CBO Publication

SUMMARY

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The Economic Impact of a Solvency Crisis in the Insurance Industry

The collapse of several large life insurers and record losses by property and casualty insurers from a string of natural catastrophes in recent years have alarmed policymakers and raised questions about what would happen to the overall economy if a solvency crisis arose in the insurance industry. According to CBO's study *The Economic Impact of a Solvency Crisis in the Insurance Industry*, a solvency crisis by itself could harm the overall economy, particularly in the short run, though the extent of the harm may not be large in many cases.

A solvency crisis in the insurance industry would reduce the supply of insurance, thereby raising the cost of spreading risk in the economy. It would shift the burden of paying for the losses that created the solvency crisis from the insolvent insurance companies to others. It would also interrupt the normal flow of funds through insurance companies and perhaps other financial markets, raising the cost of borrowing for some and lowering the return on saving for others. These impacts could lower output and income both directly and indirectly as they spread throughout the economy.

The magnitudes of the economic impacts are impossible to predict, but they probably would not be very great for the economy as a whole in many cases, although some individuals and businesses could suffer greatly. Unlike the savings and loan crisis, in which the lion's share of the economic cost was the misdirection of capital into economically unproductive projects, a solvency crisis in the insurance industry would not seriously misallocate capital.

CBO's study also reviews policy options for reducing the risks of a solvency crisis in the insurance industry. A number of options involve varying mixtures of state and federal regulation for solvency. Keeping regulation on the state level risks the possibility that the states will not adopt uniform minimum standards for effective solvency regulation. However, adopting a greater federal role in solvency regulation also raises problems. In particular, it could create an implicit contingent liability for federal taxpayers to cover losses to policyholders in the event of a solvency crisis in the industry.

Several options attempt to strengthen the ability of the property and casualty industry to handle losses arising from natural catastrophes, and indirectly affect the risks of a solvency crisis in that industry. Some call for a new federal program to reinsure catastrophe risks assumed by insurers. To the extent that the program would reduce the risk of a solvency crisis, it would do so by shifting many of the risks of catastrophe losses from insurers to the federal government.

Questions about the study should be directed to Kim Kowalewski of CBO's Macroeconomic Analysis Division at (202) 226-2776. The Office of Intergovernmental Relations is CBO's Congressional liaison office and can be reached at 226-2600. For additional copies of the study, please call the Publications Office at 226-2809.

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