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# Policyholder Runs, Life Insurance Company Failures, and Insurance Solvency Regulation

**Scott E. Harrington**

**I**ncreases in the frequency and severity of insurance company insolvencies have led to intense debate over whether solvency regulation by state insurance departments is adequate and whether federal solvency regulation would be likely to reduce the overall cost of insolvencies. A 1990 report on several key insolvencies in the property-liability insurance industry during the mid-1980s by the House Energy and Commerce Subcommittee on Oversight and Investigations, chaired by Rep. John Dingell, argued that those insolvencies were caused by poor insurer management and fraud in conjunction with ineffective state regulation.

The Dingell report was followed in 1991 by the insolvency of six life insurers (owned by four different corporations) and the subsequent downgrading of financial ratings for a number of major life insurers by insurance rating agencies. In contrast to the property-liability insurer failures ana-

lyzed in the Dingell report, the major problem in those insolvencies was the quality of invested assets. Those insurers had been damaged by significant reductions in the value of their investments in commercial real estate (primarily mortgages), "junk" bonds, or both. Several of those insolvencies were preceded by large cash withdrawals by policyholders. Those insolvencies and associated policyholder "runs" received substantial publicity in the national media. They also provided considerable impetus to proposals for federal solvency regulation.

Most analysts believe that the life and health insurance industry, which holds one-third of all corporate bonds and about 30 percent of commercial mortgages, is fundamentally sound, although some large insurers with substantial holdings of commercial real estate have been weakened by the severe slump in commercial real estate markets. In addition, the National Association of Insurance Commissioners, state legislatures, and state insurance departments have made and are in the process of making substantive changes in solvency

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*Scott E. Harrington is a professor of insurance and finance at the College of Business Administration at the University of South Carolina.*

**Table 1: Life and Health Insurance Company Impairments and Insolvencies, 1986–October 1991**

Year	Number of Insurers	Total Book Value of Assets (\$ millions)	Book Value of Assets for Largest Company (\$ millions)	Median Book Value of Assets (\$ millions)
1986	10	3,993	3,943*	11
1987	19	111	26	11
1988	10	102	46	6
1989	41	964	646	2
1990	26	773	349	6
1991	26	41,246	13,482	52

Note: Assets were not reported for a number of small companies. Median is for companies with reported assets only.

\*Combined assets of National Investors Life and University Life (Baldwin United group).

regulation in response to insolvencies in both the property-liability and life and health insurance sectors. Developments in state regulation and experience with federal regulation of depository

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institutions work against federal intervention in insurance solvency regulation. Nonetheless, whether federal solvency regulation becomes a reality during the next year or two may well depend primarily on whether another "major" property-liability or life and health insurer becomes insolvent.

### **Life and Health Insurance Company Failures**

Table 1 shows data on the number and average size of "impaired" or insolvent life and health insurers from 1986 through 1991. The data for 1986 reflect the failure of Baldwin United affiliates with combined assets of \$3.9 billion, the largest life and health insurer failure by far until 1991.

The total book value of assets of impaired and insolvent companies increased sharply in 1991 owing to the failure of six insurers that each had more than \$4 billion in assets at year-end 1990 (see Table 2). Two of those insurers, Executive Life and Executive Life of New York, were owned by First Executive Corporation. Two others, First Capital Life and Fidelity Bankers Life, were subsidiaries of First Capital Holdings Corporation. With the exception of Mutual Benefit, each of those insurers had experienced reductions in assets, premiums, or both during 1990. Reductions in both assets and premiums were pronounced for the First Executive affiliates. Executive Life's premiums had been declining since 1986. The big surprise was the failure of Mutual Benefit, a mutual company that historically had enjoyed a conservative reputation.

Accurate estimates of the total shortfall of assets relative to liabilities for impaired and insolvent life and health insurers are not available. Assessments levied by life and health insurance guaranty funds against surviving insurers to finance unpaid claim costs increased from \$140 million during 1985 to 1987 to \$393 million during 1988 to 1990 (the last available data). Property-liability insurance guaranty fund assessments from 1985 to 1990 totalled about \$3 billion.

To date, no assessments have been made for the insolvencies shown in Table 2. The California Insurance Department recently reached an agreement in which a large part of Executive Life business would be spun off to a French investor group that would contribute \$3.55 billion toward the capitalization of a new insurer. It is estimated that this payment, along with guaranty fund assessments that could total almost \$2 billion, will

**Table 2: Major Life and Health Insurer Insolvencies in 1991**

Company	1990 Book Value of Assets (\$ millions)	1990 Premiums (\$ millions)	1990 Growth Rates (percent)	
	Assets	Premiums		
Mutual Benefit	13,482 (21)	3,201 (18)	16.2	13.3
Executive Life	10,167 (33)	354 (138)	-22.8	-44.5
Executive of NY	3,172 (90)	94 (311)	-18.7	-24.9
First Capital	4,458 (69)	511 (104)	- 6.0	-47.2
Fidelity Bankers	4,069 (77)	664 (87)	14.0	- 2.6
Monarch Life	4,478 (68)	267 (167)	-12.7	15.2
Industry	1,535,886	288,850	8.4	8.4

Note: Values in parentheses are industry rankings.

ensure that all contract holders with accounts up to \$100,000 will be paid in full. Owing to a court decision, the settlement protects holders of investment contracts for which the guaranty fund statute seemed to exclude coverage. The New York Insurance Department arranged the sale of half of Executive Life of New York's business to Metropolitan Life. The remaining business will be administered by Metropolitan, but it will remain under regulatory control. At present, no assessments are expected for Executive Life of New York.

Several insurers, including Shearson Lehman Brothers Holdings, Inc. (owned by American Express), a 28 percent owner of First Capital Holdings that sold large amounts of First Capital Life business, have submitted bids to California regulators that would guarantee the policy values of First Capital Life. Virginia regulators are presently negotiating the sale of Fidelity Bankers Life, which is believed to be in better condition than its sister. New Jersey regulators sold off part of Mutual Benefit Life and are negotiating sales of other pieces. Massachusetts regulators arranged the sale of a large block of Monarch Life's business to Merrill Lynch. The magnitude of any shortfall of assets relative to liabilities and the need for significant assessments for Mutual Benefit and Monarch are uncertain.

While the details vary, the basic story is similar for those insurers. They generally wrote large amounts of investment-oriented contracts that promised fixed yields on principal for one or more years—annuities, guaranteed investment contracts, and interest-sensitive life insurance. Monarch wrote large amounts of variable life insurance that offered equity returns rather than fixed yields. To provide high yields on those products,

the insurers pursued high-risk investment strategies. The units of First Executive and First Capital Holdings had substantial holdings of junk bonds (40 percent of assets or more). When the junk bond market plunged in the first half of 1990, so did the fortunes of those companies. Mutual Benefit and Monarch invested heavily in commercial real estate with limited geographic diversification; Monarch's parent also was heavily leveraged. Significant amounts of those investments later went sour. In the case of Mutual Benefit, over 20 percent of approximately \$5 billion dollars of investments in real estate (mainly mortgages) were tied up in four projects that were classified as nonperforming at the time of the company's demise.

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As news of those insurers' financial difficulties spread, many policyholders surrendered their contracts. The run at Executive Life was prolonged: cash surrenders exceeded \$3 billion in the year preceding its insolvency. Mutual Benefit experienced an estimated \$1 billion in surrenders during the weeks preceding its board's request for intervention by New Jersey regulators. There also were reports of increased surrenders at Monarch and the units of First Capital Holdings before regulatory action.

The genesis of those developments goes back to the early 1980s, if not the late 1970s. The sharp increase in inflation and short-term interest rates during that time made yields on savings in traditional whole life insurance contracts, which largely reflected slowly changing book yields on long-term investments, look meager at best. Competitive pressure for savings dollars led to the development and expansion of products with high current yields designed to attract individual savings and investment from pensions and other employment-related savings plans. Growth in group and single premium deferred annuities, guaranteed investment contracts, and universal life insurance produced large growth in assets (over 200 percent) for the industry during the 1980s. But competition based on investment yields influenced some insurers to pursue high-risk strategies. Investment in assets with limited liquidity and considerable potential volatility and sales of contracts that often had few restrictions or relatively small penalties for early cash outs by policyholders produced substantial risk for some insurers.

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The depth of the asset quality problem in the life and health insurance industry is difficult to assess. Overall holdings of high-yield bonds are low. Commercial real estate represents a greater problem for more insurers, and companies with large holdings of commercial real estate have received significant media attention. The value of a given insurer's real estate portfolio depends on many factors including the extent of diversification across different geographic regions. In addition, an insurer's vulnerability to cash withdrawals depends on the amount of its liquid assets and the extent of restrictions and penalties for early surrender of its contracts.

As noted, most analysts believe that the industry is fundamentally sound. A study of 129 large life insurers representing 83 percent of industry assets

indicated that 81 percent of the insurers had liquid assets (short-term investments, cash, and the market value of publicly traded bonds) exceeding 50 percent of their demand liabilities (essentially net liabilities less nonsurrenderable reserves). Only 4 percent of the insurers had liquid assets less than 25 percent of demand liabilities. Since a significant proportion of demand liabilities includes surrender charges or other penalties for early withdrawal and many privately placed bonds held by insurers are relatively liquid, those data understate the true liquidity of many insurers. As of mid-February 1992, no major failure or run on a life insurer had occurred since the Mutual Benefit insolvency in July 1991—despite widespread publicity of failures and heightened concern with insurer safety and liquidity.

### Implications of Policyholder Runs

The large cash withdrawals associated with major life and health insurer insolvencies raise a number of key policy questions: Did runs bring down otherwise solvent insurers? Were there significant adverse effects on other insurers and securities markets? Is a formal government mechanism needed to provide liquidity to insurers confronted with large cash withdrawals? Should the scope of government-mandated guarantees of insurer obligations be expanded?

It is uncertain whether any of the large life and health insurers that failed in 1991 would have had assets sufficient to fund their obligations had they not been confronted with significant increases in cash surrenders. It is clear, however, that none of those insurers could have been regarded as well-capitalized at the time withdrawals began. In principle, a run could actually *cause* the economic insolvency of an insurer that is forced to liquidate assets promptly in response to policyholder demands for cash. If the insurer were allowed more time to liquidate assets in an orderly manner, the market value of its assets might exceed the market value of its liabilities. If instead it must quickly sell assets such as commercial mortgages and privately traded bonds in thin markets, the realized values from asset sales could be significantly lower than values attainable with an orderly disposition. Another possible adverse consequence of runs is that they immediately deplete an insurer's franchise value, which reflects the present value of future cash flows that are expected from prior investments in sales.

While a run could possibly force the liquidation of an otherwise solvent insurer, this possibility should be clearly distinguished from the impact of a run on an insurer that is already insolvent or virtually insolvent. If the market value of an insurer's assets, *given time to arrange for orderly sales*, is less than the market values of its liabilities, the insurer is economically insolvent. There is an important distinction between liquidity costs incurred by immediate sales of illiquid assets and reductions in underlying asset values apart from liquidity costs. The collapse of the junk bond market and large reductions in commercial real estate values significantly reduced asset values of failed life and health insurers independent of any short-term liquidity costs. As an example, First Executive's stock price plummeted during the first half of 1990 along with values in the junk bond market.

It is possible that one or more of those insurers would have been able to escape insolvency if large policy surrenders had not occurred. But their precarious financial positions primarily reflected reductions in the value of their invested assets rather than forced sales in response to demands for cash. Increased surrenders and pressure to liquidate assets were primarily the consequence rather than the cause of those insurers' problems.

Runs on financially weak insurers could negatively affect financially stronger insurers if large numbers of policyholders panicked and forced the immediate sale of relatively illiquid assets. That in turn could adversely affect asset markets and thus other parties who own similar assets. The magnitude of the life and health insurance industry's vulnerability to such problems obviously depends on liquidity and market values of assets and liabilities. The liquidity of the overall life and health insurance industry suggests that widespread problems of that sort are a remote possibility. Despite the events of 1991, the magnitude of the potential losses from severe runs in the life and health insurance industry would still appear to differ by an order of magnitude from those that could arise from widespread bank runs in a system of fractional reserve banking.

Use of the term *run* to describe large cash surrenders for troubled life and health insurers is not surprising, but its pejorative connotation may be inaccurate. Large cash withdrawals may involve surrender charges. They may require forced sale of assets at prices below levels that could be obtained in an orderly sale, and they possibly might be the last straw that leads to economic

insolvency. In addition, liquidity costs from sales of assets to meet cash demands before any regulatory takeover will reduce the values available to remaining policyholders and other creditors. But cash withdrawals by policyholders who are concerned with safety and the possibility that such withdrawals can occur if an insurer becomes weak also can have beneficial effects.

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Cash withdrawals can constrain the ability of a financially weak insurer to take on excessive risk: they can limit the ability to "go-for-broke" or "gamble for resurrection." They also can expedite the removal of an economically insolvent insurer from the market—before it is able to run up a much larger deficit. Those functions of cash withdrawals may be important if accurate verification of an insurer's market value is difficult or if supervisory authorities are prone to delay intervention until the ultimate cost of insolvency has become much greater. In this regard, policyholders who pull out cash are analogous to creditors who initiate bankruptcy proceedings.

Liquidity costs from forced asset sales and reductions in franchise values from cash withdrawals also will likely be mitigated if cash withdrawals accelerate regulatory takeover and the presumed orderly disposition of claims for remaining policyholders and creditors. In fact, if a troubled insurer is confronted with cash withdrawals that would force economic insolvency, it may be able to constrain losses by asking regulators to take over the company. Just as management of nonfinancial firms may seek reorganization and protection from creditors under federal bankruptcy law, insurer management may have some incentive to request regulatory takeover to preserve the value of the enterprise.

The possibility of large withdrawals of liquid liabilities if net worth declines also will affect an insurer's decisionmaking before problems arise. Methods for reducing the risk of costly runs

include holding more capital and investing more funds in less risky and more liquid assets, improving asset diversification, and limiting the ability of policyholders to withdraw their funds by employing contractual charges, market-adjustment provisions, and, where permissible, prohibitions on early surrenders. That some insurers were imprudent, at least based on hindsight, does not mean that the possibility of large withdrawals of liquid liabilities had little or no effect on the capital, investment, and contract design decisions of many or even most insurers in recent years. In addition, the 1991 insolvencies and consumers' heightened concern for safety will likely encourage better risk management in the years ahead. Evidence indicates that a number of major insurers already are taking steps to reduce risk.

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Does recent experience suggest the need for a governmental mechanism to supply liquidity to financially sound insurers with temporary liquidity problems? Given what is known about the effects of cash withdrawals in recent insolvencies, the case for establishing such a mechanism is not compelling at this time. Administrative issues aside, the possibility that a liquidity mechanism would encourage risk-taking and lead to fewer liquid investments and more liquid liabilities suggests caution. The failure of the life and health insurance industry to push for a formal liquidity mechanism is probably informative in this regard, although it also could reflect other factors, such as an aversion to increased regulatory control that might follow the creation of a liquidity mechanism.

As it stands, the possibility of large cash withdrawals in response to adverse news about an insurer's financial strength places regulators in a delicate situation. Increased likelihood of regulatory action will probably precipitate or accelerate a run. Even policyholders whose balances are fully protected by guaranty funds may seek their cash to avoid delays in payment following regulatory

takeover. Premature statements or actions by regulators might make a company's deteriorating financial condition worse. On the other hand, regulators might fail to take appropriate action because of fear of causing a run. Questions concerning what constitutes efficient closure policy and whether regulators should withhold information concerning an insurer's financial condition are difficult to answer.

### **Government Guarantees and Moral Hazard**

The prevention of runs against depository institutions has been a pillar of bank and thrift regulation for decades. The overriding goal has been to make the system immune from runs. Federal deposit insurance, both explicit and implicit, for example, "too big to fail," has been preeminent in achieving that goal. Depositors do not run when they are assured prompt and full payment regardless of an institution's financial condition.

Property-liability insurance guaranty funds exist in all states and the District of Columbia to protect residents from the consequences of insurer failure. Claims generally are covered up to a maximum of \$300,000 (with unlimited coverage for workers' compensation). Life and health insurance guaranty funds exist in all states; the last four states (including New Jersey) established such funds in 1991. Most of those funds cover residents only. There is no life and health insurance guaranty fund in the District of Columbia. Coverage is generally limited to a maximum of \$300,000 for individual claimants with no more than \$100,000 for cash values of life insurance and annuity contracts. About twenty states provide from \$1 million to \$5 million in coverage for guaranteed investment contracts or group annuity contracts that do not allocate funds to individual employees. Other guaranty fund statutes either specifically exclude or do not address those types of contracts.

Guaranty fund payments to policyholders of insolvent insurers are financed by assessments against surviving insurers. Limits on maximum annual assessments usually equal 1 percent or, much more commonly, 2 percent of premiums. The estimated nationwide assessment capacity of the life and health guaranty funds is about \$3 billion. Many states allow both property-liability and life and health insurers to offset assessments against state premium tax obligations in equal installments over a period of five or more years. A

few states require surcharges against policyholders. Others allow changes in premiums and policy dividends, but those actions will likely be constrained by competitive pressure.

Insolvencies in the life and health insurance industry have led to renewed calls by some parties for the creation of a federal, prefunded guaranty program with expanded coverage. Media coverage and some analyses of major life and health insurer failures have often emphasized coverage limits and omissions and lack of uniformity in state guaranty plans. Less than complete coverage protection and lack of uniformity typically are presumed to be inherently bad.

State guaranty funds also have frequently been criticized for having insufficient capacity to respond to a major failure. Those criticisms often have raised the spectre of a taxpayer bailout in the event of a major insolvency unless advance premiums are implemented to build up a fund to cover potential costs. But advance premiums for savings and loan deposit insurance did not insulate taxpayers from financing a massive bailout. Instead, the insolvency of the savings and loan insurance fund and the repeated failure of Congress to provide or require more funding greatly increased the magnitude of the insolvency problem by allowing and encouraging gambling for resurrection by insolvent institutions. While supervision of depository institutions has lately been enhanced, some analysts are skeptical of whether incentives for timely closure of troubled depository institutions have changed in any fundamental way.

To be sure, proponents of a federal, prefunded guaranty program for insurance often argue that the premiums should be risk-based (in contrast to deposit insurance) to help control default risk. But it is not clear that risk-based premiums are practical or politically feasible. Current state plans generally provide some financial incentive for financially strong insurers or state treasuries to pressure regulators for effective solvency regulation. Those incentives could be weaker if insurers had to pay fixed charges independent of insolvency experience.

Expansion of guaranty fund coverage, including steps to eliminate potential delays in receiving funds, would reduce or eliminate the likelihood of policyholder runs against troubled insurers. Since it is not obvious that the costs of potential runs exceed their possible benefits in discouraging risky behavior by insurers or in forcing closure

of weak insurers, such a rationale for expanding coverage is tenuous at this time. In fact, the major disadvantage of a significant expansion in the scope of government guarantees is that it would further reduce or eliminate incentives for buyers and agents to deal with safe insurers and for insurers to be safe. The eventual increase in the frequency and severity of insolvencies could be very costly, and it could significantly increase pressure for strait-jacket regulation. At least in the case

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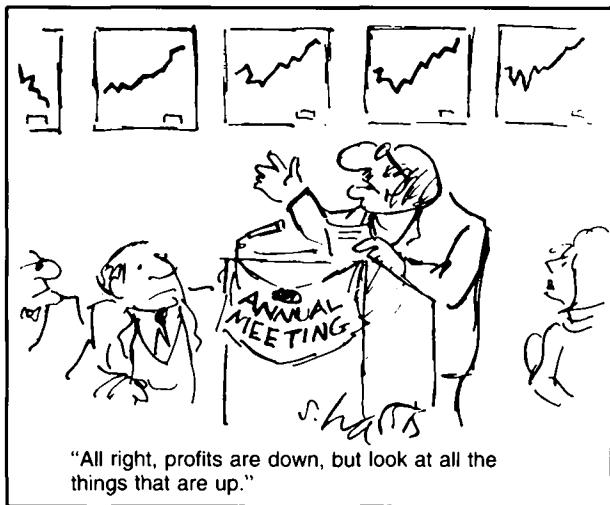
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of property-liability insurance, a strong argument can be made for eliminating guaranty fund protection for large commercial insurance buyers (with suitable safeguards for third-party claimants) to encourage them to monitor insurers' financial strength. In the case of investment-oriented contracts sold by life and health insurers, it is not at all obvious that current government guarantees of "deposits" that are invested in fixed-income obligations with significant risk to principal are excessively weak.

### State Responses and Pressure for Federal Regulation

State legislators and the National Association of Insurance Commissioners have responded to the increased frequency and severity of insurer failures—and to the Dingell report—by enacting programs designed to beef up state solvency regulation. The changes have been substantive. Major developments include the association's establishing an accreditation program in 1990 for states that meet minimum legislative, administrative, and funding standards for solvency regulation. The association has adopted a number of new model bills as part of the minimum standards program. By year-end 1991 the association had accredited nine states. In 1991 forty-two states adopted legislative packages that were designed to enhance solvency regulation and help qualify



for accreditation. Legislative packages were introduced in five other states. By 1994 regulators in accredited states will not accept the audit reports of domestic insurers in unaccredited states, and they are considering imposing more severe sanctions. Those developments have undermined arguments that federal legislation is required to implement a program of minimum standards.

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The National Association of Insurance Commissioners has taken some action in relation to all of the major criticisms in the Dingell report. Examples include adopting model bills that contain tougher standards for reducing liabilities in conjunction with the purchase of reinsurance and stricter supervision of managing general agents, significantly increasing the amount of information that insurers must report about loss reserves and reinsurance, and requiring annual statements to be accompanied by an opinion from an independent public accountant. The association is also seeking federal authority that would increase its ability to oversee foreign reinsurers. It has adopted a model bill and ten states have enacted legislation that will limit an insurer's holdings of

noninvestment-grade securities. In addition, the annual statement for life and health insurers is currently being modified to include new contingency reserves for interest rate risk and for investments in commercial real estate. Finally, the association is rapidly developing risk-based capital standards for both property-liability and life and health insurers.

Proponents of federal regulation have viewed the National Association of Insurance Commissioner's accreditation program as inadequate because the association lacks authority to require prompt compliance with an effective minimum standards program in all states. Sen. Howard Metzenbaum has introduced a bill that would create an independent federal agency to establish uniform standards for insurance solvency regulation and would create a federal guaranty system to supersede the state system. Perhaps more important, Rep. Dingell will likely introduce a proposal for some form of federal involvement in solvency regulation in the near future. Possibilities that have been discussed by House staffers include minimum federal standards or, more recently, optional federal certification with direct federal regulation of insurer solvency.

A primary objective of solvency regulation is the timely removal of economically insolvent insurers from the market. That function is especially important when market forces are insufficient to ensure that weak companies are removed before they can gamble for resurrection and run up large deficits. In practice, it is often difficult to determine when an insurer becomes economically insolvent. For property-liability insurers, a major problem that confronts regulators and other outsiders (and, to a lesser extent, insurer managers) is the valuation of insurers' liabilities. By the time an insurer actually has difficulty paying its claims, it may have accumulated large unfunded liabilities. Similarly, it often is difficult to value the net worth of a life and health insurer because the value of certain types of assets may be especially difficult for outsiders to monitor. Regulators also may find it difficult to convince a court that an insurer is insolvent when it is growing and still has significant cash flow. Such problems will likely allow some insurers to operate for a time after they have become insolvent, even if most regulators strive to close insolvent insurers promptly.

One of the most serious criticisms of state regulation is that solvency regulators often delay clo-

sure far too long—either through failure to detect probable insolvency or reluctance to shut down insolvent insurers. Skeptical observers might question whether regulators have commonly delayed closure of insurers that clearly were economically insolvent. The evidence used to support that criticism does not really justify a firm conclusion, and major insurance rating agencies have maintained high ratings on some insurers until shortly before insolvency. Nonetheless, the evidence that is available and possible incentives for regulators to delay closure are a cause for concern, especially in view of the disastrous consequences of deliberate forbearance by federal regulators in the case of insolvent savings and loans.

Insurance regulators in a given state are viewed as having primary responsibility for regulating domiciliary companies. Regulators in other states commonly are presumed to defer to the judgment of regulators in the state of domicile to help coordinate monitoring and reduce costly duplication. A possible disadvantage of that system is that the benefits of surveillance by regulators in the domiciliary state will be spread broadly among all states in which the insurer sells coverage, but the costs will be borne by the state of domicile. If this leads to too little monitoring by some domiciliary regulators, regulators in other states will have more incentive to monitor nondomiciliary insurers. That response in turn might create an incentive for some regulators to free-ride on the monitoring efforts of other states. Such problems suggest that minimum standards for state solvency regulation and cross monitoring by state solvency regulators could be advantageous. Viewed in this light, the National Association of Insurance Commissioner's accreditation program could be a rational response to potential incentive problems in a decentralized system of state regulation.

Other things being equal, these incentive issues suggest that direct federal solvency regulation or supervision of state solvency regulation could be advantageous because it might reduce the need for costly cross monitoring. Other things are not necessarily equal, however. Given political pressures that affect Congress and that thus would affect federal insurance regulators, one cannot conclude that a federal system would lead to more efficient regulation. Federal regulation of savings and loans did not contain sufficient incentives for prompt closure of insolvent firms. The consequences for taxpayers are well known.

### Related Issues: Rate Regulation and Antitrust

While state regulators have been busy beefing up solvency regulation and trying to keep would-be federal regulators at bay, state regulation of automobile and workers' compensation insurance rates in many states has been undermining traditional industry opposition to federal regulation. Consumer pressure on regulators to hold down rate increases in states with rapid real growth in claim costs has produced significant problems for many insurers and created pressure for exit from affected lines of business. Some states have deterred exit by erecting exit barriers that require an insurer to exit all lines of business to exit auto or workers' compensation insurance. Those rules make exit more costly by requiring an insurer to write off its entire investment in a state.

Failing to allow insurance rates to keep pace with growth in costs obviously is not consistent with enhancing the safety and soundness of property-liability insurers. Other things being equal, local companies will experience the greatest deterioration in financial condition, but multistate insurers also will be adversely affected, and their incentive to commit capital to support overall sales will decline. Thus, failure of regulators to allow adequate rates in a given state will likely have some external effects and thus will undermine the economic and philosophical case for state regulation.

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A system of federal solvency regulation and state control over insurance prices would not likely be stable, given political pressure in many states to deny cost-justified rate increases. Federal solvency regulation would likely be followed or even accompanied by preemption of state rate regulation for federally regulated insurers. The possibility of ultimately escaping state rate regulation makes direct federal regulation appear attractive to some insurers.

The American Insurance Association, a trade group representing large property-liability insurers that primarily write commercial lines, has distributed a discussion proposal for optional federal licensing and solvency regulation, along with pre-emption of state rate regulation. Preemption is probably more feasible for commercial lines of insurance than for personal lines. Some commercial property-liability insurers also might hope that federal solvency regulation would help them achieve other legislative goals that are related to solvency, such as revisions in Superfund legislation.

**The competitive structure of the industry, substantial heterogeneity among insurers and buyers, flexibility in pricing, and evidence on profitability suggest that the McCarran-Ferguson Act's antitrust exemption is not anticompetitive.**

The House Judiciary Committee, chaired by Rep. Jack Brooks, reported out a bill last year that would modify the McCarran-Ferguson Act of 1945 to virtually repeal the insurance industry's antitrust exemption. The McCarran-Ferguson Act explicitly endorses the primacy of state regulation and provides an exemption from federal antitrust law for activities that are subject to state oversight and that do not involve boycott, coercion, and intimidation. Cooperative activities that have developed under that exemption include the development of policy forms and the estimation and dissemination of "prospective loss costs" and "advisory rates" by property-liability insurance advisory organizations; advisory rates are now being phased out. Some type of cooperative development of policy forms would probably survive antitrust scrutiny if the Brooks bill were eventually to become law; forecasting of future claim costs by advisory organizations would not—except possibly for very small insurers.

Forecasting activities by advisory organizations reduce both the cost of information to insurers and the fixed costs of ratemaking and thus facilitate entry into markets. If the information pro-

vided by advisory organizations has significant value, its availability at low cost is likely to increase its use and thus reduce insurers' forecast risk and the need for capital. If so, raising the cost of that information by prohibiting cooperative activity could produce some combination of increased insolvency risk and higher prices. The argument against cooperative forecasting activities is that they make collusion more likely. Nevertheless, the competitive structure of the industry, substantial heterogeneity among insurers and buyers, flexibility in pricing, and evidence on profitability suggest that the antitrust exemption is not anticompetitive.

The outlook for changes in the McCarran-Ferguson Act is uncertain. There is significant division among insurers and trade groups on the subject, with some groups (such as larger, commercial line property-liability insurers) willing to compromise and accept some change in the law. There also is some support for repealing the exemption in exchange for a preemption of state rate regulation. Any significant change in the McCarran-Ferguson Act would likely erode the primacy of state regulation.

## Conclusions

Problems of asset quality will linger for many life and health insurers unless commercial real estate values increase significantly. Property-liability insurers are confronted with significant risk of unexpected increases in liabilities, especially from environmental liability claims and natural disasters. Insurance will remain a risky business. A system in which insurers never became insolvent would be inordinately costly.

State responses to the increased frequency and severity of insurer insolvencies—and to the threat of federal intervention—have been meaningful. A prudent approach for Congress at this time would be to eschew federal solvency regulation and allow continued improvements in state regulation. The key policy goals of state solvency regulation should be to achieve an appropriate balance between market and regulatory monitoring and to provide resources and incentives for regulators to engage in efficient monitoring and closure.

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