Testimony of James W. Schacht
on behalf of Certain Cigna Policyholders,
American International Group,
St. Paul Fire Marine Insurance Group,
Chubb Insurance Group,
Royal Insurance Group and the
Fireman's Fund Insurance Group

Hearing on INA Financial Corporations
Recapitalization Plan
Pennsylvania Insurance Department
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Insurance Company of North America ("INA") is the oldest capital stock insurance company in the United States having commenced business in 1792. Most historians of insurance regulation believe that adoption of the corporate form for insurance companies, as INA was the first to do, was a crucial stimulant for insurance regulation because of the perceived potential conflict between owners and policyholders that was not present with the mutual company form. The evils suspected to exist with the corporate form some 200 years ago are present today in the proposed restructuring of the CIGNA Property and Casualty Group, a transaction which raises very serious public policy concerns, as I discuss in this testimony. The irony of this situation is amazing but even more disturbing.

The reason financial institutions are regulated is because financial transactions involve a promise of future performance sold for present dollars. In insurance, where the promise is complex and the seller is more powerful than the buyer, the buyer is at a disadvantage. So government has stood with the buyer in helping to assure that the seller would be able to perform on the promise when it becomes due and that the

buyer's reasonable expectations as to what he bought are delivered.

For over 200 years the INA companies have delivered on these promises -- but now they propose to do otherwise. Government must step in and protect the buyers because the transaction being proposed is not in the best interest of policyholders or the public.

The Pennsylvania Insurance Department and other regulators, as well as a variety of people concerned with a healthy and reliable insurance industry, should worry about this transaction and where it may lead. The significance of the important public policy issues which the Commissioner must consider transcends the boundaries of Pennsylvania and in fact the United States. As discussed at greater length below, these public policy issues include the following:

- Whether allowing a transaction such as that proposed by CIGNA would have an improper precedential effect.
- Whether a transaction such as this would have an adverse effect in public confidence in the insurance industry and would be fair to the reasonable expectations of policyholders who have dealt with the CIGNA P&C Group in the past.
- Whether it is appropriate to allow an insurer to self-liquidate, without the safeguards to policyholders and other interested parties which are provided in a rehabilitation or liquidation proceeding declared pursuant to applicable state law.
- Whether it is appropriate to require numerous existing policyholders -- but not future policyholders, CIGNA P&C itself or its shareholders -- to bear the risk of an untested actuarial evaluation which, if it were to be

believed, would suggest that the proposed transaction would have little point as a method for dealing with solvency concerns.

Before addressing these and other points in greater detail, I would like to mention my personal background for the record.

PERSONAL HISTORY

Prior to joining Coopers & Lybrand L.L.P. in August of this year as Director of the firm's insurance and regulatory practice, I had spent my entire career in insurance regulation -- over 31 years.

After completing college in 1964 I joined the Illinois Department of Insurance as an examiner. From 1964 through 1974 I held various positions in the Financial Examination Division, including Chief Examiner in the latter years of that period. From 1974 to 1978 I was Deputy Director of the financial regulatory branch. In 1978 I became the Chief Deputy Director, a position I continuously held up to my departure in 1995. During my tenure in the Department I was appointed Acting Director of Insurance on three different occasions, from July 1982 to November 1983, from February 1992 to September 1992, and from February 1994 to July 1995. From January 1987 to my resignation in 1995 I also held the position of Special Deputy Receiver in which I was responsible for managing the office, and handling companies placed in receivership in Illinois.

For over 20 years I was active in the National Association of Insurance Commissioners ("NAIC") and served in a

leadership capacity for a substantial number of task forces and committees. I chaired the NAIC working group which was responsible for the Insurance Regulatory Information System (early warning system) for property and casualty companies. I also had a major role in developing model laws and regulations on casualty loss reserve certification, annual CPA audits, guaranty funds, holding companies receiverships and reinsurance. I also chaired the group which developed the first NAIC handbooks on statutory accounting practices and procedures.

I was responsible for the NAIC group which developed the Troubled Insurance Company Handbook, which was the first comprehensive guide for insurance departments for dealing with troubled insurance carriers. In addition, I led the group which developed and implemented the NAIC Financial Standards and Accreditation Program. Most recently, I chaired the group which developed legislation for an interstate compact for receiverships. In 1990, I received the NAIC's distinguished Robert E. Deneen Award in recognition of my contribution to insurance regulation.

I have spoken to numerous insurance industry and other groups on financial and regulatory subjects. I have authored numerous articles on insurance regulation and have served as a reviewer of insurance textbooks. In 1993 I was chosen to represent the United States as one of seven lecturers at an international seminar on reinsurance sponsored by the United Nations Conference on Trade and Development.

Based on this background and experience, I feel that I am in a proper position to offer opinions on this proposal from a regulatory viewpoint.

THE PROPOSED TRANSACTION

Though complicated in its details, the restructuring plan has two central aspects which would carry out CIGNA P&C's objective of separating its future from the past: the Plan of Division of INA, and the depooling of the CIGNA P&C Group. According to Gerald Isom, President of CIGNA Property and Casualty Division, at the present time, CIGNA P&C is operating an active business as well as sizeable book a run-off business, but these segments were "not operationally or legally distinguished," at least as of October 1994. The present plan is intended to effectuate the complete separation of these two parts of the business of CIGNA P&C. In examining this transaction, and its details, it is important to evaluate just what objective CIGNA P&C is trying to achieve, and whether that objective is fair and reasonable given CIGNA P&C's obligations and responsibilities.

THE PURPOSE OF THE TRANSACTION

The purpose of the transaction seems clear: to free the CIGNA Corporation and its operating subsidiaries from the uncertainties associated with existing mass tort and environmental claims. This is to be accomplished by isolating these claims and policies in an entity apart from the on-going operations. The assets dedicated by CIGNA for this run-off are

fixed. The end result for the CIGNA Corporation is a higher financial rating and freedom from these long tail claims.

CIGNA P&C premises this transaction upon the assertion that policyholders who will look to the run-off company had a reasonable assurance of repayment. This assertion, in turn, is based upon a purported new actuarial approach developed by Tillinghast, which assertedly would allow CIGNA P&C to estimate liabilities which only a few months ago CIGNA P&C stated in its public filings with the Securities and Exchange Commission could not be accurately estimated.

However, if this new actuarial method is as reliable as CIGNA P&C claims, the question arises why any restructuring at all is necessary: all resources to be dedicated to the run-off company -- including the $375 million capital contribution, the $125 million debt assumption, and the aggregate excess treaty that will be triggered when the run-off company has exhausted its liquid assets -- are already within the CIGNA system. The proposed transaction does not provide for an infusion of resources from outside the CIGNA companies to deal with any financial concerns that may exist. CIGNA's answer appears to be that potential future customers of CIGNA P&C would not trust the actuarial methods now relied upon by CIGNA sufficiently to wish to do business with CIGNA.

If that is true, the question is why <u>existing</u> policyholders of CIGNA P&C should be required to accept these same actuarial methods when <u>future</u> policyholders -- and the CIGNA

P&C system itself and its shareholders -- would not have to bear the same risk that these methods are inaccurate. If CIGNA is correct that it now has its asbestos and environmental liabilities under control, then future policyholders and rating agencies ought to have no questions about CIGNA's future. If CIGNA cannot convince these sophisticated parties of the accuracy of its actuarial methods, then why should the Commissioner accept them? This in turn leads to a further question: whether the application now before this Department should be used as a vehicle to force numerous existing policyholders to accept a transaction structured on the basis of the same actuarial methods upon which future policyholders of CIGNA, CIGNA P&C itself and its shareholders do not have to rest their financial fortunes? I do not believe that these questions can be answered in CIGNA's favor.

From CIGNA's point of view this is a win-win situation. However, from the standpoint of policyholders and claimants in the run-off company it may not be. It all depends on how the claims ultimately run-off. As Mr. MacGinnitie has stated, based on his actuarial knowledge and experience, difficult issues are raised when setting reserves for mass tort and environmental claims. He also states that reserves are estimates of what may happen in future -- not absolute predictions or guarantees. Based on my experience I concur with his observations. Uncertainty will remain: will the run-off company have sufficient assets to cover all claims when done? It is this

uncertainty that CIGNA seeks to rid itself of, but the uncertainty will not be gone. Rather, it will be merely shifted to other parties and improper ones in my view.

Moreover, if the inactive company eventually gets into trouble, CIGNA will no doubt seek to hide behind this Department's previous approval. Regulators should not be, or allow themselves to be placed, in that position.

DIRECT EFFECTS OF THE TRANSACTION

The most important part of this restructuring transaction is how it will affect those most directly impacted -- INA's policyholders, claimants against those policyholders, and other insurance companies. While these parties will be adversely impacted, there are other effects of this transaction which will be discussed later.

Policyholders

The majority of policyholders being placed in the run-off company have or may have long tail claims such as asbestos or pollution. By their very nature these claims develop over a long period of time. These policyholders reasonably expected that the entire INA group resources would respond to their claims when presented. These policyholders are now to be set adrift in a sea of uncertainty since while the assets designated for their claims are fixed, the ultimate cost for these claims is not known with certainty. At this point in time, it is fair to say that all claims that may call upon those assets is not known either. If

these policyholder claims are not paid by the inactive company they will fall on the insurance guaranty fund system if they are eligible for that coverage. If this system is not obligated to respond the liability will fall back on the policyholder.

Claimants

Where policyholders end up is often where the claimant ends up also. Liability insurance such as written by the INA group has two objectives: indemnifying the wrong-doer and compensating the victim. In the case of asbestos liability and other mass tort situations, claimants are in most cases the victims and their families.

Other Insurance Companies

If the run-off company cannot meet its obligations, they may fall on other insurance companies. This can happen in two ways: first, for example, in the case of a pollution claim, if one responsible party or its carrier cannot pay, the other parties and their insurers may have to. This may happen with other liability claims, as well. Second, the insurance industry may have to pay through the insurance guaranty fund system.

PUBLIC POLICY ISSUES AND IMPLICATIONS

There are important and significant public policy issues and questions which the Commissioner must address when considering the proposed restructuring. These broad issues are more likely harmful to insurance companies and ultimately the public than the cost from guaranty fund coverage and other

implications previously mentioned. I feel that it is imperative for a regulator to consider these long term interests of the insurance institution as well as the interest of others when evaluating this transaction. In my view, these public policy concerns argue strongly for the denial of the present application.

While several public policy issues will be discussed here, not all of the issues that will arise can even be contemplated at this time, since nothing like this transaction has occurred in the insurance industry before. The notion that claims and rights of policyholders can be separated into those which we like and will support, and those which we don't like and will not entirely support, is unheard of and foreign to the insurance mechanism. That gives reason enough to thoroughly consider the full implications of this transaction.

I am impressed by the legal arguments that have been presented that the plan cannot be approved because it violates the law and otherwise does not meet statutory requirements, but that is not the purpose of my testimony here today -- I now address the public policy reasons against approval.

Would The Proposed Transaction Have A Proper Precedential Effect?

It is no secret that many of the well-known names in the commercial property and casually insurance business are looking for ways to deal with problems associated with long tail claims, particularly like the asbestos and environmental claims present here. These companies are watching these proceedings

carefully to see if INA Financial Corporation's proposed restructuring plan will pass regulatory muster. So this matter and how it is concluded will have ramifications well beyond this hearing. An approval will give the go-ahead signal to the rest of the industry that such action will be tolerated by regulators and government, and it will begin to set the framework for other proposals. So, it is vital that the Commissioner consider not only if the statutory requirements have been satisfied but that this bold move -- and others like it -- would as a whole be in the best interest of the insurance industry and the public.

How Does The Proposed Transaction Affect The Reasonable Expectations Of The Policyholders Who Have Done Business With The CIGNA P&C System?

A group of affiliated companies trade on the strength of the entire group. Subsidiaries are created for a multitude of reasons. They are able to grow and prosper not solely on their own financial capability and strength but on the standing of the entire group. This is particularity true for a group of companies which have historically pooled risks written by individual companies in the group. The marketplace dealt with these companies as a member of a group and assumed that the group would stand behind them. As Mr. Isom of CIGNA P&C stated in his written testimony, the CIGNA P&C companies were "not operationally or legally distinguished" when they did business with their existing policyholders, and their policyholders had every right to take this fact into account in doing business with CIGNA P&C. The present transaction in its simplest terms says to

the marketplace, "if it doesn't fit our purpose we will only provide for troublesome and difficult losses only to the extent we can and that it fits our plans".

How buyers will react to this situation we can only speculate. But should government allow this to happen in the first place? This is not a question of whether a corporate veil can be pierced as a legal matter. CIGNA is asking for the Department's approval to do something that violates the premise on which its insurance was sold. As a regulatory and public policy matter, the answer to that request is simple: just say no.

Should A Company Be Permitted To Self-Liquidate Without The Protections Of Applicable State Insurance Insolvency Proceedings?

One important issue raised by this transaction is whether it is appropriate for INA or any other company for that matter, to run-off or effectively self-liquidate claims outside of formal receivership proceedings. The written testimony of Gerald Isom presented on November 28, 1995 expressly states that:

> Traditional funding approaches to our problems have not been successful . . . . The Plan is a balancing of goals designed to protect the financial security of all policyholders and to ensure the financial viability of CIGNA P&C.

The testimony of George Bernstein, which was also presented by CIGNA on November 28, 1995, is even clearer that the proposed transaction is based on purported solvency concerns:

> Had these exposures not been addressed, there would have been legitimate cause for concern that CIGNA P&C might eventually not be able to honor its policyholder

> obligations. The quality of business that CIGNA P&C would have been able to write would have declined precipitously as only second-class business would have found its way to a "B+" rated insurer. Overall, cash flow would have significantly diminished. The combination of fewer premiums and lower quality business is the classic prescription for financial disaster.

In essence, Messrs. Isom and Bernstein have suggested that the proposed transaction constitutes a kind of plan of arrangement to deal with solvency issues, and that the Department should act as it would if it were considering a plan of rehabilitation pursuant to Pennsylvania law governing insolvent insurance companies. However, none of CIGNA's companies have been placed in rehabilitation or declared to be insolvent.

I do not believe that CIGNA's proposed transaction can be considered appropriate as a method for dealing with solvency concerns, without the numerous procedural and substantive safeguards applicable to a formal rehabilitation proceeding. This is particularly true when the plan places an unequal burden on some policyholders, namely those who would be consigned to the run-off companies and must accept an actuarial method with which a number of them have already said they do not fully agree, than it does on other policyholders, who are <u>not</u> so limited. CIGNA is not simply proposing to shut down the INA and run it off. That at least would treat all INA policyholders equally. By dividing INA and running off only a piece of it, CIGNA is discriminating against some of INA's policyholders. That is simply unfair.

As noted previously, the ultimate cost to run off claims cannot be estimated with certainty. Therefore, at some point in the future, assets may be insufficient to discharge remaining obligations. Those remaining policyholders and claimants will have only guaranty funds to look to for responding to their claims. Even that conclusion assumes guaranty funds would in fact be responsible for these claims, and I am aware that questions and have already been raised with regard to that matter. Those policyholders fortunate to have matured claims early enough will be preferred over those that do not. The obvious unfairness of this result should be not be ignored or allowed. Protection from this possibility is one of the reasons we have receivership statutes. While the possibility of insolvency may seem remote now it is a risk. It is a risk that I do not believe the Commissioner can or should ignore.

Is It Right?

During the course of my tenure in regulation I've seen a number of unusual and bold steps suggested (and in some cases done) to solve the problems of a failed or failing company. I have never seen anything like this. The idea that a book of business and resulting claims can be split apart from an on-going operation should be objectionable for even a failing company, let alone one that is healthy. The public trust in the insurance industry has been built on the principle that payment of premium creates a promise that sufficient assets will be available to pay claims in the future. That public trust is lost when

restructuring such is proposed is allowed. It just isn't right and it should be not approved.

COMMENTS ON TESTIMONY OF GEORGE K. BERNSTEIN

I believe Mr. Bernstein has correctly pointed out the overriding and most important consideration from a public policy perspective as to whether this plan should be approved -- its impact on policyholders and claimants. This is, after all, the principal purpose of insurance regulation. I firmly disagree with him that the analysis should include what position policyholders would find themselves if the status quo were permitted to continue. The responsibility of management is to do what is best for policyholders and claimants. If the proposed plan does not pass regulatory muster and is disapproved, management will develop an alternative plan to deal with present problems. They have that responsibility.

The doomsday predictions which may occur if the proposed plan is not approved are not a reason to approve a plan which is not in the best interest of policyholders or the public. Similarly, the "good time" results, if the plan is approved should not be given credence. Throughout my long tenure in regulation I was often confronted with the "sky will fall" scenario if something wasn't approved. Of course, it never did and I don't believe it will in this case either. The Commissioner should evaluate the transaction solely on its merits, recognizing the serious public policy implications, and should not be deterred by a parade of horribles.

I present the following comments on certain specific statements made by Mr. Bernstein in his written testimony.

1) The plan was designed to provide additional capital and balance sheet support to CIGNA P&C thus strengthening and preserving CIGNA P&C's property and casualty operations and making it more likely that all policyholders of both the active and run-off insurers will be paid.

The plan may have been designed to provide additional capital and balance sheet support to CIGNA P&C but, in fact, it fails to do so. No additional capital is coming to CIGNA P&C from other sources. Rather, presently available assets are being allocated between active and inactive companies. Rather than the restructuring being good for policyholders and claimants in the run-off company it, in reality, places them in the worse position. They will not benefit from the ongoing insurance operations. For as long as I can remember, particularly with multi-line companies, troubles in one line of business were offset by profits and cash flow from other lines. This was one way the industry dealt with problems. Buyers, brokers, risk managers and others knew this. It was one of the reasons large multi-line companies were successful in attracting business. This implied promise is being discarded in this proposed transactions.

2) The plan will also permit CIGNA P&C to continue as a major employer providing essential insurance coverage and services to its policyholders.

The plan should not be evaluated on whether CIGNA remains as a major employer. This is not a proper criterion under the insurance law, and in any event must be dwarfed by the

impact of the proposed transaction on existing policyholders and on confidence in the insurance industry.

3) In considering whether to approve the plan you must take into account the position in which policyholders would find themselves if the corporate status quo were permitted to continue.

As mentioned previously, if this plan is not approved, the commissioner should not be troubled or threatened by what happens next. The management of CIGNA are creative and intelligent people and I'm certain that they will develop an alternative scheme for consideration if that is deemed appropriate.

4) At the same time such difficulties for CIGNA P&C would offer tremendous opportunities for its competitors. Better business would be skimmed off with great profit potential for its rivals--price competition would be diminished. Moreover, because of the long tail nature of A&E expenses, even if the P&C companies fail their competitors in the meantime would have reaped significant profits for offsetting our distant potential entirety to guaranty funds.

Whether competition is improved or not by approval of this transaction is pure speculation and something the Commissioner should not consider in evaluating this restructuring. I do find it interesting that Mr. Bernstein's sees the possibility for the property and casualty companies to fail since the rest of his statement is very optimistic and certain about the future and the ability of the run-off company to meet its obligations. There is a risk, and Mr. Bernstein knows that there is a risk, but he, like CIGNA, chooses to ignore it and hope for the best.

5) Without these ratings, INA financial has no economic motivation to provide either the $500 million in capital support

or the additional $500 million in reinsurance to stand behind Century Indemnity. It is unlikely that CIGNA corporation could commit additional stockholder equity to support a less than A-rated subsidiary. Parent corporations are not obligated to continuously fund subsidiaries and absent approval of this plan there is no assurance that existing A&E policyholders of the P&C companies will see their claims paid in full.

Absent the restructuring the parent company should have every motivation to stand behind its insurance subsidiaries. As noted earlier, buyers expect it. Buyers who acquired insurance from the INA subsidiaries in the past knew that they were dealing with an insurance group who lived up to its promises for over 200 years. If INA wants to maintain the value of its name in the marketplace and as goodwill, it has to stand behind its subsidiaries.

This restructuring allows CIGNA to keep the value of its franchise and to obtain future business while setting adrift in a sea of uncertainty the obligations resulting from its past business. How insurance buyers will react to this situation is not known since it has never happened before.

It now seems somewhat disingenuous for CIGNA and INA to raise the corporate veil by declaring that parent corporations are not obligated to continuously fund subsidiaries. If this plan is not approved, CIGNA will have no choice but to continue to fund the INA. Simply from a business standpoint, it could not afford not to do that if it wants to stay in the insurance business. If this plan is approved, however, insurance holding companies will learn that they need not make an ongoing

commitment to the carriers they own. I do not believe that is a message this Department should send.

6) It is difficult to conceive of any plan other than that proposed by CIGNA P&C that more honestly, openly and fairly addresses its A&E exposure problems. More importantly, I cannot think of situation where any policyholder of the run-off insurers is worse off after the transaction than before.

As stated previously, regulators should not feel forced to approve this plan on any presumption that this is the only and best plan.

There is at least one real and significant situation where a policyholder is worse off after the transaction than before. That event is when the assets of the run-off company are determined to be insufficient to meet obligations. This is a real possibility according to Mr. MacGinnitie.

7) Without the proposed plan there would be a strong economic incentive on the part of the elements stockholders of INA Financial to abandon those insurers currently holding the A&E exposure to whatever fate awaits them; and

8) The plan before you fully meets the operable statutory standards and your review should be limited to that plan. It is not the role of regulators to consider whether some other alternative exists that might be deemed preferable.

I concur that the role of the regulator should be to determine whether the plan as presented meets the appropriate statutory standards (i.e., not injurious to policyholders). In doing that the regulators should not view the plan as they only course of action and assume that there are no alternatives. Certainly if there are alternatives that are preferable they should be perused.

9) If parent corporation guarantees a subsidiary liabilities are good INA Financial why haven't we seen them proposed by its competitors for there own A&E policyholders?

The reason we haven't seen corporate guarantees proposed or implemented by INA's competitors is due to the simple fact that they don't need to do it. They have not proposed to cut loose their A&E liabilities-they intend to stand behind their A&E policyholders and claimants.

CONCLUSION

For the reasons I have discussed above, I believe that the proposed restructuring of CIGNA P&C should not be approved because it is bad public policy. It is dangerous, it is unfair, and it is just plain wrong.