International Association of Insurance Receivers
610 Freedom Business Center – Suite 110
King of Prussia, PA 19406
610-995-0015 Fax: 610-992-0021
E-mail: info@iair.org
Promoting professionalism and ethics in the administration of insurance receivership

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Paul A. Miller (IL), Chair Federal Home Loan Bank Legislation (E) Subgroup
Jim Mumford (IA), Chair of Receivership and Insolvency (E) Task Force
National Association of Insurance Commissioners

RE: Request for Comments on FHLBank Proposed Legislation

Gentlemen:

On behalf of the International Association of Insurance Receivers ("IAIR"), this letter responds to your request for input and perspective on the Federal Home Loan Bank ("FHLBank") proposed legislation to provide exemption to FHLBanks from the stay provisions and voidable preference provisions within state insurance receivership proceedings (the "Proposal"). IAIR appreciates the opportunity to provide this response to the Federal Home Loan Bank Legislation (E) Subgroup.

As you are aware, IAIR was founded in 1991 as an association of professionals involved with insurance receiverships and financially stressed or troubled insurers. IAIR's mission is to provide a forum to exchange information, develop best practices, establish and maintain accreditation standards, and educate its members and others concerning the administration and restructuring of such insurers.[1] IAIR's members include experienced insurance receivers (including liquidators and rehabilitators), insurance regulators and state guaranty associations.

IAIR recognizes the role of FHLBank lending as both an important source of liquidity and as a method to promote the continued viability of insurance companies, goals we share. However, FHLBank's proposed revisions to state receivership statutes, as exemplified by the FHLBank's proposed revisions to the Insurer Receivership Model Act ("IRMA") Sections 108(E) and 604(C), could result in inequitable treatment of receivership creditors, and create conflict and confusion regarding established principles and practices in insurance receivership administration as will be described further in this response. Although IAIR understands the positive impact FHLBank loans have on the liquidity management of insurance companies and supports the continued ongoing relationship between FHLBank and the insurance industry, there is concern that FHLBank's recommended revisions to state receivership statutes will have a significant negative impact on the liquidity management of insurance companies in receivership without any corresponding improvement in such companies' access to liquidity from the FHLBank. Issues such as the need to post excess high-quality collateral, purchase FHLB stock in order to become a borrower and substantial pre-payment penalties all present potential obstacles to a receiver.

[1] For purposes of this response, the use of the term "insurer" shall be used interchangeably with the term "insurance company".

This is especially true for an insurance company placed in rehabilitation, with the goal of either selling the company, or rehabilitating the company and having it re-enter the market.

It appears that the FHLBank's concern is to protect its security, which IAIR understands and appreciates. However, the Proposal could open the door to other creditor groups who could also argue for "special" treatment on the basis of the supposed advantages such creditors could offer insurers in the "zone of insolvency" if they did not need to be concerned with the negative consequences of receivership proceedings. The NAIC and each of the respective state insurance departments have been committed to the principle that policyholder interests in the unencumbered assets of the estate are primary. The receivership statutes governing liquidations afford receivers the necessary tools to marshal assets, maximize their values when liquidated, and, most importantly, fairly determine each claim's priority class and distribute the collected assets equitably. When discrete creditor groups are exempted from the operation of the priority of the distribution scheme, the favored group effectively receives priority, not only over other creditors, but especially over the interests of policyholders themselves. Considerable thought must be invested in any decision to offer such a protection to any group of creditors. It would be advisable, however, to consider whether there is an alternative, less destructive mechanism to balance the equities on which the present receivership laws function that would accomplish the FHLBank's objectives.

FHLBank's proposed amendments focus on two areas: the applications of stays and voidable preferences. As a practical matter, insurance receivership stays do not interfere with the realization of collateral held by creditors with perfected security interests. Unless there is some question about the legitimacy of the claim, receivers generally must abide by the terms of the secured claim. Where disputes arise over whether an interest is, in fact, perfected, the receivership court is available to speedily resolve these issues. The same is true for voidable preferences and fraudulent conveyances. A voidable preference only occurs if a transfer of assets is made "on account of an antecedent debt." Realization on a perfected security interest is not a voidable preference, because the transfer of the security interest occurred at, or before, the creation of the debt. It is only when lenders extend credit first, but try to secure collateral at a later date that a potential for voidable preferences arises, because only then does the debt become an "antecedent debt." Similarly, a fraudulent transfer occurs when the insolvent company transfers assets to a creditor for less than "fair equivalent value." Therefore collateral pledged in exchange for new and equivalent value, such as a loan, would not on its face be considered a fraudulent transfer, whereas collateral pledged to secure a loan that was initially unsecured or under-secured may. It is IAIR's understanding that FHLBanks rigorously enforce requirements for full and timely collateralization of all borrowings. As such, it would seem an exemption from the preference provisions is not only unnecessary but also redundant.

State Receivership Statutes were Enacted to Ensure Creditor Protection

FHLBank's proposed language would allow state receivership laws' carefully developed prioritization system, and the historical case law developed in connection with those laws, to be circumvented for the benefit of a specific secured creditor and to the potential detriment of all other creditors, including other secured creditors. If an FHLBank properly, under both state and federal law, has a perfected security interest in connection with the loans made to insurance companies, then that FHLBank will be afforded its full priority in the secured assets of the insurance company in receivership. It is imperative that the states preserve the protection afforded to all creditors, especially policyholders and third party claimants under policies issued by the insurance company placed into receivership. It should be noted that guaranty associations generally share the same priority status as policyholders when seeking reimbursement for policyholder claims that they have paid due to an insurer's insolvency. Therefore, contrary to the analysis contained in the FHLB Subgroup's Executive Summary, guaranty associations would most likely be

negatively impacted by the recommended changes to receivership statutes providing, in effect, a "super priority" to FHL Banks. The priority of receivership claims has been fully deliberated during the development, and adoption, of state receivership laws and NAIC Model laws, and should not now be revised to create a preference after such concerted efforts to ensure equity among creditors of the same class.

The provisions of IRMA, and the state receivership statutes, already afford protections to secured creditors. For example, Section 108(C) of IRMA provides that the commencement of a delinquency proceeding operates as a stay of the actions described in the section, "[e]xcept as provided in Subsections E and F *or as otherwise provided in this Act*" (emphasis added). The FHLBank proposal would create an additional exception under Subsection E, expressly allowing an FHLBank to exercise its rights under a security agreement. The implication in the Proposal that under Section 108(C) and equivalent state receivership statutes secured creditors would be prevented from exercising rights under a security agreement is incorrect. The Proposal focuses on Section 108 in isolation, and does not address the process by which secured creditors may assert their rights in a receivership. For example, IRMA Section 710, Secured Creditors' Claims, provides that the value of security held by a secured creditor may be determined by converting the security into money according to the terms of the security agreement, or by agreement or litigation. Providing a further exception for a *particular* secured creditor would create an unwarranted preference with respect to the process of handling claims of certain secured creditors.

Additionally, IRMA Section 604 describes the circumstances under which the Receiver may avoid preferences. Section 604(C) contains exemptions for certain transfers, such as a contemporaneous exchange for new value, or a payment of a debt incurred in the ordinary course of business. These exemptions recognize that certain legitimate transactions should not and will not be avoided in a receivership. The FHLBank Proposal creates a special exemption for an FHLBank security agreement that would apply under *any* circumstances. IAIR submits that the existing exceptions contained in state receivership statutes, and as exemplified by the IRMA provisions, provide sufficient protections to an FHLBank, and that a blanket exemption for a particular creditor should not be allowed.

It is important to note that the Proposal is based on subsections of IRMA, without reference to the specific sections from which they were derived. IRMA is not an amalgam of independent provisions; it is a comprehensive scheme for insurer receiverships that addresses the entire process of receivership proceedings. Notably, the structure of IRMA, from where the proposed amendment is drawn, differs from its predecessor model, on which most state receivership laws are still based. Consequently, cutting and pasting subsections from IRMA into a state receivership statute may not be feasible, and could result in ambiguous (or even contradictory) statutory provisions.

Insurance Company Liquidations Are Not The Same as Bank Liquidations

The liquidation of an insurance company is very different from the liquidation of a bank due to the nature of the financial instruments held by the involved consumers. To protect insured depositors, the FDIC takes over when a bank or thrift institution fails. Such institutions generally are closed by their chartering authority – the state regulator, or the Office of the Comptroller of the Currency. The FDIC has several options for resolving institution failures, but the one most used is to sell deposits and loans of the failed institution to another institution. Customers of the failed bank automatically become customers of the assuming institution. Most of the time, the transition is seamless from the customer's point of view. Any remaining assets are sold by the FDIC. Thus there are no priorities and business is never stopped, just transferred.

Insurance insolvencies, on the other hand, are much more complex. A bank depositor's loss in a bank insolvency is limited to the amount of his deposit and interest. A policyholder's loss is measured by the loss of indemnification from its insurance company for an unfortunate current or unforeseen future event. This is far more intricate and more compelling than a bank insolvency, as the policyholder who has suffered a loss is now left without the insurance protection previously purchased. Receivers strive to maximize and preserve assets that will be available for distribution to all creditors. Classes amongst creditors have been established to secure and protect the policyholders and effectuate equitable distributions. Recoveries by policyholders and claimants from liquidated assets could be substantially reduced under FHLBank's Proposal as it would allow FHLBanks to receive a disproportionate share of the receivership's assets. Therefore, although we understand and support the fact that lending through FHLBank can be an important tool to further an insurance company's rehabilitation, preferential treatment of loans issued to the insurer before a receivership proceeding is initiated should not be permitted beyond the perfected secured creditor position that may already be provided in the lending documents.

Conclusions and Recommendations

In summary, IAIR encourages the careful consideration of (1) possible distinctions in the treatment of FHLBank' positions under rehabilitation versus liquidation to permit continued availability of this capital source, while preserving the established claims priority determination and equitable application of state receivership provisions; (2) the impact of FHLBank's collateral requirements on availability of assets and asset/liability matching and prepayment penalties in an insurance company receivership; and (3) the preservation of the established claims priority determination under state receivership statutes. We believe it is to the advantage of all parties to work collaboratively to study and further consider the Proposal with input from FHLBank, participants from the NAIC, including representatives involved in both rehabilitation and liquidation receiverships, to avoid revisions to current state receivership statutes that would result in the disparate treatment of creditors and possibly other, unintended consequences in the conduct of an insurance company receivership.

IAIR appreciates the opportunity to provide this initial response to the FHLB Subgroup's request and to further assist the NAIC and FHLBank in the development of procedures that include the equal protection of creditors in insurance company receiverships. We look forward to the opportunity to participate in further discussions. If, after you have received these comments, you have any additional questions, please feel free to contact the undersigned.

Respectfully submitted,

Francesca G. Bliss
International Association of Insurance Receivers, President