Comments of the Center for Economic Justice the Consumer Federation of America

On the ACLI Proposal for Capital Relief on Residential Mortgage-Backed Securities

October 13, 2009

The Center for Economic Justice and the Consumer Federation of America oppose the ACLI proposal for the NAIC to abandon the credit ratings of Nationally Recognized Statistical Rating Organizations (NRSROs – the credit rating agencies) for only one class of securities – residential mortgage-backed securities (RMBS) – in favor of credit ratings from an as-yet unidentified investment management company.

We oppose this proposal because it is yet another bald attempt by life insurers to change the rules – rules the life insurers once championed – to provide capital relief to insurers at the expense of consumer protection.

The ACLI proposal is clear that life insurers seek capital relief. The proposal asserts that the current rules will require $11 billion in additional capital and the insurers want alternative ratings of RMBS to reduce the amount of capital required under risk-based capital rules to support these poorly-performing securities.

While it is reasonable for regulators to reconsider the ill-conceived action to delegate a public regulatory responsibility of evaluating the risk of insurer investments to credit rating agencies who had a conflict of interest, it makes no sense to select one class of securities for which to seek alternative ratings to another private entity – investment management companies – who also have a conflict of interest.

The NAIC should develop a plan to broaden the scope of the Securities Valuation Office so regulators have an institution dedicated to risk ratings of securities for the sole purpose of supporting regulatory financial surveillance of insurance companies.

The ACLI proposal is bad policy for several reasons. First, the proposal picks out only one class or asset-backed securities for alternative ratings – securities backed by residential mortgages. The ACLI claims that the credit rating agencies' methodologies for RMBS are flawed because the methodologies are focused on likelihood of first dollar of loss and not on the overall severity of loss. But, the credit rating agencies' approach for other types of asset-backed securities – those backed by credit card loans, auto loans and commercial property loans – use a similar methodology.

Why then, is only one class of asset-backed securities included in the proposal? It is not because the ACLI wants to improve the quality of solvency regulation, but because the ACLI wants capital relief from the capital requirements for this class of securities.

Second, it is inconceivable that regulators would consider capital relief for these very risky securities given projections for continued high unemployment, mortgage defaults and mortgage foreclosures. Mortgage delinquencies and defaults have moved through sub-prime and Alt-A loans and are now increasing most rapidly in prime mortgage loans. Hundreds of thousands of interest-only and payment-option loans will be reset in the next year or two, with predictions of related defaults and foreclosures. Insurers should be increasing their capital base significantly if they hold these very risky securities.

Third, the proposed alternative rating entities – investment management firms – also have a conflict of interest – a different conflict than that of the credit rating agencies, but nonetheless a conflict. The investment management companies manage the investments of their clients and have an interest in performing for their clients by returning gains on the investments. If an investment management company were to offer a very poor rating for RMBS which were owned by the investment management company's clients, the investments of the clients could be damaged.

State regulators are correct to belatedly recognize the problem with delegating a key regulatory function to private credit rating agencies which have a conflict of interest. But state regulators should not worsen the problem by delegating the same regulatory function to a different private entity with another conflict of interest.

Finally, we understand that regulators are concerned with insurers evading the credit rating agencies' RBMS ratings through the RE-REMIC process by which the RBMS is cannibalized into multiple securities with a significant transaction cost – but a lesser cost than meeting the capital requirements of the current RBMS ratings. The proper solution is to prohibit insurers from engaging in sketchy investments which cost the insurers a significant amount, but which do nothing to improve the capital strength of the insurer and not to rush to an illogical procedure which allows insurers to hold less capital.