American Academy *of* Actuaries

February 3, 2011

Mr. Yoshihiro Kawai
Secretary General
International Association of Insurance Supervisors
Via email: yoshihiro.kawai@bis.org

Re: Financial Stability Board paper, *Principles for Reducing Reliance on CRA Ratings*

Dear Mr. Kawai:

The American Academy of Actuaries'[1] Solvency Committee is pleased to provide its comments on the Financial Stability Board's (FSB) *Principles for Reducing Reliance on CRA [Credit Rating Agencies] Ratings* document. We understand that you are preparing a response to the FSB and hope that our contribution will be of assistance in this task as you consider the relevance of the FSB recommendations for the insurance sector.

The Academy's comments are shaped by its experience with the manner in which CRA ratings influence the regulation of the insurance industry in the United States as well as their influence on how insurance companies manage their investments and capital. Insurers are active participants in the capital markets, involved with the buying and selling of billions of dollars of securities. Insurers have long used CRAs to assist in their evaluation of the risks contained in many types of financial instruments. For many insurers, the opinions offered by the CRAs supplement, if not override, the risk analysis performed by the insurance company.

The CRA rating is the basis for classifying many of an insurer's investment holdings. These classifications form the basis for minimum capital requirements for corporate bonds and collateralized mortgage obligations, representing a significant proportion of the insurance industry's asset holdings. Insurance regulators in the US are considering various alternatives in order to reduce their reliance on CRAs, but recognize that change in the use of CRA ratings would have a significant impact on reporting and regulatory practices that have, for the most part, played a positive role in the regulation of insurance entities in the US.

We would like to make the following specific comments and suggestions:

1. We suggest that more direct regulation of these firms would be more beneficial and effective rather than imposing discipline on those that use their services. We believe that

[1] The American Academy of Actuaries ("Academy") is a 17,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

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there is considerable merit in approaching the issue that the FSB is concerned about through such a route. The SEC has proposed standardizing and improving, where necessary, the practices of CRAs so that the ratings from each CRA would be more directly comparable. This standardization is desirable and should be replicated in other countries.

2. Forcing a multitude of financial institutions around the world to develop identical analytic talents by simply eliminating the role of the few CRAs that already possess these talents seems inefficient. CRAs do possess significant capabilities to evaluate risks. It should not be assumed that these analytical capabilities can be absorbed by the regulators and financial market participants without any negative consequences.
3. The CRA rating is especially needed where the terms of the underlying security are complex, such as private placement debt or structured products (for example, CBO squareds).
4. While CRAs may not have stayed abreast of risk changes, removing reliance on CRAs raises concerns about the alternatives to them. Would investors do a better job?
5. There may be some merit to increasing capital requirements if the owner of a security cannot reasonably ascertain the inherent risk at any point in time. However, evaluating the quality of a firm's risk management practices, including the firm's ability to evaluate its risk exposure to a financial instrument, will be very challenging to enshrine in a new regulatory regime.
6. A redefinition of the role of CRA ratings in assessing the solvency of insurers by supervisors should not unduly discriminate against smaller-sized insurers.
7. A redefinition of the role of CRA ratings in assessing the solvency of insurers by supervisors should not unnecessarily increase the cost of regulatory compliance.
8. The CRAs provide a common benchmark, which, if lost, would diminish the ability to measure and compare ratings and would expand inconsistencies among insurance company financial statements.
9. The CRAs have access to privileged information that individual companies that are current or potential investors do not have.
10. The lessening of smaller companies' ability to buy securities they cannot personally rate will diminish the market demand for many securities and thus increase their cost to those who can acquire them. This could potentially reduce the liquidity of assets with consequent impacts on the financial system and the wider economy given the important role of insurers as institutional investors.
11. Decades ago, companies did have to retain employees to evaluate the riskiness of securities. There were not enough qualified people to perform these tasks. This helped spur the creation of the CRAs. CRAs receive fees from issuers in order to provide the risk analysis, in lieu of each company retaining their own employees for the analysis.

> The CRAs have been able to acquire and retain risk analysis talent and pool their conclusions for the industry.

Finally, while we applaud the review of CRAs and the influence that they exert on the standards, laws, and regulations governing the financial markets, we encourage a more in-depth analysis of the role CRAs play in the financial markets. We think the financial markets may be more stable if the focus were on how to encourage better due diligence and risk management.

Sincerely,

R. Thomas Herget

R. Thomas Herget, FSA, MAAA, CERA
Chair, Solvency Committee
American Academy of Actuaries

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