United States General Accounting Office

GAO

Testimony

For Release
on Delivery
Expected at
10:00 a.m. EST
Wednesday
February 27, 1991

Insurance Industry: Questions and Concerns About Solvency Regulation

Statement of
Johnny C. Finch
Director for Planning and Reporting
General Government Division

Before the
Committee on Commerce, Science and Transportation
U.S. Senate

GAO/T-GGD-91-10

GAO Form 160 (12/87)

050674/143240

Insurance Industry: Questions and
Concerns About Solvency Regulation

SUMMARY OF STATEMENT BY
JOHNNY C. FINCH
DIRECTOR FOR PLANNING AND REPORTING
U.S. GENERAL ACCOUNTING OFFICE

At the Committee's request, GAO summarized the results of its work regarding (1) parallels that exist between the financial condition of the insurance industry and the savings and loan industry, and (2) issues raised about the quality of regulatory oversight of the insurance industry.

The insurance industry has not experienced the magnitude of difficulties that the savings and loan industry has, and industry analysts do not believe large numbers of companies are in imminent danger of failing. Nevertheless, GAO noted similarities between the causes of failures for certain firms in both industries. Among other things, failed firms that GAO reviewed in both industries had inadequate internal controls, high growth, inadequate loss reserves and a regulator who was either unwilling or unable to act quickly to resolve problems.

GAO's work on the overall quality of oversight and solvency regulation in the industry has raised a number of questions about the ability of the insurance regulatory system to identify and resolve troubled and failing insurance companies. Among the more important of those concerns are:

-- Untimely data which inhibits regulatory ability to quickly identify problems, and financial reporting requirements which are not sufficiently comprehensive to identify the risks to which companies are exposed.

-- Wide variations among the states in both the resources devoted to regulatory oversight and the authorities that regulators have to compel behavior fostering insurer solvency.

-- Incomplete regulatory coverage of the risks to insurance companies arising from their reinsurance transactions because of the extensive international character of the reinsurance market.

-- The fairness of existing insurance industry guaranty fund arrangements which vary widely from state to state as well as the capacity of existing guaranty fund arrangements to adequately protect policyholders in the event of widespread company failures.

GAO believes these issues warrant consideration with the objective of strengthening regulation of the insurance industry.

Mr. Chairman and Members of the Committee:

We are pleased to be here today to participate in your hearings on the condition and regulation of the insurance industry. Recent events in the insurance as well as other financial industries clearly demonstrate the importance of close oversight and proper regulation. Insurance is an important part of American commercial and personal financial affairs. The purchase of insurance consumes a substantial amount of our income, either through direct insurance outlays, or through higher prices for the goods and services we buy. According to the Insurance Information Institute, total insurance written for all lines equaled $453 billion in 1989, the last year for which figures are available.

We have been examining issues related to insurer solvency and regulation for several years. Our completed work to date has focused primarily on property-casualty insurance. Therefore, my remarks today will address property-casualty insurance and its regulation. Our work has included an examination of the structure and operation of the property-casualty guaranty fund system, the mechanism for protecting those with insurable losses from the financial failure of insurance companies. We have also reported on the nature of reinsurance and its regulation, and on the operation and effectiveness of the Insurance Regulatory Information System (IRIS). Finally, in the first of a series of reports on insurance solvency regulation, we examined the way

state insurance regulators identify troubled insurers and how they coordinate regulatory efforts.[1]

COMPARISONS BETWEEN THE INSURANCE AND SAVINGS AND LOAN INDUSTRIES

You asked us to comment on parallels between conditions in the insurance industry and those in the savings and loan industry. Much has been made in the press and other venues about the similarities between these two industries. The insurance industry has not experienced the magnitude of difficulties that the savings and loan industry has, nor, according to industry analysts, do large numbers of insurance companies appear to be in imminent danger of failure. The past decade, however, has seen a trend of increasing numbers of failing companies. Moreover, these failed companies have, on average, been larger than in prior years. There is concern in the industry and among regulators that these trends may continue.

Beyond this general concern, our work has illustrated another comparison between these two industries that is troublesome.

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[1]The GAO reports referred to include: (1) Insurer Failures: Property-Casualty Insurer Insolvencies and State Guaranty Funds, GAO/GGD-87-100; (2) Insurance Regulation: Problems in the State Monitoring of Property-Casualty Insurer Solvency, GAO/GGD-89-129; (3) Insurance Regulation: State Reinsurance Oversight Increased, but Problems Remain, GAO/GGD-90-82; and (4) Insurance Regulation: The Insurance Regulatory Information System Needs Improvement, GAO/GGD-91-20.

Specifically, there are striking similarities between the causes of failures of certain firms in both industries. We reviewed 26 thrifts with high resolution costs that failed during the 21 months preceding September 30, 1987. At the request of the Chairman of the House Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, we compared the causes of these thrift failures with the underlying causes of the failures of Transit Insurance Company and Mission Insurance Company. These two companies remain the largest and most expensive failures in the history of insurance regulation.

Neither of these samples of failed companies were large enough or selected in a way that allows generalizations about both industries. However, out of 11 characteristics linked to the failure of Transit and Mission, 10 were also found to exist at all 26 failed thrifts.[2] These included:

-- Multiple regulators,

-- Growth orientation and expansion of markets,

-- Excessive underpricing and minimal or poor underwriting of insurance or of loans,

-- Imprudent management practices,

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[2]For a full discussion of this work, see "Property and Casualty Insurance: Thrift Failures Provide Valuable Lessons," Statement of Frederick D. Wolf, Assistant Comptroller General, Accounting and Financial Management Division, U.S. General Accounting Office; Before the Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, House of Representatives, April 19, 1989, GAO/T-AFMD-89-7.

-- Extensive and complex reinsurance arrangements in excess of normal prudent business practices (comparable to loan participations at thrifts),

-- Long lapses between examinations,

-- Inadequate internal controls,

-- Inadequate loss reserves,

-- Change from traditional to potentially riskier activities, and

-- Outdated audit guidelines.

To this list we would now add, based on our more recent insurance work, an unwillingness or inability on the part of the regulators to act quickly to resolve problems. Just as was true in the case of the failed thrifts, insurance regulators were unable to identify and/or act in time to forestall costly failures of Mission and Transit.

ISSUES IN INSURANCE REGULATION AND PROBLEM COMPANY RESOLUTION

The factors related to the failure of Mission and Transit raise a number of questions about the quality of insurance industry regulation. In the remainder of my testimony I would like to discuss some of the concerns and questions that have surfaced in our work about the ability of the insurance regulatory system to identify and resolve troubled and failing companies.

Poor Data

A necessary precondition for effective regulatory action is good information, that is, information which is accurate, complete and timely. All states currently require the majority of the insurance companies headquartered or licensed in their state to submit the annual financial statement developed by the National Association of Insurance Commissioners (NAIC). Some states also require all or some of their companies to file quarterly financial reports. The other principal source of regulatory information about companies is the financial examination. Generally state insurance department examinations of companies are required once every 3 to 5 years, although, if an insurance department suspects a problem, the date of a scheduled examination can be accelerated.

In our work to date, we found, particularly in those states that require only annual filings, that the information may not be timely since problems occurring early in a calendar year would not be reported until the annual statement was reviewed between March and May of the following year. Moreover, there has been little regulatory verification of the data self-reported by insurance companies on quarterly and annual statements. Another congressional investigation of insurance company failures found that "False and misleading financial reports have been a major contributing factor to every insolvency and problem company

observed by the Subcommittee."[3]

We have no reason to doubt the general veracity of the information filed by most insurance companies with their regulators. However, we also believe it is reasonable to assume that a company in trouble would be more likely to attempt hiding its true condition from the regulator. Thus, even if most companies do report with reasonable accuracy, the lack of verification of data by the regulator to determine whether information is false or inaccurate negates much of the value of the regulatory system for promptly identifying and resolving regulatory problems.

In addition to the problem of potential inaccuracies or deliberate misstatements in insurer financial reports, the general adequacy of the financial statement for identifying problems that would pose regulatory concerns may be open to question. Certain activities that insurance companies engage in and the risks associated with those activities are not captured in annual financial statements. A recent report comparing the condition of insurance and other financial industries published by the Insurance Information Institute states that

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[3]Failed Promises: Insurance Company Insolvencies, Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, U.S. House of Representatives; February, 1990; page 70.

> "Analyzing individual companies exclusively on the basis of publicly reported data is a hazardous business. Off-balance sheet assets and obligations, which can involve activities ranging from letters of credit to merchant banking, can significantly alter values, and critical variables such as the quality of assets or the adequacy of reserves or pricing often cannot be gleaned from the data until the problem is beyond remedy."[4]

These data inadequacies are particularly troublesome since, as we recently reported, the NAIC's Insurance Regulatory Information System, used by many insurance departments as part of their early warning system for identifying solvency problems in companies operating in their states, uses annual statement data exclusively. Whatever deficiencies exist in the annual statement data, therefore, apply equally to the early warning capability of IRIS.

Regulatory Resources and Authorities

In addition to an effective early warning system, the ability of state insurance regulators to identify problem companies and to act quickly and effectively depends on having sufficient resources and authorities. In our work, we have not identified readily available criteria for establishing how large a budget or how many staff are sufficient for effective regulation. We have, however, found that the level of resources available to state

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[4]Rating The Risks: Assessing the Solvency Threat in the Financial Services Industry, by Orin Kramer, Insurance Information Institute, 1991, page 7.

insurance departments varies dramatically from state to state. For example, in the five states that we visited while preparing our September 1989 report on insurance regulation, the ratio of annual statements submitted by insurance companies operating in the state to the number of reviewers assigned to analyze those statements in 1988 varied from 79 annual statements to 1 reviewer in Connecticut to 792 to 1 in Arizona.

Besides sufficient staff and other resources, state insurance regulators need the legal and regulatory tools to allow them to effectively deal with problem insurers. NAIC develops and adopts model laws and regulations that state insurance commissioners collectively feel are necessary to regulate the business of insurance. However, NAIC has no authority to require individual states to accept and codify the models. As a result, substantial differences exist in the regulatory tools used by the various state insurance departments, and in the scope of their authority. These differences translate directly into differences in the quality of regulation in the various states.

In its new program for certifying state insurance departments, NAIC has established minimum financial regulation standards, including specific laws and regulations that states should have in place. Since the certification program was adopted in June 1990, two states--Florida and New York--have been certified. We do not know how many other states will meet the minimum

standards, but it is widely believed that many states will have to adopt or amend a number of laws in order to become certified.

Reinsurance

Reinsurance is insurance for insurance companies. Insurers spread the risks they accept by buying reinsurance. This mechanism is important to the availability of insurance and to the financial stability of the insurance system. However, uncollectible reinsurance has, itself, contributed to solvency problems for some insurers. Even though the primary insurer can, for payment of a fee, pass some of its risk of loss on to a reinsurer, the primary insurer remains liable to pay all claims resulting from the business it originally insured. If the reinsurer, for any reason, is unable or unwilling to reimburse its share of the primary insurer's outlay, the result may be a significant financial loss for the primary insurer.

Regulatory coverage of the reinsurance market is incomplete because of its international character. Although many reinsurance companies are licensed or headquartered and therefore regulated in the United States, non-U.S. companies provide about one-third of the reinsurance coverage in the U.S. market. However, state insurance regulators have neither the authority to regulate nor the ability to effectively monitor the financial condition of non-U.S. reinsurers. Therefore, regulators are

unable to assess the vulnerability of U.S. primary insurers to the risks from purchasing reinsurance from non-U.S. reinsurers. Existing regulatory mechanisms to require security for these transactions have also proven inadequate.

Guaranty Funds

Every state has a guaranty fund to pay claims when a property-casualty insurer fails. Most states have guaranty funds for failed life and health insurers. The mechanism of these funds is generally similar. When an insurance company fails, the future cost of paying claims is estimated and each state's guaranty fund assesses surviving companies a percentage of their in-state insurance activity (usually 1 to 2 percent) to pay the claims as they are reported. The assessed companies can then, depending on the state, either reduce their state tax liabilities or increase their premium rates to offset the assessments. In effect, the assessment mechanism passes the cost of insolvencies on to policyholders through premium increases or to taxpayers through state tax offsets.

There are two interesting questions related to the insurance guaranty funds. The first is a question of fairness. Every fund has payment caps and eligibility rules for payment of claims against failed companies. Because these caps and rules vary from state to state, two claimants with the same insurance coverage

and identical losses in two different states may well receive different payments from their respective guaranty funds.

The second question involves the capacity of the system. The existing guaranty fund system was designed in an era when insurer failures were infrequent and relatively small in size. In addition, all funds have limits on how much an insurer can be assessed in a single year. These limits also vary from state to state. If trends toward increased size and frequency of failures seen in recent years continue, coupled with assessment limits, claims on the funds in some states may exceed their capacity to pay. Although the guaranty funds are designed so that the industry initially pays for the costs of failed companies, in the event of widespread guaranty fund capacity problems a potential liability for the states may exist.

SUMMARY

Increasing competition and narrowing profit margins are being experienced across the entire financial services sector. Moreover, fraud and mismanagement have been identified as contributing to the failure of some financial institutions. To the extent these problems adversely affect insurance companies as they have some other financial firms, the insurance regulator's responsibility is to identify problem insurance companies early and resolve them with minimum harm to insurance

markets, customers, and taxpayers. A failure to fulfill this regulatory responsibility was one of the factors that changed the savings and loan industry from an industry with some troubled institutions into an industry in trouble.

We have raised some issues that stand in the way of insurance regulators effectively fulfilling their responsibility to identify problems and act early. We believe these issues are important and need to be addressed to strengthen the insurance regulatory system.

This completes my prepared statement. We are providing copies of our published reports on insurance regulation should you want them for the hearing record or other purposes. We would be pleased to respond to your questions.

Copies of GAO reports cited in this statement are available upon request. The first five copies of any GAO report are free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

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