

To: The Honorable Alfred Gross, Virginia Commissioner of Insurance and Chair of the Financial Conditions (E) Committee

From: The Honorable Michael McRaith, Director of the Illinois Department of Insurance and Co-Chair of the Rating Agency (E) Working Group
The Honorable James J. Wrynn, Superintendent of the New York Insurance Department and Co-Chair of the Rating Agency (E) Working Group
Matti Peltonen, New York Insurance Department
Kevin Fry, Illinois Insurance Department
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Re: Evaluating the Risks Associated with NAIC Reliance on NRSRO Credit Ratings – Final Report of the RAWG to the Financial Conditions (E) Committee

Date: April 28, 2010

I. Introduction - The Rating Agency (E) Working Group (“RAWG”) of the NAIC Financial Condition (E) Committee was formed on February 11, 2009, and charged with conducting a comprehensive evaluation of state insurance regulatory use of the credit ratings of nationally recognized statistical rating organizations (“NRSROs”).¹ Specifically, the Working Group was charged to gather and assess information on:

1. The problems inherent in reliance on ratings, including impact on the filing exempt (“FE”) process and Risk-Based Capital (“RBC”);
2. The reasons for recent rating shortcomings, including but not limited to structured security and municipal ratings;
3. The current and potential future impact of ratings on state insurance financial solvency regulation; and
4. The effect of the use of NRSRO ratings on public confidence and public perception of regulatory oversight of the quality of insurance.

This report presents the Working Group’s findings in answer to those charges and recommendations to adjust the use of ratings.

II. Summary of Recommendations

The Working Group recommends that:

1. Regulators explore how reliance on ARO ratings can be reduced when evaluating new, structured, or alternative asset classes, particularly by introducing additional or alternative ways to measure risk;
2. Consider alternatives for regulators’ assessment of insurers’ investment risk, including expanding the role of the NAIC Securities Valuation Office (“SVO”); and
3. When considering continuing the use of ratings in insurance regulation, the steps taken by the NRSROs in correcting the causes that led to recent rating shortfalls, including the NRSROs’ efforts in implementing the recommended structural reforms, should be taken into account.

¹ The NRSROs whose ratings are used by the NAIC are referred to as Acceptable Rating Organizations (“ARO”). Currently, they are Standard & Poor’s, Moody’s, Fitch, DBRS, A.M. Best, and Realpoint.

III. Overview of the RAWG Process

Soon after the RAWG was formed, SVO staff was directed to:

1. summarize federal and international regulators' evaluations of NRSRO rating shortcomings;
2. assess the role of these shortcomings in the current economic crisis;
3. identify the specific NAIC regulatory mechanisms driven by ratings;
4. quantify the impact of rating downgrades on insurance companies.

The RAWG sent a questionnaire based on state regulators' points of interest in the NRSRO structure and process to the AROs. An SVO team of analysts (all of whom are alumni of the AROs with extensive rating agency experience) evaluated the responses and summarized them for the RAWG.

On September 24, 2009, at the NAIC Fall National Meeting, the RAWG held a public hearing and received testimony from capital market participants, ARO representatives and national experts on the use of ratings in regulation. The September 24 hearing provided information and perspective which is included in, or formed the basis for, many of the recommendations contained in this Report.

A second public hearing, via conference call, was held on November 18th to gather information about ARO rating of municipal securities.

IV. Findings of the Working Group

1. Problems Inherent In Reliance on Ratings for Insurance Regulation

AROs are for-profit business organizations which seek to expand the reliance upon ARO ratings in financial products and regulatory processes in order to develop new product lines and increase market share. The largest AROs also compete to obtain business from the issuers of the securities subject to the ARO rating. Reliance on ratings exposes insurance regulatory process to risks arising from competitive pressures on AROs that are beyond state regulators' control and not consistent with regulatory objectives, such as consumer protection.

- a. Ratings are used extensively in insurance regulation. In addition, insurers should be required to use such tools as due diligence reviews of investments, risk management, independent credit analysis, and risk diversification.
- b. Insurance regulators' extensive reliance on ratings, often required by statute, may reduce regulators' independent ability to monitor an insurance company's compliance with prudent investment practices.
- c. Rating agencies' use of corporate bond default history as the basis for analyzing structured securities was based on an underlying assumption that the default rates for the two classes would behave similarly in varying market scenarios. The fundamental differences in the structures of the securities and the cash flows render these types of securities so fundamentally different from one another that the use of corporate bond default history to form an opinion on the probability of particular structured securities' performance was inappropriate.
- d. Rating agencies' rating revisions tend to lag behind market and economic developments. ARO ratings tend to be long-term ratings, meant to be relatively stable over an economic cycle. As a result, ratings may not react fast enough or be sufficiently current to satisfy regulatory needs.
- e. Complex securities, such as Collateralized Debt Obligations consist (in effect) of options on derivatives and contain a great deal of leverage. As a result, the effects of AROs adopting assumptions that would later prove far different from actual experience were magnified greatly. If the assumptions do not

correctly anticipate these securities' actual behavior in a given environment, then the probability that the rating will not reflect the true creditworthiness of that security will increase exponentially.

- f. To verify the accuracy of ratings and the validity of initial assumptions and models for structured securities, it is necessary to monitor the performance of the underlying assets. Rating agencies, however, rarely engage in monitoring sufficient to discover such problems, after having issued the initial rating.
- g. Due to competition and the increasingly complex nature of financial products, the meaning of ratings and the comparability of structured product ratings between NRSROs have changed. These changes require investors to increase their expertise about credit and the NRSROs' rating methodology before ratings can be expected to be adequately understood.
- h. Credit ratings focus on the probability of default, and thus do not capture all investment risks. Credit ratings do not measure recovery given default, and therefore cannot be used to estimate the actual expected losses in insurers' investment portfolios. Rating agencies have, or are in the process of adding separate recovery ratings at least to some fixed income securities, but it remains to be determined how comparable they are.
- i. In order for the NAIC's filing exempt rule to work well, the ARO ratings need to be consistent. Currently, however, the ARO ratings are neither consistent nor uniform for individual securities, nor across different types and classes of securities.
- j. AROs use the same rating scale for municipal and corporate securities indicating that the probability of default for municipal and corporate securities are similar, when in fact, the probability that a municipal security defaults is lower than that of a corporate security with the same rating.
- k. The process by which ARO ratings are transposed into NAIC designations to determine the appropriate surplus levels under RBC assumes the default rates and losses given default assumptions for municipal and corporate securities are similar.
- l. These differences in default probability (and in the possibility of differing losses given default) across asset categories, and the assumption incorporated into the NAIC designations that these differences do not exist, can result in anomalous situations where the capital held against various investments bears less relation to the actual risk presented than is warranted.

2. Reasons for Recent Rating Shortcomings

The RAWG's hearings identified the following factors as contributing to errors when NRSRO ratings alone are used for regulatory purposes.

- a. When rating structured credit or non-standard fixed income products with little or no historical data, AROs have sometimes adopted models incorporating either excessively optimistic assumptions or inadequate probability given to severity of tail risk.
- b. It appears that some AROs have responded to business opportunities by choosing not to reject transactions submitted for ratings. These same pressures appear to have contributed not only to "grade inflation" of credit ratings, but also to a conflation and a decline in the quality of rating standards.
- c. Rating agencies that are compensated primarily for their initial ratings have little incentive to monitor underlying asset performance on structured securities or modify or update their ratings generally.

3. Current and Potential Future Impact of Ratings on Regulation

The NAIC is engaged in several reform measures that will reduce regulators' reliance on credit ratings. First, the NAIC is supporting regulators as risk-focused examinations are implemented by states, and second, the NAIC has amended its treatment of Residential Mortgage Backed Securities ("RMBS"), and is evaluating the merits of expanding a similar type of credit evaluation to other structured securities. Both of these reforms will allow regulators to "drill down" to reveal levels of granularity within a security that are not accessible through credit ratings.

The RMBS proposal replaced ratings with a model (modeling was done by PIMCO Advisory) to establish price ranges for each NAIC designation (1 through 6) for each of the approximately 21,000 different RMBS held by insurance companies. An insurer's carrying value for a particular RMBS was mapped to the price ranges to identify the appropriate NAIC designation for use in RBC. This approach: (1) identifies the actual risks presented by RMBS; (2) quantifies the severity of possible losses; (3) provides a better measure of losses against which surplus must be kept; and (4) when appropriate, frees up capital, in particular for securities held at a discount.

4. The Effect of the Use of ARO Ratings on Public Confidence and Public Perception of the Quality of Regulatory Oversight of Insurance

Congress and the Securities and Exchange Commission have considered increasing the number of entities designated as NRSROs. As the number of AROs increases, so will the competitive pressures. Where issuers pay for AROs for rating services, these competitive pressures may create incentives within the AROs that would be incompatible with prudential supervisory considerations. There is a risk that required checks and balances will be developed only after major ratings failures occur – as has been the clear pattern during the current and prior episodes of inaccuracy of credit ratings.

- a. Ratings have devolved to the point where they can be most appropriately interpreted and applied only by financial professionals who understand the rating agencies' methodologies and the implications that specific circumstances have for those methodologies.

V. Recommendations

1. Referral to the NAIC Capital Adequacy Task Force: The current RBC process should be reviewed to assess the recent performance of ratings for structured securities and how that performance has affected insurers' surplus and reserve holdings.
2. Referral to the NAIC Valuation of Securities Task Force: VOS should study the use of ratings in the financial solvency monitoring of insurance companies to confirm if ratings should differ for municipal, corporate and structured securities as general asset classes. Consideration should also be given to applying ratings differently within segments of these broader categories.
3. Referral to the NAIC Valuation of Securities (E) Task Force: An evaluation should be made to determine whether the difference between the ratings for municipal and other securities is material enough to warrant changing how ARO ratings are converted into the NAIC designations.
4. The NAIC Rating Agency (E) Working Group should evaluate whether states', municipalities' and other public entities' creditworthiness should take into account the unprecedented financial burdens many public sector issuers face from aging populations, public pension liabilities, infrastructure needs, and revenue instability caused by financial and economic dislocations.
 - a. The diminished market share of monoline bond insurers (less than 10% of new issues are guaranteed - down from about 50% before the 2008 financial crisis), renders the valuation and credit risk assessment of many municipal bonds more difficult. As a result, the credit quality of insurers' municipal bond portfolio is more opaque, and may require a more frequent and detailed

- reporting. Heightened reporting levels will enhance transparency and provide regulators information sufficient to assess creditworthiness of the issuer. Many municipal bonds without the guarantee are not actively traded, which also reduces if not eliminates any pricing discovery, and accuracy, the bonds might have had when insured and more liquid. An alternative valuation method may need to be developed, as the NAIC methodology of matrix pricing using comparable bonds may have limitations due to the difficulty of establishing benchmarks, in particular for small municipal issuers.
- b. Given the impact on municipal finances from the possible protracted equity market downturn, from expected losses in the commercial real estate market, and from the continuing foreclosures in residential real estate market, the credit assessment of municipal bond portfolios should assess the risk of unfunded pension and employee/retiree healthcare liabilities, the growth rate of many government programs (e.g. healthcare, childcare, aged home care) which generally exceeds the growth of government revenues. Continuing municipal fiscal burdens and pressures, and unprecedented burdens resulting from the "baby boomer" generation, may necessitate alternative views and assessments of municipal creditworthiness. Recent municipal defaults in South Carolina, Pennsylvania and Nevada illustrate the sensitivity of this time.
 - c. Regulators should evaluate development of a series of indicators/scales prepared for regulators as warning signs in municipal issues (especially those without strong general obligation support). These indicators could include: i) Liquidity -given the thin secondary market and overall reduced quality of many issues, liquidity is an increasing concern, ii) Sustainability - (as CALPERS and others have raised) on long portfolios given pension, OPEB and social service programs, iii) Municipal Tax Capacity - whether the government has sufficient taxing capacity and authority to satisfy current and prospective obligations, as opposed to neighboring or "competitive" taxing authorities, iv) scrutinize the risk among variant life terms of debt, and v) establishment of thresholds or milestones for reserve adjustments.
5. Referral to the NAIC Valuation of Securities (E) Task Force: VOS should continue to develop independent analytical processes to assess investment risks. These mechanisms can be tailored to address unique regulatory concerns and should be developed for use either as supplements or alternatives to ratings, depending on the specific regulatory process under consideration.
 6. Referral to the NAIC Valuation of Securities (E) Task Force: ARO ratings have a role in regulation; however, since ratings cannot be used to measure all the risks that a single investment or a mix of investments may represent in an insurer's portfolio, NAIC policy on the use of ARO ratings should be highly selective and incorporate both supplemental and alternative risk assessment benchmarks.
 7. Referral to the NAIC's SVO Initiatives (EX) Working Group: NAIC should evaluate whether to expand the use of SVO and increase regulator reliance on the SVO for evaluating credit and other risks of securities.
 8. Referral to the SVO Initiatives (EX) Working Group: Consider whether the NAIC should establish a not-for-profit rating agency where ARO rating coverage is not adequate.
 9. The NAIC Rating Agency (E) Working Group should establish a process to monitor and evaluate ARO activities. A monitoring function would:
 - a. Provide information about product offerings and the direction of financial innovation.
 - b. Permit timely regulatory intervention to set regulatory treatment for risky securities differently than that suggested by their credit quality.

- c. Promote, if not require, rating agency transparency of process, compensation, staff participation, and collateral underlying the security.
 - d. Determine the materiality of risks other than credit to financial solvency.
 - e. Monitor and assess the changes that the rating agencies are implementing, and whether ratings continue to correctly complement regulatory purposes
10. Referral to the SVO Initiatives (EX) Working Group: The SVO does not take part in the structuring of securities transactions for issuers and is not subject to the competitive pressures that can lead to the conflicts of interest discussed throughout this report; therefore, state regulators should evaluate whether to expand the SVO's role.

Modify the Filing Exempt Rule

- 11. Referral to the NAIC Valuation of Securities (E) Task Force: VOS should consider developing alternative methodologies for assessing structured security risks. Those structured security classes where an alternative method is adopted would be ineligible for filing exemption.
- 12. Referral to the NAIC Valuation of Securities (E) Task Force: VOS should consider if new investment products should be ineligible for filing exemption and/or instead be subject to regulatory evaluation. Filing exempt status can be granted or withheld on the basis of the regulatory review.
- 13. Referral to the NAIC Valuation of Securities (E) Task Force: Consideration should be given to modifying the filing exempt rule to adjust for securities with new additional ARO ratings and other measures (such as V Scores and Parameter Sensitivities) when deemed applicable. The need for different RBC and/or some other and additional regulatory processes should be evaluated.² Such processes could include the use of market information on price direction and of yield trends in addition to ARO ratings for some or all filing exempt securities.

Securities highlighted by this process can be reviewed by the SVO with the objective of adjusting the ARO rating to help ensure an accurate RBC charge.

- 14. Referral to the NAIC Valuation of Securities (E) Task Force: VOS should develop tools to better address market and liquidity risk in structured securities.

Company Specific Action

- 15. Referral to the NAIC Valuation of Securities (E) Task Force: VOS should consider requiring insurance companies to provide enhanced documentation for their investment policies and procedures to their regulators, to demonstrate they have a sound basis for their investment strategies.
- 16. Referral to the NAIC Valuation of Securities (E) Task Force: Consider additional company level processes in addition to using ratings. For example, a requirement for a "Structured Security Use Plan" (similar to a Derivative Use Plan) requiring insurers to have an appropriate investment and control environment prior to investing in structured securities.
- 17. The Rating Agency (E) Working Group will examine the extent to which insurers rely on ratings instead of performing their own due diligence.

² V Scores address the degree of uncertainty around the assumptions that underlie structured ratings (*i.e.* data limitations and modeling assumptions). Parameter Sensitivities address the sensitivity of Moody's ratings to changes in key assumptions, and so measure how the initial rating might differ if key rating input parameters were varied.

Risk Based Capital (RBC)

18. Referral to the NAIC Capital Adequacy (E) Task Force: The NAIC's Solvency Modernization Initiative (EX) Task Force and the NAIC's Capital Adequacy (E) Task Force have been discussing reform of the RBC formulae for Life, Property and Casualty, and Health Insurers. The Working Group recommends a comprehensive review of RBC, including a review of whether all RBC formulae should have greater granularity. The focus should be on a total balance sheet approach and have a greater focus on fundamental risk analysis.
19. Referral to the NAIC Capital Adequacy (E) Task Force: Consideration should be given to recalibrate the RBC formulae to require different levels of capital for municipal, corporate and structured securities. Greater quantification of risk in these very different asset classes will permit a more appropriate distribution of capital.
20. Referral to the NAIC Valuation of Securities (E) Task Force: Continue the process of evaluating the merit of an alternative method to determine the NAIC designations to structured securities, in addition to RMBS.

Asset Valuation and Interest Maintenance Reserves

21. Referral to the NAIC Capital Adequacy (E) Task Force & NAIC Blanks (E) Working Group: The Asset Valuation Reserve establishes a reserve to offset potential credit-related investment losses on all invested asset categories. Similar to risk-based capital, greater granularity should be introduced into the AVR mechanism by introducing municipal, corporate and structured asset categories.
22. Referral to the NAIC Statutory Accounting Principles (E) Working Group: The Statutory Accounting Principles (E) Working Group should analyze whether it is appropriate to continue using changes in NAIC designations to determine if realized capital gains or losses are to be classified as interest rate gains or losses. NAIC designations are an indicator of credit quality. They were chosen as a proxy in determining whether gains or losses are interest rate related for administrative simplicity. Regulators should evaluate how well they have served as a proxy in classifying realized capital gains or losses.

References to AROs in Legislation

23. Referral to the NAIC Investment of Insurers Model Act Revision (E) Working Group: Consider encouraging state regulators to identify references to AROs in state insurance laws and to consider proposing modifications that refer to alternative risk assessment methods or providers so as to lessen reliance on AROs.
24. Referral to the NAIC Investment of Insurers Model Act Revision (E) Working Group: Consider whether to propose how references to AROs in NAIC Model investment laws could be retained or changed.
25. Referral to the NAIC Investment of Insurers Model Act Revision (E) Working Group: Consider whether to propose how NAIC Model investment laws could be amended to reflect the filing exempt process.

Assessing Impact of ARO Insight or Action on Insurer Ratings

26. The Rating Agency (E) Working Group should develop information that can be posted on the NAIC website to educate consumers on the limitations of rating agency ratings of insurers.
27. Rating Agency (E) Working Group: Insurers should be required to share the information provided to NRSROs, and regulators should be proactive in considering the implications of these requirements for capital and changes in ratings as a way to safeguard public confidence in regulation. We recommend the development of a model law to accomplish these objectives.
28. Rating Agency (E) Working Group: DBRS analytical process for speculative grade securities, which incorporates both the risk of default and also the likelihood of recovery in default, should be considered to assess whether a different analytical or regulatory approach to speculative grade securities owned by insurers is warranted.
29. Rating Agency (E) Working Group: AM Best indicates that certain components of its rating process related to cash flows and liquidity, risk concentration and correlation, are being enhanced as a way to assess an organization's ability to absorb tail events (i.e., low probability / high severity losses) during adverse financial market conditions. State regulators should meet with AM Best representatives to evaluate the extent to which these adjustments in the methodology signal potential complementary areas of improvement in financial regulation.
30. Rating Agency (E) Working Group: State regulators should also meet with other AROs to evaluate what improvements they have made since the September 2009 hearing on their rating processes.

VI. Recommendations for Structural Rating Agency Reform

1. Regulators should consider how to support the following reforms for rating agencies :
 - a. Creating committees and processes to identify when new proposed transactions or securities do not warrant a rating. The committees would approve the logic for rating new types of securities. Determinations of such committees and the identified risks that support this determination should be made publicly available;
 - b. Not only applying newer rating models for new securities, but, consistently for all applicable securities, including those in the secondary market;
 - c. Creating a real-time automated process that would apply a rating agency's original assumptions to the monthly servicer remittance data;
 - d. Disclosing monthly service remittance data or any similar underlying asset performance information publicly;
 - e. Creating a data library for planned transactions where details about the proposed collateral could be posted so that investors could "inspect the collateral" before purchasing a transaction;
 - f. Develop standards for analyst training;
 - g. Monitoring and using monthly servicer performance data to update/correct their initial models and assumptions;

- h. Creating an Office of Chief Statistician and Models reporting to an independent committee of the board of directors;
- i. A third party, who is independent from both the investment banker and the originator, should review the loans proposed for the collateral pool; and
- j. Require the development of standards, greater standardization of definitions and greater consistency in the agreements used for structured securities.

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