

Regulatory Reliance on Credit Ratings

- The recent financial crisis revealed that market participants and regulators overly relied on credit ratings issued by the Nationally Recognized Statistical Rating Organizations (NRSROs). The Dodd-Frank Act requires federal financial regulatory agencies to create alternative methods for evaluating securities issued by governments and corporations.
- Through the NAIC, state insurance regulators identified particular concerns with the use of NRSRO ratings for residential mortgage-backed securities (RMBS) and for commercial mortgage backed securities (CMBS), and developed alternative methodologies for evaluating the risk of loss arising from such securities.

Issue Background

Prior to the financial crisis, state insurance regulators for many years relied on a formulaic approach to translating NRSRO ratings of bonds into for purposes of determining one significant component of Risk-Based Capital (RBC) for U.S. insurance companies, which is used by regulators to gauge an insurance company's health. This was considered appropriate given the long track record of performance of the NRSROs

Beginning in 2009 for non-agency residential mortgage-backed securities (RMBS) and 2010 for commercial mortgage backed securities (CMBS), the NAIC changed the process by which individual holdings of insurers are evaluated for application in the RBC formula. The impetus for this change was the extreme volatility of the residential and commercial mortgage markets and how that was reflected in NRSRO ratings. Given these concerns, state insurance regulators believed such changes were needed to improve regulatory oversight and consistency in the approach for two asset classes that have represented over \$300 billion in carrying value of invested assets for the U.S. insurance industry.

Key Points

- The NAIC's action was an effort to more closely align the capital requirements for RMBS and CMBS with appropriate economic expectations and part of the NAIC's efforts to reduce reliance on rating agencies where deemed appropriate. The new process results in a more accurate reflection of the risk of loss which is then mapped to a risk-based capital factor.
- While NAIC continues to rely on the NRSROs for other asset classes, the NAIC's Valuation of Securities Task Force are monitoring these other asset classes to determine whether continued reliance is appropriate.