

**WRITTEN STATEMENT OF GRACE OSBORNE  
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**BEFORE THE MEETING OF THE RATING AGENCY WORKING GROUP OF THE  
NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS**

**SEPTEMBER 24, 2009**

Good morning. My name is Grace Osborne. I am a Managing Director and the Lead Analytical Manager for North American Insurance Ratings at Standard & Poor's Ratings Services ("S&P"). I am pleased to appear before you today.

We understand that the Rating Agency Working Group ("Working Group") has been formed by the National Association of Insurance Commissioners ("NAIC") to consider and reevaluate the ways in which the NAIC utilizes credit ratings of Nationally Recognized Statistical Rating Organizations ("NRSROs"). We appreciate the opportunity to provide information in connection with this project.

Obviously, the Working Group's study comes on the heels of serious difficulties in the credit markets and our economy as a whole, and in the wake of considerable criticism of NRSROs, primarily directed at their ratings of certain mortgage-backed structured finance products. As head of our North American Insurance Ratings group, my focus is on our insurance company ratings, and I am not involved in S&P's ratings on structured finance securities. However, I can tell you at a very broad level that we at S&P are keenly aware that confidence in our ratings has been diminished. We are committed to restoring that confidence and have already undertaken a series of important measures designed to enhance the quality, independence and transparency of our credit ratings and credit ratings process. I will describe some of these changes as part of my statement here today.

I would like to begin, however, by summarizing some key points related to our insurance company rating opinions and our process for arriving at those opinions.

## *S&P's Insurance Company Ratings*

### *S&P's RBC Adequacy Model*

The Working Group has expressed interest in understanding how NRSROs arrive at their insurance company ratings and, specifically, whether those ratings result from “stress testing” of an insurer’s capital adequacy.

The rating drivers of financial strength ratings, which reflect our opinion of an insurer’s ability to meet its policyholder obligations, include both quantitative and qualitative factors. To determine a rating, an analyst will assess an insurer’s competitive position, management and corporate strategy, operating performance, investments, liquidity, capital, financial flexibility, and enterprise risk management.

S&P’s insurance company ratings have long utilized our proprietary risk-based capital (“RBC”) adequacy model. The RBC model is a quantitative tool that helps our analysts evaluate an insurer’s ability to absorb losses at varying levels of confidence. Put simply, the model seeks to estimate the amount of capital that is necessary to cover losses at varying confidence intervals, subject to a wide array of risks over the expected life of an insurance company's portfolio.

As part of our ratings process, each risk variable in the model is evaluated using confidence levels derived from our empirically observed cumulative five-year default rates for each rating level. While the RBC model is an integral part of our evaluation of capital adequacy, we do consider other significant factors as well, including qualitative considerations such as the level of reinsurance dependency and reserve adequacy. Our rating committees evaluate all these factors, and more, to help form a comprehensive opinion on a company’s level of capitalization.

*Accounting for “Downward Spirals”*

The Working Group has also asked NRSROs to address the possibility of a “downward spiral” on insurance company subsidiaries that might result from the downgrade of a parent company or other developments. As we have stated, S&P recognizes that the insurance industry has long been sensitive to market perception of credit quality. As a result, the speed with which the market can lose confidence in an insurer is an important factor in our view of the insurer’s creditworthiness. If there is a crisis in confidence — whether from problems at a parent company or some other factor — an insurer without sufficient resources to cover all contingent calls on liquidity could quickly become insolvent, despite having otherwise healthy business operations and strong capital. Any problem that erodes confidence in financial institutions that have not sufficiently anticipated liquidity needs in times of stress could have the potential to lead to a downward spiral with severe consequences -- *e.g.*, a run on the bank scenario.

Thus, when evaluating an insurance company’s financial strength or the creditworthiness of an insurance holding company, we consider a number of relevant factors including the existence of ratings-related triggers, financial benchmark triggers, material adverse condition (MAC) clauses, or other covenants. Even in “normal” times, we evaluate how an insurer is positioned to handle stress scenarios, balancing sources of liquidity available in these scenarios against its liability structure and potential liquidity calls.

It is also important to note that our process for insurance company ratings generally incorporates S&P’s new credit stability criteria, which address whether, in our view, an issuer or security has a high likelihood of experiencing unusually large adverse changes in credit quality under conditions of moderate stress. One example of this broad-based criteria en-

hancement in the insurance company context is our incremental stress analysis, first applied last year, which is designed to permit enhanced assessments of capital adequacy. As part of this process, we assume higher levels of stressed loss for certain asset classes that we believe may be subjected to unprecedented stress for some time to come.

*Sensitivity Analysis for Structured Finance Exposure*

In connection with its study, the Working Group has also asked NRSROs to address the degree to which their sensitivity analysis of insurers addresses the market risk of structured finance investments. In our case, S&P may lower an insurance company's rating if we believe that the insurance company will likely suffer sharp and substantial economic unrealized investment losses as a result of investments in structured finance or other securities. However, if we believe that an insurance company has sufficient liquidity, quality asset/liability matching, modest needs for additional financial flexibility, and the ability and willingness to hold such securities to maturity, the market risk of those securities would not likely be a driver for rating actions, although such action may still be considered.

*Criteria for Portfolio Concentration*

The Working Group has also inquired about whether NRSROs have developed criteria to address risks associated with portfolio concentration. S&P does look to investment concentrations in assessing the risks of an insurer and maintains criteria regarding an insurance company's portfolio concentration in particular asset classes. Specifically, we review unusual concentrations, such as by asset type, industry sector, or individual companies. In our view, the essence of building a portfolio is diversification, and any concentrations could subvert the benefits of diversification. We closely examine issues that might not appear to be correlated but in fact are, such as common and preferred stock issued by the same entity and perhaps

convertible or senior debt also issued by the same entity or a closely related family member. To facilitate this analysis, we have developed a formula for evaluating levels of capital adequacy and investment concentrations in our rating process.

I would be pleased to elaborate further on this formula, along with any of these insurance-related subjects, during the question and answer session.

### ***Recent Performance of Structured Finance Ratings***

As the Working Group is well aware, credit ratings on certain structured finance securities have recently received a significant amount of negative attention. While I am not a structured finance analyst, and am not familiar with the details of particular transactions, I would like to make some comments at a general level.

First let me say that S&P has a long and successful history issuing rating opinions on a wide array of issuers and debt securities, including structured finance securities. We began our credit rating activities more than ninety years ago, in 1916, and since that time our ratings have served as valuable independent opinions in the U.S. debt market. More than any regulatory framework or NRSRO recognition, the market's recognition of our independent opinions and our commitment to analytical excellence have been the primary drivers of our success over these ninety-plus years.

Although credit ratings have been -- and will continue to be -- an extremely useful tool in understanding credit risk, we have repeatedly cautioned market participants, regulators and policymakers alike to be aware of what credit ratings are intended to address. S&P's ratings reflect our current opinions regarding the creditworthiness of issuers or debt securities. At their core, they represent our opinion of the likelihood that a particular obligor or financial obligation will pay principal and interest in a timely manner. Ratings are not "buy," "sell," or

“hold” recommendations and they do not address whether any particular rated securities are suitable investments for a particular investor or group of investors, or whether the price of the security is appropriate or even commensurate with its credit risk. Put simply, if regulators and policymakers choose to incorporate ratings in their rules as benchmarks, the use of additional benchmarks may also be warranted.

In terms of our track record, S&P’s ratings, including in the area of structured finance securities, have historically performed very well. Indeed, S&P has been rating structured securities for thirty years and has developed industry-leading processes and models for evaluating the creditworthiness of a wide array of structured transactions. Since 1978, only 1.1% of structured finance securities rated by us ‘AAA’ have ever defaulted.

Of course, as I noted, we do recognize that the performance of our ratings from certain recent Residential Mortgage Backed Securities (“RMBS”) vintages and other securities related to them has been inconsistent with this track record. While much of the recent difficulty in these markets has related to the price of these securities -- a factor that ratings do not, and are not intended to, address -- defaults and ratings volatility have been much higher with these securities than we anticipated or intended. We have been disappointed -- and we understand that the market has been disappointed -- with the extent of volatility in this area. Although we conducted robust analysis of transactions and based our ratings on historical data, including market events going back as far as 75 years to the Great Depression, we (along with many other market participants and regulators) never expected such severe, negative performance in the housing and mortgage markets.

We have learned hard lessons and, consistent with our constant desire to enhance our ratings process and analytics, have taken a number of important steps that we believe will

help improve the quality of, and confidence in, our ratings. These fall into four broad categories: (i) promoting the integrity of the ratings process; (ii) enhancing analytical quality; (iii) providing greater transparency to the market; and (iv) more effectively educating the marketplace about ratings.

To date, we have made significant progress implementing these changes in several areas. For example, we have:

- Invested significantly in our compliance function;
- Established an Office of the Ombudsman to address concerns related to potential conflicts of interest and analytical and governance processes that are raised by issuers, investors, employees and other market participants across S&P' businesses. The Ombudsman has oversight over the handling of all issues, with authority to escalate all unresolved matters, as necessary, to the CEO of McGraw-Hill and the Audit Committee of the Board of Directors;
- Implemented “look back” reviews to confirm the integrity of ratings, whenever an analyst leaves to work for an issuer;
- Instituted a rotation system for analysts;
- Established an enterprise wide independent Risk Assessment Oversight Committee. The Committee will assess risks that could impact the integrity and quality of the ratings process. This committee will also assess the feasibility of rating new types of securities;

- Implemented procedures to collect more information about the processes used by issuers and originators to assess the accuracy and integrity of their data and their fraud detection measures so that we can better understand their data quality capabilities;
- Created a separate Model Quality Review Group to independently analyze and validate models used in the rating process, developed by S&P or provided by issuers;
- Updated our analytical methodologies and assumptions, including for certain structured finance products;
- Increased our analyst training programs;
- Expanded our two-way communication to listen to the concerns of market participants and better explain our ratings;
- Published a series of articles addressing certain “what if” scenarios, including with respect to structured finance ratings.
- Published a “Guide to Credit Ratings Essentials” that provides important information about ratings and their role in the markets.

In our view, these steps will help enhance our processes and better educate market participants on what ratings mean and how to use them. Restoring confidence in the credit markets will require a systemic effort, and S&P is just one part of the equation. We believe that appropriate government action, as well as meaningful private-sector initiatives, are essential

to accomplishing that goal. For its part, S&P is committed to restoring confidence in ratings and we believe that ratings will continue to play an important role in the capital markets going forward.

### ***Conclusion***

I thank you for the opportunity to participate in this public meeting. I would be happy to answer any questions you may have.