United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on Commerce, Consumer Protection, and Competitiveness, Committee on Energy and Commerce, House of Representatives

September 1989

INSURANCE REGULATION

Problems in the State Monitoring of Property/Casualty Insurer Solvency

RESTRICTED——Not to be released outside the General Accounting Office unless specifically approved by the Office of Congressional Relations.

RELEASED

GAO/GGD-89-129

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

General Government Division

B-236091

September 29, 1989

The Honorable James J. Florio
Chairman, Subcommittee on Commerce,
Consumer Protection, and Competitiveness
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

This report responds to your request that we review state monitoring of property/casualty insurer solvency, the resources available, and the extent to which states share information concerning problem insurers. We plan to continue our work in this area by evaluating state regulatory actions following detection of a problem insurer including actual state takeover and liquidation.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At this time, we will send copies to interested parties and make copies available to others upon request.

Major contributors to this report are listed in appendix IV. Please contact me on 275-8678 if you or your staff have any questions concerning this report.

Sincerely yours,

Craig A. Simmons
Director, Financial Institutions
and Markets Issues

Executive Summary

Purpose

During the 1980s, the number and size of property/casualty insurance failures and the number of insurers in danger of failure increased. On average, at least 12.6 property/casualty insurers were liquidated each year from 1981 through 1987, as opposed to an average of at least 6.9 per year from 1974 through 1980.

At the request of the Chairman, Subcommittee on Commerce, Consumer Protection, and Competitiveness, House Committee on Energy and Commerce, GAO reviewed the current state-based system of monitoring property/casualty insurer solvency and dealing with insurer failures.

For this report, GAO examined

- the methods used by state insurance departments to detect potential solvency problems,
- the resources available to state insurance departments in monitoring insurer solvency, and
- the nature and extent of interstate coordination in dealing with potentially insolvent property/casualty insurers.

Future GAO reviews will deal with actual state takeover and liquidation of insolvent companies.

Background

As the result of a 1868 Supreme Court decision that insurance was not interstate commerce and the McCarran-Ferguson Act of 1945, states exercise primary regulatory jurisdiction over the insurance business. Each state has a department of insurance that, among other things, is responsible for (1) monitoring the solvency of insurance companies, (2) taking direct control of a potentially insolvent insurer if state supervision is imposed, and, (3) if necessary, serving as liquidator/receiver in case of an insurer failure.

Each state insurance department head is a member of the National Association of Insurance Commissioners. While it has no regulatory function, this Association (1) serves as a clearinghouse for exchanges of information, (2) provides a structure for interstate cooperation in examinations of multistate insurers, and (3) distributes model insurance laws and regulations for consideration by state insurance departments.

GAO examined state insurance department actions from routine surveillance through initial detection of a problem insurer. GAO distributed a questionnaire to the insurance departments of all 50 states and the District of Columbia and did on-site audit work at five state insurance departments and at the headquarters of the Association.

Results in Brief

Each state is responsible for monitoring the financial health of insurers operating within its boundaries. All states rely for such monitoring on insurer-submitted annual statements and field examinations. Both of these are subject to significant time lags. Insurer-provided annual statements are used by many states without verification.

Several states report serious problems in fulfilling their responsibilities in insurer solvency regulation because of lack of funds. The five states GAO visited had 29 staff to analyze 6,450 annual statements. In addition, at least 31 states are relying on some examiners who are underqualified by Association standards.

While interstate coordination does take place in cases of insurer insolvency, many states do not keep each other fully informed and updated on problem insurer situations. The Association has had limited success in involving states in its activities.

Principal Findings

Problems in Solvency Examination

State insurance regulators said that to detect possible solvency problems they rely primarily on annual financial statements filed by licensed insurers and periodic field examinations done by state examiners. However, these statements are filed 2 months after the end of the accounting year and can take 6 weeks to 3 months to review, thus creating a time lag in state detection of a problem condition and allowing insolvent companies to continue doing business for months. In addition, 35 states do not require independent CPA verification of annual financial statements. (See pp. 13 and 14, and 16 and 17.)

Most states require field examinations only once every 3 to 5 years (a few states have no mandatory requirement), and such examinations can take months and sometimes years to complete. In the two largest property/casualty insolvencies of the 1980s, this time lag delayed state action in placing the insurers in receivership. Most states do not require actuarial certification of loss reserves, and half of the states do not have actuaries participating in field examinations. (See pp. 14 to 16, and 17.)

The Association assists state monitoring efforts with its own Insurance Regulatory Information System, but state officials give the system varied marks in terms of importance and reliability in detecting solvency problems. Insurance regulators in four of the five states visited have varied opinions as to the system's importance as compared to their own analysis. The Association is seeking to improve the quality of the system and has issued a set of standards intended to improve the quality of state solvency regulation. (See pp. 17 to 19.)

Resources for Solvency Regulation

Some states may not be allocating sufficient resources to solvency regulation. In a recent Association survey, 21 out of 51 insurance departments reported difficulties in obtaining adequate funding from their states for their examination staffs. The 5 states GAO visited had 29 staff available to analyze 6,450 annual statements. Officials in two of the five states said that funding shortages prevented them from hiring needed examiners. Moreover, at least 31 states are using some examiners who are underqualified by Association standards. (See pp. 20 to 22.)

Interstate Coordination

GAO asked state insurance regulators what information they would share with other states and the Association about a problem insurer located in their state. Only a few states will fully share information or provide regular updates on a financially troubled insurer. Some state regulators told GAO that they are concerned that if other states learn about a problem insurer, they might suspend the insurer's license, thus making the situation public and increasing the chances of insolvency. (See pp. 24 and 25.)

The Association has recently increased its efforts to improve coordination and cooperation among states, but it cannot require states to participate in its activities or make use of its facilities. While 3 states participated in more than 100 Association-sponsored multistate field examinations from 1984 through 1987, 28 states participated in fewer than 10 examinations. Participation in Association committees and subgroups varied sharply in the 5 states GAO visited, with 16 Texas officials and only one or two officials from each of the other four states participating. (See pp. 25 and 26.)

Recommendations

GAO is making no recommendations.

Industry Comments

The National Association of Insurance Commissioners provided written comments on a draft of this report. In its comments, the Association acknowledged that the report contained a number of valid observations, but the Association also disagreed on a number of points. Its comments and GAO's responses are presented in appendix II.

Contents

Abbreviations

AFE	Accredited Financial Examiner
CFE	Certified Financial Examiner
COIL	Conference of Insurance Legislators
IRIS	Insurance Regulatory Information System
NAIC	National Association of Insurance Commissioners
NCIGF	National Committee on Insurance Guaranty Funds

Introduction

Property/casualty insurance is the primary means by which individuals and corporations protect themselves against the possibility of economic loss resulting from damage to property or injuries to other people. According to the Insurance Information Institute, over 90 percent of the U.S. homeowners and automobile owners have such insurance.

An insurance policy is a contract for future services. Unlike a grocer or a car dealer, but like a bank or a savings and loan, an insurance company must remain solvent if its customers are to get what they paid for. Consumers may not have access to detailed information about an insurer's financial condition. The possible lack of information combined with the large number of policyholders creates a compelling reason for government regulation.

The Primary Role of State Insurance Regulation

Regulation of the insurance industry and administration of insurance company receiverships and liquidations are primarily state responsibilities. In 1868, the Supreme Court upheld the constitutionality of a state statute regulating insurance agents on the grounds that the insurance business is not commerce that the federal government may regulate under the commerce clause.[1]

In 1944, the court abandoned the proposition that insurance is not commerce and upheld the application of Federal antitrust laws to the insurance industry.[2] In 1945, Congress reestablished the primacy of state regulation by enacting the McCarran-Ferguson Act, which strictly limited the extent to which federal law, including federal antitrust law, preempted state insurance law.[3]

In general, state legislatures set the rules under which insurance companies must operate. Among their other responsibilities, state insurance departments monitor the financial condition of insurers. States use a number of basic methods to assess the financial strength of insurance companies, including reviewing and analyzing annual financial statements, doing periodic on-site financial examinations, and monitoring key financial ratios.

[1] Paul v. Virginia, 75 U.S. 168 (1868).

[2] United States v. South-Eastern Underwriters Assoc., et. al., 322 U.S. 533 (1944).

[3] 15 U.S.C. Sections 1011-1015.

State insurance departments are responsible for taking action in the case of a financially troubled insurance company. If the insurance company is based in another state, the insurance department can suspend or revoke its license to sell insurance in the department's state. If a home-based company is failing, the department can put it under state supervision or, in cases of irreversible insolvency, place a company in liquidation. State insurance regulators have established a central structure to help coordinate their activities. The National Association of Insurance Commissioners (NAIC) consists of the heads of the insurance departments of 50 states, the District of Columbia, and four U.S. territories. NAIC's basic purpose is to encourage uniformity and cooperation among the various states and territories as they individually regulate the insurance industry. Toward that end, NAIC, among its other activities, (1) promulgates model insurance laws and regulations for state consideration and (2) provides a framework for multistate "zone" examinations of insurance companies.

Recent Trends in Property/Casualty Insurer Liquidations

While the number of property/casualty liquidations each year has been very small when compared to the more than 3,000 property/casualty insurers doing business in the U.S., there was a substantial increase between 1981 and 1987 from the previous 7-year period in the number and size of insurer liquidations as well as the number of insurers targeted by NAIC for regulatory attention. From 1974 through 1980, property/casualty guaranty funds[4] assessed insurance companies in order to pay claims for 6.9 liquidations per year on average; from 1981 through 1987, the funds assessed for an average of 12.6 property/casualty liquidations annually, thus indicating that a significantly larger number of property/casualty liquidations took place in the latter period.

In addition, during the 1981-87 period, the largest number of property/casualty liquidations took place since the establishment of guaranty funds. Prior to 1981, the most that guaranty funds assessed insurers for any single liquidation was $85 million, and only one other liquidation required an assessment of more than $50 million. Since 1981, there have been four liquidations each requiring insurers be assessed over $100

[4]Guaranty funds in each state pay in-state policyholder claims on liquidated insurers by assessing property/casualty insurers doing business in the state. When an insurer is liquidated, each state's fund is responsible for paying claims by policyholders residing in the state. Only five states had property/casualty funds in 1960; by the end of 1974, all but three states had them. Insurer Failures: Property/Casualty Insurer Insolvencies and State Guaranty Funds (GAO/GGD-87-100, Jul. 1987).

million.[5] As a liquidation progresses, guaranty funds can share in proceeds from the assets of a liquidated insurer, thus recovering some of their initial costs. Even with such recoveries, the two largest liquidations, Transit Insurance Company of Missouri and Mission Insurance Company of California, may end up costing guaranty funds over $1 billion.[6]

The potential exists for still more insurer failures. Figure 1.1 shows the percentage of property/casualty companies examined by NAIC that it designated for regulatory attention because of concern over their financial conditions (such a designation does not mean that NAIC expects companies so designated to fail). The percentages shown generally reflect the situation in the mid-1980's when investment and underwriting income in the industry decreased and the number of liquidations increased. However, as insurer income has increased since 1985, and the number of insolvencies have decreased, percentages have fallen by a small amount. In 1988, on the basis of 1987 financial data, NAIC designated 569 property/casualty companies for regulatory attention, representing over 21 percent of all property/casualty companies reviewed by NAIC.[7]

[5]The following are liquidations with exact amounts assessed, both as reported by the National Committee on Insurance Guaranty Funds (NCIGF) and as converted into constant 1982 dollars:

Company	Year	Assessment through 1987	Assessment in constant 1982 dollars
Signal/Imperial Insurance Company	1978	$ 53,478,429	$ 74,069,846
Reserve/American Reserve Insurance Company	1979	85,440,723	108,703,210
Ideal Mutual Insurance Company	1984	221,535,240	205,696,602
Transit Casualty Company	1985	218,994,933	197,470,634
Midland Insurance Company	1986	131,509,572	115,460,554
Mission Insurance Company	1987	147,542,250	125,354,503

Note: The constant dollar figures are not exact because not all assessments took place in the year of insolvency.

[6]NCIGF estimated in 1987 that the Transit insolvency would ultimately cost guaranty funds $511,915,224 ($434,932,221 in constant 1982 dollars) and the Mission insolvency $598,302,123 ($508,328,057 in constant dollars).

[7]NAIC designations for each year are on the basis of annual statement data covering the previous year.

Objectives, Scope, and Methodology

In October 1987, the Chairman of the Subcommittee on Commerce, Consumer Protection, and Competitiveness, House Committee on Energy and Commerce, requested that we review (1) how state insurance departments detect financially troubled insurers, (2) the resources available to states for monitoring insurer solvency, and (3) the extent to which states share information and otherwise cooperate in dealing with problem insurers.

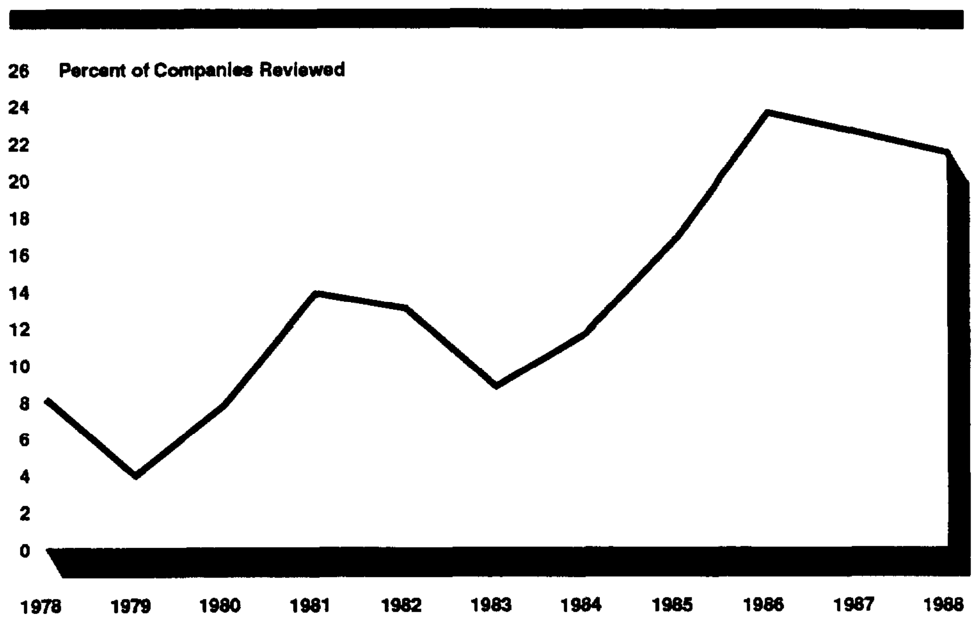
This report examines state actions from routine surveillance through initial detection of a problem insurer. Future reviews will evaluate state regulatory actions in situations involving actual state takeover and the process of liquidating insolvent companies.

The objectives of this review were to (1) determine how state regulators discover potential insurer insolvencies and whether early detection of such potential insolvencies is taking place; (2) examine the nature and extent of resources available to state insurance departments for analysis of insurer solvency; and (3) ascertain the extent to which interstate coordination and cooperation take place with regard to financially troubled multistate insurers, especially in terms of exchanging information concerning such insurers.

To meet these objectives, we designed and pretested a questionnaire and distributed it to the insurance departments of all 50 states and the District of Columbia. All except three states (Alaska, New Mexico, and West Virginia) completed the questionnaire and returned it to us. (A copy of the questionnaire and a compilation of results is in app. I.) On the basis of questionnaire results and various criteria, such as geographic diversity, the number of companies, and the size of the insurance department, we selected five states for follow-on on-site audit work: Rhode Island, Texas, Arizona, Connecticut, and Ohio. We also did audit work at NAIC headquarters in Kansas City, Missouri, in order to learn about NAIC's efforts in coordinating state solvency regulation. We also spoke with insurance company executives, representatives of insurance trade associations, and independent experts on insurer solvency issues. (See app. III for a listing of those interviewed.) In addition, we reviewed available literature on the subject, including periodical articles, reports, and records of congressional hearings. We did our review from April 1987 to January 1989 using generally accepted government auditing standards.

The NAIC provided written comments on a draft of this report. In its comments, the NAIC acknowledged that the report contained a number of valid observations, but the Association also disagreed on a number of points. NAIC's comments and our responses are presented in appendix II.

Figure 1.1: Percent of Property/Casualty Companies Designated by NAIC for Regulatory Attention, 1978 Through 1988



Source: NAIC

Problems in Solvency Examination of Property/ Casualty Insurers

Our review of the examination function of state insurance departments indicates potential problems in state monitoring of insurer solvency. According to state insurance regulators, states rely heavily on annual financial reports and field examinations, both of which are subject to significant time lags, to make determinations about insurer financial condition. State regulators rely generally on unaudited financial reports from insurers and do not rely on qualified actuaries to evaluate reserves. In addition, according to some state insurance regulators, the nationwide warning system instituted by NAIC is of varied usefulness in alerting insurance departments to potential solvency problems.

Time Lags in Reviewing Annual Financial Data

We asked in our questionnaire and in our discussions with state insurance regulators how important certain information is in discovering solvency problems with a property/casualty insurer. The insurance regulators said that one of the two most important means of detecting solvency problems is a department's own review of insurer annual financial statements. For about half the states, the annual statements are the only data states regularly receive (other than the periodic field examinations and supplementary forms filed annually concerning accident and health coverage) regarding the financial condition of an insurance company.

According to state insurance regulators, all states require licensed insurers to submit a standardized year-end annual statement by the following March. State regulators told us that it may take from 6 weeks to 3 months to review all submitted statements. If an insurer's statement indicates possible solvency problems, the chief examiner or a senior examiner takes an additional 2 or 3 weeks to review it.

In this sequence of events, a company can have a problem for more than a year before a state regulator is aware of it (especially if, as discussed below, the state does not require quarterly statements from all licensed insurers). For example, if a company had developed a problem in February 1989, it would not show up on an annual statement until the end of the year. The state regulator will not receive that year-end 1989 statement until March or April 1990 and might not review it until several weeks later. The NAIC President expressed concern about the timeliness of annual statements, saying that by the time state regulators become aware of a problem the situation might become much worse or, conversely, may have been corrected and no longer require state attention.

To speed up annual statement review, NAIC is encouraging companies to file their annual statements on computer diskette. Fifteen states require all licensed insurers to do so, with an additional 5 states requiring it only of home-based companies. This filing, however, shortens the processing time only after statements are received.

Some states have attempted to reduce the time lag involved in detecting possible insolvencies by requiring all licensed companies to file quarterly reports. Twenty-four of the 48 insurance departments responding to our questionnaire said that they required all home-based companies to file quarterly. Eighteen of the insurance departments require out-of-state companies to file quarterly. Quarterly statements are condensed versions of the annual statements. They contain a balance sheet, income statements, and a statement of changes in financial position but with less supporting data than annual statements, making them less useful in financial analysis. Quarterly filings are not subject to the NAIC Examiner Team review process described below. Two of the five states we visited in our fieldwork required a quarterly statement of all licensed companies. However, each state we visited had some type of interim reporting requirement for companies that needed additional regulatory attention. This requirement does not help in initial problem detection.

Time Lags in Field Examinations

State regulators indicated that the most important means of detecting solvency problems other than by annual statements is through on-site field examinations. These examinations, however, occur less frequently than annual statement reviews and take longer to complete.

According to a 1988 NAIC survey and as shown in figure 2.1, at least 44 states and the District of Columbia require by law that the insurance department do field examinations of home-based companies on a regular basis. Twenty-four states and the District of Columbia require that each domestic company be examined once every 4 years. Two states require an examination once every 3 years. Fourteen states have a 5 year requirement, and 4 states require periodic examination but do not specify a frequency. Three states had no statutory exam requirement, and three others did not respond to the survey.

According to officials in the states we visited, field exams on small property/casualty companies may require one or two examiners and take a month or less to complete, while examinations of large companies may require 5 to 8 examiners and take up to 8 months. The time involved may be even greater than that. In 1984, the Conference of Insurance

Legislators (COIL) reported that some examinations were not being completed and findings were not being arrived at more than 5 years after the conclusion of the examination. COIL officials who worked on the report told us in 1989 that while some states have improved their record in this area, much remains to be done.

The lengthy intervals between field exams and the length of time required to complete them had a direct impact on the Mission and Transit failures referred to in the previous chapter. In the Mission situation, the California Insurance Department, after analyzing a September 1984 quarterly financial statement, moved the beginning of Mission's regularly scheduled triennial field exam up several months. The examination revealed that Mission had assumed a number of bad risks and had engaged in questionable reinsurance accounting practices.[1] However, the field exam did not begin until the spring of 1985 and was not completed until the fall, at which point Mission was put under state supervision.

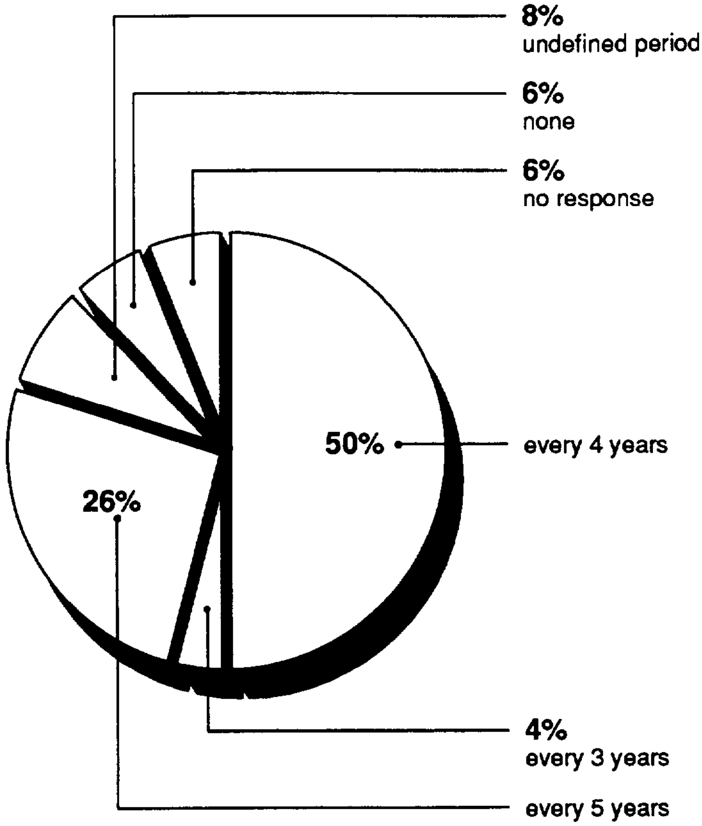
According to April 1989 testimony given before the Oversight Subcommittee of the House Energy and Commerce Committee by its state-appointed receiver, Transit Insurance Company began the questionable practices that led to its failure (i.e., assumption of questionable reinsurance risks and large-scale reliance on managing general agents)[2] as early as 1980 and was in clear difficulty by mid-1983, when A.M. Best Company lowered its rating on the basis of a review of Transit's annual financial statement for the previous year. The Missouri Insurance Department began a scheduled triennial examination in September 1984. The examination was completed in April 1985 and showed that bad risks written for Transit by its managing general agents had depleted its surplus, at which point the Missouri authorities ordered Transit not to write new policies or renew current ones. The Missouri Insurance Department then put Transit into rehabilitation in November 1985 and into liquidation in December of that year.

In both these situations, intervals between field examinations and the length of time needed to complete them led to a period during which a

[1]Reinsurance is the assumption by one insurance company of all or part of a risk undertaken by another insurance company.

[2]A managing general agent is an independent business firm that does for one or more separate insurers some or all of the functions usually done by company branch offices.

Figure 2.1: State Legal Requirements for Frequency of Field Examinations



Source: NAIC

company believed to have problems was allowed to continue doing business. This situation created more policyholder claims and increased the eventual burden on the state guaranty funds.

Many States Use Unverified Financial Data

State regulators generally accept financial data submitted to them by insurers without independently verifying the data. NAIC recommends that state insurance departments require property/casualty insurers to submit a statement by a public accountant independent of the company attesting to the validity of the annual financial statement. However, according to a 1988 NAIC survey, 37 states did not have such a requirement.[3] None of the five states we visited required CPA annual statement certification.

[3]Since the completion of the survey, 2 of the 37 states have instituted such a requirement.

Some state regulators question the effectiveness of CPA certification as a means of assuring the accuracy of financial statements. A regulator in Rhode Island said that CPA firms, when working for insurers, use different accounting practices than state examiners do in evaluating financial soundness. Nevertheless, the only means regulators have of verifying annual statement data other than through CPA certification is by on-site field examination that occurs only at lengthy intervals.

Most States Lack Actuarial Expertise

Leading insurance experts have said that a major determinant of an insurer's financial soundness is the adequacy of its reserves,[4] and that a certified actuary is highly important in establishing and maintaining reserves. However, for the most part, states do not require actuarial certification of insurer filings, and many do not use actuaries in annual statement reviews and field examinations.

NAIC recommends that states require an actuary's statement confirming the validity of the reserves for all home-based insurers. However, 33 of the 48 departments responding to our survey said that they do not require actuarial certification of reserve adequacy for all home-based property/casualty companies. In addition, 24 of the 48 insurance departments responding to our questionnaire reported that they have no actuaries working on reviewing property/casualty annual statements or on field examinations of property/causalty insurers. Of the five states we visited, only Rhode Island had actuaries working on field examinations. Some state regulators use part-time contract actuaries to assist in examinations. However, in 1988, the Consumer Insurance Interest Group and the Professional Insurance Agents of America reported that since such part-time actuaries would be working for insurers when they are not working for the states, there could be a conflict of interest.

NAIC's Warning System Is of Varied Usefulness to States

NAIC assists state efforts in detecting insurer solvency problems with its own system that gives states warnings about problem situations. This system is known as the Insurance Regulatory Information System (IRIS).

The IRIS system consists of two major elements. The first is a set of 11 ratios developed from various figures provided in the annual financial statements filed with the NAIC by insurers. The ratios serve as preliminary tests of the company's financial condition. The second element is a review of annual statements selected on the basis of the ratios and other

[4]Reserves are funds that insurers set aside for future claims payments.

factors by an Examiner Team chosen by NAIC from the ranks of state insurance examiners. These examiners (1) review the ratios, (2) analyze the statements, (3) decide whether an insurer should be designated for regulatory attention, and (4) develop a synopsis for the insurer's home state insurance department.

Our questionnaire results show that insurance departments give the NAIC system varied marks in terms of importance and reliability. Twenty-seven out of 48 departments rated IRIS ratios as of great or very great importance in becoming aware of a potential problem situation involving a home-based insurer, 15 rated IRIS as moderately important, and 6 as of some importance. Thirty-three states regarded IRIS ratios as of great or very great importance in the case of an out-of-state insurer, nine rated them as moderately important, and four as of some importance. Twenty-two departments rated IRIS ratios as greatly or very greatly reliable indicators of property/casualty insurer solvency, 17 rated them as moderately reliable, and 8 as somewhat reliable. Twenty-nine departments rated Examiner Team reports very greatly or greatly reliable as solvency indicators, 16 regarded them as moderately reliable, and 3 as somewhat reliable.

Insurance department officials in four of the five states we visited generally regard NAIC IRIS ratios and examiner team reports as of limited usefulness when compared to their own work in annual statement analysis. Several officials we talked to had problems with the NAIC system in terms of both timeliness and reliability. Regulators in Arizona and Connecticut told us that they complete their review of all insurer statements before they receive the Examiner Team report. In addition, department officials in Arizona told us that the Examiner Team reports are useful only for out-of-state insurers, since they are aware of in-state problem situations before the reports arrive. Also, regulators in Texas and Connecticut told us that they consider IRIS ratios inaccurate since they can at times indicate financial trouble where none exists. (One Texas regulator told us that his staff will spend a good deal of time analyzing a statement that has suspect IRIS ratios only to find that the company was in sound condition.)

As part of upgrading its computer facilities, in 1988 NAIC instituted a system under which quarterly data are put into NAIC's database, and certain ratios are calculated and sent to state regulators. In addition, during 1989, an NAIC working group will review the performance of IRIS ratios in detecting insurer solvency problems. It is too early to tell how these developments will affect insurance department use of the NAIC early warning system.

NAIC Financial Regulation Standards

In addition to the work on the IRIS system described above, NAIC, during the first part of 1989, prepared a "Policy Statement on Financial Regulation Standards" that was given final approval at the NAIC national meeting in June 1989. NAIC also approved a plan under which all member insurance departments must evaluate themselves on their compliance with the standards and, by mid-1990, must report back to NAIC on their compliance.

These standards cover a large number of topics dealing with the rules and practices of solvency regulation. Among other things, they prescribe that (1) states should require annual CPA audits of home-based insurers (as previously recommended by NAIC), (2) states should (as noted above) require an actuarial opinion on reserve adequacy for all home-based companies, and (3) field examinations should be done in an "efficient and timely manner."

The standards address some of the problems discussed in this chapter as well as the following chapters but are not specific on a number of points. For example, they do not specify a desirable interval between insurer field examinations and do not define what is meant by doing an examination in an "efficient and timely manner." Also, it is not clear what sanction, if any, NAIC intends to impose on insurance departments that do not comply with the standards.

Conclusions

The time required to analyze insurer statements and do field examinations and the lengthy intervals between examinations may allow financially troubled insurers to continue doing business for a period of time without state actions, thus increasing the burden on a state's guaranty fund should a liquidation actually take place. The lack of requirements for actuarial certification of reserves in most states and the nonuse of actuaries in half of the states may also add to the difficulty in detecting solvency problems. NAIC has taken steps to deal with these and other shortcomings in solvency regulation, but it is not yet certain how effective its actions will be.

Resources for Solvency Regulation

State monitoring of property/casualty insurer solvency cannot be maintained or improved without sufficient resources. We found that (1) some state regulators believe available resources to be inadequate, (2) states may not have sufficient personnel to do annual statement analysis and field examinations, and (3) some states are using field examiners who would not be qualified to represent NAIC zones in multistate field examinations.

Some States May Lack Necessary Resources

In the course of our research and fieldwork, we found evidence that some insurance departments may be facing resource problems in monitoring insurer solvency.

In 1988, NAIC did a survey of its member insurance departments concerning their ability to meet the statutory requirement that insurer field examinations be conducted at regular intervals (discussed in chap. 2). NAIC found that out of 51 departments responding to the survey, 21 reported difficulty obtaining adequate funding from the state for examiners. Among those reporting difficulties were departments in two states in which, during 1987, insurance companies wrote more than $10 billion in premiums (as compared to an average of $3.9 billion per state).

NAIC's newly adopted Financial Regulation Standards, discussed in the previous chapter, say that insurance departments should have a "sufficient staff to effectively review the financial statements." In doing our fieldwork, we found that collectively, the five states we visited had 26 reviewers to manually analyze 6,450 annual statements, a ratio of one examiner for every 248 annual statements.[1] Specifically, as figure 3.1 shows, Arizona had one reviewer for every 792 statements, Texas had one for every 499 statements, Rhode Island one for every 416 statements, Ohio one for every 227 statements, and Connecticut one examiner for every 79 statements. In 1984, COIL characterized similar workload levels as "massive" and said that because of the workload, the process of annual statement review took too much time.

We were told in our fieldwork that funding shortages had created problems for hiring examiners in two states. Connecticut officials said that two examiner positions were currently going unfilled because of lack of state funding. Also, the chief examiner in Rhode Island said that in

[1]Since a company must submit a statement to each state in which it is licensed, this total includes statements from one insurer submitted to two or more states, each of which will separately analyze each statement.

1986, because of lack of funds, only 3 of 14 authorized examiner positions were filled. These openings created an examination backlog that was not cleared up until 1987 when, after numerous requests, the legislature provided more funds.

Some states, partially because of funding problems, use independent examiners hired as independent contractors in addition to, or instead of, their own staff. Specifically, we found in our questionnaire results that seven states used contract personnel to supplement regular staff in analyzing insurer filings, eight states used contract personnel to supplement their own field examiners, and nine others used only contract personnel for field examinations. For example, Arizona relies totally on contract personnel while Rhode Island and Texas have used CPA firms to do field exams.

While using contract personnel may save money and circumvent state hiring restrictions, it may also create other problems. A recent report by the Department of Audits in Georgia concerning the state insurance department, which exclusively uses contract examiners to audit insurers, concluded that "problems [exist] relating to the department's control over the quality of the examination, the independence and objectivity of the private examiners, and the efficiency and cost controls over the examinations."[2]

Some Field Examiners Do Not Meet NAIC Qualifications

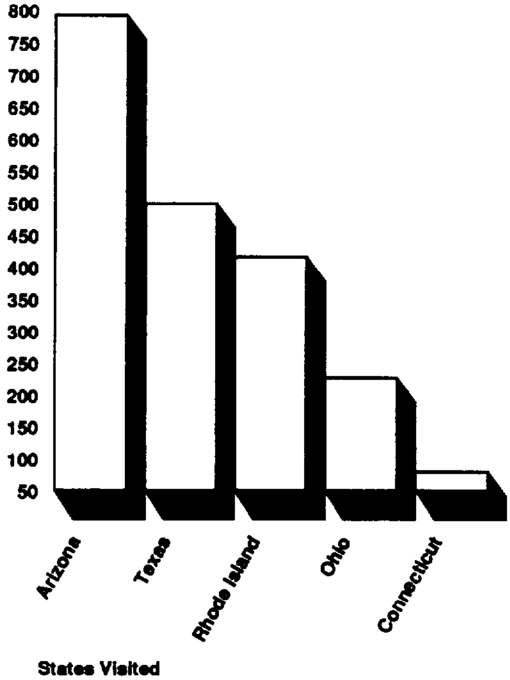
In its Examiners Handbook, NAIC sets pay and professional qualification standards for examiners participating in zone examinations — field examinations of multistate insurers organized by NAIC and done by more than one state insurance department. The personnel doing these examinations are drawn from state insurance department examination staffs and must meet NAIC standards.

Among other requirements, NAIC prescribes that an examiner representing a zone on such examinations must be certified by the National Society of Financial Examiners as an Accredited Financial Examiner (AFE) and that the examiner-in-charge must be a Certified Financial Examiner (CFE).[3] We compared the information states submitted to us on the

[2]Georgia Department of Audits, Performance Audit: Department of Insurance, Regulatory Laws and Licensing Division, February 10, 1989, p. 14.

[3]Only one examiner from each multistate zone participating in an examination is considered as representing the zone. Other examiners coming from the same zone are not subject to the AFE requirement, and neither are examiners from the home state. The examiner-in-charge must be a CFE regardless of where he/she comes from.

Figure 3.1: Ratio of Reviewers to Annual Statements



number of full-time staffers used to do field examinations with the number of AFEs and CFEs on staff. This comparison shows that 35 of the 46 departments reporting both sets of numbers had fewer AFEs or CFEs on staff than they did full-time field examiners. Thus, even if all the AFEs and CFEs worked on field examinations, the majority of state insurance departments have field examiners who would not be considered qualified to represent a zone on NAIC zone examinations.

Conclusions

In order to monitor solvency effectively, it is vital that states have a sufficient level of resources. While we know of no generally accepted criteria for determining how much states should spend on solvency regulation, what we have found indicates that some states may not be allocating sufficient resources to this area.

Interstate Coordination in Problem Insurer Cases

The interstate nature of the insurance business and the guaranty fund system makes it very important that states coordinate with each other and keep each other informed about potential insolvency situations. We found, however, that states do not fully coordinate with each other. Some states release full information to other states about problem insurers while others concerned about the possible disruptive consequences of releasing information, share almost no information. NAIC has tried and is trying to encourage coordination and to provide mechanisms for it, but both NAIC authority and successes have been limited.

The Need for Interstate Coordination

According to the Insurance Information Institute, about 900 of the 3,800 property/casualty companies in the United States operate in all or most states and write a vast majority of the Nation's property/casualty business. In theory, these companies are subject to solvency monitoring by all of the states in which they are licensed. In practice, states will leave the primary responsibility for solvency monitoring to the state in which a company is located.

If a property/casualty insurer becomes insolvent, however, all states in which it is licensed must share the burden of honoring claims. As discussed in our 1987 report on guaranty funds, each state's fund is obligated to pay claims made by policyholders living in the state.

Thus, while the home state assumes primary responsibility for monitoring the solvency of its insurers, its guaranty fund is only legally responsible for paying off policyholders residing in the state in case of insolvency. On the other hand, the other states, having informally delegated responsibility to the home state for monitoring out-of-state insurers, retain responsibility through their guaranty funds for dealing with in-state policyholders of these insurers in case of failure. If made aware of a problem insurer, these states can limit damage by ordering an out-of-state company to stop doing business in their state. This set of circumstances makes interstate coordination in problem insurer cases essential, and NAIC prescribes in its Financial Regulation Standards that a state that identifies a financially troubled insurer should notify other jurisdictions in which the insurer does business.

States Vary in the Amount of Information They Will Share About Problem Insurers

State regulators are divided in their policy on information sharing between a desire to keep other departments informed and a concern that doing so may harm efforts to rehabilitate insurers. Our questionnaire results indicate that several states are very open in sharing information on problem situations with other states, several others are very restrictive, and most fall in between, giving some information to other states and/or to NAIC in certain situations.

Our questionnaire concerned what departments tell other departments and NAIC, either formally or informally, about problem domestic property/casualty insurers. The responses indicate that 13 of 47 states would not, if a company based in the state had a strong probability of insolvency, notify other states in which a problem company was licensed. Almost all states would, if insolvency of a home-based insurer was imminent, notify other states in which a home-based insurer was licensed.

We also asked regulators in our questionnaire about the degree to which they would keep NAIC and other states informed about problem domestic property/casualty insurers in their states. Our results show that about 15 of 48 departments surveyed would provide full information upon request to states in which a problem company was licensed. According to the questionnaire results, three states would be more forthcoming, providing regular updates on a problem situation, and five would be much more restrictive. Thus, the questionnaire responses indicate that the degree to which other states and NAIC are able to find out what is happening to an insurer with financial problems depends in large part on which department is handling the situation.

Our discussion with state officials reinforces this conclusion. An Arizona official said that he could talk with regulators in 30 to 40 states about on-going problem situations, while an examiner in Rhode Island said that his out-of-state contacts were largely restricted to the immediate geographic region. Officials in Connecticut said that they place little reliance on formal or informal contacts with other regulators, preferring to depend on their own review of financial statements to detect solvency problems in out-of-state insurers.

State regulators we talked to in the course of our fieldwork, as well as other regulators who responded to our questionnaire, have a specific concern about sharing information with other states about a home-state problem insurer. They are concerned that if they do so, one or more of the other states might suspend the company's license to issue policies in the state. Since such an action is a matter of public record, divulging this information would alert the public to the existence of a problem situation. Regulators are concerned that the company would undergo a "run," with agents and policyholders withdrawing their business. Withdrawing business would make insolvency more likely and would frustrate insurance department efforts to put a company back in sound financial condition. One state insurance department official told us that for this reason, his department withheld information from other states on a troubled in-state company pending a potential takeover.

Regulators in four of the five states we visited expressed this concern, as did one of the states we did not visit in a comment attached to its questionnaire. Another state regulator expressed concern in its questionnaire that if an insurance department identifies an insurer that is actually not in financial difficulty as financially troubled, the company could sue state regulators and hold them personally liable for damages.

NAIC Has Had Limited Success in Bringing States Together

NAIC has recently increased its efforts to improve coordination and cooperation among states. A major example of such efforts is NAIC's creation of an interstate computer network that (1) allows states to communicate easily with each other or with NAIC, (2) provides state insurance departments with selected annual statement data from NAIC's data base, and (3) allows states to create customized analyses of annual statement data. However, NAIC can make networks such as this available but cannot require states to make use of them. NAIC has no regulatory power but is entirely dependent on voluntary state compliance and cooperation. We found several examples of the variations in state cooperation with NAIC and participation in NAIC activities. As mentioned in chapter 1, NAIC provides the organizational structure for interstate zone examinations of large multistate insurers. All states are notified of zone exams and given the opportunity to participate. We asked in our questionnaire about participation in zone exams from 1984 through 1987 and found that while 3 states had participated in over 100 zone examinations during that period and 11 others in between 25 and 99 exams, 28 states had participated in fewer than 10 zone exams, and 13 of those 28 states had participated in none.

NAIC also provides an opportunity for interstate contacts through its large number of committees, subcommittees, task forces, and working groups. Our five fieldwork states varied sharply in their participation in such groups. As of the beginning of 1988, 16 Texas Insurance Department officials served on a large number of NAIC subgroups. Arizona had

2 officials serving on a total of 17 NAIC subgroups, Connecticut had 1 official serving on 14 subgroups, Ohio had 1 official serving on 10, and Rhode Island had 1 official as a member of a single NAIC task force.

When we asked state officials about this participation, we found that the extent of NAIC participation is related to various factors. Texas has a three-person Insurance Board in addition to its commissioner and other Insurance Department officials available to participate in NAIC subgroups. Rhode Island officials told us that their limited participation in NAIC resulted from a lack of funding, staff, and interest on the part of the former commissioner. With a new commissioner more interested in outside activities, Rhode Island anticipates increasing its participation in NAIC.

Conclusions

The interstate operations of many large insurers and the responsibilities of individual states under the guaranty fund system make interstate coordination important. However, the exchange of information among states about problem insurers varies from state to state, as does the degree to which states are willing or able to use the coordination opportunities provided by the NAIC.

U. S. General Accounting Office Survey of State Insurance Commissioners Regarding Financially Troubled Property/Casualty Insurance Companies

U.S. GENERAL ACCOUNTING OFFICE

SURVEY OF STATE INSURANCE COMMISSIONERS REGARDING
FINANCIALLY TROUBLED PROPERTY/CASUALTY INSURANCE COMPANIES

INTRODUCTION

The U.S. General Accounting Office (GAO), an independent agency of Congress, is conducting a survey of state regulatory activities concerning financially troubled property/casualty (P/C) insurance companies during the period between the initial discovery of possible solvency problems and entry into conservation, rehabilitation, or liquidation. The purposes of the survey are to: (1) ascertain what items of information are most commonly used, and most consistently relied on, by state insurance departments in discovering and monitoring potential insolvencies; (2) determine to what extent state insurance departments take certain actions in dealing with potential insolvencies; and (3) determine the nature and extent of interstate communication and cooperation in dealing with financially troubled property/casualty insurers.

Unless otherwise noted, all references to "insurers" or "insurance companies" are to property/casualty companies. Risk retention groups are excluded.

The questionnaire should take about 1 to 2 hours of your time, depending upon the availability of your records. All survey responses will be treated as confidential and will not be disclosed to anyone outside GAO. The questionnaire is numbered only to permit us to follow up with nonrespondents. Your response is voluntary. If you have any questions, please call Mr. Steven J. Berke at (202) 447-1570. Please complete the questonnaire within 10 business days after receiving this request. In case the envelope is misplaced, the mailing address is:

U.S. General Accounting Office
General Government Division
Mr. Steven J. Berke
Room 3660
441 G Street, N.W.
Washington, D.C. 20548

If you have any comments you wish to add, please use the space provided at the end of the questionnaire.

Thank you for your cooperation.

* * * * *

I. BACKGROUND

1. How many domestic and foreign property/casualty (P/C) insurers were licensed to do business in your state, as of December 31, 1987? (PLEASE ENTER APPROPRIATE NUMBERS BELOW. IF NONE, ENTER "0.")

	Number
1. Domestic P/C insurers	N=48 Range=2-289 Mean=61.25 Median=35.5
2. Foreign P/C insurers	N=48 Range=97-1087 Mean=573 Median=587

2. Consider the number of professional staff, both in-house and contractors, if any, who spend any time either analyzing financial statements or conducting field examinations of P/C companies. (PLEASE ENTER APPROPRIATE NUMBERS BELOW. IF NONE, ENTER "0.")

	Number of staff	
	In-house (1)	Contract (2)
a. About how many full-time or full-time equivalent staff analyze P/C financial statements?	N=48 R=0-24 Mean=5.52 Median=3.5 (12-14)	N=43 R=0-8 Mean=0.40 Median=0 (15-17)
b. About how many full-time or full-time equivalent staff conduct P/C field examinations?	N=48 R=0-75 Mean=14.31 Median=9.5 (18-20)	N=43 R=0-40 Mean=4.05 Median=0 (21-23)

3. Consider the professional affiliations or certifications of your state's insurance department and contractors, if any, working on the financial condition of P/C companies, i.e., analyzing annual statements or conducting field examinations. About how many are in each of the following categories? (PLEASE ENTER APPROPRIATE NUMBERS. INCLUDE BOTH FULL-TIME AND PART-TIME STAFF AND CONTRACTORS, IF ANY. ENTER AS MANY DESIGNATIONS, PER PERSON, AS APPROPRIATE.)

	NUMBER OF STAFF	
	IN-HOUSE (1)	CONTRACT (2)
1. Fellow of the Casualty Actuarial Society	N=45 R=0-2 Mean=.22 Median=0 (24-26)	N=43 R=0-3 Mean=.44 Median=0 (27-29)
2. Associate, but not Fellow, of the Casualty Actuarial Society	N=43 R=0-2 Mean=.19 Median=0 (30-32)	N=40 R=0 Mean=0 Median=0 (33-35)
3. Certified Property Casualty Underwriters (CPCU)	N=42 R=0-2 Mean=.24 Median=0 (36-38)	N=40 R=0-1 Mean=.03 Median=0 (39-41)
4. Certified or Accredited Financial Examiner (CFE or AFE)	N=46 R=0-43 Mean=7.74 Median=5 (42-44)	N=41 R=0-37 Mean=3.02 Median=0 (45-47)
5. Certified Public Accountant (CPA)	N=45 R=0-8 Mean=1.84 Median=1 (48-50)	N=40 R=0-4 Mean=0.225 Median=0 (51-53)

4. Please provide the following financial information for your state's fiscal years 1985 through 1988. (ENTER DOLLAR AMOUNTS TO THE NEAREST $1,000.)

FINANCIAL INFORMATION	FY 1985 ($000's) (1)	FY 1986 ($000's) (2)	FY 1987 ($000's) (3)	FY 1988 (est.) ($000's) (4)	
1. All revenue collected from any insurance-related activities including taxes, fees, or assessments in P/C, life, and health insurance	N=44 R=818-692840 Mean=75334.2 Med=43559.5	N=45 R=3051-836265 Mean=86688.6 Med=51032	N=45 R=1484-1028332 Mean=101649 Med=59093	N=45 R=1978-1081476 Mean=104991 Med=58000	(54-73)
2. Total expenditures of the entire insurance department	N=45 R=478-34013 Mean=5031.73 Med=2446	N=47 R=517-35828 Mean=5579.74 Med=2848	N=46 R=561-39661 Mean=6308.22 Med=3036	N=46 R=600-57316 Mean=7437.44 Med=3446	(74-93)
3. Total cost of analyzing P/C annual statements and examining P/C insurers	N=25 R=5-3674 Mean=721.6 Med=390	N=26 R=6-3849 Mean=794.15 Med=453	N=26 R=7-4390 Mean=876 Med=472	N=26 R=8-5954 Mean=989.31 Med=530.5	(94-109)

5. Is your state's insurance department funded from the state general fund, or from dedicated or special funds? (CHECK ONE.) (110)

   1. [28] State general fund   Both 4
                                    NA 1

   2. [15] Dedicated or special funds

6. Do domestic P/C insurance companies operating in your state reimburse your department for part or all of the cost of their examinations? (CHECK ONE.) (111)

   1. [41] Yes

   2. [7] No

7. How frequently is your state's insurance department required by law to perform a field examination on domestic P/C insurers? (CHECK ONE.) (112)

   1. [23] Every 3 years

   2. [3] Every 4 years

   3. [14] Every 5 years

   4. [8] Other (specify) ____________________

* NA=NO ANSWER

8. Aside from special or targeted examinations, (e.g., exams triggered by the IRIS early warning system), what percent, if any, of domestic P/C companies does your state routinely examine more frequently than required by law? (ENTER PERCENTAGE. IF NONE, ENTER "0.") (113-115)

   N=44
   R=0-100
   Mean=21.34
   Median=4.5 %
   (Companies routinely examined)
   (more frequently than required)

9. Please indicate below which of the following, if any, are part of a regular field examinations of domestic P/C insurers. (CHECK ALL THAT APPLY.) (116-119)

   1. [48] Review examination of financial data to verify results of annual statement

   2. [47] Review of reserve adequacy

   3. [47] Check on compliance with nonfinancial statutory requirements

   4. [19] Other (please specify) ______________

10. Generally, how much time elapses between the completion of a regular examination on a domestic P/C insurer and the issuance of the final examination report? (CHECK ONE.) (120)

   1. [45] Less than 6 months

   2. [3] At least 6 months, but less than 1 year

   3. [0] At least 1 year, but less than 1 1/2 years

   4. [0] At least 1 1/2 years, but less than 2 years

   5. [0] Two years or more

   -

   6. [0] No basis to judge

II. MONITORING POTENTIAL INSOLVENCY PROBLEMS

11. How frequently, if at all, are all domestic and foreign P/C insurers, licensed in your state, required by statute or administrative action to provide your state with the following information relating to solvency or financial condition? (IN EACH ROW, CHECK ONE BOX UNDER "DOMESTIC" AND ONE BOX UNDER "FOREIGN.")

Dup (1-2)
Card 2
(3)

INFORMATION REQUIRED OF ALL LICENSED INSURERS	DOMESTIC INSURERS						FOREIGN INSURERS						
	Not required (1)	At least monthly (2)	At least quarterly (3)	At least semi-annually (4)	At least annually (5)	When filing rate changes (6)	Not required (1)	At least monthly (2)	At least quarterly (3)	At least semi-annually (4)	At least annually (5)	When filing rate changes (6)	
1. NAIC financial statement - annual	0				46	(2 NA) 0	0				46	(2 NA) 0	(4-5)
2. NAIC financial statement - quarterly	19		24			(5 NA) 0	23		18			(7 NA) 0	(6-7)
3. A and H schedule	3	0	0	1	42	0 (2 NA)	3	0	0	0	40	0 (5 NA)	(8-9)
4. Independent CPA certification of annual financial statements	37	1	0	1	9	0	37	1	0	0	8	0 (2 NA)	(10-11)
5. Other CPA statement (separate from NAIC statement)	37	1	0	1	9	0	37	1	0	0	8	0 (2 NA)	(12-13)
6. Independent actuary's opinion confirming reserve adequacy	33	1	0	0	13	(1 other) 0	34	1	0	0	10	(1 other) 2 (2 NA)	(14-15)
7. Other (specify) ________	1	1	2	0	7	(37 NA) 0	4	1	1	0	5	(37 NA) 0	(16-17)

* NA=NO ANSWER

12. Does your state require prior approval for surplus lines P/C carriers to operate in your state? (CHECK ONE.) (18)

1. [36] Yes

2. [12] No

13. How many unlicensed P/C insurers, if any, were doing business in your state on an excess/surplus lines basis, as of December 31, 1987? (ENTER NUMBER OR CHECK BOX. IF NONE, ENTER "0" AND SKIP TO QUESTION 17.) (19-21)

N=42
R=24-460
Mean=139.76
Median=125
(Unlicensed P/C insurers)

or

[6] Don't know (22)

14. Generally, do you obtain financial information on surplus lines carriers directly from the carrier, through a broker, or through another state? (CHECK ALL THAT APPLY.)

	Yes (1)	No (2)	
1. Directly from the carrier	40	8	(23) 3 NA
2. Through a broker	20	25	(24) 4 NA
3. Through another state	15	29	(25)

15. Does your state require P/C insurers operating on a surplus lines basis, or their brokers: 1) to file the same information as licensed carriers; 2) to file more information than licensed carrers; 3) to file less information than licensed insurers; or 4) are surplus lines carriers not required to file any information? (CHECK ONE.) (26)

1. [14] The same information

2. [4] More information

3. [25] Less information

4. [5] Filing not required

16. In determining whether or not to approve unlicensed alien P/C insurers to operate in your state, which of the following best describes how you use the approved list of NAIC/NAIIO? (CHECK ONE.) (27)

1. [7] As a sole basis

2. [9] As the primary basis

3. [27] As one of a number of factors

4. [2] We do not use it

3 NA

* NA=NO ANSWER

17. Of how much importance, if any, is the following information in alerting your state to a financial problem that may result in an insolvency of a domestic or foreign P/C insurer? (IN EACH ROW, CHECK ONE BOX UNDER "DOMESTIC" AND ONE BOX UNDER "FOREIGN.")

INFORMATION ALERTING YOUR STATE TO A FINANCIAL PROBLEM	DOMESTIC INSURERS					FOREIGN INSURERS					
	Very great importance (1)	Great importance (2)	Moderate importance (3)	Of some importance (4)	Little or no importance (5)	Very great importance (1)	Great importance (2)	Moderate importance (3)	Of some importance (4)	Little or no importance (5)	
1. IRIS ratios	10	17	15	6	0	11	22	9	4	1 (1 NA)	(28-29)
2. Your analysis of annual statements	33	15	0	0	0	27	17	3	0	0 (1 NA)	(30-31)
3. Financial ratios you calculate yourself	10	20	7	3	4 (4 NA)	8	18	10	2	6 (4 NA)	(32-33)
4. Analysis of private rating services	1	4	8	19	16	1	4	11	21	10 (1 NA)	(34-35)
5. Complaints from agents	6	6	17	18	1	6	5	17	17	2 (1 NA)	(36-37)
6. Complaints from consumers	11	11	18	7	1	11	10	19	6	1 (1 NA)	(38-39)
7. Formal notification by NAIC	18	16	6	4	3 (1 NA)	18	20	2	4	3 (1 NA)	(40-41)
8. Formal notification by other states	20	11	6	3	5 (3 NA)	22	15	5	2	2 (2 NA)	(42-43)
9. Informal contacts by other states	9	17	8	5	5 (4 NA)	12	20	10	4	1 (1 NA)	(44-45)
10. Informal news sources (street talk)	1	7	13	23	4	2	7	13	21	3 (2 NA)	(46-47)
11. Results of field examination	39	8	1	0	0	33	9	3	2	0 (1 NA)	(48-49)
12. CPA audit reports	2	15	16	6	8 (1 NA)	2	14	17	7	5 (3 NA)	(50-51)
13. SEC quarterly/annual reports	1	12	12	14	8 (1 NA)	1	11	13	13	8 (2 NA)	(52-53)
14. Other (specify) ______	3	6	1	0	0 (38 NA)	4	4	1	0	0 (39 NA)	(54-55)

* NA=NO ANSWER

18. Generally, how <u>important</u>, if at all, are the following items of information to your state <u>in making a definitive judgment</u> as to whether a financially troubled P/C insurer needs to be placed in conservation, rehabilitation, or liquidation? (<u>IN EACH ROW</u>, CHECK ONE BOX UNDER "DOMESTIC" <u>AND</u> ONE BOX UNDER "FOREIGN.")

INFORMATION USED TO MAKE DEFINITIVE JUDGMENT	DOMESTIC INSURERS					FOREIGN INSURERS					
	Very greatly important (1)	Greatly important (2)	Moderately important (3)	Somewhat important (4)	Little or no importance (5)	Very greatly important (1)	Greatly important (2)	Moderately important (3)	Somewhat important (4)	Little or no importance (5)	
1. IRIS ratios	4	9	21	5	9	5	12	17	8	4	(2 NA) (56-57)
2. NAIC examiner team reports	9	15	14	4	6	10	18	12	4	2	(2 NA) (58-59)
3. Your own analysis of statements	33	13	2	0	0	29	13	2	1	1	(1 NA) (60-61)
4. General field examination results	39	8	1	0	0	32	11	2	1	0	(2 NA) (62-63)
5. NAIC targeted financial examination reports	18	14	8	5	(1 NA) 2	15	13	12	4	0	(4 NA) (64-65)
6. Discussions with officials in other states	5	17	15	3	(1 NA) 7	15	18	9	1	(3 NA) 2	(66-67)
7. Other (specify) ______________	3	2	0	0	0 (43 NA)	4	1	0	0	0 (43 NA)	(68-69)

19. As <u>indicators</u> of P/C insurer solvency, generally, how <u>reliable</u>, if at all, are the following items of information? (CHECK ONE BOX IN <u>EACH</u> ROW. IF AN ITEM OF INFORMATION IS NOT PROVIDED TO YOUR STATE, CHECK "NOT APPLICABLE.")

INDICATORS OF INSURER SOLVENCY	Very greatly reliable (1)	Greatly reliable (2)	Moderately reliable (3)	Somewhat reliable (4)	Little or no reliability (5)	Not applicable (6)	
1. IRIS ratios	6	16	17	8	1	0	(70)
2. NAIC examiners team reports	12	17	16	3	0	0	(71)
3. Best's ratings	1	4	11	24	5	3	(72)
4. Results of field examinations	39	8	1	0	0	0	(73)
5. Other (specify) ______________	7	3	2	2	1	0 (33 NA)	33 NA (74)

* NA=NO ANSWER

III. ACTIONS TO DEAL WITH POTENTIAL INSOLVENCIES

20. How likely or unlikely, if either, would your state be to take the following actions in cases of financially troubled P/C companies? (IN EACH ROW, CHECK ONE BOX UNDER "DOMESTIC" AND ONE BOX UNDER "FOREIGN.")

	DOMESTIC INSURERS					FOREIGN INSURERS					
ACTIONS YOUR STATE WOULD TAKE	Very likely (1)	Somewhat likely (2)	Neither likely nor unlikely (3)	Somewhat unlikely (4)	Very unlikely (5)	Very likely (1)	Somewhat likely (2)	Neither likely nor unlikely (3)	Somewhat unlikely (4)	Very unlikely (5)	
1. Confer with executives of troubled companies	48	0	0	0	0	24	16	6	1	1	(75-76)
2. Confer with executives of other insurers	2	5	11	11	19	1	2	12	10	23	(77-78)
3. Confer with domiciliary department or commissioner						2	39	5	1	1	(79-80)
4. Require more frequent filings on financial information	47	1	0	0	0	42	3	2	0	1	(81-82)
5. Schedule immediate examination	41	6	0	0	0 (1 NA)	1	4	19	9	13 (2 NA)	(83-84)
6. Call for NAIC zone examination	16	11	6	7	6 (2 NA)	2	10	16	6	11 (3 NA)	(85-86)
7. Request that no new business be written	26	16	4	0	(1 NA) 1	29	13	4	1	1	(87-88)
8. Request that no renewal business be written	16	20	6	2	(1 NA) 3	20	15	7	3	3	(89-90)
9. Require the resignation or dismissal of one or more officers	0	6	17	14	(1 NA) 10	0	0	15	11	(1 NA) 21	(91-92)
10. Suspend or revoke license	18	14	7	2	5 (2 NA)	24	16	4	1	3	(93-94)
11. Other (specify) ____________	3	1	0	0	(44 NA) 0	1	2	0	0	0 (45 NA)	(95-96)

* NA=NO ANSWER

IV. INTERSTATE COORDINATION

21. In how many NAIC zone examinations of foreign P/C insurers has your state participated, in each of the following calendar years? (ENTER APPROPRIATE NUMBERS. IF NONE, ENTER "0.")

CALENDAR YEARS	Number of zone examinations	
1. 1984	N=44 R=0-32 Mean=4.18 Median=1	(97-99)
2. 1985	N=47 R=0-70 Mean=6.47 Median=1	(100-102)
3. 1986	N=47 R=0-80 Mean=6.17 Median=1	(103-105)
4. 1987	N=47 R=0-80 Mean=5.55 Median=1	(106-108)

22. Please indicate whether or not your state notifies the following interested parties, on a routine basis, either formally (in writing) or informally, when you take the following actions concerning a financially troubled domestic P/C insurer. (CHECK ALL THAT APPLY FOR EACH ROW.)

	INTERESTED PARTIES ROUTINELY NOTIFIED?												
	NAIC				States in which insurer is licensed				All states				
	Formally		Informally		Formally		Informally		Formally		Informally		
WHEN YOUR STATE . . .	Yes (1)	No (2)	Yes (1)	No (2)	Yes (1)	No (2)	Yes (1)	No (2)	Yes (1)	No (2)	Yes (1)	No (2)	
1. detects a problem situation in which insolvency is possible but not likely	(5	NA)	(4	NA)	(8	NA)	(6	NA)	(6	NA)	(3	NA)	
	3	40	5	39	5	35	15	27	0	42	4	41	(109-114)
2. detects a problem situation in which insolvency is a strong probability	(5	NA)	(10	NA)	(8	NA)	(10	NA)	(7	NA)	(8	NA)	
	10	33	9	29	17	23	21	17	5	36	5	35	(115-120) Dup (1-2) Card 3(3)
3. detects a problem situation in which insolvency is imminent	(7	NA)	(13	NA)	(9	NA)	(14	NA)	(8	NA)	(11	NA)	
	19	22	17	18	23	16	27	7	9	31	9	28	(4-9)
4. requests more frequent filings	(4	NA)	(7	NA)	(5	NA)	(9	NA)	(6	NA)	(7	NA)	
	4	40	2	39	6	37	4	35	1	41	1	40	(10-15)
5. consults with insurer exectives	(2	NA)	(7	NA)	(2	NA)	(6	NA)	(3	NA)	(5	NA)	
	3	43	1	40	4	42	7	35	1	44	0	43	(16-21)
6. orders immediate field examination (other than zone examination)	(2	NA)	(15	NA)	(3	NA)	(12	NA)	(5	NA)	(8	NA)	
	17	29	2	31	13	32	13	23	4	39	1	39	(22-27)
7. takes administrative actions short of conservation	(6	NA)	(14	NA)	(6	NA)	(14	NA)	(7	NA)	(10	NA)	
	22	20	5	29	21	21	11	23	6	35	1	37	(28-33)
8. applies for an order for conservation, rehabilitation, or liquidation	(2	NA)	(22	NA)	(3	NA)	(20	NA)	(5	NA)	(15	NA)	
	36	10	4	22	38	7	9	19	21	22	4	29	(34-39)
9. receives or enters into an order for conservation, rehabilitation, or liquidation	(1	NA)	(25	NA)	(3	NA)	(24	NA)	(3	NA)	(17	NA)	
	46	1	3	20	42	3	9	15	24	21	5	26	(40-45)

* NA=NO ANSWER

23. Please indicate whether your state, formally or informally, provides the following material, on a routine basis, to the parties listed below concerning a financially troubled domestic P/C insurer. (CHECK ALL THAT APPLY IN EACH ROW.)

	INTERESTED PARTIES						
	NAIC		States in which insurer is licensed		All states		
MATERIAL YOUR STATE PROVIDES ROUTINELY	Yes (1)	No (2)	Yes (3)	No (4)	Yes (5)	No (6)	
	(1 NA)		(2 NA)		(3 NA)		
1. Results of conversations with insurer executives	4	43	7	39	1	44	(46-48)
	(1 NA)		(2 NA)		(3 NA)		
2. Information filed by insurer at special request	5	42	9	37	0	45	(49-51)
	(3 NA)		(4 NA)		(4 NA)		
3. Results of special field examination	28	17	37	7	5	39	(52-54)

24. Which statement below best describes the degree to which your state keeps NAIC informed of a situation concerning a financially troubled P/C insurer not yet in formal proceedings? (CHECK ONE.)

(55)

1. [1] We do not provide information under any circumstances

2. [6] We do not provide information unless a specific need is demonstrated

3. [6] We provide limited information on request without asking for specific demonstration of need

4. [18] We do not update but provide full information on request

4 NA

5. [6] We provide limited updates and provide full information on request

6. [5] We provide situation updates on a regular basis

7. [2] Other (specify) ____________

25. Which statement below best describes the degree to which your state keeps states, in which insurer is licensed, informed of a situation concerning a financially troubled domestic P/C insurer not yet in formal proceedings? (CHECK ONE.)

(56)

1. [0] We do not provide information under any circumstances

2. [5] We do not provide information unless a specific need is demonstrated

3. [8] We provide limited information on request without asking for specific demonstration of need

4. [15] We do not update but provide full information on request

4 NA

5. [10] We provide limited updates and provide full information on request

6. [3] We provide situation updates on a regular basis

7. [3] Other (specify) ____________

* NA=NO ANSWER

26. Which statement below best describes the degree to which your state keeps states, in which insurer is not licensed, informed of a situation concerning a financially troubled domestic P/C insurer not yet in formal proceedings. (CHECK ONE.)

(57)

1. [7] We do not provide information under any circumstances
2. [18] We do not provide information unless a specific need is demonstrated
3. [2] We provide limited information on request without asking for specific demonstration of need
4. [14] We do not update but provide full information on request
5. [3] We provide limited updates and provide full information on request
6. [0] We provide situation updates on a regular basis
7. [4] Other (specify) ____________

V. ADEQUACY, TIMELINESS, AND USEFULNESS

Questions 27 through 30 are concerned with your satisfaction or dissatisfaction with the adequacy, timeliness, and usefulness of information provided by domiciliary states, the pre-1988 IRIS early warning ratios, Examiner Team Project Reports, and the NAIC zone examination. Please feel free to add your comments about this section in the space provided at the end of the questionnaire.

27. How satisfied or dissatisfied, in terms of adequacy, timeliness, and usefulness, are you with the information provided your state by domiciliary states on troubled foreign P/C insurers licensed in your state? (CHECK ONE BOX IN EACH ROW.)

INFORMATION PROVIDED BY DOMICILIARY STATES	Very satisfied (1)	Generally satisfied (2)	Neither satisfied nor dissatisfied (3)	Generally dissatisfied (4)	Very dissatisfied (5)	No basis to judge (6)	
1. Adequacy	3	29	11	3	0	1	1 NA (58)
2. Timeliness	2	24	13	8	0	0	1 NA (59)
3. Usefulness	2	32	11	2	0	0	1 NA (60)

28. How satisfied or dissatisfied were you, in terms of adequacy, timeliness, and usefulness, with the information provided by the pre-1988 system (based only on annual reports) of IRIS early warning ratios? (CHECK ONE BOX IN EACH ROW.)

INFORMATION PROVIDED BY PRE-1988 IRIS WARNING SYSTEM	Very satisfied (1)	Generally satisfied (2)	Neither satisfied nor dissatisfied (3)	Generally dissatisfied (4)	Very dissatisfied (5)	No basis to judge (6)	
1. Adequacy	6	34	5	2	0	1	(61)
2. Timeliness	7	33	4	3	0	1	(62)
3. Usefulness	7	33	6	1	0	1	(63)

* NA=NO ANSWER

29. How satisfied or dissatisfied are you, in terms of adequacy, timeliness, and usefulness, with the information provided by Examiner Team Project reports? (CHECK ONE BOX IN EACH ROW.)

INFORMATION PROVIDED BY EXAMINER TEAM PROJECT REPORTS	Very satisfied (1)	Generally satisfied (2)	Neither satisfied nor dissatisfied (3)	Generally dissatisfied (4)	Very dissatisfied (5)	No basis to judge (6)	
1. Adequacy	10	33	5	0	0	0	(64)
2. Timeliness	8	35	4	1	0	0	(65)
3. Usefulness	11	34	2	1	0	0	(66)

30. How satisfied or dissatisfied are you, in terms of adequacy, timeliness, and usefulness, with the information provided by the present system of NAIC zone examinations? (CHECK ONE BOX IN EACH ROW.)

INFORMATION PROVIDED BY NAIC ZONE EXAMINATIONS	Very satisfied (1)	Generally satisfied (2)	Neither satisfied nor dissatisfied (3)	Generally dissatisfied (4)	Very dissatisfied (5)	No basis to judge (6)	
1. Adequacy	8	33	3	4	0	0	(67)
2. Timeliness	3	22	13	9	1	0	(68)
3. Usefulness	6	33	6	2	1	0	(69)

VI. COMMENTS

31. If you have any comments which you feel are relevant to the objectives of this survey, as described in the introduction, please use the remaining space and, if necessary, you may attach additional sheets. (GAO MIGHT CITE YOUR COMMENTS BUT WILL NOT ATTRIBUTE THEM TO YOU OR YOUR STATE.)

(70)

If you would like a copy of our final report to the Congress, please check this box. ☐ (71)

Thank you for your help!

GGD/MS-4/88 * NA=NO ANSWER

Comments by the National Association of Insurance Commissioners

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

NAIC

120 West 12th Street
Suite 1100
Kansas City, Missouri 64105
816-842-3600

National
Association
of Insurance
Commissioners

August 25, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for the opportunity to review and comment on your draft report Insurance Regulation: Problems in the State Monitoring of Property/Casualty Insurer Solvency. The report clearly reflects a great deal of work on the part of GAO staff and it contains a number of valid observations. At the same time, the report makes several statements which are incorrect or misleading. Our specific comments follow.

Now page 9. See comment 1.

1. Page 12: The report states that, for the period 1981-1987, there were almost twice as many insurer liquidations requiring state guaranty fund assessments than there were for the period 1974-1980. The number of liquidations, however, is very small in relation to the total number of property-casualty insurers operating in the U.S. According to figures published by the National Committee on Insurance Guaranty Funds, there were 11 insolvencies in 1987 requiring guaranty fund assessments out of a total of 3,800 property-casualty companies.

Now pp. 9-10. See comment 2.

2. Pages 12-13: The figures on guaranty fund assessments reported on page 12-13 do not include the funds that may be recovered from the liquidated estate. Normally, a liquidator does not make a distribution to creditors until all claims have been filed and approved and all assets have been marshalled. Consequently, the net cost to the guaranty funds may be less than the figures reported here.

Now pp. 10 and 12. See comment 3.

3. Pages 13-15: The report states that potential exists for still more insurer failures and cites figures from the NAIC's Examiner Team Project as support for that statement. However, two qualifications to these figures should be pointed out. First, changes in the percentage of companies processed through the IRIS system that are designated for regulatory attention can be affected, in part, by the percentage of statements that receive manual review by the Examiner Team. Increased resources and improved procedures have allowed a greater proportion of statements to be manually reviewed which, in turn, has resulted in more companies being designated for regulatory attention. Consequently, an increase in potential insolvencies cannot necessarily be inferred from an increase in the ratio of designated to processed companies.

   Second, the number of companies designated for regulatory attention is not

See comment 4.

a good indicator of the number of potential insolvencies. Only a small proportion of designated companies are either insolvent or in imminent danger of insolvency.

Now page 13.
See comment 5.
See comment 6.

4. Page 19: The report is critical of the time-lag involved with the receipt and review of annual statements. However, it should be pointed out that some time-lag is inherent in any financial reporting system. The issue is what is a reasonable time frame in terms of the need for information and the cost of more frequent reporting. Many insolvencies take more than a year to develop. The report correctly points out that a number of states require quarterly statement as well as other interim reports from financially troubled companies, but implies this reporting is inadequate for initial problem detection. Although the quarterly statement is more limited than the annual statement, it contains the elements essential for early problem detection.

Now pp. 14-15.
See comment 7.

5. Page 21: The report implies that field examinations should be scheduled on a more frequent and regular basis. Many experts believe, however, that the timing of field examinations should be based on need rather than a uniform schedule. This facilitates targeting regulatory resources for maximum effectiveness.

Now page 15.
See comment 8.

6. Page 24: The report asserts that the time-lags involved with financial reporting and field examinations worsened the impact of the Mission and Transit insolvencies. It should be pointed out, however, that the field examinations were needed to establish the statutory grounds to place the companies in receivership. Regulators cannot arbitrarily place a company into receivership without establishing a basis for that action.

Now pp. 16-17.
See comment 9.
See comment 10.

7. Page 25: The report points out that the majority of states do not require the filing of audited annual financial reports. According to an Ernst & Whinney Survey, 11 states have promulgated rules or regulations requiring audited statements (Attachment A). A recent NAIC survey indicates that an additional 8 states have taken some form of administrative action to require audited statements. Most of these regulations apply to both domestic and foreign companies. Even though a particular state may not require it's domestic companies to be audited, those companies may be required to be audited by a foreign state's requirements. The report does not take this fact into account.

Now page 17.
See comment 11.

8. Page 26: The report indicates that the majority of states do not require actuarial certification of reserve adequacy for domestic property-casualty insurers. A list of those states that do require certification of reserves is attached (Attachment B). It also is important to note that even if a state does not require all licensed insurers to file loss reserve opinions, it will likely require certain insurers to file such opinions, particularly if they have a history of inadequate loss reserves.

See comment 12.

In addition, the report cites a 1988 report by the Consumer Insurance Interest Group and the Professional Insurance Agents of America which raised concerns about potential conflicts of interest that are created when state insurance departments hire part-time contract actuaries for field examinations who work for insurers when they are not working for regulators. However, a conflict of interest would only exist if the contract actuary was involved in examining a company for whom he or she had previously worked.

Now pp. 17-18.
See comment 13.

9. Page 28: In discussing state responses on the reliability of different solvency detection activities, the report seems to imply that they have the same objective and should be judged by a similar standard. However, these activities should be evaluated as successive stages of an integrated system rather than competing approaches to solvency detection. The IRIS ratios provide an initial screen of companies in order to target further analysis. The number of companies is reduced in later stages of the process as each company receives more extensive review. Consequently, if the process works correctly, IRIS ratios should be the least reliable indicator and field examinations the most reliable. It would be more appropriate to evaluate the performance of each stage of the process in terms of its specific objective. The report also fails to note that the NAIC Examiner Team and the NAIC Examination Oversight Task Force perform a follow-up review of state regulatory action on "first priority" companies which could result in an examination of a troubled company being called by the NAIC.

Now page 19.
See comment 14.

10. Page 30: The report criticizes the financial regulation standards, recently promulgated by the NAIC, for not being more specific. It also states that it is unclear whether the NAIC intends to impose any sanctions on states that do not comply with the standards. The standards were intentionally done as broad general statements. The specifics will follow as the self-evaluation and the accreditation program are implemented. Sanctions will also result as the program develops.

See comment 15.

11. Page 32: The report comments on the degree of variation between state resources expended for solvency regulation without noting the following factors which would, in part, explain the variation: 1) geographical differences in salary levels and other costs; 2) costs paid directly by the insurer which do not appear as a department expenditure; and 3) the number of insurers doing business in the state.

Now page 20.
See comment 16.

12. Page 34: The report compares the states that received on-site visits by the GAO in terms of the ratio of annual statements they receive to the number of examiners they have. The report uses the term "field examiner" although the analysis appears to be applicable to in-house analysts. More importantly, the comparison does not consider differences in the types or sizes of companies between states. Arizona and Texas, for example, have a substantial number of very small companies which would cause their statement/examiner ratios to be higher.

See comment 17.
Now pp. 21-22.

13. Page 37: The report incorrectly states that the NAIC requires that examiners working on zone examinations be either an Accredited Financial Examiner (AFE) or a Certified Financial Examiner (CFE). An examiner does not have to be certified to simply work on an examination; an examiner representing a zone is required to be at least an AFE and the Examiner-in-Charge must be a CFE. Consequently, the statement that "the majority of state insurance departments have field examiners who would not be considered qualified to work on NAIC zone examinations" is incorrect. Also, it is inevitable that state departments will have a number of examiners in trainina.

See comment 18.

Now page 23.
See comment 19.

14. Page 40: The report incorrectly states that, in the case of an insolvency, the domicillary state is responsible only for paying off policyholders residing in the state. The domicillary state is responsible for liquidating the company and to the extent possible, satisfying the claims of all of the company's policyholders and other creditors. Each state guaranty fund, on the other hand, is responsible only for the claims of policyholders in the state.

Now page 25.
See comment 20.

15. Page 44: The report notes the variation among states in terms of the number of zone examinations that they participate in. It should be pointed out that states' participation is generally determined by the premium volume of the company to be examined in each state. States with greater premium volume will be more likely to participate. Also, beyond a certain point, it becomes counterproductive to have additional examiners participate in a zone examination.

Now page 26.
See comment 21.
See page 24.

16. Page 45: The report also fails to consider that informal action and communication may be as effective or more effective in certain instances than formal action and communication. A Troubled Companies Manual also has been recently released which provides states with guidance on how to handle a company in financial difficulty.

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

Sincerely,

David A. Gates
President

Earl R. Pomeroy
Vice President

Attachments

j:\rwk\letters\gao8-25

The following are GAO's comments on the National Association of Insurance Commissioners' letter dated August 25, 1989.

GAO Comments

1. NAIC said that the number of property/casualty insurer liquidations is very small in relation to the total number of property/casualty insurers operating in the U.S.

This is correct and we have made an addition to our report to reflect this. (See p. 9.)

2. NAIC said that the figures on guaranty fund assessments reported on page 10 do not include the funds that may be recovered from a liquidated estate.

This is true. We stated in our report that following the initial assessment, guaranty funds may recover funds from an insolvent insurer's estate. (See p. 10.)

3. NAIC said that percentages of companies designated by the NAIC for regulatory attention can be affected by the increased proportion of all statements subject to manual review by the Examiner Team.

While it may be true that as more and more statements are subject to review, the total number of companies designated is likely to increase, we see no reason why an increase in the number of companies that the Examiner Team reviews should lead to an increase in the percentage of such companies that the Examiner Team designates for regulatory attention. Consequently, we continue to believe that an increase in the percentage of reviewed companies designated for regulatory attention indicates a greater potential for increased insolvencies.

4. NAIC said that the number of companies designated for regulatory attention is not a good indicator of the number of potential insolvencies because only a small portion of designated companies are either insolvent or in imminent danger of insolvency.

We said in our report that an NAIC designation of a company for regulatory attention does not mean that the company is in NAIC's opinion definitely expected to fail. (See p. 10). However, such a designation, according to information provided us by NAIC, is given because the NAIC Examiner Team believes that if current conditions persist an insurer may become insolvent within 1 to 5 years.

5. NAIC pointed out that a time lag is inherent in any financial reporting system and that many insolvencies take more than a year to develop.

We acknowledge that a time lag will be present under any circumstances. The question is whether the time lag currently existing is acceptable given current conditions. Many insolvencies do develop over a long period of time; however, several insurance experts told us that some insolvencies can develop in a matter of months. Under these circumstances, the time lag inherent in reliance upon annual statements for detection of solvency problems may not be acceptable.

6. NAIC said that we had implied that quarterly reporting is inadequate for initial problem detection and said further that quarterly statements, although more limited than the annual statement, contain the elements essential for early problem detection.

We did not mean to imply that quarterly reporting is necessarily inadequate for initial problem detection. As discussed on page 14 our position is that (1) quarterly statements are less useful for financial analysis than annual statements because they have less supporting data; (2) quarterly reporting cannot help in early problem detection if a state requires it only of companies in which problems have already been detected; and (3) quarterly statements are not put into the IRIS system, thus depriving states of the assistance in problem detection that the system provides for annual statements.

7. NAIC said that our report implied that field examinations should be scheduled on a more frequent and regular basis, and NAIC cited expert opinion to the effect that the timing of field examinations should be based on need rather than a uniform schedule.

While we do not have any recommendation at this time concerning frequency of examination scheduling, we believe that states need to consider whether field examinations should be conducted more frequently than at present. As we note in the report, in states that do not require auditing of financial statements, field examinations are the only means for states to obtain verified data concerning an insurer's financial condition. (See p. 17.) In addition, as NAIC says in its comments, a field examination is necessary before regulators can take formal action concerning an insolvent insurer. (See comment 8.)

8. NAIC pointed out that in the Mission and Transit situations, field examinations were needed to establish the statutory grounds to place the company into receivership.

We do not dispute the legal necessity of completing the field examinations before placing the companies into receivership. However, NAIC's comment does not affect our position that the length of time that elapsed increased the ultimate burden on guaranty funds following liquidation. Also, in the Mission situation, several months elapsed between the time a problem was initially detected and the beginning of the examination.

9. NAIC said that according to a recent survey by Ernst and Whinney, 11 states have promulgated rules and regulations requiring audited financial statements.

The 11 states cited in the Ernst and Whinney survey had responded affirmatively to the 1988 NAIC survey cited in our report. According to information provided by the NAIC, two other states that responded negatively to the survey have since instituted an audited statement requirement, and this is reflected in the report. As our report says, the majority of the states, 37, do not require audited financial statements. Thus, the data presented in chapter 2 is not affected. (See p. 16.)

10. NAIC said that our report did not take into account that even though a particular state may not require its domestic companies to submit audited financial statements, those companies may be required to be audited by another state in which they are licensed.

Any company licensed in a state that requires audited statements will submit audited statements to all states in which it is licensed. However, an insurer licensed in any state that does not require audited statements is not required to present audited statements to other states.

11. NAIC pointed out that if a state does not require all licensed insurers to file loss reserve opinions, it will likely require certain insurers to file such opinions, particularly if they have a history of inadequate loss reserves.

This is true. However, requiring only certain insurers, particularly those that have been identified as having had inadequate loss reserves, to file opinions will not help in detecting problems in companies that are not required to do so.

12. NAIC said that in a situation in which a state hired part-time contract actuaries for field examinations who work for insurers when they are not working for regulators, a conflict of interest would only exist if the contract actuary was involved in examining a company for which he/she previously worked.

We disagree. Even if a company being reviewed by such an actuary is not a past client, it is a potential future client and could affect the actuary's objectivity. Thus, the conflict of interest still exists.

13. NAIC said that different solvency detection activities should be evaluated as successive stages of an integrated system, rather than as competing approaches to solvency, and that when evaluated as such, IRIS ratios would naturally be less reliable than field examinations.

We did not intend in our report to directly compare the reliability of the IRIS system and field examinations. We noted in our report that a significant number of state regulators do not regard IRIS as greatly reliable in detecting potentially insolvent insurers.

14. NAIC said that its Financial Regulation Standards were intentionally done as broad general statements, that specifics will follow as the standards are implemented, and that sanctions will also result as the program develops.

We are pleased that NAIC intends to add specific standards and sanctions at a later time. However, we believe that failure to provide specificity in both standards and sanctions at the time of initial promulgation is likely to mean that those covered by the standards will not be aware of the conditions they must meet and the consequences if they do not do so. Moreover, interested outside parties will be unable to measure compliance.

15. NAIC said that in measuring the degree of variation between state resources expended for solvency regulation, we did not note (1) geographical differences in salary level, (2) costs paid directly by insurance companies, and (3) the number of insurers doing business in a state.

As NAIC points out, insurers do pay the costs of field examinations in some states. Since we did not have sufficient information on the amount of examination costs paid by insurers, we deleted this section of the report.

16. NAIC pointed out that we used the term "field examiner" to refer to persons doing in-house analysis of annual statements and questioned the appropriateness of this usage.

We have changed the term "field examiner" used in this context, to "reviewer" to accommodate NAIC's concern. (See p. 20 and figure 3.1.)

17. NAIC said that in comparing the number of annual statements per analyst in different states, we did not consider differences in the types or sizes of companies between states.

In the course of our fieldwork, we were told by examiners in each of the five states we visited that reviewing an annual statement (as opposed to doing a field examination) took about the same length of time regardless of the size or type of insurer that filed the statement. Thus, the type and size of insurers have no relevance in considering the workload of an annual statement reviewer.

18. NAIC said that, contrary to our statement in the draft report, not all examiners working on an NAIC zone examination were required to be Accredited Financial Examiners or Certified Financial Examiners.

We have made the appropriate changes to that section of the report. (See pp. 21 and 22.)

19. NAIC said that our report stated incorrectly that the home state was responsible only for paying off policyholders residing in the state. NAIC pointed out that the domiciliary state is responsible for satisfying the claims of all the company's policyholders and other creditors.

NAIC is correct. We should have referred to the home state guaranty fund rather than the home state in that context, and we have corrected the error. (See p. 23.)

20. NAIC pointed out that state participation in zone examinations is generally determined by the premium volume in each state of the company to be examined and that beyond a certain point it becomes counterproductive to have additional examiners participate.

We agree with both points. However, we do not believe either factor fully accounts for the fact that from 1984 through 1987, several states participated in hundreds of zone examinations while a number of other states did not participate in any.

21. NAIC said that we failed to consider that in troubled company situations, informal action and communication may be as effective or more effective in certain instances than formal action and communication. NAIC also noted that they have recently issued a Troubled Companies Report to provide guidance to states in handling troubled companies.

In our questionnaire, we asked insurance departments about both formal and informal communications and actions, and our findings on this subject include both formal and informal action. (See p. 24.) The Troubled Companies Handbook that NAIC refers to was adopted after we completed our audit work, and we were not able to review it.

Experts Interviewed for the Review

Charles Alljaria
Massachusetts State Legislature

Peter Arakas
Aetna Life and Casualty

Reginald Berry
D.C. Department of Insurance

Patricia Borowski
Professional Insurance Agents

David Brussard
Safety Insurance Company

Leslie Cheek
Crum and Forster

Charles Davis
Bob Mackin
Conference of Insurance Legislators

Paul Gulko
Guaranty Management Fund Services

Jon Harkavy
Ron Judd
Robert Esenberg
Risk Insurance Management Services

Wade E. Harrell
John J. McCartney
Liberty Mutual Insurance

Scott Harrington
Patricia Danzon
University of Pennsylvania

Charles W. Havens, III
LeBoeuf, Leiby, Lamb, and MacRae

Richard Hsia
New York Department of Insurance

Steve Kellison
Gary Sims
American Academy of Actuaries

Spencer Kimball
University of Chicago

Ilona Klasons
Murray Sherman
Insurance Group Maryland Department of Licensing and Regulation

Stephen Martin
Hartford Insurance Group

Albert J. Milius
Albert J. Milius and Associates

William O'Neill
Alan Levin
Standard and Poor's

Alan Page
Johnson and Higgins

Gregory Reynolds
Virginia Department of Insurance

Phillip Schwartz
American Insurance Association

Robert Solitro
New Hampshire Department of Insurance

Richard Stewart
Barbara Stewart
Stewart Econometrics

John Tinsley
Delaware Department of Insurance

Milton S. Wolke
CIGNA Insurance Group

John Washburn
Karl Koch
Sandra Gilfillan
Carolyn Johnson
Glenda Channel
Jean Olson
Robert Klein
Jim Bugenhagen
Bob Frerking
National Association of Insurance Commissioners

Major Contributors to This Report

General Government Division Washington, D.C.

Lawrence D. Cluff, Assistant Director, Financial Institutions and Markets Issues
Steven J. Berke, Evaluator-in-Charge
Margaret M. Schauer, Social Science Analyst
Lyle H. Lanier, Operations Research Analyst
George Quinn, Computer Programmer/Analyst
Le Alvis Samuel, Secretary/Typist

Boston Regional Office

Alfred R. Vieira, Senior Evaluator
Kenneth C. Forbes, Evaluator
Tanya Cantrell, Evaluator

Glossary

Actuary

One whose business or profession is to calculate insurance reserves and premiums.

Annual Statement

A statement of the year-end financial condition submitted in the following year by an insurer to the insurance regulator in each state in which the insurer is licensed.

Casualty Insurance

Insurance concerned primarily with the insured's legal liability for injuries to others or for damage to other peoples' property; casualty insurance also encompasses such forms of insurance as plate glass, burglary, robbery, and workers' compensation.

Claim

A request to recover under an insurance policy for a loss covered by that policy.

Conservation and Rehabilitation

Proceedings in which an insurer experiencing financial or other problems is placed under court-ordered regulatory control. Generally, the purpose of conservation is to conserve company assets and maintain the status quo pending a final determination of the company's status. In the rehabilitation process, steps are taken to resolve the cause and condition underlying the company's problems so that it can be returned to normal operations.

Field Examination

An on-site examination of an insurance company conducted by one or more state regulators.

Guaranty Fund

An association established by state law to pay certain claims made against an insolvent insurance company.

Insolvency

A state or financial condition in which a company is unable to pay obligations as they fall due in the usual course of business.

Insurance

A system under which individuals, businesses, and other organizations or entities, in exchange for payment of a sum of money (a premium), are guaranteed compensation for losses resulting from certain perils under specified conditions.

Insurance Company

An organization chartered to operate as an insurer.

Insured

A person or an organization covered by an insurance policy, including the "named insured" and any other parties for whom protection is provided under the policy terms.

Liquidation

A formal, court-ordered process in which an insolvent company's assets are converted to cash and applied toward its outstanding debts.

Managing General Agent

An independent business firm that does for one or more separate insurers some or all of the functions usually done by company branch offices.

Policy

A contract of insurance.

Policyholder

A person who pays a premium to an insurance company in exchange for protection provided by an insurance policy.

Premium

The sum paid for an insurance policy. Net premiums written represent premium income retained by insurance companies, directly or through reinsurance, minus payments made for business reinsured. Direct written premiums are the amounts actually paid by policyholders.

Property Insurance

Insurance providing financial protection against loss of, or damage to, real and personal property caused by such perils as fire, theft, windstorm, hail, explosion, riot, aircraft, motor vehicles, vandalism, malicious mischief, riot and civil commotion, and smoke.

Reinsurance

Assumption by one insurance company of all or part of a risk undertaken by another insurance company.

Reserves

Funds set aside by insurers for future claim payments.

Related GAO Products

Property and Casualty Insurance: Thrift Failures Provide Valuable Lessons (GAO/T-AFMD-89-7, Apr. 19, 1989).

Insurer Failures: Property/Casualty Insurer Insolvencies and State Guaranty Funds (GAO/GGD-87-100, Jul. 28, 1987).

Insurance Departments: Trends in Resources and Workloads in Delaware, North Carolina, and Ohio (GAO/OCE-87-2BR, Jan. 9, 1987).

Issues and Needed Improvements In State Regulation of the Property/Casualty Business (PAD-79-72, Oct. 9, 1979).

Requests for copies of GAO reports should be sent to:

U.S. General Accounting Office
Post Office Box 6015
Gaithersburg, Maryland 20877

Telephone 202-275-6241

The first five copies of each report are free. Additional copies are $2.00 each.

There is a 25% discount on orders for 100 or more copies mailed to a single address.

Orders must be prepaid by cash or by check or money order made out to the Superintendent of Documents.