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Securities Valuation Office

SVO Special Report

Hybrid Securities

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Understanding Classification Analysis

This is the third in 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 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. The fourth article reviews SVO experience in classification of hybrid securities over the past 10 years and will be published on the NAIC 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 and will be published on the NAIC website on May 29.

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

1. OVERVIEW AND OBJECTIVE

The NAIC classification methodology was created to compare securities with hybrid features — which combine debt-like features with equity-like features in varying ways — to a regulatory framework that assigns risk-based capital (RBC) factors to insurer investments. Features of the security to be classified are compared with the criteria and evaluated with respect to guidelines to determine if the security most resembles the traditional characteristics of one of the three security types; a debt like payment obligation, or the payment promise more typically associated with a preferred like, or a common equity like security. RBC factors vary based on both credit quality and asset classification. The RBC regime has been described as an early warning system. It establishes a number of levels of regulatory intervention linked to defined RBC ratios. The insurer is required to report its Authorized Control Level Risk Based Capital (ACL); the total RBC the insurer needs to avoid being taken into conservation by its regulator. Whether remedial action is necessary, and the extent of any such action, depends on the level of RBC ratio reported.¹

The methodology requires the analyst to identify the contractual rights between the parties and to arrive at an independent opinion of what corresponding expectations the investor should have based on that contract. Important features to consider include the degree of financial flexibility the issuer has to defer payments; what rights the investor may have in the event of a deferral, and how long a deferral may continue before the investor can exercise those rights. A range of possible conditions are examined to ascertain the likelihood that protections written to operate in one context could be rendered meaningless in another. This is what the *Purposes and Procedures Manual* identifies as “synergistic analysis:” contractual provisions may interact or conflict and therefore must be reconciled into a meaningful insight as to the likely impact on the investor.

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¹ Instruments classified as common equity like are assigned, nominally speaking, an RBC factor of 30% while highly rated bonds are assigned a risk based capital charge of .3%. However, contrary to many published press reports, the 30% assigned to common like instruments only apply by default since insurers are allowed to use their own Beta factors to adjust the RBC factor, which could then range from 15% to 30% for common stock. It is also important to remember that the RBC charge is not a dollar for dollar charge to capital requirements—the book/adjusted carrying value multiplied by the RBC factor is taken through the covariance calculation which works to reduce the capital requirement.

Understanding Classification Analysis (Continued)

The NAIC classification methodology consists of only three asset categories. Further, and most importantly, it is not designed to require an assessment of the *probability* of the occurrence of any particular scenario. It intentionally seeks to retain a US legal and financial cultural perspective, and therefore requires that the foreign financial and regulatory regimes governing many hybrid offerings be related back to US concepts, consistent with the expectations of US insurance regulators.

A distinguishing feature of the methodology is that the criteria — the five fundamental rights and corresponding expectations (Figure 1) — are encapsulated into descriptive security characteristics to which the three (debt, preferred and common equity) RBC risk weightings apply. Conceptually speaking, in the debt profile, the investor has bargained for creditor status and the receipt of payment of interest and principal on an agreed schedule. Non-payment is an event of default, thereby permitting the right of acceleration of the obligation. Whatever the complexity or structural aspects of the security, the defining characteristics must be obvious and not subject to any condition or any other right.

On the other hand, the preferred stock profile, whether cumulative or non-cumulative in nature, reflects the investor's claim over common at all times; a liquidation preference; and an *expectation* of being paid dividends on a scheduled basis. In an extreme and otherwise unavoidable financial distress scenario, dividends can be missed for a limited period of time, and failure to make such payments under those circumstances is not an event of default. This is an important feature of the preferred stock profile. The profile of any given preferred security may inflect more toward the debt side of the debt-equity risk continuum, or more toward the equity side, but it must be obvious that contractual features protect the expectation of payment except in dire financial stress.

The purchaser of a traditional common stock is fully exposed to enterprise risk, and little by way of contractual provisions obligates the issuer to make any payments at all. Market expectations of regular dividend payments, when the issuer has a history of paying dividends, offer only limited, non-contractual, protection to an investor.

2. COMPONENTS OF CLASSIFICATION METHODOLOGY

a. The Guidelines — Fundamental Rights and Expectations

The guidelines² should be read and understood in the order in which they are written. After explaining the regulatory objective of the methodology in the first paragraph, the

FIGURE 1. THE CLASSIFICATION CRITERIA — INVESTORS RIGHTS AND EXPECTATIONS

- Claim Status
- Right to Influence Management
- Right to Periodic Payments
- Agreement as to Maturity
- Involuntary Redemption

Purposes and Procedures Manual says that the classification decision is to be “based on the difference in investor expectation and the rights exhibited by the security under review.” It goes on to say that the intent is to create three profiles which the SVO is “required to use ... to determine whether the characteristics of a filed security *are more consistent with one profile than with another*” (emphasis added). The debt-equity guidelines are not the “grid” (i.e., the Tables and Comments) that appears at the end of the description of the guidelines. The identified rights and expectations are not the only possible criteria or factors used by the SVO. Any unlisted criteria that may be introduced in the analysis of a given security, however, are deemed to be subsidiary to the published criteria or factors.

b. Profiles

The regulatory intent is to create three distinct profiles to be used as benchmarks of the primary characteristics of the security class. The profiles are grounded in recognition that every investment carries an expectation as to the kind of commitment the investor is making to the issuer; the investor's relationship to management; the agreement as to payments; the term of the investment; and whether and how the investor gets repaid if the issuer was to experience financial distress.

Instruments that fit within the debt profile, (Figure 2) would clearly exclude any hint of equity participation. The documentation for such instruments would have to make clear that the investor is not making a commitment to the

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² Part Seven, Section 1 (c) of the *Purposes and Procedures Manual*, entitled: “Guidelines for Determining Status of New Instruments as Debt, Preferred Equity or Common Equity.”

Understanding Classification Analysis (Continued)

enterprise that involves a willingness to absorb losses. The debt instrument provides the investor a creditor's claim at all times for the full amount of the loan and interest. The claim takes priority over the claims of the issuer's preferred and common stock holders. The documents clearly evince a bright line test guiding the relationship between the investor and issuer management: missed scheduled payments constitute an event of default permitting the investor to accelerate its right of payment. There are no other relevant contractual conditions or limitations to payment. Management relates to this class of investor by making payments in full at the agreed upon times or risking an acceleration with its attendant consequences.

The profile for preferred stock (Figure 3) encompasses a range of securities with different terms. The common thread in the securities is a clearly expressed expectation that dividends will be paid on schedule and that the preferred investor will be called upon to absorb enterprise losses if, and only if, contributions made by common shareholders have been exhausted. Strong contractual protections reinforce and support these expectations. So while the preferred profile anticipates that the investment provides support to the issuer's senior bondholders and lenders, it also anticipates this support to be relatively weak when compared to the support associated with common holders. Of the range of potential securities that can fit within this profile, redeemable cumulative preferred with stated maturity lies on a point closest to the debt side of the debt-equity continuum while perpetual non-cumulative preferred, depending on all of its characteristics, lies either on the point closest to the common side of the debt- equity continuum or in common territory. This concept of risk continuum is discussed in detail below.

The profile for common stock (Figure 4) is that of permanent capital and an obvious commitment to the future of the enterprise. The contract may well contain clauses associated with preferred or debt like instruments, but in financial distress, those rights may be so jeopardized that the provisions offer little or no meaningful protection. A security classified as common may have some limited priority over traditional common equity. However, it will exhibit a greater risk of absorption of enterprise losses than is compatible with the expectation that dividends will be paid on schedule. Such securities can be easily characterized as intending to provide strong protection to senior lenders, bondholders and even preferred stock.

3. PARAMETERS AND CONSTRAINTS

a. **The Context** — The profiles provide the SVO with distinct conceptual models to guide the analysis. From this conceptual framework, two important distinguishing concepts begin to emerge. One is the degree of economic

FIGURE 2. THE CLASSIFICATION PROFILE OF DEBT INSTRUMENTS

| | |
|-------------------------------|--|
| Claim | Creditor status at all times; priority in distribution to PS and CS; acceleration rights |
| Rights | No contractual provisions aimed at influencing management; right to cumulative payments |
| Payments | Scheduled with deferral being an event of default permitting acceleration |
| Maturity | Contractually established maturity or equivalent |
| Involuntary Redemption | Claim for full par value, subject to availability of funds; full principal protection (i.e., creditor claim at all times) subject to credit risk |

commitment to the enterprise (i.e., willingness to expose an investment to loss). The other is the permanence of the investment itself. The greater the commitment and permanence, the greater the equity content of the security. The less economic commitment and permanence, the more debt like the security.

Some securities with equity content, such as trust preferred securities, contain a relatively straightforward combination

(Continued on page 4)

FIGURE 3. THE CLASSIFICATION PROFILE OF PREFERRED STOCK

| | |
|-------------------------------|--|
| Claim | Preferred status; priority in distribution to CS at all times; no acceleration rights. |
| Rights | Contingent voting rights; no profit participation; may have cumulative or non cumulative rights. |
| Payments | Scheduled but deferrable or subject to declaration; deferral is not an event of default; but usually no dividend is paid to common |
| Maturity | May or may not have maturity date; may be subject to redemption at issuer's option |
| Involuntary Redemption | Claim preferred to common for full par value, subject to availability of funds after payment of all debt; contains loss absorption but retains claim to liquidation preference |

Understanding Classification Analysis (Continued)

FIGURE 4. THE CLASSIFICATION PROFILE FOR COMMON STOCK

| | |
|-------------------------------|---|
| Claim | Residual Status |
| Rights | Voting rights; profit participation, non cumulative |
| Payments | If and when declared |
| Maturity | No maturity and no redemption anticipated |
| Involuntary Redemption | Purely residual with no minimum or maximum; no principal protection |

of features that clearly identify them as fitting within one model. Other securities, however, as in the case of some recent hybrids, contain more complex combinations of features. How one feature interacts with or affects another may change the overall character of the contractual provisions and thus the expectations of the issuer and investors. Where this is the case, the SVO must exercise its analytical discretion in accordance with the criteria and profiles.

b. **Risk Continuum** — Although the RBC categories and the classification profiles are often referred to as three “buckets” — the profiles are more accurately compared to segments on a line that represent a continuum of risk, encompassing senior secured (or Treasury) debt on one side, preferred securities in the middle, and traditional common equity on the other (Figure 5), with many other types of securities among and between these distinctions. In the analysis of a traditional security such as a US Treasury security the analyst can readily assign it a point in the debt profile. The same concept applies to other types of traditional instruments. If the analyst only considered traditional securities or those with relatively minor variations from them, this task would be simple.

However, hybrids differ substantially in their features. They combine preferred like, common like and debt like features in very different proportions and, in addition, incorporate novel and untested legal mechanisms. As this happens, assigning the security to a particular point on the continuum is no longer simple. In some respects the security may have debt like features; in others, common like features. The task of the analyst in making the classification assignment is to merge the attributes, applying synergistic analysis (described in greater detail below).

c. **Anchoring Analytical Discretion** — The analytical discretion exercised by the SVO is not self generated but derives from Paragraph (G) of the Relevant Principles.³ Paragraph (G) charges the SVO with analytical responsibility for classification and provides the SVO with the necessary discretion to attain the purpose of the guidelines — relating new instruments back to the RBC framework. This exercise of discretion is anchored to the guidelines and to the communicated professional experience of the office.⁴ Although there are securities where it is important to consider whether an issue should be classified as a bond or as preferred, the typical issue in a hybrid classification is whether a security should be classified as preferred or common stock like for statutory purposes.

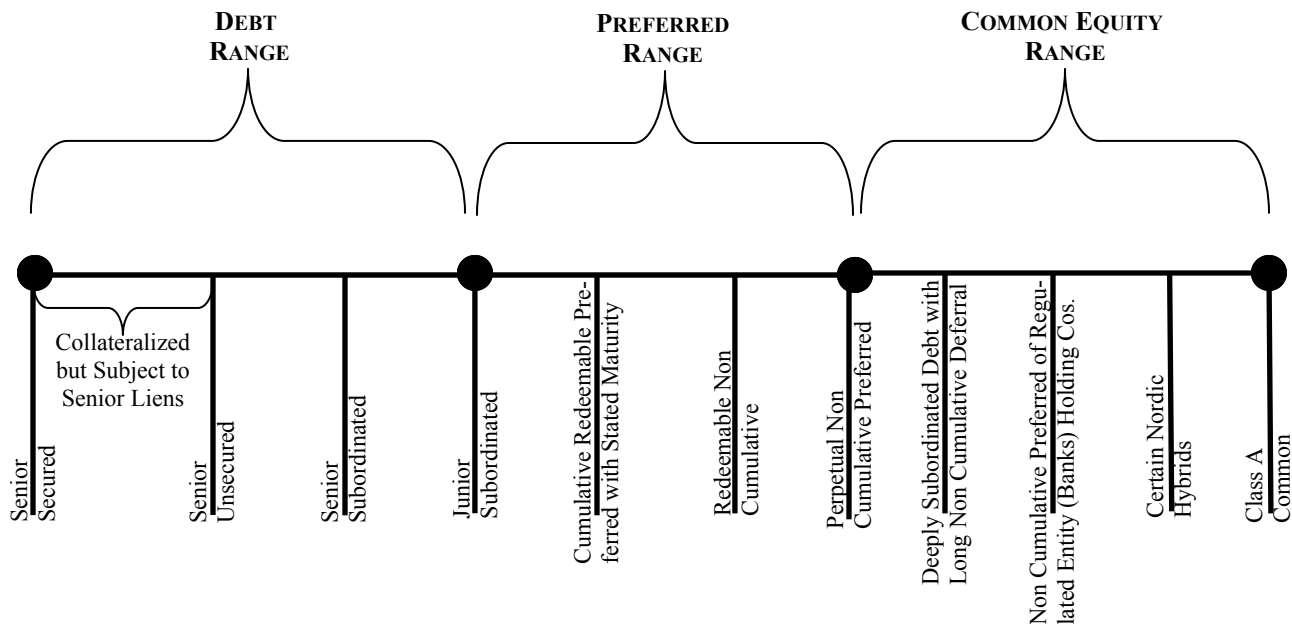
d. **Protective Elements** — A key principle that permeates classification analysis is contained in paragraph (A) of the Relevant Principles. The paragraph provides that the expectations and rights of a preferred stock security holder are considered to be more debt like than common stock like since both debt and preferred equity contemplate a par like claim and a series of periodic payments to be realized in the future. From the perspective of the NAIC, the key difference between bond and preferred stock promises is that the debt instrument provides a higher certainty about receipt of payments and stronger legal rights to protect the payment claim.⁵ In general terms, this principle requires the SVO to ascertain that a security classified as preferred stock has features that protect the expectation of receiving par like claims and the contemplated series of periodic payments vis-à-vis others in the issuer’s capital structure. Thus, in the SVO’s view, while the profile for preferred envisions that the issuer may defer payments, the issuer’s right to defer payments must be balanced by meaningful contractual protections that restrict the issuer’s exercise of that right. This idea is consistent with the features one would find in traditional preferred which include, for example, dividend stopper provisions, representation on the issuer’s Board and cumulation of unpaid dividends. This protection was evident in trust preferred securities which incorporate many of the same protections found in traditional preferreds, and limited deferrals to relatively shorter periods. The analysis focuses on whether the features make it costly enough for management to exercise its right not to pay, so as to ensure that the right would only be exercised by an issuer in sufficiently dire circumstances. This explanation, relating to the principle contained in paragraph (A) relates to the preferred like profile. However, the guidance is also relevant to possible classification as common stock. The implication is that to the extent preferred is limited to the

³ See, part Seven, Section 1(c) (iii) (G)

⁴ See, Part Seven, Section 1 (c) (iii) and (iv)

Understanding Classification Analysis (Continued)

FIGURE 5: TYPES OF HYBRID SECURITIES



articulated standard, many more instruments are likely to be classified as common stock.

e. **Degree of Subordination** – Paragraph (B) of the Relevant Principles provides that the degree of subordination the holder is exposed to is another guiding principle in the exercise of discretion. In classifying a given issuer’s junior subordinated note, the analyst would have to consider not only actual or legal subordination (i.e., the liabilities enjoying priority over the subordinated obligation), but structural subordination (such as when a holding company, dependent on cash flow from operating subsidiaries, issues the note), and the capital structure going forward (such as the issuer’s right to issue senior or parity notes in the future). Even assuming debt like contractual language, the analyst would ask whether the note may be on parity with, or even subordinate to, legally, structurally, or otherwise, a preferred issue of the same issuer.

f. **Principal Protection** — The Manual also provides that if an investment is not principal protected at maturity (meaning that the security does not grant the holder a creditor claim at all times to principal and interest) it must be classified as equity, regardless of the length of maturity.⁶ This principle is also restated in the classification methodology for the debt profile as a criterion.⁷ A bond guaranteed by an NAIC 1 rated entity can nevertheless have terms that indicate that the amounts

due to the investor under the guaranty could be less than 100 percent of principal. A security with such a provision could therefore be classified as preferred equity like instead of debt like.

g. **Status of Security under Foreign Law** — The guidelines also provide that the status of a security governed by non US law, or of a non US issuer is relevant to classification analysis, especially when the law relates to the issuer’s potential insolvency. Foreign law may empower a foreign official to actively intervene in the affairs of the issuer. The guidelines acknowledge that this authority may impact the rights of the investors and therefore require that the applicable financial and legal framework be related back to the most approximate treatment under the US financial capitalization and legal framework.

h. **Other Principles** — The Relevant Principles includes other guidance that may be applied in specific cases. When they are deemed to be applicable, the other principles act as an overlay to the profiles that helps shift the classification analysis away from one security type and toward another security type. There are cases in which securities on their face suggest a perpetual preferred classification. However, when such a security lacks certain

⁶ See, Part Seven, Section 3 (d) Short Dated Non-Principal Protected Securities

⁷ Part Seven, Section 1 (c) (iv) – “grid”, the Debt Column, criteria V, Claim
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Understanding Classification Analysis (Continued)

investor protections, it can cause the analyst to lean toward recommending that senior credit committee approve classification as common equity rather than as preferred, especially when considered in conjunction with other features.

4. OVERARCHING PRINCIPLES

a. **Synergy** — The guidelines provide that the SVO classification determination be *influenced* by the degree to which the security characteristics of any one profile predominate in a specific security, but “*subject to the synergistic effect of different provisions or characteristics within a security, (and) the regulatory objectives of the NAIC.*” The SVO must therefore consider the implication and value of contractual provisions when read together and balanced against each other in the facts of a given security and probable scenarios. Accordingly, the mere presence of contractual protections may be insufficient to place a security within a given profile.

b. **Regulatory Objective** — The NAIC classification analysis is regulatory — specifically, identifying the most suitable RBC security category based

on a security’s characteristics. The SVO has no role in setting the RBC level or discretion in considering RBC when making a classification decision. Whether RBC, say, for common like securities should be set lower than common stock is a ply issue the SVO may not intrude upon. From the view of the NAIC, invested assets do not belong to the insurer, but to the policyholder whose claims they support. Accordingly, as complexity increases to the point where meaningful distinction between debt and preferred or between preferred and common becomes more difficult, it also becomes more important.

c. **Communicated Professional Experience** — The comments contained in the grid that appears at the end of the description of the classification methodology provide additional guidance to the SVO and some measure of transparency to interested persons. The comments are intended to communicate the position of the SVO on recurring classification issues. Like the Relevant Principles, they serve to reinforce the concepts and guidance provided for in the profiles and are subservient to them and to the regulatory objective of the analysis.



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