorial Life Insurance Company
36 1994	EBL Life Insurance Company	73 2008	Memorial Service Life Insurance Company
37 1994	Investors Equity Life Insurance Company of Hawaii, LTD	74 2009	Medical Savings Insurance Company

Exhibit 1B





The Life & Health Insurance Guaranty Association System  
**The Nation's Safety Net**

# Keeping Promises

**L**earning that your life or health insurance company is in trouble can be frightening, but policyholders can take comfort in knowing that the guaranty association safety net will be there when they need it. By continuing coverage to policyholders of a failed insurer and providing benefits under its policies, state life and health insurance guaranty associations play a vital role in keeping the promises made by the insurance industry—even when a company goes out of business. In the last 25 years alone, state guaranty associations have:

- Provided protection to more than 2.3 million policyholders
- Guaranteed more than \$21.2 billion in coverage benefits
- Paid out more than \$5.2 billion in benefits to fulfill insurer promises

Each state, along with the District of Columbia and Puerto Rico, has a life and health insurance guaranty association to protect its residents if an insurance company licensed in the state fails. When a company failure occurs, affected associations are triggered to provide continuing coverage and benefits to policyholders living in their states. If the company does not have enough funds to meet its obligations to policyholders (a common occurrence with insolvent insurance companies), each state guaranty association ensures that the covered claims of resident policyholders continue to be paid.

Associations may also provide continuing coverage to their residents—a vital aspect of the life and health insurance safety net. In some cases, it would be difficult for people whose company has failed to find comparable coverage elsewhere. When a failure does occur, guaranty associations often place the policies of an insolvent insurer (including the policies of those who might otherwise be uninsurable) with a financially sound insurer. In other cases, guaranty associations simply provide covered benefits directly.

The guaranty system safety net has evolved over the years as associations have become more experienced in meeting the needs of policyholders of failed insurers. One major step in this evolution was the creation of the National Organization of Life & Health Insurance Guaranty Associations (NOLHGA) in 1983. NOLHGA was created to help the state guaranty associations deal efficiently with the large-scale challenges presented by national insurance company failures, which affect policyholders in many states.

In short, the guaranty system safety net has grown stronger through the years, and it stands ready to protect policyholders if their company fails.

*Guaranty associations play a vital role in keeping  
the promises made by the insurance industry—  
even when a company goes out of business.*

## A Foundation of Protection

Each of the 50 states, along with the District of Columbia and Puerto Rico, has a life and health insurance guaranty association to protect residents if an insurance company fails. Each state's guaranty association law is based on a version of the National Association of Insurance Commissioners (NAIC) Life and Health Insurance Guaranty Association Model Act (which has been updated several times since its creation in 1971), and every state offers nearly the same foundation of coverage to its residents for each insolvency:

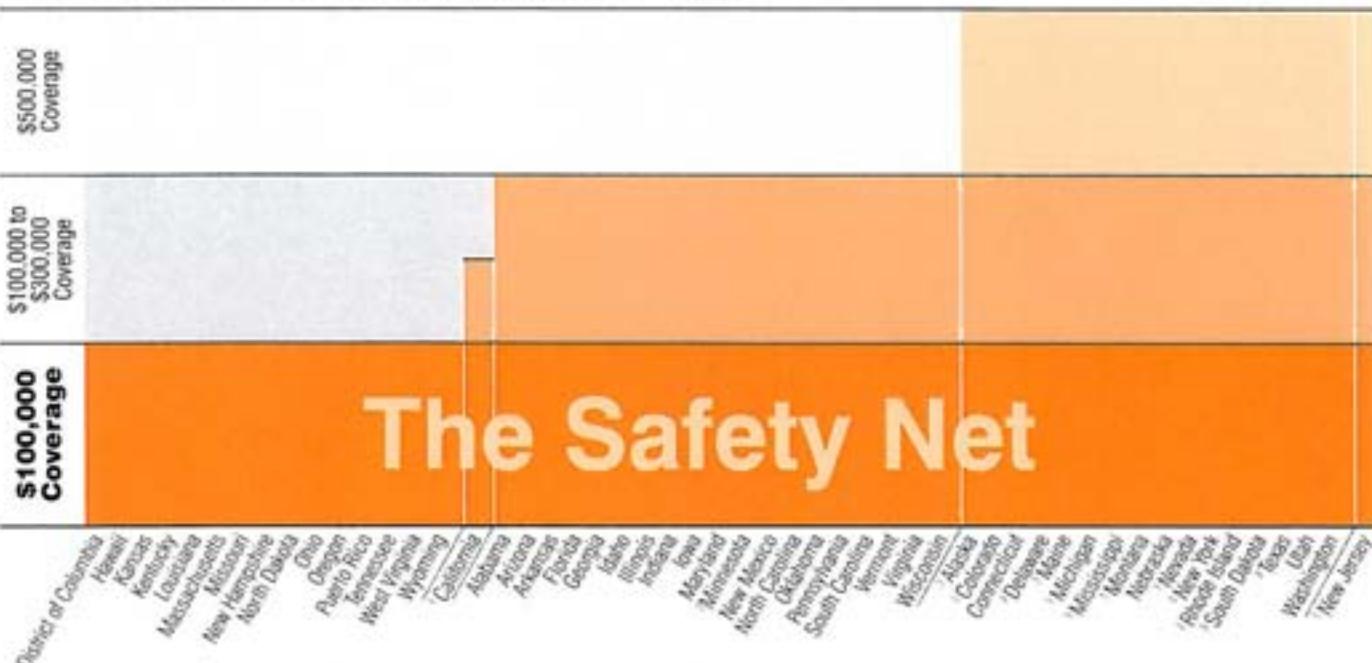
- \$100,000 in health insurance benefits
- \$300,000 in life insurance death benefits
- \$100,000 in net cash surrender and net cash withdrawal values for life insurance
- \$100,000 in present value of fixed annuity benefits, including net cash surrender and net cash withdrawal values
- A limit of \$300,000 in the aggregate with respect to any one life (unless a state's guaranty association benefit limits exceed this amount)

As the following charts illustrate, several states have elected to provide their residents with benefit protection levels higher than those mentioned above. No matter where they live, policyholders throughout the United States can look to their guaranty associations to provide a nationwide safety net of protection should their insurance company fail.

## HEALTH INSURANCE

All state guaranty associations offer resident policyholders up to \$100,000 in benefit protection for health insurance (long-term-care insurance is typically considered health insurance for guaranty coverage purposes). More than half provide even more protection to their policyholders.

### Policyholder Protection: Health Insurance Benefits



1. Health insurance benefits are adjusted from the \$200,000 level based on changes in the health-care cost component of the Consumer Price Index from January 1, 1991, to the date of the insurer's insolvency.

2. Benefit levels in Minnesota may increase annually pursuant to a statutory provision for an inflation adjustment to benefits in accordance with a U.S. Department of Commerce index.

3. These states provide up to \$500,000 for basic hospital, medical, and surgical insurance or major medical insurance; \$300,000 in disability coverage; and \$100,000 for health benefits not defined as disability insurance or medical insurance (with the exception of Maine, which provides \$300,000 instead of \$100,000 for supplemental health coverage, and Texas, which provides \$200,000 instead of \$100,000 for supplemental health coverage).

4. Coverage is provided only for health insurance issued by a life insurance company. The \$500,000 benefit limit applies to individual health policies; group or blanket health insurance is covered up to the limits stated in the policy.

5. New Jersey covers health insurance policies up to the limits stated in the policies. Coverage does not include HMO policies.

## LIFE INSURANCE

All state guaranty associations, with the exception of California (see the charts below), offer resident policyholders up to \$300,000 for life insurance death benefits and \$100,000 for net cash surrender and net cash withdrawal values. Some states provide hundreds of thousands of dollars more protection to their policyholders.

### Policyholder Protection: Life Insurance Death Benefits



1. California covers 80% of death benefits up to \$250,000.

2. Benefit levels in Minnesota may increase annually pursuant to a statutory provision for an inflation adjustment to benefits in accordance with a U.S. Department of Commerce index.

3. In Utah, the \$500,000 limit applies if death occurs before the guaranty association is triggered. If death occurs after triggering, the benefit is limited to the covered portion of the policy as defined by statutory reference to the covered cash value (see below).

### Policyholder Protection: Life Insurance Net Cash Surrender & Net Cash Withdrawal Values



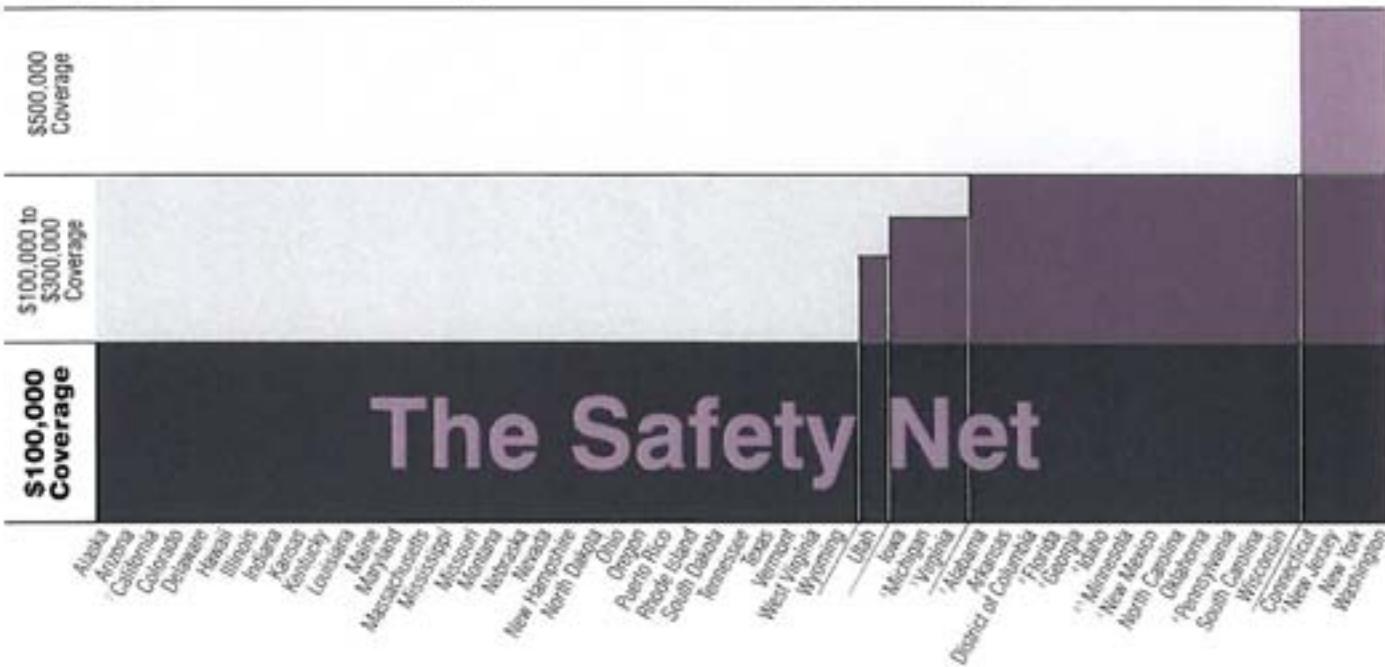
4. California covers 80% of the cash surrender value with a \$100,000 benefit limit.

5. Benefit levels in Minnesota may increase annually pursuant to a statutory provision for an inflation adjustment to benefits in accordance with a U.S. Department of Commerce index.

## ANNUITIES

All state guaranty associations offer resident policyholders up to \$100,000 in benefit protection for fixed annuities<sup>1</sup>, regardless of whether the annuities are in deferred or payout status at the time of insolvency. A number of states provide even greater protection.

### Policyholder Protection: Annuity Benefits



1. In general, protection is provided for contracts or certificates, or portions thereof, issued to individuals, which are guaranteed by the insurer and under which the policyholder has not agreed to bear investment risks such as stock market or interest rate fluctuations.
2. California covers 80% of the annuity contract value with a \$100,000 benefit limit.
3. In these states, the \$250,000 benefit limit applies for certain retirement annuities. Other annuities are covered at a \$100,000 benefit level.
4. In these states, the \$300,000 or \$500,000 benefit limit applies if the annuity is in payout status. If the annuity is deferred, a \$100,000 cash value limit applies.
5. Benefit levels in Minnesota may increase annually pursuant to a statutory provision for an inflation adjustment to benefits in accordance with a U.S. Department of Commerce index.

### Peace of Mind

Across the country, residents of every state can count on a proven and reliable safety net that is ready to provide protection for both local and national insolvencies. In the face of an insolvency that affects policyholders in many states, one of the guaranty system's greatest strengths becomes evident—the seamless cooperation of state guaranty associations working together to provide protection to resident policyholders. States can and do offer additional levels of protection to their residents, but the underlying foundation of coverage remains strong and extends nationwide.

The life and health insurance guaranty association system—the nation's safety net—has been tested over the years and remains in place, ready to provide coverage when otherwise there would be none and to provide peace of mind when otherwise there would be doubt.

*NOTE: The information and charts provided in this report are general in nature and are based on information available as of November 2008. They are not intended as legal advice, and no liability is assumed in connection with their use. For specific coverage provisions, consult the applicable state guaranty association statutes.*

# Protecting Policyholders

America's life and health insurance policyholders have a powerful friend—one whose presence is felt only in times of trouble. When their insurer fails, policyholders are protected by their state's guaranty association. Each association serves as a safety net, ensuring that residents continue to receive insurance coverage without interruption.

Sometimes, policyholders in many states are affected by the failure of a single insurance company. When this occurs, the state guaranty associations work together to form what amounts to a nationwide safety net, providing protection to policyholders across the country. Even in the face of a multi-state insolvency, the guaranty association system stands ready—the safety net is in place.

The core protections offered by this safety net are similar no matter where policyholders live. Some states offer additional benefit levels to their residents, but the foundation of coverage provided by the guaranty association system stretches across the nation.

Although life and health insurance company insolvencies have declined in recent years, the protections offered by state guaranty associations are as important as ever. No one can be sure when the next insolvency will occur. When it does, the guaranty system safety net will do what it has done so well for years—protect policyholders in their time of need.

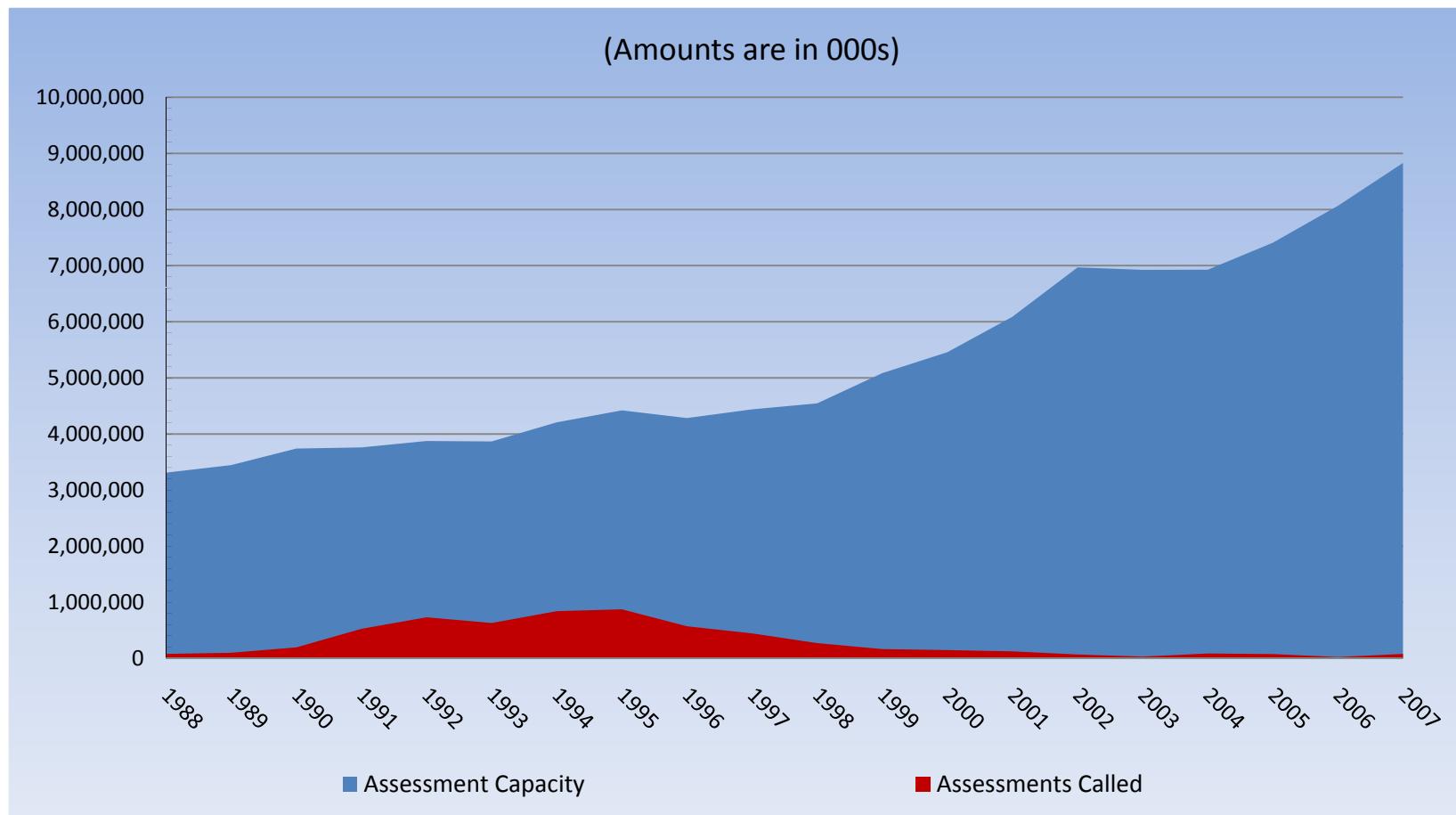


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# Total Assessment Capacity

Life and Health Insurance Guaranty System  
1988 - 2007



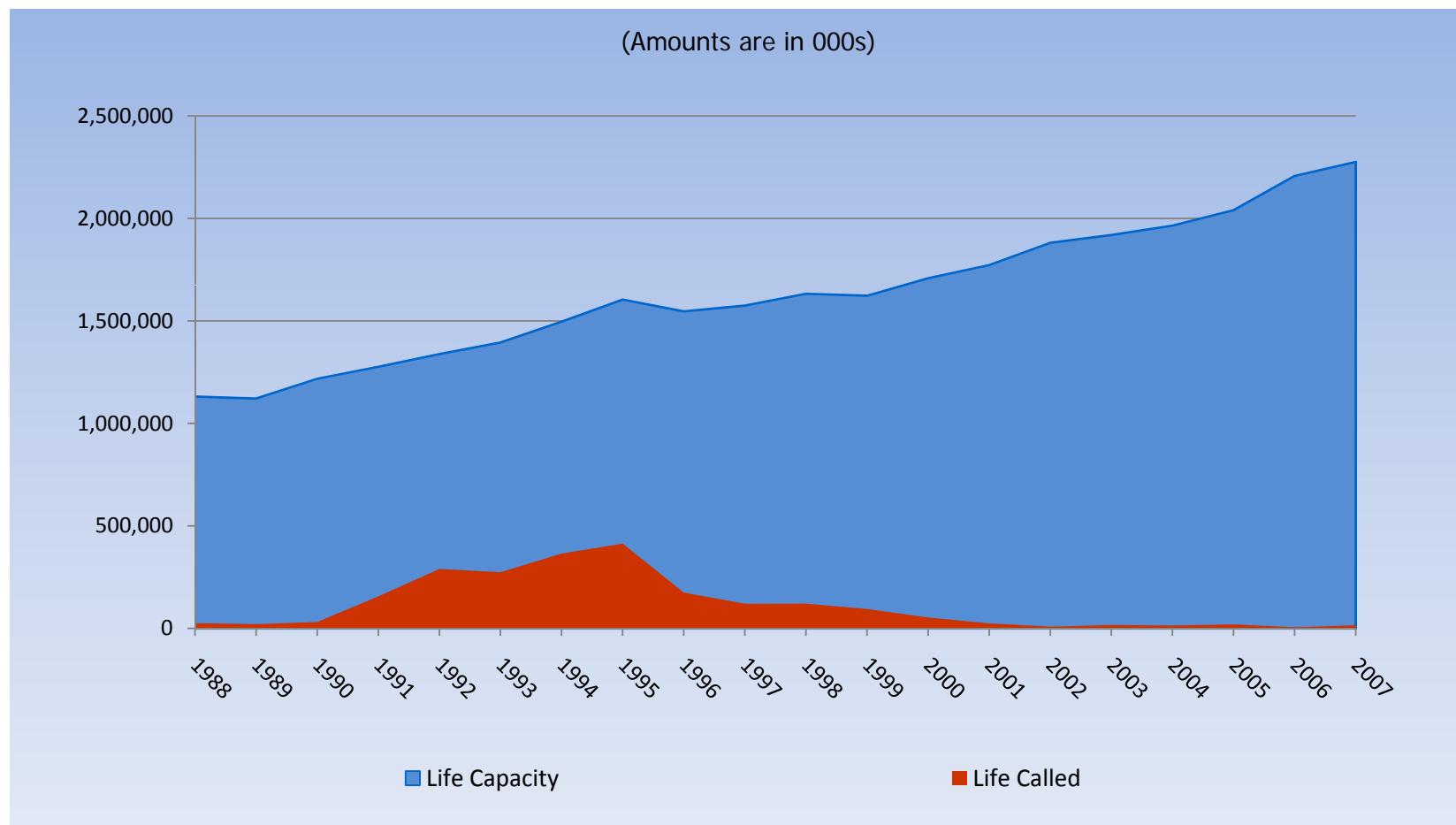
Assessments Called are the amounts actually billed to member companies that were necessary to carry out the obligations of guaranty associations with respect to impairments or insolvencies of a member insurer (i.e. Class B assessments). The amounts do NOT include administrative assessments (i.e. Class A assessments). All figures shown are for the period 1988 through 2007.

Exhibit 3A



# Life Account Assessment Capacity

Life and Health Insurance Guaranty System  
1988 - 2007



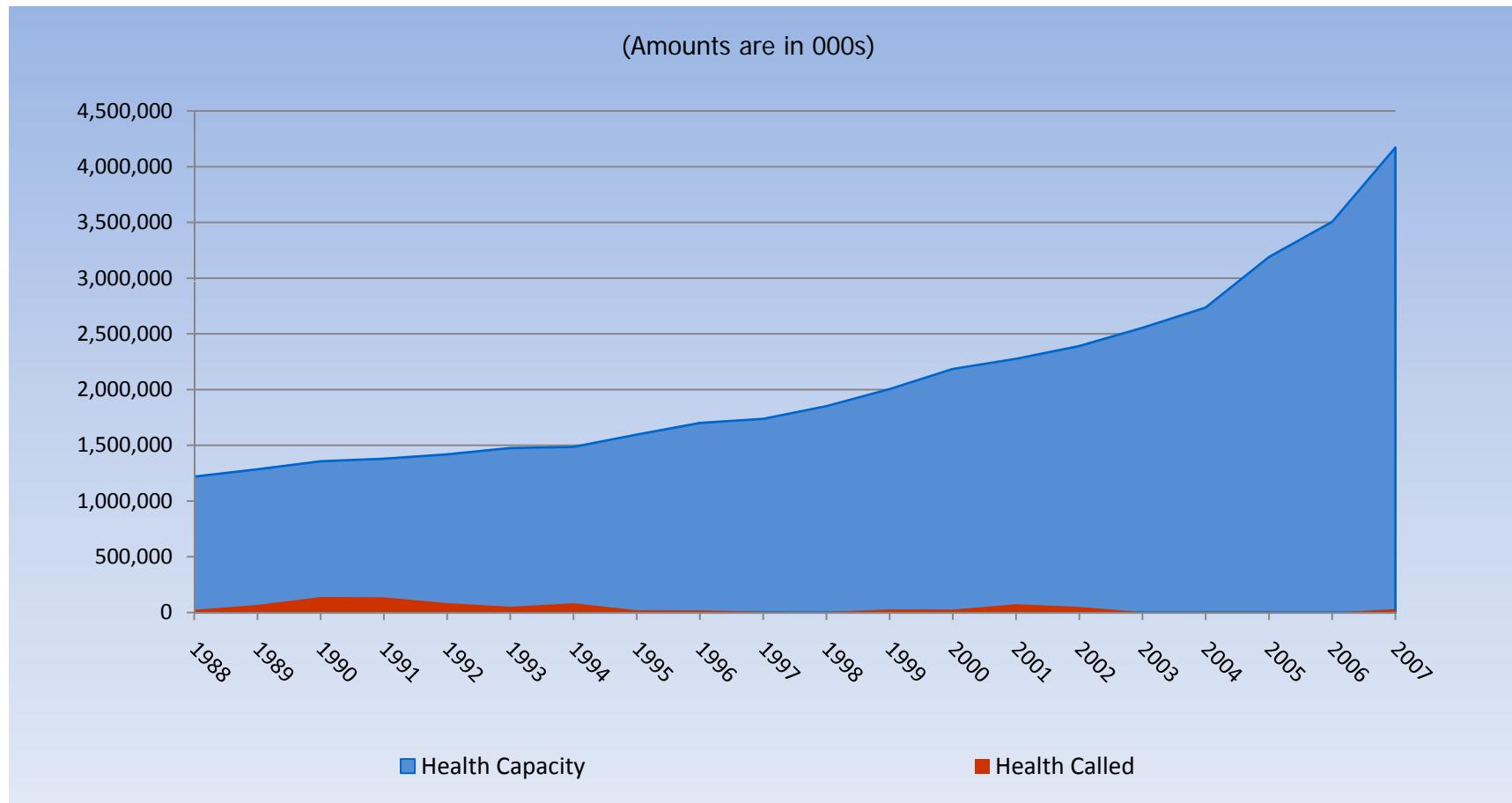
Assessments Called are the amounts actually billed to member companies that were necessary to carry out the obligations of guaranty associations with respect to impairments or insolvencies of a member insurer (i.e. Class B assessments). The amounts do NOT include administrative assessments (i.e. Class A assessments). All figures shown are for the period 1988 through 2007.

Exhibit 3B



# Health Account Assessment Capacity

Life and Health Insurance Guaranty System  
1988 - 2007



Assessments Called are the amounts actually billed to member companies that were necessary to carry out the obligations of guaranty associations with respect to impairments or insolvencies of a member insurer (i.e. Class B assessments). The amounts do NOT include administrative assessments (i.e. Class A assessments). All figures shown are for the period 1988 through 2007.

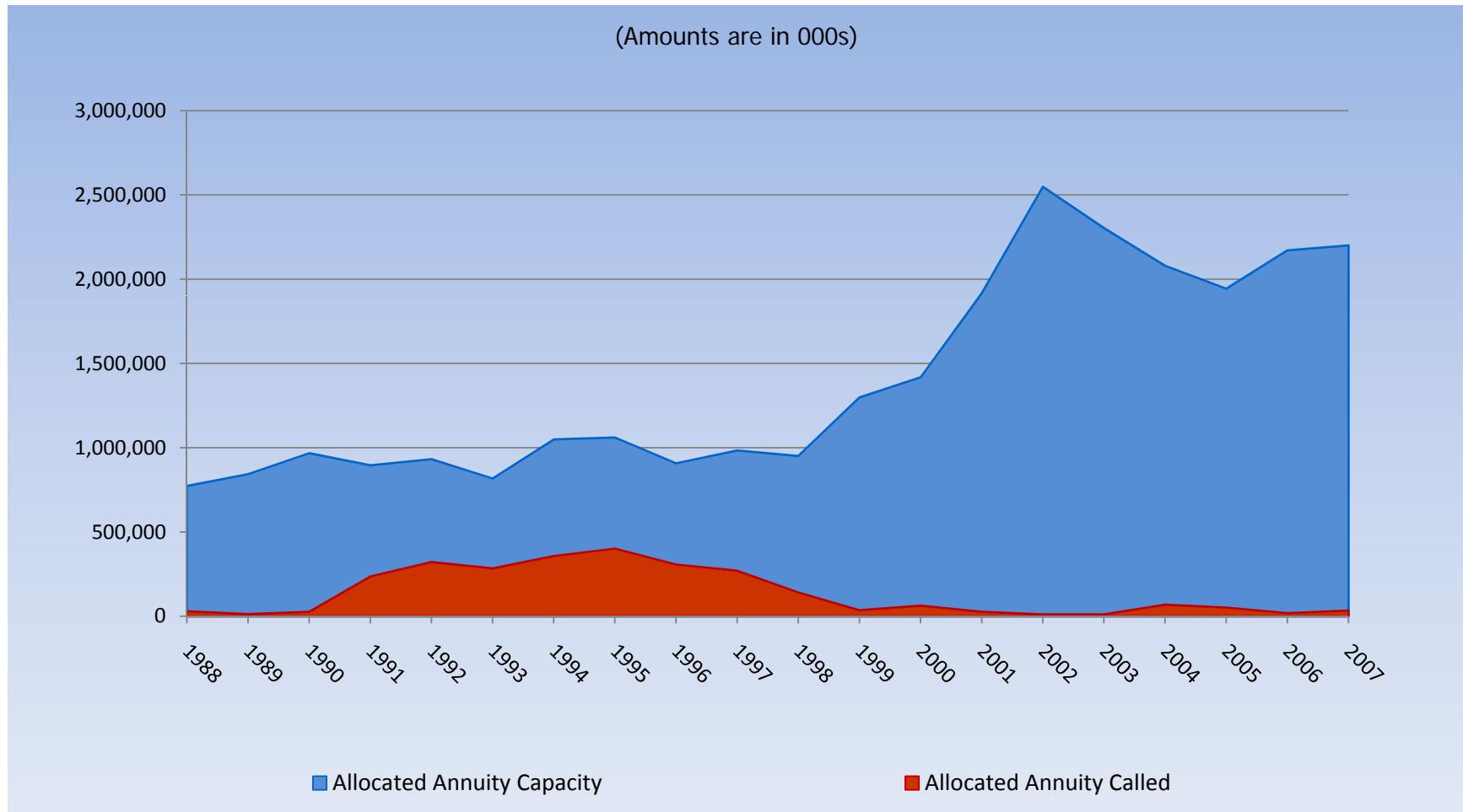
Exhibit 3C



# Allocated Annuities Assessment Capacity

## Life and Health Insurance Guaranty System

1988 – 2007



Assessments Called are the amounts actually billed to member companies that were necessary to carry out the obligations of guaranty associations with respect to impairments or insolvencies of a member insurer (i.e. Class B assessments). The amounts do NOT include administrative assessments (i.e. Class A assessments). All figures shown are for the period 1988 through 2007.

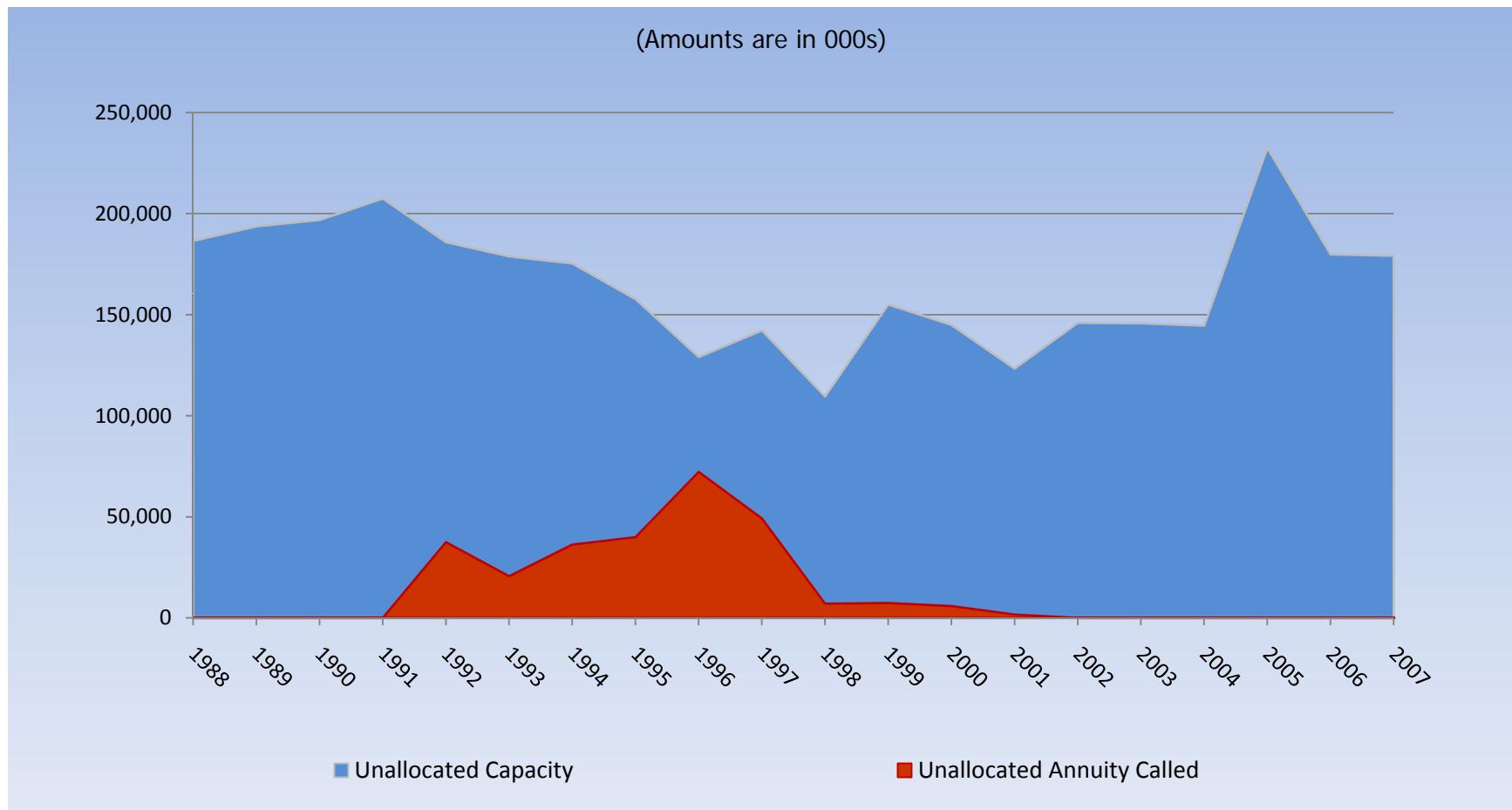
Exhibit 3D



# Unallocated Annuities Assessment Capacity

## Life and Health Insurance Guaranty System

1988 – 2007



Assessments Called are the amounts actually billed to member companies that were necessary to carry out the obligations of guaranty associations with respect to impairments or insolvencies of a member insurer (i.e. Class B assessments). The amounts do NOT include administrative assessments (i.e. Class A assessments). All figures shown are for the period 1988 through 2007.

Exhibit 3E



# Guaranty System

Next 10 Years @ 100% of 2007 Capacity

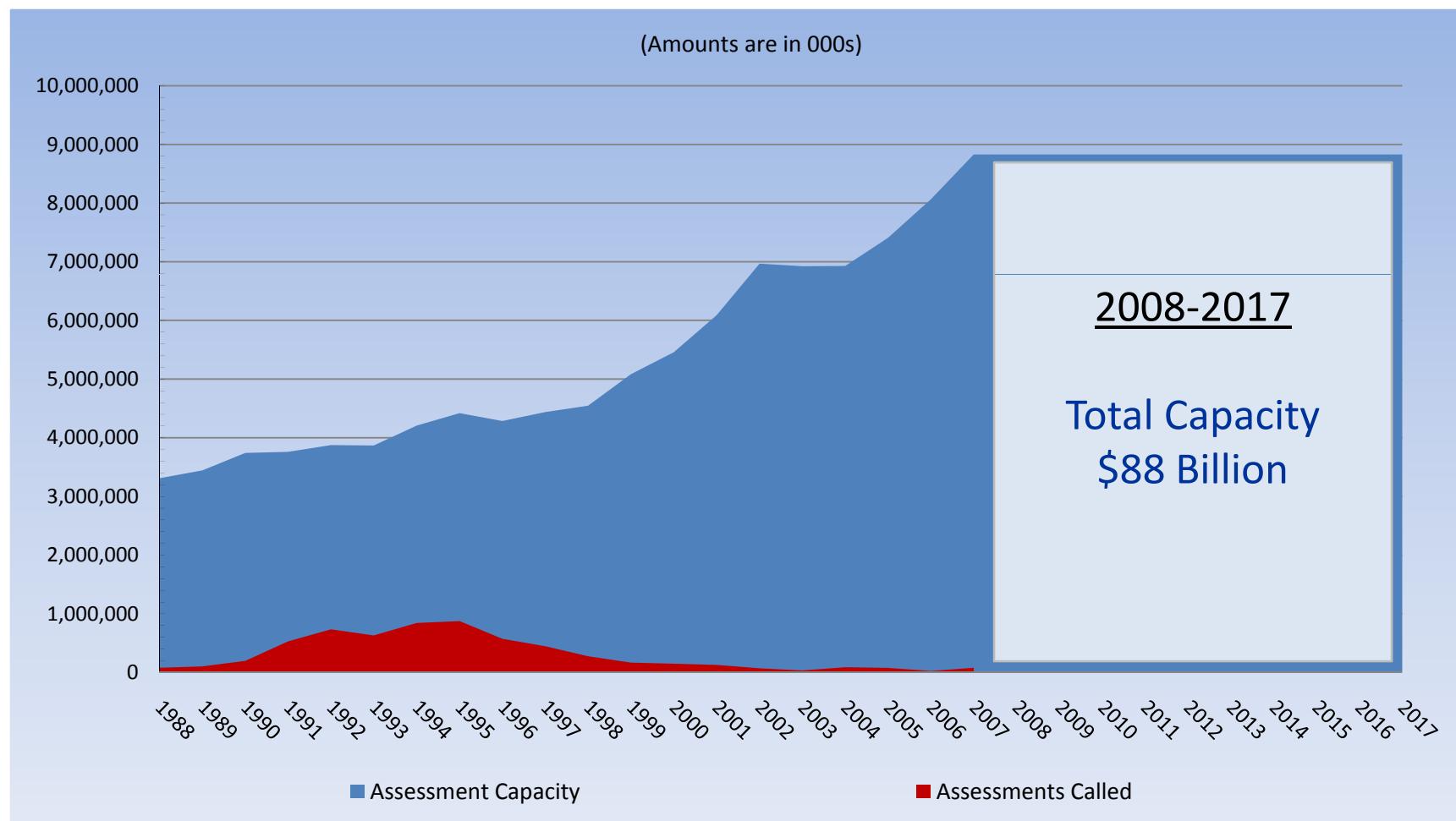


Exhibit 4A



# Guaranty System

Next 10 Years at 80% of 2007 Capacity

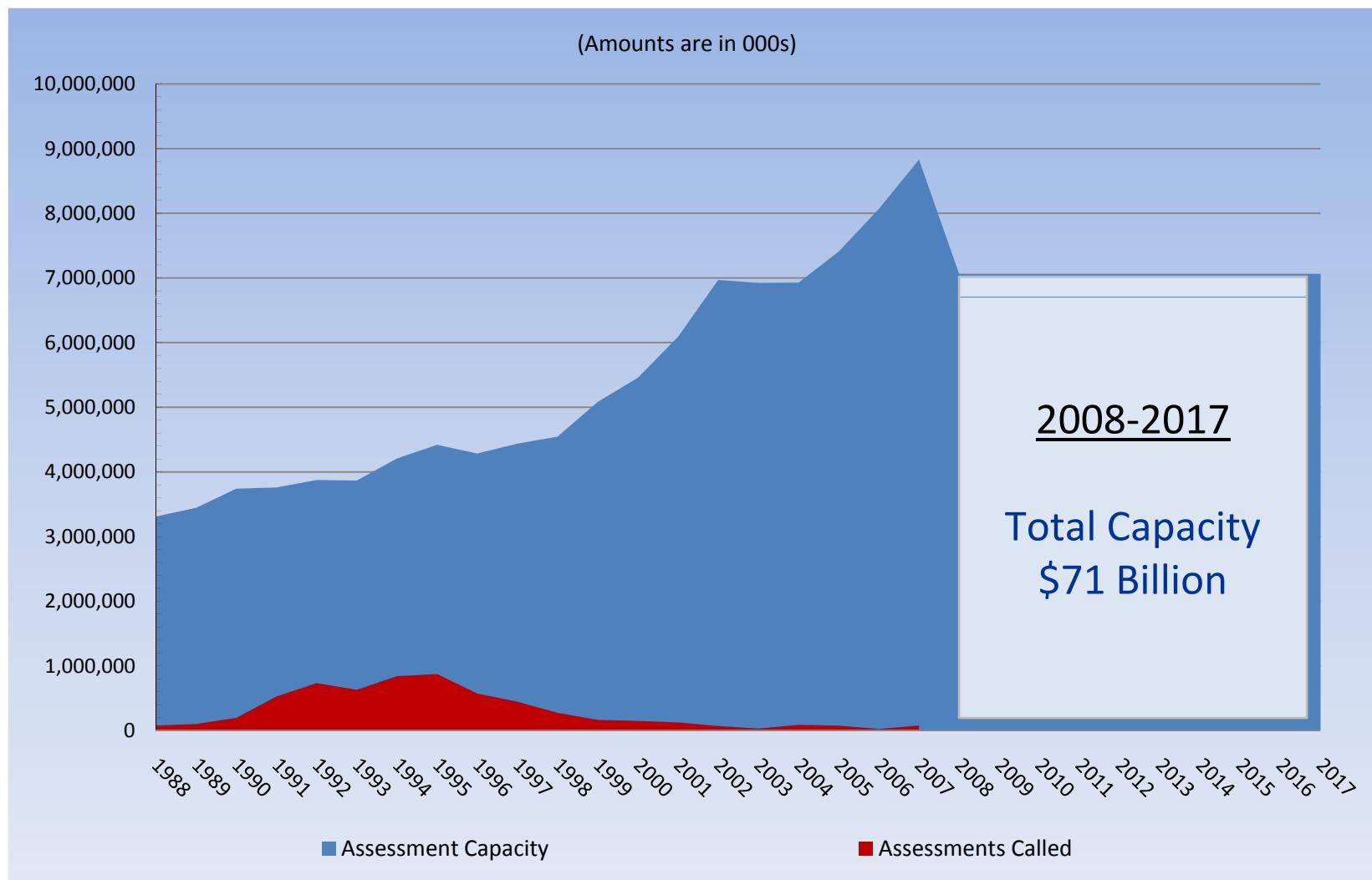


Exhibit 4B



# Life and Allocated Annuity Accounts Capacity

Next 10 Years @ 100% of 2007 Level

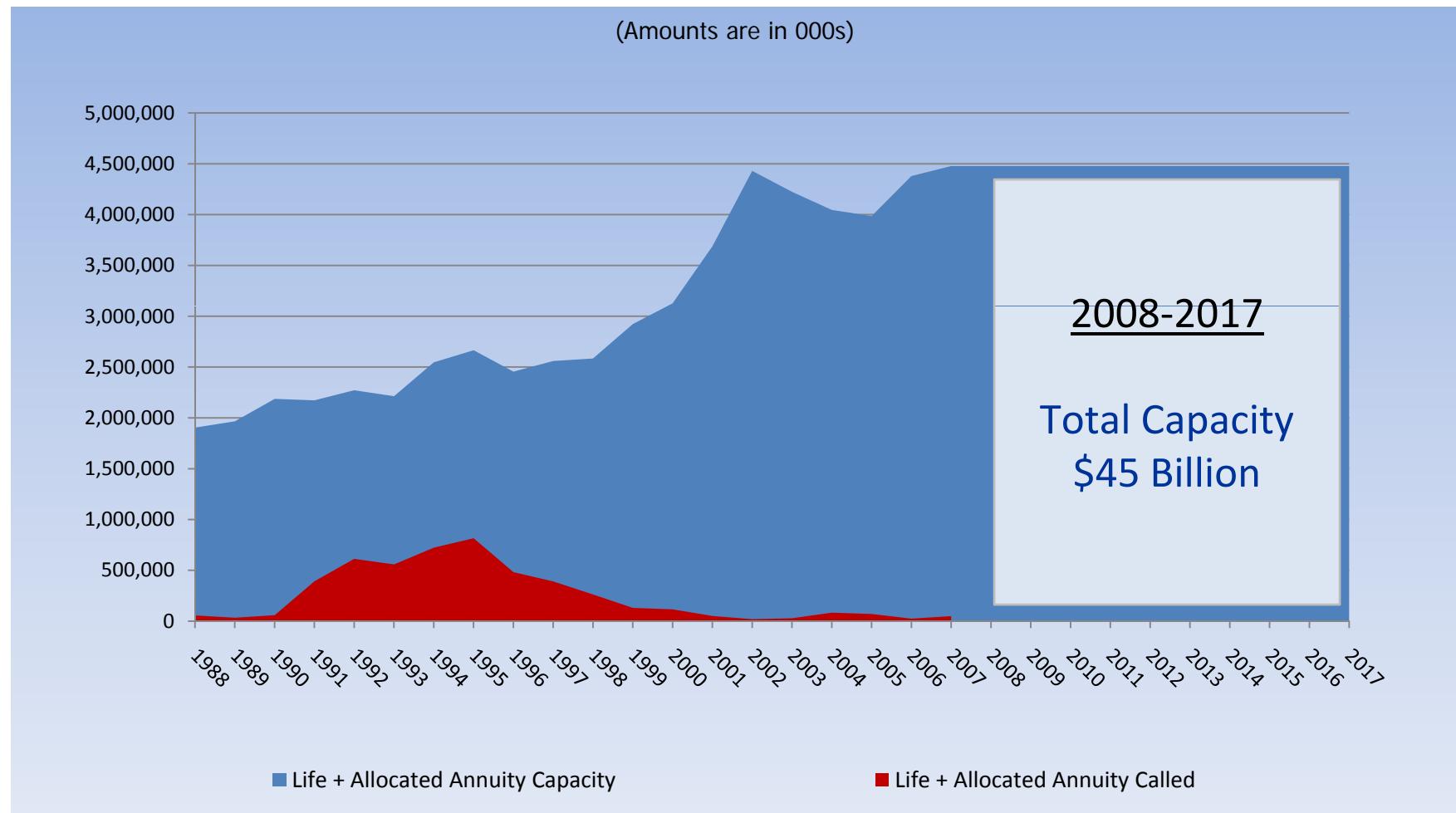


Exhibit 4C



# Life and Allocated Annuity Accounts Capacity

Next 10 Years @ 80% of 2007 Level

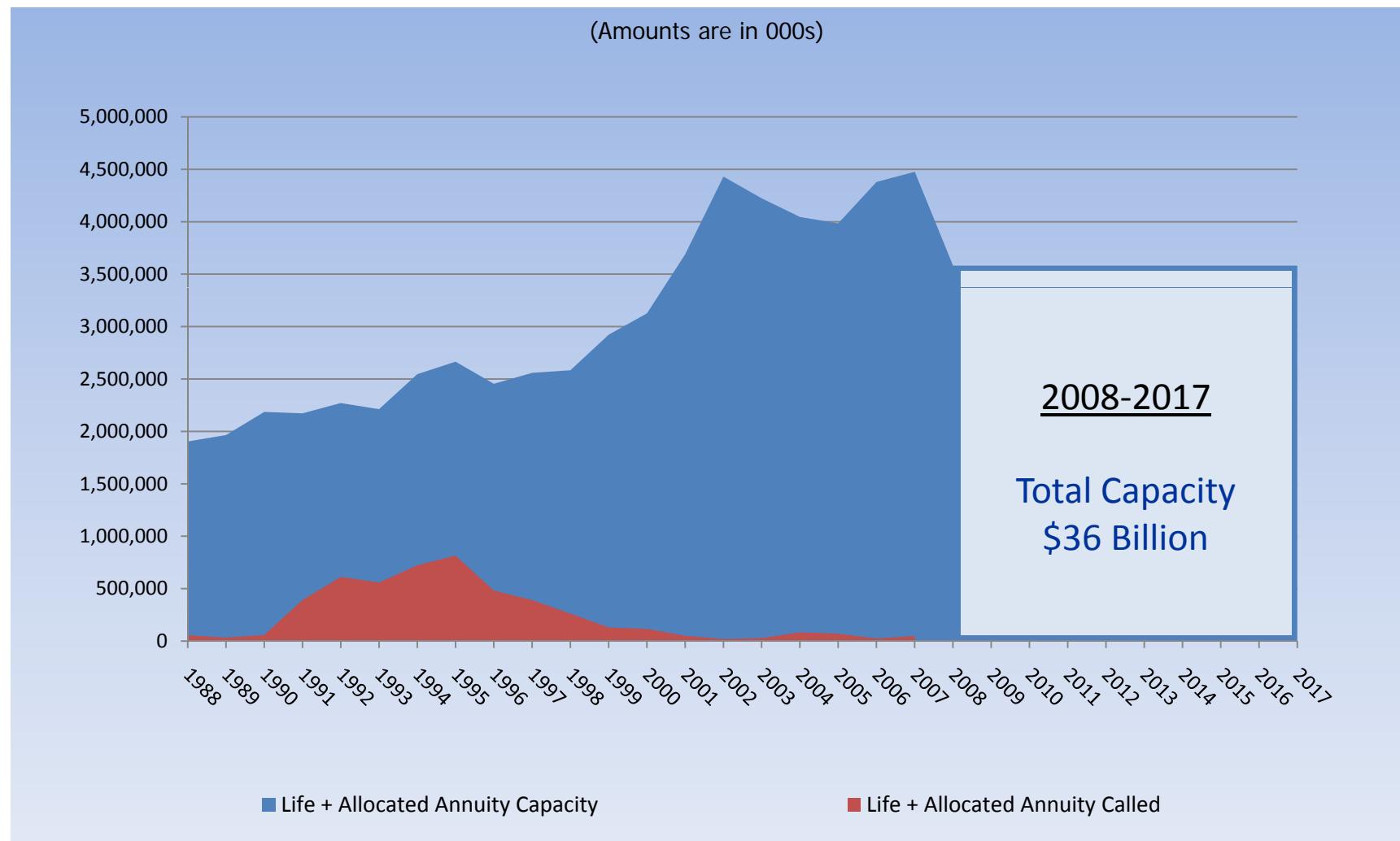


Exhibit 4D

