



International Association for the  
Study of Insurance Economics

# Études et Dossiers

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# Regulation of Rating Agencies: An Insurance Industry Perspective

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## Agenda

- I. Interaction of rating agencies (CRAs) with the insurance industry**
- II. Issues of concern**
- III. Regulatory initiatives**
- IV. Impact of IOSCO code of conduct**
- V. Outlook: policy conclusions**

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## I. Interaction of Rating Agencies with the Insurance Industry

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## Relevance of Ratings for the Insurance Industry

- insurers as issuers (shares / hybrid capital)
- asset management
- choice of insurance provider by intermediaries and prospective clients
- regulatory purposes (e.g. asset regulation)
- ➔ insurance companies depend crucially on high standards, reliability and quality of ratings issued by CRAs

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### Leading Rating Agencies for Insurers (I)

|                        | Standard & Poor's                  | Moody's Investors Service       | A.M. Best                       | Fitch Ratings                 |
|------------------------|------------------------------------|---------------------------------|---------------------------------|-------------------------------|
| Ratings first pulished | 1916                               | 1909                            | 1906                            | 1924                          |
| Headquarters           | US                                 | US                              | US                              | US & UK                       |
| Employees              | 5000+                              | -2100                           | 500+                            | 1250                          |
| Analysts               | 1250                               | 900+                            | 100+                            | 700+                          |
| Insurance analysts     | 100+                               | -60                             | 100+                            | 27                            |
| Offices                | 31                                 | 17                              | 3                               | 40                            |
| Owner                  | McGraw-Hill (publishing and media) | Independent and publicly traded | Independent and privately owned | FIMALAC (French conglomerate) |
| Industries rated       | all                                | all                             | insurance/reinsurance           | all                           |

Source: Swiss Re, 2003

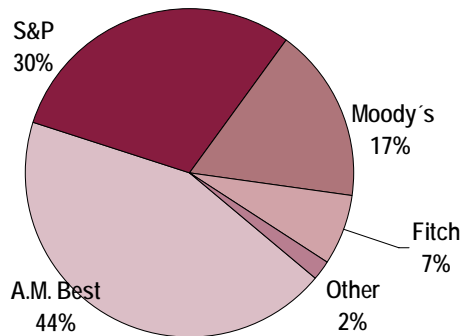
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### Leading Rating Agencies for Insurers (II)

Estimated global revenue shares for insurer ratings, 2002:



Source: Swiss Re estimates, 2003

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## Insurance Financial Strength Ratings for German Insurers

|                    | solicited            | unsolicited  |
|--------------------|----------------------|--|
| AM Best            | 22 <sup>1</sup>      |  |
| Fitch <sup>2</sup> | 23 (? <sup>3</sup> ) | 14 (? <sup>3</sup> ) traditional ratings<br>131 quantitative IFS ratings (Q-ratings) |
| Moody's            | 22                   | 2  |
| Standard & Poor's  | 57                   | 59   |

<sup>1</sup> with participation of rated insurer, initiation status not disclosed; no public data ratings by AM Best for German insurers  
<sup>2</sup> includes UK life insurers active in Germany, reinsurers not included  
<sup>3</sup> only limited disclosure of initiation status

Sources: AM Best, Fitch, Moody's, S&P

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## Fitch: Development of German Rating Activities\*




| Jahr | Schaden | Kranken | Leben | Total |
|------|---------|---------|-------|-------|
| 2002 | 1       | 1       | 1     | 3     |
| 2003 | 1       | 1       | 6     | 8     |
| 2004 | 2       | 5       | 11    | 18    |
| 2005 | 7       | 7       | 23    | 37    |

\*includes UK life insurers active in Germany, reinsurers not included

Source: Fitch

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## II. Issues of Concern

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## Experience of German Insurance Industry with CRAs

- in general, quality of ratings and working relationship with CRAs are regarded as satisfactory
- however, a number of problematic incidents have occurred
- some important issues of general concern:
  - transparency of rating methodology
  - disclosure of type of rating
  - interaction with rated companies (e.g. prior notification, appeal process)
  - potential conflicts of interest
  - integrity of rating process and of rating analysts
- ➔ introduction of binding minimum standards considered necessary in order to provide a reliable framework for CRAs' actions

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## Regulatory Framework for Rating Agencies

- CRAs traditionally subjected to little formal regulation despite vital importance of ratings for functioning and stability of financial markets
- whereas comparable institutions / professions (e.g. auditors, actuaries, equity analysts) adhere to a wealth of legal standards or professional codes, no adequate framework for CRAs

## Problems and Imperfections of Rating Markets

- main competitive factor: reputation, usual competitive factors (price, service level) of far less importance
- insufficient incentives and opportunities for other market participants to scrutinize rating agencies and impose sanctions for inferior quality of ratings or “misbehaviour” of rating agencies
- informational asymmetries (CRAs / rated entities / users of ratings)
- high potential for conflicts of interest
- high barriers to market entry / natural oligopoly
- ➔ market mechanism is not fully functional, partial market failure

### III. Regulatory Initiatives

### Activities of Regulatory Authorities – Overview

Over the last years, regulatory authorities world-wide have become very concerned about inadequacy of legal framework for CRAs and shortcomings in rating quality

→ have taken initiatives and actions to ensure sufficient quality of ratings

- global level: IOSCO (2003, 2004)
- European level: EU Parliament (2003/4), CESR (since 2004), CEBS (2005/6), EU Commission (2006)
- United States: SEC, Congress
- European national level: e.g. hearing in German Bundestag (2003), annual report on CRAs by French securities regulator AMF (since 2005)

## IOSCO Code of Conduct Fundamentals for CRAs (I)

- publication of Statement of Principles Regarding the Activities of Credit Rating Agencies in September 2003
- publication of Code of Conduct Fundamentals for CRAs in December 2004
- objective: establishing globally recognised binding minimum standards for business conduct of CRAs
- voluntary adherence, no legal enforcement mechanism
- CRAs are expected to incorporate the provisions of the IOSCO code into their own codes of conduct
- deviations from the IOSCO code are to be disclosed and explained

## IOSCO Code of Conduct Fundamentals for CRAs (II)

### Key provisions:

- quality and integrity of rating process, interaction with rated entities (e.g. prior notification, appeal process, treatment of confidential information)
- CRA independence and avoidance of conflicts of interest
- transparency of rating methodology
- disclosure of type of rating (initiation, participation)
- internal enforcement function
- disclosure of own code of conduct and communication with market participants and the public (e.g. over complaints from the market)

## European Union: Discussion on Regulation of CRAs

- Feb. 2004: **EU-Parliament**: Resolution on credit rating agencies, calling on European Commission to examine need for legislative intervention
- March 2005: **CESR**: technical advice to the European Commission on possible measures concerning credit rating agencies: no further legislative initiatives suggested, IOSCO code and existing provisions in EU directives (e.g. recognition of "External Credit Assessment Institutions" under new Capital Requirements Directive) deemed sufficient for the time being
- Jan. 2006: **European Commission**: Communication on Credit Rating Agencies:
  - at present no proposals for new legislative action
  - Commission will monitor developments carefully and ask CESR to monitor CRAs' compliance with IOSCO code and report on an annual basis
  - new legislation will be considered again if new circumstances arise

## CESR: Voluntary Framework for Monitoring Compliance with IOSCO Code

established in Dec. 2005, three elements of CRAs' commitment:

- annual report on compliance with IOSCO code to CESR
- annual meeting between CESR and CRAs on issues related to the implementation of the IOSCO code
- explanation to national CESR member in case of substantial incident with issuers

Participating CRAs so far:

Standard & Poor's, Moody's, Fitch, Dominion Bond Rating Service

## United States

- since 1975 system of Nationally Recognized Statistical Rating Organizations (NRSRO) for ratings used for regulatory purposes
- current reform proposals for NRSRO system:
  - SEC: consultation paper on proposed new definition of NRSRO (April 2005)
  - Congress: alternative proposal introduced by Senator Fitzpatrick (Bill introduced June 2005)

## IV. Impact of IOSCO Code of Conduct

## IOSCO Code: Effectiveness and Limitations (I)

### Effectiveness of IOSCO code:

- reputational effects / market mechanism:
  - strong market pressure for CRAs to adhere to generally recognized minimum standards
  - increasing importance of high quality standards as a competitive factor
- monitoring by supervisory authorities and threat of further regulation if no or insufficient compliance with IOSCO code

## IOSCO Code: Effectiveness and Limitations (II)


### Limits to the IOSCO code:

- legally not binding
- no external arbitration or enforcement mechanism
- many provisions contain general guidelines only (e.g. transparency of methodology, qualification of rating analysts)
- wording often ambiguous, ample scope of interpretation (e.g. "where feasible and appropriate")
- ➔ only limited legal certainty
- ➔ no guarantee for impact on CRAs' business conduct

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## Impact of IOSCO Code – Preliminary Assessment

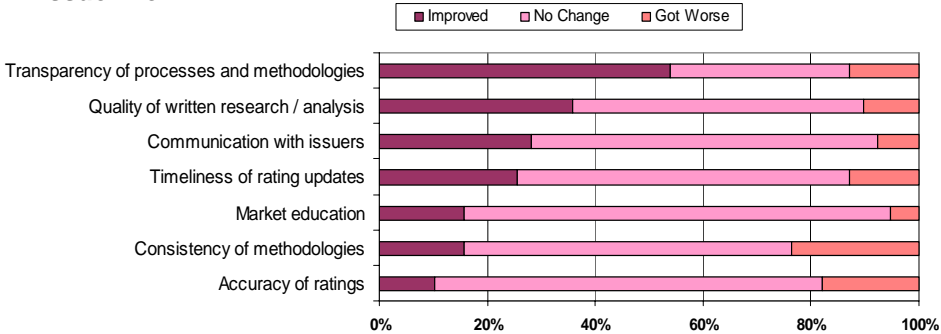
- global CRAs have developed codes of conduct that largely incorporate the IOSCO provisions, with a few deviations only
- improvement of standards, e.g. with respect to transparency of methodology
- CRA increasingly agree to entering into a dialogue with market participants
- however, implementation of code provisions into daily practice not yet complete
- problems of interpretation of code provisions

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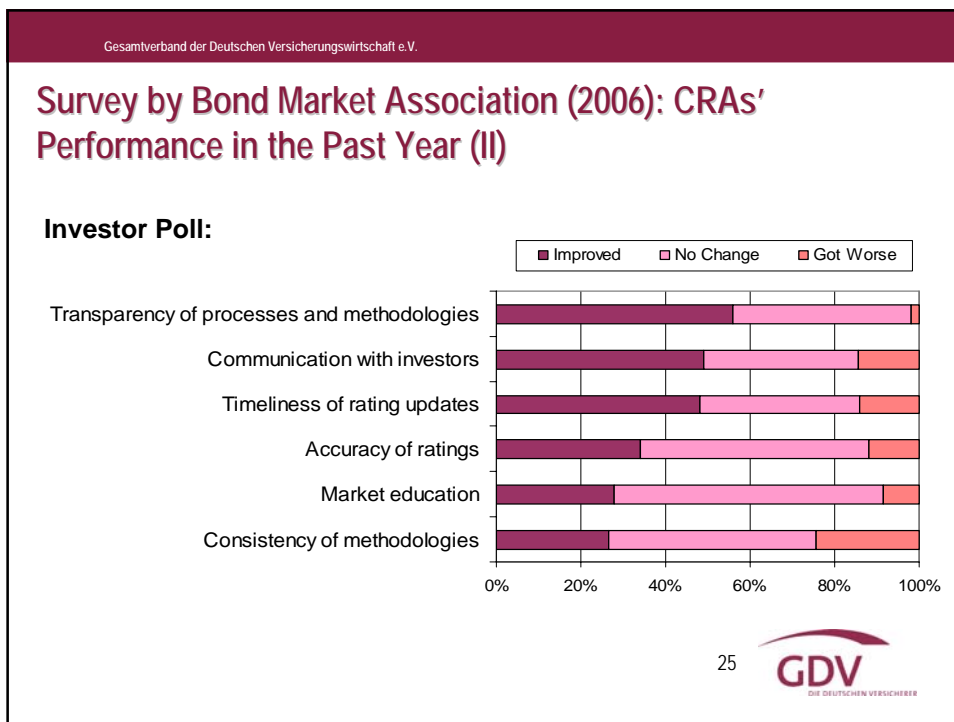
## Survey by Bond Market Association (2006): CRAs' Performance in the Past Year (I)

**Issuer Poll:**



| Category                                    | Improved (%) | No Change (%) | Got Worse (%) |
|---|--------------|---------------|---------------|
| Transparency of processes and methodologies | 55           | 30            | 15            |
| Quality of written research / analysis      | 35           | 55            | 10            |
| Communication with issuers                  | 28           | 65            | 7             |
| Timeliness of rating updates                | 25           | 60            | 15            |
| Market education                            | 15           | 75            | 10            |
| Consistency of methodologies                | 15           | 60            | 25            |
| Accuracy of ratings                         | 10           | 70            | 20            |

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### Case Study (1): Fitch – Quantitative IFS-ratings (Q-Ratings) for German Insurers

- in Dec. 2004, attempt by Fitch to introduce a new type of unsolicited rating (Q-rating) for German insurers
- severe shortcomings in Fitch's designated approach (e.g. intransparency of rating process and methodology, insufficient interaction with rated companies)
- GDV called on Fitch to postpone release of Q-ratings and improve procedures in line with provisions of new IOSCO code
- significant improvements could be achieved, in particular
  - 3 month delay in assignment and publication of Q-ratings
  - consultation on rating methodology
  - transparency of rating methodology
  - improvements in interaction with rated companies
  - clear disclosure of character of Q-ratings

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DIE DEUTSCHEN VERSICHERER

## Case Study (2): Fitch – Formal Complaint by GDV

- for several years, extensive dialogue between GDV and Fitch on a number of issues
- some improvements achieved, but persistent violations of minimum standards by Fitch in some areas, in particular
  - quality of market reports on German life insurance
  - disclosure of type of traditional IFS-ratings (solicited/unsolicited)
  - prior notification of rated entities, notification period
- particular interpretations of several provisions of IOSCO code by Fitch and GDV
- ➔ GDV will submit a formal complaint to Fitch to resolve these issues, using the complaint procedure provided for by the IOSCO code

## V. Outlook: Policy Conclusions

## Outlook and Policy Conclusions (I)

- IOSCO code of conduct has increased legal certainty and improved business conduct of rating agencies
- further regulatory action not required for the time being, wait for experience with IOSCO code and other new regulatory measures
- extensive monitoring of market developments and CRAs' compliance with IOSCO code by supervisory authorities essential
- periodical review of implementation of minimum standards and CRAs' business conduct required to decide on further course of action
- if necessary, IOSCO code should be amended and enforcement mechanism should be implemented

## Outlook and Policy Conclusions (II)

- increasing use of ratings as part of the regulatory framework (Basel II, Solvency II)
- further regulatory action on CRAs might be considered
- need for close co-ordination of all European regulators involved (CESR, CEIOPS, CEBS, national supervisory authorities,...)
- need for consistency in all legal provisions relating to CRAs (e.g. with respect to rating definitions and recognition requirements for rating agencies)
- need for co-ordination at an international level, in order not to impose new restrictions on functioning of international financial markets