Statement
of the
American Council of Life Insurers

on

Improving Transparency in
State Regulation of Insurer Investments

before the

Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises
of the
House Financial Services Committee
of the
United States Congress

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Mr. Chairman and members of the Subcommittee, I am Michael J. Hunter, Executive Vice President and Chief Operating Officer of the American Council of Life Insurers (ACLI). I am here today on behalf of our 377 members which account for 91 percent of the life insurance industry's total U.S. assets. ACLI members offer life insurance, annuities, pensions (including 401(k)s), long-term care insurance, disability income insurance, reinsurance, and other retirement and financial protection products.

I would like to thank the Subcommittee for the opportunity to present the life insurance industry's views regarding the current regulatory oversight of investments held by insurance companies. As investors holding approximately $4.2 trillion of securities or approximately 12% of the total investments in the U.S. capital market[1], actions and decisions regarding the regulatory oversight of our investments are critical to the business operations of ACLI member companies, the customers we serve, and arguably to our nation's economic stability. As you are aware, the insurance industry is a state regulated industry with companies operating under the supervision of each state in which the company is licensed to operate. The NAIC is an association comprised of the state insurance regulators. The Securities Valuation Office (SVO) is an NAIC organization that is charged with examining the credit quality and value of insurers' investment portfolios.

We understand that one reason this Committee has called for this hearing is to better understand the decisions made earlier this year by the SVO regarding hybrid securities. Hybrid securities are structured with characteristics of both debt and equity. Each hybrid security is structured with unique characteristics that take into account capital treatment, rating agency concerns and tax treatment. These securities are widely issued by highly rated financial institutions, including insurance companies, to boost their capital positions and allow the issuer to defer coupon payments in times of financial distress. And,

[1] ACLI 2006 Factbook

because they tend to be high value and low risk investments, insurers often hold hybrid securities within their diverse portfolios. Insurers have generally classified these securities as bonds in their financial statements. This is consistent with the classifications of hybrids by the Nationally Recognized Statistical Rating Organizations ("NRSRO's"; ie, Standard & Poor's, Moody's, etc.), and with their structure (i.e. sold with par value as opposed to shares).

The decisions made by the SVO beginning in March created such a level of uncertainty in the capital markets that holders of these securities experienced a substantial decrease in their market value. The aggregate decrease in market value among all insurers was approximately one billion dollars. Additionally, insurers experienced a drastic reduction in the ability to trade these securities. Companies that previously could liquidate positions as great as fifty million dollars in a single day were only able to sell approximately ten million dollars in a day after the SVO's action. When these classifications were first made, there was universal disagreement with these decisions from buyers, sellers, rating agencies and even some regulators. Even with this disagreement, the SVO never reexamined its actions and instead went on an aggressive course of action that resulted in many additional securities being reclassified or classified incorrectly. Based on these factors, I believe a fundamental issue for this Subcommittee to consider is what role the SVO should play in the ratings and valuation of the securities held by insurance entities, and exactly how that role should be carried out.

I should acknowledge that as of today it appears that a workable short-term solution to the hybrid securities situation has been reached. We anticipate a favorable response to this solution by the capital markets and expect to experience a recovery of some of the market value and liquidity in the market for hybrids. This short-term solution was accomplished thanks to the extraordinary effort of both the industry and NAIC leadership over the last few months. I compliment and commend Superintendent Iuppa on the vital leadership role he played to help us get to this positive outcome.

In 1907, the NAIC established a committee for the valuation of securities. That committee established uniform values for securities held by insurers by contracting with Moody's, Poor's Publishing and other rating agencies. Eventually, the NAIC felt that they could perform this function internally at a reduced cost and thus formed the SVO. In addition to lowering internal costs to the NAIC, the SVO was responsible for the valuation of investments made in private and public companies for which no value was obtainable from private statistical rating organizations. However, in the late 1990's the NAIC realized that a more effective way of valuing securities would be to rely on the values provided by Nationally Recognized Statistical Rating Organizations (NRSRO's), so today insurers rely on NRSRO's to determine the value and classification of most of their securities. With the SVO employing approximately twenty analysts and the NRSRO's employing approximately twenty thousand analysts, that decision resulted in a more efficient and reliable ratings process. In the event that a security is not rated by an NRSRO, the SVO will value and classify that security. Additionally, a state regulator may ask the SVO to value or classify any security that an insurer has in its portfolio.

To understand the importance of the classification of securities to an insurer, one must understand the NAIC's Risk-Based Capital (RBC) system. The RBC system uses a formula to establish the minimum amount of capital necessary for an insurance company to support its business operations. The system limits the amount of risk a company can assume by requiring higher amounts of capital for bearing higher amounts of risk. Computing risk-based capital helps determine when and what actions regulators should take in the event a company's actual capital and surplus falls below its calculated minimum.

All securities are classified as either debt/preferred stock or common stock. Within each of these designations, each security is assigned a classification ranging from a 1 (highly rated) to 6 (at or near default). While a highly rated class 1 debt instrument or preferred stock requires a 0.3% capital charge, a highly rated class 1 common stock requires a capital charge of 30%, or one hundred times higher than that of debt or preferred stock. To put this in another context, a highly rated debt instrument or preferred stock with a market value of one million dollars would require a company to allocate three thousand dollars for risk-based capital, while a common stock of equal market value would require three hundred thousand dollars be allocated. Due to the extremely high capital requirement for common stocks and the risk-averse nature of life insurers, their portfolios contain substantially more debt securities than common stock.

The SVO's recent actions on hybrid securities illustrate the effect that both classifications and reclassifications can have on both insurers and the capital markets. While our member companies had serious concerns with the underlying rationale for these decisions, our primary concerns with the SVO are those of process and transparency. We believe the SVO must adopt and employ an open, transparent process by which it classifies securities, disseminates those decisions to market participants, and provides clarity as to why and how these classifications are made.

It is also imperative that reclassifications not be made to securities previously classified by the SVO absent a material change in the structure of the security. Insurance entities purchased these with an expectation that the classification by the SVO would be consistent for the life of the security only to have the classification changed with no rationale provided for such change. Entities cannot effectively manage their investment portfolios with this level of uncertainty and lack of transparency. When the SVO reclassified several securities from debt to common stock in March, investors were left to wonder what prompted the change. Industry representatives immediately requested the SVO communicate the additional risks it perceived these securities contained that are not considered in the ratings process of the NRSRO's. We commend the New York Insurance Department's recently drafted document identifying the risk factors they believe are inherent in hybrid securities. The SVO however, has yet to respond to industries repeated requests for this information, even though they are the ones making these decisions.

Further, when the SVO acts to a request to rate a security, the only entity that receives the decision on the classification is the entity that requested the classification. Other insurers may own the security, but have no way to know if it has been "downgraded" by the SVO. Similarly, issuers of securities, dealers and investors do not receive this information. By contrast, NRSRO's issue a press release with the rating of each new security along with the corresponding rationale for the rating given. We are at a loss to understand the public policy purpose behind this apparent intentional lack of transparency on the part of the SVO. The SVO should disclose information on its classifications and rating designations by public dissemination because such information is material to the market and information disclosed unevenly can erode investor confidence. Additionally, the basis for the SVO's decision on a particular security is only disclosed to the entity that made the request. The SVO considers this information privileged and confidential; the entity is prohibited from sharing this information with other investors or issuers of the security. As insurers and other investors eventually learn of an SVO classification, they are unable to speak with the SVO to obtain clarification as to why and how the decision was made. There is no legitimate public policy served by this secrecy.

In the case of hybrid securities, and as a direct result of all the recent confusion, the SVO has begun a process by which all classification decisions regarding these securities are posted in a report on the NAIC website. We applaud this move as a good first step in improving transparency and are strongly in support of it. However, this system is not in place for other SVO rated securities and as previously noted, the empirical basis for these ratings is not disclosed.

SVO staff has stated publicly that their designations are not produced to aid in the investment decision-making process and, therefore, are not suitable for use by anyone other than regulators and the individual insurers affected. This is a completely unrealistic and impractical position to take. As we have recently seen, SVO actions do have an immediate and significant impact on the capital markets. This stance does nothing more than foster a lack of confidence in the integrity of the process, as well as within the industry and the market place.

It is important to understand that this is not the first time that the SVO's actions have been called into question. In fact, during the late 1990's the NAIC itself commissioned KPMG to conduct an extensive review of the SVO's operations. The findings in that report advised the NAIC that there were serious deficiencies in the SVO's work product. To our knowledge, however, the NAIC has taken no action to this day to implement the KPMG recommendations. Choosing not to act before now to address these problems almost certainly helped lead to the situation that surfaced this year regarding hybrid securities. Recently, NAIC leadership and other key regulators involved with SVO issues have stated their intent to perform a thorough review of all SVO process and transparency issues. We support the NAIC taking such action, and look forward to working with them in hopes of finding a system that works for all parties affected by SVO decisions.

In summary, we would like to leave the Subcommittee with three main points:

1. Buyers and sellers of securities must know in advance when the SVO is analyzing a particular security or class of securities. This will provide stakeholders the opportunity to provide input to the SVO to insure that a fully informed decision will be made;

2. The SVO must publicly communicate the empirical basis for all ratings decisions made so that issuers of securities can understand what risk characteristics the SVO has identified that could lead to a different rating than that of the NRSRO's. Armed with this information, investors will be in a position to assess their investment portfolios and make an informed decision as to whether they wish to continue to hold the security or securities in question;
3. The NAIC has shown a willingness to allow the use of NRSRO ratings, and expanding that system is one option for consideration, leaving the SVO to focus solely on solvency issues. However, should regulators not be willing to cede all rating and classification decisions to the NRSRO's, it is then imperative that an open, transparent system for SVO action be implemented.

I again would like to thank the Committee for inviting the ACLI to participate in this hearing.