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Credit Ratings in Insurance Regulation: The Missing Piece of Financial Reform

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Credit Ratings in Insurance Regulation: The Missing Piece of Financial Reform

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Abstract

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 directed federal financial regulators to remove credit ratings from their rules, but had nothing to say about the use of credit ratings by state insurance regulators. This omission is significant because insurers own nearly twice as many foreign, corporate, and municipal bonds as banks do. During the 2000s, state insurance regulators came to rely increasingly on rating agencies rather than the regulators' in-house valuation office to assess the credit risks of these holdings.

After the perceived widespread failure of ratings in the crisis, the insurance regulators did undertake a review of their use of ratings in regulation. This review, which has been going on for over two years, does not seem to be on a path to eliminate the use of credit ratings in insurance regulation. The one decisive action regulators have taken in this area, ceasing reliance on credit ratings on mortgage-backed securities in favor of a standard more favorable to the industry, seems to be an example of what I call a "rule bailout"—an ad hoc regulatory rule change to benefit a struggling industry during a crisis.

The increasing dependence on outsourced credit ratings under industry pressure during a boom, rule bailout during a crisis, and subsequent reconsideration of the use of credit ratings suggests a political cycle of financial regulation, in which significant reform is feasible only in the aftermath of crisis. This cycle complicates several leading technical proposals for improving capital regulation and may limit what we can expect from the project of financial regulation generally.

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Table of Contents

I. Introduction 1668

II. The Rise of Rating-Dependent Regulation of Insurance 1671

III. The Financial Crisis, the Ratings Crisis, and the Insurance Industry 1676

IV. Analysis Without Action: NAIC's Inconclusive Review of Rating-Dependent Regulation 1680

V. Action Without Analysis: The "Rule Bailout" of Life Insurers 1689

VI. The NAIC and the Limits of Capital Regulation 1694

VII. Conclusion 1697

I. Introduction

One of the few financial reforms on which Republicans and Democrats in Congress have agreed is the elimination of credit ratings from financial regulation. Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ordered federal financial authorities to excise credit ratings from their regulations within one year,[1] and the House Republicans' alternative draft financial regulation bill contained a similar provision.[2] Dodd-Frank's sweeping and unequivocal command was noteworthy not just for its bipartisanship, but also because it seemed to resolve at one stroke a struggle over the proper use of credit ratings that had

1. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 § 939A (2010) [hereinafter Dodd-Frank Act].

2. *See* Consumer Protection and Regulatory Enhancement Act, H.R. 3310, 111th Cong. §§ 602–603 (2009) (providing for elimination of credit ratings from federal financial regulation within three months of enactment). Despite agreement on this particular point, most Republicans in Congress voted not to enact Dodd-Frank. *See* U.S. House of Representatives, *Final Results for Roll Call 413* (June 30, 2010), *available at* http://clerk.house.gov/evs/2010/roll413.xml (last visited Nov. 25, 2011) (showing that, in final vote on the Dodd-Frank Act in the House, 173 Republican members voted Nay, 3 voted Yea, and 2 did not vote) (on file with the Washington and Lee Law Review); *see also* U.S. Senate, *U.S. Senate Roll Call Votes 111th Congress Second Session* (July 15, 2010), *available at* http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=111&session=2&vote=00208#position (last visited Nov. 25, 2011) (showing that, in final vote on the Dodd-Frank Act in the Senate, 38 Republicans voted Nay and 3 voted Yea) (on file with the Washington and Lee Law Review).

been going on for at least fifteen years. Law professors,[3] financial economists,[4] and even some of the rating agencies themselves[5] had been criticizing the regulatory use of ratings since the mid-1990s with little to show for their efforts. Section 939A might have seemed like a sudden and complete, if unexpected, victory for the reformers.

But Dodd-Frank, definitive as it was in ordering an end to the use of credit ratings in federal financial regulation, had nothing to say about the use of ratings in the state-based insurance regulatory system. It is as though the financial reformers forgot about insurance, the industry that owns about 20% of the corporate and foreign bonds[6] and 16% of the municipal bonds in the United States,[7] and that bears a corresponding amount of the credit risk that rating agencies assess and regulators monitor. By comparison, banks own about 7% of corporate and foreign bonds[8] and 9% of municipal bonds[9] outstanding.

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3. *See, e.g.*, Frank Partnoy, *The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 623 (1999) (arguing that incorporation of credit ratings into regulation "has encouraged the rating agencies to shift from the business of providing valuable credit information to the far more lucrative business of selling regulatory licenses."). Partnoy explains that

> the new regulatory scheme has had dramatic effect, not only causing a decline in the informational value of credit ratings, but also creating incentives for the agencies to provide inaccurate ratings and for market participants to pay for regulatory entitlements stemming from the agencies' ratings, instead of paying for the informational content of the ratings.

Id.

4. *See* Financial Economists Roundtable, Statement on Reforming the Role of the Statistical Ratings Organizations in the Securitization Process (Dec. 1, 2008), at 2 ("[T]he FER [Financial Economists Roundtable] challenges the wisdom of incorporating SRO [rating agency] ratings in securities and banking regulations issued by governmental entities.").

5. *See* Thomas McGuire, Moody's Investor Servs., Ratings in Regulation: A Petition to the Gorillas 1 (Apr. 28, 1995) ("Moody's . . . recommends that use of ratings be phased out of financial regulation, such that the sole judge of the quality of rating opinions will again be the investors who bear the risks of fixed-income investment.").

6. Fed. Reserve Bd., Flow of Funds Accounts of the United States: Flows and Outstandings Second Quarter 2011, FED. RES. STATISTICAL RELEASE Z.1, Sept. 16, 2011, at 93 tbl.L.212 (figure derived by summing holdings of property-casualty insurance companies and life insurance companies).

7. *Id.* at 92 tbl.L.211 (same derivation).

8. *Id.* at 93 tbl.L.212 (figure derived by summing holdings of U.S.-chartered commercial banks, foreign banking offices in the U.S., bank holding companies, banks in U.S.-affiliated areas, and savings institutions).

9. *Id.* at 2 tbl.L.211 (same derivation).

This Article explores the previously unexamined use of credit ratings by state insurance authorities, who have jealously guarded their primary authority over insurance regulation from Congressional intrusion for sixty-five years.[10] Part II of the Article traces the rise of rating-dependent regulation of insurance and the displacement of the state insurance regulators' in-house public rating capability by private credit rating agencies in the 2000s. Part II reviews how the failure of financial products that had received high credit ratings stressed the industry during the financial crisis.

Part III examines the insurance regulators' reconsideration of their use of credit ratings in response to the crisis. Regulators have studied the problem for years, starting in February 2009, but their study and analysis has led to only limited proposals to reduce reliance on ratings. Even if all proposals pending today are adopted, the insurance regulation system will continue to be heavily rating-dependent. The insurance regulators' continued embrace of credit ratings is important on its own, because it threatens to defeat the purpose of Dodd-Frank's directive to remove ratings from federal financial regulation: Artificial regulatory demand for ratings will continue, and credit rating agencies' decisions will continue to exert outsized influence through the regulatory system. Insurance regulators' continued reliance on credit ratings also is important because it illustrates how reluctant regulators are to give up using these measures of credit quality, which are readily available and are, for better or worse, widely recognized. In fact, Congress recently learned the hard way just how attached the federal financial regulators are to credit ratings, as these authorities missed Dodd-Frank's one-year deadline for eliminating credit ratings.

Part IV examines one very important exception to the general proposition that insurance regulators have acted only slowly and cautiously. This exception is the regulatory treatment of residential and commercial mortgage-backed securities. After the mass rating downgrades of mortage-backed securities in the financial crisis, regulators moved swiftly on industry's request to abandon credit rating agencies and to give these securities more favorable regulatory treatment so that the industry would not have to raise more capital. The timing, low visibility, and industry-

10. *See* Robert W. Klein, *The Insurance Industry and Its Regulation: An Overview*, *in* THE FUTURE OF INSURANCE REGULATION IN THE UNITED STATES 13, 32–36 (Martin F. Grace & Robert W. Klein eds., 2009) (describing states' struggle to retain authority to regulate insurance in the years since the Supreme Court recognized federal authority to regulate the industry in *United States v. Southeastern Underwriters Ass'n*, 322 U.S. 533 (1944)).

friendly nature of this action suggests that it is better understood not as a principled reaction to the problems of rating-dependent regulation, but rather as an example of what I call a "rule bailout"—an ad hoc rule change by regulators to benefit the regulated industry when the industry is under stress. Although explicit bailouts that put government funds at risk have received much more attention than rule bailouts, rule bailouts arguably are more insidious and dangerous. They attract less attention than explicit bailouts. And when a rule bailout allows an industry to change rules that an industry sought the moment those rules become inconvenient—as apparently happened in the case of the insurance industry—rule bailouts promote unfairness and moral hazard.

Part V situates the rule bailouts of insurance and other segments of the financial industry in the broader context of the political cycle of financial regulation. If the large, powerful financial industry is cyclical in nature and the political will to regulate it exists only in the aftermath of crisis, then efforts to constrain regulatory discretion or strengthen regulators are limited in what they can accomplish. Even if the scope of financial regulation is understood broadly, to encompass the *ex post* reallocation of the gains and losses from the financial cycle in the interest of justice, such an approach is limited by the difficulty of identifying the gains and losses to be allocated, except in the broadest terms. Thus, what we can expect from the overall project of financial regulation may be limited.

Part VI concludes, arguing that despite the insurance regulators' valuable and empirical work, we simply do not know at this point whether these regulators should abandon credit ratings in favor of any particular alternative. Even if the analytically correct answer were clear, it might be irrelevant because of the insurance industry's preference for private credit ratings and its apparent power over its own regulation.

II. The Rise of Rating-Dependent Regulation of Insurance

One of insurance regulation's main goals is reducing the likelihood that insurers will fail to meet policyholders' claims due to insolvency,[11] and insurance law seeks to control the risk that insurers will become insolvent

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11. *See* EMMETT J. VAUGHAN & THERESE M. VAUGHAN, FUNDAMENTALS OF RISK AND INSURANCE 106 (10th ed. 2008) ("Clearly, a primary focus on insurance regulation is on insurer solvency. Indeed, it has been argued that this should be the primary function of regulation.").

due to investment losses.[12] It employs two tools to this end: investment holding limits, which require insurers to hold investments that meet some standard of safety,[13] and capital requirements, which require insurers to maintain prescribed levels of capital as a margin of safety against insolvency.[14]

Credit risk—used here to refer to the risk that an insurer's investments will go into default or otherwise not pay as agreed—is especially important for insurers, who often hold investments for a long period of time to satisfy liabilities that will arise in the distant future, such as life-insurance claims on a pool of currently middle-aged policyholders.[15] Banks and brokers, by contrast, may be more concerned about liquidity risk—the risk that all their creditors will demand repayment at once.[16] This was the risk that brought down so many institutions during the financial crisis.[17]

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12. *See id.* at 108 (discussing how and why "the insurance code of each state spells out the particular investments permitted to each type of insurance company in the state").

13. Investment holding limits are prescribed by state statute and vary widely from state to state. In the 1990s, the National Association of Insurance Commissioners (NAIC) attempted to establish a model law for investment holdings. The effort ran into difficulties, and ultimately resulted in *two* model laws reflecting two different philosophies about proper investment limits. In 1996, NAIC promulgated the Model Investment Act (Defined Limits Version), which lists permitted investments one by one and forbids non-listed investments (the "pigeonhole" approach). *See* 3 NAIC MODEL LAWS, REGULATIONS, AND GUIDELINES 280-1, §§ 3–32 (2011). In 1997, NAIC promulgated the Model Investment Act (Defined Standards Version), which permits any investment that meets a general standard of prudence in the context of the insurer's portfolio (the "portfolio" approach). *See id.* 283-1, §§ 1–19 (2011). Most states have not enacted either of NAIC's model laws. *See id.* 280-1, State Adoption (showing adoption of the Model Investment Act (Defined Limits Version) by seventeen states); *id.* 283-1, State Adoption (showing adoption of the Model Investment Act (Defined Standards Version) by one state). The major insurance-regulating states are divided between the "pigeonhole" and "portfolio" approaches. *Compare* CONN. GEN. STAT. § 38a-102(a) (2011) (stating that, subject to exceptions, an insurance company may make such investments "as are prudent in respect of the business of said insurance company and diversification considerations"), *with* N.Y. INS. LAW §§ 1404–05 (prescribing lists of permitted investments for life and non-life insurers).

14. The NAIC's Risk-Based Capital Model Act requires insurers to follow risk-based capital rules adopted by NAIC. *See* 3 NAIC MODEL LAWS, REGULATIONS, AND GUIDELINES 312-1, § 2.A (2011) (stating that domestic insurers must submit an annual report outlining the extent of their risk-based capital).

15. *See* GUILLAUME PLANTIN & JEAN-CHARLES ROCHET, WHEN INSURERS GO BUST 2, 90–96 (2007) (contrasting the credit risks of the banking industry with those that insurers face). Moreover, if insurer solvency benefits parties other than owners or creditors, one might not expect owners or creditors to bargain hard to protect the interests of these third parties.

16. *See id.* at 2 (explaining how banks by their very nature are subject to "runs"). Banks, of course, are also concerned with credit risk.

17. *See, e.g.*, FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT

Both the tools insurance law uses to control insurers' financial risk are designed to help manage credit risk. Investment holding limits restrict insurers to instruments with lower credit risk, and capital requirements are calibrated to account for the greater losses that instruments with greater credit risk are likely to suffer: riskier instruments are more likely to suffer large losses, so they require a larger capital cushion.

As a simple example of capital requirements,[18] consider an insurance company with $1,000 in assets.[19] If it is subject to a 10% capital requirement, then the insurer must maintain $100 in capital and thus can have only $900 in liabilities. If the company is subject to a 30% capital requirement, then the insurer must maintain $300 in capital and thus can have only $700 in liabilities. The insurer's owners must supply the capital, so the requirement determines how much money the owners must put up to maintain a business of a given size (as measured by assets). The difference between having to hold 10% of asset value as capital and having to hold 30% as capital is the difference between being able to run a $1,000 business with $100 and $300, respectfully, of one's own money. It is also the difference between being able to sustain 10% and 30% of losses before becoming insolvent, at least in an accounting sense.

One might expect creditors, such as insurance policyholders, to demand that insurers maintain such a safety cushion, and one might likewise expect insurers to maintain such a cushion in order to be able to stay in business when they suffer investment losses. The insurer might not hold as much capital as the creditors would like, or as much as policyholders would bargain for if they were not diffuse.[20] Even so, capital

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291 (2011) (detailing Bear Stearns's failure after "runs" and how regulators permitted Bear to operate with "insufficient liquidity"); *see also id.* at 343 (citing "runs" and "reliance on short-term funding" as causes of the failure of Lehman Bros.); *id.* at 355 (recounting the runs on Washington Mutual, Wachovia, Goldman Sachs, Morgan Stanley, and Merrill Lynch in the wake of Lehman's failure).

18. *See generally* Memorandum from Acad. Joint RBC Task Force, Am. Acad. of Actuaries, to Lou Felice, Chair, NAIC Risk-Based Capital Task Force (Feb. 12, 2002) [hereinafter AAA Feb. 12, 2002 Memo], *available at* http://www.actuary.org/pdf/finreport/jrbc_12feb02.pdf (describing insurance risk-based capital requirements consistent with this example).

19. The phrase "$1,000 in assets" can mean different things because not all assets are similarly valued. In applying the risk-based capital rules, financial assets may be valued at amortized cost or at the lower of amortized cost or market, with lower-risk assets valued at cost and riskier ones valued at the lower of cost or market. For life insurers, only assets in the lowest NAIC category, NAIC-6, are carried at the lower of cost or market. *Id.* § iii at 1. The "Detailed Grid—2001 Asset Risk Factors" delineates how each of the three formulas handle the various risk elements faced by Life, P&C, or Health companies.

20. *See* PLANTIN & ROCHET, *supra* note 15, at 27–28 (stating that the diffusion of

requirements constrain the freedom of the firms that are subject to them, and firms that are subject to capital regulation—whether insurers, banks, or brokers—chafe at and seek to circumvent their restraints. Regulators and the regulated constantly struggle over the formulation and application of capital requirements.

The body charged with developing capital rules for the insurance industry is the National Association of Insurance Commissioners (NAIC), an association of state insurance regulators that was founded in 1871 and counts all states' regulators as members.[21] The NAIC's Risk-Based Capital Model Law, which has been adopted in all states but Texas, requires state regulators to follow the NAIC's risk-based capital guidelines.[22]

An organization within the NAIC—the Securities Valuation Office (SVO), created in 1907[23]—historically has been charged with assessing the credit risk of insurance company investments. The SVO maintains its own rating scale, running from 1 (least risky) to 6 (most risky). The NAIC's capital rules are keyed to this 6-point scale: the difference between an NAIC-1 and an NAIC-6 rating on a $1,000 bond owned by a life insurer apparently is the difference between holding $3 and $195 in capital against the bond. For property/casualty insurers, the difference in capital required is even more stark—the charge is $3 for NAIC-1 and $300 for NAIC-6[24]

The SVO, which is funded by assessments on insurance companies,[25] apparently has relied on rating agency ratings as a starting point or benchmark for its assessments for a long time, because the SVO has not had the staff and resources to do its own credit analysis for every instrument

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insurance policies among policyholders results in "the absence of a tough, sophisticated claimholder" who could attempt to negotiate for the insurer to maintain a larger capital cushion).

21. VAUGHAN & VAUGHAN, *supra* note 11, at 105.

22. *See* 3 NAIC MODEL LAWS, REGULATIONS, AND GUIDELINES 312-1, § 2.A (2011). The Risk-Based Capital Model Act has been adopted almost universally, unlike the NAIC's model acts on investment limits. *See id.* 312.17-21, at § 15 (providing a chart reflecting adoption of the Risk-Based Capital Model Act in all states but Texas). Even Texas requires compliance with NAIC's risk-based capital rules except where they conflict with express provisions of state law. 28 TEX. ADMIN. CODE § 7.402 (2010) (incorporating the NAIC Risk-Based Capital guidelines into the law by reference).

23. *See* Partnoy, *supra* note 3, at 700 n.367.

24. AAA Feb. 12, 2002 Memo, *supra* note 18, § iii at 1.

25. *See* Press Release, Nat'l Ass'n of Ins. Comm'rs, NAIC Waives $790,000 Industry Assessment (Feb. 8, 2005), *available at* http://www.naic.org/Releases/2005_docs/SVO_Assessment_Waiver.pdf (noting that the $790,000 waiver was granted in accordance with an agreement that "called on the industry to pay a fixed assessment of $1.58 million in 2004" to offset lost SVO revenue).

owned by an insurer in the United States. In 1998, an SVO staffer wrote that the SVO's reliance on credit rating agencies was "essential to its productivity" because "covering the growing universe of structured securities simultaneously in a manner comparable to that of the [rating agencies] is not part of its mission."[26] But the SVO retained authority to take a more pessimistic view on an instrument's risk than the credit rating agencies.[27]

This changed in 2000, when the NAIC adopted a provisional exemption for investment-grade corporate and municipal securities. High agency ratings on corporate and municipal bonds were no longer subject to SVO review unless the state regulators requested such a review.[28] In 2004, NAIC adopted the "filing exempt" rule (FE Rule), which further constricted the SVO's role by providing that *any* bond or preferred stock with a current rating from a recognized rating agency need not be filed with the SVO.[29] The NAIC thus permitted insurers to decide whether their holdings would be rated by the SVO or by rating agencies. And insurers do overwhelmingly choose to rely on agency ratings: 80% of insurer holdings are rated by agencies rather than the SVO,[30] and the 20% that the SVO does assess are overwhelmingly those that are not rated by the agencies.[31]

Why did the NAIC decide to permit insurers to opt out of using its existing rating capability? According to a report by the accounting and

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26. Frederic P. Vigneron, *The NAIC Securities Valuation Office's Analysis of Asset-Backed Securities*, *in* HANDBOOK OF STRUCTURED FINANCIAL PRODUCTS 99, 109 (Frank J. Fabozzi ed., 1998).

27. *Id.*

28. *See* Nat'l Ass'n of Ins. Comm'rs, Statement and Testimony by Chris Evangel Before the NAIC's Working Group Public Hearing—Nov. 18, 2010 at 3, *available at* http://www.naic.org/documents/committees_e_rating_agency_evangel_comments.pdf (commenting that insurance regulators adopted the exemptions for "reasons of efficiency and effectiveness").

29. *See* Memorandum from Nat'l Ass'n of Ins. Comm'rs, Understanding the NAIC Filing Exemption (FE) Rule 1 (Feb. 25, 2004) (draft) 1, *available at* http://www.naic.org/documents/svo_FE_FAQ.pdf (explaining that "recognized" agencies in this context are those that the SEC has designated "nationally recognized statistical rating organizations").

30. *See* Chris Evangel, Managing Dir., Sec. Valuation Office, *Panel 1—Use of Ratings in Regulation*, 11 (Sept. 24, 2009), *available at* http://www.naic.org/documents/committees_e_rating_agency_090924_panel1_evangel.ppt (last visited Nov. 25, 2011) (giving a public hearing regarding the NAIC's use of credit ratings) (on file with the Washington and Lee Law Review).

31. Interview with Chris Evangel, Managing Dir., Sec. Valuation Office, Sec. Valuation Office (June 29, 2010) (interview notes on file with the Washington and Lee Law Review).

consulting firm KPMG that NAIC commissioned in 1998, the SVO lacked the resources and budget to do much beyond rely on agency credit ratings in most cases anyway: "SVO has difficulty completing an in-depth analysis on the more complex non-rated issues due to the large volume of submissions it receives, as well as limited qualified, trained staff available to perform the analysis."[32] The consultants outlined two options: a "massive increase in the budget and staff" of the SVO so that it could carry out the credit analysis it was supposed to carry out,[33] or bypassing the SVO altogether for instruments with credit ratings.[34] They recommended the latter, arguing that there was "little opportunity for the SVO to add value by conducting detailed independent credit reviews where a [rating agency] . . . has, or should have, already undertaken such analysis."[35]

Commenters who argue that a public rating entity is the solution to the rating-agency problem[36] should take heed of the fate of the SVO—an actual, functioning public credit rater bypassed by regulators who were apparently unwilling to charge industry enough to permit it to perform its function.

III. The Financial Crisis, the Ratings Crisis, and the Insurance Industry

Of course, just a few years later, the ratings in which regulators of all stripes—not just state insurance regulators—had put so much stock were being blamed for a global financial crisis. Specifically, since the beginning of the crisis there has been a widespread perception, shared, for example,

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32. KPMG PEAT MARWICK, REPORT ON REVIEW OF DUE DILIGENCE PRACTICES AND PROCEDURES OF THE SEC. VALUATION OFFICE 2 (1998).

33. *Id.* at 27.

34. *See id.* at 30 (recommending "eliminat[ing] the requirement for a complete SVO filing package for public NRSRO-related issues").

35. *Id.* at 3. The KPMG consultants went even further with a suggestion not adopted by the NAIC: KPMG recommended that when an instrument is not rated by credit rating agencies, regulators should simply accept the insurer's assessment of credit risk. *Id.* at 30.

36. *See, e.g.*, Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis*, *in* RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 41, 41–42, 51–57 (Richard M. Levich et al. eds., 2002) (suggesting that safety-and-soundness regulators take a more active role in regulatory judgments); *see also* Milosz Gudzowski, Note, *Mortgage Credit Ratings and the Financial Crisis: The Need for a State-Run Mortgage Security Credit Rating Agency*, 2010 COLUM. BUS. L. REV. 245, 248, 264–80 (arguing that a government entity should replace credit rating agencies in rating residential mortgage-backed securities and residential-mortgage-backed-securities-collateralized debt obligations).

by both the majority and dissent in the 2011 Financial Crisis Inquiry Commission report,[37] that ratings on "structured products"—financial products based on the performance of pools of mortgages and other debt obligations—were too high relative to the products' actual risk, and that those high ratings had led investors to take on too much exposure to the high-rated products.[38] A growing body of empirical research suggests that this perception is largely accurate.[39]

Whether initial ratings were inflated or not, the eventual downgrades of complex, mortgage-based financial products and the market's loss of confidence in these products were among the immediate causes of the failures of many large institutions during the financial crisis.[40]

The U.S. insurance industry was not immune to the effects of widespread, large downgrades on securities initially rated as safe. Most famously, the near-collapse of the titanic AIG seems to trace primarily to the decision of an offshore trading affiliate to write huge amounts of protection on structured products tied to U.S. housing.[41] When AIG itself

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37. *See* FIN. CRISIS INQUIRY COMM'N, *supra* note 17, at xxv (reporting the majority's conclusion that "failures of credit rating agencies were essential cogs in the wheel of financial destruction"); *id.* at 418 (reporting the dissenters' conclusion that "[f]ailures in credit rating and securitization transformed bad mortgages into toxic financial assets").

38. *See* Manuel Adelino, Do Investors Rely Only on Ratings? The Case of Mortgage-Backed Securities 1, 36 (Nov. 24, 2009) (unpublished manuscript) (finding that, for all ratings classes except AAA, yield spreads at time of issuance generally predicted default, even after controlling for ratings) (on file with the Washington and Lee Law Review).

39. *See, e.g.*, ADAM ASHCRAFT ET AL., FED. RES. BANK OF N.Y., STAFF REPORT NO. 449, MBS RATINGS AND THE MORTGAGE CREDIT BOOM 1–5 (2010) (stating that ratings on residential mortgage-backed securities became more generous between 2005 and 2007 and underperformed a model that assessed default probability based on factors observable at time of security issuance); *see also* Efraim Benmelech & Jennifer Dlugosz, *The Credit Rating Crisis* 25 (Nat'l Bureau of Econ. Research, Working Paper No. 15045, 2009) (reporting that structured finance ratings underperformed corporate bonds in 2007–2008, with more frequent and more severe rating downgrades); Richard Stanton & Nancy Wallace, *CMBS Subordination, Ratings Inflation, and the Crisis of 2007–2009* 1–5 (Nat'l Bureau of Econ. Research, Working Paper No. 16206, 2010) (finding that rating-agency standards for commercial mortgage-backed securities fell from 1996 to 2007 at the same time that issuers were including smaller and smaller subordinated tranches to cushion the high-rated senior tranches, and that ratings required unrealistically small subordination tranches by 2005); Adelino, *supra* note 38, at 1, 36 (finding that, for all ratings classes except AAA, yield spreads at time of issuance generally predicted default, even after controlling for ratings).

40. *See* FIN. CRISIS INQUIRY COMM'N, *supra* note 17, at 226 (reporting that the failure or near failure of many large financial firms was the result of both the downgrading of mortgage-backed financial products by rating agencies and the panicking of investors).

41. *See id.* at 344–52 (describing the failure and rescue of AIG in a chapter titled "September 2008: The Bailout of AIG"); William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 945, 952–63 (2009) (describing in detail the causes of AIG's

lost its AAA credit rating, that gave counterparties the right to demand collateral to cover potentially gigantic losses on the products AIG had insured. The "bond insurance" industry was effectively destroyed in the financial crisis through its insurance of and investment in structured products. When insured structured products defaulted at high rates, the resulting wave of claims against the bond insurers sank the entire industry. More prosaically, the mortgage insurance industry also teetered on the brink of collapse as mortgage defaults sparked gigantic payouts, with at least one important player, suffering regulatory takeover and bankruptcy.[42]

These cases are idiosyncratic, however. AIG's case is unrepresentative, as most U.S. insurers are not affiliated with a gigantic offshore trading operation and AIG's problems did not originate in affiliates subject to NAIC capital regulation. The bond insurers' case is unrepresentative because the entire industry is located in New York and is regulated by the New York State Department of Insurance, not the NAIC. Mortgage insurers' losses stem primarily from their core business—insuring mortgages—rather than their investments. The crisis affected thousands of United States insurance companies, not just those that were affiliated with AIG or that were bond or mortgage insurers.[43]

Those companies, including the bread-and-butter life, health, property, and casualty insurers that serve most Americans, generally have survived the crisis to date.[44] So far, there have been no high-profile failures of life/health or property/casualty companies subject to the NAIC's capital rules, and this may speak well of the effectiveness of the existing rules.

But the industry *did* experience substantial stress, and that stress in fact prompted the NAIC's most decisive regulatory change to date. Life

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collapse); *see also* John Patrick Hunt, *Rating-Dependent Regulation of Insurance*, 17 CONN. INS. L.J. 101 (2011).

42. *See* Marie Baudette, *Mortgage Insurer PMI Group Files for Bankruptcy*, WALL ST. J., Nov. 25, 2011 (describing seizure of PMI's mortgage insurance unit by Arizona regulators in October 2011, parent company's unsuccessful legal challenge to seizure, and parent company's subsequent bankruptcy filing).

43. *See* INS. INFO. INST., A FIRM FOUNDATION: HOW INSURANCE SUPPORTS THE ECONOMY 1 (2010), *available at* http://www2.iii.org/assets/docs/pdf/A_Firm_Foundation_20101.pdf (reporting that there were 2,741 property and casualty insurance companies and 1,128 life/health insurance companies in the U.S. in 2008).

44. *See* Testimony of the Nat'l Ass'n of Ins. Comm'rs, Before the H. Subcomm. on Ins., Housing, and Comty. Opportunity, Comm. on Fin. Servs., Nov. 16, 2011, at 2 (statement of Joseph Torti III, Deputy Director and Superintendent of Insurance and Banking, Rhode Island Department of Business Regulation), *available at* http://financialservices.house.gov/uploadedfiles/111611torti.pdf (stating that "in 2009, 140 banks failed, but only 18 insurers did").

insurers owned over $145 billion in residential mortgage-backed securities as of year-end 2008,[45] and the rating agencies' downgrades of these securities in 2009 triggered a requirement that the industry raise capital—$9 billion, according to the industry's own estimate.[46] As described below, it was the unattractive prospect of raising that capital that sparked the industry's successful campaign to get the NAIC's rating-based capital rules changed.

The full effect of the mortgage exposure on the insurance industry is still unknown. Mortgage-backed securities continue to suffer losses as borrowers default, and insurers' losses are likely to be spotted later than banks' because insurers' investments are more likely to be held in categories that give the insurers discretion in deciding whether to recognize losses on their financial statements. It seems premature for the insurance industry to declare victory over the mortgage crisis.

But even if the industry never suffers high-profile insurer insolvencies, the ratings crisis was still serious enough to prompt not just the life insurers' successful lobbying for a rule bailout, but also a comprehensive effort on the NAIC's part to rethink its use of agency ratings in its capital rules from the ground up.

Understanding that reaction is important even if it turns out that insurers have performed well under the NAIC's supervision during the crisis. First, insurers and their regulators are critically important ratings consumers, so any attempt to improve rating agencies by reforming rating-dependent regulation must take into account what the NAIC is doing. If the NAIC's rules create artificial demand for ratings among insurers, then Congress's attempt in the Dodd-Frank Act to eliminate artificial demand by excising ratings from federal rules will be incomplete. Second, the NAIC's experience has lessons for the design of financial regulation more generally. The rule bailout for regulatory constituents; the protracted reconsideration of rating-dependent regulation from first principles that has not lead to abandonment of ratings; and the decision not to turn to public provision of ratings despite having the infrastructure in place to build such a capability—

45. *See* Letter from John Bruins & Andrew Melnyk, Am. Council of Life Insurers, to Michael Moriarty & Lou Felice, Nat'l Ass'n of Ins. Comm'rs, Aug. 10, 2009 (stating that, at the end of 2008, life and health insurers held over $145 billion in residential mortgage-backed securities) (on file with the Washington and Lee Law Review). This figure excludes "agency" securities—those issued or guaranteed by government-sponsored housing enterprises. *See id.*

46. *See id.* (estimating an increase in capital requirement from about $2 billion to $11 billion).

these have significance beyond Dodd-Frank, and even beyond rating-dependent regulation.

IV. Analysis Without Action: NAIC's Inconclusive Review of Rating-Dependent Regulation

The financial crisis spurred a widespread reconsideration of the use of credit ratings in financial regulation. Incorporation of credit ratings into financial regulation, so the argument goes, *both* reduces the quality of ratings by creating artificial demand for ratings that is not based on market forces *and* increases the harm caused by poor quality ratings by elevating ratings' importance.

This was not a new idea. Indeed, the leading rating agencies themselves were among the first critics of the use of ratings in financial regulation,[47] perhaps in part because the second-tier agencies got a competitive boost from government recognition of their ratings. The agencies were followed by some professors of law.[48] It was only after Enron retained an investment-grade credit rating up until four days before its collapse[49] that policymakers started to consider the idea of removing ratings from regulation along with other suggestions for reform of rating agencies.[50]

Following years of study, the SEC and Congress decided not to scale back the delegation of regulatory authority to rating agencies, but rather to encourage market entry by new agencies in order to improve the agencies' performance.[51] That was the central point of the Credit Rating Agency Reform Act of 2006 (CRARA).[52] Some commenters have pointed out that

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47. McGuire, *supra* note 5, at 1.

48. *See* Partnoy, *supra* note 3, at 623–24 (arguing that rating-dependent regulation has transformed rating agencies from sellers of valuable information to sellers of "regulatory licenses" and urging replacement of credit ratings in regulation with credit spreads or other market measures). Other law professors were unconvinced, even after Enron's collapse. *See* Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 65–66 (2004) ("While favorable regulatory treatment is clearly an important part of the value of obtaining ratings, ratings must be doing more.").

49. Hill, *supra* note 48, at 43.

50. *See* U.S. SEC. & EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS (2003) (describing post-Enron inquiries into the role of credit rating agencies).

51. *See id*. at 28–29, 43–45 (identifying rating-dependent regulation as a potential issue but declining to consider it further, while identifying potential measures to reduce regulatory barriers to entry into the rating-agency market as an area for further study).

52. *See* Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat.

increased competition in the face of rating-dependent regulation might cause the agencies to perform worse by reducing the value of reputation and by strengthening issuers' hand in shopping around for high ratings to satisfy regulatory requirements,[53] but this line of thinking did not carry the day.

The world never really got a chance to find out whether CRARA's approach was misguided or not, because the financial crisis of 2007–2009 was upon us before the Act had much of a chance to have any effect. The SEC's rules implementing the Act took effect in late June 2007,[54] scarcely one month before the Fed took the first of its extraordinary actions to address "dislocations in money and credit markets."[55] The financial crisis refueled the critics of rating agencies and rating-dependent regulation because the failure of high-rated complex financial products was widely seen as a cause of the financial

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1327 (codified in scattered sections of 15 U.S.C.) (improving ratings quality by modifying practices in the credit rating agency industry). The main point of CRARA was to reduce "artificial barriers to entry" by setting forth a transparent and relatively undemanding process through which the SEC could recognize a rating agency for regulatory purposes. *See* S. REP. NO. 109-326, at 7 (2006) (stating that the registration process is the "most important[]" feature of Act); *see also* 15 U.S.C. § 78*o*-7(a) (2006) (detailing the registration process); Hunt, *supra* note 41, at 115 n.58 (comparing the NAIC's list of approved rating organizations to the SEC's list of nationally recognized statistical rating organizations, and finding that NAIC's list is a subset of the SEC's list).

53. *See, e.g.*, Benjamin Klein & Keith Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 626–27 (1981) (arguing that cost competition erodes value of reputation); *see also* Patrick Bolton, Xavier Freixas & Joel Shapiro, *The Credit Ratings Game* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 14712, 2009) (arguing that, compared with monopoly, duopoly facilitates rating shopping and inflation, leading to less efficient outcomes); Vasiliki Skreta & Laura Veldkamp, *Ratings Shopping and Asset Complexity: A Theory of Ratings Inflation*, 56 J. MONETARY ECON. 678, 679 (2009) (stating that where rated entities can choose which ratings to disclose, competition can lead to markets acting on excessively high ratings, even without conscious inflation); Bo Becker & Todd Milbourn, Reputation and Competition: Evidence from the Credit Rating Industry 14 (Feb. 12, 2009) (Working Paper) (finding, through empirical study, "a significant positive correlation between competition and credit ratings, suggesting that more competition pushes ratings toward the higher end of the rating spectrum").

54. *See* Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations, 72 Fed. Reg. 33,564 (June 18, 2007) (codified at 17 C.F.R. pts. 240, 249b) (adopting rules for implementing CRARA).

55. Press Release, Board of Governors of the Federal Reserve System (Aug. 10, 2007), http://www.federalreserve.gov/newsevents/press/monetary/20070810a.htm (last visited Nov. 25, 2011) (on file with the Washington and Lee Law Review).

crisis. The SEC,[56] Congress,[57] and the G-20's staff arm[58] all undertook reviews of the regulatory use of credit ratings, as did the NAIC.

In February 2009, the NAIC created a working group (the Working Group) to "gather and assess information on . . . [t]he problems inherent in reliance on ratings," as well as "[t]he reasons for recent rating shortcomings."[59] The regulators' decision to reconsider the use of credit ratings might have led them to abandon the use of private credit ratings altogether, perhaps with an orderly plan to phase out their reliance on the rating agencies. The regulators might have decided to replace the private raters by reinvigorating the SVO, or even transforming the SVO into a public rating agency. Indeed, one might have expected the state insurance regulators to be the most likely of all regulators to eliminate rating-dependent regulation entirely because, uniquely among regulators, they had a public rating capability—albeit a dormant one[60]—at their disposal.

Contemporary observers believed that such a decisive move was at least possible,[61] and when the SVO presented a set of regulatory options to the Working Group, its own upgrade was (perhaps unsurprisingly) at the

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56. References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 40,088 (proposed July 11, 2008) (to be codified at 17 C.F.R. pts. 240, 242, 249); Security Ratings, 73 Fed. Reg. 40,106 (proposed July 11, 2008) (to be codified at 17 C.F.R. pts. 229, 230, 239, 240); References to Ratings of Nationally Recognized Securities Rating Organizations, 73 Fed. Reg. 40,124 (proposed July 11, 2008) (to be codified at 17 C.F.R. pts. 270, 275).

57. *See supra* Part II (discussing Congress's attempt to excise credit ratings from financial regulation through the Dodd-Frank Act).

58. *See* FIN. STABILITY FORUM, REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE 37–38 (2008) (calling for review of how investors use ratings in regulation); *see also* FIN. STABILITY BD., PRINCIPLES FOR REDUCING RELIANCE ON CRA RATINGS 1 (2010) ("Standard setters and authorities should assess references to credit rating agency (CRA) ratings in standards, laws and regulations and, wherever possible, remove them or replace them by suitable alternative standards of creditworthiness.").

59. MICHAEL MCRAITH, NAT'L ASS'N INS. COMM'RS, EVALUATING THE RISKS ASSOCIATED WITH NAIC RELIANCE ON NRSRO CREDIT RATINGS – FINAL REPORT OF THE RATING AGENCY WORKING GROUP TO THE FINANCIAL CONDITIONS COMMITTEE 1 (2010) [hereinafter RAWG FINAL REPORT], *available at* http://www.naic.org/documents/committees_e_rating_agency_report_adopted_by_e_committee.pdf.

60. *See* Evangel, *supra* note 30 (indicating that SVO ratings are used for only 20 percent of insurers' holdings) (percentage computed by author).

61. *See* Sean P. Carr, *NAIC Seeks to Form Its Own Rating Agency*, A.M. BEST NEWSWIRE, (Oct. 20, 2008) (discussing the NAIC's plans for developing its own rating agency) (on file with the Washington and Lee Law Review); *see also* RAWG FINAL REPORT, *supra* note 59, at 5 (stating that agency ratings "have a role in regulation").

top of the list.[62] Perhaps 2010 would see the adoption of a public alternative to private rating agencies.

It was not to be. The idea of an NAIC-run rating entity promptly attracted "concern" from insurers, who reportedly "worr[ied that] a new levy on insurance companies . . . would send the wrong signal to the industry, particularly in the current climate."[63] The idea of strengthening the SVO as a replacement for private rating agencies faded from view in successive drafts of the Working Group's report, along with the idea of completely abandoning rating-dependent regulation. The Working Group's recommendation in December 2009 to "Eliminate or Modify the Filing Exempt Rule"[64] became a recommendation in April 2010 to "Modify the Filing Exempt Rule."[65] December's "consider the possibility of establishing an SVO-like entity as a not-for-profit rating agency"[66] became April's "[c]onsider whether the NAIC should establish a not-for-profit rating agency *where ARO [private rating agency] coverage is not adequate*."[67] The recommendation that "ARO ratings should no longer be used to set RBC for structured securities"[68] disappears entirely and the final report expressly provides that "ARO ratings have a role in regulation."[69]

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62. *See* NAT'L ASSOC. INS. COMMS., STAFF REPORT: NAIC USE OF NRSRO RATINGS IN REGULATION 3 (2009), *available at* www.naic.org/documents/committees_e_rating_agency_comdoc_naic_staff_report_use_of_ratings.doc (suggesting that the NAIC "[c]onsider replacing NRSRO ratings with alternative NAIC SVO analytical processes" as lead potential reform approach) (on file with Washington and Lee Law Review).

63. Sean P. Carr, *Insurers Concerned About NAIC Pursuit of Its Own Rating Agency*, A.M. BEST NEWSWIRE, Apr. 20, 2009 (on file with the Washington and Lee Law Review).

64. MICHAEL MCRAITH, NAT'L ASS'N INS. COMM'RS, EVALUATING THE RISKS ASSOCIATED WITH NAIC RELIANCE ON NRSRO CREDIT RATINGS – EXPOSURE DRAFT REPORT OF THE RATING AGENCY WORKING GROUP TO THE FINANCIAL CONDITIONS COMMITTEE 7 (2009) [hereinafter RAWG EXPOSURE DRAFT] (on file with the Washington and Lee Law Review).

65. RAWG FINAL REPORT, *supra* note 59, at 6. The report recommends including "the use of market information on price direction and of yield trends in addition to ARO ratings for some or all filing exempt securities" in addition to making new investment products and certain classes of structured securities ineligible for filing exemption. *See id.*

66. RAWG EXPOSURE DRAFT, *supra* note 64, at 5

67. RAWG FINAL REPORT, *supra* note 59, at 5 (emphasis added).

68. RAWG EXPOSURE DRAFT, *supra* note 64, at 7.

69. RAWG FINAL REPORT, *supra* note 59, at 5. The Working Group goes on to qualify this statement by recommending that the use of ARO ratings in regulation be supplemented by alternative risk assessment benchmarks in order to better address the full spectrum of risks represented in an insurer's portfolio. *See id.*

Although the Working Group retreated from the ideas of materially strengthening the SVO and/or completely eliminating rating-dependent regulation, its final report did reflect considerable dissatisfaction with the status quo.[70] In its final report, the Working Group found that "policy on the use of ARO ratings should be highly selective"[71] and it identified ten separate issues for further study by various committees and task forces within the NAIC with a view toward reducing regulators' use of ratings.[72]

As of late November 2011, the NAIC's process continues. Groups within NAIC have completed studies of the performance of ratings on corporate issuers during the financial crisis (generally acceptable, but financial issuers fared poorly);[73] of the performance of municipal, corporate, and structured bonds relative to rating over time (municipal bonds have outperformed their ratings; structured bonds have underperformed their ratings);[74] and of possible alternatives to credit ratings.[75] The NAIC is considering specific proposals to stop relying on

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70. *See id*. at 2–4 (emphasizing that rating-dependent regulation exposes the insurance regulatory process to risks arising from competitive pressures on AROs and that certain assumptions upon which ARO ratings rely have proved to be unreliable)

71. *Id.* at 5.

72. *See id*. at 4–6.

73. *See* Proposed Methodology to Assess the Reliability of NRSRO Credit Ratings, Memorandum from Bob Carcano, Senior Counsel, Sec. Valuation Office, Nat'l Ass'n Ins. Comm'rs, to Matti Peltonen, Chair, Valuation of Sec. Task Force, Nat'l Ass'n Ins. Comm'rs 2–3 (Oct. 8, 2010), *available at* http://www.naic.org/documents/committees_e_vos_exposure_staff_reports_ra_wg_carcano_nrsro_ratings.pdf ("For non-financial issuers on the whole, none that were rated investment grade at the end of 2008 defaulted in 2009. None that were rated A or higher at the end of 2006 defaulted by the end of 2009.") (on file with the Washington and Lee Law Review).

74. *See* Analysis of the Performance of NRSRO Credit Ratings and Implications of Default Statistics Associated with NAIC Designations, Memorandum from Bob Carcano, Senior Counsel, Sec. Valuation Office, Nat'l Ass'n Ins. Comm'rs, to Matti Peltonen, Chair, Valuation of Sec. Task Force, Nat'l Ass'n Ins. Comm'rs 3 (Oct. 10, 2010) [hereinafter SVO Rating Performance Analysis], *available at* http://www.naic.org/documents/committees_e_vos_exposure_staff_reports_ra_wg_carcano_nrsro_ratings_analysis.pdf (finding that current NAIC designations overstated default risk relative to corporate issuers and understated default risk for structured securities) (on file with the Washington and Lee Law Review).

75. *See* Alternatives and Supplements to the Use of NRSRO Credit Ratings, Memorandum from Bob Carcano, Senior Counsel, Sec. Valuation Office, Nat'l Ass'n Ins. Comm'rs, to Matti Peltonen, Chair, Valuation of Sec. Task Force, Nat'l Ass'n Ins. Comm'rs 1–2 (Oct. 8, 2010) [hereinafter SVO Rating Alternatives Report], *available at* http://www.naic.org/documents/committees_e_vos_exposure_staff_reports_ra_wg_carcano_nrsro_ratings.pdf (presenting a methodology for analyzing credit ratings) (on file with the Washington and Lee Law Review).

agency credit ratings for general obligation municipal bonds[76] and to make adjustments to agency ratings for structured securities.[77]

But there is no indication that the NAIC plans anything approaching the complete elimination of credit ratings from its regulations. NAIC recognizes three major categories of bonds—corporate, municipal, and structured.[78] Even if all the proposals currently pending before NAIC are adopted, ratings will continue to be important in each of these categories. For corporate bonds, there is no proposal to change the NAIC's reliance on ratings, so agency ratings apparently will continue to be taken at face value. For municipal bonds, agency ratings presumably will continue to be used for revenue bonds (those backed by specific projects), even if they are abandoned for general obligation bonds (those backed by the full faith and credit of government entities).[79] For structured bonds, agency ratings apparently will continue to be the starting point for analysis, even if NAIC adopts rules calling for the ratings to be adjusted.[80]

It is unclear what will emerge from the lengthy project the NAIC has undertaken to reevaluate and selectively reduce its use of credit ratings. What does seem likely, however, is that the NAIC will neither completely eliminate ratings from its regulatory system nor substantially displace the private agencies by expanding the SVO. The report that finds that ratings on municipal, corporate, and structured products are not comparable

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76. *See* Robert Carcano & Hankook Lee, The Revised Recalibration Proposal, Aug. 3, 2011, at 1, 13, *available at* http://www.naic.org/documents/committees_e_capad_vos_c1_factor_review_sg_related_docs_svo_proposal_attachment4.pdf (arguing that agency ratings overstate default risk for municipal general obligation bonds and proposing an NAIC designations for such bonds that do not rely on agency ratings).

77. As of November 2011, NAIC was considering a final proposal to adjust rating-based designations for structured bonds. *See* Revised Draft Amendment to Purposes and Procedures Manual to Provide Final Instructions for Modeled and Non-Modeled Securities, Nov. 7, 2011, at 11 (providing for adjustment of preliminary rating-based NAIC designations for structured bonds, upward if carried at a discount to par and downward if carried at a premium to par) (on file with the Washington and Lee Law Review); Revised Instructions Flowchart, Nov. 7, 2011 (same) (on file with the Washington and Lee Law Review). NAIC also is considering a proposal to require different amounts of risk-based capital for different types of structured securities based on the historical performance of those securities. For example, structured securities based on health care receivables, which historically have had high credit losses, would require more capital than structured securities based on aircraft leases, which have performed better. *See* Carcano & Lee, *supra* note 76, at 2, 14.

78. *See* Carcano & Lee, *supra* note 76, at 1–2 (discussing the three categories).

79. *See id.* at 14 (proposing retention of agency-rating based system for municipal bonds other than general obligation bonds).

80. *See* sources cited *supra* note **77**.

suggests recalibrating SVO's rating-based scale, not replacing the ratings.[81] The report on credit-rating alternatives presents a sample scheme in which agency ratings account for fifty percent of the credit risk assessment (with market prices and non-rating financial strength measures accounting for the rest) and the SVO's role is to monitor "anomalous" situations in which other measures of credit disagree.[82]

The state insurance regulators' retreat to a highly selective approach to reforming rating-dependent regulation stands in contrast to Congress's bold, broad-stroke decision to eliminate rating-dependent regulation entirely by mandating that each federal finance regulator "*shall* modify [its regulations] to remove any reference to or requirement of reliance on credit ratings."[83]

The contrast suggests an immediate consequence of insurance regulators' retention of rating-dependent regulation. If the insurance regulators maintain rating-dependent regulation, then Dodd-Frank's purpose in eliminating credit ratings from federal financial regulation will be substantially frustrated. According to the theory that apparently underlies Dodd-Frank, rating-dependent regulation blunts rating agencies' incentives to produce high-quality ratings by creating demand for all ratings, of high or low quality. Supposing this to be true, rating-dependent *state* regulation will continue to harm rating quality even if credit ratings are stripped out of federal regulations—which may or may not happen, as the federal financial regulators, along with bank lobbyists, apparently are resisting this requirement.[84] This is important because insurance is important. But beyond that, poor-quality ratings affect the public because private actors use them, not just because regulators use them. Correcting rating agencies' incentives for quality by removing ratings from federal regulation makes little sense as long as the rating agencies' most important

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81. *See* SVO Rating Performance Analysis, *supra* note 74, at 13–15 (recommending that "three separate NAIC designation frameworks be developed for corporate, municipal, and structured securities").

82. *See* SVO Rating Alternatives Report, *supra* note 75, at 5. Although this idea is presented only as an example and not as a formal proposal, it is the most concrete suggestion in the report and thus may suggest the author's perception of what is likely to garner support. *See id*.

83. Dodd-Frank Act § 939A (emphasis added).

84. *See* Jean Eaglesham & Deborah Solomon, *Why Credit Raters Keep Their Power*, WALL. ST. J., Nov. 16, 2010, at C1 (reporting that John Walsh, acting Comptroller of the Currency, has stated that Dodd-Frank "goes further than is reasonably necessary" and that Sheila Bair, chairman of the FDIC, has warned that finding an alternative to credit ratings "is going to be very, very difficult").

regulatory customers—the state insurance regulators—continue to use them. The Dodd-Frank project of fixing rating-dependent regulation will remain radically incomplete without much more aggressive changes at the state level. Thus, the regulatory use of ratings promises to become an important new front in the longstanding battle over state versus federal control of insurance regulation.

The difference is probably explained in part by the fact that the NAIC process is driven by the regulators who will actually have to regulate without relying on credit ratings. The perspective of the reformer of credit rating agencies conflicts with that of the financial regulator. Reformers ask, "What is wrong with rating agencies?" The answer, "They are a government-sponsored oligopoly," is appealing across the ideological spectrum, as the political parties' agreement on the issue suggests. Regulators, on the other hand, ask, "How should we go about judging risk?" There, the answer, "Use the same credit rating agencies the market does," is appealing. The decision of Congress—which was at least temporarily under the sway of the reformers—to end federal rating-dependent regulation makes the conflict in perspectives acute.

Using credit rating agencies is appealing to financial regulators for two sets of reasons: political and substantive. Using ratings is politically appealing because it serves the parochial interests both of regulators and of the regulated: The regulators get to defer responsibility (and blame) for credit assessments to the rating agencies. The regulated insurers don't have to pay a lot for regulatory assessments of ratings, because most instruments have a credit rating paid for by the issuer in place. Moreover, the insurers get to keep decisions about creditworthiness in the private sector.

Some of the political problems with eliminating rating-dependent regulation may apply with particular force to insurance, but regulators' desire to use credit ratings is not confined to insurance. For example, in July 2008 the SEC proposed an aggressive cutback of its historically heavy reliance on credit ratings.[85] But, as of mid-February 2011, the SEC had not

85. *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 40,088 (proposed July 11, 2008) (proposing "to amend various rules and forms under the Securities Exchange Act of 1934 . . . that rely on NRSRO ratings") (to be codified at 17 C.F.R. pts. 240, 242, 249); Security Ratings, 73 Fed. Reg. 40,106 (proposed July 11, 2008) (proposing "to replace rule and form requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934 that rely on security ratings . . . with alternative requirements") (to be codified at 17 C.F.R. pts. 229–30, 239–40); References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 40,124 (proposed July 11, 2008) (proposing "to amend five rules under the Investment Company Act of 1940 and the Investment Advisers Act of 1940 that rely on NRSRO

taken action on the most important aspects of its proposals.[86] And banking regulators are leading the charge against Dodd-Frank's requirement to eliminate ratings from financial regulation.[87] Insurance regulators' reluctance to abandon the use of ratings is just a particularly telling example of a general regulatory tendency that simultaneously highlights the political case for Dodd-Frank's outright ban (Congress must act decisively because regulators won't) and undercuts the substantive case for such a ban.

Rating-dependent regulation is substantively appealing because the alternative ways of measuring risk—using market prices, insurer models, or third parties other than rating agencies—are not terribly attractive.[88] Market prices are volatile and are not always available. More fundamentally, market prices reflect credit risk along with many other factors, and the "other factors"—market liquidity and investor risk aversion—become critical when a crisis strikes.[89] Risk assessments conducted by insurers themselves suffer from fairly obvious conflicts of

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ratings") (to be codified at 17 C.F.R. pts. 270, 275).

86. *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 52,358 (Oct. 9, 2009) (adopting a final rule removing some references to credit ratings from its rules) (to be codified at 17 C.F.R. pts. 240, 242, 249, 270); References to Ratings of Nationally Recognized Rating Orgs., 74 Fed. Reg. 52,374 (proposed Oct. 9, 2009) (reopening comment on more significant proposed changes to SEC rules) (to be codified at 17 C.F.R. pts. 229–30, 239–40, 242, 249, 270, 275); Sec. Ratings, 76 Fed. Reg. 8,946 (proposed Feb. 16, 2011) (reopening comment on significant proposals in wake of the Dodd-Frank Act) (to be codified at C.F.R. pts. 200, 229–30, 232, 239–40, 249); Asset-Backed Sec., 75 Fed. Reg. 23,328 (proposed May 3, 2010) (proposing a rule that would eliminate reliance on ratings in determining whether asset-backed securities are "shelf eligible") (to be codified at 17 C.F.R. pts. 200, 229–30, 232, 239–40, 243, 249).

87. *See* Eaglesham & Solomon, *supra* note 84, at C1 (noting that banking industry organizations share the view that eliminating all use of ratings from federal financial regulation is overkill, and advocating for the continued use of some ratings); *see, e.g.*, Letter from Kenneth E. Bentson Jr., Exec. Vice President, Pub. Policy & Advocacy Sec. Indus. & Fin. Mkts. Ass'n, to Office of the Comptroller of the Currency et al., at 2–3 (Oct. 25, 2010) ("Credit Rating should be a permissible input in any replacement standard.") (on file with the Washington and Lee Law Review); Letter from Mary Frances Moore, Vice President, Office of Regulatory Policy, to Office of the Comptroller of the Currency et al., at 1 (Oct. 25, 2010) ("[W]e would encourage the agencies to adopt a standard that would employ credit ratings as one possible (albeit not mandatory) factor in determining the creditworthiness of an asset.") (on file with the Washington and Lee Law Review).

88. *See generally* Memorandum from Bob Carcano, Senior Counsel, Sec. Valuation Office, to Matti Peltonan, Chair of the Valuation of Sec. Task Force (Oct. 8, 2010) (reviewing alternatives to agency credit ratings and reaching similar conclusions) (on file with the Washington and Lee Law Review).

89. *See* John Patrick Hunt, *One Cheer for Rating Agencies: How the Mark-to-Market Accounting Debate Highlights the Case for Rating-Dependent Capital Regulation*, 60 S.C. L. REV. 749, 775–77 (2009).

interest. Although regulators could oversee the insurers' models, this approach failed spectacularly for the Wall Street investment banks in the financial crisis.[90] Non-rating-agency third parties—being private entities that provide credit opinions in return for compensation—aren't clearly an alternative to rating agencies.

V. Action Without Analysis: The "Rule Bailout" of Life Insurers

In contrast to the slow progress on principled reform of rating-based regulation, regulators took swift and decisive action on another front: granting capital relief to life insurers after credit rating agencies downgraded the insurers' holdings of mortgage-backed securities. The life insurers' argument in favor of this capital relief was reasonable (if contested in its factual specifics by the rating agencies), but the timing of the request and the regulators' action suggest that the action is fruitfully analyzed as a "rule bailout"—an ad hoc change to industry rules during a crisis to avoid harsh consequences to the industry.

As of year end 2008, the life insurance industry's $145 billion in mortgage-backed security holdings was associated with a capital requirement of $2 billion.[91] The amount of the capital requirement strongly suggests that the securities held by life insurance companies, like the overall population of mortgage-backed securities, overwhelmingly had received high, or "investment-grade" ratings.[92] After rating agencies downgraded 64% of AAA-rated residential mortgage-backed securities below investment grade, life insurers' capital requirements increased to $11 billion.

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90. *See* FIN. CRISIS INQUIRY COMM'N, *supra* note 17, at 151–54 (describing the failure of SEC's Consolidated Supervised Entity program for capital regulation of the large investment banks).

91. *See* Letter from John Bruins & Andrew Melnyk, Am. Council of Life Insurers, to Michael Moriarty & Lou Felice, NAIC, 3 (Sept. 10, 2009) [hereinafter ACLI Sept. 10, 2009 Letter] (on file with the Washington and Lee Law Review).

92. "Investment-grade" typically refers to instruments that receive ratings of AAA, AA, A, or BBB on the rating scale used by Standard & Poor's and Fitch. (Moody's uses slightly different notation from the other major agencies, and investment grade covers the Aaa, Aa, A, and Baa categories per Moody's scale). These ratings correspond to the top two designations, NAIC-1 and NAIC-2, on the insurance regulators' scale. Nat'l Ass'n of Ins. Comm'rs, *supra* note 28, at 6. Life insurers are required to hold 0.4% capital against NAIC-1 instruments and 1.3% capital against NAIC-2 instruments. *Id.* at 7. So, the $2 billion capital requirement against $148 billion in holding corresponds closely to an NAIC-2 rating. *Id.*

In August 2009, the American Council of Life Insurers (ACLI) argued that the capital rules based on agency credit ratings—ratings that the insurers chose to use—required insurers to hold too much capital against mortgage-backed securities. The ACLI argued that it was inappropriate to rely on credit ratings in computing capital requirements applicable to mortgage-backed securities, because agency ratings are based "primarily on the likelihood of the first dollar of loss" and did not take *severity* of loss into account.[93] A mortgage-backed security with a 5% chance of default received the same rating whether the expected loss in case of default was 10% or 100%.

NAIC adopted ACLI's proposal to switch away from agency ratings in October 2009.[94] NAIC did not return the risk assessment function to the SVO, but instead contracted with a private, third-party provider, one that is not a rating agency, to assess the credit risk of mortgage-backed securities using a methodology that takes into account the severity of loss.[95] As NAIC later reported, the switch reduced the insurance industry's 2009 capital requirement by $5.4 billion.[96]

NAIC undertook this action in a proceeding that received remarkably little public attention. The existing records of the proceeding do not suggest that NAIC considered comments from any party other than the rating agencies themselves, who stated that their ratings should not be the sole basis of regulatory decisions.[97] Rating agencies also spoke up to take issue with ACLI's criticisms of their work.[98]

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93. ACLI Sept. 10, 2009 Letter, *supra* note 91, at 1.

94. NAT'L ASS'N OF INS. COMM'RS, RFP 1344—ASSESSMENT OF RESIDENTIAL MORTGAGE BACKED SECURITIES (RMBS), 9–14 (Oct. 23, 2009).

95. *See* NAT'L ASS'N OF INS. COMM'RS, INTERIM REPORTING INSTRUCTIONS FOR THE YEAR ENDING DECEMBER 31, 2010 2–3 (Dec. 1, 2010), *available at* http://www.naic.org/documents/structured_securities_modeled_securities_instructions.pdf (detailing the modeling process adopted by the NAIC).

96. *See* NAT'L ASS'N OF INS. COMM'RS, ESTIMATED RBC IMPACT FROM THE RMBS INITIATIVE 1 (Apr. 8, 2010), *available at* http://www.naic.org/rmbs/100408_rbc_impact_estimate.pdf. The NAIC's RBC formula combines capital charges from various sources in a way that makes the total capital charge less than the sum of the individual capital charges. *Id.* at 1–2. The $5.4 billion figure cited in the text incorporates the charge-reducing effect of this method, which is intended to compensate for the covariance of various risks. *Id.* Were it not for the "covariance adjustment," the NAIC's change in methodology would have reduced the industry's capital requirement by $7.3 billion. *Id.*

97. *See* NAIC Proceedings 2009 4th Quarter, at 3-8 to -9, Minutes of Joint Executive Committee/Plenary Conference Call, Nov. 5, 2009 (referring only to rating agency comments in connection with adoption of proposal to change treatment of RMBS) (on file with the Washington and Lee Law Review).

98. *See* Debash Chatterjee et al., *Special Report: Moody's Ratings on U.S. RMBS*

ACLI's point was sensible on its terms—the amount of loss, not the fact of default, seems to be what is relevant in deciding how much capital to require against a particular holding—but the problems about which ACLI complained seem to have been evident before the financial crisis. ACLI did not claim that agencies changed their rating methodologies to focus on the first dollar of loss during the financial crisis, and it does not appear that the agencies did either.[99] If ratings were an inappropriate way of measuring the credit risk of mortgage-backed securities in 2009, it seems that they were just as inappropriate in 2004. What changed was not the usefulness of credit ratings as a regulatory tool, but rather the amount of capital that rating-dependent regulation required of the industry. The change to the regulatory treatment of mortgage-backed securities seems to be an example of a rule bailout.

The absence of public attention to the rule bailout of the insurance industry mirrors a larger pattern. Bailouts that directly put government funds at risk—the direct injections of cash into the large banks, into the government-sponsored housing enterprises Fannie Mae and Freddie Mac, and into AIG, GM, and Chrysler—triggered intense public rage and scrutiny. Bailouts that simply helped regulated firms avoid regulatory consequences of the crisis, such as being forced to raise capital or being declared insolvent, were noticed mostly by financial commentators, if at all.

The emphasis on the risk of taxpayer dollars is in some sense misplaced, as the direct dollar cost of those bailouts seems likely to be much less than the amount put at risk.[100] More fundamentally, focusing on

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Reflect Expected Recoveries: Ratings on Impaired Securities Do Not Overstate Risk, at 2 (Nov. 6, 2009), *available at* http://www.naic.org/documents/committees_e_rating_agency_final_report.pdf (arguing that Moody's ratings on high-yield bonds reflect expected loss on default, not just probability of default).

99. *See, e.g.*, Richard Cantor, *Strengthening Analytical Quality and Transparency*, MOODY'S GLOBAL CREDIT POL'Y (Moody's Inv. Serv., New York, N.Y.), Nov. 2009, at 5 (describing the changes in analytical methodologies used in its structured finance ratings process for mortgage-backed securities); Joseph Snailer, *Updates to Moody's U.S. Structured Finance Rating Methodologies*, (Moody's Inv. Serv., New York, N.Y.), Apr. 1, 2008, at 2–3 (describing Moody's methodological changes since the beginning of the financial crisis without mentioning any change to the use of recovery rates in the residential MBS methodology).

100. As of March 2011, the latest date for which a systematic study is available, the Congressional Budget Office estimated that of $432 billion disbursed under the TARP program, which covered bailouts of banks, AIG, and auto manufacturers, as well as mortgage modification programs, there would be a net $19 billion loss to the government. *See* CONG. BUDGET OFFICE, REPORT ON THE TROUBLED ASSET RELIEF PROGRAM—MARCH 2011, at 2 tbl.1 (2011). The Office of Management and Budget (OMB) estimated a $64 billion loss as of December 31, 2010, with most of the difference explained by the fact that

direct taxpayer losses misses what is probably the more important problem with bailouts: They allow the bailed-out firm and those who dealt with it voluntarily to escape the consequences of failure. Thus, they are unfair, they corrode the legitimacy of the system,[101] and they may produce moral hazard—a willingness to take excessive risks because of the belief that the risks' negative consequences will not materialize.

These costs exist even for bailouts that don't cost the taxpayer any money and even for bailouts that are "justified" in the sense that they avert economic loss. That means that bailouts justified on a short-term dollars-and-cents basis may not be justified from a broader perspective. It also means that regulators should put a premium on avoiding situations in which bailouts seem to be needed.

Rule bailouts specifically are quite tempting. No regulator wants to watch its industry collapse on the regulator's watch, and rule bailouts typically can be accomplished directly by the regulator, more or less behind the scenes, without howls of taxpayer protest. The fact that rule bailouts can be accomplished with little public attention makes them attractive to the regulated as well as to the regulator: A rule change that no one notices is far more attractive than a cash infusion that causes the regulated party to be pilloried in public. Rule bailouts thus may induce *more* moral hazard than cash bailouts.[102] The attitude in the boardroom might well be: "Don't worry; we can get the regulators to change the rule if we get into trouble, and no one will notice."

Accordingly, the law has attempted to restrain rule bailouts. After S&L regulators did a disastrous failed rule bailout of the thrift industry in the late 1980s, allowing insolvent S&Ls to double down on bigger and

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OMB assumed much greater expenditures on mortgage programs. *See id.* at 4 tbl.3.

101. Adam Levitin has argued that bailouts of some kind are inevitable and that the crucial issue is maximizing their political legitimacy. Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 439–40 (2011). If, as Levitin suggests, bailouts were done transparently and included losses to the bailed-out firms' trading partners, that certainly could increase their legitimacy. *Id.* at 514 (concluding that bailouts must be conducted in transparent, politically accountable ways to ensure public legitimacy). Rule bailouts, by contrast, typically are not meaningfully transparent (because they involve changes to obscure rules in little-noticed proceedings) and, in the short term, avoid losses to trading partners. Levitin does not explicitly address rule bailouts. *See id.* at 503 (citing Steven M. Davidoff & David T. Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 468 (2009)) (stating that in bailouts "agencies do not proceed using notice- and comment-rulemaking; instead, they proceed simply by doing deals"). In any event, the extent to which bailouts' legitimacy *can* be increased is unknowable, and the extent to which their legitimacy *should* be increased is beyond the scope of this Article.

102. I thank Anupam Chander for this point.

bigger debts in an effort to get back into the black rather than enforcing regulatory requirements on the books,[103] Congress enacted the FDIC Improvement Act, which requires S&L regulators to take "prompt corrective action" to deal with distressed banks.[104] And, after highly publicized insurer failures around the same time, legislatures in every state (with the possible exception of Texas) adopted similar requirements for insurance regulators.[105]

Nevertheless, regulators engaged in rule bailouts in response to the recent crisis. Through the mid-2000s, insurers chose to rely on rating agency ratings to set capital requirements for their holdings, enjoying the benefits of so doing as agencies awarded high ratings to mortgage-backed and other structured securities. When the agencies got around to downgrading huge waves of those securities in the financial crisis, insurers successfully pressured the NAIC to change the rules to avoid raising the corresponding capital. Likewise, banks successfully pressured accounting regulators to allow them to avoid the negative effects of their regulatory choices: Banks chose to hold assets in categories that had to be marked to market, enjoying the benefits of so doing as markets rose during the mid-2000s. When the market collapsed, banks successfully pressured the accounting regulators to change the rules to avoid recognizing the corresponding losses.[106]

And the cycle of reaction against bailouts is repeating itself. The centerpiece of Dodd-Frank is the "resolution authority" it confers on banking regulators, ostensibly so that they will not have to bail out large

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103. *See* FREDERIC S. MISHKIN, THE ECONOMICS OF MONEY, BANKING, AND FINANCIAL MARKETS 292–99 (2008).

104. 12 U.S.C. § 1831*o* (2006); *see also* MISHKIN, *supra* note 103, at 299 (describing the prompt corrective action requirement as "[p]robably the most important feature" of post-S&L reform legislation); Richard S. Carnell, *Regulatory Incentives*, *in* MAKE MARKETS BE MARKETS 35, 39 (Robert Johnson & Erica Payne eds., 2010) (describing prompt corrective action as an example of a "properly framed statutory standard[]" that "heighten[s] regulatory accountability and counteracts perverse incentives").

105. *See* 3 NAIC MODEL LAWS, REGULATIONS, AND GUIDELINES 312-1, § 6 (2011) (requiring state insurance commissioners to take control of insurers if capital falls below specified level). Texas apparently permits, but does not require, regulatory action if an insurer does not maintain the required capital. *See* TEX. INS. CODE § 822.211 (listing options which "the commissioner may enter" "[i]f an insurance company does not comply with the capital and surplus requirements of [a given chapter of the code]"); *see also* 3 NAIC MODEL LAWS, REGULATIONS, AND GUIDELINES 312-1, State Adoption (2011) (reporting adoption of the Risk-Based Capital Model Act in every state but Texas).

106. *See, e.g.*, Hunt, *supra* note 89, at 750 (noting that the push against mark-to-market accounting led to political pressure on the Securities and Exchange Commission to revise the rules).

banks in the future.[107] But this approach seems unlikely to prevent either future rule bailouts or the conditions that lead to them: industry-wide stresses, coupled with regulatory discretion in fashioning definitions and applying rules. To be sure, some problems are simply so big that a rule bailout is ineffective and is therefore not tempting—no rule bailout would have saved Lehman Brothers or the bond insurers, so none was tried—but efforts to prevent rule bailouts where they *are* tempting seem no more likely to succeed now than they were in the past.

VI. The NAIC and the Limits of Capital Regulation

The story here can be understood as an example of the cyclical distorting pressures of politics that affect any capital regulation system.

When times are good, industry is strong and wants to take risks, and regulations are weakened.[108] Here, the weakening took the form of removing the SVO's ability to veto rating agency credit risk assessments. During a financial crash, regulators face tremendous pressure to insulate industry from the consequences of its previous risk-taking, because regulators don't want to preside over collapse. Here, regulators carried out a rule bailout of the life insurers. After the crash, the will to regulate may return, at least for a time. Here, that will has taken the form of reconsidering regulatory reliance on ratings in the insurance context.

Any proposal for reforming capital regulation that does not take the political cycle into account is incomplete. It is not clear, however, that it is possible to take this cycle into account adequately in financial regulation, as we see by briefly examining three possible approaches to dealing with the problem of the political cycle in capital regulation.

The first is to constrain regulatory discretion, as some current proposals for reforming capital regulation suggest. For example, Markus Brunnermeier and his co-authors propose that "regulation should be based on pre-set rules; otherwise, few regulator/supervisors will actually dare to face the odium of tightening in boom conditions."[109] An example of a constraint intended to control regulators' temptation to engage in rule

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107. *See* Dodd-Frank Act §§ 201–17 (comprising title II, "Orderly Liquidation Authority").

108. *See, e.g.*, Carnell, *supra* note 104, at 36–37 (describing pressure on banking regulators to be lax during expansionary period).

109. *See, e.g.*, MARKUS BRUNNERMEIER ET AL., THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION 37 (2009).

bailouts is the "prompt corrective action" requirement discussed previously.[110]

The second approach is to strengthen the regulator or to strengthen regulation itself. The regulator's institutional independence theoretically could be strengthened, for example by making the SVO independent of industry funding.[111] Capital requirements themselves could be strengthened, for example by simply increasing them.[112]

Although there is nothing wrong with either of these approaches, they cannot address the larger problem because rules cannot effectively prohibit their own alteration. The temptation to yield to a large, powerful financial industry in the face of an enormous boom will likely be great.

A third method would be to try to deal with the timing problem with an *ex post* approach. Rather than requiring regulators to decide in advance whether particular arrangements are acceptable, regulators could look at events in the light of outcomes and take appropriate action.

For example, rather than having to decide (by application of capital requirements or otherwise) during a possible bubble whether a firm is taking excessive risk, a regulator could look at *effects* to make a decision about whether practices, investments, arrangements, etc. were acceptable. Victims of a crash could be compensated out of the gains of those who profited during the expansion. One approach to this would be to give notice to market participants that even compensation that has already been paid will be at risk if a bubble collapses—to state categorically that it will not be out of bounds to go after payments like the AIG bonuses.[113] If financial market participants are always going to be more informed and more

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110. *See supra* note 104 and accompanying text (discussing the prompt corrective action requirement).

111. One alternative to industry funding, funding through the legislative appropriation process, may pose its own threats to independence. *See* Joan MacLeod Heminway, *Sustaining Reform Efforts at the SEC: A Progress Report*, 30 No. 4 BANKING & FIN. SERVS. POL'Y REP. 1, 9-11 (2011) (arguing that implementation of Dodd-Frank reforms at SEC is vulnerable to Congressional underfunding).

112. Simply increasing capital levels may be "procyclical," that is, increase the volatility of economic output, in some circumstances. *See, e.g.*, Francisco Covas & Shigeru Fujita, *Procyclicality of Capital Requirements in a General Equilibrium Model of Liquidity Dependence*, 23 INT'L J. CENTRAL BANKING 137 (2010) (modeling procyclical effects of time-varying and constant capital requirements).

113. A counterpart to this approach, relying on private rights of action, is explored in Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 410–22 (2009) (proposing a "doctrine of clawbacks" that would permit disgorgement of benefits to avoid unfair enrichment, even if benefits were conferred under a claim of right).

sophisticated than regulators, regulatory schemes that require regulators to understand market conditions and foresee effects are always going to be limited. Allowing regulators to benefit from hindsight can, in principle, correct in part for this inequality.

One might argue, of course, that regulators will indulge in hindsight bias, that market participants will not make smart decisions if they can't be secure in profiting from them, and that it is simply immoral and/or lawless to redistribute in this way. Although all these issues can be debated,[114] the *ex post* approach is severely limited in practice by the fact that time moves in only one direction. There is a limit to the extent to which regulators will be able to unwind completed transactions, locate funds that have been disbursed, and compensate victims; efforts to do justice in the wake of the Bernard Madoff scandal are just one recent, high-profile example.[115]

The rule bailout of the insurance industry, together with the other rule bailouts of the financial crisis, suggests the possibility that what we can expect from the project of financial regulation may be limited. To the extent we will continue to have a large, powerful financial sector, perhaps we must reconcile ourselves to living with its instabilities and with the unfairness of rule bailouts.

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114. For example, Anna Gelpern argues in implicit response to such criticisms that crisis containment is an enduring feature of global finance and that "some well-worn paradigms—sanctity of contracts, moral hazard, and the liquidity-solvency distinction—fall flat . . . consistently in crisis after crisis." *Id.* at 1055. Gelpern suggests that extraordinary crisis measures with redistributive consequences are inevitable and the best course is to make them as legitimate and accountable as possible. *See id.* at 1106; *see also* Levitin, *supra* note 101, at 514 ("Bailouts . . . must be conducted in transparent, politically accountable ways to ensure public legitimacy, which is essential for their ultimate efficacy."). On the specific issue of "sanctity of contract" and its relationship to financial crises and financial bubbles, contrast arguments for modifying contracts in crisis based on their negative effects, with arguments that widespread poor judgment in financial bubbles undermines bubble contracts at formation. *Compare* Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1149–52 (2009) (making case for legislative modification of rigid securitization contracts based on spillover effects on the economy generally), *with* John Patrick Hunt, *Taking Bubbles Seriously in Contract Law*, 61 CASE W. RES. L. REV. 681, 684–85 (2011) (claiming "that the distinctive characteristics of bubbles make them inappropriate for private ordering, drawing on the contract doctrines of incapacity, mistake, and misrepresentation").

115. *See* Bob Van Voris, *For Madoff Victims, an Avenging Angel*, BLOOMBERG BUSINESSWEEK, Feb. 14–20, 2011, at 38–40 (describing how Madoff trustee Irving Picard has recovered approximately $10 billion of the $65 billion purportedly in customer accounts when Madoff's fraud was revealed in December 2008).

VII. Conclusion

Regulating a large and powerful industry is hard. Assessing credit risk is also hard, and doing it right is expensive. These factors combine to create strong pressure on regulators to rely on credit rating agencies or other outsourced credit monitors—even though regulatory reliance on credit ratings may undermine their usefulness in various ways. The struggle playing out at the NAIC and at the federal level over removing ratings from regulation illustrates this dynamic.

The NAIC could end rating-dependent regulation in insurance. It could decide to stop relying on external credit ratings, and strengthen its own internal capability. The filing fees that are already in place supply a mechanism for doing this, although they might have to be much higher than they were when the NAIC first started to consider relying on agency ratings for capital requirements.

Should the NAIC end rating-dependent regulation? The cost is the development of an internal capability that is probably fairly expensive relative to the scale of the NAIC's current operations. The benefits include (potentially) better credit assessments. They also include the possibility that eliminating rating-dependent insurance regulation will improve the quality of credit ratings for other users. The latter is an externality to the insurance industry, so one would not expect it to receive adequate consideration in an industry-only process.

What about the outsourced, non-rating agency alternative the NAIC has adopted for some securities such as RMBS? Certainly it avoids the problem of rating-dependent insurance regulation hurting overall rating quality. And it may well lead to better-quality assessments.

Yet that proposition raises a different question. Under the new system, the insurance industry, through its regulator, is paying for insurance-specific assessments. It is not saving money by using credit ratings that already exist. Thus, if the industry is paying for these assessments anyway, why do so through an outside party? Why pay PIMCO or BlackRock to do them rather than the SVO? The decision raises the troubling prospect of indulging a pure "private good, government bad" preference.

The NAIC has taken some useful steps relevant to the basic analytical question about use of credit ratings in regulation: How good or bad are credit ratings relative to other measures? Nevertheless, the history of the use of credit ratings in insurance regulation to date raises the troubling prospect that industry power rather than analysis may determine the ultimate outcome.