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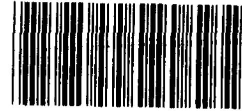

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PROPERTY AND CASUALTY INSURANCE

Thrift Failures Provide Valuable Lessons

Statement of
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Before the
Subcommittee on Oversight and Investigations
Committee on Energy and Commerce
House of Representatives

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to participate in your inquiries into the business practices and events involving two of the property and casualty insurance industry's most costly failures to date. The Subcommittee's investigation into the causes of the failures of Transit Casualty Company (Transit) and Mission Insurance Company (Mission)[1] noted what appeared to be a pattern of practices similar to those found in failed savings and loan associations. At your request, we compared characteristics of these two failed insurance companies noted by the Subcommittee with those found in our work on failed thrifts. In recent years, GAO has performed numerous reviews of conditions within the thrift industry, and we annually audit the financial statements of the industry's insurer, the Federal Savings and Loan Insurance Corporation (FSLIC). We have testified on these matters on over 20 occasions at congressional hearings, including those conducted by this Subcommittee, as well as by the banking, budget, and other committees of both the House and Senate.

More specifically, with regard to thrift failures, between September 1987 and March 1989, we conducted a review of 26 thrifts which failed during the 21 months preceding September 30, 1987, and, which as of that date, FSLIC estimated to be the most

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[1]Liquidators estimate the ultimate losses resulting from Transit, which failed in 1985, and Mission, which failed in 1987, to be approximately $2 billion and $1.5 billion, respectively.

costly to resolve. The characteristics of failed thrifts described here pertain only to those found at the 26 institutions included in our review.[2] These characteristics are not necessarily indicative of those found at all failed thrifts, although we believe that similar situations may also be present at other failed institutions.

With regard to the failed insurance companies, we previously examined the circumstances surrounding the Mission failure although our work did not result in a GAO report.[3] We did not conduct an independent review of the characteristics of Transit, but rather reviewed the findings of the Subcommittee as documented in Subcommittee staff briefing and summary memorandums as well as other documents concerning both Transit and Mission provided to us by Subcommittee staff. These included correspondence with receivers and others responding to the Subcommittee's inquiries on these failures or by others providing information to the Subcommittee on the activities at the failed insurers. We also obtained information from publications and other data aggregated by industry groups such as the National Association of Insurance Commissioners and the National Committee on Insurance Guaranty Funds.

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[2]We are now finalizing our report on thrift failures, which we will issue shortly.

[3]We performed this work for this Committee's Subcommittee on Commerce, Consumer Protection, and Competitiveness.

I wish to emphasize that because of the limited scope of our work, our observations regarding the two insurance companies only apply to those entities. They should not be construed as necessarily applying to other organizations within that industry. However, many of the problems identified at the 26 failed thrifts and at Transit and Mission can be generally characterized as internal control weaknesses.

The broad objectives of internal controls are to safeguard assets, to ensure accuracy and reliability of data, to ensure compliance with policies and applicable laws and regulations, and to promote management efficiency. In our view, establishing and maintaining effective systems of internal control are among the most basic of management's responsibilities.

Like the Subcommittee, we noted definite similarities in certain practices of the failed thrifts we reviewed and the two insurance companies. We also identified several other issues related to the two industries. Before discussing those similarities and other issues, I would like to briefly provide some background data on the insurance industry.

BACKGROUND

Since your hearings have focused on property and casualty insurance, I will restrict my discussion to the property and casualty segment of the industry. Approximately 3,800 insurance companies in the United States sell some form of property and casualty insurance. Property insurance provides financial protection against loss of or damage to real and personal property, while casualty insurance is concerned primarily with the insured's legal liability for injuries to others or for damage to others' property. The property/casualty segment of the industry had assets in excess of $426 billion at year-end 1987.[4]

Generally, the two major sources of income for insurance companies are premiums and investment income. For 1987, net premiums written by property and casualty companies totaled more than $190 billion, up 9.4 percent from the 1986 total, while net investment income was approximately $24 billion, up over 9 percent from the previous year.[5] The income before taxes of the property/casualty segment of the industry was about $13.3 billion

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[4]Year-end 1987 is the most recent date for which financial information on property/casualty insurance companies was available to us. Most of these data come from Best's Aggregates and Averages: Property/Casualty, 1988.

[5]Net premiums written are direct premiums written plus assumed reinsurance premiums minus ceded reinsurance premiums. An insurer's net premiums constitute a measure of its business volume. Also, some insurance departments consider net written premium as an approximate measure of an insurer's exposure relative to its policyholders' surplus.

in 1987, an increase of 151.1 percent over the 1986 total. In addition, for 1987, the industry's underwriting losses, which are the excess of claims paid over premiums received less dividends to policyholders, amounted to over $10 billion, down about 35 percent from 1986. Policyholders' surplus, the safety cushion for policyholders in the event an insurer suffers adverse results, was approximately $100 billion at year-end 1987.[6]

Insurance Company Failures

Insurance company failures in the late 1960s and 1970s generally involved companies that were small, handled mostly automobile insurance, and operated in one state or region. According to officials with experience in insolvency proceedings, no such profile can now be drawn on more current insurance company failures because of the diverse nature of the failed companies and their lines of insurance, the reasons for impairment, and the specific economic conditions affecting each at the time of failure. Likewise, officials within the industry indicated that the causes of more recently reported failures are many and varied and cited the following as contributing factors: underpricing premiums, underreserving for losses, problems with

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[6]Policyholders' surplus is the net worth of an insurer as stated on its annual statement. For a stock insurer, it is the sum of surplus and capital. For a mutual insurer, it is surplus.

risk-sharing arrangements, fraud or incompetence, and overexpansion.[7]

The 1980s have witnessed an increase in property/casualty company liquidations.[8] During the 1970s, the average number of liquidations was at least six per year. This increased to an average of at least 12 liquidations per year from 1980 through 1987 and reached a record high of at least 23 liquidations in 1985. We understand there were seven liquidations in 1988, and five have been reported thus far in 1989. Forty-eight percent of the liquidations between the end of 1969 and the end of 1987 have occurred since 1983. Although the number of liquidated companies increased, it still totaled less than 1 percent of all property/casualty companies in each year. The incidence of liquidations has been geographically widespread, but from 1969 to 1987 just over half of these occurred in six states--New York, California, Pennsylvania, Texas, Illinois, and Florida.

We believe that the potential problems in this segment of the industry may be more extensive than the figures above would indicate. For example, the number of companies designated for regulatory attention by the National Association of Insurance

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[7]See Insurer Failures: Property/Casualty Insurer Insolvencies and State Guaranty Funds (GAO/GGD-87-100, July 28, 1987).

[8]Liquidation is a formal, court-ordered process in which an insolvent company's assets are converted to cash and applied towards its outstanding indebtedness.

Commissioners quadrupled from 132 in 1979 (8.5 percent of the 1,566 companies reviewed based on 1978 annual statements) to 569 in 1988 (21 percent of the 2,654 companies reviewed based on 1987 statements). In 1985, the year which experienced the largest number of liquidations, 418 companies (17 percent of 2,458 property/casualty companies) were designated for regulatory attention. Thus, while the number of liquidations may have decreased since 1985, the number of designated problem companies is increasing.

To further illustrate, data obtained from the state of Texas indicate that recent years have witnessed a sharp increase in the number of insolvent insurance companies requiring action by the State Board of Insurance.[9] In Texas, when capital of financially troubled insurance companies or other insurance-related entities becomes impaired to the point where the company is declared insolvent,[10] they are placed into receivership through the actions of the state Attorney General's Office and the courts for the purpose of liquidation. This process is referred to as receivership. In 1979, approximately 50 Texas insurance companies or other insurance-related entities were active

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[9] Report on the Audit of the Early Warning System of the State Board of Insurance (SAO Report Number 9-065), Office of the State Auditor (Austin, TX: February 1989). This report addresses all segments of the state's insurance industry, not just property/casualty insurance companies.

[10] The Office of the State Auditor of Texas defines insolvency as a state of financial condition in which a company is unable to pay obligations as they fall due in the usual course of business.

receiverships. By August 31, 1988, that number increased to 131 active receiverships. Fifty-four of these receiverships involved property/casualty insurance companies.

It should be noted that until relatively recently, the extent and seriousness of troubled institutions within the thrift industry was an issue over which sharp disagreement existed. For various reasons, relatively few troubled institutions were closed or merged by the federal regulator until 1988. However, by that time, the troubled institutions had already incurred huge losses which vastly increased the government's cost to deal with them. While we are not suggesting that the extent of the problems in the insurance and thrift industries is comparable, we believe that the Subcommittee's findings and other indications of problems point to a need to obtain and assess objective, verified, and consistent information on the overall financial condition of the property/casualty insurance industry.

BUSINESS STRATEGIES

The Subcommittee's investigation has noted that both Transit and Mission embarked upon strategies leading to growth through expansion into new business activities during a time of severe price competition in the industry. To be successful, such strategies must include safeguards to ensure the entity is

equipped both to manage and control any increased volume of business generated, has the assets to offset increased liabilities, and has or obtains the requisite expertise to operate the new lines of business. Information obtained by the Subcommittee indicated that strategies followed by these two companies did not adequately employ such safeguards. Similarly, our reviews of thrift failures noted excessive growth and poorly managed entry into new activities to be characteristics of many of the thrifts we reviewed that experienced large losses.

Growth-Oriented Strategies

Excessively growth-oriented strategies, which occurred at many of the failed thrifts, resulted from management decisions to attempt to generate increased earnings which resulted in compromising the safety and soundness of the institutions' credit and investment policies. These strategies were implemented by soliciting deposits at above market rates and using the proceeds to make loans and investments of a highly speculative nature, often of dubious economic value. While this resulted in rapid growth, such growth was accompanied by increased--and often fatal--risk.

The Subcommittee found that both Transit and Mission pursued growth in a manner which entailed greater risks. The level of growth at Transit and Mission can be illustrated by increases in

direct written premiums and assumed reinsurance premiums.[11] From 1979 to 1984, Mission's direct written premiums and assumed reinsurance premiums increased by 63 percent. The Subcommittee has suggested that "excessive underpricing and minimal or poor underwriting" contributed to this growth. According to Transit's receiver, Transit had huge increases in premium revenues. Transit's direct written premiums and assumed reinsurance premiums increased 182 percent from 1979 to 1984.

In part, Transit accomplished this expansion through the extensive use of managing general agents (MGAs). According to a publicly released Subcommittee briefing memorandum:

> "The use of managing general agents (MGAs) by insurance companies to write business on their behalf is an industry practice that can be exceedingly dangerous. In effect, the insurance company hands over responsibility for its business to the MGA, granting the agent power to underwrite business, obligate the company, handle claims, and even arrange for reinsuring the business written by the MGA in the company's name. Such a complete delegation of authority would be dangerous by itself, but the problem is compounded by the fact that the MGAs are compensated by commissions on the amount of business they write."

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[11]Direct written premiums are all of the premiums arising from policies issued directly by the primary insurance company to its policyholders, while assumed reinsurance premiums are those premiums arising from policies which an insurer accepts, in part or wholly (as the reinsurer), from another insurance company (a ceding company, or the reinsured). See pages 12 through 15 for a discussion of reinsurance activities at Transit and Mission.

While the use of MGAs is a common insurance industry practice and is not necessarily detrimental per se, such an arrangement can pose increased risk if adequate controls do not exist to ensure that MGAs act in the company's best interests. The Subcommittee has suggested that such controls did not exist at Transit.

Expansion Into New Lines of Business

Virtually all of the failed thrifts in our review expanded from traditional home mortgage lending to lending and investments in high-risk activities. Similarly, both Transit and Mission expanded beyond their traditional lines of coverage into new areas, several of which were characterized by greater potential exposure, and included some of the higher risks in the industry, such as chemical companies, asbestos companies, toxic waste sites, and satellite launches.

Until the late 1970s, Transit's business generally focused on writing commercial motor transportation coverage. However, in the 1980s, Transit embarked on new, riskier business strategies concentrating on large-scale commercial liability coverages, written through a network of MGAs and approximately 1,000 subagents. The Subcommittee has noted that Transit management apparently had little expertise and experience in these new areas. According to Transit's receiver, the manner in which it

pursued these riskier activities ultimately proved to be the primary cause of its insolvency.

Traditionally, Mission's primary business was worker's compensation insurance. Beginning in 1983, however, Mission changed its business mix to include commercial multiple peril,[12] automobile, and other liability lines, for which it lacked experience. In addition, Mission also became heavily involved in complex arrangements to spread the exposure of risks it had underwritten to other companies, which the Subcommittee indicated that the Mission receiver cited as being one of the primary causes of its insolvency because these activities were improperly administered and controlled.

UNDERWRITING DEFICIENCIES

The Subcommittee cited poor underwriting as a significant factor in the two insurance company failures. Underwriting, as it relates to the insurance industry, is the process of selecting risks for insurance and of determining for what amounts and on what terms the insurance company will accept the risks. In making such determinations, companies consider various factors, including past loss experience for specific types of risks.

[12]Commercial multiple peril is a "package" policy offering coverage against a variety of perils at a cost lower than the combined costs of individual coverages.

Insurance companies generally set limits on the amount of risk they are willing to undertake, and thus the amount of insurance they will provide.

If a company is approaching its designated financial capacity or self-imposed limit, the company can expand its capacity to write additional business through the process known as reinsurance. In theory, reinsurance is the assumption by one insurer of all or part of an insurance risk undertaken by another insurer, a process designed to spread or divide insurance risks among various companies. Under a reinsurance contract, the primary insurer transfers or "cedes" to another insurer (the "reinsurer") all or part of the financial risk accepted in issuing insurance policies to the public. The reinsurer, for a premium, agrees to indemnify or reimburse the ceding company for all or part of the losses which the latter may sustain from claims it receives. Nonetheless, the ceding company remains liable for any claims.

When ceding insurance, underwriting standards are critical in terms of both initially issuing insurance coverage and subsequently ceding that risk to reinsurers. Because the underwriting company remains liable for any claims which arise, the collectibility of amounts due it from the reinsurer for claims is of paramount importance. Therefore, when determining whether or not to reinsure an insurance risk, the ceding company

must evaluate the level of losses anticipated in relation to the financial condition of the reinsurer.

The Subcommittee noted that problems at Transit relating to underwriting and reinsurance were compounded by the fact that Transit extensively used managing general agents. Unless there is adequate review of the policy underwriting and other activities of the MGA (including the selection of acceptable reinsurers), unacceptable risks to the underwriting insurer may be incurred.

Receivers of both Transit and Mission cited problems related to their reinsurance portfolios as primary factors in their demise. For example, the Subcommittee noted that "Many of the reinsurers used by Transit's MGAs were not sound financially, and others have refused to pay the gigantic claims arising from policies which they believe were poorly underwritten by Transit and its MGAs. Transit's inability to pay the claims on business written in its name, coupled with the breakdown of its reinsurance network, was the direct cause of the company's insolvency in December 1985."

In addition to the risks to the ceding company, the failure of the ceding company to properly underwrite its reinsured risks can have an impact on others reinsuring that risk. Deficiencies in underwriting standards of a ceding company can impact a

reinsurer which has not performed adequate underwriting procedures on the assumed reinsurance, including visiting the ceding company and reviewing its underwriting procedures. For example, Integrity Insurance Company, currently estimated to be the third largest property/casualty failure, had losses from reinsurance assumed from Mission which amounted to approximately 13 percent of Integrity's deficit.

Although reinsurance activities play an important role in the insurance business, reinsurance rates and contracts to a large extent are not regulated. This makes it particularly critical that all parties to such agreements fully understand them and employ safeguards such as adequate underwriting to protect their interests.

In many respects, the problems experienced with reinsurance agreements are similar to those we have noted with reverse repurchase agreements and loan participations in the securities, banking, and thrift industries.

REGULATION AND SUPERVISION OF THE INSURANCE INDUSTRY

Unlike the thrift industry, the insurance industry is regulated entirely by the states.[13] Statutes in each state provide for organizing and maintaining an insurance department responsible for supervising insurance companies and enforcing compliance with state laws. State insurance departments have authority to license companies to sell insurance in their states, to regulate the rates insurers can charge for various lines of insurance, to examine the records of licensed insurers, to take regulatory action in the case of problem companies, and to supervise the liquidation of insolvent insurance companies. Insurance companies are subject to formal regulation by the insurance department of the state in which they are domiciled as well as by any other states in which they are licensed to do business.

The National Association of Insurance Commissioners (NAIC) consists of the heads of each state insurance department. NAIC's basic function is to encourage uniformity and cooperation among the states and U.S. territories as they individually regulate the insurance industry. NAIC also performs various analyses and

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[13]In a 1944 decision, the Supreme Court held that insurance is interstate commerce and as such is subject to regulation by the federal government. However, in 1945, the Congress passed the McCarran-Ferguson Act, which provides that federal antitrust law applies to the insurance business only to the extent that such business is not regulated by state law. Such limitation does not apply, however, to acts of boycott, coercion, or intimidation.

reviews insurance companies' annual financial statements to identify those which may require closer monitoring. Although NAIC has no statutory or regulatory authority, it drafts model legislation and regulations and recommends them for adoption by the states.

In contrast, the thrift industry is subject to both federal and state regulation. Federally chartered thrifts are regulated by the Federal Home Loan Bank system; state-chartered thrifts are primarily regulated by the states, although if federally insured, they are also subject to certain FSLIC regulations as well. GAO and others have noted that some states permitted institutions they chartered to engage in riskier activities than those permitted by the federal regulator and that such activities in many cases resulted in large losses contributing to thrift failures. The fact that the insurance industry is entirely regulated by the states highlights the need to ensure consistency and adequacy in its regulation.

Examinations

To ensure and assess the financial strength of insurance companies, each state requires that state regulators generally conduct examinations at least once every 3 to 5 years, but regulators may perform examinations at any time if they become aware of developing problems. To avoid duplication in examining

companies with multistate operations, NAIC coordinates zone examinations of companies that have a large volume of business in many states. (NAIC has divided the country into four geographic zones). These examinations are conducted by state examiners from participating zones. Reports of examinations are filed with the insurance commissioner of each state in which the company does business.

The Consumer Insurance Interest Group and the National Association of Professional Insurance Agents recently surveyed 47 insurance departments and issued a report in April 1988.[14] Among other things, this survey found that

- -- fewer than half of the insurance departments conduct financial examinations of domiciled companies at least every 3 years;
- -- the scope and capabilities of insurance departments vary greatly from state to state;
- -- in most states, regulators lack the personnel and tools to properly monitor insurers for solvency; and
- -- four out of ten insurance departments do not have the capability to retrieve statistical information on financial examinations.

The report recommended that sufficient numbers of examiners be put in place to conduct financial examinations of all insurers headquartered in the state at least once every 3 years.

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[14] A Study of State Insurance Department Operations (April 1988).

Intervals Between State Examinations

Based on our experiences with failed thrifts and our review of the Subcommittee's findings on Transit and Mission, it would appear that examinations performed once every 3 to 5 years may not be frequent enough. Even lapses of 1 or 2 years did not provide regulators of failed thrifts the time needed to take supervisory or enforcement actions which might have prevented insolvency. Both Transit and Mission were examined every 3 years, but between examinations, both made significant operational and strategic changes which affected their financial condition and which ultimately contributed to their demise. As with some of the failed thrifts we reviewed, by the time regulators conducted examinations, both companies were already nearly insolvent.

Although the examination report on Transit covering the 3 years ending in 1980 noted some problems, it did not indicate they were serious. However, Transit's examination report for the 3 years ending in 1983, which was not issued until April 1985, noted several areas of serious concern, including deficiencies in accounting and other records, and poor internal controls over its managing general agents and subagents. In addition, Transit's loss reserves were found to be understated. Transit was placed in conservatorship about 6 months after the examination report was issued.

An examination report on Mission, covering the 3 years ending in 1981, disclosed only minor areas of concern. Three years later, an examination identified numerous areas of significant concern. For example, examiners noted that Mission

-- showed a net operating loss of $88 million for 1984 but paid $13 million in dividends,

-- lost control of its reinsurance accounting function,

-- understated losses incurred and loss adjustment expenses,

-- accrued inadequate loss reserves,

-- failed to reconcile subsidiary accounts with the general ledger, and

-- recorded questionable transactions to present a better financial picture.

State Guaranty Funds

Providing protection for policyholders in the event an insurance company fails is a function conducted by the states. To carry out this function, each state has established a guaranty fund for property/casualty insurance companies. In 1969, NAIC prepared a model guaranty fund act, and most states now follow its basic guidelines.

Although there is not a central fund to cover losses for the insurance industry comparable to the FSLIC fund for the thrift industry, property/casualty insurance guaranty funds exist at the

state level. Unlike FSLIC, there is no permanent fund (except in New York) dedicated to paying claims against insolvent property/casualty insurance companies. Rather, claims against the insolvent insurers are paid by the guaranty funds from a special assessment made on other licensed insurers in their state in response to a property/casualty insurer's failure. Guaranty funds may be able to reduce the amount of assessments ultimately required through the liquidation of the assets of the insolvent insurers.

State guaranty funds are basically similar in structure and operations and generally parallel the NAIC's model fund act. Differences among the state funds include variations in when they start paying claims, what claims they cover, how much they will pay, and how they administer claim payments. Each state's guaranty fund is responsible for claims in that state against the insolvent insurer. As a result, recovery on claims depends on the state in which the insured party resides. Accordingly, a failure may affect one or more state guaranty funds, as was the case with the Transit and Mission failures. For example, claims against Transit and Mission have been filed in over 30 states, resulting in assessments to other insurers of over $233 million and $221 million for Transit and Mission, respectively, through 1987.

ACCOUNTING AND AUDITING ISSUES

Maintaining accurate and complete financial and business records and accurately reporting the information compiled from those records is critically important to corporate managers, stockholders, policyholders, and regulatory personnel, each of whom must make judgments based upon the information reported. Management must have accurate information to effectively analyze past performance and help establish and measure its attainment of long-term and short-term goals; stockholders need accurate reports from which to make investment decisions; and policyholders need accurate financial information to assess the entity's viability. In addition, accurate and complete financial information is vital to regulators in performing their oversight responsibilities.

Quality of Financial Information

Regulators cited deficiencies in accounting or other records at each of the 26 failed thrifts in our review. Two of the most frequently cited problems were documentation deficiencies and understating loss reserves, which Subcommittee documentation indicates were also present at Transit and Mission.

Like the thrifts, both Transit and Mission had documentation deficiencies which resulted in inaccuracies in the reported

position of the company. For example, at Transit, the receiver indicated records were so inadequate that the extent of the company's reinsurance activities was not known. In 1983, the receiver indicated that Transit's financial statements listed 450 reinsurers, when in fact the company had done business with approximately 1,700 reinsurers. Transit had no master policy register to record all the policies that had been furnished to MGAs or to tell what policies had been written so that premiums could be reconciled to individual policies. The receiver stated that by the end of 1983, Transit was so out of control that management had no reasonable idea of how many policies had been issued or how much premium income had been written, paid, or collected. The Chief Financial Officer at Mission indicated that the information system at Mission was "barely adequate," while examiners went further, indicating that Mission had material control deficiencies within its reinsurance accounting function.

At thrifts, loss reserves are required to be recorded for expected losses from uncollectible loans and from real estate. Examiners cited 18 of the 26 failed thrifts for inadequate loss reserves on their real estate and loan portfolios. Similarly, insurance companies are required to record reserves for estimated losses related to claims which have been filed but have not been paid (reported claims) and losses related to claims which have been incurred but have not been reported (IBNR claims). Often,

the assistance of an actuary is sought to analyze historical trends to reliably estimate the amounts involved.

Statements from receivers of both Transit and Mission indicate that loss reserves at these companies were inadequate. According to testimony presented to the Subcommittee, during the period of ongoing operations, neither Transit nor a subsidiary of Mission, whose activities ultimately contributed material losses to the receivership, employed in-house or other actuaries to determine the IBNR liability. Instead, both used predetermined formulas. The Transit formula for calculating reserves was never adjusted, even when Transit began insuring riskier activities. Similarly, the formula used by the Mission subsidiary was not adjusted for 5 years.

Prescription of Accounting Principles by Regulators

As with the thrift industry, the insurance regulators prescribe accounting principles to be employed in companies' financial reports to the regulator. NAIC has codified statutory accounting practices (SAP), which can be either more or less restrictive than generally accepted accounting principles (GAAP), in its publication Accounting Practices and Procedures Manual for Fire and Casualty Insurance Companies.[15] In addition, the

[15]A summary of major SAP/GAAP differences is provided in attachment II.

various states can adopt or permit accounting practices which differ from GAAP or those codified by NAIC.

While some provisions of SAP would appear to require more stringent accounting standards than GAAP for the insurance industry, other provisions exist which could result in SAP net worth exceeding GAAP net worth. Nonetheless, SAP overall are considered to be somewhat conservative, and we are not aware of any states' creating liberal rules to overstate the financial condition of companies they regulate. At this point, however, we would just make the observation that there is always the potential for difficulty in a situation where inconsistent methods for measuring financial condition and operating results can be permitted.

Within the thrift industry, the adoption of regulatory accounting principles (RAP), which became more lenient than those prescribed by GAAP, allowed many institutions to report a more favorable financial condition than would have been reported under GAAP. Some have credited these regulatory accounting principles with obscuring the true financial condition of the industry and contributing to the deep insolvency of the Federal Savings and Loan Insurance Corporation. The Congress passed the Competitive Equality Banking Act of 1987, which required regulators to adopt certain changes to phase out many of these GAAP/RAP differences. Current legislative proposals addressing the thrift industry's

problems also provide restrictions on the use of regulatory accounting practices which differ from GAAP.

Audit and Accounting Guidance Outdated

Significant changes affecting the insurance industry have occurred in the last decade. These include economic factors such as interest rate fluctuations influencing the return on company investments and court determinations expanding insurers' liability. As the industry changes, auditors must develop new audit procedures to identify and review risks associated with those changes. The American Institute of Certified Public Accountants (AICPA) promulgates standards for auditing the insurance industry. In 1966, the AICPA provided industry audit guidance in its publication, Audits of Fire and Casualty Insurance Companies, and in 1982 added guidance on auditing reinsurance activities as an appendix. In July 1987, the AICPA released the Exposure Draft: Proposed Audit and Accounting Guide - Audits of Property and Liability Insurance Companies for public comment. It is our understanding that significant revisions to this guide are ongoing as a result of the public comments received, and the final guide is not expected to be published before the end of 1989.

In our recent report on audit quality in the thrift industry, we noted that the AICPA Audit and Accounting Guide for Savings

and Loan Associations had not been substantively revised since 1979 to reflect changes in the industry.[16] We recommended that the AICPA immediately revise the guide to provide guidance in areas where audit deficiencies were noted in our review.

LESSONS LEARNED FROM THE THRIFT INDUSTRY

While there are obvious, basic differences between the thrift and insurance industries and the manner in which they are regulated, our extensive work with thrifts nonetheless suggests a number of lessons which we believe would be applicable to both. We are offering these for your information and for consideration by the state authorities, the industry, and other interested parties. Central to this is our belief that the unprecedented crisis we are now facing in the thrift industry, whose cost of resolution is estimated to be in excess of $100 billion, did not have to happen; it was to a large degree preventable. The warning signs were clear, but unfortunately they were ignored. It is certainly our hope that we will learn from the thrift crisis, and regulators can apply these lessons to other industries.

[16] CPA Audit Quality: Failures of CPA Audits to Identify and Report Significant Savings and Loan Problems (GAO/AFMD-89-45, February 2, 1989).

Need for Adequate Systems of Internal Control

Our recent assessments of both failed thrifts and banks noted the most predominant characteristics were the absence of effective systems of internal control and widespread noncompliance with laws and regulations. We have made legislative proposals which would require bank and thrift management to annually report to their regulators on the status of their systems of internal control and on their compliance with laws and regulations. We have also proposed that independent auditors of these institutions read, consider, and report on the validity of the assessments contained in the management reports. Our proposals for reporting are intended to help increase management's awareness of its responsibility regarding these matters, to better affix accountability, and to provide timely and useful information to regulators. Insurance regulatory authorities may wish to consider similar requirements.

Financial Audits

A common characteristic of the failed thrifts was inadequate financial books or records, and the Subcommittee identified similar conditions at Transit and Mission. Under such circumstances, it cannot be expected that the annual financial information reported to state regulators, or to NAIC, will be accurate or reliable. We noted that the banking regulators do not uniformly require annual

financial statement audits of banks, and we have proposed legislation to require this. Given the fact that most states do not require insurance companies to obtain annual audits, we believe insurance regulators should also consider requiring such audits of financial statements prepared in conformity with generally accepted accounting principles, along with a requirement that the audited statements be reconciled to the information reported to the regulators. Such requirements would appear especially appropriate in view of the periods lapsing between examinations, as discussed below. The quality of audits can be enhanced by having up-to-date auditing guidance.

Examination Frequency

Long lapses between examinations can permit adverse changes to occur and not be detected--thus forestalling appropriate regulatory actions. We noted cases of thrifts doubling or tripling their liabilities and embarking on reckless business strategies between examinations. We believe insurance regulators should evaluate the effectiveness of the current practice of 3-to-5-year intervals between examinations.

Adequate Examination and Supervisory Resources

In the early to mid 1980s, as the extent and seriousness of the thrift industry's problems began to be recognized, the federal

regulator attempted to bolster its examination and supervisory resources but was delayed in doing so by federal personnel and compensation ceilings. Adequate resources in this area are essential (1) to identify any problems in regulated companies and (2) where problems are identified, to carry out the necessary monitoring and enforcement actions to minimize losses. To the extent that the insurance regulators' 3-to-5-year examination cycles reflects a lack of resources, we would question their ability to take the timely action often necessary to minimize losses.

Delays in Acting on Problems

One clear message from the thrift crisis is that the costs of delays in acting on problems, once they are identified by examiners, are enormously expensive. Insolvent organizations have little to lose, and thus have strong incentives to take risks. When such risky ventures result in further losses, the costs of resolution increase accordingly. This happened all too often in the thrift industry where severely troubled institutions were permitted to remain in operation through "forbearance" granted by regulators and liberalized regulatory accounting principles which masked problems.

CONCLUSIONS

As a final point, we would note that because of the insurance industry's size, the fact that it is supervised by the states, and the lack of uniformity in regulatory and reporting requirements, the task of monitoring the industry's problems and dealing effectively with them will be a formidable one. We commend the Subcommittee's efforts in this critical area.

The failures in the insurance industry over the past several years are cause for concern in our view, and the Subcommittee's findings regarding the two failed companies it has recently investigated are disturbing. We are not in a position to say whether such problems typify failed insurance firms or are instead isolated instances. We also have ongoing work in the general area of insurer solvency and regulation. We have several related studies under way, including two which were requested by the chairman of this Committee's Subcommittee on Commerce, Consumer Protection, and Competitiveness. The first examines the way states supervise property casualty insurers and how they initially identify problem institutions. The second looks at the Insurance Regulatory Information System (IRIS), the early warning system for insurer failures. Another ongoing review is looking at the practice and regulation of reinsurance. Should the Subcommittee desire further assistance in this regard, please do not hesitate to call on us.

Mr. Chairman, this concludes my prepared statement; I would be pleased to respond to any questions you or other members of the Subcommittee may have.

ATTACHMENT I

CHARACTERISTICS THE SUBCOMMITTEE NOTED AT MISSION AND/OR TRANSIT	CHARACTERISTIC NOTED AT 26 FAILED THRIFTS?
1. Multiple regulators	YES
2. Growth orientation and expansion of markets	YES
3. Excessive underpricing and minimal or poor underwriting	YES
4. Imprudent management practices	YES
5. Extensive and complex reinsurance (comparable to loan participations at thrifts)	YES
6. Long lapses between examinations	YES
7. Use of managing general agents	NO
8. Inadequate internal controls	YES
9. Inadequate loss reserves	YES
10. Change from traditional to potentially riskier activities	YES
11. Outdated audit guide	YES

ATTACHMENT II

THE MAJOR DIFFERENCES BETWEEN SAP AND GAAP

SAP	GAAP
a. Bonds are carried at promulgated amounts which are primarily at amortized cost; however, certain bonds are required by the NAIC to be carried at market.	a. Bonds are carried at amortized cost unless permanently impaired or the enterprise does not have the ability or intent to hold the bonds until maturity.
b. Common and preferred stocks are reflected at values published by the NAIC, which are generally based on market values. Sinking-fund preferred stocks are carried at amortized cost; however, certain issues are required by the NAIC to be carried at market.	b. Common and nonredeemable preferred stocks are carried at market. Preferred stocks that by their terms must be redeemed by the issuing company are carried at amortized cost if the company has both the liability and intent to hold the stocks until redemption, and there is no decline in the market value of the stock that is other than temporary.
c. Stocks of subsidiaries or affiliates are valued on one of the following bases: o Statutory book values of the assets of the companies if held directly by the insurer o Net worth of the companies determined in conformity with GAAP o Market values if the companies are publicly traded o Any other value that can be substantiated to the satisfaction of the NAIC subcommittee o The changes in values are recorded as direct charges or credits to surplus	c. Investments in unconsolidated subsidiaries are generally accounted for on the equity method. When reporting on a consolidated basis, investments in subsidiaries are eliminated.
d. Nonadmitted investments are recognized by a charge to surplus through unrealized depreciation of investment carrying value.	d. Adjustments of carrying values as a result of permanent impairment and declines in market values of stocks that are other than temporary are recorded as realized losses.

ATTACHMENT II

e. Certain assets and certain reductions of liabilities are not recognized by the state insurance departments and, accordingly, are excluded from the balance sheet. Such assets, principally furniture and equipment, prepaid expenses, and certain receivable balances and, in certain states, federal income tax recoverables, are referred to as nonadmitted assets.	e. All assets are included at cost or recoverable amount.
f. Costs of acquiring policies are charged to expense when incurred (generally, at the beginning of the policy period).	f. Acquisition costs that vary with and are primarily related to new and renewal business are deferred and amortized over the policy period.
g. Policyholder dividends are recorded as liabilities when they are declared.	g. Undeclared policyholder dividends at the balance sheet date are estimated and accrued.
h. Minimum liabilities for losses may be required for certain types of risks based on a statutory formula.	h. Liabilities for losses are based on estimates of the ultimate amount of losses to be incurred.
i. Estimated amounts of salvage and subrogation are generally not recognized by regulatory authorities on paid and unpaid losses until they have been received in cash.	i. Estimated amounts of salvage and subrogation recoverable on paid and unpaid losses are recorded as reductions of the liability for unpaid losses.
j. Because federal income tax returns are filed on a statutory basis, no deferred federal income taxes are required.	j. Deferred federal income taxes are provided for differences arising from reporting revenues and expenses in different periods for financial statement and federal income tax purposes.

Source: Exposure Draft: Proposed Audit and Accounting Guide--Audits of Property and Liability Insurance Companies (AICPA, July 22, 1987, pages 76-78.)