M E M O R A N D U M

TO: FACI Subcommittee II Members

Cc: Brian Duperreault
Michael McRaith
James Brown

FROM: John J. Degnan

DATE: May 21, 2013

RE: **May 7, 2013 FACI Subcommittee Meeting: Summary**

The Subcommittee met by telephone conference call at 3:00pm on the above date. In attendance were: James P. Brown, Anne-Melissa Dowling (for Commissioner Leonardi), Robert Easton (for Superintendent Lawsky), Scott Harrington, Commissioner Lindeen, Commissioner Consedine, Michael Sproule, and John Degnan.

At the request of Director McRaith, the Subcommittee was asked to address the following questions:

1. Do credit rating agencies affect how insurers operate and manage capital?

2. Do insurers manage capital in accordance with the expectations or demands of credit rating agencies?

3. How often do insurers meet with a credit rating agency?

4. For what purpose do insurers meet with a credit rating agency?

5. Do credit rating agencies affect competition in a line of insurance: In what way(s)? Is this a positive or negative impact?

<u>Questions 1 and 2:</u>

The Subcommittee elected to address the first two questions together since they are so closely interrelated. It seemed to the Subcommittee that most insurers in both the property/casualty and life sectors are directly affected, to some degree, by the actions of the credit rating agencies and do, as a result, to some degree, operate and manage capital in accordance with their expectations. This was thought to be correlated with the degree to which a particular carrier markets its financial strength ratings as part of its value proposition. However, in the P&C space, the significant adverse impact on commercial carriers of a rating below A- virtually requires attention by such carriers to the impact of their operations and capital management on their ratings; this factor is probably of less significance to most personal lines carriers. Such an outcome was thought to be consistent with a "reasonably functioning" competitive marketplace.

There was extensive conversation about the use by the credit rating agencies of their "models" and the process by which ratings are assigned. Most of the agencies are reasonably transparent with their models and allow insurers to effectively assess the impact on those models of particular capital management decisions. However, one regulatory participant noted that his Department had received at least one complaint from an insurer that a rating agency had deviated from its own methodology in the assignment of a rating. There was an observation made that companies tend to evaluate their decisions against the model deemed most stringent in the expectation that the others will follow suit. There was some indication that the credit rating agencies models generally presented more stringent standards than the NAIC's RBC model.

The consensus was that insurers probably do not manage solely to the models but that they are "very aware" of the implications to the models of a particular decision. As such, it might be said that the credit rating agencies' assignment of ratings are important but do not unilaterally dictate management decisions.

The importance of financial strength ratings is also reflected in the fact that, at least in the P/C space, some of the largest brokers and agents have credit rating criteria for the assignment of business to an underwriter or at least provide such information to an insurance buyer to better inform its decision as to which carrier to use.

In addition, it seems reasonable to conclude that capital management decisions by carriers such as stock buybacks, debt to capital ratios, and dividend yields are influenced significantly by the rating impacts yielded by the agencies' models. In addition, operational decisions such as lines of business to write and rates to charge appear to be similarly influenced by the credit rating agencies.

Although not discussed by the Subcommittee, it should be noted that Standard & Poors issued this month a new Rating Methodology which will apply to all life, health and P/C insurers and will trigger ratings reviews for all carriers over the next six months. Adding emphasis to qualitative factors in their reviews, the new methodology is based on eight rating factors: (1) insurance industry and country risk assessments, (2) competitive position, (3) capital and earnings, (4) risk position, (5) financial flexibility, (6) enterprise risk management, (7) management and governance, and (8) liquidity. This announcement is consistent with the comments of several subcommittee members that the rating agencies appear to be "stepping up" their game since the 2008 financial crisis. It remains to be seen whether that phenomenon, if accurately perceived, will alter in any way the degree to which carriers are affected by rating agency standards.

There was some discussion about the degree to which ratings assigned by the agencies should be incorporated into regulatory reviews of financial strength and solvency or into the emerging dialogue around international standards. Although, as referenced earlier, it was noted that rating agency models were often more stringent that those of the NAIC RBC models, regulatory Subcommittee members commented that reliance on ratings had actually diminished since 2008, that such ratings had not entered into Supervisory College reviews except for an assessment of how companies pay attention to them, or that they were more relevant as a business metric than as a financial strength indicator.

Question 3:

Most of the credit rating agencies require an annual meeting with each carrier although one agency, in particular, now requests two meetings each year and welcomes quarterly updates throughout the year. However, there are numerous "off-line" interactions between rating agencies and carriers which are subject specific, e.g. impact from a catastrophe or a particular loss scenario.

In addition, several of the rating agencies are using frequent "data collection" surveys throughout the year, often as many as four to five times each.

Question 4:

Obviously, given the above discussion, insurers meet with credit rating agencies to convey information deemed relevant to the review process by the particular agency. These formal meetings, once or twice a year, are rigorous reviews, involving the most senior management of the company and generally last a full day. That level of engagement speaks strongly to the level of importance attributed to ratings by insurers.

Occasionally, specific intended actions of an insurer will trigger the need for a meeting as in the case, for example, of a debt or equity offering or the need for a catastrophe bond rating.

Question 5:

Time did not allow for extensive discussion of this issue but there was some sentiment for the conclusion that, except for the potential impact on product pricing driven by capital management decisions, there generally was not a significant impact on competition driven by credit rating agencies.

JD/cl