

CBO TESTIMONY

Statement of
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NOTICE

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Mr. Chairman, I appreciate this opportunity to appear before your Subcommittee to give you some preliminary findings from the report that we are preparing at your request on the economic impact of possible solvency problems in the insurance industry. Our report does not evaluate the likelihood of solvency problems in the industry. It hypothetically assumes that such problems could exist on a large enough scale to have noticeable impacts on the overall economy, and then lays out what these macroeconomic impacts might be. The focus is not on the economic impacts of the event that precipitated the problems in the first place, such as a natural disaster, but on what additional impacts may arise solely from solvency problems in the insurance industry.

In my testimony today, I will address the following topics: how the insurance industry affects economic activity; what solvency problems mean; how solvency problems could arise in the insurance industry; what their possible major economic impacts could be; and whether the current solvency regulation of insurers is adequate to prevent such problems.

My main points can be summarized briefly:

- o Although analysts agree that the current financial problems of the insurance industry are considerably smaller than those that existed in the savings and loan industry during the 1980s, and that solvency

problems are not likely in the near future, some rare events--such as a truly catastrophic natural disaster--could ignite solvency problems for insurers.

- o Solvency problems in the insurance industry could damage the overall economy because the industry is an important financial intermediary, but the exact dimensions of the damage are difficult to predict. However, it seems clear that the economic impacts of the solvency problems alone are likely to be much less than the impacts of the event that precipitated the problems in the first place, particularly in the case of a truly catastrophic natural disaster.
- o Regulation of the solvency of insurers by the states is improving rapidly, but additional improvements are needed.

HOW THE INSURANCE INDUSTRY AFFECTS ECONOMIC ACTIVITY

The insurance industry is an important financial intermediary. The industry sells various insurance policies, annuities, and other investment assets such as guaranteed investment contracts and invests the proceeds in a variety of financial assets such as corporate bonds and commercial mortgages. These

operations protect policyholders by efficiently spreading the risks of economic losses. They also make credit markets more liquid and efficient, which lowers the costs of borrowing and raises the return to policyholders who save with life insurers. Consequently, solvency problems in the industry could harm the economy by reducing the amount of efficient risk spreading and by interrupting the normal flow of funds in financial markets.

The Benefit of Risk Spreading

Risk spreading raises social welfare and promotes a greater level of economic activity by protecting policyholders from various economic losses. The life and health insurance industry specializes in protecting individuals and their beneficiaries from financial hardships caused by premature death and costly illness. In 1989, for example, the amount of life insurance in force at U.S. insurers totaled about \$8.7 trillion, and the payments to beneficiaries and policyholders of life insurance policies totaled almost \$51 billion. The property and casualty industry specializes in protecting against losses of various types of property and against losses from injury caused to others. Payments by U.S. property and casualty insurers on claims for losses totaled about \$169 billion in 1989.

Insurance protects a policyholder from loss by spreading the policyholder's risk of loss among the other policyholders and the owners of the insurance company. Policyholders secure insurance protection by paying premiums to insurance companies for protection during a specific period of time. These premiums add to the reserves of insurance companies, which are used to pay for losses by the policyholders. When a policyholder files a claim for an insured loss, the insurer pays for the loss by drawing down its reserves by the amount of the claim. In effect, each policyholder already has paid for a small portion of the loss.

The owners or equityholders of insurance companies also assume some of the policyholders' risks. In particular, they assume some of the risk of abnormally large losses by policyholders because the chances and the magnitudes of losses are not known with certainty. When the insured losses are abnormally large, but not large enough to cause the insurance company to fail, the equityholders of the company bear some of the burden of paying for the abnormal losses through lower dividend receipts and a drop in the market value of the insurers' equity.

It is important to note that the protection given to a single policyholder arises because losses are spread widely, not because losses are eliminated for the whole economy. When a natural disaster destroys property, for example,

this destruction is a permanent loss for the economy, which lowers the productive capacity of the economy. Property insurers pay policyholders for the insured losses they have suffered, but they do so by withdrawing funds from their resources: reserves and capital and surplus. The total loss of property to the economy is not changed. The lost property is replaced by reducing the financial capital of insurers.

Nevertheless, the risk spreading enhances social welfare. Risk spreading makes individuals and businesses better off because they generally do not like certain risks. It also allows individuals and businesses to buy goods and services and undertake activities that they would avoid or be unable to buy without insurance. Society is made better off by enjoying a larger supply of goods and services produced by risky activities. Moreover, the larger supply from risky activities does not necessarily come at the expense of a smaller supply of low-risk activities. Risk spreading promotes a greater level of economic activity than would exist without insurance. By pooling many risks, insurance companies can economize on the amount of resources necessary to provide a given level of risk spreading and thereby free up resources that can be used for other purposes.

Improving the Liquidity and Efficiency of Credit Markets

By providing a significant amount of funds to credit markets, the insurance industry improves the liquidity and efficiency of these markets. Savers are able to invest in a greater assortment of assets, and borrowers face a more ready source of funds and lower borrowing costs. In 1989, for example, the insurance industry supplied over \$120 billion to credit markets in the United States, or about a quarter of all funds supplied by private financial intermediaries. Most of the assets held by the insurance industry are corporate, state, and local bonds as well as commercial mortgages.

The insurance industry dominates the market for corporate bonds, which is an important source of credit for business. For example, the industry's net purchases of corporate bonds amounted to almost 70 percent of the \$97 billion worth of net corporate bonds issued during 1989. And at the end of 1989, the insurance industry held about 40 percent of the \$1.4 trillion of outstanding corporate bonds; state and local government retirement funds were the next largest domestic holder with \$182 billion (13 percent). Most of these bonds are investment-grade issues. For life insurers, a large share of corporate bonds are purchased directly from companies, and are known as private placements. Well-capitalized, small and medium-sized businesses have traditionally relied on the private placement market for

financing their longer-term needs because they have limited access to or cannot afford the open bond market, which is dominated by large companies. During the 1980s, some leveraged buyouts also were financed in the private placement market.

The market for commercial mortgages also relies heavily on the insurance industry for funds. The insurance industry, particularly the life insurance industry, traditionally has provided long-term financing for commercial properties such as office buildings, shopping centers, warehouses, and factories. During 1989, for example, net purchases of commercial mortgages by the insurance industry accounted for about 31 percent of the net change in the market, and at year-end, the insurance industry was the second largest holder of commercial mortgages, accounting for about 27 percent of the \$745 billion in existing loans in the commercial-mortgage market. (Commercial banks were the largest holder with 46 percent.)

Typically, the industry's long-term mortgage loans are made on completed projects, replacing the short-term financing used for construction and start-up costs. These long-term loans generally carry lower risk than other commercial mortgage loans because insurers require that the cash flow from the project is able to cover a multiple of the property's debt service before the loan is made. In recent years, however, some life insurers have

made large amounts of "bullet" mortgage loans on commercial real estate. A bullet mortgage is typically a relatively short-term loan to a real estate developer who is required to make only interest payments until the loan matures, at which point the principal is due in full. Because they are speculative loans, bullet mortgages are much riskier than the majority of mortgages made by life insurers and have the potential to create financial problems for those insurers that invested heavily in them.

Tax-exempt borrowers have relied on the property and casualty industry for a large amount of financing. This financing takes the form of obligations issued by state and local governments, nonprofit organizations, and nonfinancial corporations by way of industrial revenue bonds; the interest income from these obligations is exempt from federal income taxes. Households are the primary source of funds for this market, both directly and indirectly through mutual funds and money market mutual funds, but the property and casualty industry also is an important participant in this market. The market for tax-exempt securities had about \$1 trillion outstanding at the end of 1989, and the property and casualty industry was the second largest holder with about \$136 billion, or 14 percent of the total. Purchases of tax-exempt securities by the property and casualty industry have been relatively small in recent years because the depressed levels of underwriting income probably have reduced the tax advantages of these securities.

Some issuers of tax-exempt securities also rely on the insurance industry to provide insurance, or guarantees, on their tax-exempt securities. This use of insurance coverage has been available since the early 1970s. By purchasing insurance, the issuers probably are able to reduce their interest costs because they can offer an extra layer of protection to investors against potential delays in interest payments, or against defaults on interest and principal. An example of insured securities are those issued by state and local housing authorities to finance the construction of affordable housing projects.

DEFINITION OF SOLVENCY PROBLEMS

Solvency problems arise from an unusual situation in which the industry's contributions to the welfare of the nation and to economic activity are severely disrupted. The small number of insolvencies that typically occurs every year has no noticeable impact on the overall economy; the insolvencies are usually small, and the state guaranty funds are able to cover--up to their prescribed limits--the losses to policyholders. These typical insolvencies do not make up solvency problems, in my view. Nor would I expect solvency problems to arise from an orderly consolidation in the industry.

Instead, solvency problems would involve the insolvency of one or more large insurers or the insolvency of many smaller insurers so that the overall economy would be damaged by the subsequent reduction in the amount of financial intermediation by the industry. Given the reduction in the net worth of the industry that would be associated with the solvency problems, the industry would have a smaller capacity to spread risks--the supply of insurance would fall, and the industry would be unable to cover its obligations to policyholders in full. In addition, the industry would channel fewer funds to credit markets.

EVENTS THAT COULD PRECIPITATE SOLVENCY PROBLEMS IN THE INSURANCE INDUSTRY

Solvency problems in the insurance industry would require an extraordinary set of events to have a noticeable impact on the overall economy. Although the insurance industry has never experienced such severe solvency problems, it is possible to imagine events that could cause them, however unlikely they may be. In general, such events could be a catastrophic increase in claims by policyholders; a collapse of markets for assets that the insurance industry holds; and a severe loss of capital resulting from other factors. A catastrophic increase in claims by policyholders is probably the most likely cause of

solvency problems for the property and casualty industry. For the life insurance industry, recent events have shown that a collapse of asset prices is the most likely source of insolvency. Recent events have also shown that life insurers are susceptible to runs by policyholders, but liquidity problems are not likely to lead to solvency problems because insurance regulators and the Federal Reserve are very sensitive to the possibility of liquidity problems and can take the necessary actions to prevent massive runs.

Catastrophic Increases in Claims by Policyholders

For property and casualty insurers, catastrophic increases in claims for losses could arise from natural disasters, such as earthquakes and hurricanes; spills of toxic wastes and other environmental damage; and commercial accidents, such as a nuclear meltdown. This Subcommittee has already received testimony that insured losses from a particularly catastrophic earthquake in California could amount to \$40 billion to \$60 billion. Claims for environmental damage could amount to hundreds of billions of dollars in certain worst-case scenarios. Given that the capital and surplus of the whole property and casualty industry amounted to \$134 billion at the end of 1989, these events could wipe out a significant portion of the net worth of the property and casualty industry. For life and health insurers, catastrophic

increases in payments of benefits could arise from an unexpectedly rapid spreading of the human immunodeficiency virus (HIV), which causes AIDS, but this possibility currently appears to be a manageable risk for those insurers.

Collapse of Asset Markets

A severe drop in the prices of bonds or other assets that the insurance industry holds also could threaten the smooth functioning of the insurance industry. The collapse of the market for a single financial asset normally would have a small impact on the financial condition of insurers because they typically hold well-diversified portfolios of high-quality assets. But life insurers, like savings and loans and banks, assumed greater investment risks during the 1980s, and the collapses of the junk bond and commercial real estate markets have pushed a number of moderately large life insurers into insolvency.

Additional problems may appear in the coming years as a large number of risky "bullet" mortgage loans on commercial real estate come due in a weak real estate market. Given that the junk bond market has rebounded from its lows of two years ago and that the bottom may be near for the commercial

real estate market, these markets appear rather unlikely to be a major source of additional financial difficulties for insurers in the near future.

Severe Losses of Capital as a Result of Other Factors

Severe losses of capital also could arise in other ways. A renewed downturn in the profitability of the property and casualty industry, also known as the "hard market" phase of the industry's periodic underwriting cycle, could create problems for weak insurers. Indeed, solvency problems in the industry have been closely related to this cycle. Fraud and mismanagement could wipe out the net worth of some insurers, but these areas are unlikely to be a source of widespread solvency problems for the insurance industry as the states improve their regulation efforts.

Runs on life insurers are a potential, but one would hope not very likely, source of solvency problems. The failure to stem a run might cause it to escalate and turn a liquidity crisis into a solvency crisis, forcing all but the strongest insurers to sell assets quickly at reduced prices. Insurance regulators, however, would step in to protect besieged companies. Insurance regulators would prevent policyholders from redeeming their policies until the threat of a continuing run subsided, as the regulators in New Jersey did last

year when they seized control of the Mutual Benefit Life Insurance Company after it suffered a flood of withdrawals. Moreover, the Federal Reserve has the authority to provide the necessary liquidity by lending to insurers through its discount window.

ECONOMIC IMPACTS OF SOLVENCY PROBLEMS IN THE INSURANCE INDUSTRY

Solvency problems in the insurance industry would undermine the industry's beneficial financial intermediation, which could harm the overall economy, particularly in the short run. They would reduce the supply of insurance, thereby raising the price of insurance; shift the burden of paying for the losses that created the problems; and interrupt the normal flow of funds through financial markets, which could raise the cost of borrowing for some and lower the return to saving for others. Such impacts could lower output and income both directly and indirectly as they spread through the economy.

The exact nature of these various impacts is difficult to predict in general. They depend on a myriad of factors that may interact with each other. Moreover, empirical economic models of the insurance industry and its relationship to the rest of the economy do not exist. Also, the insurance industry has never experienced massive solvency problems. For certain worst-

case scenarios, the impacts could, in principle, be significant. For most cases, however, the economic impacts of solvency problems would probably not be very burdensome for the economy as a whole, though some individuals and businesses could suffer greatly. Moreover, whatever impacts did occur would not last forever. Financial markets would adjust relatively quickly, and the insurance industry would eventually regain its financial health.

Impacts from a Higher Price for Insurance

One important consequence of solvency problems in the insurance industry would be a reduction in the capacity of the industry to write insurance, thereby raising the price of insurance. The industry's capacity to write insurance depends on its capital and surplus, or net worth. When abnormal losses reduce capital and surplus, the industry must reduce the amount of insurance it writes; the price of insurance will then rise, and less profitable lines of insurance may be dropped. Such disruptions would force policyholders to assume greater amounts of risk or pay a higher price for insurance, both of which raise business costs and hurt consumer budgets.

Although a higher price for insurance would clearly harm social welfare, its impact on economic activity is more difficult to predict, but the

impact seems likely to be small and short-lived except in extreme cases. Greater business costs would lower the supply of output in the short run at existing prices of goods and services and with no change to fiscal and monetary policies. In time, resources would move out of those risky activities that were no longer profitable under a higher price and into less risky activities. Consequently, the supply of output eventually might be little changed, but the composition of output could be changed, which would hurt social welfare. To the extent that the abandoned risky activities earned greater average returns than the less risky activities, the level of output could be affected over a longer period of time. Nevertheless, the level of output would eventually return to where it would have been without solvency problems, since the insurance industry eventually would recover and restore normal pricing and availability of insurance.

The magnitudes of these short-run impacts would be relatively large if risk were a large component of costs for businesses, but available evidence suggests that the cost of risk is, on average, a small fraction of business costs. Small businesses and those engaged in risky activities, however, could be noticeably hurt by a higher price of insurance because they face a higher cost of risk. Also, small businesses have fewer opportunities to spread risks in other ways. Higher prices for personal lines of insurance would also affect the level and composition of consumer spending. Available evidence suggests that

consumers would reduce their purchases of both insurance and goods and other services if the price of insurance rose. To the extent that businesses and consumers reduced their insurance coverage, they would need to increase their saving in low-risk assets in order to cover their greater exposure to risk.

Impacts from Shifting the Burden of Past Losses

Another way that solvency problems could harm the economy is by shifting the burden of the losses that created the solvency problems. Typically, those groups bearing the burden of an insolvency include the owners of the insolvent insurance company, the policyholders of the insolvent insurer, the policyholders of the remaining solvent insurers in the state, and possibly state taxpayers. The latter two parties share in the loss because, although the guaranty funds assess the solvent insurers to cover their payments to policyholders, insurers can pass the assessments on to policyholders or take a credit against their premium tax liabilities, depending on state law.

If solvency problems were too large for the guaranty funds to handle, however, then the burden of the losses could be spread in other ways because state taxpayers do not ultimately stand behind the guaranty funds. The policyholders of the insolvent insurers might not be paid off in full.

Borrowing by the guaranty funds could shift some of the burden from current policyholders to future policyholders and state taxpayers. The magnitude of the decline in spending in the short run and the length of time necessary for the economy to recover the losses would depend on how those various parties adjusted their spending in response to their losses.

Generally speaking, the greatest near-term decline in spending would probably occur if the policyholders of the insolvent insurers were not paid off in full. Large and visible losses to these policyholders would raise uncertainties in the minds of other policyholders about the security of their insurance assets. Consequently, all policyholders might decide to lower their spending and increase their saving in order to reduce their chances of being wiped out by the failures of their insurers. Moreover, large losses could reduce the opportunities of the policyholders of the insolvent insurers to borrow in order to maintain their spending on consumption or replace the losses on property formerly covered by the insolvent insurers.

If the state guaranty fund system works, however, the near-term decline in spending probably would be much smaller. Most likely, the guaranty funds would have to borrow in order to indemnify the policyholders of the insolvent insurers. (In extreme cases, state taxpayers might be called in to prop up the funds, even though, as I mentioned earlier, they have no statutory obligation

to do so.) The policyholders of the insolvent insurers would receive payment for their losses up to the limits prescribed by the guaranty funds, and could spend the money on current needs as well as repairing or replacing their damaged property. The other policyholders and taxpayers would not reduce their spending very much because they would not begin repaying the borrowed amount until the future.

How quickly the economy recovers the losses would also depend on who bears the burden of the losses. The length of time necessary for the economy to recover the losses probably would be shorter if current policyholders bore the losses rather than future policyholders and taxpayers. Although the near-term decline in spending would be greater, shifting the burden to current policyholders would spur additional saving and lower real interest rates, thereby promoting a quicker recovery of the lost capital than if the burden were shifted to future policyholders and taxpayers.

Impacts from Interrupting the Flow of Funds Through Financial Markets

Insurers invest their premium receipts and retained earnings in various financial assets, thereby providing credit markets with a large source of funds. As noted earlier, most of these assets are corporate, state, and local bonds

plus corporate equities that are traded in open markets. Other assets are bonds and commercial mortgages that insurers sometimes buy directly from the issuers in the private placement market. This intermediation by insurers makes credit markets more liquid and efficient; policyholders who save with life insurers are able to invest in a greater assortment of assets and earn a higher return. Moreover, borrowers face a more ready source of funds and lower borrowing costs.

Consequently, an interruption in intermediation by the insurance industry could raise the cost of borrowing for those businesses and state and local governments that rely on insurers as a major source of their borrowing. It could also lower the prices of bonds and commercial mortgages and the return to policyholders who save with life insurers. If solvency problems harmed the confidence of policyholders, runs on life insurers could occur, which would magnify the economic impacts in the short run. But, as I noted earlier, insurance regulators, and if necessary the Federal Reserve, would take the necessary actions to nip any runs in the bud.

Temporary Credit Crunch for Some Borrowers. Even if no major disruptions occurred in credit markets, insolvencies of insurers could lead to credit problems for those borrowers who rely on insurance companies as an important source of funds. Credit problems might occur because solvency

problems could interrupt and destroy financial relationships that were established over time and could temporarily reduce the flows of funds to credit markets through insurance companies. Fewer funds could flow through the insurance industry if sales of insurance fell, especially of those life insurance products with savings features, or if pension funds and businesses chose other intermediaries to manage their assets.

Higher borrowing costs for some borrowers would be temporary, however. Eventually the funds that were once provided through insurers would reach the credit market through other channels. Businesses that once placed funds with insurers might self-insure by placing funds in their own reserves to cover expected losses, or by forming captive insurance companies. Individual policyholders could switch from saving with insurers to saving with depository institutions and mutual funds. Furthermore, those borrowers normally serviced by insurers would eventually obtain credit from other financial intermediaries. Nevertheless, the rechanneling of funds would not occur immediately, so that borrowers who rely quite heavily on insurers could face a temporary "credit crunch," forcing them to postpone their planned expenditures.

The shift of borrowers from insurers to other lenders also might temporarily raise borrowing costs for other borrowers. The good credit risks

that shifted from insurers to other lenders could force other borrowers who are considered somewhat less creditworthy to go without funds or face much higher borrowing costs than before. Borrowing costs for others also could increase temporarily because any new capital provided to the insurance industry would have to come from competing needs.

Capital Losses on Bonds and Commercial Mortgages. A second economic impact operating through financial markets could be capital losses on bonds and commercial mortgages, which could also harm the amount of financial intermediation in the economy. These assets are important investments not only for insurers, but also for many other individuals and institutions. Large sales of these assets to meet large claims by policyholders or to liquidate insolvent insurers could push their prices down and harm the owners of these assets. For example, "fire sales" of commercial mortgages and real estate in the weak real estate market of the early 1990s could have been particularly burdensome to banks, thrifts, and other insurers that were already struggling to recover from losses on these assets. Additional losses for these lenders could have forced them to scale back even further their lending for those and other risky loans until their capital positions had improved.

DEFICIENCIES IN REGULATING THE SOLVENCY OF INSURANCE COMPANIES

Our review of the criticisms of the state system for regulating the solvency of insurers indicates that it suffers from deficiencies that limit its effectiveness for protecting policyholders and for mitigating the potential adverse economic impacts arising from the solvency problems of insurers. Unlike all other financial institutions, the solvency of insurers is regulated entirely at the state level. The federal government currently has no responsibility for regulating the solvency of insurers or for protecting policyholders from losses arising from the insolvency of their insurers.

Before the 1980s, the state system of regulating solvency was largely adequate to maintain a sound insurance industry. The increase in the number and size of insolvencies of insurers during the 1980s, however, indicated that regulators had failed to keep up with changes in insurance and other financial markets that have dramatically altered the nature of the risks borne by the industry. Although analysts agree that the industry is not now facing a solvency crisis, regulating the solvency of insurers needs to be brought up to date.

The states and the National Association of Insurance Commissioners have moved quickly to shore up their standards for regulating solvency and are currently working to strengthen regulations governing the following areas:

- o Capital and surplus requirements;**
- o Investment risks that insurers assume;**
- o Fraudulent activities by insurers;**
- o Accounting for uncertainty about reinsurance recoverables;**
- o Uniform minimum standards for regulating solvency nationwide;**
- o Corrective actions for financially weak insurers, and procedures for liquidating multistate insurers; and**
- o The ability of guaranty funds to meet their obligations to the policyholders of insolvent insurers.**

The first four need to be corrected in order to better promote sound business practices. Uniform minimum standards for solvency regulation will help to prevent jurisdiction shopping by insurers and to protect states using strong solvency regulations from the costs of weak solvency regulation by other states. The last two must be corrected in order to protect policyholders more effectively from losses associated with the insolvency of their insurers.

The states can easily fix most of these deficiencies, but some analysts argue that they may have trouble maintaining a uniform set of minimum standards for regulating solvency over time. They argue that a substantially greater federal role in regulating the solvency of the insurance industry is necessary to eliminate this problem. However, it is not clear that such an extreme solution is warranted or desirable. The states are moving quickly to strengthen their solvency regulations, and because their efforts at creating a uniform system of minimum standards are relatively new, it seems prudent to wait and see how successful the states will be. Moreover, an important danger inherent in an expanded federal role is that it could unintentionally create an implicit responsibility for the federal government to bail out the guaranty funds in the event that they were unable to meet their obligations in full.

CONCLUSION

Solvency problems in the insurance industry could have a variety of economic impacts. At a minimum, solvency problems, by reducing the supply of insurance, would hurt social welfare by reducing opportunities for spreading risk. But other impacts are likely. A higher price of insurance could reduce the supply of output and shift the composition of output away from risky

activities in the short run. Solvency problems could shift the burden of the losses that precipitated the problems, which could affect the magnitude of the decline in spending in the short run and the length of time necessary for the economy to recover the losses. Solvency problems also would temporarily interrupt the normal flow of funds through financial markets, which could raise the cost of borrowing for some and lower the return to saving for others.

Stronger solvency regulations are necessary in order to reduce the risk of solvency problems in the insurance industry. Stronger regulations are necessary for promoting sound business practices, achieving greater uniformity of minimum solvency regulations nationwide, and more effectively protecting policyholders from losses arising from the insolvency of their insurers. The states are working hard to correct the remaining deficiencies in regulating the solvency of insurers, and it remains to be seen how successful they will be.

