

TESTIMONY

TO THE NAIC RATING AGENCY WORKING GROUP

HEARING ON THE
“ROLE OF THE RATING AGENCIES IN STATE
INSURANCE REGULATION”

BY DEPUTY SUPERINTENDENT MICHAEL MORIARTY
NEW YORK STATE INSURANCE DEPARTMENT

THURSDAY, SEPTEMBER 24, 2009

NAIC FALL NATIONAL MEETING
WASHINGTON DC

I would like to thank Co-Chairmen James Wrynn and Michael McRaith and members of the NAIC Rating Agency Working Group for inviting me to testify today at this hearing on the “Role of the Rating Agencies in State Insurance Regulation.”.

My name is Michael Moriarty and I am Deputy Superintendent for the New York State Insurance Department.

Chris Evangel, Director of the Securities Valuation Office (“SVO”), has already given a comprehensive description of the role that the SVO plays with respect to assisting state regulators in their oversight of the financial condition of insurance companies. My particular focus today is on the changes made in 2004 regarding the process by which insurance companies file investment securities with NAIC Securities Valuation Office.

At the time New York was (and still is) the chair of the NAIC Valuation of Securities Task Force, which is the NAIC group that is charged with overseeing the SVO.

NAIC’s Reliance on Rating Agencies for Capital Requirements

Beginning in 2002, the Securities Valuation Oversight Working Group (which has since been folded into the Valuation of Securities Task Force) began to review a series of initiatives intended to enhance the effectiveness of the processes at the SVO.

The goals of the review at that time were the following:

1. Continuation of reforms initiated in late 1999 as a result of the Effectiveness and Efficiency initiative; continue to improve the SVO process that is relied on by state insurance regulators to monitor insurance company investments.
2. Produce timely and accurate credit ratings and valuations for bonds, preferred stock, and common stock.
3. To the extent appropriate, leverage off ratings and valuations already provided by third parties such as the Nationally Recognized Statistical Rating Organizations (S&P, Moody’s and Fitch), and market facilitators, such as stock exchanges and valuation services.

As a result of this review, the following proposals were developed for the Working Group’s consideration:

- Exempt All Rated Securities from Filing with NAIC Securities Valuation Office.
- Establish Procedure for Direct Regulatory Input in the Utilization of Research Unit.
- Consider Alternatives to the Filing of Securities Not Rated by an NRSRO, Including Allowing Insurers to “Self-Rate” Securities

After deliberation the first two proposals passed. The last one did not. Thus, beginning in 2004, any investment security rated by an NRSRO need not be filed or reviewed by the Securities Valuation Office. Insurance regulators explicitly relied on the rating agencies

for determining the creditworthiness of entities issuing debt in the capital markets. This had the direct impact of calculating the capital an insurer would need to support such investments.

The rationale at the time was fairly straightforward. NRSRO ratings were deemed sufficient to establish credit quality of assets. SVO work in this area seemed redundant and would add minimal additional value to the state regulatory process. Furthermore, utilization of NRSRO ratings would eliminate the manual process whereby companies print and mail forms for submission to the SVO. This saved insurance companies and SVO staff time and money for activity that often results in the same end product; that is an NAIC designation equivalent to the NRSRO rating. That is because prior to the explicit recognition of the ratings by NRSROs, there had always been the implicit use of ratings. The NAIC has limited resources. Rating agencies play an important role in the capital markets arena. Reliance on them in terms of rating individual securities was seen as an efficient use of resources.

So even before the explicit recognition of ratings that resulted in the Filing Exemption (“FE”) rule, securities that were rated and had to be filed with the SVO almost always received the same NAIC designation equivalent to the rating. Thus, the FE rule was seen as recognition of a practice that already existed and eliminated the need to file securities with the SVO and the attendant cost to the industry.

At the time the rule was passed there was a recognition that the regulators and the SVO should have flexibility to override an NRSRO rating and the ability to do so was incorporated into the rules.

Summary

NAIC reliance on ratings by NRSROs was seen as practical, efficient and effective use of limited resources. The reliance was not based on a detailed review and an affirmation of the methodology used by the rating agencies. The NRSROs were relied upon by many capital markets participants, were overseen by the U.S. Securities and Exchange Commission, and had a track record of reliability.

The events of the past few years, especially in the mortgage backed structured security sector, require a thorough and deliberate review of this policy.