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INSURER FAILURES

Regulators Failed to Respond in Timely and Forceful Manner in Four Large Life Insurer Failures

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Insurer Failures: Regulators Failed to Respond in Timely and Forceful Manner in Four Large Life Insurer Failures

SUMMARY OF STATEMENT BY
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GAO is testifying on its findings about the failures of four large insurance companies and the effectiveness of state solvency regulation of these insurers. The failures of Executive Life, its subsidiary Executive Life of New York, First Capital, and Fidelity Bankers had national consequences. The four insurers had a total of more than 900,000 policies with policyholders and annuitants in every state.

The four insurers failed in large part because of reckless practices of poorly controlled growth and risky high-yield investments. During the 1980s, the assets of the four insurers grew 6 to 10 times faster than assets of the life insurance industry overall. This growth was fueled primarily by sales of high-yield retirement investment products, not traditional life insurance policies. To cover the high rates paid to policyholders and maintain profitability, the insurers invested heavily in high-yield assets--most notably junk bonds--with inadequate reserves to cover investment losses. High up-front costs due to rapid growth seriously depleted the insurers' surplus, or net worth.

To bolster their statutory surplus and reported financial condition, the four insurers reduced policy reserves on their balance sheets through reinsurance transactions and received, from their parent holding companies, millions of dollars in surplus infusions and loans. Although reinsurance is a legitimate practice used in the life insurance industry to diversify risks, the four insurers relied on questionable reinsurance transactions to artificially inflate their surplus. Without phony reinsurance and borrowed surplus, the Executive Life insurers would have been insolvent as early as 1983.

The four failed insurers had significant internal control weaknesses over their investment activities, reinsurance arrangements, insurance sales practices, and transactions with affiliates. All four insurers delegated key operations, such as investment management and product sales, to outside parties without adequate oversight. Deficient financial controls and lax oversight resulted in significant errors and irregularities in financial reporting to regulators. These misstatements overstated asset values, misrepresented the types of assets held, and understated liabilities.

California and New York regulators had evidence for years before the takeovers that the Executive Life insurers were insolvent, and California and Virginia regulators recognized that First

Capital and Fidelity Bankers, respectively, were on the verge of insolvency. However, regulators failed to respond to danger signals and did not take timely or forceful action to avert the failures or minimize policyholder losses. GAO believes earlier and more forceful intervention was clearly warranted for the four insurers. Such intervention should have compelled the insurers to correct problems and could have minimized the damage that was ultimately inflicted.

Regulators were ill-equipped and unwilling to act effectively in handling the four insurers' problems. Statutory accounting and reporting requirements prescribed by regulators failed to ensure the filing of financial statements that presented the true magnitude of the deterioration in the four insurers' financial condition. Reported surplus was inflated by the surplus relief accounting gimmick and loans from parent holding companies. Moreover, the approach to determining statutory reserves for troubled and nonperforming assets is flawed and delayed recognition of the insurers' mounting junk bond losses.

Regulators did not demonstrate the capability to deal with the risky investments of the four insurers. Regulators rely on the National Association of Insurance Commissioners' Security Valuation Office to monitor the financial condition of insurers' securities portfolios. However, flawed security ratings provided regulators with a distorted picture of junk bond holdings. Insurance regulators did not have specific authority to limit junk bond holdings when the insurers built up their portfolios.

Interaffiliate transactions were a regulatory blind spot. State insurance holding company laws rely on insurer disclosure to monitor affiliated relationships. Except for infrequent field examinations, regulators have no way to verify insurer-reported information. Executive Life failed to comply with reporting requirements in state holding company laws and left regulators unaware of interaffiliate transactions that depleted its assets and masked its financial condition. Even though inappropriate service agreements can be used by affiliates or the parent to siphon funds out of an insurer, holding company laws in California do not require prior approval for service agreements and cost-sharing arrangements. Virginia requires prior approval for only those affiliated service contracts over a certain threshold.

Regulators have been slow in banning the surplus relief accounting gimmick. Whereas New York ultimately took forceful--albeit late--action to eliminate reinsurance problems at Executive Life of New York, California practiced regulatory forbearance for Executive Life and First Capital. Virginia did not restrict surplus relief reinsurance until December 1991, and many states still have not acted to ban this gimmick.

Despite untimely, incomplete, and inaccurate information, state regulators were aware of the troubled conditions of the four insurers. Yet, the regulators generally did not take forceful action to resolve the insurers' fundamental problems, even after the managements of the Executive Life insurers and First Capital failed to correct deficiencies and regulatory violations.

Upon finding solvency problems, California and New York regulators initially chose to forbear rather than promptly disclose the Executive Life insurers' true condition. Regulators allowed the insurers to be recapitalized with borrowed surplus without correcting the underlying causes of capital inadequacy. California regulators also failed to respond swiftly to the deterioration of First Capital. In the end, regulators took over the four insurers to protect the companies from policyholder runs.

The regulatory inaction that GAO found in the four failures was due in part to inadequate measures of solvency and a lack of standards for regulatory intervention. Although general authority provides maximum flexibility, GAO believes such authority must also include requirements compelling regulators to intervene when insurers operate in hazardous conditions characteristic of failure.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the failures of four large insurance companies and the effectiveness of state solvency regulation of these insurers. Executive Life and its subsidiary Executive Life of New York--both owned by First Executive Corporation--were taken over in April 1991 by state regulators in California and New York, respectively. First Capital and Fidelity Bankers--subsidiaries of First Capital Holdings Corporation--were taken over in May 1991 by California and Virginia, respectively. In each case, state regulators took these actions to stop policyholder runs and protect the insurer's assets.

These insurer failures have had national consequences. When they were taken over, the four insurers had a total of nearly $85 billion in business and more than 900,000 policies. Policyholders and annuitants live in every state. As a result of certain moratoria imposed when the states took over the insurance companies, policyholders concerned about the security of their savings have been unable to cash in their policies. Moreover, the 75,000 annuitants of Executive Life are being paid only 70 percent of their benefits.

Dwindling surplus due to rapid growth together with massive junk bond holdings of the four insurers led to a loss of policyholder confidence, ensuing policyholder runs, and eventual regulatory takeovers of the companies. California and New York regulators had evidence for years before the takeovers that the Executive Life insurers were insolvent. Similarly, California and Virginia regulators recognized that First Capital and Fidelity Bankers, respectively, were on the verge of insolvency well before their actual takeovers. However, regulators failed to respond to danger signals and did not take timely or forceful action to avert the failures or minimize policyholder losses. We believe that earlier and more forceful regulatory intervention was clearly warranted for the four insurers. Such intervention should have compelled the insurers to correct problems and could have avoided or minimized the damage that was ultimately inflicted.

To determine the causes of these failures, we reviewed financial information about the four insurers from annual statutory financial statements filed with state regulators, 10-K statements filed with the Securities and Exchange Commission by their parent holding companies, public reports of regulatory financial examinations, analyses done by insurance rating services, and records of recent congressional hearings. To identify whether the actions taken by state regulators and the National Association of Insurance Commissioners (NAIC) were adequate, we did fieldwork at the insurance departments in California, New York, and Virginia, and at NAIC's Securities Valuation Office (SVO). The insurance departments and SVO were cooperative in our current review.

BACKGROUND

Before the late 1970s, life insurance companies focused on bearing risks of death and illness and sold products offering a relatively low but stable return for policyholders. In response to increasing competition for policyholders' savings from mutual funds, savings and loans, and other financial intermediaries during the late 1970s and 1980s, insurers began issuing new interest-sensitive products, such as universal life, single-premium annuities, and guaranteed investment contracts (GIC). The increasing emphasis on selling investments had significant financial effects. The higher rates of return that insurers offered to compete with the product offerings of other financial intermediaries substantially narrowed their profit margins. In addition, to sustain payment of these higher rates and maintain profits, some insurers--including the ones we are discussing today--invested heavily in high-risk, high-return assets, such as noninvestment grade bonds (junk bonds) or speculative commercial mortgages and real estate.

Competitive strategies like these have strained many insurers and increased the number of insurer insolvencies. The number of life/health insolvencies averaged about five per year from 1975 to 1983. Since that time, the average number has more than tripled to almost 18 per year, with a high of 47 in 1989.

Insurance companies are subject to solvency regulation in each state in which they are licensed to do business. On the basis of monitoring of annual statutory financial statements and periodic field examinations, regulators may determine that an insurer is financially troubled, meaning that policyholders are exposed to greater than normal financial risk. Once regulators identify a troubled insurer, they must be able and willing to take timely and effective actions to resolve problems that would otherwise result in insolvency. When problems cannot be resolved, regulators must be willing and able to close failing insurers in time to protect policyholders and reduce costs to state guaranty funds. The insurance department of the state in which the company is domiciled has primary responsibility for taking action against a financially troubled insurer.

State regulators do not regulate insurers' parent holding companies or noninsurance affiliates and subsidiaries of insurers. Instead, most states have various statutory guidelines for transactions between an insurer and affiliated companies, and some states require prior regulatory approval for significant interaffiliate transactions.

THE FOUR INSURERS FAILED DUE TO POORLY CONTROLLED GROWTH, RISKY ASSETS, AND DWINDLING SURPLUS

Executive Life, Executive Life of New York, First Capital, and Fidelity Bankers failed largely because of reckless practices of poorly controlled growth and risky investments. High up-front costs, incurred during a period of rapid growth in the 1980s, seriously depleted the insurers' surplus, or net worth. To bolster their statutory surplus and reported financial condition, these insurers reduced their required policy reserves through questionable reinsurance transactions and borrowed funds from their parent holding companies. Without phony reinsurance and borrowed surplus, the Executive Life insurers would have been insolvent as early as 1983.

Internal control and corporate governance processes of the four failed insurers were very weak. Because of these weaknesses, the highly risky investment activities, unacceptable reinsurance transactions, uncontrolled growth in insurance sales, as well as questionable transactions with affiliates were not subject to effective internal checks and balances, thus presenting an opportunity for mismanagement and fraud. In the end, these activities contributed significantly to the deterioration in the financial strength of the insurers.

Rapid Growth in Riskier Lines of Business

The growth in assets of the four insurers during the 1980s dramatically outpaced the overall asset growth of the life insurance industry. While assets industrywide nearly tripled in the last decade, rising from $481 billion to $1.4 trillion, assets of the four failed insurers grew at six to ten times the industry average, as shown in table 1.

Table 1: Percentage Growth in Reported Assets For the Life Insurance Industry and the Four Companies (1980-1990)

Period covered	Industry average	Executive Life (CA)	Executive Life (NY)	First Capital	Fidelity Bankers
1980-1985	95%	824%	1,021%	844%	34%
1985-1990	66	82	35	139	1,685
1980-1990	223	1,578	1,273	1,917	2,294

Source: Best's Insurance Reports (Life/Health Editions).

At its peak in 1989, Executive Life reported $13.2 billion in assets--more than 21 times its size in 1980. Executive Life of New York's assets peaked in 1988 at $4 billion, more than 17 times its 1980 level. First Capital also experienced rapid growth, with assets increasing to $4.7 billion in 1989, over 21 times the 1980 level.

Unlike the other three insurers, Fidelity Bankers did not grow rapidly during the first half of the 1980s. Fidelity Bankers began its explosive growth following its purchase by First Capital Holdings Corporation in 1985. By 1990, the insurer was reporting $4.1 billion in assets--about 24 times its 1980 level.

During the 1980s, the four insurers grew mainly by selling high-yield retirement investment products to individuals and pension funds. These interest-sensitive products carried higher liquidity risks. All or most of the insurers' policy reserves were for annuities--similar to long-term certificates of deposit--rather than traditional life insurance. Executive Life also sold a large number of GICs, which have no life insurance features, to municipal bond authorities.

Rapid growth itself is not necessarily dangerous as long as an insurer has adequate capital and effective internal controls to manage the increased volume. However, because rapid growth is often characteristic of troubled companies, it should be a red flag indicating a need for increased regulatory attention.

Concentration in Risky Assets

To cover the high rates promised to policyholders and maintain profitability, the four insurers invested in risky, high-yield assets. These insurers became heavily concentrated in the junk bond market and, to a lesser extent, invested in real estate-related assets. Table 2 shows the amount of junk bond holdings reported by the four insurers in their 1990 statutory financial statements.

Table 2: Junk Bonds Reported by the Four Insurers as a Percentage of Assets in 1990 (Dollars in billions)

	Junk bonds	Percent of assets
Executive Life (CA)	$6.4	63%
Executive Life (NY)	2.0	64
First Capital	1.6	36
Fidelity Bankers	1.5	40

Source: Best's Insurance Reports (1991 Life/Health Edition).

The carrying value of insurers' junk bond holdings as reported in statutory financial statements filed with state regulators exceeded the market values of the bonds.[1] Life insurers generally carry bonds at cost on the assumption that bonds will

[1]Market values--as assigned by SVO--are also disclosed in an insurer's annual statutory financial statement.

be held to maturity. Only bonds in or near default--as determined by NAIC's SVO--are carried at the lesser of cost or market value.

Several large junk bond holdings of these insurers were in or near default but were not reported as such in statutory financial statements. The Executive Life insurers accepted more bonds and stocks from the impaired issuers in lieu of overdue interest and principal payments and delayed recognition of losses on its impaired bonds. Bonds and stocks accepted in lieu of interest and principal payments, so-called "payment-in-kind" transactions, amounted to $87 million in 1989 for the Executive Life insurers. In at least one case, Executive Life also bought even more bonds thereby providing cash to fund operating losses and interest payments of the bond issuer. The security holdings, including the private placements, of the insurers were largely placed though Drexel Burnham Lambert. In effect, these actions by the Executive Life insurers delayed recognition of the weaknesses in their bond portfolios. Moreover, purchasing more bonds from impaired issuers also greatly increased the insurers' losses when the companies issuing the bonds collapsed.

Moreover, the four insurers did not have adequate statutory reserves against their bond portfolios to cushion against potential losses. Under statutory accounting rules, a life insurer must establish a mandatory securities valuation reserve (MSVR) to buffer surplus from losses or fluctuations in the market value of bond and stock holdings. The MSVR is based on a formula requiring higher reserves for junk bonds than for higher quality bonds with a maximum reserve of 20 percent for impaired bonds. Losses on defaulted bonds are charged directly against the MSVR.

Due to mounting bond losses and the fact that the maximum MSVR may be accumulated over 10 to 20 years, the Executive Life insurers' reserves represented only about 1 percent of their junk bond holdings in 1990. Since adequate reserves had not been accumulated to guard against the downside risk associated with junk bond holdings, relatively minor losses on the junk bond portfolios of these insurers would have wiped out both the MSVR and reported net worth. Table 3 shows the insurers' MSVR in 1990 as a percentage of their junk bond holdings and the percentage loss in junk bond values that would have eliminated both the insurers' surplus and MSVR.

Table 3: MSVR in 1990 as a Percentage of Junk Bonds and the Percentage Bond Loss to Eliminate Surplus and MSVR

	MSVR as a percent of junk bonds	Percent loss that eliminates surplus and MSVR
Executive Life (CA)	0.8%	8.3%
Executive Life (NY)	1.3	10.4
First Capital	4.5	11.2
Fidelity Bankers	3.6	11.7

Source: Insurers' 1990 annual financial statements and Best's Insurance Reports (1991 Life/Health Edition).

Public awareness of the risks and increasing losses associated with the insurers' extensive junk bond holdings led to policyholder runs. First Executive Corporation--the parent of the Executive Life insurers--announced an $847 million charge for bond defaults and losses during 1989.[2] The February 1990 failure of Drexel Burnham Lambert exacerbated the collapse of the junk bond market. Combined, these events led to a massive run on Executive Life and Executive Life of New York, with policyholders withdrawing a total of about $4 billion in 1990. According to regulators, the April 1991 takeovers of Executive Life and Executive Life of New York spurred policyholder runs on junk bond laden First Capital and Fidelity Bankers.

The four insurers also held illiquid and troubled real estate in the form of direct real estate investments, residential and commercial mortgages, and real estate-backed securities. The true exposure to real estate losses was not apparent from statutory financial statements because some real estate was reported as bonds, common stocks, and "other assets." All four acquired raw or partially developed land as a result of defaults and restructurings of bonds in their portfolio. In 1990, First Capital reported that it held $271 million in mortgages and $65 million in real estate owned or acquired through foreclosure which represented nearly 8 percent of its assets. The Executive Life insurers' ownership of real estate assets--$916 million reported in 1990--was, on the other hand, partly the result of an investment strategy similar to the acquisition, development and construction activities of the thrift industry during the 1980s. For example:

-- Executive Life gave substantial equity interests as well as fees to a former member of the insurer's board of directors for locating properties, obtaining financing, and managing the

[2]The $847 million charge was on a consolidated basis under generally accepted accounting practices. See page 12 also.

properties.[3] This person provided minimal cash contributions. Executive Life held the remaining equity position and was obligated to repay the debt on the properties.

-- Executive Life invested in 8 real estate joint ventures and limited partnerships, reportedly totaling $508 million. Even though Executive Life exercised control over the ventures, the ventures' liabilities were not recorded by Executive Life on its statutory financial statements.

-- Executive Life invested in real estate, including raw land in Florida, rent-controlled apartments in New York City, and an amusement park in Oklahoma City.

Despite the risks associated with these types of speculative real estate investments, statutory accounting practices had not required life insurers to set up reserves to cushion against potential losses. Starting with the 1992 annual financial statement to be filed in March 1993, life insurers will have to establish an asset valuation reserve--similar to the MSVR--for all assets, including mortgages and real estate.

Dwindling Surplus

Under statutory accounting practices, an insurer's costs of selling policies--such as agents' sales commissions--are charged to expenses when they occur. Because most premium income is deferred and expenses are charged off immediately, an insurer's surplus shrinks as the company grows. Because of the rapid growth that the four insurers pursued, their surplus was depleted to levels that were much lower than the industry as a whole. To bolster their statutory surplus, the insurers resorted to the use of questionable financial reinsurance transactions to reduce required policy reserves on their balance sheets. They also received surplus infusions and loans from their parent companies that were supported by debt acquired at the holding company level.

Surplus Relief Reinsurance

All four insurers relied heavily on financial reinsurance to relieve the strain of growth on their surplus. Under a reinsurance contract, the original insurer transfers or "cedes" to another insurer (the "reinsurer") all or part of the risk

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[3]The board member resigned in September 1987, the same month that the real estate joint venture was started. This individual remained on the holding company's board of directors until December 1989, only days before the insurer purchased 63 acres near the former board member's ranch.

accepted in selling policies to the public. The reinsurer, for a premium, agrees to indemnify or reimburse the ceding company for all or part of the losses that the latter may sustain from claims it receives. Insurers routinely use reinsurance to transfer risks under large policies in excess of a specified retention.

Reinsurance has both legitimate and illegitimate uses. It is used legitimately in the life insurance industry to diversify risks. A ceding company obtains surplus relief to the extent that it can reduce its required policy reserves for liabilities transferred to reinsurers. However, reinsurance can also be used to mask an insurer's true financial condition by artificially inflating its surplus. Some financial or so-called "surplus relief" reinsurance transactions transfer little or no risk of loss to the reinsurer. These transactions distort an insurer's statutory financial statement by decreasing its required policy reserves and thus increasing its surplus, even though the insurer's liability remains the same.

The four insurers relied on surplus relief reinsurance to artificially inflate their surplus. These insurers were paying reinsurance premiums for the benefit of claiming credit on their statutory financial statements, even though the financial reinsurers were not liable to pay any claims. For example, Executive Life paid $3.5 million to reinsurers in exchange for statutory reserve credits of $147 million in 1990; however, the reinsurers had no contractual liability to reimburse any of the $1 billion in claims that were supposedly covered by the reinsurance treaties. Executive Life was not reinsuring against the risk of loss from policyholder claims; the company was renting surplus. Without surplus relief reinsurance and the commensurate increase in spurious surplus, the Executive Life insurers would have been insolvent as early as 1983.

Surplus Infusions

During the 1980s, all four insurers also received millions of dollars in surplus aid from their parent holding companies. Without surplus infusions from Executive Life to its New York subsidiary and from First Executive to the California company, both Executive Life insurers would have been statutorily insolvent in 1986. Although these infusions allowed the insurers to meet minimum capital requirements, surplus aid represents a temporary solution that does not correct underlying causes of capital deficiencies. The continuing need for surplus infusions demonstrated the inherent capital inadequacies of the four insurers.

In addition to direct equity contributions, the surplus aid also took the form of loans from the parent holding companies to the insurers. Borrowed surplus is referred to as a surplus note or contribution certificate. Because the loans were subordinated debt and could not be repaid without regulatory approval, the insurers were allowed to count the borrowed funds as surplus on their statutory financial statements without recognizing the liability to repay the funds. Table 4 shows the surplus reported by each insurer at year-end 1990 and the amounts of surplus notes.

Table 4: Reported Surplus and Surplus Notes for 1990 (Dollars in millions)

	Surplus[a]	Surplus notes
Executive Life (CA)	$474	$300
Executive Life (NY)	185	131
First Capital	107	36
Fidelity Bankers	122	50

Source: Insurers' 1990 annual financial statements and Best's Insurance Reports (1991 Life/Health Edition).

[a]Figures for Executive Life, First Capital, and Fidelity Bankers are inflated by surplus relief reinsurance. See page 18.

Given the size of the contributions that surplus notes and other cash infusions were making to these companies' surplus, the insurers' continued solvency clearly depended on the willingness and ability of their parent holding companies to continue such practices. Both First Executive Corporation and First Capital Holdings Corporation borrowed money to capitalize their insurance companies and depended on payments from their insurance subsidiaries to service the debt. In effect, under these arrangements, the insurance companies represented collateral for the debt of the holding companies. With holding companies borrowing based on the performance of the very insurance companies that they were propping up with borrowed money, management was constructing a financial house of cards that was bound to collapse.

Management and Internal Control Weaknesses

Internal controls are essential to properly manage an insurance company, to ensure corporate accountability and accurate financial reporting, and to protect against fraud. Establishing and maintaining an effective internal control system are crucial to fulfilling an insurer's fiduciary responsibility to policyholders. Whenever serious internal control problems exist, the probability of accurate financial reporting decreases, and the probability of failure increases. Internal control weaknesses and breakdowns in corporate governance have been a significant cause of bank and thrift failures. This Subcommittee found that poor controls and reckless management also caused the Mission and Transit property/casualty insurance failures.

The four failed life insurers that we have evaluated had significant weaknesses in their internal controls. These control weaknesses existed for their investment activities, reinsurance arrangements, insurance sales practices, and transactions with affiliates.

Executive Life failed to establish effective policies and procedures for the prudent selection of investments. Investment decisions for the Executive Life insurers reportedly were dominated by one person, and the trades were done primarily through Drexel Burnham Lambert. Until the late 1980s, Executive Life did not have in-house investment expertise to do due diligence on private placement securities or direct real estate investments. It did not set up an investment department until 1988 or hire real estate specialists until mid-1990. In the cases of First Capital and Fidelity Bankers, the parent holding company charged substantial fees for investment management. Moreover, the risky investments selected by the holding company contributed to the insurers' demise.

All four insurers delegated key operations and authority to outside parties without adequate oversight or control. Outside consultants handled bond and real estate investments, product pricing, and reinsurance arrangements for the Executive Life insurers. Their decisions were not subject to internal review procedures, thus presenting an opportunity for mismanagement or fraud. First Capital and Fidelity Bankers contracted with securities brokers for sales of insurance policies and investment products with commissions based on the volume of business. First Capital conceded to regulators that it could not control the volume of insurance sales generated by an affiliated broker.

Deficient financial controls and lax oversight resulted in significant errors and irregularities in financial reporting to regulators. The misstatements overstated asset values, misrepresented the types of assets held, and understated liabilities. For example:

-- The Executive Life insurers misclassified junk bonds in or near default and carried them at cost rather than SVO-assigned market value; this misclassification overstated statutory bond values by $157 million in 1990.

-- Executive Life shifted $789 million of its junk bond holdings to unreported affiliates in 1988 in exchange for supposedly investment grade securities. This transaction reduced the insurer's required MSVR and inflated its surplus by about $109 million.

-- The Executive Life insurers did not have valid treaties and letters of credit backing hundreds of millions of dollars in reinsurance credits in their annual financial statements. For example, state examiners reported that some documents were missing, backdated, or did not conform to regulatory requirements. In 1983, Executive Life of New York claimed credit for reinsurance that did not exist.

REGULATORS WERE ILL-EQUIPPED AND UNWILLING TO ACT EFFECTIVELY IN HANDLING THE FOUR INSURERS' PROBLEMS

As the life insurance industry has taken on more risks since the 1970s, regulatory accounting and reporting requirements have not kept pace with the rapid changes. One key to effective regulation is timely, complete, and accurate financial information. Another is that regulators be able and willing to act in resolving problems once they determine that an insurer is troubled.

In the four failures we reviewed, state regulators (1) did not demonstrate the capability to deal with risky investments of the life insurers, (2) were unaware of interaffiliate transactions that depleted insurers' assets or masked their financial condition, and (3) were slow in banning the surplus relief accounting gimmick. Even though they were aware of the four insurers' financial woes, state regulators did not intervene swiftly and forcefully in protecting policyholder interests.

Regulators' Information Was Not Timely, Complete, or Accurate

Statutory accounting and reporting requirements prescribed by regulators failed to insure the filing of financial statements that presented the true magnitude of the deterioration in the four insurers' financial condition. If financial statements do not fairly and promptly present an insurer's true condition, regulators cannot act quickly to resolve problems. Furthermore, the infrequency with which on-site examinations are done, even for companies known to be experiencing difficulty, significantly impairs the regulators' ability to evaluate financial condition and act on adverse findings. We have identified a number of areas where regulators lacked crucial information about the four troubled insurers.

First, certain statutory accounting practices allow the use of gimmicks that mask solvency problems. As I discussed earlier, reported statutory surplus was artificially inflated by holding company "loans" and surplus relief reinsurance. However, the statutory financial statements did not provide the information necessary for regulators to distinguish between valid reinsurance and this statutory accounting gimmick. Under Generally Accepted Accounting Principles (GAAP), financial reinsurance would not reduce policy liabilities and, therefore, would not increase an insurer's net worth. Likewise, GAAP does not count surplus notes as net worth because they are considered to be liabilities.

Second, insurance holding companies are not required to file consolidated financial statements based on statutory insurance accounting principles, nor are they subject to consolidated capital requirements. As a result, regulators generally do not receive information on a statutory basis about the condition or leverage of the holding company parents. We believe such information would be useful in anticipating that an overleveraged parent company may no longer have the capability to support the insurer or may attempt to siphon funds from the insurer.

Third, the approach to determining statutory reserves for a life insurer's security holdings is flawed. The MSVR is based on a formula that is not linked to current market values, and thus, does not correspond to the risk of loss in an insurer's portfolio. The MSVR requirements delayed recognition of mounting junk bond losses in the four insurers' portfolios. The statutory financial statements for 1989 filed by the Executive Life insurers did not reflect all of the impairments on their junk bond holdings which had been recognized in the companies' GAAP financial statements. The two insurers wrote off only $335 million in losses and did not even disclose $435 million in additional impairments on their statutory financial statements. Because the maximum MSVR may be accumulated over 10 to 20 years, an insurer with a rapidly deteriorating portfolio likely would not have accumulated a sufficient MSVR to cover its investment losses. In addition, because the MSVR is not linked to market values, even the maximum reserve amount may not be sufficient to cover actual losses.

Fourth, current capital and surplus requirements are not meaningfully related to the risks an insurer accepts. Therefore, even compliance with minimum capitalization requirements provides little information about the adequacy of the cushion necessary to protect policyholders from unanticipated losses. For example, Virginia required a minimum of $2 million in statutory capital and surplus for Fidelity Bankers. Although New York now requires $6 million to start a life insurance company, Executive Life of New York needed only $450,000 under a grandfather clause. Similarly, California requires $4.5 million for a new life insurer, but Executive Life and First Capital were grandfathered and each needed only $1 million. NAIC recognizes the inadequacy of static capital requirements and is developing risk-based capital requirements that will relate to the nature and riskiness of a company's assets and insurance business.

Fifth, regulators rely on infrequent field examinations to verify financial data reported by insurers and detect solvency problems. In the cases we reviewed, examinations were done about once every

3 years and took months or even years to complete.[4] Appendix I shows the time lags between the examinations of the four insurers and reporting delays. California and New York regulators waited until 1990 on the regular triennial schedule to examine the Executive Life companies again, even though the 1986 and 1987 examinations found numerous control weaknesses and resulted in material decreases in the insurers' surplus.

Sixth, regulators did not get financial information early enough to identify and react to the rapid deterioration that these insurers experienced in 1990. For example, in January 1990 when First Executive Corporation announced its massive bond losses and policyholders began a run on the Executive Life insurers, the last complete statutory financial statements available to state regulators were already more than a year old; regulators did not receive the 1989 annual financial statements until March 1990. Even quarterly statements were not timely enough to keep the regulators up to date. Starting in March 1990, the troubled Executive Life insurers provided monthly and even weekly reports so that the regulators could track the policyholder runs and mounting bond losses.[5] First Capital and Fidelity Bankers were required to provide limited monthly reports in early 1991.

Finally, state regulators did not keep each other informed about solvency problems, despite their interdependence in monitoring the troubled insurers. For example, when California regulators were doing their 1987 examination of Executive Life, the most current on-site examination information available from New York about the insurer's major subsidiary was more than 3 years old. New York regulators' report on their 1986 examination of Executive Life of New York was not provided to other state regulators until 1990. In addition, Minnesota and New Jersey regulators said that their states had trouble getting information about Executive Life from California. In early 1990, NAIC formed a multistate working group to help disseminate financial information and status reports to other states where the Executive Life insurers were licensed.

<u>Regulators Were Not Able to Identify Junk Bond Risks and Minimize the Four Insurers' Exposure to Loss</u>

Although losses on their junk bond portfolios contributed significantly to the four insurers' failures, regulators were not prepared to address this risk effectively. First, bond rating

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[4]Hereafter, the year of the examination refers to the year under review, not the year in which the examination took place.

[5]The Executive Life insurers provided weekly reports of daily surrender activity, bimonthly reports of insurance operations, and monthly reports of cash flow and investment activity.

procedures of the NAIC-operated SVO provided regulators with a distorted picture of junk bond holdings. Second, the Executive Life insurers masked their exposure to high-risk bonds, and regulators were not able to determine the true value of Executive Life's bond portfolio until well after the damage had been done. Finally, regulators lacked specific authority to limit exposure to junk bonds and other high-risk assets during the period that the four insurers built up their portfolios.

SVO helps regulators to monitor the financial condition of insurers' securities portfolios. SVO determines uniform statutory values for all securities held by insurers and publishes an annual manual of quality ratings and prices. SVO quality ratings and values determine whether an insurer can carry a bond at cost or must mark the bond down to a market value estimated by SVO. The SVO ratings also determine the amount of MSVR that an insurer must maintain to absorb losses. SVO's valuation process is intended to assure regulators that insurers' securities holdings reported in annual statutory financial statements have been reviewed and appropriately valued by professional securities analysts.

Before 1990, SVO's system of rating junk bond holdings did not reflect the true extent of an insurer's junk bond holdings. NAIC acknowledges that the old system counted some junk bonds as investment grade and has since revised the SVO system to better reflect the quality of an insurer's publicly-traded bond holdings. Using SVO's old rating system, First Executive reported in 1989 that 35 percent of its bonds were investment grade. Using Standard & Poor's rating system, however, less than 8 percent of the Executive Life companies' bond portfolio in 1989 was investment grade.

Our preliminary work at NAIC's SVO indicates other unremedied flaws in the regulatory bond valuations. SVO now follows the major rating services in rating publicly traded bonds, but it still does not have clear standards and guidance for analysts valuing private placement bonds. SVO relies on insurers to provide the information needed to assign ratings for private placements because the issuers may not report their financial condition publicly. As a result, SVO may use outdated, incomplete, and sometimes unaudited information that does not accurately reflect a bond issuer's current financial condition.

Flawed SVO valuations allowed Executive Life to overstate the value of its junk bond holdings in its statutory financial statements. For example, in 1988, Executive Life shifted $789 million of junk bonds to unreported affiliates in exchange for securities collateralized by the junk bonds. Because SVO classified the majority of the junk-collateralized issues as investment grade, Executive Life was able to reduce its MSVR, thus increasing its reported statutory surplus, even though the company had not reduced its exposure to junk bond losses.[6] SVO now relies on major rating services to help value junk-bond collateralized securities.

Inflated SVO valuations of other bond holdings of Executive Life also allowed the insurer to carry defaulted junk bonds at overstated historical costs in its 1989 statutory financial statement. Our preliminary work indicates that SVO did not downgrade various junk bonds in cases where the issuers were not making interest payments. In other cases, because Executive Life had agreed to exchange its bonds for issues with deferred or reduced payments, SVO allowed the insurer to ignore the deteriorating quality of its bond portfolio. At your request, we plan to issue a subsequent report detailing how the SVO process contributed to the overvaluations of Executive Life's securities holdings.

Even if SVO could produce accurate valuations, the states would have to effectively enforce the requirement that insurers use SVO valuations in their statutory financial statements.[7] SVO itself has no enforcement role in assuring that their securities values are properly applied by insurers. Even though analysts may test some bond values reported in annual statutory financial statements, regulators generally rely on infrequent field examinations to detect improper valuations. Between examinations, the Executive Life insurers were able to obscure their junk bond loss exposure by reporting their own inflated values for impaired securities rather than submitting the issues to SVO for valuation.

Following First Executive's announcement about the bond losses and the ensuing policyholder run in early 1990, state regulators had to determine whether the Executive Life insurers could survive as going concerns. According to the chairman of NAIC's Executive Life working group, regulators needed to estimate both which bonds might default in the future and how much the insurers might lose. Because the California department did not have the expertise to evaluate Executive Life's portfolio, it had to get an independent actuarial firm to assess whether the insurer's assets could support its liabilities. The actuarial firm, however, did not independently evaluate the asset portfolio and instead relied on optimistic assumptions about default rates and investment income provided by Executive Life; actual bond losses

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[6]California did not fully review Executive Life's 1988 annual financial statement until the fall of 1989. In December 1989, California regulators made Executive Life reverse the bond transactions and recalculate its MSVR.

[7]One of NAIC's accreditation standards is that a state require securities owned by insurers to be valued by SVO.

surpassed even the worst-case scenario in the actuarial studies. Regulators did not request an independent evaluation of the default risk for Executive Life's portfolio until February 1991.

Even if regulators had obtained a clear picture of the four insurers' junk bond exposure, they lacked specific statutory or regulatory authority to limit junk bond holdings. Although a 1987 New York regulation limited insurers' holdings of junk bonds to 20 percent of assets, the regulation did not correct Executive Life of New York's problems because the insurer did not have to divest holdings in excess of the cap.[8] California's limit on junk bond holdings was not effective until January 1992, and Virginia's limit was not effective until July 1992. In June 1991, NAIC adopted a model regulation limiting an insurer's investment in medium and lower grade bonds to 20 percent of its assets. According to NAIC, 31 states did not have specific limits on junk bond holdings as of July 1992.

Interaffiliate Transactions Were a Regulatory Blind Spot

Interaffiliate transactions can be used to mask an insurers' true condition, and improper transactions with affiliates have caused previous insurance company failures.[9] Nevertheless, state insurance regulators have a limited capability to evaluate and control an insurer's relationships with its holding company and affiliated entities. State holding company laws rely on insurer disclosure to monitor affiliated relationships, and some states have prior regulatory approval requirements to prevent abusive transactions. Regulators cannot effectively assess interaffiliate transactions if the insurer fails to report either the identity of its affiliates or the transactions. Except for infrequent field examinations, regulators have no way to verify the insurer's reported information on affiliate relationships or transactions.

Executive Life failed to comply with California holding company laws, thereby undermining regulators' solvency monitoring efforts. Executive Life repeatedly failed to report and get approval for transactions with its parent holding company and affiliates. As a result, California regulators could not effectively assess the impact of those transactions on the

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[8]According to regulators, Executive Life of New York had to keep the junk bonds to pay the high yields promised to policyholders.

[9]Abusive interaffiliate transactions caused the Baldwin-United failure--the largest life insurance failure before the Executive Life takeovers. According to state regulators, the parent holding company milked the insurance subsidiaries to service its own debt.

insurer's solvency and protect policyholder interests. For example, Executive Life did not get California's approval before it made a $131 million surplus loan to its New York subsidiary in 1987. The transaction removed cash from Executive Life when the insurer was already seriously troubled. That money will not be available to pay policyholders of the California insurer unless New York lets the subsidiary repay Executive Life. In addition, Executive Life's 1990 annual statutory statement did not identify 36 subsidiaries and affiliates within the holding company system, even though the insurer had invested in many of those affiliated companies.

Inappropriate interaffiliate service arrangements can also be used by affiliates or the parent to siphon funds out of an insurance company. Even though excessive management expenses associated with these service arrangements can contribute to insurer failure, holding company laws in California do not require prior approval for service agreements and cost-sharing arrangements. Virginia requires prior approval for only those affiliated service agreements exceeding a certain threshold. New York requires prior notice with a 30-day period to reject service agreements. However, Executive Life of New York circumvented regulators by not providing notice of one service agreement and failing to follow terms of another agreement.

Surplus Relief Reinsurance Is a Continuing Problem

Until the early 1980s, surplus relief reinsurance was largely unregulated. In its 1980 examination, New York regulators found that Executive Life of New York's surplus would have been nearly depleted without surplus relief reinsurance. By the 1983 exam, surplus relief reinsurance exceeded the insurer's "bonafide" surplus. In 1985, New York prohibited credit for surplus relief reinsurance that did not transfer risk to the reinsurer but allowed 3 years to write off such existing financial reinsurance. In the 1986 exam, New York regulators found that Executive Life of New York's problems with unacceptable surplus relief reinsurance persisted and that its reinsurance program was rife with internal control deficiencies. In 1988, New York regulators disallowed $148 million in reinsurance credits on the insurer's 1986 financial statement. Further, New York fined the Executive Life of New York $250,000 and required three of its officers to resign.[10]

In California, regulators detected certain financial reinsurance arrangements that did not transfer risk and were not in compliance with state law as early as the 1983 field

[10]These three officers continued to work for Executive Life in California after their dismissals from New York.

examinations. However, California, like New York had done for its insurers, allowed Executive Life and First Capital 3 years to write off the unacceptable surplus relief reinsurance. In the 1986 examinations of First Capital and Executive Life, California found that both insurers had entered into even more surplus relief reinsurance arrangements to support their explosive growth. In fact, California regulators found Executive Life's problems to be so serious that they extended the examination to 1987. However, in contrast to the forceful--albeit late--actions taken by the New York regulators, California again did not immediately disallow the unacceptable surplus relief reinsurance but instead let the insurers amortize the amounts.[11]

California's bulletin restricting surplus relief reinsurance was not issued until 1989 and even then granted yet another 3-year write-off period.[12] Virginia did not restrict surplus relief reinsurance until December 1991. As a result of the slow response to and continued forbearance on the surplus relief reinsurance problem, Executive Life still had $147 million in unacceptable surplus relief reinsurance while First Capital had $65 million and Fidelity Bankers had over $57 million in 1990. Many states still have not acted to restrict use of this statutory accounting gimmick.[13]

<u>Regulators Failed to Respond in Timely and Forceful Manner to Danger Signs</u>

Despite untimely, incomplete, and inaccurate information, state regulators were aware of the troubled conditions of the four insurers. Yet, the regulators generally did not take forceful action to resolve the insurers' fundamental problems. Instead, the approach was to work cooperatively with insurer management to resolve financial problems. Although informal actions and cooperation can be an effective regulatory tool, we believe this approach is not warranted in instances when management repeatedly fails to correct unsafe practices.

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[11]In a related matter, Executive Life did have $180 million in surplus relief reinsurance disallowed in the 1987 examination due to defective letters of credit from an off-shore reinsurer.

[12]In November 1991, California issued a new bulletin that further restricts the kinds of life reinsurance and strengthens the risk transfer requirements.

[13]In 1986, NAIC adopted a model regulation on life reinsurance agreements based on New York's law. As of July 1992, only 23 states had adopted the model. Because this model is required for NAIC accreditation, NAIC expects more states may adopt surplus relief reinsurance regulations.

The fostering of a strong internal control environment by regulators is fundamental to protecting policyholder interests. However, we saw no evidence of a comprehensive internal control or risk assessment in the examination workpapers we reviewed. Further, we saw little evidence that examiners assessed the adequacy of controls over insurer operations delegated to outside consultants or affiliated parties.

While New York examiners repeatedly cited instances of internal control deficiencies, they did not determine the root causes of the numerous weaknesses. For example, most of the examination recommendations for Executive Life of New York simply called for keeping better records and complying with New York insurance laws and regulations. In their 1980 and 1983 examinations of the insurer, examiners found numerous internal control problems and regulatory violations, including a blurring of the identities of Executive Life of New York and its parent Executive Life as well as a failure to maintain proper records. Such control deficiencies and regulatory violations were again identified in the 1986 and 1990 examinations. Despite identifying numerous internal control deficiencies, New York regulators failed to follow up between examinations or compel the insurer to correct the problems.

California examiners also identified numerous internal control deficiencies in examinations of Executive Life but failed to recognize the severity or take appropriate action. For example, the 1983 examination identified a lack of separation of duties for investment decisions yet recommended only that a second member of the board of directors' executive committee share responsibility for approving transactions. For the 1987 examination, examiners reported that Executive Life had adequate controls over its reinsurance program, despite the continued use of unacceptable surplus relief reinsurance and the disallowance of $180 million in unsecured reinsurance. An unreleased report of the 1990 examination of Executive Life states that "The Company's accounts and records for the most part were found to be in proper order. The exceptions noted pertained to some of the other invested assets and a portion of the actuarial records." Nonetheless, the examination reduced the insurer's assets by almost $500 million and increased the liabilities by over $300 million resulting in a surplus deficit of $356 million. In effect, the examiners found everything was okay except for the assets and liabilities.

Upon finding solvency problems, California and New York regulators chose to forbear rather than to disclose the Executive Life insurers' true condition and risk precipitating a policyholder run. The regulators did not conclude examinations at the companies or delayed reporting their findings until the insurers appeared solvent again. To that end, regulators allowed the Executive Life insurers to be recapitalized with loans from their holding company without correcting the underlying causes of capital inadequacy. In fact, California allowed Executive Life to use backdated demand notes--basically IOUs--from its parent holding company to appear solvent in 1987, and the insurer did not get the cash until months later. Even faced with mounting junk bond losses and a hemorrhaging policyholder run beginning in January 1990, regulators delayed until April 1991 before they moved to conserve the Executive Life insurers and minimize policyholder losses. During that period the Executive Life insurers sold their higher quality, more liquid assets to fund the policyholder demands for cash, leaving the companies at takeover with an even higher proportion of low-quality assets.

California also failed to respond swiftly to the deterioration of First Capital. First Capital was put on the "watch list" in 1987 because of the leveraged buyout by First Capital Holdings and concerns about the insurer's operating losses, reinsurance, and aggressive investments. The analyst responsible for the insurer identified that the company appeared to be in hazardous operation in October 1989. An unreleased report of the 1989 examination found that the insurer was nearly insolvent. Yet, California regulators avoided formal actions against the insurer because they did not want to alarm the public. By May 8, 1991, California's financial analysis chief wrote that First Capital "is very quickly unraveling and we may be unable to avoid conservatorship." California issued a cease and desist order to protect the insurer from a policyholder run on May 10, 1991--more than a year and a half after the analyst's report that the insurer was in hazardous operation.

Even though Fidelity Banker's financial condition, as measured by its capital ratio, indicated a steady deterioration since 1985, Virginia's 1988 examination of the insurer did not report any significant problems. Once Virginia determined in early 1990 that Fidelity Bankers was financially troubled, the regularly scheduled triennial examination was moved ahead a year. We found that the insurer's statutory surplus would have been only $3 million without surplus relief reinsurance identified in the 1990 examination. Yet, Virginia indicated that it did not take over Fidelity Bankers because it was insolvent. In the end, regulators responded swiftly because heightened policyholder surrenders threatened the insurer.

The ineffective regulatory handling of the four insurers we reviewed is due in part to inadequate measures of capital adequacy and a lack of standards for regulatory intervention. Clearly, the statutory minimum capital requirements were not meaningful given the volume of business and investment risks of the four insurers. Without better measures of capital strength, determining the financial soundness of insurers will continue to be ambiguous. Further, California and New York do not have statutory or regulatory standards defining a troubled insurer.[14] Virginia's new regulatory standards defining hazardous condition were not effective until January 1992.

Without criteria defining a troubled insurer, regulators may hesitate to take formal action and challenge an insurer's management. For example, even though California, New York, and Virginia have general authority to take action against any insurer operating in hazardous condition, regulators did not use that authority to address the poorly controlled growth and massive junk bond loss exposure threatening the four insurers' solvency. We believe that standards defining hazardous conditions, such as uncontrolled growth and a concentration of risky assets, would have prompted earlier and more forceful intervention.

State regulators we talked to provided several reasons why they did not act sooner and more forcefully. Their reasons included concerns that publicity about formal actions would have accelerated the policyholder runs, thus exacerbating rather than reversing the financial decline. They also expressed concern that formal actions may not be granted or upheld by the courts. Some regulators said they do not believe they have the resources or expertise to successfully defend corrective actions against insurer challenges. For this reason, California regulators expressed reluctance to challenge Executive Life's management, even though California courts must uphold regulatory actions against an insurer found to be in hazardous condition.

While we agree that general authority provides maximum flexibility for regulators, we believe such authority must also include requirements compelling regulators to intervene in hazardous conditions characteristic of failure. NAIC is working on a model policy for states' consideration to encourage uniform action against insurers that do not meet the new risk-based capital requirements. While we support these efforts, we are concerned that the model would have to be adopted without modification by all states to be effective. NAIC does not have the authority to compel such a response.

CONCLUSIONS

Reckless growth and investment practices contributed significantly to the downfall of these four insurers. The four invested heavily in high-risk assets with inadequate reserves to cover potential losses. They relied on phony surplus relief

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[14]As of July 1992, only 18 states have adopted NAIC's Model Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition, even though this model is required for NAIC accreditation.

reinsurance and money borrowed from their parents to artificially inflate their surplus and mask their true condition. Without surplus relief reinsurance and borrowed surplus, the Executive Life insurers would have been insolvent in the early 1980s, while First Capital and Fidelity Bankers would have been on the verge of insolvency.

Despite untimely, incomplete, and inaccurate information, state regulators were aware of the troubled conditions of the four insurers well before the insurers were taken over. Even after the managements of the Executive Life insurers and First Capital failed to correct deficiencies and regulatory violations, regulators generally did not take forceful action to resolve the insurers' problems. State insurance regulators clearly should have been more aggressive in ensuring that the Executive Life insurers corrected internal control and other weaknesses identified throughout the 1980s.

It was not until the insurers hemorrhaged from policyholder runs that state regulators moved to take them over. Ironically, these actions were designed to protect the companies from their policyholders, rather than protecting the policyholders from their companies.

This completes my prepared statement. I would be pleased to answer any questions.

LAGS IN FIELD EXAMINATIONS AND REPORTING DELAYS

State insurance departments generally do on-site field examinations of insurers every 3 to 5 years, though a troubled insurer could be examined more frequently. The state of domicile leads the examination, and examiners from other states in which the insurer is licensed can participate.

After the examiners finish their fieldwork, they submit the report to the heads of the insurance departments participating in the examination--the report date. The company examined then has the opportunity to review the report and submit comments. The final report is then distributed to all states where the company is licensed and filed as a public document--the filing date.

Executive Life, Executive Life of New York, First Capital, and Fidelity Bankers were examined about every 3 years. Not only were the examinations infrequent, but reporting took months or even years. Table I.1 includes, for examinations done on these four insurers, the period covered by each exam, the report date, and the filing date, where available.

Table I.1: Field Examinations of Four Failed Insurers

Period covered	Report date	Filing date
Executive Life of California		
December 31, 1987 to December 31, 1990	5/10/91	Not filed
December 31, 1983 to December 31, 1987[a]	4/1/88	7/14/88
December 31, 1980 to December 31, 1983	5/10/85	11/14/85
Executive Life of New York		
January 1, 1986 to December 31, 1990	Not applicable[b]	Not applicable
January 1, 1984 to December 31, 1986	5/6/88	5/2/90
January 1, 1981 to December 31, 1983	1/28/87	3/2/87
First Capital[c]		
December 31, 1986 to December 31, 1989	1/30/91[d]	Not filed
December 31, 1983 to December 31, 1986	8/28/87	12/07/88
December 31, 1980 to December 31, 1983	4/24/85	7/29/86
Fidelity Bankers Life[e]		
December 31, 1988 to December 31, 1990	9/13/91	4/3/92
December 31, 1985 to December 31, 1988	9/29/89	12/19/89

[a]Period covered by exam originally ended December 1986 but was extended to December 1987.

[b]The examination was terminated on April 15, 1991 when the insurer was taken over by state regulators.

[c]The company was named E. F. Hutton Life until 1987, when it was purchased by First Capital Holdings Corporation.

[d]The draft examination report was submitted for the insurer's review, and the comment period ended May 5, 1991.

[e]The company was purchased by First Capital Holdings Corporation in 1985.

Sources: Financial examination reports.

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