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

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Many commentators, including the Financial Crisis Inquiry Commission, have identified the poor quality of credit ratings as an important cause of the recent financial crisis. The leading agencies all have acknowledged poor performance in some areas. One popular explanation for agencies’ poor performance is the incorporation of ratings into regulations. Rating-dependent regulation arguably reduces agencies’ incentives to do a good job (by creating artificial demand for ratings) and amplifies the negative effects of their doing a bad job (by creating regulatory consequences for rating downgrades).

Last year’s Dodd-Frank Wall Street Reform and Consumer Protection Act apparently embraced this explanation wholeheartedly: Dodd-Frank requires federal financial regulators to remove ratings from their rules within one year. As this Essay explains, Dodd-Frank’s approach is seriously incomplete because the states use credit ratings extensively in their regulation of the insurance industry and its huge investments, which account for about half of all corporate bonds outstanding. Thus, despite Dodd-Frank, ratings will remain an important part of the overall financial

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regulatory system in the United States unless Congress preempts state insurance regulation or the states abandon their use of credit ratings.

State insurance regulators in fact are reconsidering their use of credit ratings in insurance regulation in a process unexplored to date in the scholarly literature. Although this slow, deliberate process has not been completed, at this writing it seems unlikely to result in total rejection of credit ratings in insurance regulation. Instead, it seems likely that regulators will adopt a nuanced approach, reducing their reliance on ratings in some areas but not eliminating the use of ratings altogether. The one area in which state insurance regulators have acted decisively – moving away from credit ratings in assessing the risk of mortgage-backed securities, seems to be a result-oriented “rule bailout” of the life insurance industry rather than principled reform of rating-dependent regulation.

Both aspects of the insurance regulators’ experience – the slow progress in true reform of rating dependence and the rule bailout of their regulated constituency – have broader implications. First, the state insurance regulators’ reluctance to eliminate ratings from regulation altogether suggests that financial regulators more generally will be reluctant to abandon credit ratings, which are convenient and to which there are no clearly superior alternatives. Indeed, the Dodd-Frank project of total elimination apparently has run into serious resistance from federal regulators already. Second, rule bailouts are not limited to insurance – accounting authorities effected a rule bailout of the banking industry by changing mark-to-market rules during the crisis – and this tendency should be taken into account in capital regulation. For example, concerns that high capital requirements will exacerbate downturns are probably excessive if capital requirements are likely to be relaxed in a downturn. As it stands, it seems that the Dodd-Frank command to eliminate ratings from federal regulations, popular as it was, may turn out to be ineffective both in improving credit ratings and in fixing capital regulation.
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I. INTRODUCTION

The financial reformers forgot about insurance: The Congressional program embodied in last year’s Dodd-Frank financial reform law\(^1\) is radically incomplete if the conventional understanding of the recent financial crisis is at all correct. One of the few matters on which Democrats and Republicans in Congress apparently have agreed is that *credit ratings must be excised from financial regulation*. Dodd-Frank directs federal regulators to accomplish that goal for federal financial regulation within a year,\(^2\) and although most Republicans opposed final passage of the Dodd-Frank Act,\(^3\) the House Republicans’ draft financial reform bill contained the same requirement.\(^4\)

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\(^1\) Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, July 21, 2010 [hereinafter Dodd-Frank Act]

\(^2\) See Dodd-Frank Act, § 939A.


\(^4\) See Consumer Protection and Regulatory Enhancement Act §§ 602-03 (available at [https://docs.google.com/fileview?id=0B55mSfYugJNzMWNjMzg0NjUtYWNiNC000OTRI](https://docs.google.com/fileview?id=0B55mSfYugJNzMWNjMzg0NjUtYWNiNC000OTRI))
The decision to excise credit ratings from federal financial regulation, sweeping as it is, is incomplete because the states operate a critically important system of rating-dependent financial regulation. They do so through their regulation of what may be the most important group of credit-rating users: the insurance industry. Insurers own half the corporate bonds and 15% of the municipal bonds outstanding in the United States by dollar value and the states have jealously guarded their primary authority to regulate insurance for over 65 years.

Under the states’ rating-based regulatory system, which is operated by the association of state insurance regulators, the National Association of Insurance Commissioners (NAIC), insurers endured their own financial stresses based on the failure of high-rated mortgage-backed securities and

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6 See Robert W. Klein, The Insurance Industry and Its Regulation, in THE FUTURE OF INSURANCE REGULATION IN THE UNITED STATES 13, 32-36 (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)).
other structured financial products, and received their own bailout – in the form of an industry-friendly rule change rather than an infusion of cash. In response, state regulators have been considering reform of rating-dependent regulation for the past two years. And none of this has attracted much attention outside the specialized domain of insurance commentators.

This Essay explores what the previously unexamined use of ratings by state insurance authorities has to teach us, both about the use of ratings in regulation and about the financial regulation more generally. To do so, it starts by telling the story of rating-dependent regulation of insurance in the years leading up to and immediately following the financial crisis of 2007-09. That story begins in the late 1990s with an existing governmental credit rater, the Securities Valuation Office of the National Association of Insurance Commissioners (the SVO), which is overmatched by its task: rating every security held by an insurance company in the United States – and which therefore relies heavily on credit rating agencies to do its job.

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7 Public attention has focused on the failure of AIG and, to a lesser extent, bond and mortgage insurers. Although credit ratings did play a role in these cases, they do not arise from the rating-based regulatory system that the states operate through the NAIC, which is the subject of this Essay. The role of rating-dependent regulation in the collapse of AIG and the bond insurers is explored in Rating-Dependent Regulation of Insurance, __ CONN. INS. L. REV. __ (forthcoming 2011).
Starting in 2000, regulators at first temporarily and then permanently degraded the SVO’s authority and decided to rely more heavily on private rating agencies. Specifically, regulators adopted a rule requiring the SVO to defer to the judgment of private rating agencies about the creditworthiness of insurers’ investments whenever the regulated insurers decide to use private agencies rather than the SVO.

In so doing, the NAIC acted more or less in parallel with other regulators. Although concerns about the use of ratings in regulation date back at least as far as 1995, and redoubled after the agencies’ failure in 2000 to warn of Enron’s precarious situation up until four days before its collapse, no regulatory body took steps to reduce its use of credit ratings in regulation until the financial crisis of 2007-09.

That crisis was widely blamed at least in part on credit rating agencies. Securities that received high ratings from the agencies failed in various ways: they suffered higher-than-expected actual losses, a near-total loss of market confidence, and severe downgrades from the agencies that once rated them so highly. Those failures reverberated throughout the financial sector, sending many large institutions to – and over – the brink of collapse and triggering the unprecedented government bailouts about which so much has been said. In response, regulators around the globe started to rethink their use of ratings as part of a broader project of financial regulatory
reform.

Although the U.S. insurers subject to NAIC’s rating-dependent regulatory system did not suffer spectacular collapse, they did suffer significant stress due to their investments in high-rated securities that suffered severe downgrades. In response to this stress and the overall perception that ratings had failed, NAIC began to reconsider its use of ratings in two sharply contrasting proceedings, one directed at rating-dependent regulation of insurance in general, and the other directed specifically at mortgage-backed securities.

The broad reconsideration of credit ratings in insurance regulation is a thoughtful, comprehensive, and nuanced reconsideration of the use of ratings that appears to proceed from first principles. Three features of this broad proceeding are noteworthy: First, as of this writing it has continued for two years without concrete action. Second, it has steadily retreated from any idea of eliminating rating agency ratings from regulation. Third, it has steadily retreated from the idea of materially upgrading the SVO and substantially displacing rating agencies from insurance regulation.

The second proceeding, the narrowly targeted one that deals primarily with mortgage-backed securities, responds to the life insurance industry’s concerns that it would have to raise capital because of rating-agency downgrades of those securities. The narrow proceeding too has three
noteworthy features: *First*, action was swift and comparatively silent. Within a few months of the industry’s proposal, credit ratings on mortgage-backed securities had been replaced – permanently – with assessments provided by other private third-party providers. The result was a very significant reduction in the amount of capital the industry was required to hold. And this happened with almost no comment. *Second*, the scope of this proceeding has steadily expanded to encompass other instruments, such as commercial mortgage-backed securities, that also have suffered severe downgrades that would require additional capital. *Third*, the timing and rationale for this proceeding suggest that it is something other than a regulatory change made on the merits of credit ratings. Instead, what is suggested is a targeted rule change to relieve the parochial concerns of a regulated industry during a crisis – a response I call a “rule bailout.”

Both proceedings echo, in the insurance context, larger themes that have sounded throughout the financial crisis. The fitful progress of the broad reform effort is not an insurance-specific phenomenon; insurance regulators are not the only ones to have retreated steadily from an initial goal of completely eliminating rating-dependent regulation: the SEC and banking regulators have done the same. The insurance regulators’ difficulties in replacing rating-dependent regulation suggest that true reform of rating-dependent regulation is difficult, not just for insurance regulators but for
any financial regulator. Reform is difficult politically because both regulators and the regulated have a stake in rating-dependent regulation: The regulators want to defer responsibility and the regulated industry wants to keep down regulatory costs and, perhaps, reserve regulatory power in private hands. Reform is also difficult substantively, because none of the alternatives to rating-dependent regulation is compelling.

The fact that insurance regulators seem unlikely to remove credit ratings from their regulatory scheme entirely is also important because of the interaction of federal and state regulators: removing credit ratings from federal law seems intended at least in part to improve the performance of credit raters themselves, not just to limit the consequences of poor performance, so state retention of rating-dependent regulation of insurance will complicate that project substantially.

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8 See Frank Partnoy, The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Rating Agencies, 77 WASH. U.L.Q. 619, 623-24 (1999) (rating-dependent 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. 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.”).
With respect to the narrow proceeding, the insurance regulators’ rule bailout echoes the accounting authorities’ rule bailout of banks via relaxation of mark-to-market rules. The larger message here is more troubling; it suggests intractable limits on what capital regulation can do. Whatever rules are on the books, regulators will be under pressure to relax them and allow reckless behavior when times are good – as the embrace of agency ratings shows -- and to relax them in different ways in a crisis to avoid total collapse, as demonstrated by the insurance regulators’ embrace of rule bailout. Only in the aftermath of collapse do political factors favor increased stringency.

II. THE NAIC’S INCREASING RELIANCE ON CREDIT RATINGS FOR INSURANCE REGULATION BEFORE THE FINANCIAL CRISIS

One of insurance regulation’s main goals is reducing the likelihood that insurers will fail to meet policyholders’ claims due to insolvency, and insurance law seeks to control the risk that insurers will become insolvent due to investment losses. It employs two tools to this end: investment holding limits, which require insurers to hold investments that meet some

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standard of safety,\textsuperscript{10} and capital requirements, which require insurers to maintain prescribed levels of capital – excess of assets over liabilities – as a margin of safety against insolvency.\textsuperscript{11}

\textsuperscript{10} Investment holding limits are prescribed by state statute and vary widely from state to state. In the 1990s, the 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 NAIC MODEL LAWS, REGULATIONS, AND GUIDELINES 280-1, §§ 1-32. 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 MODEL LAWS, REGULATIONS, AND GUIDELINES 283-1, §§ 1-19. Most states have not enacted either of NAIC’s model laws. See Model Investment Act (Defined Limits Version), State Adoption (adoption by 17 states); Model Investment Act (Defined Standards Version), State Adoption (adoption by one state). The major insurance-regulating states are divided between the “pigeonhole” and “portfolio” approaches. Compare CONN. GEN. STAT. § 38a-102(a) (subject to exceptions, 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).

\textsuperscript{11} The NAIC’s Risk-Based Capital Model Act requires insurers to follow risk-based capital rules adopted by NAIC. 3 NAIC MODEL LAWS, REGULATIONS, AND GUIDELINES 312-1, § 2.A. The Risk-Based Capital Model Act has been adopted almost universally,
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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. Banks and brokers, by contrast, may be more concerned about liquidity risk – the risk that all their creditors will demand repayment at once. This was the risk that brought down so many institutions during the financial crisis.

Both the tools insurance law uses to control insurers’ financial risk are designed to help manage credit risk. Investment holding limits restrict

unlike the NAIC’s model acts on investment limits. See Risk Based Capital (RBC) for Insurers Model Act, State Adoption (reflecting adoption of Risk-Based Capital Model Act in all states but Texas). 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.


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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, consider an insurance company with $1,000 in assets. 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

\[ \text{See Memorandum from Academy Joint RBC Task Force, American Academy of Actuaries, to Lou Felice, Chair, NAIC Risk-Based Capital Task Force, Feb. 12, 2002 [hereinafter “AAA Feb. 12, 2002 Memo”], for a description of insurance risk-based capital requirements that is consistent with this example.} \]

\[ \text{The term “$1,000 in assets” can mean different things, as not all In applying the risk-based capital rules, financial assets may be valued at amortized cost or at the lower of amortized cost or market, with lower-risk assets valued at cost and riskier ones at the lower of cost or market. For life insurers, only assets in the lowest NAIC category, NAIC-6, are carried at the lower of cost or market. AAA Feb. 12, 2002 Memo, supra note 14, at 11 (“Detailed Grid – 2001 Asset Risk Factors”).} \]
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 of one’s own money. It’s also the difference between being able to sustain 10% and 30% 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. Even so, capital 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 counts all states’ regulators

\(^{16}\) See Guillaume Plantin & Jean-Charles Rochet, When Insurers Go Bust 27-28 (2007).
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as members and was founded in 1871. 17 An organization within the NAIC – the Securities Valuation Office (SVO), created in 1907 18 – 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. 19

The SVO, which is funded by assessments on insurance companies, 20 apparently has relied to 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 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

17 VAUGHAN & VAUGHAN, supra note 9, at 105.

18 See Partnoy, supra note 8, at 700 n. 367.

19 AAA Feb. 12, 2002 Memo, supra note 14, at 11 (“Detailed Grid – 2001 Asset Risk Factors”). For property/casualty insurers, the difference is even more stark – the charge is $3 for NAIC-1 and $300 for NAIC-6. Id.

securities simultaneously in a manner comparable to that of the [rating agencies] is not part of its mission.”

But the SVO retained authority to take a more pessimistic view on an instrument’s risk than the credit rating agencies.

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. In 2004, NAIC adopted the “filing exempt” rule (“FE Rule”), which further constricted 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. The NAIC thus permitted insurers to decide whether their holdings would be rated by the SVO or by rating agencies. And insurers do


22 Id. at 109.


24 NAIC, Understanding the NAIC Filing Exemption (FE) Rule, (draft Feb. 25, 2004), at 1. “Recognized” agencies in this context are those that the SEC has designated “nationally recognized statistical rating organizations” (NRSROs). Id.
overwhelmingly choose to rely on agency ratings: 80% of insurer holdings are rated by agencies rather than SVO,\(^25\) and the 20% that SVO does assess are overwhelmingly those that are not rated by the agencies.\(^26\)

Why did the NAIC decide to permit insurers to opt out of using its existing rating capability? According to a consultants’ report commissioned in 1998, the SVO lacked the resources and budget to do much beyond rely on agency credit ratings 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.”\(^27\) The consultants outlined two options: a “massive increase in the budget and staff” of the SVO,\(^28\) so that it could carry out the credit analysis it was supposed to carry out, or bypass SVO altogether for instruments with credit ratings.\(^29\) They recommended the

\(^{25}\) Chris Evangel, *Panel 1 – Use of Ratings in Regulation* (Sept. 24, 2009) at 11 (presentation by SVO managing director on NAIC use of credit ratings at public hearing).

\(^{26}\) Interview with Chris Evangel, Managing Director, SVO, June 29, 2010. Interview notes on file with author.


\(^{28}\) *Id.* at 27.

\(^{29}\) *See id.* at 30 (recommending “eliminat[ing] the requirement for a complete SVO filing package for public NRSRO-related issues).
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.”

Commenters who argue that a public rating capability is the solution to the rating-agency problem should take heed of the fate of 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 RATING 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

\[\text{\textsuperscript{30}}\] \textit{Id.} at 3 (June 1998). The KPMG consultants went even further with a suggestion not adopted by 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. \textit{Id.} at 30.

of the crisis there has been a widespread perception, shared for example by both the majority and dissent in the recent Financial Crisis Inquiry Commission report,\(^{32}\) 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.\(^{33}\) A growing body of empirical research suggests that this perception is to some extent accurate.\(^{34}\)

\(^{32}\)See Financial Crisis Inquiry Comm’n, supra note 13, at xxv (reporting majority conclusion that “failures of credit rating agencies were essential cogs in the wheel of financial destruction”); id. at 418 (reporting dissenters’ conclusion that “[f]ailures in credit rating and securitization transformed bad mortgages into toxic financial assets”).


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.

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.\(^{35}\) When AIG itself 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

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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.

These cases are idiosyncratic, however: AIG’s case is unrepresentative, as most U.S. insurers are not affiliated with a gigantic offshore trading operation. 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 NAIC. Mortgage insurers’ losses stem primarily from their core business – insuring mortgages – rather than their investments. The crisis also affected the thousands of United States insurance companies that were not affiliated with AIG and were not bond or mortgage insurers.36

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

36 Insurance Information Institute, Industry Overview [Assumes 300 AIG affiliates – being checked.]
But the industry did experience substantial stress, and that stress in fact prompted NAIC’s most decisive regulatory change to date. Life insurers owned $145 billion in residential mortgage-backed securities as of year end 2008, and the rating agencies’ downgrades of these securities in 2009 triggered a requirement that the industry raise capital -- $9 billion, according to its estimate. 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 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,

37 Letter from John Bruins & Andrew Melnyk, Am. Council of Life Insurers, to Michael Moriarty & Lou Felice, NAIC, Sep. 9, 2009, [hereinafter “ACLI Sept. 9, 2009 Letter”], at 3. This figure excludes “agency” securities, those issued or guaranteed by government sponsored housing enterprises.

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 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 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 NAIC’s rules create artificial demand for ratings among insurers, then Congress’ attempt in the Dodd-Frank bill to eliminate artificial demand by excising ratings from federal rules will be incomplete. Second, NAIC’s experience has lessons for the design of financial regulation more generally. The rule bailout for regulatory constituents; the protracted, nuanced reconsideration of rating-dependent regulation from first principles that did 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 – these have significance beyond Dodd-Frank, and even beyond rating-dependent regulation.
IV. THE BROAD RECONSIDERATION OF THE USE OF CREDIT RATINGS:

MOVING AT A DELIBERATE PACE TO AN UNCERTAIN RESULT

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 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, 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 and eventually, after Enron retained an

39 Thomas McGuire, Ratings in Regulation: A Petition to the Gorillas (June 1995), at 1 (“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.”).

40 See generally Partnoy, supra note 8 (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 Hill, Regulating the Rating Agencies, 82 WASH. U. L.Q. 43, 65-66 (2004)
investment-grade credit rating up until four days before its collapse, policymakers started to consider the idea of removing ratings from regulation along with other suggestions for reform of rating agencies.

Years of study followed, during which time the SEC and Congress ultimately 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. That was the central point of the Credit Rating Agency Reform Act of 2006. Some commenters have

(“While favorable regulatory treatment is clearly an important part of the value of obtaining ratings, ratings must be doing more.”).

41 See Hill, supra note 40, at 43.


43 See SEC SOX REPORT, Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets 28-29, 43-45 (Jan. 2003) (identifying rating-dependent regulation as a potential issue but declining to consider it further, while identifying potential measure to reduce regulatory barriers to entry into rating-agency market as an area for further study).

44 The main point of CRARA was to reduce “regulatory barriers to entry” by setting forth a transparent and relatively undemanding process by which a rating agency could become recognized for regulatory purposes by the SEC. See REPORT OF THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS TO ACCOMPANY S. 3850,
pointed out that increased competition in the face of rating-dependent regulation might cause the agencies to perform worse, by reducing the value of reputation and strengthening issuers’ hand in shopping around for high ratings to satisfy regulatory requirements, 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 2007-09 was upon us before the Act had much of a chance to have an effect. The SEC’s

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*CREDIT RATING AGENCY REFORM ACT OF 2006, S. REP. NO. 109-326, at 7 (2006)* (registration process is “most important” feature of Act); *15 U.S.C. § 78o-7(a)* (registration process). The NAIC’s list of officially recognized rating agencies closely tracks the SEC’s.

rules implementing the Act took effect in late June 2007, scarcely one month before the Fed took the first of its extraordinary actions to address “dislocations in money and credit markets.” The financial crisis refueled the critics of rating agencies and rating-dependent regulation, as the failure of high-rated complex financial products was widely seen as a cause of the financial crisis. The SEC, Congress, and the G-20’s staff arm all


49 See discussion supra Part I.

50 See Financial Stability Forum, Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, April 9, 2008, at 37-38 (calling for review of use of rating in regulation); Financial Stability Board, Principles for Reducing Reliance on CRA Ratings, Oct. 27, 2010, at 1 (“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
undertook reviews of the regulatory use of credit ratings, as did the NAIC.

In February 2009, the NAIC created a working group to “gather and assess information on … the problems inherent in reliance on ratings,” as well as “[t]he reasons for the recent rating shortcomings.” 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 – at their disposal.

Contemporary observers believed that such a decisive move was at least possible, and when the SVO presented a set of regulatory options to the creditworthiness”).


52 See Sean P. Carr, NAIC Seeks to Form Its Own Rating Agency, BESTWIRE, Oct. 20,
working group, its own upgrade was (perhaps unsurprisingly) at the top of the list. Perhaps, so it seemed, 2010 would see the adoption of two public options – not just a public alternative to private health insurance but also a public alternative to private rating agencies.

It was not to be – no more in the latter case than in the former. The idea of an NAIC-run rating entity promptly attracted “concern” from insurers, who reportedly “wor[r]ied that] a new levy on insurance companies would send the wrong signal to the industry, particularly in the current climate.” 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. A recommendation in December 2009 to “Eliminate or Modify the Filing Exempt Rule” becomes a recommendation in April 2010

2008, with RAWG Final Report, at 5 (agency ratings “have a role in regulation”).

53 See Staff Report: NAIC Use of NRSRO Ratings in Regulation (March 10, 2009), at 3 (suggesting “[c]onsider replacing NRSRO ratings with alternative NAIC SVO processes” as lead potential reform approach).


“Modify the Filing Exempt Rule.” December’s “consider the possibility of establishing an SVO-like entity as a not-for-profit rating agency” became April’s “Consider whether the NAIC should establish a not-for-profit rating agency where ARO [private rating agency] coverage is not adequate.” The recommendation that “ARO ratings should no longer be used to set RBC for structured securities” disappears entirely and the final report expressly provides that “ARO ratings have a role in regulation.”

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, found that “policy on the use of ARO ratings should be highly selective,” and 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.

As of January 2011, the NAIC’s process continues. Groups within

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56 RAWG Final Report, at 6.
57 RAWG Exposure Draft, at 5.
58 RAWG Final Report, at 5.
59 RAWG Exposure Draft, at 7.
60 RAWG Final Report, at 5.
61 RAWG Final Report, at 5.
NAIC have completed studies of the performance of ratings on corporate issuers during the financial crisis (generally acceptable, but financial issuers fared poorly);\(^{62}\) 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);\(^{63}\) and of possible alternatives to credit ratings.\(^{64}\)

It is unclear what will emerge from the thoughtful, nuanced, and 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 bonds...


\(^{64}\) Alternatives and Supplements to the Use of NRSRO Credit Ratings, Memorandum from Bob Carcano and Wes Beal, SVO, to Matti Peltonen, Chair, Valuation of Securities Task Force, Oct. 8, 2010 [hereinafter SVO Rating Alternatives Report]
products are not comparable suggests recalibrating SVO’s rating-based scale, not replacing the ratings. The report on credit-rating alternatives presents a sample scheme in which agency ratings account for 50% 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.

Contrast the state insurance regulators’ retreat to a highly nuanced and selective approach to reforming rating-dependent regulation with the Congress’ bold, broad-stroke decision to eliminate rating-dependent regulation entirely: each federal finance regulator “shall modify [its regulations] to remove any reference to or requirement of reliance on credit ratings.”

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


66 SVO Rating Alternatives Report, 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 authors’ perception of what it likely to garner support.

67 Dodd-Frank Act, §939A (emphasis added).
substantially frustrated. Even if credit ratings are stripped out of federal regulations – which may or may not happen, as the federal financial regulators apparently are resisting this requirement, along with bank lobbyists\textsuperscript{68} – rating-dependent state regulation of the huge insurance industry will continue to blunt agencies’ incentives for quality. 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 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, so 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 explain in part by the fact that the NAIC

\textsuperscript{68} Jean Eaglesham & Deborah Solomon, \textit{Why Credit Raters Keep Their Power}, \textit{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.”).
process is driven by the regulators who actually will 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, the SEC in July 2008 proposed an aggressive cutback of its historically heavy reliance on credit ratings, but as of mid-February 2011 had not taken action on the most important aspects of its proposals. And banking regulators are leading the charge against Dodd-Frank’s requirement to


eliminate ratings from financial regulation.\textsuperscript{71} 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.\textsuperscript{72} Market prices are volatile and are not always available. More fundamentally, market prices reflect credit risk along with many other factors, and the

\textsuperscript{71} See Eaglesham & Solomon, supra note 68. Banking industry organizations share the view that eliminating all use of ratings from federal financial regulation is overkill, and have advanced an interpretation of Dodd-Frank’s text that would permit the continued use of ratings as part of the assessment of creditworthiness. See, e.g., Letter from Kenneth E> Bentsen, Jr., EVP, SIFMA, to Office of the Comptroller of the Currency et al., Oct. 25, 2010, at 2-3 (“Credit ratings should be a permissable input in any replacement standard.”); Mary Frances Monroe, VP, ABA to Office of the Comptroller of the Currency et al., Oct. 25, 2010, at 1 (“[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.”).

\textsuperscript{72} See generally SVO Alternatives Memo (reviewing alternatives to agency credit ratings and reaching similar conclusions).
“other factors” – market liquidity and investor risk aversion – become critical when a crisis strikes. Risk assessments conducted by insurers themselves suffer from fairly obvious conflicts of interest. Although regulators could oversee the insurers’ models, this approach failed spectacularly for the Wall Street investment banks in the financial crisis.

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. THE NARROW RECONSIDERATION OF THE USE OF CREDIT RATINGS FOR MORTGAGE-BACKED SECURITIES: SPEEDY PROGRESS TO TOTAL ELIMINATION

In contrast to the slow, deliberate, and fitful 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


74 See FINANCIAL CRISIS INQUIRY COMM’N, supra note 13, at 151-54 (describing failure of SEC’s CSE program for capital regulation of the large investment banks).
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.\(^75\) 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.\(^76\) After rating agencies downgraded 64% of AAA-rated residential mortgage-backed securities below investment grade, life insurers’ capital requirements increased to $11

\(^75\) ACLI Sept. 9, 2009 Letter, at 3.  

\(^76\) “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. Evangel Presentation, at 6. Life insurers are required to hold 0.4% capital against NAIC-1 instruments and 1.3% capital against NAIC-2 instruments, Evangel Presentation, at 7, so the $2 billion capital requirement against $148 billion in holding corresponds closely to an NAIC-2 rating.
In August 2009, the American Council of Life Insurers argued that the capital rules based on agency credit ratings – ratings that the insurers had chosen to use – required insurers to hold too much capital against mortgage-backed securities. The Council 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. 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. 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.\textsuperscript{79} As NAIC later reported, the switch reduced the insurance industry’s 2009 capital requirement by $5.4 billion.\textsuperscript{80}

NAIC undertook this action in a proceeding that received remarkably little public comment or attention,\textsuperscript{81} although the rating agencies spoke up after the fact to defend their ratings.\textsuperscript{82}

ACLI’s point was sensible on its terms – the amount of loss, not the fact


\textsuperscript{80} See NAIC, Estimated RBC Impact from the RMBS Initiative, April 8, 2010. 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. 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. 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. \textit{Id}.

\textsuperscript{81} NAIC received a total of two comments on ACLI’s proposal. Both addressed technical details of the proposal’s implementation and neither took issue with the basic idea ACLI presented. See NAIC, Joint Conference Call Agenda, Oct. 14, 2009.

\textsuperscript{82} See Debash Chatterjee et al., Moody’s Ratings on U.S. RMBS Reflect Expected Recoveries: Ratings on Impaired Securities Do Not Overstate Risk, Nov. 6, 2009, at 2 (arguing that Moody’s ratings on high-yield bonds reflect expected loss on default, not just probability of default).
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 they did.\textsuperscript{83} 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. It appears that 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,

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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. Indeed, apart from the injections into the hybrid-form government-sponsored housing enterprises – entities that the market had always assumed would be bailed out if distressed – the overall direct financial effect of the bailouts on the government’s finances may well be positive. Taxpayers in some sense have already made money on the direct capital injections into large banks,84 and it seems plausible as of January 2011 that they will do so on AIG.85 In January 2011, the Congressional Budget Office cut its estimate of taxpayer loss on GM and Chrysler in half:

84 See http://bailout.propublica.org/list/index (reporting that Bank of America, Citigroup, JPMorgan Chase, Wells Fargo, Goldman Sachs, Morgan Stanley, PNC Financial Services, and U.S. Bancorp, the complete set of banks that received over $5 billion in bailout funds, have repaid the bailout funds with interest. SunTrust, which received nearly $5 billion, has not repaid any principal, although it has paid $376 million in interest and other charges).

85 See Judy Greenwald, Good Progress Seen in AIG Recovery, BUSINESS INSURANCE, Jan. 3, 2011.
The estimated loss went from $40 billion in September 2009 to $19 billion.86

More fundamentally, focusing on direct taxpayer losses misses what is probably the more important problem with bailouts: They allow the bailed-out firm to escape the consequences of failure. Thus, they are unfair, they corrode the legitimacy of the system, and they may produce moral hazard – a willingness to take excessive risks because of the belief that their 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 that are 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.  

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 bigger debts in an effort to get back into the black rather than enforcing regulatory requirements on the books, Congress enacted the FDIC Improvement Act, which requires S&L regulators to take “prompt corrective action” to deal with distressed banks. 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.

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87 I thank Anupam Chander for this point.


89 12 U.S.C. § 1831a; see also Mishkin, supra note 88, at 299 (2008) (describing prompt corrective action requirement “[p]robably the most important feature” of post-S&L reform legislation); Richard Scott Carnell (describing prompt corrective action as an example of a “properly framed statutory standard[]” that “heighten[s] regulatory accountability and counteracts perverse incentives”)

90 See NAIC Model Law 312-1, § 6 (requiring state insurance commissioner to take
Nevertheless, regulators engaged in rule bailouts in response to the recent crisis: 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 through the mid-2000s. 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.91

And the cycle of reaction against bailouts is repeating itself. The

control of insurer if capital falls below specified level); id. State Adoption (reporting adoption of Model Law 312 in every state but Texas). Texas apparently permits, but does not require regulatory action if an insurer does not maintain the required capital. See TEX. INS. CODE § 822.211.

centerpiece of Dodd-Frank is the “resolution authority” it confers on banking regulators, ostensibly so that they will not have to bail out large banks in the future. 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 therefore is 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. REFORM OF RATING-DEPENDENT INSURANCE REGULATION, THE POLITICAL CYCLE REGULATORY CYCLE, 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, wants to take risks, and regulations are weakened. Here, the weakening took the form of

\[92 \text{ See Dodd-Frank Act, Title II, §§ 201-17 (“Orderly Liquidation Authority”).}\]
\[93 \text{ See, e.g., Richard Scott Carnell, Regulator’s Incentives, 25, 36-37, in MAKE MARKETS BE MARKETS (2010) (describing pressure on banking regulators to be lax during}\]
removing the SVO’s ability to veto rating agency credit risk assessments. In 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 returns. Here, that will has taken the form of a serious, sustained effort to reduce regulatory reliance on ratings in the insurance context. But any proposal that does not take the political cycle into account is seriously 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 in an influential work on financial regulation 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.” An example of a constraint intended to control expansionary period).

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regulators’ temptation to do rule bailouts is the “prompt corrective action” requirement discussed previously. 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. Capital requirements themselves could be strengthened, for example by simply increasing them.

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 is likely to prove to be great.

A third approach 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

95 See supra note 89 and accompanying text.
96 But see (arguing that UK’s Financial Services Authority, funded by industry assessments, is more independent than the SEC, which is funded through the Congressional budget process); (contrasting independence of Fed with that of SEC; Fed
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. If financial market participants are always going to be more informed and more 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 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, the ex post approach is severely limited in practice by the fact that time moves

97 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 conferred under a claim of right).
only in 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.⁹⁸

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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⁹⁸ See Bob Van Voris, For Madoff Victims, an Avenging Angel, BLOOMBERG BUSINESSWEEK, Feb. 10, 2011 (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).