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The Role of Credit Rating Agencies in Insurance Regulation

Much has been written about the role of the credit rating agencies in the financial crisis. A few things are clear. The rating agencies erroneously gave AAA ratings to hundreds of billions of dollars of residential mortgage-backed securities (RMBS) from 2005 to 2007. The agencies had, and continue to have, a conflict of interest because of the way they are compensated – paid by the entities issuing the securities. The consequences of this market structure are well documented – rating agencies competed for market share and profit by giving AAA ratings to pretty much any mortgage-backed security that walked through the door.

The problem is a structural one for which no conflict of interest policy within the rating agencies can counter the market incentives created by the issuer-pays model.

It is clear the rating agencies did not know what they were doing when they initially rated the RMBS issued from 2005 to 2007. The vast majority have been downgraded with most to below investment grade ratings. But, if the rating agencies did not know what they were doing a few years ago, why do we have any confidence that they know what they are doing today? Insurers who wanted regulators to accept the rating agencies' RMBS ratings a few years back, now want the regulators to ignore those ratings.

The faulty ratings of RMBS are not the only problem identified with the national rating agencies. There appears to be a double standard for rating municipal bonds versus corporate securities – with lower municipal bond ratings than for corporate bonds with comparable historical and expected levels of default.

The evaluation of securities is a critical part of insurance solvency regulation. The risk associated with a particular security held as an investment by an insurer has implications for the financial strength evaluation and capital requirements of those insurers. Insurance regulators have incorporated this evaluation of financial strength into financial surveillance tools, such as the risk-based capital ratio.

There is one group of insurers for whom the evaluation and rating of securities is even more important – bond insurers who guarantee the securities.

Rating agencies are free to offer ratings and be compensated in the manner they choose. **But state insurance regulators should not be delegating their regulatory responsibilities to private entities, particularly to private entities whose incentives are not aligned with those of the public function.**

We are gravely troubled by the fact that regulators did in fact delegate a critical public role to private entities. What makes this action even more inexplicable is that the regulators had and continue to have a tool to provide evaluation of securities specifically for the purpose of insurance regulation – The Securities Valuation Office.

Our concern with regulators' delegation of a critical financial solvency role to private actors is compounded by the actions of regulators in the past year to change accounting and reserving rules to provide "capital and surplus relief" to insurers. After loudly proclaiming that, because of state regulators' efforts, insurance companies were and remain financially strong, regulators have been changing the rules to allow insurers to hold less surplus and reserves and, more ominously, change the definition of surplus to, for example, include more non-liquid assets that provide no protection for policyholders.

On Tuesday, we heard the life insurers ask the regulators to ignore the rating agencies' ratings of RMBS – that these ratings were too low, based on a faulty methodology and that regulators should use an alternative rating methodology designed by the industry itself. If adopted, the change would provide \$10 billion in capital relief. This request is, of course, quite troubling. If the credit rating agency ratings are not reliable for some securities, why would regulators believe that the ratings for other securities are reliable? Should insurers be able to pick the source of ratings for regulatory purposes?

In reviewing some of the other testimony for today's hearing, I note that Moody's cautions strongly against regulatory use of its and other credit rating agency ratings for regulatory purposes – arguing that the use of ratings as a regulatory tool for the oversight of regulated entities can adversely affect the behavior of market participants as well as regulators." Among other problems, Moody's says that issues may be encouraged to shop for the highest rating among the credit rating agencies – a result, I suggest, is directly attributable to the issue pays market structure.

Regulators should utilize and, if necessary, expand the capacity of the SVO so regulators can have an independent means of evaluating the risk of securities for regulatory purposes. This would not only strengthen financial surveillance of insurers, but would also be highly cost effective action for the insurance industry.

To date it seems as if regulators are moving from one industry request for relief to the next with no overarching strategy to address the fundamental problems. CEJ, along with other consumer groups have long taken strong financial oversight of insurance companies as a given. Our confidence has been shaken in the past year. Now you have both the opportunity and responsibility to make the structural changes needed to strengthen state-based regulation. Please don't waste this opportunity.