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Financial crises at insurance companies: learning from the demise of the National Surety Company during the Great Depression

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This article explores the economic issues related to financial crises at insurance companies, using an example from the Great Depression, the National Surety Company. National Surety was a large and diverse American insurance company that experienced a major crisis in 1933 due to losses from its guarantees of mortgage-backed securities. I find that policyholders were able to stage a massive run on the company by demanding the return of their unearned premiums. A key dynamic of the crisis was that policyholders at an insurance company have a dual role as holders of liabilities and as providers of income. In addition, I establish that government officials believed National Surety to be systemically important, due to the size of its insurance business and because many of its counterparties were societal actors that these officials sought to protect. As a result, the New York State Insurance Commissioner used emergency powers to reorganize the company, with the goal of providing continuity to its business lines outside mortgage-backed security insurance.

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JEL classification: G01, G22, N22, H8

I

The crisis at the insurance company AIG during 2008 shined a spotlight on the role of insurance companies in the economy, and the potential harm that could occur if a large insurance company were to fail in a disorderly manner. The episode raised many questions about how to regulate such companies and resolve one if it were to experience a crisis. With this experience as motivation, the 2010 Dodd–Frank Act empowered the federal government of the United States to regulate systemically important non-bank institutions, including insurance companies. This in turn has further heightened the demand for research on these institutions. Yet, while scholars

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have studied the banking history of the US in great detail, much less has been written about the history of the insurance industry.

This article uses a historical example from the 1930s, the National Surety Company, to explore the economic issues related to systemically important insurance companies. National Surety's experience bears remarkable resemblances in many ways to AIG's 75 years later: both companies operated large and diverse insurance businesses which were generally profitable, but both experienced major crises when their guarantees of mortgage-backed securities (MBS) soured following a decline in the real estate market and revelations of badly underwritten mortgages. Both AIG and National Surety were spared from disorderly resolution by government intervention. National Surety did not have nearly the same role in the 1933 financial crisis as AIG did in 2008, but nevertheless its history presents an opportunity to study the economic issues related to insurance companies in a different, historical context.

The article has three main contributions. First, National Surety's history shows how government officials viewed the insurance company as systemically important. I use the modern concept of systemic importance as a tool for understanding the social and economic dynamics at work. When National Surety became unable to meet its obligations in April 1933, voices in government and finance spared few adjectives in describing the potential adverse consequences of National Surety's failure. Various commentators expressed fears that it would be 'catastrophic', 'tragic', 'calamitous', 'disastrous' and the 'cause of immeasurable suffering'. The key factor was the sheer size of National Surety, with policies written for vast numbers of policyholders. In addition, many of its counterparties were fiduciaries and governments, societal actors which are often given special protection as a matter of public policy. Lastly, its connections to other insurance companies through reinsurance agreements, and its status as the largest surety company in the world, raised fears about its failure's particular effect on the insurance sector.

As a second contribution, the article shows how a liquidity crisis could and did develop at an insurance company. Banks are often a benchmark for thinking about liquidity crises. Though insurance companies are different from banks and do not owe demand deposits, they do have obligations to repay paid-in but unearned premiums when requested by policyholders. Such repayments often come at a penalty or with a delay for the policyholders, but nevertheless they represent a source of potential cash outflows for insurance companies. National Surety's case demonstrates a run developing through this mechanism in practice. In the company's last several weeks, an avalanche of policy cancellations led to a large cash outflow.

The longer-term roots of the crisis at National Surety were grounded largely in one line of its insurance business, the guaranteeing of mortgage-backed securities – one part of a wave of such securitization that took place in the 1920s. When those securities soured in unexpectedly large numbers in the late 1920s and early 1930s, the losses threatened National Surety's capital buffer and devoured its liquidity reserves. During 1932 and 1933, National Surety then faced two additional large shocks to its solvency and its liquidity: the collapse of the corporate bond market, in which National had invested most of its assets, and the banking holiday in March 1933, which interrupted the company's normal flow of funds. The egress of policyholders and the accompanying return of unearned premiums was the final shock.

The third contribution of this article is to highlight a few key dynamics that shape any effort to arrange for the orderly resolution of an insurance company. Of primary importance is the dual position of policyholders as sources of income and as holders of liabilities in the form of unearned premiums. As a result, losing the confidence of those policyholders might not just cause outflows of cash as those policyholders demand the return of unearned premiums, but also reduce cash inflows as they cease paying premiums after having cancelled their policies. Negotiating with policyholders of an insurance company therefore carries an added danger compared to, for example, negotiating with depositors at a bank, as the latter may create a cash outflow if they lose confidence in the bank, but would not directly affect cash inflows. Indeed, the main strategic goal of state regulators and federal officials was to preserve the good will of policyholders and therefore the going concern value of the company for the sake of creditors.

With the goal of preserving National Surety's going concern value, the resolution strategy provides an interesting model for the orderly resolution of an insurance company viewed by regulators as systemically important. Since National Surety could not meet its obligations, the New York insurance commissioner believed its only available choices by law were to liquidate or rehabilitate. The rehabilitation options were limited, as regulators deemed the company too big to reinsure, and fresh capital could not be arranged. Instead, the rehabilitation involved splitting the company in two: liability for existing losses was left in the old company which was liquidated slowly, while liability for future losses was placed in a new company. In addition, the new company bore liability on future losses only for a subset of the old company's business, mainly excluding the MBS guarantees. A last component of the rehabilitation strategy was the clear communication of the plan at the time of the company's takeover, with the goal of preserving the good will of policyholders of the new company. All of this contrasted with the less successful rehabilitation of the Globe and Rutgers Fire Insurance Company, which had been taken over by insurance regulators a month prior. The Globe and Rutgers case serves as an interesting contrast by demonstrating the pitfalls of attempting to negotiate with an insurance company's policyholders, delaying communication and not preserving the firm's going concern value.

II

National Surety had a large and diverse business that primarily centered on surety, fidelity and credit insurance. National Surety was active in virtually every corner of these types of insurance, especially fidelity and surety. Fidelity bonds in general guarantee the actions of an individual, whereas surety bonds guarantee the performance of some undertaking. The two naturally overlap and many contracts involve elements of

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both. For example, National underwrote a construction bond that guaranteed the performance of the companies that constructed the Hoover Dam in 1931. This is a form of surety known as contract surety, i.e. guarantees of the fulfillment of contracts. It also wrote depository bonds to guarantee the deposits of municipal governments; public official bonds to guarantee the actions of those officials while in office; fidelity bonds to guarantee the actions of administrators, executors, guardians and other fiduciaries; blanket and schedule bonds to cover financial institutions and public entities against criminal acts by their employees; judicial bonds to cover parties involved in court proceedings; and more. It also conducted large amounts of insurance for plate glass, burglary, forgery, fraud, crime and merchant's protection. Altogether, the policyholders were a diverse mix of individuals, small and large financial and non-financial businesses, and municipalities.[1]

National Surety experienced a severe crisis in March and April 1933. Ultimately, once the New York State insurance department determined that the company could not meet its obligations as they came due, the department seized the institution on 30 April. The crisis resulted from the combination of four shocks: a longer-term outflow of cash to pay out losses on MBS insurance contracts; the illiquidity of many investments due to the state of the bond market; the bank holiday; and finally a loss of confidence culminating in a run on the firm by policyholders seeking return of unearned premiums. This section discusses each of these shocks in turn.

During the Depression, National Surety's troubles were created more than anything else by its business of guaranteeing of mortgage-backed securities (MBS), a form of credit insurance. Among the company's various lines of business, this was a relatively young one, having been initiated only in 1923, after the New York State Attorney General issued an opinion in late 1922 that surety companies possessed the power under existing law to guarantee MBS.[2] National Surety's business of guaranteeing MBS boomed from 1923 to 1928. It was part of and interacted with a surge in the demand for mortgage credit, a wave of MBS issuance (one of several such waves in US history), and the national construction boom, all of which occurred in the mid 1920s.[3] National Surety's role as guarantor appears to have reduced the perceived credit risk on these MBS, both directly through the guarantee and indirectly through the information monitoring that investors believed National Surety to have conducted. For example, the advertisement reprinted in Figure 1 shows the

[1] National Surety Papers (henceforth NSP) has descriptions of National Surety's business lines throughout. See also Reconstruction Finance Corporation Papers (henceforth RFC), Loan Application no. 1 of the National Surety Company, p. 4; *Best's Insurance Reports: Casualty and Miscellaneous*, editions from the 1920s up to 1932; and Nichols (1933). Ackerman (1928) gives a general guide to the surety business at the time.

[2] NSP, 'Preliminary report of investigation into the affairs of National Surety Company', folder 29. For contemporary descriptions of the surety company's MBS guarantees, see McKenna (1927), Halliburton (1939), and Kniskern (1926). Kniskern was the vice president in charge of this business at National Surety.

[3] Snowden (2010).

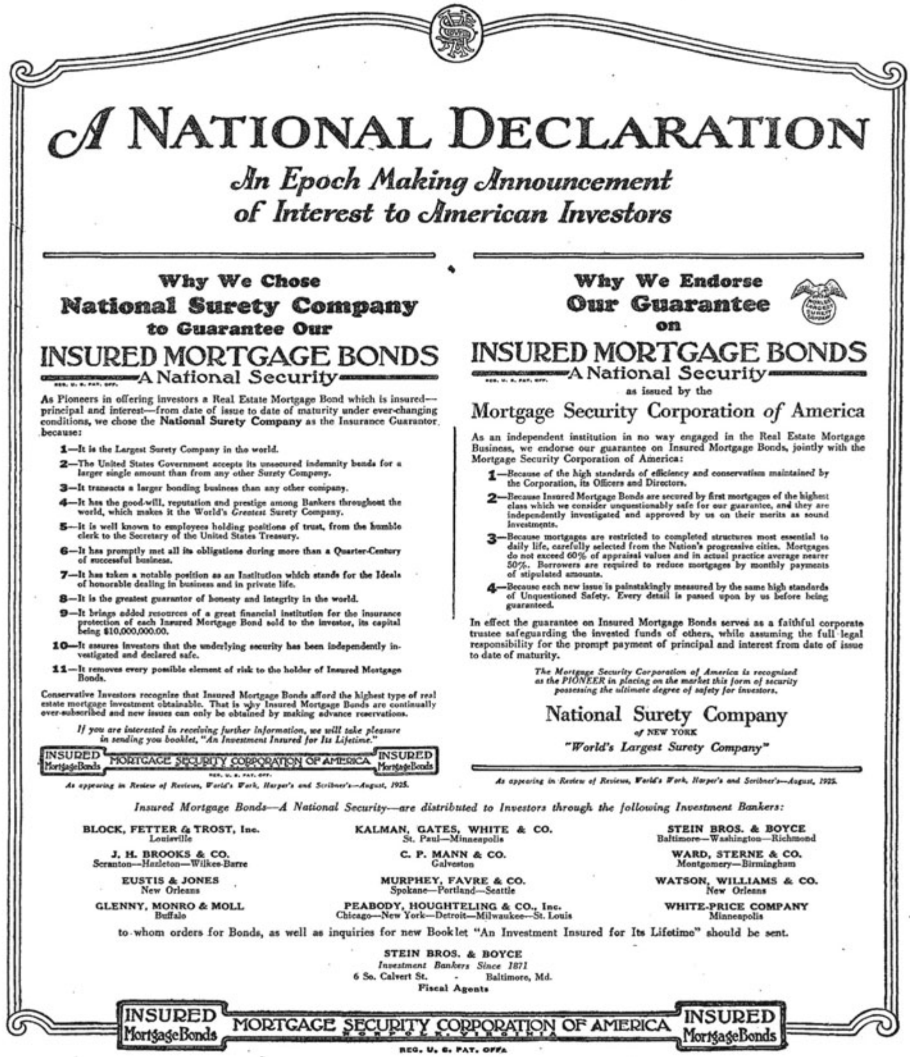

Figure 1. *Advertisement for MBS guaranteed by National Surety*
Source: New York Times, 15 July 1925, p. 10.

way in which National Surety's endorsement was used to sell MBS. These advertisements were geared toward retail investors, who were the largest buyers of these securities. Savings banks and other financial institutions also purchased the securities.

In October 1928, National Surety ceased writing guarantees on MBS. The decision reflected mounting problems arising in this line of business. Delinquencies on the underlying mortgages first became meaningful in 1925, and subsequently increased, in line with national trends. By the late 1920s, several of the mortgage companies with which it dealt were experiencing financial difficulties.

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Ex post, it is clear that this line of business suffered from severe underwriting and informational asymmetry problems. The main issues were the quality of the underlying mortgages, and the financial condition of the mortgage companies. National Surety made efforts to evaluate the mortgages and required a maximum 60 percent loan-to-value ratio, but many of the mortgages were evidently poorly conceived, and the mortgage companies that originated them clearly had an incentive to push through as large a volume as they could. National Surety also did not seek much control over the total leverage or risk taking of the mortgage companies whose bonds it guaranteed, even though such factors would affect the risk taken by National Surety in guaranteeing their bonds. The mortgage companies depended heavily on the ability to finance their mortgages by issuing bonds, and once that bond market dried up, they ceased funding new mortgages. After the first losses appeared, these companies went bankrupt *en masse* quite quickly, as their capital positions had never been very large.

In terms of the magnitude of the business, National Surety in total guaranteed 80 different MBS series issued by about 30 mortgage companies. The MBS contained about 11,000 mortgages, typically single-family properties with some mixed use properties as well, and a small number of apartment and other small commercial buildings. The properties were dispersed across 38 states, largely reflecting the geographic locations of the different mortgage companies that issued the MBS. By 1933 when National Surety was taken over, there were more than 20,000 investors holding MBS bearing the company's guarantee, reportedly somewhat below the peak from the late 1920s. Total guarantees peaked at about $73 million in December 1928, representing about 0.4 percent of all residential and commercial mortgage loans in the country. Ultimately, the business was a relatively small portion of National Surety's total business, equaling about 2.5 percent of the company's total notional value of all guarantees. Yet, it presented severe liquidity challenges.[4]

From November 1928 to March 1932, National Surety had a net cash outflow of about $6.3 million due to this mortgage business.[5] A year later in April 1933, the net cash outflow totaled $15 million.[6] In return, the company acquired the real estate collateral underlying the foreclosed loans, which the company was reluctant to liquidate quickly given the state of the housing market. By the end of April 1933, though, National had run out of cash and was simply unable to meet its obligations.[7] To

[4] NSP, folder 29, 'Preliminary report of investigation into the affairs of National Surety Company', p. 44, gives the figures on total guarantees. NSP, folder 65, 'Report of James A. Martin, Esq., Upon the Fairness and Propriety of Reorganization Expenses Passed Upon and Determined by the Reorganization Managers and all matters pertinent thereto', pp. 5–7, gives the number of MBS, states with mortgaged properties, and the number of investors. Data on the total value of real estate loans in the country are from Fisher (1951), p. 64.

[5] See RFC Papers.

[6] 'Reorganization plan', *National Underwriter*, 4 May 1933, p. 21.

[7] NSP, folder 1, Deposition of Herbert C. Clark, an examiner in the New York State Insurance Department.

put these numbers in context, we must have a sense of National Surety's buffer in the form of loss reserves and capital. This turns out to be a difficult, because National Surety – like many companies in the 1920s –owned and loaned money to a web of subsidiaries, whose net value to National Surety must be known in order to calculate the true capital position. Nevertheless, the overall size of the company's balance sheet was about $48 million in 1928 before losses began to accumulate and before most of the subsidiaries were created. At that time, the capital and surplus were listed on the books as totaling $27 million together. By year-end 1932, capital and surplus had been reduced to $9 million. The capital buffer was evidently not large enough to absorb short-run losses of this size. To the outrage of investors once the financial plight of the company became public, National Surety had continued to pay 10 percent dividends ($1.5 million per year) up to 1930 and did not eliminate dividends entirely until 1932.

To meet the demands for cash, National Surety borrowed money from a group of three New York banks starting in mid 1930.[8] Eventually, on 1 April 1932, the loans came due and the three banks demanded repayment. National Surety turned to the Reconstruction Finance Corporation (RFC). National borrowed repeatedly from the RFC, as shown in Table 1, and the last advance came on 18 January 1933. With that advance, the credit line that National had negotiated with the RFC was maxed out at about $12 million. By February, the RFC's advances to National Surety were past due.[9] Without any additional sources of new cash, National was unable to pay out obligations that came due, and the New York State Insurance Commissioner seized it at the end of April. At the time, the RFC did not yet have the authority to make preferred stock investments.

The second factor contributing to National Surety's crisis was the collapse in the value of corporate bonds that began in late 1931 and continued through the first part of 1933. Such bonds accounted for about half of its assets. With its bond portfolio having fallen in value by about one-third, National Surety was reluctant to meet cash needs by liquidating securities, which would involve realizing losses. This fall in bond value was one of the rationales for borrowing from the RFC, in order to avoid liquidating bonds at values many expected or hoped would not persist. The RFC's evaluation of National Surety's loan application commented that the company's capital position would be reduced by about $10 million if the bonds were marked to market. Of course, this impairment of bond values affected a wide variety of financial institutions in this period.

The bank holiday that took place in mid March 1933 delivered a third shock to National Surety's cash flow position. In New York, the holiday began on Saturday, 4 March. State and federal government officials allowed the first reopenings on Monday, 13 March. National Surety's own bank deposits were inaccessible during

[8] NSP, folder 29, Preliminary report, p. 62.
[9] NSP, folder 1, deposition of Stewart S. Hathaway, p. 2.

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Table 1. *RFC loans to National Surety*

Date of loan draw	Size of draw (dollars)
Loan 1	
2 May 1932	722,000
19 May 1932	28,000
1 June 1932	500,000
6 June 1932	712,676
17 August 1932	11,325
Loan 1 total	1,974,001
Loan 2	
30 June 1932	8,291,000
21 July 1932	589,000
10 November 1932	100,000
12 November 1932	400,000
6 December 1932	500,000
18 January 1933	400,000
Loan 2 total	10,280,000
Grand total	12,254,001
Amount repaid	253,301
Net amount due (30 April 1933)	12,000,700

Source: National Surety Papers, folder 1, Deposition of Stewart S. Hathaway, p. 2.

the holiday. Likewise, the deposits of National Surety's counterparties were also tied up. As a result, while National's policyholders continued to file claims, the policyholders could not make premium payments. The New York Insurance Commission directed insurance companies to halt claim payments until the end of the holiday, putting the casualty and surety businesses in a state of 'paralysis'. Thus, National Surety emerged from the holiday with a liquidity deficit. This effect should have faded over time, but company officials and the insurance commissioner still cited it as a source of the liquidity problems that led to the company's seizure in April.[10]

After the holiday, a portion of National Surety's funds remained inaccessible because they were deposited in banks that were not licensed to reopen. At the end of April, National Surety still had $1.18 million out of reach in suspended banks.

Finally, bank closures also led to an additional shock to National Surety's capital position because of its guarantees of bank deposits. As it became clear that not all banks would reopen, National Surety began to receive sizable claims on its deposit

[10] 'Bank closing practically paralyzed casualty-surety business; no cash to meet claims', *Weekly Underwriter*, 11 March 1933, p. 515.

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guarantees. These losses appear to have totaled at least $1.9 million, including $1.1 million tied to banks Pennsylvania and the rest to banks in the Midwest.[11]

As shown in Figure 2, by the winter of 1933, National Surety's stock price had fallen to around 5 dollars per share, down from a high of over 150 dollars per share, established in early 1928 just as National Surety was pulling away from the mortgage business. Clearly the market had learned of National Surety's business troubles long before the run that commenced in March 1933. Of course, other stock prices in general also fell by large amounts in the same period, as shown by the Dow Jones index, but National's decline started earlier.

By April 1933 it appears that National Surety had widely lost the confidence of its policyholders and other counterparties. The loss of confidence led to an 'avalanche of cancellations' during April by its existing policyholders. These cancellations created a large cash outflow problem for the company, as National owed its policyholders the return of unearned premiums – the portion of premium payments that cover future time periods. In other words, insurance policyholders pay for insurance in advance. When a policyholder makes an initial premium payment, the entire payment is unearned, and becomes earned as time goes on or as key events happen as stipulated in the contract. These unearned premiums constituted a runnable liability for National Surety. At the same time, cash inflows fell off sharply as policyholders withheld payments to renew their policies or enter into new ones.[12]

In court filings, the New York Superintendent of Insurance asked the judge to think of demands for the return of unearned premiums as being equivalent to a bank run. That analogy was adopted by the trial court and ultimately the appellate court as well. The key similarity is that unearned premiums represent demand obligations, and therefore are subject to a run in the same manner as bank deposits. Just like a bank would have difficulty redeeming deposits *en masse* if requested with little notice, an insurance company would likewise have difficulty in returning all unearned premiums if demanded all at once.

Surety companies in this period generally appear to have allowed for cancellation of contracts upon notice, i.e. at any time. Several guides to the surety business published during the 1920s and 1930s, including one written by the general counsel of National Surety (Nichols 1933), describe fidelity and surety bonds as cancellable on demand. In

[11] NSP, folder 1, exhibit A, pp. 10–11. Further details are available from RFC, report dated 22 April 1932, p. 2, which states that National Surety owed about $1.1 million to the state of Pennsylvania on depository bonds covering more than one bank in that state. 'Reorganization plan', *National Underwriter*, 4 May 1933, p. 21, notes the key impact of the losses in Pennsylvania. NSP shows additional losses on a few more banks located in the Midwest. Also see NSP, exhibit A, folder 1, p. 11, which states that National Surety held $650,000 of its own cash in closed banks, and $1,250,000 in restricted or limited withdrawal banks.

[12] NSP, folder 1, exhibit A, describes the loss of confidence of counterparties. The avalanche quote is from 'Big Bill's column', *Eastern Underwriter*, 5 May 1933, p. 17. Widespread cancellations were noted in 'Reorganization Plan', *National Underwriter*, 4 May 1933, p. 21.

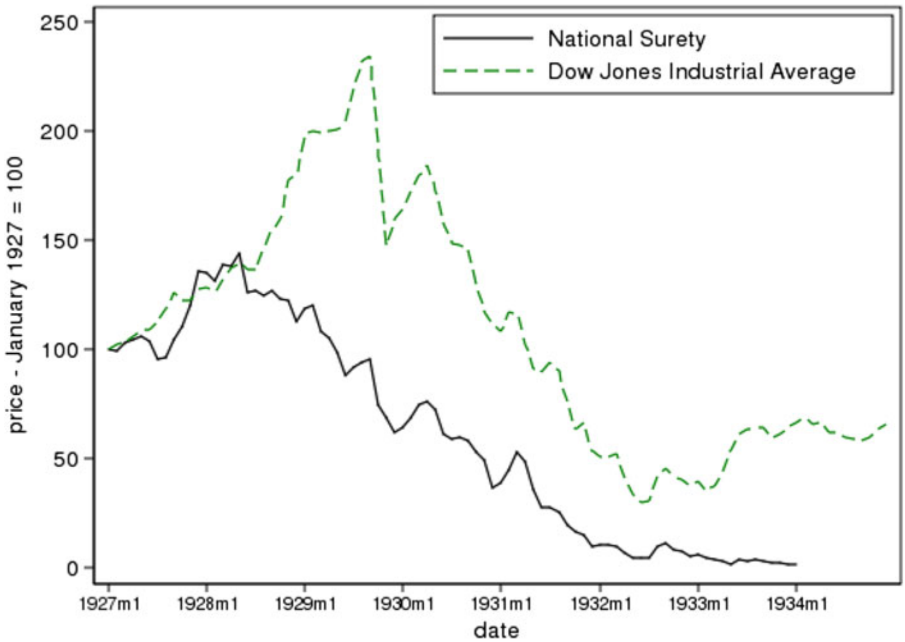

Figure 2. *National Surety Stock Price*
Notes: Prices are indexed to 100 in January 1927. Monthly values are computed using the average of the high and low closing prices in each month. National Surety stock prices are taken from CRSP, adjusted for a split in 1928. The Dow Jones index data are taken from the NBER Macro History Database, series 11009B.

a few instances they describe 30-day delays as being included in certain contracts, but typically the delay applied to the surety company rather than the policyholder.

The only real source of friction preventing cancellation seems to have been the legal inability of policyholders to cancel without first arranging for substitute bonds from a different company. For example, about 2 percent of National Surety's business (measured by aggregate bond amounts) was in judicial bonds, which must remain in force for the life of the judicial proceedings unless replaced by another bond. Another 12 percent of National Surety's business was for fiduciaries, which cannot cancel their bonds while still in their positions unless they can find a replacement. Indeed, National Surety suggested to the court at the time of its takeover that not all of the policy cancellation requests it had received were valid, though I have not found data to quantify the extent of validity.[13]

Once cancelled, the next questions are how quickly National Surety would have been required to return the unearned premium, and how large the unearned

[13] Mackall (1929) discusses the ability of policyholders to cancel different types of surety bonds. See also NSP papers, exhibit A, p. 11.

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premiums were. On the first question the texts on the surety business provide little information. The answer most likely lies in corporate billing and payment practices. Regardless, National Surety officials described the cancellations they received as calling for 'the immediate return of substantial sums by way of unearned premiums'. This language suggests that the unearned premium was due immediately upon cancellation.[14]

The magnitude of the unearned premiums and cancellations appear to have been quite large. At the time of its takeover, the company listed $2.25 million in liabilities for bonds or policies where notice of cancellation had been given. This is roughly one quarter the size of total unearned premiums as of 31 December 1932, suggesting the same percentage of policyholders (by dollar volume) had cancelled their policies. This is inexact because the size of unearned premiums may vary over the course of a year depending on when policyholders enter into contracts. If, for example, all policyholders enter their contract in December, the unearned premium would be large at year-end and then decline for the rest of the year.

Surety companies in general appear to have carried large amounts of unearned premiums relative to the premiums written each year. In 1932, National Surety wrote $13.3 million in premiums and had $8.6 million in unearned premiums at year-end. This ratio of about 65 percent holds throughout available data from 1923 to 1932. Most surety and fidelity contracts required annual premiums at fixed rates, particularly since many contracts provided guarantees with no fixed terms. Fidelity guarantees, for example, typically remained in force indefinitely until cancelled by the policyholders, who pay annual premiums to keep the guarantees in force. Many surety bonds required annual renewal, at rates established in the contracts. Likewise, blanket bonds, depository bonds, public official bonds, and judicial bonds also were indefinite in term. For some policies of this sort, insurers issued certificates of continuation annually. Some bonds did carry fix terms, for example if they covered a contract with a definite length. In such cases the amount of unearned premium and presence of annual premiums depended on the length of the contract.[15]

Contemporaries widely attributed the run on National Surety to rumors that spread about the company's impending collapse. The chairman of National Surety, William Joyce, complained bitterly that 'unfounded rumors' regarding his company's condition, and which led to the cancellations, were tantamount to 'financial treason'.[16] Certainly, the company's troubles were well known by 1932, especially with the reduction in its published capital position in that year, and the cessation of dividends.

[14] See Crobaugh and Redding (1929), p. 482; Ackerman (1928), p. 15; Pettit and Caruthers (1925); Arnold (1927), p. 511; Nichols (1933); Spectator (1907), p. 17.

[15] See Ackerman (1928), p. 422; Mackall (1929), pp. 9, 123, 194–5, 240–51; Joyce (1906); Lunt (1922), pp. 17, 257; Pettit and Caruthers (1925), p. 2; United States Fidelity and Guaranty Company (1920), pp. 32, 55.

[16] NSP, folder 1, deposition of William B. Joyce; 'Stock prices mainly steady but rails dip', *Brooklyn Daily Eagle*, 1 April 1933, p. 20.

The decline in its stock price is suggestive of this. An insurance periodical, the *Spectator*, noted that losses on MBS guarantees had hit National Surety and its peers 'heavily', and described how National Surety had been forced to set up a subsidiary to administer and sequester this business. The rumors appear to have changed in character, though, in late March 1933. A scanning of the financial press at the time suggests that the rumors that the company would fail became widespread around the very end of March.[17] The timing of the rumors at the very end of March suggests a link to the failure of another insurance company, the Globe and Rutgers, which failed on 24 March.

Though National Surety had no direct link to Globe and Rutgers and the two companies had no investments in common, they were linked in investors' minds because of common misadventures in mortgage securitization. Globe and Rutgers, a fire insurance company, failed largely because of losses on an equity stake it had taken in an MBS issuer.[18] In fact, these were the two largest insurance companies in New York to be taken over by the state during the Depression, and both owed their collapses to mistakes in the mortgage field.

National Surety was not the only company to face a run by its policyholders in these years. Globe and Rutgers also experienced a run in which 'hundreds of assureds cancelled their policies and asked for the return of the unearned premiums'.[19] Elsewhere in the insurance field, while large life insurance companies survived the Depression with very few failures, liquidity pressures created significant problems at times, especially during the bank holiday when policyholders requested loans against their policies or sought to surrender their policies for their cash value. In response, the New York state insurance commissioner used emergency powers to ban such loans and surrenderings on life insurance policies. That ban was kept in for several months, into September 1933. The insurance commissioner never placed similar protections for other types of insurance companies, which is why policyholders were able to stage a run on National Surety and Globe and Rutgers.[20]

III

In the 1930s, the phrases 'too big to fail' and 'systemically important' had not yet been coined. Nevertheless, those writing about National Surety in 1933 clearly expressed fears about the wide-reaching damage that would result from the potential disorderly liquidation of the company, what would today be called systemic consequences. For example, in the insurance industry press, leading weekly insurance magazines issued strong statements describing potential systemic consequences. In an editorial, the

[17] 'National Surety reports', *New York Times*, 31 March 1933, p. 30; 'Abreast of the market', *Wall Street Journal*, 27 March 1933, p. 2; and *Milwaukee Journal*, 28 March 1933, p. 8.
[18] 'Big Bill's column', *Eastern Underwriter*, 31 March 1933, p. 19.
[19] 'Insurance lines becoming normal', *New York Times*, 3 April 1933.
[20] 'Insurance concerns tighten loan rules', *New York Times*, 9 March 1933, p. 6.

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National Underwriter wrote of the 'tragic consequences that inevitably would follow the complete failure of an institution of the prominence of the National Surety'.[21] The *Eastern Underwriter*'s editorial stated 'It would have been a calamity if the National Surety Co., with all of its good will in the world of finance, business and industry, had disappeared.'[22] In the political sphere, Jesse Jones, the head of the RFC, wrote in his memoir that 'somber tragedies were averted' by the successful rehabilitation program, in which the RFC participated.[23] Similarly, the deputy of the insurance commissioner, who was in charge of the National Surety case, stated in a deposition that 'if a situation were created calling for the cancellation and termination of these policies, the business, commercial, industrial, financial and judicial interest of the country would have suffered immeasurably… [The superintendent] felt it incumbent upon him as a matter of public policy to do all that he could to prevent such a catastrophe from arising … The attendant disturbances [would] be material and disastrous.'[24]

This section considers the mechanisms underlying these alarming statements, examining the different ways that National Surety was connected to the rest of the economy.

One source of National Surety's systemic importance was its sheer size.[25] Indeed, National Surety was widely described as the largest surety company in the world, including when it described itself in its advertisements. The insurance commissioner of New York, in justifying his act to rehabilitate National Surety to the court, warned that National was connected to a large and varied number of counterparties:

> So huge in amount and so varied in character are the bonds and policies of this company that unless a sound and practicable plan of reorganization is effected the consequences will constitute a nationwide calamity, vitally affecting banks, insurance companies, and the entire industrial and commercial life of the country…
>
> The general effect upon the life and business of the country by such a disaster will be appreciated by those outside as well as inside the business of bonding and insurance. With the multitude of business and financial transactions which are based primarily upon the soundness of the Company issuing the bond or policy, the results are unfortunately so tragic and far reaching that further comment or analysis is unnecessary.[26]

Quantitatively, there is more than one way to measure the size of an insurance company. A typical yardstick is premium activity, as it is a direct indicator of the volume of business being conducted, and because such data are generally readily

[21] 'Reorganization plan', *National Underwriter*, 4 May 1933, p. 21.

[22] See 'Editorial', *Eastern Underwriter*, 5 May 1933, p. 16. The *National Underwriter* and the *Eastern Underwriter* were two of the leading insurance newspapers at the time, along with *Insurance Field, Spectator* and *Weekly Underwriter*.

[23] Jones (1951), p. 153.

[24] NSP, folder 1, Deposition of Samuel R. Feller, pp. 2 and 8.

[25] This section draws heavily from NSP, folder 1, exhibit A, pp. 4–6.

[26] NSP, folder 1, exhibit A, p. 4.

available. Data on premiums do depict National Surety as the largest surety company in the United States during the 1920s and early 1930s. In 1932, for example, the company accounted for about 15 percent of the volume of surety business as measured by premiums written, for example. That said, the surety sector appears to have been fairly concentrated among five companies: National Surety; another New York company, American Surety; and three Maryland-based companies, Fidelity and Deposit, Maryland Casualty, and United States Fidelity & Guaranty. Together, these five companies accounted for more than 50 percent of all surety premiums written nationally. As shown in Table 2, two of those companies did much more non-surety business than National Surety, as measured by premiums, primarily in the fields of automobile liability and workers' compensation.

Another yardstick might be the total dollar size of contingent liabilities, which court filings reveal totaled roughly $3 billion at National Surety at the time of its failure. As one measure of scale, this equaled about 5½ percent of GDP at the time. Though GDP was quite low in 1933, the business volume across the surety industry had fallen significantly as well, so on net it is not clear if this figure is higher because of the contraction in GDP.[27] Unfortunately, such data are not readily available for other insurance companies in that era for purposes of comparison. An insurance company's size could also be measured by its geographic reach. Here, National Surety appears to have been particularly national in scope. While many other surety companies were more regional in focus, the insurance commissioner stated that 'The National Surety had outstanding bonds … affecting money, interests, and responsibilities in practically every city and town in the country.'[28] It also had operations in several foreign countries, with the largest volumes in France and Germany.

Along with National's size, the identities of its particular counterparties were also a source of concern, along with the sheer number of those counterparties. Federal, state, and local governments were counterparties on about one-third of National Surety's contingent liabilities (roughly equally split between federal and state/local). These entities took out contract surety bonds on a variety of contractors, such as construction companies on infrastructure projects, as well as a wide array of commercial surety bonds on government officials, such as postmasters, who were required to follow certain laws as part of their jobs. National Surety also provided deposit insurance to governmental entities with funds in commercial banks, as such governmental deposits are usually required to carry some form of security. In some cases, banks post collateral against such deposits. In others, banks took out bonds, issued by companies like National Surety, as an alternative form of security for the deposits. These bonds were estimated to total $40 million, $15 million of which covered deposits at New York banks. The cancellation of those bonds would have required the banks to repay the deposits if they could not post collateral or arrange for new surety

[27] 'Troubles two-time casualty business', *Insurance Field*, 5 January 1933, p. 15.
[28] NSP, folder 1, Fuller deposition, p. 3.

Table 2. *Premiums written during 1932 by the insurance companies with the largest surety, fidelity and credit businesses*

Company	Premiums: Surety, fidelity, and credit	Workers comp.	Auto	Other	Total	Note: total assets
National Surety	10.7	0.0	0.0	2.7	13.4	41.1
American Surety	6.8	0.2	0.9	1.0	8.9	24.8
Maryland Casualty	3.7	5.4	8.0	6.6	23.7	40.6
Fidelity & Deposit	9.0	0.4	0.0	0.8	10.2	24.1
United States Fidelity & Guaranty	8.2	5.8	9.0	7.4	30.4	56.7

Note: Figures are in millions of dollars.
Source: New York Insurance Commissioner, *Annual Report for the Year Ended December 31, 1932,* part III, p. xl.

bonds, both of which would have been difficult given the depressed state of the bond market in 1933 and, again, the weakness among other surety companies.

Outside government, a large portion of National Surety's other counterparties on commercial surety policies were administrators, executors, guardians and other fiduciaries. Traditionally, such actors have been afforded special protections by the government, while at the same time being subject to fairly strict regulation. For example, over 70,000 fiduciaries had bonds issued by National Surety, with total contingent liability of about \$350 million. About 17,000 people took out judicial bonds totaling \$56 million. Such counterparties were required by law to obtain insurance or bonding policies covering their activities, and therefore would be forced to find new policies if National had failed. Such a search would most likely have been acutely difficult in the financial environment of the spring of 1933.

A third channel of systemic importance was through reinsurance contracts. State insurance department and RFC officials feared that National Surety's failure could drag down its reinsurance counterparties, concluding this type of contagion was 'extremely dangerous'.[29] Likewise, the insurance press noted relief among officials at other insurance companies that there would be little contagion through reinsurance contracts: 'Relief is expressed that reorganization of the National Surety will not cause serious injury to other companies under reinsurance agreements.'[30] The reinsurance contracts were provided both from and to National Surety: 10 other surety and casualty companies ceded approximately \$64 million in reinsurance to it, and in turn

[29] NSP, exhibit A, part E, p. 6.
[30] 'Reorganization plan', *National Underwriter*, 4 May 1933, p. 21.

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National Surety ceded approximately $70 million in reinsurance with the same companies. These companies would have been liable to National Surety's customers if National had been liquidated. In addition, if National Surety's reinsurance to them were voided, they might have been forced to raise capital or find new reinsurance partners. The reinsurance provided by National Surety to others appears to have covered workmen's compensation insurance in particular, a line of insurance that the company itself did not write directly. This line of insurance was performing very poorly in the early 1930s and delivering large losses to other insurance companies. As a result, there was a potential for sizable losses for those companies and difficulty in finding new reinsurance partners if National had failed.

Finally, state insurance department and RFC officials also feared an indirect effect on the surety business as a whole. Given National's position at the top of the surety business, they thought its failure might have undermined the confidence of other surety companies' counterparties. Court documents suggest that this is one reason the RFC agreed to the rehabilitation plan. For example, the RFC stated that it decided to go along with the New York insurance commissioner's plan because 'such action would prove of benefit not only to the National Surety Co. and its creditors but also to the surety bond business as a whole'.[31] An insurance magazine declared that 'It would have hurt the prestige of American suretyship world-wide because the National's operation extended over a wide territory, including several European countries.'[32]

New York State insurance officials justified their intervention by arguing that a disorderly liquidation of National Surety would have had systemic consequences. Based on the evidence just presented, it is difficult to judge how widespread the harm would have been if National Surety had counterfactually failed. One problem is that government supervisors can often be captured by the institutions they are charged with supervising. National Surety officials naturally supported the argument that it was systemically important, as they had a strong incentive to preserve their jobs and the value of their stock in the company. Other, potentially more neutral, parties appeared to agree as well, though. National Surety had no other supervisors besides the New York insurance department, but RFC officials were involved by virtue of a large outstanding loan. RFC officials may have been less captured than insurance officials since they had been interacting with the company for less than two years at this point. They also might have had an incentive to object to this line of reasoning since the reorganization would probably have increased the riskiness of the collateral behind the RFC's loan to the company, as the reorganization substituted stock in the new company for marketable debt securities. Had the new company failed, the RFC could have taken a large loss. (I describe the reorganization in detail in the next section.) Nevertheless, RFC officials supported the plan, specifically citing the benefits not just to National Surety but also to 'the surety bond business as a

[31] NSP, folder 1, deposition of Stewart S. Hathaway, p. 4.
[32] 'Editorial', *Eastern Underwriter*, 5 May 1933, p. 15.

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whole'.[33] The insurance industry press expressed similar sentiments. Finally, while some of National Surety's creditors appealed the reorganization plan, they did not do so on the grounds that National Surety's failure would not have been disruptive, but rather that the Commissioner did not have the legal powers to conduct the reorganization as he did, and that they as creditors perceived themselves as being worse off after the reorganization.

Another problem with the Insurance Commissioner's arguments relates to the matter of whether business could have been easily transferred from National Surety to other insurance companies. If such transfers were frictionless, i.e. speedy and costless, then National Surety's failure might not have greatly affected its policyholders, as long as they had no outstanding claims. However, officials in the New York insurance department saw obstacles to such transfers of business. Issuing an insurance policy requires a certain amount of underwriting and accounting work. That work, along with other factors, could lead to long delays, during which 'the business, commercial, industrial, financial, and judicial interests of the country would have suffered immeasurably'.[34] Nevertheless, these frictions are a bit at odds with efforts the insurance department made to prevent other companies from raiding business immediately after National Surety was placed in rehabilitation, mostly in the form of moral suasion.[35] Potentially, there could have been some heterogeneity in the ability of different types of policyholders to switch their business to other companies. Such heterogeneity could have meant that competitors might have been able to steal the most easily switched policies but other policyholders would have been left without much ability to find new insurance coverage, at least quickly. Overall, though, the transferability argument may be somewhat weaker than officials stated.

At the very least, it is clear that the New York State legislature granted the Insurance Commissioner emergency powers for rehabilitation specifically because it feared the very sort of fallout that appeared imminent to insurance officials when National Surety experienced its crisis. Indeed, the *Yale Law Review* (1934) described the purpose of that legislation in this way: 'The broad scope of the powers conferred on the Superintendent indicate that this act leaves him free to adopt any reasonable course of action that seems appropriate to attain the desired end of financial stability' (p. 1148). The Superintendent of Insurance made the same observation to the trial court.[36]

IV

This section describes how National Surety was reorganized, with an emphasis on the economic principles that guided the state insurance department and RFC in designing the reorganization.

33 NSP, folder 1, deposition of Stewart S. Hathaway, p. 4.
34 NSP, folder 1, deposition of Samuel R. Feller, p. 3.
35 This is discussed in all the major insurance periodicals following National Surety's takeover.
36 NSP, folder 1, deposition of Samuel R. Feller, p. 8.

The reorganization involved splitting the old National Surety Company in two parts: a new company and a liquidating corporation. In the new company regulators placed a subset of the old company's business lines that were expected to be profitable. Mainly, this excluded mortgage guarantees and depository bonds on closed banks, which were responsible for the great bulk of the old company's losses. The new company's liabilities were limited to future losses, and only on the business lines it assumed. In other words, the new company assumed no responsibility for any claims that had already been filed, either for losses or for unearned premiums. The name for this new company was National Surety *Corporation* – a deliberate piece of wordsmithing meant to invoke continuity with the old National Surety *Company*.

The second company created by the reorganization was a liquidating corporation. This corporation was responsible for the existing claims on the old company. Such claims included the repayment of unearned premiums from cancelled policyholders, and loss claims on insurance policies that had already been filed prior to the reorganization. This liquidating corporation was also responsible for all future claims on the lines of business not taken over by the new company, i.e. mainly mortgage guarantees and depository bonds on closed banks.

Table 3 provides a guide to how the assets and liabilities of the old company were split between the new company and the liquidating corporation. On the asset side, the most liquid assets went to the new company, including cash, and the more readily salable stocks, bonds, mortgages, and real estate. One item on the asset side of the new company, premiums due on the business taken over by the new company, was of course intangible and would have been worth nothing in liquidation without the reorganization. That asset nevertheless could only be placed in the new company since it was the one that would continue operating. The less liquid assets went to the liquidating corporation, including the less liquid stocks, bonds, and mortgages, as well as cash trapped in closed banks, debts due from reinsurance partners, and a large debt owed to the company by its subsidiaries. These assets were to be slowly sold off and the proceeds given to the liquidating company's liability holders. (This exercise might benefit from a consolidated balance sheet. Though constructing such a consolidated balance sheet is not entirely impossible, it would almost certainly be meaningless given the misleading accounting used at the subsidiaries.)

The new company had a sizable capital buffer created through a transaction with the RFC. Indeed, the RFC played a key role in this reorganization. The RFC owned a claim to a large chunk of National Surety's best assets, as security to the sizable loan National Surety had accumulated to the RFC prior the reorganization. Without the release of those assets by the RFC, the reorganization could not have moved those assets into the new company. The RFC agreed to release a portion of those assets from the collateral pool, but only in return for the addition of a new asset to the pool. That new asset was the entire capital stock of the new company, which was held by the liquidating corporation but which the RFC had the first claim to. In the process, the stockholders of the old company were wiped out. As noted above, financial stability was part of the motivation for RFC officials to

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Table 3. *Reorganization of National Surety*

New company			
Assets		Liabilities	
Stocks and bonds	4.9	Capital (owned by liquidating corp.) + surplus	4.0
Premiums due	4.0	Reserves	7.1
Cash	1.2	Past due premiums	0.7
Mortgage loans	1.3	Total	11.9
Real estate	0.4		
Other	0.0		
Total	11.9		
		Contingent liabilities:	
		Future claims on continuing lines of business	
Liquidating company			
Assets		Liabilities	
Capital stock of new corp.	4.0	Capital + surplus	9.0
Stocks and bonds	15.0	Reserves	11.0
Loans to subsidiary	9.9	Borrowed money (including RFC loan)	12.4
Mortgage loans	1.3	Accrued commissions	0.4
Money in closed banks	1.1	Total	32.8
Due from reinsurance	0.2		
Other	1.3		
Total	32.8		
		Contingent liabilities:	
		Past claims on all lines of business	
		Future claims on discontinued lines of business	
		All unearned premium claims	

Notes: Figures are in millions of dollars.

allow this transaction. At the same time, though, RFC collateral rules were quite strict. The RFC put positive value on the capital stock of the new company, one sign of confidence that the new company would prosper.

As part of the reorganization process, company officials tabulated data showing the profitability of its business lines, from 1923 to 1932, broken down into the business lines that would be discontinued (and placed into the liquidating corporation) and those that would be continued. These data, shown in Table 4, were used to support the idea that the business placed into the new company would be profitable. Those business lines earned a 4 percent profit from 1923 to 1932, while the discontinued business lines created a 24 percent loss.

The new company survived the reorganization. Creditors of the old company also benefited from the proceeds of a lawsuit against the directors of the old company, settled for \$1.35 million in 1937. Ultimately, the capital stock of the new company

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Table 4. *Profit and loss by business line, 1923–32*

	Business lines to be continued	Business lines to be discontinued	All business lines combined
Earned premiums	138.6	32.0	170.6
Losses incurred	63.4	24.8	88.2
Expenses incurred	69.2	14.8	84.0
Underwriting profit	6.1	−7.6	−1.5
Profit as percentage of premiums	4.4%	−23.8%	−0.9%

Notes: Figures are in millions of dollars.

was sold in 1936 for $10 million, with the proceeds benefiting creditors and paying down the RFC loan. Commercial Investment Trust (later known by its abbreviation, CIT) was the buyer. CIT later sold National Surety to Fireman's Fund Insurance Group, based in San Francisco, which was in turn eventually acquired by Allianz, the Munich-based insurance giant.

A few principles guided the reorganization. One principle was the preservation of the good will of policyholders. In the process, preserving that good will would also maintain the going concern value of the business. The concern was that if policyholders fled the new company the end result would be the very disorderly liquidation that officials were trying to avoid. In addition, the going concern value was embodied in the capital stock of the new company, which was a key asset held by the liquidating corporation to satisfy the claims of the old company's debtors, and to secure the RFC loan. If the company had been liquidated, that going concern value would have been dashed, and the creditors would have had fewer assets available. To this end, the state insurance department and the RFC designed the reorganization to put the new company into a very strong operating position, with liquid assets, a sizable capital buffer, and no exposure to unprofitable business lines.

The engineering of a capital stock with positive value out of a failing company was touted by the plan's proponents as creating 'assets from ashes'.[37] In a way, the creditors of the liquidating corporation capitalized the new firm, not by infusing new cash, but by ceding claim to the liquid assets of the old company in return for ownership of the new company. From an economic point of view, a key question is who the winners and losers were. In evaluating this, the key counterfactual is a disorderly liquidation. In the counterfactual, stockholders would have been wiped out, and all creditors would have had equal claim to the firm's assets. As events actually unfolded, stockholders were still wiped out, but a distinction was made between creditors placed in the

[37] See, for example, the obituary of William Joyce, the head of National Surety, *New York Times*, 6 August 1962, p. 25.

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liquidating corporation and those placed in the new company. The creditors placed in the new company fared well. The creditors placed in the liquidating corporation did better than the counterfactual only if the value of the capital stock of the new company, which they had claim to, exceeded the cost to them of surrendering the best quality assets to the new company, as well as the conversion of their claims into long-term obligations with no fixed maturity.

In order to preserve the going concern value of the new company, a second and related principle guided the reorganization: negotiating with policyholders of the new company was considered dangerous by state insurance department and RFC officials, and was avoided. In particular, it was feared that negotiating with policyholders about altering the extent of their contingent liabilities could lead those policyholders to lose confidence in the firm, cancel their policies, and therefore undercut the firm's revenue stream. Fundamentally, this is a dynamic that would complicate any attempt to rehabilitate an insurance company: policyholders are both the holders of an insurance company's contingent liabilities, and providers of income through premium payments. An insurance company therefore cannot negotiate with liability holders without risking a reduction in their revenue. To understand this dynamic, it is instructive to contrast insurance companies with commercial banks. If a bank were to negotiate with its liability holders, even if those negotiations soured and the liability holders demanded the return of their funds, that run would not affect the income stream from the assets of the bank. Though a typical bank does have some counterparties who both hold deposits and borrow money, banks' liabilities and income streams are overall much more separated.

A third principle was that reinsurance was not a viable alternative. Typically, reinsurance is one option for a troubled insurance company. In this case, though, National Surety was widely viewed as too big for even a group of other companies to reinsure. The *Weekly Underwriter* stated in an editorial that that 'So great were the transactions of the company, ordinary methods of reinsurance would probably have failed to adjust the situation to the best advantage of all concerned.' Specifically, the size of the reinsurance reserve was reportedly too large for regulators to find a willing counterparty. Companies which had been approached had offered only 40–50 cents on the dollar for that reserve.[38]

In designing the rehabilitation program for National Surety, the insurance department sought to avoid a repeat of the loss of good will that followed their takeover of a different insurance company, the Globe and Rutgers Fire Insurance Company, about a month earlier on 24 March 1933. An insurance magazine called this episode 'One of the most sensational financial dramas which this town of many dramas had witnessed.'[39] When the state took over the Globe and Rutgers, the insurance department announced its intention to rehabilitate the company, much as it later announced its intention to rehabilitate National Surety. But unlike in the case of National Surety, no actual rehabilitation plan was in place at the time of the takeover. Instead, the

38 'National Surety deal big discussion topic', *Weekly Underwriter*, 6 May 1933, p. 889.
39 'Globe and Rutgers', *Eastern Underwriter*, 31 March 1933, p. 19.

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state insurance department announced that one would be worked out soon. The uncertainty led to cancellations by Globe and Rutgers' policyholders, even though Globe and Rutgers couldn't even pay out the unearned premiums because it was under court-ordered payment restrictions. Worse, as time went on and state insurance department officials had difficulty in quickly announcing a rehabilitation plan, the rush to cancel policies reportedly gathered momentum. This in turn delayed the rehabilitation planning even more, because with the loss of business from cancelled policies, plans for rehabilitation needed to be modified, especially because original estimates for additional capital became too low and new sources of capital needed to be found. At one point, the insurance department decided that so much of the business had been lost that there was not much of a company left to rehabilitate, and proposed liquidating it. Eventually, though, a rehabilitation plan was enacted.[40] Court files on the Globe could provide the basis for further research if they contain information on the incentives of policyholders to run.

V

There have been proposals at various points over US history to establish national regulation and supervision of insurance companies, but such activity remained at the state level until the Dodd–Frank Act in 2010. The Dodd–Frank Act created the Financial Stability Oversight Council (FSOC) and charged it with designating and regulating non-bank systemically important financial institutions, including insurance companies. Since then, the FSOC has designated three insurance companies as systemically important, AIG, Prudential and MetLife, and a financial services company, General Electric. The FSOC has since rescinded the designations of General Electric and AIG. In addition, MetLife has contested its designation in federal court, and the case is currently under appeal at the time of this writing.

With this new regime of insurance company supervision, policymakers at the national level are devoting greater attention to insurance companies, and in the process are grappling with fundamental questions about those companies. How can an insurance company be systemically important? Can an insurance company have a liquidity crisis? How should a systemically important insurance company be regulated? How should such a company be resolved? In this conclusion, I consider each of these questions in turn, and use the National Surety episode as a source of historical perspective to answer those questions.[41]

How can an insurance company be systemically important? In designating MetLife, Prudential and AIG as systemically important, the FSOC delineated three

[40] For a discussion of cancellations affecting Globe and Rutgers, see 'Globe and Rutgers', *Eastern Underwriter*, 31 March 1933, p. 21; 'With the editors', *Spectator*, 4 May 1933, p. 8; 'Insurance Commissioner Convention', *National Underwriter*, 8 June 1933; NSP, folder 1, Feller deposition.

[41] For other recent papers that discuss systemic risk in the insurance sector, see Acharya and Richardson (2014), Cummins and Weiss (2014), Harrington (2009).

mechanisms by which financial distress at insurance companies could be transmitted to the economy: exposures of economic actors to the insurance company, the effect of liquidating the insurance company's assets, and any critical market roles fulfilled by the insurance company. Only the exposures channel was raised in the discussion of National Surety by contemporaries. In terms of asset liquidation, though National Surety was the largest surety company in the world, as a surety company its assets were still significantly smaller than other types of financial institutions, such as life insurance companies. For illustration, in 1932, the largest life insurance company was Metropolitan Life, which had assets of $3.8 billion in 1932, about 80 times the size of National Surety's balance sheet. Fundamentally, the business models of these companies necessitated very different balance sheets. Because life insurance policies function essentially as lifetime savings plans, life insurance companies invest premiums in long-term assets, which they accumulate to match the long-term nature of their liabilities. Surety policies are shorter term in nature and therefore such companies do not operate with balance sheets that are nearly as large. The reverse is true for contingent liabilities, though. Life insurance companies' contingent liabilities are not nearly as large relative to their assets. In 1932, Metropolitan Life's life insurance policies, for example, had total value of about three times its balance sheet, whereas National Surety's contingent liabilities were about 60 times the size as its balance sheet. Contemporaries also said little about National Surety's key role in markets, although there was some discussion about whether National Surety's customers would be able to find insurance at other companies.

The National Surety experience also points to potential market confidence and risk aversion effects in the presence of correlated risks among financial companies. Contemporaries feared that National Surety's would lead market participants to lose confidence in surety companies more generally. Indeed, two of the other major surety companies, Maryland Casualty and United States Fidelity and Guaranty, had very similar business models to National Surety, including large exposures to MBS guarantees. These concerns resemble similar dynamics that arose in during the 2007–9 financial crisis about correlated risks among monoline insurance companies, including MBIA and Ambac. Rumors about the condition of certain monoline insurers led to reduced confidence in the sector more broadly, creating disruptions in insured securities markets during the crisis. Such market confidence effects pose a channel in which systemic risks can be created by a group of firms with correlated risks, each of which individually may not be large enough to trigger any of the three FSOC-delineated mechanisms.[42]

Can an insurance company have a liquidity crisis? After MetLife was designated by the FSOC as systemically important, its officials have often discussed this question publicly. They point out that insurance companies run different business models than banks. Since insurance companies' liabilities are longer in term than banks'

[42] Schwarcz and Schwarcz (2014); Bergstresser, Cohen and Shenai (2010); Acharya and Richardson (2014).

liabilities, they have less of a maturity mismatch. MetLife officials also note that there are disincentives for policyholders to call their policies early, in the form of surrender charges and tax penalties.[43] National Surety appears to have had very few disincentives in place to discourage a wide swath of its policyholders from cancelling their policies. In another part of the insurance world, life insurance companies in the 1930s had liquidity problems of their own, leading the New York insurance commissioner, for example, to prohibit life insurance companies from being able to pay out surrender values or make policy loans for six months during 1933.

How should a systemically important insurance company be regulated? One school of thought focuses on an activities-based mode of regulation, in which regulatory attention is devoted to nontraditional insurance activities at any insurance company, not just systemically important ones. This view, promoted for example by officials from MetLife, is clearly responsive to the experience of AIG, whose problems were concentrated in its financial products division. Likewise, had National Surety not entered into the mortgage security guarantee field, it almost certainly would not have experienced this crisis. Yet, National Surety was not the only surety company that engaged in this business, and such an activities-based mode of regulation would require all of its peers to have been subject to extra scrutiny, regardless of their size. In addition, National Surety's mortgage business was no secret to regulators. It sought and received direct permission from the New York Attorney General and the state insurance commissioner to engage in this activity. While it was a new activity, evidently neither the risks of the activity nor the scope of the corporate governance and other incentive problems were apparent. Activities-based modes of regulation would rely on supervisors being able to accurately assess the risks of nontraditional businesses, which they failed to do in National Surety's case.

Finally, how should a systemically important insurance company be resolved? The experience of the New York insurance department in the 1930s highlights the pitfalls of negotiating with the policyholders of an insurance company in the same way that debt holders of a bank may be negotiated with. Negotiating with insurance policyholders is particularly problematic because policyholders are also a core source of income through the payment of premiums. If policyholders' confidence is undermined, they could request the return of unearned premiums, undermining the financial position of the company. In other words, the debt structure and the income stream of insurance companies are linked in a way that they are not at banks. Finally, National Surety provides an interesting example of a resolution strategy that created 'good' and 'bad' companies. The resolution appears to have been relatively successful, even in the absence of new capital injection, with the public-spirited cooperation of National Surety's single largest creditor, the Reconstruction Finance Corporation.

43 See Wheeler (2012) and Kandarian (2013).

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