

MANAGING INSURER INSOLVENCY

**Prepared by Stewart Economics, Inc. for
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INTRODUCTION

In recent years, the number and size of insurer insolvencies have reached unprecedented levels. They have become a major disruption to the insurance system.

This report, commissioned by the National Association of Insurance Brokers, is addressed to the governmental and private business community interested in the subject of property-casualty insurer insolvency.

The purpose of the report is to describe the problem of property-casualty insurance company insolvency, what was and is done about it, and what might better be done about it. The report is mainly about companies writing commercial lines, that is, insurance for business and industry.

Following an Executive Summary, the report has six sections: (1) the special nature of insolvency in insurance, (2) why the problem is worse now, (3) past and present regulatory responses to insolvency, (4) the future regulatory response, (5) regulatory resources needed, and (6) general conclusions.

The insurance business has changed mightily in recent years, and the insolvency problem has changed with it. The problem can no longer be handled with old techniques and, especially, with old objectives, attitudes and expectations. Those include but are not limited to regulatory objectives, attitudes and expectations.

The perspective of the paper is regulatory. In matters of insurer insolvency, the regulator is expected to lead and everyone looks to the regulator. But the changes that will work will have to be made by all of us.

EXECUTIVE SUMMARY

The insolvency of a property-casualty insurance company is perhaps more damaging than that of any other kind of private company.

The benefit a policyholder pays for is compensation for an event which may or may not occur. The protection is usually many times – a perhaps a hundred times – the premium. For the policyholder who paid premiums to an insurer and saw the insured event occur and the insurer become insolvent, the leverage of misfortune is great.

Insurance company insolvencies have been the focus of public and regulatory attention for a century. Preventing insolvency is often said to be the chief purpose of insurance regulation. That view of the regulatory objective, and the accompanying ideas about how to achieve it, developed when insurance meant fire and marine insurance.

The situation has changed. The insurance business has shifted from mainly property to mainly liability, and within liability toward the most uncertain lines in which claims, and hence loss costs, take the longest to resolve.

The insurance promise to pay is at risk to economic, social, legal and technological changes for a long time, and right now no one knows how to evaluate those possible changes. The result is less ability to estimate losses and hence less ability to set prices and loss reserves accurately.

For a hundred years, the insurance business had formal and legal arrangements for avoiding competition on price. Companies competed in other ways but not on price.

That situation has changed too. Now companies compete mainly on price, though they have little experience in doing so. Industry structure – a large number of companies with undifferentiated products – makes for price competition of the fiercest kind.

Unforeseeable costs and unfamiliar competition add up to more and worse insolvencies than before and more and worse insolvencies than the regulatory and guaranty systems were designed for. We have to reexamine the whole system.

What we find is different from what we generally expect. Regulatory tools can be improved, but that is not where the big gain is to be made. The big gain is in rethinking the regulatory mission.

Many years ago, the mission was to prevent insolvencies. It was achieved by government support for cartel pricing which covered the costs of the weak. When that did not do the job, the regulators prevented insolvency by forcing the strong to accept the weak in merger. Keeping weak insurers afloat was an accepted cost of the cartel system.

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The system worked until the 1960s – when the industry became more competitive and when the dominant insurance became liability rather than property. Both trends, competition and liability insurance, are inevitable and irreversible.

Those trends are not without cost. One cost is bigger insolvencies, and more difficult challenges of measurement and decision for regulators. Managing insurer insolvency is more than ever a matter of informed and disciplined judgment. No set of numbers or mechanical rules can make it an easy exercise.

Recently, in the leftover ethic of preventing insolvency, there has grown up the practice of delaying insolvency. That means trying to prevent it in the old sense, though without the old tools, and meanwhile pretending it is not there.

Delaying insolvency makes insolvencies worse and the public damage worse. In today's competitive casualty world, the most productive view of the regulatory mission is neither prevention nor delay, but minimizing public harm.

Managing insurer insolvency is not a technical problem or a mechanical problem. It is an enforcement problem.

Minimizing public harm usually means taking insolvent insurers out of the marketplace promptly. We propose some technical ways to improve detection of insolvency. But the essential condition for success is a sharp sense of the need to act right away.

If that change in viewpoint can be achieved – and it will not be easy – then improvements in regulatory technique and in guaranty fund design, such as those proposed in this report, can be pursued with confidence that they will really help.

I. THE NATURE OF INSOLVENCY IN INSURANCE

To understand the grave public and private concern about insurer failure, we should start with what insurance does when it is working.

The Insurance Business and Its Role

The property-casualty insurance business (hereafter "insurance", because this report does not address life and health insurance) reduces the uncertainty of the financial consequences of external events ("risks") for its customers. It performs that role by accepting those risks, as defined in insurance contracts ("policies"), in return for the payment by the customer to the insurance company of a price (the "premium").

The function is recognized almost universally around the world. In many societies, the government alone deals with it, through emergency management, disaster relief and social welfare programs. Such programs are important in the United States, but a larger portion of the function is entrusted to private industry in this country than in any other. Four percent of our gross national product is private property-casualty insurance premiums. Those premiums are paid to reduce the financial risks of yet other private individuals and businesses.

Hence the reliability of the insurance business in performing its role is an important public policy question in the United States.

How The Insurance Business Works

The insurance business specializes in accepting financial risks which other people want to get rid of. From the transferor's viewpoint, those risks cannot be handled safely and economically, and often cannot be handled at all. From the insurer's viewpoint, those same risks, and enough others like them, can be handled. What we have is a highly specialized and, in many ways, unique industry for the acceptance and management of unwanted risks.

At the center of the risk-bearing function are specialized financial institutions, insurance companies, which select, accept and then arrange the financial risks so they can be managed.

The number of insurance companies is large – perhaps 250 major organizations in this country and many more around the world. Mature industries such as insurance normally arrange themselves with far fewer providers. Instead, insurance has come upon ways of functioning in an orderly and efficient manner with a large number of participants. The participants both cooperate and compete.

Cooperation is made possible through standard policy forms and the sharing and layering of coverage, and through reinsurance, that is, the insurance of insurance companies by yet other insurance companies. As a result, the risks which an industrial company needs to shift may be primarily handled by one or a handful of insurers, with the financial consequences of a loss being spread among hundreds of them.

Cooperation means interdependence. Because of interdependence, the industry is stronger than it looks, but individual companies are not spared each other's misfortunes. An insolvency is not confined but runs through the whole system.

At the heart of it all is the ability of every insurer to pay when it is called upon to do so by the terms of its policies. That raises yet another characteristic of the insurance business which bears directly on the insolvency problem.

Premiums Before Costs

Key to the insurance function is the idea that a premium can be paid in advance in order to assure that the customer will be paid a far larger sum in the event of the misfortune which is being insured against. In insurance, unlike the world of tangible goods, you the customer pay not when or after you get delivery but before you get delivery.

You can buy a tennis racket from a manufacturer which goes broke the next year and not suffer at all. You can buy a car from a manufacturer which goes broke the next year and only suffer a little. And so forth throughout the economy.

The big exceptions are those businesses which are, by their nature, collectors of money in advance – banks and insurance companies. But insurance companies can cause even more suffering because one can lose more than one put in. Paying an insurance premium provides security for more assets than putting money in a bank.

The Steps in an Insurance Insolvency

The typical insurance insolvency first becomes visible in a dispute over financial condition between the insurance company and the insurance department of its state of domicile. The agency normally wins either because it was right at the beginning or because the existence of the controversy scares away customers who are able to insure elsewhere, leaving the insurance company with the less desirable risks. The self-fulfilling quality of an official assertion of insolvency makes regulators cautious.

Then the insurer is placed by a state court under the control of the state insurance department, in what is typically called rehabilitation or receivership. The problem with receivership is that it permits claims to be paid as they are presented which, in bankruptcy terminology, is called a "preference", because people who come along later with equally meritorious claims may not get anything.

Accordingly, the theory has been not to prolong the rehabilitation or receivership period. If the company cannot be brought out of receivership quickly, the regulators proceed to liquidation.

Liquidation in insurance is very much like liquidation elsewhere. The insurance department as liquidator collects the remaining assets and then decides who gets how much of them.

In the interest of completeness and of fairness among claimants, the liquidation process consumes a large portion of the remaining assets. As liability insurance, uncertain and long lasting, becomes a larger factor in insolvencies, liquidations become even more costly and drawn out.

Who Gets Hurt

When an insurance company fails, three groups of people get hurt.

First are the policyholders. If you have a homeowners policy with a company that goes broke and your house burns down, you may wait ten years to get sixty cents on the dollar for a claim which everyone acknowledges is perfectly all right otherwise. That is the way we normally think about insolvency. As a result, we may overlook the second and third kinds of victim.

The second are people who have liability claims against the insurance company although they are not policyholders. Liability claims take time to evaluate, measure and resolve. A liability claimant against an insolvent insurance company may wait a long time and may become a classic victim of preferences, as other claimants exhaust the remaining assets first.

The third victim of insolvency is the insurance system itself. An insolvency impairs the functioning of the cooperative or interdependent side of the business. Legal obligations are in dispute. Funds are held back because of uncertainty. Funds are held back because one will never do business with the insolvent company again. Cooperation gives way to disputation. The whole system slows down.

The conclusion to be drawn from all this is that insurer insolvency in a private insurance system like ours causes serious harm and is a serious challenge for public policy. Next we should examine how and why the insolvency problem is getting worse.

II. WHY THE PROBLEM IS WORSE NOW

The insolvency problem is worse now, and threatens to get even worse in the future, for two big reasons. The first is the importance and difficulty of liability insurance. The second is chronic overcapacity and price competition.

Problems of Liability Insurance

For centuries, commercial insurance was property, more specifically fire and marine, insurance. Today, commercial insurance is two-thirds liability (or "casualty"). Liability has problems which are unique to it and, on this scale, new to the insurance business.

The usual reason insurers go broke is that they do not charge enough for their product. Charging an adequate price requires two increasingly difficult achievements – forecasting costs accurately and then getting a price which will cover those costs.

By its nature, liability insurance involves time lags and uncertainty. Claims can turn up long after policies have expired. The insurer is dealing both with its policyholder and with a stranger who is claiming the policyholder did something wrong. Facts can be in bitter dispute. Rules of civil liability, or tort, change over time. Economic costs inflate over time.

Yet the liability insurer has to forecast its claim costs through all this uncertainty, and the time covered by the forecast just keeps getting longer. Actuarial techniques for such forecasting, however statistically sophisticated, are all grounded in an assumption that the future will bear a predictable relationship to the past. That may no longer be so.

The Rising Cost Curve

The uncertainty regarding liability cost forecasts is even more threatening because insurers are on a rising rather than a declining cost curve.

For a hundred years, cost per unit of exposure to risk declined in almost every line of insurance – ocean marine, fire, workers' compensation, automobile and even, for thirty years, general liability. The reasons were technological advances, new construction, public safety and health legislation, changing attitudes and other factors which reduced the frequency and severity of claims.

While the underlying unit costs of the insured event were going down, the rules of payment were remaining the same. Accordingly, insurance prices based on past experience tended to cover the forecast costs and to leave a profit.

That has been reversed for liability insurance. Tort law has been changing in favor of claimants since the mid-1950s. So the legal liability of policyholders, for which insurers become liable by contract, has been expanding too.

Additional Adverse Changes

While it is widely recognized that liability insurance is hurt by adverse changes in legal liability rules, it is less well recognized that three other adverse changes are going on.

First, liability insurance has now become subject to catastrophes in the classic fire insurance sense.

What used to destroy fire insurance companies was that a whole city would burn down, and insurers whose business was concentrated in that city would go down with it. Casualty insurance, whose paradigm was a lot of automobile accidents at scattered locations, was thought not to have a conflagration problem.

Now, if an insurer backs a drug company and the drug company puts a pill on the market which inflicts an awful injury, the result for the insurance company is going to be awful too. Products can be on the market for a long time before improved technology reveals they are harmful, and the harm can be latent for a long time as well. The result can be a catastrophe just as large, concentrated and unforeseen as a big city fire.

Second, during the liability insurance crunch of the mid-1970s, many insureds saw that they had only limited buying power in the commercial insurance market. Consequently, they retained for themselves the most predictable loss exposures and purchased external insurance for those which were least predictable.

The effect has to be that the "book" of business remaining in the typical commercial liability insurance company is more volatile and uncertain than it was fifteen years ago. It is unlikely that insurers have the larger risk in their prices.

Third, the insurance marketplace is now very competitive. In almost all commercial markets, most of the time insurance companies compete against one another to get more business. They do it mainly through lower prices and more permissive underwriting.

In liability insurance, companies can keep lowering prices and underwriting standards for a long time before claims start to catch up. Aggressive pricing and underwriting are often justified by optimistic loss forecasting and reserving, which get back into premiums in a kind of positive feedback loop. In a competitive market, it is very hard to stop.

Competition and Overcapacity

Besides the difficulty of price competition in casualty insurance, the other force driving the insolvency problem today is structural overcapacity in the insurance business.

In the nineteenth century, after decades of fire insurance company insolvencies due to big city conflagrations, insurers got together, quite legally, and agreed on prices, commissions and so forth. The industry operated as a classic cartel. That stabilized pricing and permitted the accumulation of adequate surplus and reserves.

After the mid-1940s, the cartel broke down. Some conduct was outlawed. Areas of concerted action were limited by law and competition.

For today's insolvency problem, the key cartel legacy is the large number of insurance companies. As long as prices and many costs were uniform, the market could support a virtually unlimited number of participants. Competitive forces were not allowed to drive the inefficient ones out.

Even though the old cartel protections were gone by the early 1970s, attitudes in the business were conditioned by many years of stability and well being. There was widespread disregard of the nature and consequences of competition. Once market forces were free to work, participants did not always recognize them or know how to deal with them.

Supply and demand were put out of balance partly by cartel overpopulation. They were put further out by a reduction in demand, as sophisticated insurance buyers retained more of their own risks.

Combining excess capacity, unfamiliar competition and uncertain casualty meant that the first shaking out would be chaotic and destructive, which is indeed what happened in the early 1980s. That episode will not be the last. After two years of higher prices and infusions of capital, insurers are once again competing for business.

Where there is too much capacity (financial resources, people, etc.), firms cut prices and thus drive down returns. Low returns force participants out either through bankruptcy or merger or because they want to earn more elsewhere. Only afterward are the survivors' returns able to rise to a level appropriate to the risk and variability of the business.

Competition's incentives (to improve) and its punishments (to fail) are why competition is desirable from a public policy point of view. The discipline of the marketplace fosters efficiency, innovation and meeting needs.

This is especially relevant to the recent disruptive turn in casualty insurance markets. Because the balance of supply (or capacity) and demand is reflected in prices and

therefore in rates of return in competitive markets, competition encourages the reallocation of resources. Resources enter markets where they earn a higher return and leave markets where they earn a lower return.

In insurance, fewer resources are needed in mature, established markets – such as fire, automobile, workers' compensation and marine – and more resources are needed in emerging, difficult casualty markets. Because insurers now have little commitment to difficult casualty markets, they can enter and exit easily, by writing more or less business or none at all.

If they became convinced they could not earn acceptable returns in familiar and mature markets, but could do well in riskier, more rewarding casualty markets, they would go there. The investment would make them steadier and more committed participants. There would be less of the disruptive in-and-out behavior of recent years. A more stable casualty market would be an important benefit of competition.

Such benefits do not come without costs. Those costs include the consequences of failures, which are different in insurance than in other businesses. The bankruptcy of an insurance company eviscerates its product and undercuts the usefulness of the whole insurance mechanism. So special attention and arrangements are needed.

The Regulatory Challenge

The broad regulatory challenge is to keep the benefits of competition and of a growing supply of liability insurance, while limiting the economic and social harm done by insurer insolvency.

If that is the challenge, the next questions are the adequacy of the past and present approaches, and then the best regulatory response for the future.

III. REGULATORY RESPONSES OF THE PAST AND PRESENT

So far we have examined why insurance company insolvencies are serious and why the fundamentals of the insurance market suggest they will be larger and more frequent in the future than in the past.

That background suggests the following order for considering the appropriate regulatory response:

- (a) the regulatory response to insolvencies in the past;
- (b) the regulatory response that has become the current practice;
- (c) the regulatory response which is best for the future; and
- (d) resources which will help the future regulatory response.

The Past Response: Prevention

Prevention of insolvency was for a long time the main aim of insurance regulation in this country. There were a lot of reasons, but the main one was that the country was short of capital. The departure of a supplier of capital, such as an insurer, was to be regretted. Departure by insolvency was disruptive as well.

Individual companies did what they could to prevent their own insolvency. They shared risks among themselves. They mapped their fire exposures to keep them separated. They ran fire brigades. Most important, during the last seventy years of the nineteenth century, they tried to set up a system for accumulating surplus so they could withstand a big fire when it came.

The chosen method for doing so was price maintenance through agreement. The insurers cannot have been unaware of the profit implications, but the record shows fear of insolvency drove them. The problem during most of the century was that they could not make the agreements stick. Too many companies would stay out. Others would join but later cut prices or increase agent commissions, openly or not, for competitive advantage.

Finally, after the San Francisco earthquake and fire, they got it to stick. Rating bureaus – local, regional and national – made fire insurance rates under committees of company representatives. It was done openly and was legal under federal law, as insurance was held not to be interstate commerce and hence not subject to the antitrust laws.

The states, however, did not agree as to whether it should be allowed by state law. A New York report in 1911 concluded that cartel costs were preferable to insolvency costs. Thereafter, most states regulated the rating bureaus and put the power of law behind them.

The insolvency record was good. How much of that was due to concerted ratemaking we will never know, because regulators rescued weak companies by forcing merger with strong ones.

The system began to break down in the 1940s, and today insurance competition is much like that in the rest of the economy. After the recent, fierce price war and violent turnaround, we hear some nostalgia for a stabilized market. But no one really wants a return to full cartelization, and it would be impossible if anyone did.

The Present Response: Delay

Since prevention of insolvency is no longer possible, regulators have fallen into another way of dealing with it. It is still thought of as prevention, but it is really something else. We call the current practice the "delay of insolvency".

As we are using the terms, prevention of insolvency is an active government strategy for minimizing the social costs of insurer insolvency. It was implemented through two tools beyond the basic ones of financial reporting and examination – cartel pricing and rescue by forced merger.

By contrast, delay of insolvency is a passive government strategy, if indeed it is a strategy at all.

Because the regulatory agencies have inherited the idea that their main duty is to keep insolvencies from happening, they see rescue as the preferred course of action or inaction when a company gets in trouble. Publicly facing the facts, as a self-fulfilling prophecy, may kill the company. Neither management nor the regulator wants that to happen.

In delaying insolvency, the regulator lets the company postpone recognition of the facts and enter into financial reinsurance and other transactions which buy time. Insurance department staff may delay or adjourn examinations, change the dates as of which examinations are made, and gradually move into unannounced restrictions, orders and informal rehabilitation.

The usual effect is to let the company continue selling policies to the unsuspecting, paying claims in preferential order and digging itself deeper into the hole. Delaying insolvency by looking away or helping or just failing to take action is thus likely to make the loss, when eventually it has to be faced, worse than it would have been if acted upon earlier.

So why do regulators do it? The answer is that they are responding to their situation. Their rewards favor delay. Their penalties favor delay. The whole structure of motivation with which society has surrounded regulators favors delay. We never

acknowledge the fact. Most of us are not even aware of it. We should now look in some detail at how it works in the real world.

Why Delay Occurs

There are many reasons why well-intentioned regulators fall into the delay syndrome. The very fact that the reasons are understandable and not sinister just shows how deeply rooted in the system the delay syndrome has become. Here are nine of the reasons.

First, regulators and the business continue to look upon insolvency as a regulatory failure and upon the regulator as sort of a doctor, with an oath to save the patient, rather than as a public safety officer with an oath to protect the public against dangerous individuals. This meretricious medical analogy exalts heroic life-saving efforts, and concentrates attention and sympathy on the individual company rather than on those who have trusted it or on society or on the insurance system as a whole.

Second, the practice which we call delay of insolvency developed when insolvencies rarely exceeded one or two million dollars. The risk to the public and to the rest of the insurance business was small. Delay was not a big thing. In today's competitive casualty world, that is no longer so.

Third is the difficulty of establishing the true financial condition of an insurance company writing a lot of casualty business. The big element is the loss reserve liability. Reserve estimates are the product of judgments and predictions by claims adjustors, actuaries, auditors and insurance examiners.

The estimates may vary widely. Setbacks in court on contested seizures of insurance companies make commissioners and insurance department staff extra cautious. One response is to wait for another round of loss development to reinforce reserve estimates.

Fourth, insurance accounting fosters fuzzy decisionmaking by managements and regulators. Bonds may be carried at artificial values and yet the commissioner may not be able to challenge those values for solvency evaluation purposes. Financial statements do not show how and where shaky reinsurance will hit the balance sheet.

Fifth is the conservatism of statutory accounting conventions, which makes room for rationalizing that the situation is not as serious as it looks.

We have long relied on the "hidden" values in the statutory statements. Nonadmitted assets are a fertile source for those looking for values to support delay. Ignored are the reasons why those assets are not admitted in the first place.

The greatest hidden values in the statutory balance sheet are on the liability side – in the regulatory requirement that casualty reserves be carried at ultimate value without discounting for the time value of money. When a company's reserves are found deficient, it is easy to think the deficiency can be offset by a discount to present value.

Discounting reserves, whether directly or by reinsurance, assumes that the insurance company is sufficiently reserved to earn back the discount, by compounding investment income, before claims have to be paid. It also assumes the company will be around long enough.

Sixth is a seemingly practical consideration. Casualty claims are paid out over years. Insurance companies are broke on the balance sheet long before they have to default in the marketplace. That abets a drift from accrual accounting by the regulatory rules to cash accounting by the daily necessities.

Seventh is hope about the profit cycle. As financial distress usually turns up at the end of price wars, there is a persistent thought that if the company is allowed to stay in business it can make enough profit in an imminent hard market to get well and bolster its reserves.

The reality is usually different. Chronic overcapacity has shortened the life of hard markets in which a company can charge high prices, even assuming that a troubled company still has the capital and reputation to get the business.

In addition, the troubled company is likely to have so seriously underestimated its loss costs and so compromised its underwriting standards that reserve deficiencies will only get bigger over time.

Eighth, a casualty company today can be in much worse trouble than appears under routine scrutiny. If the financial deterioration has not been detected early and the gap is large, it can be personally embarrassing to everyone who might have caught it. The department staff may be disposed to see if things will work out, which means holding back, temporizing and aiding in informal rehabilitation.

Ninth and last, the legal concept of insolvency is itself a problem. The statutory definitions are vague and unhelpful. The commissioner must go to court to take over a distressed company, and court attitudes have not always been helpful or realistic.

At trial, lawyers representing the company will be permitted to contest the proceedings and to be paid from the company's assets. In the face of vigorous resistance, courts often require high levels of proof for the commissioner's action.

The statutes usually say the regulator can proceed upon his finding of hazard to policyholders. But that is not how it works in a court fight. The regulator finds legal comfort in waiting for indisputable insolvency.

Those nine pressures, beliefs and characteristics of the situation come together to obscure the company's financial picture and to cloud decisionmaking. There are many pleas and reasons for delay and no countervailing cry for decisive action. Delay has constituencies; prompt action does not. Delay of insolvency is understandable in human terms. It is not in the public interest.

Where Help May Work

Before discussing why delay is not in the public interest, we should acknowledge that there are cases where regulatory forbearance may be justified.

The grind of economic forces is the primary cause of insolvencies in insurance today. But failures do occur for other reasons.

First is manipulation of the insurer's assets and affairs for the benefit of others, either managers, controlling persons or affiliated entities. Second is evaporation of major assets, including declining values in investment portfolios, bad real estate holdings, failure of subsidiaries or depositories, and unrecoverability of reinsurance. Third is one or more large net losses.

The first – fraud and manipulation – is intolerable in a financial security business. It demands formal action promptly upon discovery. If the wrongdoing is caught early in the game and if the manipulator can be isolated and cut off for good, it may be possible to remove the hazard by direct regulatory orders and disciplinary actions, such as license revocation, injunctions and criminal prosecution.

The chief risk of regulatory error here is the propensity of honest people to be overly optimistic about those who are not. Greed and contempt for others are highly recidivistic.

The second and third types of situation – asset and liability catastrophes – are also amenable to regulatory management. The main task is to measure the damage to the insurer's financial base and to determine whether the company can succeed alone or needs recapitalization or forced sale or liquidation.

In these situations it is possible to set sensible regulatory goals and timetables and to monitor the company's progress. These are the cases where regulation is most likely to achieve results and hence where patience may be justified.

Those three causes of insolvency – manipulation, asset catastrophes and liability catastrophes – are relatively rare. They must be distinguished from the fourth cause, bad management or at least bad market position, which is the usual cause by far.

The Futility of Delay

The usual insolvency is the result of the economics of an overcrowded insurance business combined with the difficulties of managing in a casualty insurance world. As the competitive pressure rises, it blurs the line between bad management leading to bankruptcy and simply ordinary management unable to cope with a changed world, call it blameless bankruptcy.

This fourth, or management, cause of insolvency evidences itself in a badly underwritten and underpriced book of business. Such a book of casualty business creates pervasive and intractable problems. Yet there has been a persistent belief among regulators and troubled managements that an insurer with a chronically high combined ratio may still be able to "write its way out."

What it takes, so the theory goes, is frugal management combined with expense control, loyal (or, even better, unknowing) agents and customers, surplus aid through financial reinsurance or sales of books of business, and quietly patient regulators.

The theory, whatever its value in the simpler and safer markets of a bygone era, is useless in a competitive, casualty dominated environment. The pressure on insurers to maintain or expand premium volume is enormous. The high fixed costs of automated systems and salaried professionals have made insurer overheads less adjustable to changes in volume.

When prices fall, an insurer has three choices. Expand the number of risk units insured. Reduce performance capabilities in order to cut expenses. Accept higher unit expenses on steadily decreasing volume.

Taking the third course, accepting a higher expense ratio, is the safest but also the least likely to be followed. The reason is that higher expenses will immediately reduce earnings and surplus.

The second course – stripping the service capability – is also rarely taken, despite rhetoric about cutting costs to the bone. It would require hurting the organization and the people in it, to whom there is still the remnant of a psychological contract of permanent employment.

Significant expense reduction, other than by simple cutting, requires long-run investment in marketing, distribution, training and systems. It does not work fast enough to track changes in premium volume.

So the first course remains: increase exposure to maintain volume. It can be accomplished only by accepting a progressively worse relationship between price and future loss cost.

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The temptation is to cut prices, lower underwriting standards and venture into unfamiliar classes of business. Once underwriting standards have been eroded, repricing and purging the book of business is very difficult, even after market conditions have improved.

So troubled a company will have to increase its loss reserves year after year. Word of its trouble will get around in the market. Regulators and others are more open with information. Agents and brokers are more cautious about where they place valued accounts.

What this adds up to is that the badly managed insurer will not have much breathing room. For the regulator, it means there is not much chance for recovery or rehabilitation of an insurer with an underpriced and badly underwritten book of casualty business.

A regulatory policy of trying to save the company – delay of insolvency – will usually fail and make the outcome worse. Regulation, for its own sake as well as for the sake of the public, has to break out of the delay syndrome.

For the future, the regulatory priority should be to minimize the harm done by the insolvency of an insurer. The objective of minimizing harm can be best achieved by early detection and prompt action to take the insurer out of the marketplace.

IV. THE FUTURE REGULATORY RESPONSE

Most people will acknowledge the existence of a problem of insurer insolvency. Some would say that it could be managed if only the McCarran-Ferguson Act, which grants insurance limited antitrust exemption, were repealed or if the responsibility for regulating the insurance business were transferred to the federal government.

If the challenge were all that simple, or the alternative all that inspiring, perhaps that would be the end of it. In fact, the situation is as complex from the regulatory point of view as it is from the business point of view.

The system of state regulation of insurance is facing challenges in the insolvency area which are more difficult than they ever were and which will become yet more difficult.

The industry has only brief experience with price competition and difficult casualty insurance. More of the facts relevant to pricing and reserving are outside the knowledge and control of insurers and regulators.

The data is less reliable, as anyone who has run an insurance company or done actuarial analysis of its loss reserves can attest. The changes in tort law, technology and economics, which used to favor insurers, are now unfavorable – the rising cost curve.

The result is that the less strong, the less responsive, and the less willing to recognize adversity quickly are going to get into trouble. The insurer insolvency problem is going to get worse rather than better in the years ahead. Prevention is no longer possible and delay is ineffective and unwise.

The Objective: Minimizing Harm

Given that insolvencies will happen, the aim of public policy should be to minimize the public harm they do.

The key is in the attitude. If the regulator is not ashamed of insolvency, then he will move quickly. Moving quickly reduces the shortfall for insureds and claimants and reduces the drain on the insolvency guaranty funds, which were set up for forsaken policyholders and not for failed managements.

In a competitive business, eventually market economics call the result. In insurance, there are too many participants, including too many companies. It is in the public interest for some to leave. Because of the sensitivity and economic leverage of insurance, it is in everyone's interest that the departures be graceful.

Merger will happen by itself. It can no longer be forced by government. Quiet retirement, especially from reinsurance, will just happen. Insolvency is the only means of exit within the regulatory ken, and the object should be to make it smooth and harmless.

Objective over Technique

We experience and we expect insolvencies greater in number and severity than ever before.

A natural response in the insurance community and doubtless soon in state and federal legislatures, will be to go back to an old refrain – that the problem is essentially technical or mechanical or one of inadequate resources. Hence when more big insolvencies come about, critics will say they could have been prevented if state regulation only were better staffed, better skilled, and better armed.

The proposals tend to have recurring themes: increase in budgeted human and other resources for insurance departments; more extensive and detailed financial reporting; more frequent and more intensive financial examination and review; quicker taking powers over borderline insurers; expanded use of outside experts; more detailed disclosure and review of everything; better cooperation among the state insurance departments.

Response to any "more is better" notion is always difficult. Undoubtedly, enhanced regulatory capability will yield gains in prevention and detection of hazard. But the marginal advantage is a decreasing one. It is a hard question at what point further expense and burden on the system are justified.

Some familiar proposals are not promising at all. For example, the insistence for decades that independent audits of insurers by private accounting firms would preserve solvency is just not borne out by the evidence. Over the years, more and more insurers have adopted audit programs, but insolvencies regularly occur in recently audited companies.

Another familiar example is the proposal that threshold capital requirements be moved up. Good managements do it routinely, as do many departments and, in a sense, the early warning tests of the National Association of Insurance Commissioners.

But for the past fifty years, some have wanted to go further – to a statutory, automatic or tripwire level for regulatory intervention far above insolvency or capital impairment. The main reason it would not work is that it would do nothing about the competitive fundamentals of the failing company, while perpetuating the myth that the regulator could and should save the company if only given more time.

The first step in getting hold of the insolvency problem is to see that it is not essentially technical. The insurance departments are already more sophisticated from the technical point of view than is often recognized.

Technique cannot and should not drive the public policy mission or objective. There are no magic mechanical solutions. Insolvencies will occur. Delay is now futile and costly. Regulators ought to stop it and instead focus on directly minimizing public harm. The industry, the state legislatures, the Congress and the public ought to support them.

For that to happen, prompt action needs a constituency comparable to that of prevention and delay.

Building a Constituency

Because of its history and interdependence, the whole insurance world unconsciously tends to acquiesce in the delay of insolvency.

Regulators wonder whether they should have caught it earlier and, conversely, whether they should announce they have caught it now. The regulator can only be sure that decisive action will get no support. Other regulators, other insurers, agents, brokers, reinsurers, advisers, investors, lenders and customers may be reluctant to start a run on the company and create a self-fulfilling prophecy.

That is an impressive constituency for the primary regulator's doing the wrong thing. Since delay can now cost hundreds of millions of dollars, we can no longer afford to indulge in it. The regulator needs more incentives, even pressure, to do the right thing.

There is really only one way to build a countervailing constituency for sound, meaning prompt, action to minimize harm.

That way is to help everyone concerned with the insurance business understand what is going on in today's market and help them shed unrealistic expectations. Then they can work together to keep insolvency costs down and still get the competitive and coverage benefits.

It is in everyone's long-term interest to take bankrupt or incipiently bankrupt insurers out of the market. Everyone needs help in pursuing his long-term interest against his short-term convenience. The regulators need the support of an informed and realistic insurance community if we are to expect them to perform the disagreeable work of taking out insolvent insurers before they do more harm.

V. REGULATORY RESOURCES

Given today's competitive casualty insurance market, there will be insolvencies. We can no longer do good by preventing them, and we can do harm by delaying them. Assuming the abandonment of prevention and delay as regulatory objectives, and the adoption of the goal of minimizing public harm, what can be done to help in the technical area?

Technical Improvements

Assuming a shift to a public goal of minimizing harm, here are four changes which would help.

First, general knowledge should be improved.

Promising areas are (a) information about delegation of key company functions, such as underwriting and claims, to outsiders and the compensation involved, (b) reinsurance terms, and (c) the identity and compensation basis of those, inside and outside, who set reserves.

Letting in more light of publicity is not intended to embarrass or to invite individual liability. Rather it is to put everyone, in business and regulation, through the disciplining exercise of seeing his procedures in the department store window.

Second, financial information and analysis should be improved.

In the Annual Statement blank, the National Association of Insurance Commissioners has lengthened the period of loss development and has required disclosure of reinsurance problems, both going to casualty tail issues. The techniques of examination and financial analysis of insurers have been under continuing study and refinement.

Still promising areas are (a) yet longer reported loss development periods and their separation more finely by class and line, and (b) the market value of fixed-value assets – bonds, sinking fund preferred stocks and trade receivables such as agents' balances.

Third, balance sheets should be more disciplined.

Discounting loss reserves to present value, like holding bonds at amortized cost, assumes a going business. But if we are talking about bankruptcy, "going concern" values do not belong on the balance sheet. They are not for failing companies. Statutory accounting is designed to generate a balance sheet which will hold up under ultimate adversity. Those values should either be off that balance sheet at all times or should be clearly identified and quantified.

Any reserve discounting should be explicit as to discount rate and dollar effect. Unrecoverable, doubtful or disputed reinsurance should be reduced or disallowed entirely. Contingent obligations, such as financial guarantees and investment commitments, should be shown.

In general, continuing to rely on the intended conservatism of the statutory statement to absorb other problems is just to cancel it out without really knowing the risks.

Fourth, regulators should have more power to do what is necessary to minimize harm from impending insolvency.

An example is the power to issue binding orders to cure capital impairments and to restore surplus to levels appropriate to business undertaken, all within fixed deadlines. The familiar "ninety-day letter" is a start in that direction, although today it is more a bargaining chip in the delay game.

We should not expect too much from expanded enforcement powers, nor do we want to suspend the constitutional protections of insurance corporations. But we are starting in a world where many regulators can be held, and can be threatened to be held, personally liable for putting an insurance company under. We have a long way to go.

Guaranty Funds

Since the 1930s, some states have had funds or other arrangements for drawing on surviving insurers to cover the shortfall in an insolvency. The funds and assessment arrangements were not widespread until the late 1960s and early 1970s, when anticipation of a possible shake out and congressional pressure led to the enactment of guaranty legislation for almost all lines in almost all states.

The original guaranty funds were modeled on the Federal Deposit Insurance Corporation. The federal banking funds, the FDIC and the Federal Savings and Loan Insurance Corporation, have been and are being heavily used to prevent insolvency of individual institutions.

In the cause of avoiding loss to depositors, the federal funds are being spent to rescue commercial banks and savings and loan associations which have run themselves into the ground and to keep them in the marketplace. An overpopulated banking and thrift industry is being kept overpopulated for the time being at considerable public expense.

The insurance guaranty funds and assessment arrangements have been used differently. They are not, and should not be, involved in preventing insolvency. Their proper role, and one to which the states and private industry have so far adhered, is to minimize the public harm from insurer insolvency.

MANAGING INSURER INSOLVENCY

The insurance funds vary in financing and in what is covered, but the purpose is to protect policyholders and claimants, not to save the company. In an overpopulated industry, but one upon which so many people depend, that concept seems just right.

The purpose of this paper is to evaluate one aspect of state insurance regulation, not federal banking regulation. Federal examples have often been very instructive to the states. But the states would be well advised not to follow the federal example here.

The insolvency guaranty funds should, however, be more predictable. They should be the responsibility of the regulator, not the industry. They should be written and applied uniformly. Their eligibility rules and coverage limits are decisions by state legislatures, and the courts should respect them as they do other statutes.

Most important, the role of the guaranty funds in minimizing public harm from insolvencies should be respected and defended. They should not be instruments of company rescue. They should not be asked or allowed to bankroll the delay of insolvency.

VI. GENERAL CONCLUSIONS

The insurance industry is overpopulated. It is price competitive. Casualty insurance is harder now than fire and marine insurance were in the past. Insurance companies will go broke.

But an insurance insolvency is more disruptive than that of a manufacturer or even of a bank. So we as a society have to be careful.

Technical improvement of insolvency regulation is possible, but insolvency regulation is not essentially a technical problem. It is a problem of understanding, and of changing, the regulatory mission what we are trying to do.

Prevention worked once but no more. Delay never works, but that is what we have drifted into.

The regulatory mission for the future should be to minimize the public harm from the insolvency of an insurance company.

Let insolvencies happen but catch them quickly. Support regulators who get realistic and tough. Minimize the harm to the innocent.

Henceforth our goal should be to let change happen, while guarding those who depend upon the insurance institution.

Richard E. Stewart
Richard S. L. Roddis
Barbara D. Stewart

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