# Should the Feds Regulate Insurance Company Solvency?

**Scott E. Harrington**

The solvency of financial institutions has recently received enormous attention. Following the savings and loan debacle, concerns have arisen over the financial condition of many commercial banks. The Federal Deposit Insurance Corporation is likely to require substantial additional funds to protect insured bank deposits and to continue the policy of guaranteeing nominally uninsured deposits. In the state-regulated insurance industry, both the number and magnitude of insolvencies have increased significantly relative to historical norms. These insolvencies, along with reductions in operating income and asset values of some of the largest insurers, have led a few observers to question whether financial problems in insurance could ultimately rival those of the savings and loan industry.

A highly publicized, sensational report by the Subcommittee on Oversight and Investigations of the U.S. House Committee on Energy and Commerce chaired by Rep. John Dingell of Michigan (the Dingell report) argues that the insolvency of several sizeable property-liability insurers in the mid-1980s was primarily caused by gross mismanagement and fraud coupled with weak solvency regulation by the states. The report's general prescription is for more comprehensive and competent regulation. If such oversight is not forthcoming by the states, the report suggests that the federal government will be compelled to fill the void. The popular media have run numerous stories with a similar theme. State oversight and systems for paying the claims of insolvent insurers are commonly portrayed as inadequate.

The Dingell report highlights a number of important issues, but it is simplistic and misleading in several key respects. It exaggerates the scope of financial problems in insurance and the deficiencies of state regulation. Like many synopses of problems in the savings and loan industry, it overstates the role of fraud and mismanagement and understates the role played by exogenous economic factors. More important, however, is the failure of the Dingell report and most discussions in the popular media to recognize clearly a major lesson from the savings and loan debacle: comprehensive government guarantees of financial institutions encourage high-risk strategies and facilitate fraudulent activity. Although recognition of this basic problem is essential for sound public policy, siren calls for comprehensive federal (or federally mandated) guarantees of insurance claims have nonetheless begun. The danger exists that an inappropriate federal response in this area could set the stage for increasing problems in the years ahead.

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### State Solvency Regulation

Following a nineteenth century U.S. Supreme Court decision and the enactment by Congress of the

McCarran-Ferguson Act in 1945, state governments historically have had primary responsibility for insurance regulation. Some coordination and uniformity among the states have been achieved through actions of the National Association of Insurance Commissioners (NAIC), a voluntary association of state insurance commissioners. In addition to promulgating insurer financial reporting requirements, the NAIC meets regularly to debate and adopt "model" legislative bills for subsequent consideration by individual state legislatures.

**Despite the lesson from the S&L debacle that comprehensive government guarantees of financial institutions encourage high-risk strategies and facilitate fraudulent activity, siren calls for comprehensive federal or federally mandated guarantees of insurance claims have begun.**

Primary responsibility for solvency regulation of an insurer traditionally has rested with regulators in its home state, that is, its state of domicile. Solvency regulation has three main facets: controls over the insurer's operations such as licensing requirements, minimum net worth requirements, and limitations on choice of investments; monitoring of the insurer's financial condition, including periodic on-site examinations; and a system for paying a portion of any claims against insolvent insurers. The most important solvency monitoring system is administered by the NAIC. Statistical analysis of financial ratios and scrutiny of financial results by a team of examiners are used to identify for state regulators the insurers requiring further regulatory review or action. A number of states have developed their own statistical review systems to augment or replace the NAIC system.

The NAIC adopted a model property-liability insurer guarantee fund bill in 1969 after a bill was introduced in the Senate to create a federal guarantee system. At that time only a few states had guarantee systems. The remaining states rapidly adopted property-liability insurance guarantee fund legislation based on the NAIC model. Following an insolvency, each state's guarantee fund estimates the amount needed to pay claims of its citizens against the failed insurer and then assesses all surviving insurers in proportion to their premium volume in the state. (New York's prefunded plan is the only exception to this system of postinsolvency assessment.) A majority of states limit coverage to $300,000 per claim except for workers' compensation insurance claims, which usually are covered without limitation. A number of states have coverage limits below $300,000.

In most states the maximum assessment on insurers in any one year is limited to either 1 or 2 percent of an insurer's state premium volume. If the limit is reached, additional assessments are made in subsequent years. Guarantee-fund laws in a majority of states include a provision that in principle permits insurers to recoup assessments in subsequent premiums (some states require surcharges). Other states allow insurers to offset assessments against state premium taxes over a period of years. Most states have adopted analogous guarantee systems for life and medical insurance claims.

### Insolvency Experience

During the 1970s an average of six property-liability insurers failed each year and subsequently required guarantee-fund assessments. One third of these insolvencies occurred in 1975. Table 1 shows property-liability insurance guarantee fund experience for the 1980s. From 1984 to 1989 the number of insol-

**Table 1: Nationwide Assessment Experience of Property-Liability Insurance Guaranty Funds: 1980–1989**

| Year | Net Assessments (in millions, $1989) | Net Assessments/ Net Written Premiums (%) | Number of Defaults During Year |
|---|---|---|---|
| 1980 | 21.7 | .01 | 4 |
| 1981 | 69.4 | .05 | 6 |
| 1982 | 63.1 | .05 | 9 |
| 1983 | 52.9 | .04 | 3 |
| 1984 | 143.8 | .10 | 17 |
| 1985 | 364.2 | .22 | 25 |
| 1986 | 494.3 | .25 | 18 |
| 1987 | 981.4 | .46 | 14 |
| 1988 | 495.8 | .23 | 12 |
| 1989 | 772.4 | .37 | 14 |

*Number of companies declared insolvent that had produced assessments as of year-end 1989. According to the NCIGF, 23 insolvencies occurred in 1989; 14 had net assessments by year-end.

Sources: National Conference of Insurance Guaranty Funds (NCIGF), *Best's Aggregates & Averages* (1990 ed.), and *Economic Report of the President* (1990)

vencies was much higher than historical norms, but the annual insolvency rate was always less than 1 percent of all insurers. Not surprisingly, net assessments by guarantee funds increased dramatically during this period, but they still represented less than one half of one percent of nationwide premiums in each year. Many insurers that failed in the 1980s wrote relatively greater amounts of commercial insurance compared with earlier periods in which many of the insolvent insurers specialized in auto coverage. The number of insurers designated by the NAIC for regulatory attention also increased substantially during the 1980s, but the NAIC attributes much of this increase to rapid growth in the number of insurers' financial statements that received in-depth analysis.

According to the NAIC, an average of 11 life and medical insurers operating in multiple states failed each year from 1985 to 1989. Still the average life and medical insurance guarantee fund assessment during the 1980s represented only .05 percent of total premiums. Almost half of the life and medical insurers' insolvencies occurred in 1989, a result that the NAIC attributes largely to escalating health care costs and lower margins on life insurance products with payments that are sensitive to changes in interest rates.

### The Dingell Report and NAIC Action

The Dingell report is the product of an 18-month investigation and hearings held during 1988 and 1989. The subcommittee "found no evidence of an overall crisis threatening the existence of the insurance industry at the present time." It stated, however, that the "same early warnings of potential disaster are abundantly evident, as they were 5 years ago in the thrift industry. If such warnings are not heeded, the insurance industry and the nation could face a solvency crisis rivaling the present savings and loan situation." The report's conclusion that insolvency problems are primarily caused by fraud, mismanagement, and weak state regulation was based on the analysis of four property-liability insurer insolvencies. Three of these insolvencies (Mission Insurance Company and affiliates, Integrity Insurance Company, and Transit Casualty Insurance Company) were large compared with historical norms. (Regulators took actions to conserve Mission's assets in 1985; liquidation was ordered in 1987. Liquidation proceedings for Transit Casualty and Integrity began in 1985 and 1987, respectively.)

As of year-end 1989, net guarantee fund assessments for these three insolvencies totalled almost $900 million. The National Conference of Insurance Guaranty Funds (NCIGF) projected that net assessments ultimately would total $1.3 billion. The magnitude of the ultimate deficit and required guarantee fund assessments is subject to substantial uncertainty. According to the Dingell report, the receivers for these insolvencies estimated a total deficit of $5 billion. Transit Casualty accounted for over half of this amount, but the report suggested that the estimate for Transit Casualty could contain substantial error. As of year-end 1989, the NCIGF projected net assessments of approximately $300 million for this company.

The Dingell report documents a pattern among these insurers of rapid growth in new and risky product lines and, based on hindsight, substantially inadequate prices and deficient loss reserves (reported liabilities for expected claim costs). These insurers also made extensive use of "managing general agents" that were authorized to make risk selection and pricing decisions and to arrange for reinsurance—the transfer of some of the risk assumed to reinsurers. Much of the reinsurance sold by these companies was provided by hundreds of different reinsurers, many of which were located outside of the United States. In principle, reinsurance helps spread risk and enhances the solvency of the ceding insurer (the insurer purchasing reinsurance). But claim payments due from many of the reinsurers for these and other insolvent companies have not been made. Some reinsurers are now themselves insolvent; many others are refusing payment, alleging fraudulent activity such as the concealment of information by ceding insurers. Many of the resultant disputes are presently being litigated.

**The Dingell report found "no evidence of an overall crisis threatening the insurance industry at the present time" but stated that "some early warnings of potential disaster are abundantly evident." Studying four property-liability insurer insolvencies, it concluded that these problems are caused by fraud, mismanagement, and weak state regulation.**

The Dingell report's criticisms of state solvency regulation include insufficient resources devoted to regulation, use of unreliable information, lack of coordination among regulators in different states,


*"But look on the bright side. We did not create even one single hazardous waste!"*

and infrequent and poorly prioritized on-site financial examinations. The report expresses particular dismay at the absence of requirements for independent CPA audits of insurers' financial statements, for certification of loss reserves by an actuary, or both in about two-thirds of the states. (Because of multistate operations, insurers subject to mandatory independent CPA audits nonetheless account for over 90 percent of nationwide premiums.)

**Industry analysts generally believe that the financial condition of both the property-liability and life and medical insurance industries is basically sound. Under the current regulatory system and reasonable economic scenarios, it is highly unlikely that insolvency problems in insurance will even begin to rival those of the thrift industry.**

During the past several years, the NAIC has taken a number of steps designed to improve solvency regulation. Model bills have been enacted that require increased disclosure and oversight of the activities of managing general agents and reinsurance brokers and managers. Another model bill was amended to strengthen significantly the conditions that a reinsurer must meet before a ceding insurer can reduce its reported liabilities as a result of purchasing reinsurance. The NAIC also promulgated substantial changes in property-liability insurers' financial statements, including a significant expansion in the amount of information to be disclosed regarding reinsurance transactions and loss reserves.

In 1989 the NAIC adopted standards for solvency regulation that require enactment of key NAIC model bills (or similar legislation). The standards also require independent CPA audits of financial statements and an opinion on loss reserves by a qualified actuary or other specialist. In 1990 the NAIC adopted a program in which states can be certified for compliance with these standards. Compliance will be evaluated by an NAIC audit team that includes academics, former regulators, and retired insurance executives.

The demise of Mission, Integrity, Transit Casualty, and other property-liability insurers has led to a valid concern about the ability of regulation to detect and deal with aggressive pricing and deliberate understatement of loss reserves, as well as about the extent to which reinsurance can be used to finance excessive growth. The responses by the NAIC would appear to be sensible in view of the evidence. The extent to which pressure and publicity generated by the Dingell investigation may have influenced some of these changes is not clear.

On the basis of these developments, data on insolvencies, and evaluation of industry net worth relative to liabilities, industry analysts generally believe that the financial condition of both the property-liability and life and medical insurance industries is basically sound. Under the current regulatory system and given reasonable economic scenarios, it is highly unlikely that insolvency problems in insurance will even begin to rival those of the thrift industry. This does not mean, of course, that insolvencies will not continue or that improvements in regulatory oversight and guarantee fund design are not desirable.

### Errors of Omission and Emphasis

The Dingell report's story of fraud, mismanagement, and weak regulation overlooks several important aspects of the insolvency problem in the property-liability insurance industry: the inherent riskiness of the insurance business, the role of unexpected growth in claim costs for liability insurance, and formidable problems that regulators face when

attempting to monitor solvency. Furthermore, the report devotes little or no attention to the adverse effects of guarantee fund protection on consumers' incentives to seek safe insurers and thus on insurers' incentives to reduce insolvency risk, or to the policy implications of these effects.

Insurers face both investment risk and underwriting risk—the risk that eventual claims will substantially exceed the amounts expected when the insurance contract is written. Since actions to reduce insolvency risk, such as holding more capital, are costly, the efficient level of insolvency risk is not zero. Financial difficulties and insolvencies would not be eliminated even if all insurers were well managed and monitored by competent and conscientious regulators.

Property-liability insurers invest mainly in medium- and long-term government and high-grade corporate bonds. Since changes in interest rates generally have a greater impact on the value of these investments than on the value of insurer liabilities, the market values of property-liability insurers' net worths fluctuate with changes in interest rates. It is not clear, however, whether any recent property-liability insurers' insolvencies have been related to interest-rate risk. Most life and medical insurers are also exposed to interest-rate risk. In addition, many life and medical insurers are exposed to the risk of changes in margins on savings-oriented products. While bond portfolios of most life and health insurers primarily contain investment-grade securities, the recent insolvency of a sizeable life insurer with significant holdings of junk bonds has received considerable publicity, and the value of commercial mortgages held by many life and medical insurers has declined recently as a result of conditions in the commercial real estate market.

Life and medical insurers generally are subject to less risk of large, unexpected increases in claim costs than are property-liability insurers. This risk is especially pronounced for commercial liability insurance coverage because claims can be made many years after coverage is sold. Possible changes over time in the types of injuries compensable through tort action, in legal standards for liability, and in jury awards for compensatory and punitive damages all expose liability insurers to significant underwriting risk.

Unexpected growth in liability claim costs for policies sold during the early 1980s is likely to have contributed to the increase in the number and magnitude of property-liability insurer insolvencies that began in 1984. This increase in insolvencies followed sharply deteriorating industry financial results for commercial liability insurance coverage and coincided with the onset of the highly publicized liability insurance crisis.

**The Dingell report overlooks the inherent riskiness of the property-liability insurance business, the role of unexpected growth in claim costs for liability insurance, and the problems regulators face when trying to monitor solvency. The report also devotes little attention to the adverse effects of guarantee fund protection on consumers' and insurers' incentives for safety.**

Table 2 shows the growth in losses reported by insurers for policies sold in the early 1980s between the first year that losses were reported and year-end 1989. Results are shown for major liability insurance product lines and for workers' compensation. (Commercial multiperil insurance includes property and liability coverage sold as a package to small and medium-sized businesses.) As can be seen, the growth rates for commercial general liability insurance (which includes coverage for product liability and environmental liability) was especially large. While some of this growth could reflect the deliberate understatement of loss reserves in the early 1980s, the figures nonetheless suggest substantial unexpected growth in claim costs. (The figures do not include the experience of insurers that later became insolvent. Such companies may

**Table 2: Percentage Growth (through 1989) in Industrywide Reported Claim Costs Following Year of Accident: 1982–1984 (surviving companies only)**

| Type of Insurance | 1982 | 1983 | 1984 |
|---|---|---|---|
| Commercial General Liability | 37.9% | 43.8% | 44.0% |
| Commercial Multiperil | 13.3 | 20.2 | 16.8 |
| Commercial Auto Liability | 10.6 | 16.4 | 20.1 |
| Workers' Compensation | 2.1 | 8.3 | 16.1 |
| Personal Auto Liability | –.9 | 1.6 | 5.5 |

Source: *Best's Aggregates & Averages* (1990 ed.).

have been most likely to deliberately understate loss reserves in the early 1980s.)

Mission, Integrity, and Transit Casualty had been in business for many years before they failed. They also had received the highest financial rating from the major insurance company rating agency, the A.M. Best Company, almost until the time that regulatory action was taken, and they had been audited by leading CPA firms. As emphasized in the Dingell report, these insurers rapidly expanded sales of liability coverage before failing. In retrospect, much of this coverage was very risky—toxic waste liability, liquor law liability, products liability for pharmaceutical companies, excess limits coverage, and reinsurance.

On the basis of hindsight, the Dingell report concludes that these companies engaged in massive and deliberate understatements of loss reserves. The report is especially critical of inadequate loss reserves for injuries that had not yet been reported to the insurers at the time that their financial statements were prepared (called "incurred but not reported" losses). But the reserves for many types of liability coverage written by these companies cannot be established with much precision. A significant amount of reserve inadequacy for these and other insurers that failed since 1984 is likely to have been caused by unpredictable increases in both the frequency and severity of claims. Furthermore, financial problems associated with unexpected growth in liability insurance claim costs could have caused some insurers to "go for broke" by engaging in low-ball pricing and other forms of risky behavior in the face of imminent insolvency.

**Insurance guarantee funds probably contributed to the increased frequency and severity of insolvencies in recent years, as well as to the greater prevalence of insolvent companies that wrote significant amounts of commercial insurance as opposed to personal auto coverage.**

The property-liability insurance market also appears to be characterized by cyclical fluctuations in prices. While the causes of such fluctuations are not fully understood, cyclical reductions in commercial liability insurance prices during the early 1980s are likely to have contributed to the financial problems and subsequent insolvency of some insurers. Further research on property-liability insurers' insolvencies might help to sort out the relative influences of cyclical effects, unexpected growth in claim costs, and go-for-broke strategies and fraudulent behavior.

### The Problem with Guarantees

Government-mandated guarantees of the obligations of financial institutions provide valuable protection to customers. Guarantees of bank deposits in a fractional reserve banking system also help prevent runs that could have large macroeconomic effects. In addition, it is sometimes argued that the substitution of regulatory oversight for monitoring by numerous individuals can produce significant savings in total monitoring costs. On the downside, spreading the cost of insolvencies broadly through government guarantees reduces incentives for consumers to deal with safe firms and thus for firms to be safe. In practice, government regulation also is unlikely to offset fully the reduction in private monitoring. As a result, a point can be reached in which additional government guarantees increase the total cost of insolvencies, including the cost of monitoring.

Insurance guarantee funds probably contributed to the increased frequency and severity of insolvencies in recent years, as well as to the greater prevalence of insolvent companies that wrote significant amounts of commercial insurance as opposed to personal auto coverage. Without guarantee-fund protection, policyholders generally would have considerably more incentive to buy coverage from safe insurers. (Persons or entities with few assets to protect that are legally compelled to buy liability coverage would represent an exception.) There would be much less incentive to choose an insurer with the lowest premium, regardless of its safety. Although many insurance buyers might be ill-prepared to assess competing insurers' financial strength, a strong preference for safety by policyholders would motivate insurers to make their promises to pay claims more credible. This could be achieved by holding more capital or by taking steps to obtain high ratings from private financial rating services. Agents and brokers would be more motivated to identify and deal with safe insurers to avoid loss of future income due to policyholder departures in the event that an insurer failed. Other parties, such as providers of mortgages and auto loans, also would be expected to pay more attention to the soundness of insurers. Insurance guarantee funds dilute these incentives. The greater the guarantee, the greater will be the dilution.

Insurers with substantial intangible assets (such as those that arise from investments in sales forces) that could be lost in the event of insolvency have considerable incentive to operate safely regardless of the scope of guarantee-fund protection. But guarantee-fund protection gives buyers less incentive to purchase coverage from such insurers unless their intangible assets are associated with the provision of desired services. Moreover, guarantee-fund protection provides an incentive for entry by weak insurers with low premiums, and it probably facilitates risky behavior by previously strong insurers that have been damaged by unexpected increases in claim costs or uncontrollable reductions in asset values.

By reducing incentives for safety, guarantee funds increase the burden on regulatory monitoring. Since the market provides less discipline to high-risk insurers, more discipline must be provided by government regulation to avoid an increase in the frequency and severity of insolvencies. Increases in regulatory monitoring, however, are unlikely to offset fully the effects of reduced private oversight for two reasons. First, the amount of information and knowledge concerning insurers' safety that is available to regulators will seldom, if ever, equal that which is diffused among and communicated through hundreds and thousands of market participants and transactions. Second, by spreading the cost of insurers' insolvencies broadly among insurers, policyholders, and taxpayers, guarantee funds could actually reduce pressure on state governments to commit resources to adopt internal controls that are necessary for efficient solvency regulation.

### Improving Incentives for Safety

Expanding the scope of protection provided by insurance guarantee funds should be avoided. Instead, policymakers should work to reduce the scope of protection and to achieve a better balance between providing incentives for safety and protecting consumers from losses in the event of insolvency. One approach is to reduce or even to eliminate guarantee-fund protection for commercial insurance. This would increase incentives for commercial buyers to deal with financially sound insurers and would discourage policyholders from buying coverage that they know is underpriced.

The American Insurance Association, a major trade and lobby organization for commercial property-liability insurers, recently endorsed eliminating protection for commercial coverage. The NAIC amended its model bill for property-liability insurance guarantee funds several years ago to remove guarantee-fund protection for corporations with net worths greater than $50 million. While the details vary widely, about 10 states have adopted limitations related to the insured's net worth. These restrictions make a lot of sense, if the courts will uphold them. (A 1989 federal court ruling held that Michigan's net worth limitation was arbitrary and therefore violated equal protection under the Michigan and U.S. constitutions, but it was overturned on appeal.)

**Policymakers should work to reduce the scope of protection provided by insurance guarantee funds and to achieve a better balance between providing incentives for safety and protecting consumers from losses in the event of insolvency.**

A majority of state guarantee funds contain small deductibles for covered claims. Consideration might be given to incorporating a coinsurance provision that would require buyers with guarantee-fund protection to bear a percentage (for example, 10 percent) of their loss above any deductible in the event of insolvency. (The coinsurance percentage could be waived if this loss would fall on some party other than the buyer.) This change could be made for commercial coverage or, conceivably, for both personal and commercial coverage.

Are reductions in guarantee-fund protection politically feasible? The benefits of guarantee-fund protection are obvious and highly visible. The costs are spread broadly, and they are largely invisible to the public. The popular media are more likely to emphasize incomplete coverage under existing guarantee funds than to promote informed discussion of the advantages of further restrictions. These factors work against adopting economically efficient restrictions and in favor of expanding inefficiently. Reductions in guarantee-fund protection for commercial insurance coverage may nonetheless be possible, as suggested by the net-worth limitations for corporate protection in some states. Requiring auto and homeowner insurance buyers to bear a small percentage of loss in the event of insolvency is much less likely.

Establishing risk-based capital requirements for insurers or adopting advance risk-based premiums for insurance guarantee funds also might mitigate

the adverse effects of guarantee-fund protection on incentives for safety. An NAIC task force is studying the possibility of making the amount of capital required for an insurer depend on the nature and volatility of coverage sold and other factors related to insolvency risk. A system of risk-based premiums for guarantee funds would link premium charges to similar characteristics. These proposals have theoretical appeal, but their successful application is likely to be impeded by the inability to measure accurately insurers' risks in general and the magnitude of insurers' liabilities in particular. Moreover, regulatory choice of capital standards or risk-based premium rates could become subject to substantial political pressure. As a result, these approaches could be significantly inferior to restricting the scope of guarantee-fund protection.

Any guarantee-fund system with advance premiums (as opposed to the current postinsolvency assessment schemes) also would create a risk that accumulated funds would be appropriated by state legislatures for noninsurance purposes or used to keep afloat insurers that should be liquidated. Experience under New York's advance premium system provides some support for the first concern. Experience in the savings and loan industry suggests that the latter concern could be justified as well. It also is possible that postinsolvency assessment provides financially strong insurers (and their trade organizations) with more incentive to exert pressure for effective solvency surveillance and prompt liquidation of insolvent insurers than would be the case with advance premiums.

**Among the most common proposals for federal intervention in solvency regulation are establishing minimum standards for state regulation, federally regulating companies that operate in many states, and setting up a federal insurance guarantee program.**

An alternative to a government-run guarantee system with advance risk-based premiums would be to require insurers to purchase guarantee-fund protection from private insurers. A variant of this approach, which has been suggested for the banking industry, would require private coverage for some percentage (for example, 10 percent) of mandated protection. It is not clear how payment of the obligations assumed by private guarantee insurers would be assured under these approaches. One possibility would be to require the purchase of coverage from a consortium of reputable insurers. Even then, the amount of additional capital needed might be large enough to make private coverage infeasible without a government guarantee. Furthermore, allowing a consortium of insurers to set rates freely on the basis of perceived insolvency risk would present obvious antitrust issues, and it most likely would produce considerable litigation. The alternative of close regulatory control over privately determined rates might ultimately differ little from a government-run system.

### A Federal Role?

Rep. Dingell has promised to make some form of legislation dealing with insurer insolvency a priority in this session of Congress. Among the most common proposals for federal intervention in solvency regulation are establishing minimum standards for state regulation, federally regulating companies that operate in many states, and setting up a federal insurance guarantee program.

As noted earlier, recent actions by the NAIC that are designed to improve state solvency regulation would appear to be sensible. Establishing the NAIC's standards for solvency regulation and its program for certifying state compliance significantly weaken the case for federal standards. The NAIC certification program has been criticized for not stipulating adequate penalties or sanctions for states that do not become certified, but the failure of a state to be certified will indicate that its domiciliary insurers are not regulated according to NAIC standards. These insurers should then receive closer scrutiny in other states where they do business (or in states where they may be seeking a license). The attendant erosion in traditional deference to regulators in the state of domicile could create pressure for certification. Financially strong insurers also can be expected to provide pressure for certification of their state of domicile.

Recent insolvency experience and the debate these insolvencies have generated should lead to improved monitoring by state regulators. Regulators need to pay close attention to insurers with rapid growth and extensive use of reinsurance in difficult-to-price product lines, especially when most of their policyholders are largely protected by guarantee funds, when their owners or principals have little to lose from insolvency, or both. Academic researchers have argued that more attention should be devoted to measuring interest rate risk and to estimating and

monitoring the market value of net worth. It also would be helpful to dismantle the systems of restrictive rate regulation for auto and workers' compensation insurance that exist in some states. Attempts to hold rates below market-clearing levels are clearly imcompatible with the goal of promoting solvency, and administration of these programs may divert resources from solvency regulation.

Some observers have argued that experience in the savings and loan industry provides a compelling case against federal intervention in insurance regulation. Indeed, the Dingle report noted, "By granting Federal deposit insurance coverage to state-chartered thrift institutions without a corresponding requirement for minimum capitalization and investment restrictions equivalent to Federally chartered institutions, the Federal regulatory structure bet the system's solvency on the adequacy of state standards." Even if the entire cost of the thrift industry bailout was due to state-chartered institutions, this statement would not inspire much confidence in federal regulation or decisionmaking. Whether federal incompetence, by itself, was the root cause of the savings and loan debacle, this explanation makes the federal decision to insure state-chartered institutions appear very foolish. Moreover, it was the deliberate congressional policy of forbearance for insolvent savings and loans that allowed losses to reach such monumental proportions.

### Conclusion

The case for federal intervention in insurance solvency regulation is weak. While problems exist, the insurance industry is not on the brink of disaster. State regulators have taken a variety of steps to improve solvency regulation. Attention should be focused on other ways to improve state regulation, especially on possible modifications in guarantee-fund design to provide greater incentives for consumer monitoring and safe operations by insurers.

Rather than help, federal intervention, even in the form of minimum standards for state solvency regulation, could make matters far worse. A real danger exists that any federal intervention would be accompanied by expanding the scope of guarantee-fund protection, as is suggested by the history of federal guarantees for banks and thrifts. The worst possible scenario would be the adoption of comprehensive federal insurance with advance premiums unrelated to risk. Even if some relation between premium rates and risk were required, significantly expanding the scope of protection would probably further reduce incentives for insurer safety, increase the burden on solvency regulation, and pave the way for more frequent and severe insolvencies in the years ahead.

**Federal intervention in insurance solvency regulation, even in the form of minimum standards for state solvency regulation, could make matters far worse than they are.**

### Selected Readings

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