AMERICAN FRATERNAL ALLIANCE CEO Forum

Alliance Initiative to Improve State Solvency Regulation

Dear Alliance Member Society CEOs:

I wanted to update you on the Alliance's initiative to improve existing state regulation governing fraternal solvency, receivership and liquidation procedures. This effort to update state solvency regulation is one of the Alliance's highest priorities in 2018. I encourage you to carefully review the following information and contact me with any questions, comments, or concerns you may have about this issue.

Fraternal solvency regulation a core concern for the Alliance

Fraternal solvency has always been a "hot button issue" for the Alliance, its members, and the regulators responsible for financial oversight of the insurers in their states. There are two key factors at the heart of the solvency debate: 1) whether to allow fraternals complete autonomy when it comes to maintaining a society's solvency or whether to provide state regulators sufficient authority to intervene in the operations of a financially impaired society and protect the financial interests of its members; and 2) how to effectively update state fraternal codes to assure the needed clarity for regulators when we know that uncertainty and delay will ultimately damage the financial interests of member certificate holders and the fraternal system itself.

From the perspective of state regulators, the issue is further complicated by fraternals' long-standing exemption from participation in state guaranty funds. While state guaranty funds don't "guarantee" that policyholders will receive their full policy benefits in the event of a commercial insurer insolvency, the lack of this "safety net" creates heartburn for some regulators, whose primary responsibility is protecting consumers' financial interests and who deal with fraternal insolvencies much less frequently than commercial insurer failures.

The fact of the matter is that while fraternals offer products that are like those of commercial insurance companies, we are fundamentally different types of organizations. Fraternals are not-for-profit membership organizations with a purpose that extends beyond the financial services products they offer and includes charitable, benevolent, educational, faith-based, patriotic, and social missions. Further, we are organized differently, with local chapter systems and representative forms of governance.

History lesson

From their inception more than a century ago, fraternals have had their own *national* solvency mechanism – maintenance of solvency or assessment – that is required under all state laws and is included in our societies' bylaws and insurance contracts with members. On the other hand, guaranty funds are organized and operated on a *state-by-state* basis. An individual state's guaranty fund law can't override the fraternals' national solvency mechanism.

Thus, fraternals were excluded from state guaranty fund participation when these funds were created in the 1970s. Even if we were to agree that including fraternals in state guaranty funds is warranted – which we do not – including fraternals in such funds today is both practically and politically impossible. It would require the repeal of all state laws mandating our maintenance of solvency provision **AND** agreement from commercial insurers that fraternals should be included in these state funds. In addition, creating a fraternal-only guaranty fund is not feasible given the current structure of the fraternal market.

This means it is up to the fraternal community to assure that we protect the members we serve

Nonetheless, these legal and practical obstacles to guaranty fund participation do not diminish the concern of regulators for better solvency protection for fraternal certificate holders, or lessen the need to improve the fraternal regulatory system and avoid the potential for legislative and regulatory measures that pose existential threats to the entire fraternal community.

As we have seen in New York, Ohio, and Illinois in just the past decade, financially impaired fraternals can trigger punitive regulatory measures that force the Alliance and financially healthy societies to negotiate from a defensive position. These situations are often exacerbated because the financially troubled society refuses to modernize the organization's governance structure or to consider a merger before the society becomes insolvent and its appeal to potential suitors is damaged beyond repair.

The questions that the Alliance and the fraternal sector must address are a) whether it is more important to protect the financial interests of members of a struggling society or to protect the existence of the society itself; and b) whether to develop a proactive solution to the problem that can be put in place before the next fraternal failure.

The reasons for proactively advocating for improvements to solvency regulation

The Alliance's Policy Development Task Force identified the reasons that improvements to state solvency regulation were needed and developed the building blocks of the amendments we would like state regulators to consider.

The reasons to consider fraternal solvency modernization are:

- In a business environment that requires significant capital to invest in product development, distribution, IT platforms, and regulatory compliance, it is increasingly difficult for struggling fraternals to recover from financial impairments. Moreover, there are few, if any, sources of capital available to fraternals other than member assessments.

- Rescues by healthy fraternals are more difficult and less likely than in the past. Consolidation within the fraternal sector means that there are simply fewer societies with the capacity to acquire struggling fraternals. Stronger societies are less willing to bear the financial cost of such acquisitions because it is not fair to their members and, equally important, they do not want to be perceived as being the "safety net" for failing fraternals. This makes it more likely that regulators will have to work out solutions or liquidate financially troubled fraternals.

- The one fraternal insolvency and subsequent liquidation that has occurred within the last decade – ACA Assurance – demonstrated significant flaws with the application of its home state's solvency, receivership and liquidation laws; laws that are similar to those in other jurisdictions. The process was incredibly and unnecessarily expensive and the costs were borne entirely by the fraternal, resulting in members having the values of their certificates permanently reduced.

- Finally, fallout from another failure – and it is almost inevitable that another society will suffer irreparable financial damage sometime in the near future – could have a significant impact on the entire system. Rather than reacting to a crisis we know will occur, or be forced to accept a solution designed by regulators, it makes more sense to develop our own "fix" and proactively implement it in those states with a significant number of domiciled societies.

The cornerstones of our proposed amendments to state solvency regulation

Based on these reasons, the Alliance developed the following concepts for its proposal to improve state solvency regulation:

- Early regulatory intervention with an authorized control level RBC ratio as the trigger point.

- Requirement for fraternals to notify regulators prior to assessing members and an ability for regulators to disapprove such an assessment if it is not in the best interests of members.

- Streamlined process for voluntary workout prior to liquidation that includes:
    - A plan for voluntary transfer of certificates to another fraternal or to a commercial insurer
    - An approval process for a transfer when the fraternal has crossed into significant financial impairment that permits decisions on mergers or transfers be made by a majority vote of the fraternal's board rather than a 2/3 vote of the supreme governing body (convention)
    - Ability of regulators to issue a limited certificate authority for the acquiring organization if it is not licensed in the state
    - Ability to suspend certain membership requirements to facilitate transfer to the acquiring society before further losses are incurred

- Streamlined liquidation process to help minimize costs to members and reduce the potential reduction in the certificate benefits due to a member assessment.

The Alliance's Policy Position

In September 2017, the Alliance Board engaged in a thorough debate on this issue and adopted a policy position that:

- Approved the conceptual outline for improvements to state solvency, receivership, and liquidation regulations

- Authorized staff to meet individually or collectively with regulators from Wisconsin, Minnesota, Ohio, Illinois, and Texas to discuss their interest in modernizing solvency regulation in their states.

- Authorized staff to pursue advocacy initiatives that would result in the introduction and potential enactment of regulatory and legislative measures to modernize solvency oversight in those states, if such measures were supported by state regulators.

- Precluded staff from pursuing such regulatory reforms on a national basis or through the NAIC model law process.

Alliance Action and Results to Date

Beginning in November 2018, Alliance staff reached out to regulators in each of the five states to determine their interest in discussing amendments to fraternal solvency regulation in their states. It is important to note that because each state's solvency statutes are different, the Alliance's concepts need to be crafted to work specifically for each state. In fact, several components of the Alliance's conceptual proposal are already in force in some states because of regulators' reaction to previous financial impairments. To date, we have made the most progress with regulators from Minnesota and Wisconsin. The following is a summary of the developments on this issue in each state:

Minnesota – After securing support for the proposal from the Alliance's two Minnesota-domiciled members (Catholic United Financial and Sons of Norway), Alliance staff, retained legal counsel, member society executives, and the executive director of the state life insurance company trade group have met several times via teleconference and in-person with officials from the Department of Commerce (DOC) to develop legislative language for a state-specific measure. The DOC expressed support for the proposal, but the Alliance still must address regulators' concerns about technical aspects of the measure before gaining their full endorsement.

To meet legislative deadlines for passage of bills in the 2018 session, the Alliance introduced its proposals in both the House and Senate in mid-March. Recognizing that the regulators will require further refinement, both bills were approved by their respective legislative committees late last month to meet deadlines and now await further legislative action in each chamber. During the next few weeks the Alliance will work with DOC officials to work out final language for the measure before the bills are taken up by the House and Senate. We hope to have the bill passed and signed into law this legislative session. If successful, we expect regulators in other key fraternal states will be more inclined to support similar measures in 2019.

Wisconsin – The Alliance went through a very similar process with officials from the Wisconsin Office of the Commissioner of Insurance. After securing support for the measure from the Alliance's four domiciled member societies, Alliance staff, retained counsel, and member society executives met with regulators to discuss the measure and to develop state-specific language for introduction in the Wisconsin legislature. State regulators expressed strong support for the measure, but preferred to postpone introduction until the 2019 legislative session. In large part, this was due to the very short 2018 legislative session in Wisconsin and the Department's desire to get its number one priority – enactment of a Corporate Governance Disclosure bill – in place this year. The Alliance is confident that we will be able to both introduce and enact our proposed solvency bill in 2019.

Texas – The Texas legislature is not in session in 2018, but Alliance staff and retained local counsel met with Texas regulators on Monday, March 19, to discuss the conceptual components of our proposal. The Texas Department, which is in the midst of dealing with a fraternal insolvency, is very supportive of the concept and requested that the Alliance provide a draft of a Texas-specific measure for their consideration. We will send them a draft proposal in the coming weeks, while at the same time reaching out to our five domiciled members in the state to brief them on the initiative and discuss a possible introduction of a solvency bill in 2019.

Ohio – The Ohio Department is awaiting draft legislative language from the Alliance's retained counsel. We hope to have that to them by mid-April, but do not anticipate any legislative action in 2018 because of the upcoming gubernatorial election which could result in leadership changes at the Department.

Illinois – We are awaiting feedback from state regulators on draft legislative language submitted to them earlier this month. We do not anticipate any legislative action in 2018 because of the upcoming gubernatorial election which could result in leadership changes at the Department.

And then there was six…Pennsylvania added to the discussion at the NAIC meeting

On Sunday, March 25, the Alliance invited regulators from the five states authorized by the Board (Minnesota, Wisconsin, Illinois, Ohio, and Texas) to a meeting to discuss the status of our proposal to amend solvency, receivership, and liquidation regulations in these states.

During the NAIC meeting, Minnesota regulators discussed the issue with regulators from Pennsylvania, who told the Minnesota regulators that they were unaware of our proposal, but that they were interested in the concept. Pennsylvania regulators then spoke with Alliance staff and asked if they could attend the Alliance's meeting on the topic. We encouraged them to participate in the meeting.

In addition to Alliance staff, retained counsel, and the executive director of the Minnesota state life insurance trade group, representatives from Thrivent, Modern Woodmen of America, WoodmenLife, and Royal Neighbors attended the session, along with regulators from Minnesota, Wisconsin, Texas, and Pennsylvania. Regulators from Illinois and Ohio were unable to participate. Minnesota state Rep. Joe Hoppe, the sponsor of the House version of the Alliance's legislation, also attended the meeting.

The meeting was very productive, with regulators having the opportunity to ask questions about not only the overarching objectives of the measure with Alliance staff, but also the state-specific technicalities of the proposal with the Alliance's legal and legislative experts. All regulators voiced support for the concepts of the measure, and regulators from Texas and Pennsylvania indicated that they would like to see proposed legislative language for their states for consideration in the 2019 legislative sessions.

As, a result of the meeting, the Alliance will be drafting a Pennsylvania-specific version of our proposal for consideration by state regulators later this year. Prior to that, however, Alliance staff will be meeting with Pennsylvania-domiciled fraternals at their Annual Legislative Day on April 17 in Harrisburg, PA, and at a Fraternal Societies of Greater Pittsburgh seminar on May 17 in Pittsburgh to brief them on the initiative and to discuss a possible legislative introduction in 2019.

Your comments encouraged and welcomed

I welcome your comments and questions about this unprecedented advocacy initiative. I understand that some members may view this as an unwarranted and unwelcome expansion of regulatory authority. That viewpoint was expressed by several Alliance Board members and addressed in conjunction with the Board's September 2017 discussion that resulted in its adoption of a public policy position in support of modernized solvency regulation.

The question that the Board had to answer was "What are the risks of not taking action on this issue?" The Board decided that the consequences of inaction far outweighed the potential risks of expanded solvency oversight by regulators. Moreover, the Board decided that once a fraternal has reached the point of failure where it cannot continue as a viable insurer and member assets are at serious risk, the paramount consideration must be protecting those assets and those members – not preserving the fraternal itself. A definitive process that is understood by all parties is the most effective way to accomplish this important objective.

Please let me know what you think by emailing me at jannotti@fraternalalliance.org.

AMERICAN FRATERNAL ALLIANCE

Joseph J. Annotti
President and CEO
American Fraternal Alliance
1301 W. 22nd Street, Suite 700
Oak Brook, IL 60523
P: 630.522.6322, x117
F: 630.522.6326
C: 847.525.7792
jannotti@FraternalAlliance.org
www.FraternalAlliance.org