

Insurance agenda



Is credit rating broken?

The regulation and transparency of credit rating agencies (CRA) is becoming a global focus with the G20 leaders calling for enhanced CRA oversight. This will have mixed implications for insurers.

The regulation and transparency of credit rating agencies (CRAs) is under the spotlight globally, following breakdowns in the credit rating function, particularly the perceived failures in the CRAs' rating of sub-prime mortgage securities.

Spotlight on independence and transparency

While CRAs have put in place some measures to deflect the criticism, the G20 leaders have called for enhanced CRA oversight. Several jurisdictions have taken steps, including advanced legislative or regulatory proposals, that will have a broad impact on CRA operations. Among other initiatives, the EU has issued a regulation increasing CRA oversight, China is considering consolidating and strengthening existing CRA regulations, and Japan and the US are considering possible legislation. In addition, the International Organisation of Securities Commissions (IOSCO) has strengthened its code of conduct for CRAs.

Many of these measures are driven by the need for greater transparency in the ratings process, with emphasis moving away from judgement to robust and proven rating methodology. Interestingly, a number of the legislative and regulatory proposals for CRAs appear to leverage elements of the regulatory model that has been applied around the world for the audit profession.

A mixed blessing for insurers

For insurers these changes may be a double-edged sword - on one hand providing greater confidence for investment activities but, on the other hand, potentially more onerous requirements for companies themselves to achieve high ratings. It is foreseeable that these measures will put downwards pressure on ratings and, while this may be relative, companies will need to consider how to manage any such messages with the investment community.

The changes may further complicate the already fraught area of counter-party risk, particularly in the reinsurance area. With fewer reinsurers meeting credit rating standards there will be long term implications for insurers, who will need to meet additional capital requirements caused by any drop in rating. Insurers own internal risk management processes may also trigger the need to replace

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the counter party - a move that will become increasingly difficult with fewer eligible reinsurers.

How will the banking sector respond?

There is a broadly held view that Basel is over-reliant on credit ratings, especially for selective markets such as securitisation where internal models tend to be weak. In some cases, ratings agencies can be viewed as a defacto regulator, given their ultimate influence on determining levels of capital. We wait to see how banking regulation responds to the increased CRA scrutiny and the inevitable flow on impact to insurers.

Key elements of recent regulation:

- ▶ Expanded and more consistent oversight of CRAs. A greater number of countries will require CRA registration and implement oversight mechanisms.
- ▶ Greater CRA transparency. New or enhanced requirements are likely to include a focus on the disclosure of rating methodologies and the ratings track records.
- ▶ New governance structures. In addition to independent board members, there may be requirements for board level experts in securitisation and structured finance.
- ▶ Conflicts of interest requirements. The limitations are likely to vary, but may include independence requirements and restrictions on the provision of advisory services to clients that are also rated by the CRA.
- ▶ Current payment model. There is significant criticism of the current model where the issuer pays for ratings, leading to discussion of potential alternatives.
- ▶ Enhanced liability exposure. Reduced liability protection and enhanced litigation exposure.

The future for CRAs?

While this debate has further to go (and Australia's approach remains unclear), we certainly endorse the need for greater transparency and the proposed amendments to address the perceived conflicts of interest. Nevertheless, it seems unlikely that alternative models to CRAs, such as investor pays or government rating agencies will be adopted in Australia or other developed markets. Consequently, in our view, buyer responsibility needs to remain the focus of the debate.

Feedback and further information

We hope you find Insurance agenda both useful and thought-provoking. Of course, we welcome any feedback and are happy to discuss any of these issues personally if you would find this valuable. Please contact:

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