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Securities Valuation Office

SVO Special Report

Hybrid Securities

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During the 2006 Winter national meeting, the Valuation of Securities Task Force (“VOSTF” or “Task Force”) of the Financial Conditions (E) Committee adopted five recommendations aimed at improving how state insurance regulators communicate opinions on perceived risks in new financial products purchased, or eligible for purchase, by insurance companies. Insurance companies are the primary constituency of the NAIC. Nevertheless, the NAIC recognizes that financial market participants need to understand the regulatory policy applicable to insurance companies, including how the SVO applies regulatory guidance given to it by state insurance regulators. These articles are intended to help educate insurance companies and others on these issues. The adopted recommendations are that the NAIC would:

- *Post SVO Determinations Regarding Publicly Traded Securities On The NAIC Website*
- *Increase Issuer Or Underwriter Access To SVO for Analysis of securities on financial products*
- *Publish articles that describe in more detail the SVO’s Classification Methodology*
- *Develop clarifying and/or substantive revisions to the NAIC Purposes and Procedures Manual, and*
- *Establish an Invested Asset Working Group.*

This is part of a planned series of five articles discussing the classification process developed by state insurance regulators in 1994, and how it is applied to hybrid securities (sometimes hereinafter referred to as equity content or high equity content securities). This article provides background on the events that motivated the adoption of the Task Force recommendations and the original concerns that lead to the adoption of the classification methodology. The classification methodology reflects a regulatory opinion that ratings do not reflect all potential or likely relevant risks in hybrids. The rationale for this is examined in a second article to be published on this website on May 7. A third article discusses the components of the classification model and the application of the classification methodology, identifying the analytical principles that guide and constrain analytical discretion in the classification decision making process will be published on this website on May 14. The fourth article reviews SVO experience in classification of hybrid securities over the past 10 years will be published on this website on May 21. It focuses on both the development of securities with higher equity content and the classification implications for such securities. The fifth article discusses synergistic analysis in the context of actual examples will be published on this website on May 29.

These articles were given to the Task Force for review and comment prior to their publication.

Web Address:

www.naic.org/svo.htm

The Historical Background

1. 2006 — SPOTLIGHT ON NAIC CLASSIFICATION METHODOLOGY

It is important to understand the sequence of events that lead the NAIC in 2006 to reexamine the risk based capital (RBC) framework for hybrid securities and to adopt the recommendations discussed above. The NAIC, that is, the Plenary, Committees, Subcommittees, Task Forces and Working Groups through which the work of the NAIC is conducted, meets quarterly to discuss issues of concern to regulators, insurance companies and their advisors and to continue work on active regulatory initiatives.

During the 2005 NAIC Spring national meeting, representatives of the New York Insurance Department (NYID) publicly expressed concern that New York insurance companies were reporting hybrid securities, specifically trust preferred securities, as bonds. The NYID considered this classification choice to be an aggressive reporting stance and that in its view the securities should have been reported either as preferred stock or as common stock for state insurance statutory purposes. At the time of this statement, the NYID also chaired the Task Force. Also, given that the statement was made at a national meeting of the Task Force, it was calculated to warn regulated entities that the members of the Task Force were aware of and concerned with what seemed to be a potentially significant reporting issue. The NYID repeated its concerns at the NAIC Summer national meeting. At the Winter national meeting of the VOSTF, the NYID announced that it had instructed one of its domiciliary companies to file a new type of hybrid security with the SVO for classification analysis. The request was in accordance with provisions in the *Purposes and Procedures Manual* and the authority of state insurance officials to request SVO assistance in the analysis of invested assets in context of that official's resolution of a regulatory matter. (The capital security to be filed was subsequently identified as a new type of hybrid security, referred to in this article as a debt-equity hybrid, issued for the first time in August 2005.)

The members of the industry and capital market participants present at the meeting received the announcement that the SVO would analyze the new security type for purposes of classification, with seeming equanimity. No one challenged either the concern expressed by the NYID or its rationale for involving the SVO.

The 2006 NYID announcement was noteworthy because trust preferred securities are typically rated by nationally recognized statistical rating organizations (NRSROs). Since January 2004, securities with an NRSRO rating are exempt from filing with the SVO for credit risk assessment (i.e., the FE rule). The methodology for classification of

securities was initially conceived prior to the FE rule, when insurance companies were obligated to report all securities — whether or not rated by an NRSRO — to the SVO. However, since the adoption of the FE rule, it was generally understood that insurance companies would classify rated securities in accordance with the asset category decision made by the NRSRO (or perhaps more correctly, the issuer) at the time the NRSRO rated the security.¹ Prior to the Winter 2006 meeting request from the NYID, the SVO did not have an on-going responsibility to classify filing exempt securities, except upon request of an insurance company and payment of a fee or upon request of a regulator for statutory classification.

The SVO reviewed the debt-equity hybrid filed by the insurance company and concluded that the security should be reported under the common stock category of the annual statement, and be subject to the corresponding statutory RBC factor. This conclusion was communicated to the NYID verbally and in writing. Subsequent to its receipt of the SVO analysis in March 2006, the NYID instructed nine of its domiciliary insurers who owned the security to report it as common equity for statutory purposes. The NYID other New York companies to file some debt-equity hybrids and also some trust preferred securities with the SVO for classification analysis. Other insurers interested in the asset class but possibly concerned over their proper reporting status subsequently submitted Advanced Rating Service/Emerging Investment Vehicle Applications² to the SVO for other planned debt-equity hybrids.³

Following some initial surprise, and as interest in or concern for the decision spread, the NYID arranged for a conference call in mid April 2006. The SVO joined the call to explain the development of the classification process and the general logic and process employed to make classification decisions. This effort at an explanation proved unsatisfactory to some participants who claimed that the NYID decision and SVO analysis had caused insurers to sell off hybrid security holdings and thereby caused an interruption in the normal functioning of the market. Some market participants argued that the securities were *rated* by NRSROs at the highest rating levels and therefore that the ratings made classification unnecessary.

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¹ "See, question number 30 of the "Frequently Asked Questions" portion of the document dated February 25, 2004 and dubbed "Understanding the NAIC Filing Exemption Rule. Question number 30 asks: *In the past, the SVO has categorized a debt security as preferred. How should I classify this for FE purposes?* The response to the question is: *If the FE security is classified by an NRSRO as debt, it should be reported as debt. If it is categorized by an NRSRO as preferred stock, it should be reported as preferred stock.* This document was received and reviewed by the Task Force in 2004 and put on the NAIC webpage at the direction of the Task Force.

² ARS/EIV Applications are insurer sponsored broker-dealer requests addressed to the SVO for analysis of an investment product for regulatory purposes prior to the time an insurance company has actually purchased it.

³ The SVO eventually analyzed 108 securities for classification under the NYID assignment. Of these, 35 were classified as Common Stock, 69 as Preferred, and 4 as Bonds. The SVO conducted a number of additional classifications for other insurers under the ARS/EIV Application Submission process.

The Historical Background (Continued)

In any event, by June 2006 interest and concern over the issue had swelled to such proportions that the Task Force was asked to consider the issue of hybrid classification at its next meeting and subsequently devoted its full agenda at the Summer national meeting to this one issue. At the conclusion of the meeting, the Task Force adopted a proposal that the SVO classification decisions should be “put into abeyance” while the Task Force considered the SVO classification of these securities, including the matter of timely dissemination of SVO decisions. However, when this recommendation came before the parent committee, the Financial Condition (E) Committee rejected it.

Members of the Financial Conditions (E) Committee considered that the issue required an evaluation of RBC as much as of classification methodology and that accordingly, the proper response was to proceed expeditiously to conduct the reevaluation of the RBC framework. The Committee also decided not to set aside the classification decisions of the SVO since the classification process was formally adopted, applicable to hybrids, and applied to further legitimate state regulatory concerns of interest to all NAIC members. Accordingly, the Committee directed the Chairs of the VOSTF and of the Capital Adequacy Task Force to schedule a joint public hearing to gather information about the new type of hybrid security, and the concerns of insurers and their market participant advisors. The intent was to make a joint recommendation to the

Committee by the Fall national meeting. Of particular concern to the Committee was that the groups determine, by December 2006, what RBC factor would apply to hybrids owned by insurance companies in conjunction with the filing of year-end 2006 annual statements. The SVO was directed to continue classification of hybrids and to continue inputting the decisions into the NAIC Valuation of Securities Database and Automated Valuation System. Members of the Committee expressed the view that hybrid securities had undergone so much evolution since the SVO last reviewed and formally opined on them that investment management at insurers should be aware of possible changes in treatment.

The joint hearing was held in New York City on July 13, 2006. A joint group called the Hybrid Securities RBC Working Group and composed of members of the VOSTF and the Capital Adequacy Task Force was created to address the issues raised at the meeting. Subsequent to the hearings, the Hybrid Securities RBC Working Group determined to approach the problem in two steps: the adoption of an interim RBC solution for year-end 2006 and a longer term project to review the RBC structure for hybrid securities. The short-term solution was successfully completed and reported to the Committee at the Winter national meeting while work continues on the long term RBC solution. This is the state of events as of this writing.

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ABOUT THE NAIC

The NAIC, founded in 1871, is a not-for-profit corporation whose members are the state officials who regulate the insurance business within the 50 states, the District of Columbia and the five U.S. territories. The NAIC assists state insurance regulators, individually and collectively, in achieving fundamental insurance regulatory goals such as promoting the reliability, solvency and financial solidity of insurance institutions.

The Securities Valuation Office (SVO), based in New York City, is part of the NAIC, with Executive Headquarters in Kansas City. The Financial Conditions (E) Committee is the NAIC entity tasked with maintaining the regulatory framework needed to safeguard the financial condition of insurance companies. Study of specific regulatory issues related to financial condition is assigned to specific Task Forces charged with developing expertise in the subject.

The Valuation of Securities Task Force (“VOSTF”) administers the NAIC policy related to the quality of investments, their valuation and their classification for risk-based capital purposes for the Committee. In turn, the SVO is the component of NAIC professional staff assigned to the VOSTF. The function of the SVO is to perform the day-to-day analysis necessary to fulfill the NAIC policy objectives entrusted to the VOSTF. The valuation of securities function within the NAIC was created in 1907. The SVO was established as a permanent staff function of the NAIC in 1945. Over time the SVO has acquired a variety of analytical and verification functions and its work product has been directly linked to a number of state insurance regulatory mechanisms. SVO work product is distributed to state insurance regulators reflecting that SVO opinions are rendered after the insurance company has purchased a security solely to provide the regulator with an independent opinion of what the company has purchased.

The transparency initiatives seek to provide market participants with insight into the analytical perspective of the SVO for securities that insurance companies have or might purchase so that interested persons may take the state insurance regulatory perspective into account.

The Historical Background (Continued)

2. THE EVOLUTION OF CLASSIFICATION METHODOLOGY

The NAIC first encountered hybrid securities in 1994. Equity linked notes (ELNs) were products created to provide debt like cash flow for a defined time period and a return linked to equity at a defined point in time. ELNs were structured to provide the investor a return stream linked to the performance of one or more common stocks, coupled with repayment of 100% of principal at maturity backed by a Treasury STRIP. When ELNs were first reported to the SVO and by the SVO to regulators, the record of regulatory deliberations, i.e., the minutes contained in the NAIC Proceedings,⁴ show a concern that SVO credit assessment procedures, concerned as they are with risk of default, are not designed to account for or factor in the risk that contractual provisions linked to the equity content could excuse the issuer from owing a payment to the investor.

The Invested Asset Working Group (IAWG) of the Task Force, whose charge it was to consider how to accommodate the regulatory framework to financial product innovation, considered a number of approaches. By the 3rd quarter of 1995, the IAWG had not developed a comprehensive response but had identified the concept of “principal protection” (the idea that the investor had creditor status throughout the life of the investment) as a

useful debt characteristic marker. The *Purposes and Procedures Manual* was subsequently amended to include this concept as an instruction to the SVO, in essence creating the first classification concept.⁵ Henceforth, for regulatory purposes, the absence of principal protection required the SVO to classify and insurance companies to report an instrument as an equity investment while its presence was one factor the SVO would consider before an insurer could report the security as debt and take the debt RBC factor. The application of the principal protection concept seemed to be a sufficient response to ELNs. However, by the 3rd quarter of 1996 the Chair of the IAWG said that the regulatory community was again concerned that the regulatory framework was inadequate to reflect the risk of new types of hybrid securities. By the 4th quarter of 1996, the IAWG held a conference call to discuss criteria that could be used by the SVO to classify securities as either debt or equity. And shortly thereafter, the IAWG adopted the first debt equity guidelines based on these concepts. The Task Force adopted the guidelines for inclusion in the December 31, 1996 *Purposes and Procedures Manual*.

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⁴ The NAIC Proceedings is a compilation of all deliberations conducted by NAIC regulatory groups. Information pertaining to the development of the classification methodology and the rationale that impelled it can be found in the deliberations of the Invested Asset Working Group in the following volumes and years of the Proceedings: 4th Q, '94; 1st Q '95; 2nd Q '95; 3rd Q, '95; 3rd Q, '96; 4th Q, '96; 2nd Q, '99; 3rd Q, '99.

⁵ This principle still governs SVO activity, see Part Seven, Section 3 (d).

FIGURE 1. GUIDELINES FOR DETERMINING STATUS OF NEW INSTRUMENT AS DEBT OR EQUITY

VOS/TF acknowledges that proliferation of hybrid instruments exhibiting both the characteristics of debt and equity. The following guidelines, therefore, have been developed to assist the SVO staff in categorizing these instruments appropriately. The guidelines are intended to be used in the context of a specific transaction. NO single guideline shall be the determining factor in the decision-making process. In considering the following guidelines, the staff shall take into account factors such as maturity or tenor and any extension right given to the issuer. However, these factors will be subsidiary to the guidelines published below. These guidelines are not intended to be used to guide the structuring or creation of securities or transactions by any party.

	EQUITY	DEBT
Rights	Right of ownership — Voting rights in the management of the company.	Creditor rights.
Periodic Payments	Dividends as declared.	Stated schedule of repayment of both principal and interest. Failure to perform as contractually stated would be an act of default.
Priority of Liquidation	After all creditors are satisfied.	Creditor status.
Taxation	Dividends are paid after tax by the issuer and are not deductible.	Payments are pre-tax and deductible by the issuer. Security holders receive IRS 1099-INT or 1099-OID.
Principal	No principal protection.	Principal protection, except for credit risk.
Rights on Liquidation	Residual value based on percentage of ownership.	Par value Maximum.

The Historical Background (Continued)

The next three years saw the extensive use of trust preferred securities by US and foreign banking entities and the first of the Tier 1 transaction structures. In time, concern was expressed that the applications of the guidelines would lead to inconsistent classifications. The principle concern was that the first NAIC debt-equity guidelines did not distinguish between preferred and common equity. In addition, the guidelines consisted of the grid, shown in Figure 1 below, with little in the way of language to place the classification criteria in context or explain how the analysis would be conducted or the analytical factors or parameters that would guide the analysis. After studying the issue between 1997 and 1998, the SVO proposed an amendment that resulted in the

replacement of the guidelines in Figure 1 with the existing guidelines found in Part Seven, Section 1 (c) of the Purposes and Procedures Manual. The new guidelines were adopted on October 5, 1999, effective as of January 1, 2000. It is noteworthy that industry and market participants both reviewed the proposal before its adoption and suggested only relatively minor comments with the result that the proposed amendments were adopted in substantially their original form.⁶

⁶ The guidance is found in Part Seven, Section 1 (c) of the *Purposes and Procedures Manual*, "Guidelines for Determining Status of New Instruments as Debt, Preferred Equity or Common Equity."



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