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# INSURANCE REGULATION

# The Failures of Four Large Life Insurers

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Insurance Regulation: The Failures of Four Large Life Insurers

SUMMARY OF STATEMENT BY
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GAO is testifying on the financial characteristics and regulation of four large insurance companies recently taken over by state regulators. GAO's observations about the regulation of the insurers are preliminary because its review of the performance of state regulators is not yet complete.

Executive Life and its subsidiary Executive Life of New York were taken over in April 1991 by state regulators in California and New York, respectively. First Capital and Fidelity Bankers were taken over in May 1991 by California and Virginia, respectively. These failures, due in large part to a reckless strategy of high growth and investment in high-risk assets, have had national consequences. The four insurers had a total of more than 900,000 policies with policyholders and annuitants in every state.

During the 1980s, the assets of the four insurers grew six to ten times faster than assets of the life insurance industry overall. This growth was fueled primarily by sales of high-yield retirement investment products, not traditional life insurance policies. To cover the high rates paid to policyholders and maintain profitability, the insurers invested heavily in high-risk assets--most notably junk bonds. High upfront costs due to rapid growth seriously depleted the insurers' surplus, or net worth.

To bolster their statutory surplus and reported financial condition, the four insurers reduced policy reserves on their balance sheets through reinsurance transactions and received from their parent holding companies millions of dollars in surplus infusions and loans. Although reinsurance is a legitimate practice in the life insurance industry to reduce the strain on surplus of selling new policies, the Executive Life insurers and First Capital relied on questionable reinsurance transactions to artificially inflate their surplus. Without reinsurance and borrowed surplus, the Executive Life insurers would have been insolvent as early as 1983.

Dwindling surplus due to rapid growth together with massive junk bond holdings of the four insurers led to a loss of policyholder confidence, subsequent policyholder runs, and eventual state takeovers of the companies. California and New York regulators of the Executive life insurers recognized before the takeovers that the insurers had serious solvency problems, and California and Virginia regulators recognized that First Capital and Fidelity Bankers, respectively, were undercapitalized. However, the regulators' oversight of the insurers was not effective in stemming their financial deterioration.

Although GAO has not yet determined the full extent of inadequacies in state handling of these insurers, it has observed significant weaknesses in the regulatory oversight of the four insurers. State insurance regulators lacked timely, complete, and accurate information needed to effectively monitor the four troubled insurers. Regulators did not get financial data early enough to identify and react to the insurers' problems. Moreover, the statutory financial statements did not fairly reflect the insurers' true conditions. Even though regulators were aware that the Executive Life insurers and First Capital had serious solvency problems, they examined the insurers only once every 3 years.

Regulators' efforts to limit junk bond holdings and restrict unacceptable reinsurance were not effective in stemming the solvency problems of the four insurers. Regulators did not know about the quality or value of the insurers' junk bond holdings and did not have specific authority to limit such holdings when the insurers built up their portfolios. Even when New York and California acted to limit more junk bond acquisitions by the insurers, these limits did not reduce the insurers' exposure to mounting junk bond losses. Whereas New York took forceful--albeit late--action to eliminate reinsurance problems at Executive Life of New York, California practiced regulatory forbearance for Executive Life and First Capital.

Finally, holding companies are a regulatory blind spot. State holding company laws rely on insurer disclosure to monitor affiliated relationships, and some states require prior regulatory approval to prevent abusive transactions. Except for infrequent field examinations, regulators have no way to verify insurer-reported information. GAO does not know to what extent interaffiliate dealings may have contributed to the failures of the four insurers in part because regulatory examination reports from New York and Virginia are not yet available. However, on the basis of preliminary work in California, GAO found that Executive Life's failure to comply with state holding company laws undermined California regulators' efforts at solvency monitoring.

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss the financial characteristics of four large insurance companies that were taken over by state regulators and our preliminary assessment of the regulatory actions regarding those insurers. Today, I will provide you with a picture of the companies' financial condition leading up to their failures and our observations thus far about the performance of the state regulators as they supervised the four insurers.

Executive Life and its subsidiary Executive Life of New York--both owned by First Executive Corporation--were taken over in April 1991 by state regulators in California and New York, respectively. First Capital and Fidelity Bankers--subsidiaries of First Capital Holdings Corporation--were taken over in May 1991 by California and Virginia, respectively. In each case, state regulators took these actions to stop policyholder runs and protect the insurer's assets.

These insurer failures have had national consequences. When they were taken over, the four insurers had a total of nearly $85 billion in business and more than 900,000 policies with policyholders and annuitants in every state. As a result of certain moratoria imposed when the states took over the insurance companies, policyholders concerned about the security of their savings have been unable to cash in their policies. Moreover, the 75,000 annuitants of Executive Life have been paid only 70 percent of their benefits.

Dwindling surplus due to rapid growth together with massive junk bond holdings of the four insurers led to a loss of policyholder confidence, subsequent policyholder runs, and eventual regulatory takeovers of the companies. Despite untimely, incomplete, and inaccurate information, California and New York regulators of the Executive Life insurers recognized before the takeovers that the insurers had serious solvency problems. California and Virginia regulators recognized that First Capital and Fidelity Bankers, respectively, were undercapitalized. The regulators' actions clearly were not effective in stemming the financial deterioration of the companies. However, we have not yet determined the full extent of inadequacies in state regulatory handling of these troubled insurers.

We obtained financial information about the four insurers from annual statutory financial statements filed with state regulators, 10-K statements filed by their parent holding companies with the Securities and Exchange Commission, public reports of regulatory financial examinations, and analyses done by insurance rating services. To identify what actions were taken by state regulators and the National Association of Insurance Commissioners (NAIC), we did fieldwork at the California Department of Insurance, and we met with regulators in Virginia. We also reviewed records of recent congressional hearings about these failures. I want to emphasize that California, New York, and Virginia were cooperative in our current review. However, we do not have statutory access to state insurance departments or NAIC. This lack of access has on several occasions limited our ability to assess the effectiveness of state insurance regulation.

BACKGROUND

During the late 1970s and 1980s, investment strategies in the life insurance industry changed, and profit margins dropped due to increasing competition from mutual funds, savings and loans, and other financial institutions that offered investment products at comparatively higher rates of return. Before the late 1970s, life insurance companies focused on bearing risks of death and illness and sold products offering a relatively low but stable return for policyholders. In response to increasing competition for policyholders' savings, insurers began issuing new interest-sensitive products such as universal life, single-premium annuities, and guaranteed investment contracts (GICs). The increasing emphasis on selling investments had significant financial effects. The higher rates of return insurers offered to be competitive substantially narrowed their profit margins. Also, in an attempt to pay these higher rates and maintain profits, some insurers--including the ones we are discussing today--invested heavily in high-risk, high-return assets such as noninvestment grade bonds (junk bonds) or speculative commercial mortgages and real estate.

Competitive strategies like these have strained many insurers and increased the number of insurer insolvencies. The number of life/health insolvencies averaged about five per year from 1975 to 1983. Since that time, the average number more than tripled to almost 18 per year, with a high of 47 in 1989.

Insurance companies are subject to solvency monitoring in each state in which they are licensed to do business. Once regulators identify a troubled insurer, they must be able and willing to take timely and effective actions to resolve problems that would otherwise result in insolvency. When problems cannot be resolved, regulators must be willing and able to close failed insurers in time to protect policyholders and reduce costs to state guaranty funds. The insurance department of the state in which the company is domiciled has primary responsibility for taking action against a financially troubled insurer.

State regulators do not regulate insurers' parent holding companies or noninsurance affiliates and subsidiaries of insurers. Instead, most states have various statutory guidelines for transactions between an insurer and affiliated companies, and some states require prior regulatory approval for significant interaffiliate transactions.

## THE FOUR INSURERS HAD RAPID GROWTH, RISKY ASSETS, AND DWINDLING SURPLUS

Executive Life, Executive Life of New York, First Capital, and Fidelity Bankers shared characteristics worth noting: rapid growth, a concentration of risky assets, and dwindling policyholders' surplus, or net worth. These insurers, to bolster their statutory surplus and reported financial condition, reduced their required policy reserves through reinsurance transactions and received from their parent holding companies surplus infusions and loans. Such a strategy can significantly affect the appearance of financial strength as reflected in an insurer's financial statements. Without reinsurance and borrowed surplus, the Executive Life insurers would have been insolvent as early as 1983.

### Rapid Growth

The growth in assets of the four insurers during the 1980s dramatically outpaced the overall asset growth of the life insurance industry. While assets industrywide nearly tripled in the last decade, rising from $481 billion to $1.4 trillion, assets of the four failed insurers grew at six to ten times the industry average, as shown in Table 1.

Table 1: Percentage Growth in Reported Assets For the Life Insurance Industry and the Four Companies (1980-1990)

| Period covered | Industry average | Executive Life (CA) | Executive Life (NY) | First Capital | Fidelity Bankers |
|---|---|---|---|---|---|
| 1980-1985 | 95% | 824% | 1,021% | 844% | 34% |
| 1985-1990 | 66 | 82 | 35 | 139 | 1,685 |
| 1980-1990 | 223 | 1,578 | 1,273 | 1,917 | 2,294 |

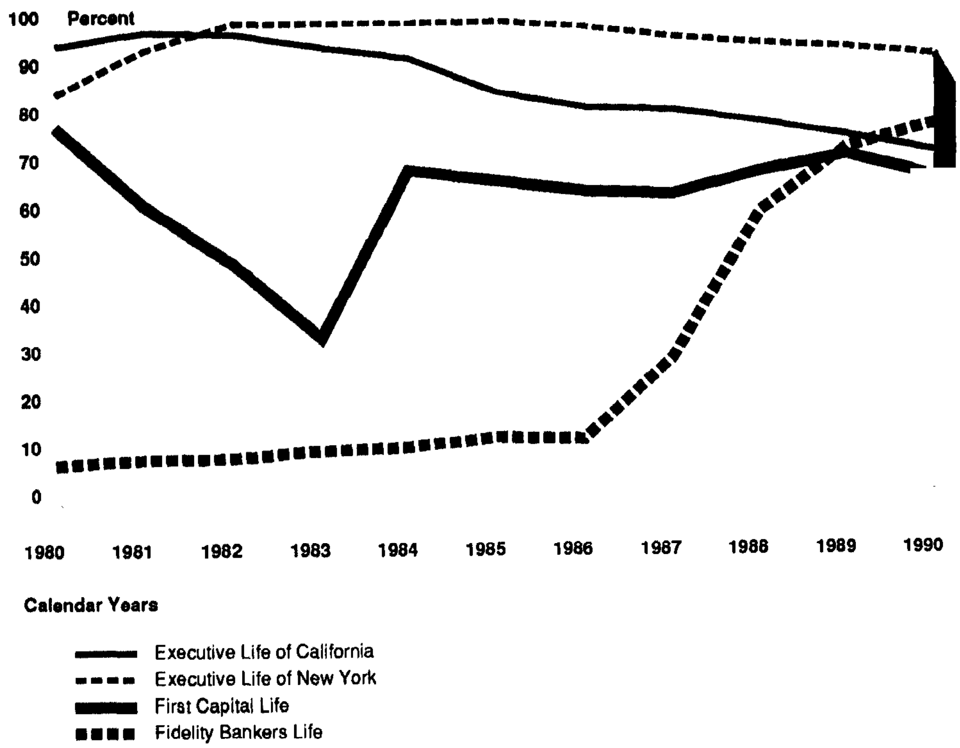
Source: Best's Insurance Reports (Life/Health Editions).

At its peak in 1989, Executive Life reported $13.2 billion in assets--more than 21 times its size in 1980. Executive Life of New York peaked in 1988 at $4 billion in assets, more than 17 times its 1980 level. First Capital also experienced rapid growth, with assets increasing to $4.7 billion in 1989, over 21 times the 1980 level.

Unlike the other three insurers, Fidelity Bankers did not grow rapidly during the first half of the 1980s. Its reported assets had increased 34 percent by 1985. However, in late 1985 it was purchased by First Capital Holdings Corporation and was reporting $4.1 billion in assets by 1990--about 24 times its 1980 level.

During the 1980s, the four insurers grew mainly by selling high-yield retirement investment products. All or most of the insurers' policy reserves were for annuities--similar to long-term certificates of deposit--rather than traditional life insurance. Executive Life also sold a large number of GICs that had no life insurance features. Figure 1 shows the annuity reserves as a percentage of total policy reserves that the four insurers set aside from 1980 through 1990.

Figure 21: Annuity Reserves as a Percentage of Total Reserves for the Four Insurers (1980-1990)




Source: Best's Insurance Reports (Life/Health Editions).

## Investments in Risky Assets

To cover the high rates paid to policyholders and maintain profitability, the four insurers invested in relatively risky, high-yield assets, most notably junk bonds. These insurers became heavily concentrated in this risky market. Table 2 shows the junk bond holdings reported by the four insurers in 1990.[1]

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[1]In statutory financial statements filed with state regulators, life insurers generally carry bonds at amortized value (purchase price adjusted to decrease or increase the book value to par at

Table 2: Junk Bonds Held by the Four Insurers as a Percentage of Assets in 1990 (Dollars in billions)

| | Junk bonds | Percent of assets |
|---|---|---|
| Executive Life (CA) | $6.4 | 63% |
| Executive Life (NY) | 2.0 | 64 |
| First Capital | 1.6 | 36 |
| Fidelity Bankers | 1.5 | 40 |

Source: Best's Insurance Reports (1991 Life/Health Edition).

The four insurers did not have had adequate statutory reserves against their bond portfolios to cushion against potential losses. Under statutory accounting rules, the maximum reserve required against a life insurer's junk bond holdings is 10 to 20 percent.[2] Due to mounting bond losses, the Executive Life insurers' reserves against future loss represented about 1 percent of their junk bond holdings. As a result, a 10-percent loss on their junk bond holdings would have wiped out the reserves and net worth of the two insurers. Similarly, a 10-percent loss on junk bonds would have left First Capital and Fidelity Bankers seriously undercapitalized. Table 3 shows the insurers' security valuation reserves in 1990 as a percentage of their junk bond holdings and the percentage loss in junk bond values that would have eliminated the insurers' surplus and bond reserves.

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maturity date). Bonds in or near default are carried at the lesser of amortized or market value.

[2]The "mandatory securities valuation reserve" is intended to buffer surplus from losses or fluctuations in the market value of securities held. Higher reserves are required for junk bonds than for higher quality bonds with a maximum reserve of 20 percent for defaulted bonds. The security reserve may be accumulated over 10 to 20 years.

receives. Insurers routinely use reinsurance to transfer risks under large policies in excess of a specified retention.

Reinsurance has both legitimate and illegitimate uses. It is a legitimate practice in the life insurance industry to diversify risks and reduce the surplus drain from selling new policies. A ceding company obtains surplus relief to the extent that it can reduce its required policy reserves for liabilities transferred to reinsurers. However, reinsurance can also be used to mask an insurer's true financial condition by artificially inflating its surplus. Some financial or so-called "surplus relief" reinsurance transactions transfer little or no risk of loss to the reinsurer. These transactions distort an insurer's financial statement by decreasing its required policy reserves and thus increasing its surplus, even though the insurer's liability remains the same.

Executive Life, Executive Life of New York, and First Capital relied on surplus relief reinsurance to artificially inflate their surplus.[3] These insurers were paying reinsurance premiums for the benefit of claiming credit on their statutory financial statements, even though the financial reinsurers were not liable to pay any claims. For example, Executive Life paid $3.5 million to reinsurers in exchange for reserve credits of $147 million in 1990; however, the reinsurers had no contractual liability to reimburse any of the $1 billion in claims supposedly covered by the reinsurance treaties. Executive Life was not reinsuring against the risk of loss due to policyholder claims; the company was renting surplus. Without surplus relief reinsurance and the commensurate increase in spurious surplus, the Executive Life insurers would have been insolvent as early as 1983.

### Surplus Infusions

During the 1980s, all four insurers also received millions of dollars in surplus aid from their parent holding companies. Without surplus infusions from Executive Life to its New York subsidiary and from First Executive to the California company, both Executive Life insurers would have been insolvent in 1986. Although these infusions allowed the insurers to meet minimum capital requirements, surplus aid represents a temporary solution that does not correct underlying causes of capital deficiencies. The continuing need for surplus infusions demonstrated the inherent capital inadequacies of the four insurers.

In addition to direct infusions of cash, the surplus aid also took the form of loans from the parent holding companies to the

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[3]We could not obtain data on surplus relief reinsurance for Fidelity Bankers because the regulatory examination report is not yet available.

reinsurance problems for Executive Life of New York, California practiced regulatory forbearance for Executive Life and First Capital. In part, California regulators' efforts to monitor Executive Life were undermined by the insurer's failure to comply with state holding company laws.

Regulators' Information Was Neither Timely, Complete, Nor Accurate

State regulators did not have timely, complete and accurate information to monitor the four troubled insurers. Without timely financial statements that fairly present an insurer's true condition, regulators cannot act quickly to resolve problems. We have identified a number of areas where regulators lacked crucial information about the four troubled insurers.

First, financial statements filed in accordance with statutory accounting practices did not fairly reflect the four insurers' true financial condition. For example, as I previously discussed, reported surplus was artificially inflated by surplus relief reinsurance. However, the financial statements did not provide information necessary for regulators to distinguish between valid reinsurance and this statutory accounting gimmick. In addition, statutory financial statements for 1989 filed by the Executive Life insurers did not reflect known losses on their junk bond holdings. The two insurers wrote off only $335 million in losses and did not even disclose $435 million in additional impairments.

Second, an insurance holding company is not required to file consolidated financial statements based on statutory insurance accounting. Such information would be useful in assessing interaffiliate transactions and the overall financial condition of the holding company system. Insurance regulators instead use 10-K reports for publicly traded insurance holding companies. However, the 10-K report is based on generally accepted accounting principles, which may be more or less restrictive than statutory accounting.

Third, regulators relied on infrequent field examinations to verify financial data reported by the insurers and detect solvency problems. Such examinations were done about once every 3 years and took months or even years to complete.[4] Appendix I shows the time lags between the examinations of the four insurers and reporting delays. California and New York regulators waited until 1990 in the triennial schedule to examine the Executive Life companies again, even though regulators had identified

[4]Hereafter, the year of the examination refers to the year under review, not the year in which the examination took place.

group to help disseminate financial information and status reports to other states where the Executive Life insurers were licensed.

## Regulators Lacked Information to Evaluate and Authority to Limit Junk Bond Holdings

Regulators also had inadequate information about the quality of the four insurers' bond holdings and inadequate regulatory authority to limit junk bond holdings during the period that the four insurers built up their portfolios. Before 1990, NAIC's bond rating system did not fully disclose an insurer's holdings of noninvestment grade bonds. NAIC acknowledged that its old system counted some junk bonds as investment grade, but its new classification system is intended to better reflect the quality of an insurer's bond portfolio. Under NAIC's old rating system, First Executive reported in 1989 that 35 percent of its bonds were investment grade. However, according to Standard & Poor's rating system, less than 8 percent of the Executive Life companies' bond portfolios in 1989 was investment grade.

Not only did regulators not know the extent of the insurers' junk bond holdings, but they did not know what those bonds were worth. Regulators knew that the market values for the junk bonds were less than the amortized values in the insurers' 1989 statutory financial statements. According to the chairman of NAIC's working group, regulators needed to know which bonds might default and how much the insurers would lose. Because the California department did not have the expertise to evaluate Executive Life's portfolio, in early 1990 it had to get an independent actuarial firm to assess whether the insurer's assets could support its liabilities. The actuarial firm, however, relied on optimistic assumptions about default rates and investment income provided by Executive Life; actual bond losses surpassed even the worst-case scenario in the actuarial studies. Regulators did not request an independent evaluation of the default risk for Executive Life's portfolio until February 1991.

Even if they had accurate and up-to-date information, regulators did not have specific statutory or regulatory authority to limit junk bond holdings. In 1987, New York limited insurers' holdings of junk bonds to 20 percent of assets. However, the New York regulation did not correct Executive Life of New York's problems because the insurance company was grandfathered and did not have to divest of junk bond holdings in excess of the cap. In 1990, Executive Life of New York's junk bond holdings were 64 percent of assets and represented 962 percent of the insurer's reported surplus and bond reserves.

Even though California did not adopt investment limits on junk bonds until 1991, Executive Life agreed in 1990 not to acquire more junk bonds. Virginia has a bill pending to limit insurers'

Capital had $65 million. Many states still have not acted to restrict use of this statutory accounting gimmick.[8]

## Holding Companies Are a Regulatory Blind Spot

State insurance regulators have limited capability to evaluate and control an insurer's relationships with its holding company and affiliated entities. State holding company laws rely on insurer disclosure to monitor affiliated relationships, and some states have prior regulatory approval requirements to prevent abusive transactions. Regulators cannot effectively assess interaffiliate transactions if the insurer fails to report either the identity of its affiliates or the transactions. Except for infrequent field examinations, regulators have no way to verify the insurer's reported information.

Interaffiliate transactions can mask an insurer's true condition, and improper transactions with affiliates have caused previous life insurer failures.[9] We do not know to what extent interaffiliate dealings may have contributed to the four insurance failures in part because reports of the latest regulatory examinations by New York and Virginia are not yet available.

However, on the basis of our preliminary work in California, we found that Executive Life's failure to comply with state holding company laws undermined California's solvency monitoring efforts. Executive Life repeatedly failed to report and get approval for transactions with its parent and affiliates. As a result, California regulators could not effectively assess the impact of those transactions on the insurer's solvency and protect policyholder interests. For example,

-- Executive Life did not get California's approval before it made a $131 million surplus loan to its New York subsidiary in 1987. The transaction removed cash from Executive Life when the insurer was already seriously troubled. That money will not be available to pay policyholders of the California

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[8]In 1986, NAIC adopted a model regulation on life reinsurance agreements based on New York's law. As of October 1991, only 19 states--including Virginia--had acted to adopt the model. Since this model is required for NAIC accreditation, NAIC expects more states may adopt surplus relief reinsurance regulations.

[9]Abusive interaffiliate transactions caused the Baldwin-United failure--the largest life insurer failure before the Executive Life takeovers. According to state regulators, the parent holding company milked the insurance subsidiaries to service its own debt.

## LAGS IN FIELD EXAMINATIONS AND REPORTING DELAYS

State insurance departments generally do on-site field examinations of insurers every 3 to 5 years, though a troubled insurer could be examined more frequently. The state of domicile leads the examination, and examiners from other states in which the insurer is licensed can participate.

After the examiners finish their fieldwork, they submit the report to the heads of the insurance departments participating in the examination--the report date. The company examined then has the opportunity to review the report and submit comments. The final report is then distributed to all states where the company is licensed and filed as a public document--the filing date.

Executive Life, Executive Life of New York, First Capital, and Fidelity Bankers were examined about every 3 years. Not only were the examinations infrequent, but reporting took months or even years. Table I.1 includes, for examinations done on these four insurers, the period covered by each exam, the report date, and the filing date, where available.

[a]Period covered by exam originally ended 12/31/86 but was extended to 12/31/87.

[b]The company was named E. F. Hutton Life until 1987, when it was purchased by First Capital Holdings Corporation.

[c]The draft examination report was submitted for the insurer's review, and the comment period ended May 5, 1991.

[d]The company was purchased by First Capital Holdings Corporation in 1985.

Sources: Financial examination reports.

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Table 3: Bond Reserves in 1990 as a Percentage of Junk Bonds and the Percentage Bond Loss to Eliminate Surplus and Reserve

| | Reserves as a percent of junk bonds | Percent loss to wipe out surplus and reserves |
|---|---|---|
| Executive Life (CA) | 0.8% | 8.3% |
| Executive Life (NY) | 1.3 | 10.4 |
| First Capital | 4.5 | 11.2 |
| Fidelity Bankers | 3.6 | 11.7 |

Source: Insurers' 1990 annual financial statements and Best's Insurance Reports (1991 Life/Health Edition).

Public awareness of the risks and increasing losses associated with these extensive junk bond holdings led to policyholder runs on the insurers. First Executive Corporation--the parent of the Executive Life insurers--announced a $847 million charge for bond defaults and losses during 1989. The February 1990 failure of Drexel Burnham Lambert exacerbated the collapse of the junk bond market. These events led to a massive run on Executive Life and Executive Life of New York, with policyholders withdrawing a total of about $4 billion in 1990. According to regulators, the April 1991 takeovers of Executive Life and Executive Life of New York spurred policyholder runs on junk bond laden First Capital and Fidelity Bankers.

## Dwindling Surplus

To bolster their statutory surplus, the insurers resorted to the use of questionable reinsurance transactions to reduce required policy reserves on their balance sheets. They also received surplus infusions and loans from their parent holding companies. Statutory surplus is a measure of an insurer's solvency. Under statutory accounting practices, an insurer's costs of selling policies--such as agent sales commissions--are charged to expenses when they occur. Because most premium income is deferred and expenses are charged off immediately, an insurer's surplus shrinks as the company grows. For the four insurers, rapid growth had the effect of depleting their surplus to levels that were much lower than the industry as a whole.

### Surplus Relief Reinsurance

All four insurers relied heavily upon reinsurance to relieve the strain of growth on their surplus. Under a reinsurance contract, the original insurer transfers or "cedes" to another insurer (the "reinsurer") all or part of the financial risk accepted in selling policies to the public. The reinsurer, for a premium, agrees to indemnify or reimburse the ceding company for all or part of the losses that the latter may sustain from claims it insurers. Borrowed surplus is referred to as a surplus note or contribution certificate. Since the loans were subordinated debt and could not be repaid without regulatory approval, the insurers were allowed to count the borrowed funds as surplus on their statutory financial statements without recognizing the liability to repay the funds. Table 4 shows the surplus reported by each insurer at year-end 1990 and the amounts of surplus notes.

Table 4: Reported Surplus and Surplus Notes for 1990 (Dollars in millions)

| | Surplus[a] | Surplus notes |
|---|---|---|
| Executive Life (CA) | $474 | $300 |
| Executive Life (NY) | 185 | 131 |
| First Capital | 107 | 36 |
| Fidelity Bankers | 122 | 50 |

Source: Insurers' 1990 annual financial statements and Best's Insurance Reports (1991 Life/Health Edition).

[a]Figures are inflated by surplus relief reinsurance. See p. 22 for Executive Life and First Capital.

In summary, the insurers' continued solvency depended on the willingness and ability of their parent holding companies to infuse surplus. Both First Executive Corporation and First Capital Holdings Corporation borrowed money to capitalize their insurance companies and depended on payments from their insurance subsidiaries to service the debt. In fact, the insurance companies represented collateral for the holding companies' debt. With holding companies borrowing based on the performance of the very insurance companies that they were propping up with borrowed money, management was in essence constructing a financial house of cards that was bound to collapse.

## REGULATORS LACKED CRUCIAL INFORMATION AND THEIR ACTIONS WERE NOT EFFECTIVE IN STEMMING THE INSURERS' PROBLEMS

State insurance regulators used untimely, incomplete and inaccurate financial reports to monitor the four troubled insurers. Even though regulators were aware that the Executive Life insurers and First Capital had serious solvency problems, they examined the insurers only once every 3 years. Regulators' efforts to limit junk bond holdings and restrict unacceptable reinsurance were not effective in stemming the solvency problems of the four insurers.

Even when New York and California acted to limit more junk bond acquisitions by the insurers, these limits did not reduce the insurers' existing exposure to mounting junk bond losses. Whereas New York took forceful--albeit late--action to eliminate continuing problems in the 1986 and 1987 examinations. For example:

-- New York regulators, in their 1980 examination of Executive Life of New York, found internal control problems, including a blurring of the separate operating identities of Executive Life of New York and its parent Executive Life as well as improper allocation of income and expenses. The 1983 examination of Executive Life of New York revealed more control deficiencies, including failure to maintain proper records. The 1986 examination found that control deficiencies identified in the earlier examinations still had not been corrected.

-- California regulators, in their 1983 examination of Executive Life, found problems with poor record keeping and unacceptable reinsurance. The 1986 examination of Executive Life revealed continuing problems with reinsurance. In fact, California regulators found the problems to be so serious that they extended the examination to 1987.

Fourth, regulators did not get financial information early enough to identify and react to the rapid deterioration that these insurers experienced in 1990. For example, in January 1990 when First Executive Corporation announced the massive bond losses and policyholders began a run on the Executive Life insurers, the last complete financial statements available to state regulators were already more than a year old; regulators did not receive the 1989 annual financial statements until March 1990. Even quarterly statements were not timely enough to keep the regulators up to date. Starting in March 1990, the troubled Executive Life insurers provided monthly and even weekly reports so that the regulators could track the policyholder runs and mounting bond losses.[5] First Capital and Fidelity Bankers were required to provide monthly reports in early 1991.

Finally, the states did not keep each other informed about solvency problems, despite their interdependence in monitoring the troubled insurers. For example, when California regulators were doing their 1987 examination of Executive Life, the most current information available from New York about the insurer's major subsidiary was more than 3 years old. New York regulators' report on their 1986 examination of Executive Life of New York was not provided to other state regulators until 1990. In addition, Minnesota and New Jersey regulators said that their states had trouble getting information about Executive Life from California. In early 1990, NAIC formed a multistate working

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[5]The Executive Life insurers provided weekly reports of daily surrender activity, bimonthly reports of insurance operations, and monthly reports of cash flow and investment activity.

junk bond holdings. In June 1991, NAIC adopted a model regulation limiting an insurer's investment in medium and lower grade bonds to 20 percent of its assets. According to NAIC, 16 states had set specific limits on holdings of high-yield, high-risk bonds as of November 1991.

## Regulators Tried to Curb Reinsurance Problems

Until the early 1980s, surplus relief reinsurance was largely unregulated. In its 1980 examination, New York found that Executive Life of New York's surplus would have been nearly depleted without surplus relief reinsurance. By the 1983 exam, surplus relief reinsurance exceeded the insurer's surplus. In 1985, New York issued a regulation prohibiting credit for surplus relief reinsurance that did not transfer risk to the reinsurer and allowed 3 years to write off such existing financial reinsurance. In the 1986 exam, New York found that Executive Life of New York's problems with unacceptable surplus relief reinsurance persisted and that its reinsurance program was rife with internal control deficiencies. In 1988, New York disallowed $148 million in reinsurance credits on the insurer's 1986 financial statement. Further, New York fined the Executive Life of New York $250,000 and required three officers to resign.[6] According to New York, the insurer no longer had any surplus relief reinsurance.

As early as the 1983 field examinations, California detected certain financial reinsurance arrangements that did not transfer risk and which were not in compliance with state law. However, California allowed 3 years for Executive Life and First Capital to write off the unacceptable surplus relief reinsurance. In the 1986 examination of First Capital and the 1987 examination of Executive Life, California found that both insurers had entered into even more surplus relief reinsurance arrangements to support their explosive growth. In contrast to the forceful--albeit late--actions taken by the New York regulators, California again did not immediately disallow the unacceptable surplus relief reinsurance but instead let the insurers amortize the amounts.[7]

California's bulletin restricting surplus relief reinsurance was not issued until 1989 and even then granted another 3-year write-off period. As a result, Executive Life still had $147 million in unacceptable surplus relief reinsurance in 1990 while First

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[6]These three officers continued to work for Executive Life in California after their dismissals from New York.

[7]Executive Life did have $180 million in surplus relief reinsurance disallowed in the 1987 examination due to defective letters of credit from an off-shore reinsurer.

insurer unless New York lets the subsidiary repay Executive Life.

-- Executive Life shifted $789 million of its junk bond holdings to unreported affiliates in 1988. The transaction had the effect of reducing the insurer's bond reserves and inflating its surplus by about $109 million, thus obscuring its true financial condition.[10]

-- Executive Life's 1990 annual statutory statement did not identify 36 affiliates and subsidiaries, even though the insurer had invested in many of those affiliated companies.

CONCLUSIONS

The reckless growth pursued by these four insurers was supported by questionable business strategies. The four insurers were heavily invested in poor quality assets. They relied on phony financial reinsurance and money borrowed from their parents to artificially inflate their surplus and mask their true financial conditions. Without surplus relief reinsurance and borrowed surplus, the two Executive Life insurers would have been insolvent in the early 1980s while First Capital and Fidelity Bankers would have been undercapitalized.

Despite untimely, incomplete, and inaccurate information, state regulators were aware of the troubled conditions of the four insurers before the companies were taken over but did not take effective action to stem the financial deterioration of the companies or minimize losses. Only after the insurers hemorrhaged from policyholder runs did state regulators move to take them over. As I mentioned at the outset of my remarks, we are still reviewing the performance and capabilities of the state regulators, so my observations today do not represent our final assessment.

This completes my prepared statement. I would be pleased to answer any questions.

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[10]In 1990, California regulators made Executive Life reverse the bond transactions and restate its financial statements.

Table I.1: Field Examinations of Four Failed Insurers

| Period covered | Report date | Filing date |
| --- | --- | --- |
| Executive Life of California | | |
| December 31, 1987 to December 31, 1990 | 4/5/91 (Draft) | Not filed |
| December 31, 1983 to December 31, 1987[a] | 4/1/88 | 7/14/88 |
| December 31, 1980 to December 31, 1983 | 5/10/85 | 11/14/85 |
| Executive Life of New York | | |
| January 1, 1986 to December 31, 1990 | Ongoing | Not applicable |
| January 1, 1984 to December 31, 1986 | 5/6/88 | 5/2/90 |
| January 1, 1981 to December 31, 1983 | 1/28/87 | 3/2/87 |
| First Capital[b] | | |
| December 31, 1986 to December 31, 1989 | 1/30/91[c] | Not filed |
| December 31, 1983 to December 31, 1986 | 8/28/87 | 12/07/88 |
| December 31, 1980 to December 31, 1983 | 4/24/85 | 7/29/86 |
| Fidelity Bankers Life[d] | | |
| December 31, 1988 to December 31, 1990 | Ongoing | Not applicable |
| December 31, 1985 to December 31, 1988 | 9/29/89 | 12/19/89 |