United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, House of Representatives

December 1992

INSURANCE REGULATION

Weak Oversight Allowed Executive Life to Report Inflated Bond Values

GAO/GGD-93-35

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-249901

December 9, 1992

The Honorable John D. Dingell
Chairman, Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

The National Association of Insurance Commissioners (NAIC) [1] created the Securities Valuation Office (SVO) to help regulators value insurers' assets—a key step in monitoring insurer solvency. At hearings your Subcommittee held on September 9, 1992, we testified that flawed SVO valuations allowed the Executive Life Insurance Company to overstate the value of its bond holdings and that regulators did not effectively enforce the requirement that SVO value all securities the insurer held. In part, these weaknesses in regulatory oversight hindered regulators' efforts to identify Executive Life's exposure to risky bonds and address the troubled insurer's financial condition in a timely manner. As discussed with you, this report provides additional information on these matters.

Results in Brief

SVO's ability to support state regulators in monitoring insurer solvency appears doubtful. SVO's bond valuation criteria focus narrowly on bond default—defined simply as nonpayment of interest—and neglect other factors, such as difficulties an issuer experiences generating cash to pay interest, that may be considered in determining whether a bond is impaired for generally accepted accounting principles (GAAP) reporting purposes. Further, SVO does not obtain current or complete information to evaluate an insurer's bond holdings and has not provided its analysts clear standards for assigning ratings and documenting their work. As a result, SVO assigned inflated ratings to a number of bonds Executive Life held, thus overstating Executive Life's financial strength, as reflected in its 1989 statutory financial report filed with regulators.

A gap exists in enforcement of the requirement that insurers use SVO valuations to prepare statutory financial reports. SVO does not verify that insurers obtain an SVO rating for all bonds they hold—regulators are responsible for this task. Regulators generally rely on infrequent field examinations to detect improper bond valuations. As a result, Executive

[1]Each state regulates insurers independently. State regulators, however, have joined together to form NAIC, a private, voluntary association whose objectives include promoting more consistent, effective insurer regulation.

Life was able to obscure its bond loss exposure by supplying its own inflated ratings for bonds not rated by SVO and misreporting SVO ratings in its statutory financial statements. Moreover, Executive Life did not have sufficient statutory reserves to cushion against bond losses.

Background

NAIC has long been involved in valuing insurer investments. In 1907, NAIC established a permanent staff, located in New York City, to provide regulators and insurers standardized values for securities. Under NAIC guidelines insurers are supposed to report bond and stock purchases and any investments in affiliated companies to SVO. SVO is to assign quality ratings to the bonds and stocks and determine the value insurers will report for all investments in securities and affiliated companies.

The value an insurer reports on its statutory financial statements[2] for the securities it holds and the valuation reserves the insurer maintains in connection with its portfolio are key variables in determining solvency. In 1990, government, municipal, and corporate bonds that SVO was responsible for rating represented about 56 percent and stocks another 9 percent of the life insurance industry's $1.4 trillion in assets. Because securities entail some risk of investment loss, life insurers are required to maintain a formula-based valuation reserve, known as the mandatory securities valuation reserve (MSVR), to provide a cushion against such losses.[3] Losses incurred on impaired bonds are charged to the MSVR and ultimately affect an insurer's solvency.

Since SVO is to determine when losses on impaired bonds must be reported and SVO ratings are a key variable in determining the amount of MSVR that an insurer must maintain, SVO plays a pivotal role in determining insurer solvency. For bonds, SVO is to analyze the default risk involved in each bond and, on the basis of this analysis, assign a quality rating. This quality rating determines whether an insurer may report a bond at cost or market value in its statutory financial statements. Bonds are to be reported at an SVO-assigned market value, which can be substantially less than cost, when SVO determines that the bond is in default. The MSVR formula—prescribed by NAIC—uses SVO's quality ratings to establish valuation reserves, with

[2]Statutory financial statements are to be prepared in accordance with accounting principles and standards specified in the insurance laws and regulations of the various states. Statutory financial statements are to be filed with state insurance regulators, who are to use the statements to monitor the solvency of insurers.

[3]On the 1992 annual statutory financial statements due to be filed March 1, 1993, the MSVR will be replaced by the new asset valuation reserve (AVR.) See page 31.

larger reserves required for lower grade bonds than for higher quality bonds.

NAIC changed SVO's procedures in 1990 to address concerns that SVO's rating criteria were more liberal than those of the private rating agencies. First, NAIC expanded the number of categories in SVO's quality rating system from four to six in order to recognize more precisely differences in default risk between bonds. In particular, a new rating category was created for certain junk bonds[4] that SVO's prior system had classified as investment grade. Second, SVO now adopts ratings published by recognized private rating agencies such as Moody's and Standard and Poor's when available.[5]

Since this change in procedures, SVO's principal role has been to rate private placements—securities that insurers and other investors have purchased in private transactions with the issuers. NAIC data indicate that private placements represented about 28 percent of the life insurance industry's 1990 bond holdings, and they present unique valuation challenges. Insurers have no assurance that private placements can be sold readily should the need arise because, by definition, no public trading market exists for private placements. SVO analysts must rely on their judgment to estimate the value of private placements. Since financial and other data on the issuers may not be publicly reported, regulators depend on SVO to provide accurate and thorough analyses of private placements.

SVO's small staff has a large workload. In 1991, SVO rated securities of 30,357 issuers. Securities of 15,403 of these issuers had been rated by 1 or more private rating agencies, and SVO, under its new procedures, relied on these private ratings to evaluate the issuers' securities. Securities of another 5,049 issuers had been guaranteed by some other SVO-rated issuer; in these cases, SVO relied on the guarantor's rating. The remaining 9,905 issuers had sold private placements, and SVO had to rate these securities independently. Each of SVO's 9 professional analysts, therefore, had to assemble and evaluate information on an average of 4 of these 9,905 private placement issuers each workday, or about 1,100 a year.

Objectives, Scope, and Methodology

As discussed with the Subcommittee, our objective was to use Executive Life's reporting on its bond portfolio as a case study for assessing the effectiveness of (1) SVO in developing ratings and values for securities and

[4]"Junk bond" is a popular term for a high-yield, noninvestment grade bond.

[5]Appendix II compares SVO's current and pre-1990 rating systems with selected private agency rating systems.

(2) regulators in ensuring that valuation procedures were followed. At the end of 1989, Executive Life's portfolio included more than 900 bonds valued at $9.9 billion, and the insurer reported MSVR and surplus of $1.0 billion. We reviewed a judgmental sample of 56 bonds, which were reported at $1.2 billion in Executive Life's 1989 statutory financial statement. Our sample consisted of those bonds about which regulators or external auditors had raised questions. Appendix I provides additional details on the scope and methodology of our review; appendix IV lists the 56 bonds reviewed.

NAIC provided written comments, included in appendix II, on a draft of this report. These comments are evaluated on pages 14 and 15 in appendix II. We did our work between February 1992 and June 1992 in accordance with generally accepted government auditing standards.

SVO's Valuation Criteria Neglect Some Impairments in Value

For reporting under statutory accounting principles, determining whether a bond is in default—which SVO defines as when interest is not being paid—is the key issue in determining its value. SVO's procedures state that a bond is in default when an issuer defers interest or principal payments because the issuer cannot make the required payments. Until SVO learns that interest is not being paid on a bond, insurers may report it in statutory financial statements at cost even though the bond's true worth may be substantially less. When SVO learns that a bond is in default, it requires insurers to report the bond at market value and write off the loss against the MSVR. Since provisions to restore MSVR come out of capital and surplus, bond losses directly affect solvency.

For reporting under generally accepted accounting principles, in contrast, factors other than nonpayment of interest may be considered when determining whether financial statements should reflect losses on bonds whose value is impaired. For example, in preparing Executive Life's GAAP financial statements, consideration was given to several indicators of bond impairment, such as whether

- an issuer had proposed an exchange offer or restructuring transaction for its bonds,
- an issuer's financial statements reflected a reduced ability to generate the cash needed to pay interest, or
- the market price of an issuer's bonds had been significantly depressed for an extended period.

Since 1991, SVO has given some weight to market price as an indicator of impairment, and it requires insurers to report bonds trading at less than 25 percent of face amount at market value. However, SVO does not consider other indicators of impaired value. Further, this market price test does not address troubled private placement bonds. By definition, no organized market exists for private placements.

In 6 of the 56 cases we examined, SVO's rating did not reflect the financial difficulty issuers were experiencing because SVO's criteria for determining when bond losses must be recognized focus narrowly on nonpayment of interest. For example, at the end of 1989 Executive Life held notes issued by a manufacturer of consumer household goods, reported at a cost of $12 million. SVO's rating for the notes, which SVO's analyst based on the issuer's 1988 financial statements, did not indicate that their value was impaired. However, these financial statements expressed concern about the company's ability "to continue in its present form," in part because "it is unlikely that the Company will meet [its] debt service payments." The issuer did not make the interest payment due April 1989 on the notes Executive Life held. Executive Life and other creditors agreed to accept additional notes for this payment and other interest due during 1989 and for part of the interest due until 1991. SVO's analyst maintained that if creditors agreed to revise the terms of the notes and the issuer was in compliance with these revised terms, the notes should not be considered in default. The issuer's failure to make a cash interest payment due in October 1990 precipitated its March 1991 bankruptcy filing. Executive Life's GAAP financial statements reflected that the notes were impaired at the end of 1989, with a market value $5.4 million less than the cost Executive Life reported in its statutory financial statements.

SVO Does Not Obtain Sufficient Data to Develop Valid Ratings

Regulators depend on SVO for complete and up-to-date analysis of insurers' bond holdings in order to establish accurate values for statutory financial reporting. SVO analysts, however, rely on insurers that hold securities to provide information on issuers. The analysts do not actively seek other sources, even though the data may be available from such public sources as the Securities and Exchange Commission. For certain bonds we reviewed, Executive Life did not provide SVO data that would have revealed indicators of impairment, thus leaving SVO unaware of critical details that affected the bonds' quality and value. On purchasing a security, an insurer is generally to provide SVO with the issuer's financial statements and a summary of the terms and investment merits of the security prepared by the insurer's investment department. Further, the insurer is supposed to submit updated financial information each year, which in some cases may be unaudited, and to inform SVO of any missed interest or principal payments or other adverse developments affecting a security. SVO staff may obtain additional information from the financial press or other sources.

SVO's ratings may not reflect the current status of issuers because outdated financial information is used to develop ratings. SVO analysts identified a specific financial statement as the basis for 24 of the bond ratings we reviewed; 22 of these were fiscal year 1988 statements rather than more recent statements issued during 1989. For example, outdated information was used to rate notes issued by a provider of long-term health care services that Executive Life held at the end of 1989 and reported at a cost of $6 million. SVO's analyst used the issuer's 1988 financial report (for the year ended March 31, 1988) to develop the 1989 year-end rating. The analyst rated the notes as investment grade because the March 1988 report showed strong positive cash flow. However, a more recent financial report that the issuer filed with the Securities and Exchange Commission on June 28, 1989, covering the year ended March 31, 1989, was available and showed that the issuer had negative cash flow and had sustained a large loss. The issuer did not make an interest payment due August 1990 and filed for bankruptcy in February 1991. Because the 1989 financial report showed negative cash flow, instead of the strong positive cash flow on which the SVO analyst relied in assigning an investment grade rating, we believe the rating was erroneous and seriously understated the risk inherent in the notes.

SVO publishes its Valuation of Securities Manual as of December 31 of each year and issues a supplement in February that includes ratings for securities for which SVO received information too late for inclusion in the manual. However, SVO does not use the supplement to update ratings to reflect events occurring between December 31 and March 1 (when statutory statements are filed) that significantly affect bond values. Yet, under statutory accounting, insurers are supposed to disclose in statutory financial statements events occurring after the close of the fiscal year that significantly affect their financial condition. For example, at the end of 1989 Executive Life held notes issued by a diversified holding company, reported at a cost of $17.8 million, that SVO's rating indicated were of low quality but not impaired. SVO's analyst used the issuer's 1988 financial report, which reflected continued losses and a negative financial trend, to develop this rating. As of December 31, 1989, the issuer had not missed an interest payment; however, it did not make the interest payment due the following day—January 1, 1990. SVO did not revise its rating in the February supplement to reflect this missed payment. SVO's rating manual did not reflect that the notes were impaired until the end of 1990, whereas Executive Life's GAAP financial statements recognized the impairment at the end of 1989. Market price data Executive Life's external auditors obtained in 1989 indicate that the statutory statements overstated the notes' value by $12.4 million.

In other cases, SVO's ratings did not reflect the true status of an issuer because Executive Life did not provide SVO with information that indicated a bond's value was impaired. For example, at the end of 1989 Executive Life held notes and debentures issued by a developer of residential communities reported at a cost of $24.5 million, which SVO rated as low quality but not impaired. A financial report filed during 1989 indicated that the issuer struggled financially during the year. The issuer borrowed more money from existing bond holders to make interest and principal payments on the notes and debentures and was granted an extension of time to make the interest payments due Executive Life on the notes. In December 1989, the issuer circulated a restructuring proposal stating that its interest payment requirements were inconsistent with orderly continuation of its business. The issuer proposed several options for restructuring its finances, such as exchanging existing bonds for low- or no-interest bonds or exchanging bonds for some of its properties. Executive Life did not notify SVO of this proposal, which indicated it was likely the notes and debentures were impaired. Based on the market price of the notes and debentures at the end of 1989, the cost of $24.5 million Executive Life reported to regulators in the statutory statements overstated their value by $3.5 million. In April 1990, Executive Life agreed to exchange its bonds for the issuer's troubled Florida real estate holdings.

Because SVO's procedures do not require insurers to submit documents detailing all the provisions and conditions of each bond, analysts may not learn the true status of a bond. For example, at the end of 1989 Executive Life held three issues of airline company equipment trust certificates valued at $83.1 million, one rated by SVO as investment grade and two rated as low quality but not impaired. After its March 1989 bankruptcy filing, the issuer did not make the November 1989 interest payments on these certificates and remained in default on interest payments through 1991. The SVO analyst responsible for rating the issuer told us that while he knew of the bankruptcy, a provision of the bankruptcy law permits continued payments on certain debts secured by transportation equipment.

Consequently, he believed that interest due on the certificates was being paid. The analyst did not research which of the issuer's certificates were covered by the provision or contact holders to determine whether or not interest was being paid. Therefore, SVO's rating did not reflect that the investment was impaired. For GAAP reporting purposes, Executive Life recognized that the certificates were impaired at the end of 1989; on the basis of the market price of the certificates, we believe Executive Life's statutory statements overstated their value by $5.9 million.

SVO Does Not Provide Clear Standards for Its Analysts

SVO plays a key role in determining the value of an insurer's bonds—and ultimately whether the insurer is solvent. Clear standards for how SVO analysts assign ratings would ensure more consistent application of SVO policy and more reliable rating decisions. Standards for how SVO analysts should document their work would facilitate review of analysts' decisions and fix accountability for compliance with SVO policy. SVO, however, lacks the standards to ensure thorough, consistent, high-quality work by its analysts.

While SVO's analysts used various analytical approaches and techniques to rate the bonds we reviewed, the analysts had limited guidance on the use of these techniques. SVO's Purposes and Procedures Manual and a training manual for new analysts include a brief overview of the rating process and financial analysis concepts. SVO has also defined seven key financial measures and benchmark levels of the measures typical of each rating category. An analyst need not calculate each measure, SVO officials told us, if the rating for a bond is clear without calculating them all. SVO's Procedures and training manual, however, do not provide guidance on which financial analysis concepts or financial measures would be most useful or meaningful in a given situation.

Because SVO's written policies were not clear or comprehensive, we had difficulty determining whether some questionable ratings resulted from erroneous implementation of these policies. For example, at the end of 1989 Executive Life held debentures issued by a diversified communications and entertainment company, reported at a cost of $19.8 million, which SVO considered investment grade. Moody's and Standard and Poor's rated the debentures noninvestment grade.[6] The issuer's 1988 financial statements, which SVO's analyst used to rate the debentures, show that the issuer was highly leveraged and generating

[6]The ratings both Moody's and Standard and Poor's assigned were equivalent to an SVO noninvestment grade rating even under the more liberal SVO rating system in effect before 1990.

barely enough cash to meet its interest payments. The analyst explained that broadcasting companies like the issuer generally look weaker by traditional financial measures than other types of companies. Although SVO had informal guidelines for analyzing such companies, the issuer did not qualify as investment grade even under these more liberal guidelines. In fact, the issuer's ability to generate cash to pay interest and its overall leverage were much weaker than the average for the broadcasting industry at the time. As another test, SVO's analyst computed a "market-adjusted" leverage ratio that he believed demonstrated that the issuer was sounder than traditional measures would indicate. The analyst made this determination despite the absence of SVO policy defining or providing benchmarks for this ratio. SVO's investment grade rating was clearly erroneous and hindered regulators' efforts to learn the full extent of Executive Life's junk bond holdings.

SVO also lacks standards for documenting its analysts' work on all issuers. SVO had not developed standard analytical worksheets or rating checklists but did generally maintain a 5" by 7" card for each issuer, on which a ratings history and key financial data could be recorded. Some analysts had devised notation systems to record on the card the source and date of the financial data they used and the key financial measures considered. A computer system SVO has recently developed to accumulate and manage financial data on the corporate securities it rates may improve records of how ratings were assigned. Since the system depends on financial information obtained from a commercial database service, however, it currently covers about 6,000 of the about 10,000 corporate issuers whose securities SVO must rate and does not cover private placement issuers or the approximately 20,000 state and local government issuers SVO rates.

For several of the erroneous ratings we noted during our review, SVO lacked a clear record of the basis for the rating and necessary supporting documentation. SVO has no written policy concerning which of the source documents its analysts have used to develop ratings should be retained or for what period. We found that document files supporting SVO's ratings were haphazard: some contained recent financial information and others contained data that were several years old. SVO analysts identified a specific financial statement as the basis of 24 ratings we reviewed; in 12 of these cases, the financial statement used was not on file. SVO officials told us that their standard practice was to discard records on issuers for which no updated financial information is received for 24 months. In two cases, SVO had no records on the issuers and appeared to have discarded records contrary to this policy. Bonds of these two issuers had been rated in both

1989 and 1990; SVO first decided not to rate the bonds because updated financial information had not been provided as of December 31, 1991. We began our review of SVO's files in early 1992. Under SVO's policy, the financial information used to assign the 1990 rating should still have been on file at this time.

Where records on an issuer were incomplete, we could not determine whether an analyst had ignored or misunderstood critical data or had simply not obtained it. For example, at the end of 1989 Executive Life held bonds issued by a manufacturer of metal buildings, reported at a cost of $4.4 million; SVO's rating for these bonds indicated they were of low quality but not impaired. The responsible SVO analyst told us he based the 1989 rating on the issuer's 1988 financial statements. The notes to these financial statements show that the issuer had not made the interest payment due in July 1988 on the bonds; a subsequent financial report shows that interest due throughout 1989 was not paid. SVO did not retain the 1988 statements in its files. Consequently, we could not determine whether the analyst had failed to review the notes to the statements or had simply been provided an incomplete document. For GAAP reporting purposes, Executive Life considered the notes impaired at the end of 1989 with a reported value $2.2 million less than the cost shown on Executive Life's statutory financial statements.

Regulatory Enforcement of Reporting Requirements Has Not Been Effective

Because of a gap in the enforcement of SVO's valuation requirements, Executive Life was able to obscure its junk bond losses. SVO itself does not verify that insurers follow its procedures. SVO does not routinely review insurers' financial statements to ensure that all bonds have been rated by SVO or that the ratings are reported accurately. Given the small size of SVO's staff, it would be unrealistic to expect it to do so.

Even if SVO addresses the weaknesses in its rating process, state regulators would have to effectively enforce the requirement that insurers use SVO valuations in statutory financial statements. While state regulators may manually test some bond values in statutory financial statements, NAIC does not require them to verify all bond ratings and values each year. Regulators generally rely on infrequent—once every 3 to 5 years—field examinations to detect improper bond valuations. As a result, regulators' awareness of the deterioration in Executive Life's bond portfolio was delayed.

Executive Life had a history of not obtaining SVO ratings for all its bonds and of incorrectly reporting SVO ratings in its statutory financial statements. On the basis of a special compliance review in 1985, SVO found serious bond reporting problems in Executive Life's 1984 statutory financial statement. The insurer had failed to submit 56 issues reported at $203 million for SVO valuation, had provided insufficient documentation for SVO to rate 27 bonds reported at $92 million, and had substituted false ratings for 33 bonds reported at $152 million.[7]

Similarly, for 10 of the 56 bonds in our sample Executive Life failed to obtain an SVO valuation. In statutory financial statements these bonds were reported at a cost of $253 million but, for GAAP reporting purposes, Executive Life had recorded losses totalling $60 million for 2 of these 10 bonds. Others of the 10, we believe, were of dubious value, and their value may have been significantly overstated in Executive Life's statutory financial statements. For example, Executive Life held notes issued by a company engaged in land development, home construction, and mortgage banking at the end of 1989. Executive Life did not obtain an SVO rating for the notes, which were reported at a cost of $85.1 million in its 1989 statutory financial statements. Executive Life acquired these notes on December 28, 1989, in exchange for its holdings of four other issues of notes of the same issuer. Although the terms of the new notes were less attractive than those of the old notes, Executive Life assigned them the same rating SVO had assigned the old notes. The new notes were secured by the assets of the issuer's Colorado home-building operations, which, financial reports indicate, were one source of the issuer's losses. They paid interest at an initial stated rate of 7.75 percent, a reduction from the weighted average 11.2 percent rate of the old notes; further, just 0.25 percent of the stated rate was payable in cash in the first year. Beginning in 1992, interest and principal payments on the new notes were tied to sales of homes by the Colorado operation. Excluding interest contingent on home sales, the notes paid an effective interest rate of 2 percent. At the end of 1989, the market price of the old notes was $64.5 million less than the cost Executive Life reported to regulators for the new notes in its statutory statements. Consequently, we believe their value may have been significantly overstated.

In another example, Executive Life did not obtain an SVO rating for its holdings of notes issued by a financial services holding company, which it reported at a cost of $15 million at the end of 1989. In 1987, Executive Life

[7]Regulators in California—the insurer's state of domicile—required Executive Life to refile its bond valuations for 1984 and carry the revisions forward to its 1985 statutory financial statement.

accepted common stock in a now-defunct savings and loan association's parent in partial payment of the original $38 million principal amount of the notes. Correspondence between Executive Life and the issuer chronicles a history of problems in obtaining interest payments. A November 1988 letter to the issuer acknowledges receipt of a check for an overdue interest payment on the notes. The letter concludes, on the basis of the issuer's request that the check be held "until a snag in 'some release and administrative documentation'" was resolved, that the issuer had no funds in its account to cover the check. Similarly, in December 1989, Executive Life agreed to accept payment of $50,000 of the $487,500 due on the note and to defer payment of the balance until August 1990. Clearly, the issuer was not current on interest payments at the end of 1989, but the rating Executive Life reported for the notes—although indicating low quality—did not reflect that the notes were in default. Since the notes were placed privately, no true market price for them existed. The notes were secured by more of the stock that Executive Life had previously accepted in partial payment of the notes. Based on the value Executive Life reported for the stock for GAAP purposes, the collateral backing the notes was worth $3.3 million, or about $11.7 million less than the $15 million value reported for the notes in Executive Life's 1989 statutory financial statements.

We also found three bonds in our sample for which Executive Life incorrectly reported SVO ratings. On the basis of the market value of these bonds, we estimated that the value of $93 million reported in the 1989 statutory financial statement for these bonds was overstated by $74 million. Similarly, during the California insurance department's 1990 field examination of Executive Life, examiners found that Executive Life incorrectly reported SVO ratings and carried defaulted bonds at cost rather than SVO-assigned market values; this false reporting overstated statutory bond values by $127 million in 1990.

Two recent NAIC initiatives should facilitate the regulators' task of verifying bond information to detect deviations from SVO valuations. In the past, verifying possibly hundreds of bond ratings and values used in an insurer's statutory financial reports was a laborious manual process. Starting with statutory financial statements filed with state regulators in 1992, insurers are to submit detailed listings of their securities holdings—including ratings and values—in a computer-readable format. Also, NAIC has developed a software package state regulators may use during field examinations that compares the ratings and values in an insurer's computerized securities listings with those in SVO's valuation database and reports any discrepancies. While these steps should facilitate field examinations of securities holdings, NAIC has not yet required such reviews between examinations. Thus, state regulators may still forgo an opportunity to recognize more quickly the true financial condition of an insurer that reports false ratings and values for its bond portfolio.

Statutory Reserve Was Not Sufficient to Absorb Bond Losses

As we previously testified, the approach to determining statutory bond reserves is flawed and delayed recognition of Executive Life's bond losses. The MSVR is based on a formula that is not linked to current market values and thus does not correspond to an insurer's loss exposure. For bonds, a life insurer uses SVO ratings to determine the maximum reserve that must ultimately be accumulated against its entire portfolio. The MSVR formula requires minimal reserves for high-quality bonds and requires a 20-percent maximum reserve for the lowest quality bonds and impaired bonds. The maximum reserve may be accumulated over a period of years. For 1989, the MSVR formula was calculated to accumulate this maximum in 10 years for the lowest quality and impaired bonds, and 20 years for other bonds. In contrast, GAAP requires insurers to establish a reserve equal to the estimated loss when a bond loss is probable.

Executive Life's MSVR left the insurer poorly prepared to absorb the bond losses it faced. As of the end of 1989, Executive Life accumulated an MSVR of $583 million, or about 44 percent of the maximum required reserve. The overstatements in value for the sample bonds that we discuss in this report—a total of nearly $164 million—would have consumed about 28 percent of Executive Life's reported MSVR in 1989. Executive Life's 1990 statutory financial statement showed that mounting bond losses had reduced its MSVR to a mere 0.8 percent of the reported value of its bond portfolio at the time. Moreover, the $127 million overstatement in bond values found in Executive Life's 1990 examination was more than the insurer's reported MSVR of $54 million in 1990.

Conclusions

Default—defined as nonpayment of interest—is SVO's central operating criterion for valuing bonds in statutory financial statements. If SVO does not recognize that interest due on a bond is not being paid, insurers may report it in statutory statements at historical cost, even though the public market may have concluded that the bond is worth substantially less than this historical cost. GAAP reporting, in contrast, takes a broader view in determining when insurers' financial statements should reflect the impairment in value indicated by market prices. Other factors considered include whether the issuer has shown the ability to generate the cash needed to meet its obligations and whether the issuer has proposed a restructuring of its debts.

Under its current procedures, SVO does not effectively apply even its narrow valuation criterion. To obtain information on bond issuers, SVO's analysts rely on insurers, who may be reluctant to disclose facts about their investments that would call their solvency into question. This passive approach to gathering data left SVO unaware of critical details that affected the value of Executive Life's investments. SVO's passive approach is of particular concern for private placement securities, where publicly reported data are often not available. Further, SVO does not have standards for how its analysts should assign ratings and values that would better ensure consistent, reliable rating decisions.

Even if SVO develops consistent, reliable, and well-informed ratings, statutory financial statements will still not accurately reflect an insurer's financial condition if regulators do not ensure that SVO ratings are used. NAIC has now developed the technology to facilitate reviewing the accuracy of ratings and values shown in these statements. However, regulators generally check the ratings and values insurers report for their security holdings only during infrequent examinations instead of during annual reviews of the statutory financial statements that insurers file. Thus, regulators would not recognize a company's financial problems soon enough if a company reported false values for its securities.

Agency Comments and Our Evaluation

In its written comments on a draft of this report, NAIC disagreed with our conclusion that SVO's ability to support state regulators was doubtful. NAIC objected that the sample of bonds we reviewed was too small to permit broad conclusions about SVO's effectiveness. Although we cannot estimate what proportion of SVO's ratings were erroneous based on our sample, we identified flaws in SVO's procedures for rating insurers' bond holdings that led the office to assign erroneous ratings to Executive Life's bond holdings. We believe that SVO's procedures could result in similarly erroneous ratings being assigned to other bonds held by insurers.

NAIC said we ignored the improvements made in SVO procedures since 1989. We discuss NAIC's actions to correct identified deficiencies in SVO's procedures in our report where pertinent. During our review, however, we identified other deficiencies in SVO procedures that contributed to erroneous ratings for Executive Life's bonds. We believe these deficiencies, such as the narrow default definition and reliance on outdated information, create the risk that SVO will rate other insurers' bonds incorrectly.

NAIC also said we ignored the inherent conservatism of the MSVR required by statutory accounting principles. We believe that the MSVR is a flawed approach to reserving for an insurer's securities holdings. The MSVR's assumed conservatism was not evidenced in the case of Executive Life; the insurer's MSVR against its entire portfolio in 1989 was $183 million less than the allowance for bond losses recognized in its 1989 GAAP financial statements.

Appendix II includes NAIC's detailed comments and our evaluation of those comments.

We are sending copies of this report to the chairmen and ranking minority members of selected committees of Congress and to other interested parties. We will also make copies available to others on request.

The major contributors to this report are listed in appendix V. Please contact me at (202) 275-8678 if you have any questions concerning this report.

Sincerely yours,

James L. Bothwell

James L. Bothwell
Director, Financial Institutions
and Markets Issues

Contents

Abbreviations

AICPA	American Institute of Certified Public Accountants
AVR	Asset Valuation Reserve
GAAP	Generally accepted accounting principles
MSVR	Mandatory Securities Valuation Reserve
NAIC	National Association of Insurance Commissioners
SVO	Securities Valuation Office

Scope and Methodology

As a case study in how life insurers value assets in statutory financial statements, we reviewed Executive Life's reporting on its bond portfolio as of December 31, 1989.

We chose Executive Life's 1989 statutory statements because 1989 represented a crucial point in the unraveling of Executive Life. Through late 1989, private rating services gave Executive Life high ratings for financial soundness and claims paying ability. In late 1989, however, losses on Executive Life's bond portfolio mounted. First Executive Corporation, Executive Life's parent company, recorded an $847 million charge for bond defaults and losses in its 1989 GAAP financial statements.[8] Public disclosure of these losses in early 1990 contributed to a policyholder run on Executive Life. The drain on the insurer's resources resulting from the policyholder run prompted regulators to intensify their surveillance of Executive Life. The statement we presented at hearings your Subcommittee held September 9, 1992, provides a fuller chronology of the collapse of Executive Life.[9]

Executive Life's 1989 statutory financial statements reported a bond portfolio including over 900 bonds valued at $9.9 billion, MSVR of $583 million, and surplus of $459 million. We selected for review a judgmental sample of 56 bonds reported at a cost of $1.2 billion. The sample consisted of those bonds about which regulators or external auditors had raised questions. First Executive's external auditors identified some of these bonds during their 1989 GAAP audit as they attempted to determine whether to (1) classify certain bonds as impaired, thus affecting First Executive's allowance for credit losses; (2) recognize interest paid on certain bonds in additional bonds rather than cash as income; or (3) classify certain bonds as real estate rather than securities. Regulators identified another group of bonds through an inquiry to Executive Life about bond restructurings. Bonds that SVO recognized as already in default were excluded from our sample. Appendix IV lists the bonds reviewed.

To assess the effectiveness of SVO's bond-rating process, we reviewed SVO's written procedures concerning the process, discussed the process with SVO officials, and reviewed guidance provided to SVO by its parent body, NAIC's Valuation of Securities Task Force. Regarding the sample of 56 bonds, we

[8]This represents the consolidated loss on a GAAP basis for First Executive Corporation and its subsidiaries, including Executive Life.

[9]Insurer Failures: Regulators Failed to Respond in Timely and Forceful Manner in Four Large Life Insurer Failures (GAO/T-GGD-92-43, Sep. 9 1992).

reviewed SVO's files relating to the issuers, compared the data in these files to data in Executive Life's files, and discussed the ratings assigned to the bonds with the responsible SVO analysts.

To assess regulators' effectiveness in enforcing reporting requirements for bonds, we reviewed NAIC guidance concerning valuation of bonds, discussed the requirements with SVO and California officials, and discussed with California regulators the steps they take to verify insurer compliance with these requirements. Regarding the sample of 56 bonds, we compared the ratings and values for the bonds reported in Executive Life's 1989 statutory statements with those SVO developed and identified any discrepancies.

When we found discrepancies in SVO ratings or in Executive Life's reporting, we attempted to estimate how these discrepancies affected Executive Life's statutory financial statements. For impaired bonds reported in statutory statements at cost, we calculated the difference between cost and market value using price data published by a major rating agency. However, these agencies do not publish market price data for infrequently traded bonds or private placement bonds. When market price data were not available from these agencies, we used other approaches to estimating market value, which we describe in the text of the report.

We did not review a random statistical sample of bonds, and accordingly we cannot project the results of our review to either Executive Life's portfolio as of December 31, 1989, or to the universe of bonds rated by SVO as of that date. However, while SVO officials acknowledged that some of the ratings they assigned to bonds in our sample were erroneous, they did not maintain that any ratings had been assigned contrary to SVO policy and procedures. We believe that to the extent that the process followed in rating the sample bonds was generally consistent with SVO's stated policies and procedures, similar errors may exist in the ratings of bonds we did not review.

We did our work between February 1992 and June 1992 in accordance with generally accepted government auditing standards.

Comments by the National Association of Insurance Commissioners

NAIC

Hall of the States
444 N. Capitol Street, N.W., Suite 309
Washington, D.C. 20001-1512
202-624-7790

FAX 202-624-8579 Washington Counsel
FAX 202-624-8460 Financial Analysis

National
Association
of Insurance
Commissioners

October 19, 1992

Mr. Charles Bowsher
Comptroller General
United States General Accounting Office
Washington, DC 20548

Dear Mr. Bowsher:

Thank you for the opportunity to review and comment on your draft report INSURANCE REGULATION: Weak Oversight Allowed Executive Life to Report Inflated Bond Values. The report reflects the diligent work of your staff, and several valid points are made therein. However, we disagree strongly with the central conclusion that the "SVO's ability to support state regulators in monitoring insurer solvency appears doubtful." The conclusion, we feel, is based upon numerous errors of fact and in methodology.

See comment 1.

Our first objection is that the report's broad conclusion concerning the adequacy of the SVO's functions regarding the full universe of securities rated is unsupported because it is based on a very narrow and very biased sample of securities. The report's conclusion about the SVO's ability was based upon the GAO's sample of only 34 issuers out of the 10,000 or so corporate issuers rated or reviewed annually by the SVO -- .0034 percent of the total. Furthermore, these issues were held by one insurer out of a population of over 5,000 insurers, and the losses on those issues represented a very small percentage of Executive Life Insurance Company's (ELIC) assets -- 0.4 percent. In fact, the overly broad nature of the report's conclusion is reflected in the report's own language, that the sample was "judgmentally selected," and in the words of a GAO Senior Reviewer, who stated that the sample "has no predictive value." We could not agree more.

See comment 2.

Another failing of the report that goes directly to its conclusion is that it fails to discuss, for the most part, SVO improvements and whether they appear to address identified weaknesses in the report. The GAO's critique is based upon 1989 SVO and NAIC procedures. In the intervening three years, the NAIC has made numerous improvements in our systems and has increased the SVO's staff

Mr. Charles Bowsher
Page 2

substantially. Few of the improvements are mentioned in your report. The staff increases were not mentioned at all. Furthermore, in those few instances in which the GAO makes passing reference to NAIC and SVO improvements, GAO does not mention whether the improvements address the problems discussed in the report. This is significant, inasmuch as the report's conclusion about the SVO's inability to support state regulators in monitoring solvency has the ring of a structural, permanent deficiency, rather than a correctable problem.

See comment 3.

Another important problem with the report is that its discussion of Generally Accepted Accounting Principles (GAAP) treatment fails to discuss the inherent conservatism of Statutory Accounting Principles (SAP) in terms of the Mandatory Securities Valuation Reserve (MSVR) (since replaced by the Asset Valuation Reserve, or AVR). The report also omits any discussion of whether, on the whole, the selective devaluations under GAAP outweighed the reserves set under SAP for the whole portfolio. It must be remembered that reserves established under SAP's MSVR are against the whole portfolio, while writedowns taken under GAAP are against specific, selected issues.

As the remainder of this letter will describe in detail, while some of the report's' comments were appropriate, the analysis was incomplete in a number of instances and, incorrect concerning certain securities. Furthermore, some of the conclusions about SVO treatment of certain securities are not supported in the report.

Our specific comments follow.

See comment 4.

1. Page 1, Paragraph 1, Line 5: To say that "flawed SVO evaluations" allowed ELIC to overstate the value of its bond holdings is at best misleading. GAO's own statistics should reveal that ELIC's failure to comply with regulations contributed far more to the overstatement than did what GAO asserts were "flawed SVO evaluations". Further, we question whether the GAO took the valuation reserve into account when calculating overstated values.

See comment 5.

2. Page 1, Paragraph 1, Line 9: As is consistent with California Commissioner Garamendi's testimony on September 9, 1992, the GAO is incorrect in stating that California's examiners were hindered by their inability to identify ELIC's exposure to risky bonds. As the GAO knows, SVO advised the California Department of Insurance, in writing, as early as 1985 of ELIC's "serious bond

Mr. Charles Bowsher
Page 3

reporting problems", but the GAO chose not to make this comment until page 14 of their report (Page 14, Paragraph 3, Line 3).

See comments 1 and 2.

3. Page 1, Paragraph 2, Line 1: In view of the errors and false premises in GAO's report, this conclusion is without foundation. Further, by basing this conclusion on a review of the situation in 1989, the GAO ignored the many enhancements made by SVO and the NAIC as a whole since 1989 which are significant.

See comment 6.

4. Page 1, Paragraph 2, Line 2: In 1989 the SVO was required under the SVO Purposes and Procedures Manual to "focus narrowly on bond default". However, the definition of default has since been changed in the Purposes and Procedures Manual thus permitting a broader focus. Lest readers be confused by GAO's wording, we would note that, in addition to default, the SVO focuses on a wide range of criteria as outlined in Purposes and Procedures. These criteria include rating agency opinions, Zeta Services' financial model, historical financial data, projections, financial ratios, the auditor's opinion, the issuer's industry and operating environment, management, covenants, structure, collateral and third party support or other credit enhancements.

Now on page 1. See comment 7.

5. Page 2, Paragraph 1, Line 1: The SVO works with the most current information available.

Now on page 1. See comment 8.

6. Page 2, Paragraph 1, Line 2: SVO's Purposes and Procedures presents a broad framework for credit analysis. However, credit ratings are at least 50 percent judgmental as is demonstrated in written materials of Moody's and Standard & Poor's, and judgment cannot be reduced to "clear standards". Comment number 26, below, also applies.

Now on page 1. See comment 9.

7. Page 2, Paragraph 1, Line 4: Of the 56 bonds reviewed by the GAO we count three instances of "inflated ratings" attributable, arguably, to our errors in judgment (this, of course, with the benefit of hindsight). In each instance we rated the bond at our lowest non- default rating.

See comment 10.

8. Page 2, Paragraph 2, Line 5: Today, regulators can match insurers' portfolios with SVO's ratings electronically to obtain exceptions via a software process called Examination Jumpstart.

See comments 3 and 11.

9. Page 2, Paragraph 2, Line 10: Statutory (MSVR) reserves were created to cover reasonably expected default losses over a reasonable time horizon, and not

Mr. Charles Bowsher
Page 4

forced fire sale type liquidations of an entire portfolio. Any financial institution subjected to a sustained "run on the bank" may quickly become impaired due to the lack of sufficient liquidity. ELIC experienced such a run due to negative press coverage and a greatly depressed junk bond market which has since recovered.

Now on page 2. See comment 12.

10. Page 3, Paragraph 1, Line 8: The Mandatory Securities Valuation Reserve (MSVR) is no longer in use, having been replaced by more sophisticated methodology. The GAO should include this important piece of information at the first mention of MSVR.

Now on page 3. See comment 13.

11. Page 4, Paragraph 1, Line 1: The SVO has used ratings of "recognized private rating agencies" since 1908.

Now on page 3. See comment 14.

12. Page 4, Paragraph 2, Line 7: It is worthy of note that there is now a reasonably liquid market for private placements of high and medium quality.

Now on page 3. See comment 2.

13. Page 4, Paragraph 3, Line 1: The analytical staff has since been enhanced by a senior analyst with over 20 years of experience, three administrative assistants, improved computer software and data retrieval, an attorney with real estate and rating agency experience and an executive with over 20 years of multifaceted lending experience.

Now on page 3. See comment 15.

14. Page 4, Paragraph 3, Line 9: Once initially rated, the annual update of a security can usually be done in half the time of an initial rating. Approximately 95 percent of the securities we rate already carry our own rating or that of a rating agency.

Now on page 4. See comment 1.

15. Page 5, Paragraph 1, Line 2: In view of the audit portfolio's adverse selection, we agree with the GAO Senior Examiner who stated to us, "The sample has no predictive value." GAO's Senior Examiner stated this opinion in an interview with NAIC staff on March 2 and we agree with this opinion. The use of Executive Life's bond portfolio and GAO's method of adverse selection results in a sample of bonds that have no predictive value. Therefore, no valid conclusions can be drawn using such a sample.

Now on page 4. See comment 6.

16. Page 5, Paragraph 3, Line 2: The key issue is determining a 1 through 6 rating which determines the reserve. Further, the definition of SVO's default rating has been broadened since 1989.

Mr. Charles Bowsher
Page 5

Now on page 5. See comment 6

17. Page 6, Paragraph 3, Line 4: It is incorrect to state that SVO does not consider other indicators of impaired value, but SVO generally follows the same procedure as Moody's and Standard & Poor's which is to wait until the contractual interest has not been paid before rating a security as defaulted.

Now on page 5. See comment 6.

18. Page 7, Paragraph 1, Line 11: As stated above, the definition of default has been expanded since 1989.

Now on page 5. See comment 16.

19. Page 7, Paragraph 2, Line 5: SVO analysts obtain and use a variety of information sources available to them at the SVO and from external sources.

Now on page 6. See comments 7 and 17.

20. Page 8, Paragraph 2: SVO's policy is straightforward. It uses the most recent available annual report prior to the December 31 publication date for all ratings in the Valuation of Securities Manual. If radical change in the issuer's financial status is apparent, analysts are instructed to obtain interim financial statements. For private issuers, these frequently are not available.

Now on page 6. See comment 18.

21. Page 8, Paragraph 3, Line 4: For practical reasons, as well as to ensure uniformity in reporting by all insurers, the SVO obviously must adhere to an 'as of' date. This is consistent with GAAP and SAP. Subsequent to the 'as of' date, disclosure, by way of notes, is the responsibility of the insurer, in this case ELIC so that the financial statements are not misleading.

Now on page 7. See comment 19.

22. Page 9, Paragraph 1, Line 10: Only the owner of a private placement can disclose the omission of an interest payment or other breach of contract, as continuous year round audit by CPA's is unrealistic. The rating agencies, too, rely on advice from owners.

Now on page 7. See comment 19.

23. Page 10, Paragraph 2, Line 1: SVO does require full disclosure of the status of all issues and issuers in bankruptcy for purposes of evaluation.

Now on page 8. See comment 20.

24. Page 10, Paragraph 2, Line 13: GAO's statement as to the dates of actual non-payment of interest on these certificates is incorrect. No interest payment due in 1989 had been missed on any of the equipment trust certificates in question. In fact, payments on all of these certificates continued into 1990, as the airline continued to operate until an order of liquidation was entered on January 18, 1991.

Mr. Charles Bowsher
Page 6

25. Page 11, Paragraph 1: Analysts now have SVO's Credit & Pricing Manual, a compendium of existing and new policies and guidelines.

26. Page 11, Paragraph 2: As a matter of policy, SVO analysts are finance graduates with MBAs and have received credit/securities analysis training and experience at well known financial institutions. Analysts and Credit Committee members often attend training and briefing sessions conducted by outside experts to enhance their knowledge and keep current in the industries in which they specialize. Four analysts have completed various stages of the rigorous CFA. SVO's four person Credit Committee has, collectively, 60 years of credit experience. Accordingly, entry-level guidance in simple matters such as which ratios to compute and which financial measures would be most useful in a given situation is unnecessary. More conceptual guidance is found in SVO's Credit & Pricing Manual and imparted via frequent, almost daily, discussions between analysts and members of the Credit Committee.

27. Page 11, Paragraph 3, Line 1: See comments regarding Page 11, Paragraph 1 and Page 2, Paragraph 1, Line 2.

28. Page 11, Paragraph 3, Line 7: SVO's rating system has since been expanded from four to six categories. The issue to which GAO refers is not rated investment grade under SVO's new rating system, although we would note that the issuer continues to perform well and meet its obligations.

29. Page 12, Paragraph 1, Line 11: As the issuer was a member of a new, specialized, industry, cable TV, the use of traditional measures would not have been appropriate.

30. Page 12, Paragraph 2, Line 3: Rating checklists have been proposed by a variety of people for many years. While they do have some applications, they repeatedly have been rejected by corporate credit professionals as poor substitutes for good judgment. And, as stated earlier, 50 percent of most rating decisions consist of good judgment.

31. Page 12, Paragraph 2, Line 13: The external data base of 6,000 relates to approximately 10,000 corporate issuers in the NAIC corporate data base. The remaining 20,000 issuers are municipal and governmental issuers, approximately

Mr. Charles Bowsher
Page 7

75 percent of which are rated by Nationally Recognized Statistical Rating Agencies before being filed with the SVO.

Now on page 9. See comment 9.

32. Page 12, Paragraph 3, Line 1: In only three cases did the GAO present strong arguments for "erroneous ratings."

Now on page 9. See comment 25.

33. Page 12, Paragraph 3, Line 3: A written policy is now in place.

Now on page 9. See comment 26.

34. Page 12, Paragraph 3 and Page 13, Paragraph 2: It has been standard policy to remove securities from the data base and discard previously submitted financials after a 24-month period of time during which no new financials are received. The policy is currently under review.

Now on page 10. See comment 27.

35. Page 13, Paragraph 2, Line 14: Certified public accountants are now auditing NAIC statutory statements, and writedowns in one statement but not the other will be disclosed in a footnote of the audit report.

Now on page 10. See comment 28.

36. Page 13, Paragraph 3, Line 2: ELIC may have overvalued its portfolio in its 1989 statutory financial statements but it is simply not true that ELIC was able to obscure its exposure to high yield bonds. ELIC's 1989 statutory financial statement shows that 58 percent of its bond portfolio was rated below investment grade by NAIC.

Now on page 10. See comment 10.

37. Page 14, Paragraph 2, Line 4: See comments for Page 2, Paragraph 2, Line 4.

Now on page 13. See comments 3 and 12.

38. Page 17, Paragraph 2: GAO's argument that MSVR is flawed is moot because MSVR has been replaced. However, as stated above, MSVR reserves were computed on a higher base than market value and include all securities including investment grade securities. Consequently the reserve was probably much larger than selective reserving against known problem loans.

Now on page 13. See comment 3.

39. Page 17, Paragraph 2, Line 13: Selectively criticizing statutory accounting principles (SAP) simply by contrasting them with GAAP is comparing apples to oranges. The two have been developed over many years to serve different objectives.

Now on page 13. See comments 3 and 6.

40. Page 18, Paragraph 2, Line : This statement is false. It ignores the central role of the 1 through 6 rating system and the fact that reserves are determined by a broad range of security analysis issues.

Mr. Charles Bowsher
Page 8

Now on page 14. See comment 29.

41. Page 18, Paragraph 2, Line 5: The issue of SVO not knowing if an interest payment has been made or not, applies only to privately placed bonds and not to publicly traded issues.

Now on page 14. See comment 1.

42. Page 18, Paragraph 3: The GAO's concluding paragraph is at best questionable because it is based on the errors, factual omissions, and overstatements as detailed above. Even if the paragraph were credible, it applies to 10% of all bonds in NAIC's data base and, by dollar volume, even less. We remind the reader that the GAO's own Senior Examiner stated that the sample used was by no means random and "has no predictive value."

I hope these comments are helpful to you in finalizing the report. Please let me know if we can be of any further assistance to you.

Very truly yours,

William H. McCartney
President, NAIC and
Director of Insurance
State of Nebraska

WHM/tac

cc: Richard Fogel
Lawrence Cluff

GAO Comments

The following are GAO's comments on NAIC's letter dated October 19, 1992.

1. As discussed on page 4, and in more detail in appendix I, we reviewed a judgmental sample of troubled bonds held by one insurer and cannot estimate what proportion of SVO ratings were in error. We did not intend to make such an estimate. Our objective was to use Executive Life as a case study for assessing SVO's effectiveness in rating and valuing bonds. On the basis of our sample, we identified flaws in SVO's stated procedures for rating insurers' bond holdings that led the office to assign erroneous ratings to Executive Life's bond holdings. We believe that to the extent that the process followed in rating the sample bonds was generally consistent with SVO's stated policies and procedures, similar errors may exist in the ratings of bonds we did not review.

Moreover, NAIC's objections that our sample cannot be generalized to SVO's entire workload ignores the broader implications of our findings. In the case of Executive Life, we found that by rating impaired bonds as though they were in good standing, SVO provided regulators with a distorted picture of the insurer's junk bond holdings. A gap in enforcing the use of SVO valuations allowed Executive Life to further obscure the deterioration in its portfolio. We believe overstated bond ratings and values hindered regulators' efforts to fully identify Executive Life's exposure to risky bonds and address the insurer's troubled financial condition in a timely manner.

2. NAIC said that we examined the rating procedures SVO followed during 1989 without discussing the improvements NAIC has made since 1989. In particular, NAIC stresses that since 1989, it has increased SVO's staff. As of October 1992, SVO had a professional staff of 12, an increase from 9 in 1989. As discussed on page 3 of our report, even considering SVO's increased staff, each analyst was responsible for assembling and evaluating data on about 1,100 private placement issuers in 1991.

We believe NAIC's actions to correct identified weaknesses in SVO procedures are positive steps; where pertinent, we discuss NAIC's actions in our report. During our review, however, we identified other deficiencies in SVO procedures, such as its narrow default definition and reliance on outdated information, that contributed to erroneous ratings for Executive Life's bonds. We believe these deficiencies create the risk that SVO will rate other insurers' bonds erroneously.

3. We disagree that the MSVR for statutory financial reporting is an inherently conservative method of establishing bond reserves. The MSVR is

based on a formula that is not linked to current market values and thus does not correspond to an insurer's loss exposure. Also, we have used GAAP reporting as a point of reference to demonstrate that statutory reporting is not inherently conservative. Executive Life's MSVR held against its entire portfolio in 1989 was $183 million less than the allowance for bond losses recognized in the insurer's 1989 GAAP financial statements. As we discuss on page 13, the bond losses Executive Life sustained during 1990, and overstatements related to bonds the insurer reported incorrectly, exhausted its MSVR.

We believe that statutory and GAAP reporting for impaired securities should be consistent. However, we do not believe that GAAP is without flaws. GAAP allows bonds to be carried at historical cost on the basis of subjective judgements about whether an observed decline in a security's market value is permanent and whether an insurer intends to hold a security to maturity. We do not support historical cost accounting for securities nor do we believe that prudent accounting can or should hinge on such subjective judgements. We have urged the Financial Accounting and Standards Board to adopt fair value accounting for securities.

4. The overstatements identified in our report resulting from Executive Life's failure to comply with bond reporting requirements were greater than those resulting from flawed SVO ratings. However, we disagree with NAIC's inference that flawed SVO ratings are, therefore, insignificant. When an insurer fails to use SVO's valuations in its statutory financial statement, regulators can detect the resulting overstatements by verifying insurer-reported data. However, regulators rely on SVO to monitor the financial condition of insurers' securities portfolios. When flawed SVO valuations overrate bonds, as we found for Executive Life, regulators have no ready way to verify SVO's ratings and detect the overstatements.

NAIC questioned whether we considered Executive Life's MSVR when calculating the overstatements we discuss. We considered these reserves in the aggregate rather than for individual bonds because the MSVR is maintained in connection with an insurer's entire portfolio. As we discuss on page 13, the bond losses Executive Life sustained during 1990, and overstatements related to bonds the insurer reported incorrectly, exhausted its MSVR.

5. As discussed on page 11, SVO called bond reporting problems at Executive Life to the California Insurance Department's attention in 1985. This was the result of a special compliance review and not a service SVO

routinely provides to regulators. We believe the overstated ratings SVO assigned to bonds Executive Life held hindered regulators' efforts to fully identify the insurer's exposure to bond losses and address its troubled financial condition in a timely manner.

6. NAIC claims that it has broadened the definition of default in its Purposes and Procedures Manual to include bonds that are near default. We noted, however, that the 1989 edition of SVO's Procedures included the phrase "near default" and is identical to the 1992 edition's wording. In response to our inquiry, SVO provided just two examples where, during 1990 and 1991, it rated bonds in the default category because the issuer was near default. SVO officials acknowledged that they generally consider a bond in default only when an interest payment has been missed.

Unless SVO rates a bond as in default, an insurer can carry troubled bonds at historical cost and not reflect losses in its statutory financial statements. In discussions held after we received NAIC's written comments, SVO officials claimed that the statutory MSVR would offset unrecognized losses on impaired bonds carried at cost. As discussed on page 13, however, Executive Life's MSVR was inadequate to absorb the bond losses the insurer faced. A broader default definition would have allowed more timely recognition of impaired bonds in statutory financial statements.

7. NAIC insists that SVO works with the most current information available. We found that this is not the case. As we discuss on page 6, SVO routinely based its 1989 ratings on 1988 financial information—data that was 1 year old at the time the 1989 ratings were published. For example, in the case of the provider of long-term health care services, SVO did not obtain the most recent annual report, which was issued well before December 31, 1989; this report disclosed serious deterioration in the issuer's financial condition.

8. We agree that SVO analysts should exercise sound judgment when rating bonds, and accept that extensive training and practical experience can help analysts develop sound judgement. Clear standards telling analysts the essential analyses they should perform would have ensured more consistent, reliable rating decisions. Standards telling analysts how they should document their analysis would facilitate review of analysts' decisions and fix accountability for the exercise of sound judgment.

9. We do not say that errors in judgement on the part of SVO's staff are our principal concern. Instead, our report identifies fundamental flaws in SVO's

rating criteria and procedures. As we discuss on page 4, SVO's narrow criterion for determining when statutory financial statements should reflect bond losses neglects some impairments in value. As we discuss on pages 5 and 6, SVO is sometimes unaware of critical details that affect a bond's quality and value because SVO does not obtain sufficient data to develop valid ratings. Finally, as we discuss on pages 6 and 7, SVO lacks the standards to ensure thorough, consistent, high-quality work by its analysts.

10. As we discuss on page 12, this software can be a useful tool for regulators. However, NAIC does not require regulators to perform this analysis during annual reviews of insurers' statutory financial statements.

11. As NAIC points out, Executive Life was subject to a policyholder run starting in early 1990. In January 1990, Executive Life's parent announced an $847 million charge for bond defaults and losses in 1989. In February 1990, the failure of Drexel Burnham Lambert exacerbated the collapse of the junk bond market. Combined, these events led to the massive policyholder run. We recognize that a "run on the bank" can imperil any financial institution. Certainly, a run would be devastating for an insurer already experiencing massive bond losses.

12. We added a footnote to reflect that life insurers will be required to report an Asset Valuation Reserve (AVR), which will replace the MSVR, on the 1992 annual statutory financial statements due to be filed in March 1993. Whereas the MSVR covered only bonds and stocks, the new AVR also provides reserves for reported holdings of real estate and mortgages. However, we disagree that the AVR methodology for bonds is more sophisticated than the MSVR was. For bonds, the AVR remains a formula-based portfolio reserve that is not linked to current market values and thus does not correspond to an insurer's loss exposure.

13. Before 1990, some SVO analysts considered private agency ratings as a point of reference when assigning SVO ratings. In 1990, NAIC changed SVO's procedures and SVO now adopts private agency ratings when available.

14. NAIC implies that private placements may be readily traded. The Securities and Exchange Commission rule 144A allows resale of some privately placed securities among very large institutions. The rule, however, does not allow privately placed securities that are not registered with the Commission to be sold to institutions with less than $100 million in assets or to the general public.

15. NAIC does not dispute our statement that, on average, each SVO analyst must assemble and evaluate data on about 1,100 private placement issuers a year.

16. The insurers who hold bonds are the principal source of the data SVO analysts use. As NAIC suggests, SVO analysts have access to a variety of reference materials and may obtain additional information directly from an issuer of bonds or the issuer's financial advisors and investment bankers. According to SVO's internal guidance on using outside information sources, however, private rating agencies have the resources to delve far more deeply into the affairs of an issuer and to conduct more intensive research than SVO does.

17. As to the use of interim financial statements, we believe SVO analysts would need to review interim financial statements in order to determine whether a radical change in an issuer's financial status had occurred.

18. We believe that adhering to an "as of" date for SVO ratings and relying on insurer disclosure of subsequent events can result in misleading financial statements. Executive Life did not disclose the January 1 nonpayment of interest by the diversified holding company in the notes to its 1989 statutory financial statements. Since regulators generally rely on infrequent—once every 3 to 5 years—field examinations to verify data in statutory statements, regulators may not learn soon enough that an insurer failed to disclose material information.

Moreover, we believe that ignoring a default 1 day past the "as of" date further evidences that SVO's narrow default definition delays recognition of bond losses. The notes issued by the diversified holding company clearly were impaired as of December 31, 1989; nonpayment of interest by the company on the following day simply confirmed this fact. SVO's rating manual did not reflect that the notes were impaired until the end of 1990, whereas Executive Life's GAAP financial statements recognized the impairment at the end of 1989.

19. We did not suggest continuous independent audits of private placement issuers. However, we believe that SVO's reliance on unverified insurer-provided data can result in analysts lacking critical facts about the quality and value of insurers' bond holdings. SVO may well have to rely on insurers to provide data on the private placements issued by closely held companies. However, for public companies that file regular reports with the Securities and Exchange Commission and companies in

court-supervised bankruptcy proceedings, information is readily available. In two cases involving public companies—the troubled developer of residential communities and the bankrupt airline company—we found that Executive Life failed to report the issuers' financial troubles and nonpayment of interest to SVO, resulting in SVO overrating the bonds.

NAIC's argument that SVO's approach is similar to that of private rating agencies fails to recognize SVO's central role in solvency regulation. NAIC describes SVO's purpose as providing regulators assurance that insurers' securities holdings have been reviewed and appropriately valued by professional securities analysts. We believe that given SVO's reliance on insurer-provided data, regulators may have a false sense of assurance that insurers' holdings are appropriately valued.

20. We asked NAIC to provide documents supporting their claim that the airline company had made all interest payments due in 1989 on the equipment trust certificates. SVO's documents—printouts from SVO's ratings database and from a commercial bond information database—merely showed that the certificates traded at between 92 and 93 percent of par value at the end of 1989. During our work, we obtained a copy of a petition filed with the bankruptcy court on behalf of the certificate-holders; this petition clearly states that the interest due November 1989, and on subsequent dates, was not paid.

21. We view SVO's action to prepare the SVO Credit and Pricing Manual as a positive and responsive step towards developing clear standards. After providing written comments on our report, NAIC provided us the draft of the Manual, dated October 20, 1992. This draft did not include planned sections that are to describe (1) analysis procedures for assigning initial ratings to securities, (2) analysis procedures for annual and interim updates to securities ratings, (3) procedures for rating municipal securities, (4) procedures for obtaining prices for defaulted securities, and (5) procedures to be followed in special credit analysis and pricing situations.

22. NAIC implies that in 1989 the debentures issued by the diversified communications and entertainment company were properly assigned an investment grade rating—which corresponds to a noninvestment grade rating of "3" under SVO's new rating system. (See app. III for more complete details on SVO's 1990 and pre-1990 rating systems.) We disagree. Both Moody's and Standard and Poor's rated the debentures as noninvestment grade in 1989. Their ratings were equivalent to an SVO noninvestment grade

rating even under the more liberal SVO rating system in effect before 1990. Informal guidelines SVO had developed for rating broadcasting companies also indicated that the debentures should have been assigned a noninvestment grade rating of "No*." This is equivalent to the "4" rating SVO assigned the debentures under its new rating system.

23. We recognize that analysts may need to modify traditional techniques in order to properly analyze unusual cases. However, we found that SVO had not developed any policy defining or providing benchmarks for the nontraditional techniques used in this case.

24. We have modified our report to indicate that SVO's financial data system was intended to cover only the approximately 10,000 corporate issuers of securities held by insurance companies, and not the approximately 20,000 state and local government issuers.

25. After providing us written comments on our report, SVO referred us to separate memoranda, dated July 16, 1992, and August 11, 1992, on analysis of covenants in securities documents and securities guaranteed by third parties, for a description of their record retention policy. These memoranda, and the draft SVO Credit and Pricing Manual, discuss documents SVO analysts might examine during their analysis, but they do not indicate which documents analysts should retain for SVO's permanent records.

26. We revised our report to reflect that while SVO did not have a written policy on record retention, its standard policy was to remove securities from its database and discard its records after a 24-month period during which no new data were received. We also revised our report to reflect that the two cases in which SVO had not retained any documentation concerning the issuers of bonds SVO had rated were contrary to its policy. In each case, SVO rated the bonds in both 1989 and 1990. We began our review of SVO's files in early 1992. Under SVO's policy, the financial information used to assign the 1990 rating should still have been on file at this time.

27. Since 1991, NAIC has required an annual audit of statutory financial statements by a certified public accountant. However, the audit report is not due until June 1—3 months after the March 1 filing date for statutory financial statements. As a result, regulators have a time lag in learning of discrepancies noted by the auditors.

Neither NAIC nor the American Institute of Certified Public Accountants (AICPA) have issued guidance that requires that the audit report disclose securities that have been written down for GAAP reporting purposes but not for statutory reporting. The AICPA is studying guidance that would require a reconciliation of GAAP and statutory statements in the report, including a comparison of total GAAP and statutory securities valuation reserves. These disclosures would affect both the GAAP and statutory audit reports. However, the statutory financial statement filed with state regulators and available to the public still would not reflect any discrepancies.

28. We clarified the text to reflect that because Executive Life failed to follow SVO bond valuation requirements, the extent of the insurer's junk bond losses was obscured.

29. We disagree that the issue of SVO not knowing whether interest had been paid on a bond applies only to private placements. Both the developer of residential communities and the airline company we discuss on page 7 filed regular reports with the Securities and Exchange Commission, and the notes, debentures, and equipment trust certificates we discuss were registered with the Commission. The fact that financial and other data on the issuers of private placements may not be publicly reported only heightens our concern that SVO analysts may not have vital data on the issuers of such bonds.

Comparison of Current and Pre-1990 SVO Rating Systems With Selected Private Agency Rating Systems

			Rating system			
			Current SVO system		Pre-1990 SVO system	
Bond type	Moody's	Standard and Poor's	Rating categories	Maximum MSVR (percent)	Rating categories[b]	Maximum MSVR (percent)
Investment grade[a]	Aaa, Aa, A	AAA, AA, A	1	1%	Yes	2%
	Baa	BBB	2	2%	Yes	2%
Noninvestment grade[a]	Ba	BB	3	5%	Yes	2%
	B	B	4	10%	No*	10%
	Caa, Ca, C	CCC, CC, C	5	20%	No**	20%
	Caa, Ca, C	CI, D	6	20%	No	20%

[a]As determined by the Moody's and Standard and Poor's rating agencies.

[b]SVO's pre-1990 system used verbal rather than numerical categories. Bonds in the "Yes" category were considered good quality. Bonds in the "No*," "No**," and "No" categories were considered progressively lower quality.

List of Securities Reviewed

Issuer	Type of instrument	Maturity date	Reason selected	SVO rating[a]	Registration status[b]
ABC Holdings Inc.	Note	1996	Possible permanent impairment	NO**	Private placement
American Pacific Corp.	Debenture	1994	Possible permanent impairment	YES	Registered security
Anthony Acquisition Corp.	Debenture	1999	Issuer paid interest in kind	NO**	Private placement
Anthony Acquisition Corp.	Debenture	2002	Issuer paid interest in kind	NO**	Private placement
DynCorp	Debenture	2003	Issuer paid interest in kind	NO**	Registered security
Eastern Air Lines Inc.	Equipment trust certificate	1993	Possible permanent impairment	YES	Registered security
Eastern Air Lines Inc.	Equipment trust certificate	1996	Possible permanent impairment	NO**	Registered security
Eastern Air Lines Inc.	Equipment note	1993	Possible permanent impairment	NO**	Registered security
Eastern Air Lines Inc.	Equipment trust certificate	2001	Possible permanent impairment	NO**	Registered security
ECL Industries Inc.	Note	1994	Possible permanent impairment	NO**	Registered security
Forum Group Inc.	Note	1993	Restructured security	YES	Registered security
FPA Corporation	Debenture	2000	Reclassified as real estate Restructured security	NO**	Registered security
FPA Corporation	Note	1993	Reclassified as real estate Restructured security	NO**	Registered security
GACC Holding Co.	Note	1996	Issuer paid interest in kind	YES	Registered security
GACC Holding Co.	Note	1995	Issuer paid interest in kind	NO**	Registered security
Jackson County Federal Savings and Loan Association	Debenture	2008	Restructured security	Not rated	Private placement
Kash n' Karry Food Stores Inc.	Note	1992	Issuer paid interest in kind	NO**	Registered security
Koor Industries Limited	Note	1996	Possible permanent impairment	NO**	Registered security
Leaseway Holdings Inc.	Debenture	2002	Issuer paid interest in kind	NO**	Registered security
M.D.C. Holdings Inc.	Note	2000	Possible permanent impairment	Not rated	Private placement
Olympia Broadcasting Corp.	Debenture	1996	Possible permanent impairment	NO**	Registered security

(continued)

Issuer	Type of instrument	Maturity date	Reason selected	SVO rating[a]	Registration status[b]
Owens-Illinois Inc.	Note	1990	Issuer paid interest in kind	YES	Registered security
Owens-Illinois Inc.	Note	1991	Issuer paid interest in kind	YES	Registered security
Owens-Illinois Inc.	Note	1996	Issuer paid interest in kind	NO*	Registered security
Owens-Illinois Inc.	Debenture	1999	Issuer paid interest in kind	NO*	Registered security
Papercraft Corporation	Note	1994	Issuer paid interest in kind	NO**	Private placement
Papercraft Corporation	Note	1995	Issuer paid interest in kind	NO**	Private placement
Pennsylvania Engineering Corp.	Debenture	1993	Possible permanent impairment	Not rated	Registered security
Pope, Evans and Robbins Inc.	Note	1998	Issuer paid interest in kind	NO**	Private placement
Postal Management Service Corp.	Note	1990	Possible permanent impairment	NO**	Private placement
Raleigh Real Properties Inc.	Note	1991	Possible permanent impairment	Not rated	Private placement
M.J. Raynes Inc.	Debenture	1993	Reclassified as real estate	Not rated	Private placement
Raynes Associates Limited Partnership	Note	1990	Reclassified as real estate	Not rated	Private placement
RB Furniture Inc.	Note	1990	Restructured security	Not rated	Private placement
RBI Acquisition Corp.	Note	1996	Restructured security	NO**	Private placement
RBI Acquisition Corp.	Note	1990	Restructured security	NO**	Private placement
RJR Nabisco Capital Corp.	Debenture	Various	Issuer paid interest in kind	YES	Registered security
RJR Nabisco Capital Corp.	Debenture	2001	Issuer paid interest in kind	YES	Registered security
RJR Nabisco Group Inc.	Debenture	2007	Issuer paid interest in kind	YES	Registered security
Rorer Group Inc.	Debenture	2001	Restructured security	YES	Registered security
SCI Television Inc.	Note	1990	Possible permanent impairment Restructured security	NO	Registered security
SCI Television Inc.	Debenture	1997	Possible permanent impairment Restructured security	NO	Registered security
SCI Television Inc.	Debenture	1999	Possible permanent impairment Restructured security	NO	Registered security
Schulman Trust	Note	2003	Reclassified as real estate	NO**	Private placement

(continued)

Issuer	Type of instrument	Maturity date	Reason selected	SVO rating[a]	Registration status[b]
The Southland Corp.	Debenture	2002	Issuer paid interest in kind	NO**	Registered security
The Southland Corp.	Note	1997	Issuer paid interest in kind	NO**	Registered security
The Southland Corp.	Note	1995	Issuer paid interest in kind	NO**	Registered security
SSC Holdings Corp.	Note	1990	Issuer paid interest in kind	NO**	Registered security
SSC Holdings Corp.	Debenture	2000	Issuer paid interest in kind	NO**	Registered security
Tamco Financial Corp.	Note	1992	Reclassified as real estate Restructured security	Not rated	Private placement
Thortec International Inc.	Note	1990	Restructured security	Not rated	Private placement
Viacom Inc.	Debenture	2006	Issuer paid interest in kind	YES	Registered security
Viacom Inc.	Debenture	2002	Issuer paid interest in kind	YES	Registered security
Webcraft Technologies Inc.	Note	1996	Possible permanent impairment	NO**	Registered security
Webcraft Technologies Inc.	Debenture	1998	Possible permanent impairment	NO**	Registered security
200 90th Associates Limited Partnership	Note	1991	Reclassified as real estate	Not rated	Private placement

[a]Appendix III explains the SVO rating system. "Not rated" indicates that SVO did not assign a rating to the bond for 1989.

[b]"Registration Status" refers to whether the bond has been registered with the Securities and Exchange Commission. Under exceptions provided in the Commission's rules, private placements are not registered with the Commission.

Major Contributors to This Report

General Government Division, Washington, D.C.

Lawrence D. Cluff, Assistant Director
MaryLynn Sergent, Assignment Manager

Accounting and Financial Management Division, Washington, D.C.

M. Lavonne Paden, Professional Accounting Fellow

Boston Regional Office

Alfred R. Vieira, Regional Management Representative
Monty Peters, Evaluator-in-Charge
Leslie Siddeley, Evaluator

Ordering Information

The first copy of each GAO report is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877

Orders may also be placed by calling (202) 275-6241.