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SVO Research

The One-Year Anniversary of Provisional Exemption

Ray Spudeck, Research Manager

■ Introduction

Beginning with the regulatory annual statements filed by insurers at year-end 2000, investment filing requirements of U.S. insurers were modified to allow the option of self-reporting certain highly rated transactions. Over the last year, a number of articles appearing in this *Monthly Newsletter* have updated the insurance community, both regulators as well as industry, with the adoption of this exemption possibility by insurers.

With the completion of the year-end processing of securities, the Addendum 2001 VOS data (the CD) is now available. This article compares the distribution of NAIC designations, including the provisional exemption designation, from the Addendum 2000 CD, the first time in which provisional exemptions could appear, to the Addendum 2001 CD.

■ The Data

Figure 1 on page 3 summarizes the data from both the 2000 and the 2001 Addendum data files. Overall, the number of securities contained in the database grew by over 6 percent, from 189,718 to 201,479. As the data in Figure 1 suggest, the difficult economic climate during the last year had its predicted effect on the credit risk distribution of securities in the database. While still heavily skewed toward the highest quality investments, the distribution of risk, as evidenced by NAIC designations, did slip some between 2000 and 2001.

The number of NAIC 1 securities (and the provisionally exempt declared 1PEs) increased by 3,388, but on a percentage basis slipped from representing almost 85 percent of the data to slightly over 81 percent of the data in 2001. The number of NAIC 2 securities (and provisionally exempt declared 2PE) increased by 1,656, increasing slightly on a percentage basis from 7.2 percent of the data to 7.6 percent in 2001

The number of NAIC 3 and NAIC 4 securities marginally increased (by 733 and 94 respectively). Somewhat more noticeable was the increase in NAIC 5 and 6 designated securities. The total number of 5's and 6's increased by 43 percent, from a total of 2,313 securities to 3,293. Even with this increase, the number of NAIC 5, 5*, 6 and 6* securities is still only a little over 1.5 percent of the total number of securities listed on the database.

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From the Director

Chris Evangel, SVO Managing Director

The Enron saga continues to be an intriguing story. In Enron's earlier press days, one might have believed this story was confined to a paper's financial section or a lead in the all-business cable station on a failed business. What we have learned so far has transformed from the unfolding events into a national focus on investments, pensions, financial reporting, and government oversight to name just a few issues.

For our brief discussion here, I want to focus on an area with some provincial concerns here, related slightly to the larger Enron story, but on a much more narrow issue: the role of independent credit analysts. We will avoid any discussion on buy-side or sell-side analysts as that discussion may divert the focus here to other issues. The national credit rating agencies recently completed a public inquiry on their practice as related to Enron, but the ultimate oversight of credit rating agencies remains unclear.

This reviewer believes a huge hurdle exists in efforts to alter the current structure of maintaining independent credit assessments, retaining private sector ownership of these credit rating services, maintaining acceptance of those credit assessments by financial market participants, while at the same time seek to alter investors about rapid declines in Enron-like entities well in advance of a failure to meet these troubled entities' financial obligations. The daunting challenge rests on the ability to alter the current credit assessment structure based on the previous, and generally accepted, principles.

Perhaps to disappoint from the start this commentary will not offer, nor imply, an answer, but will try to offer a perspective to consider before others head down a path to change the existing credit rating process. Some questions one might consider when conducting an inquiry of the current practice with specific focus on Enron might include: what did they know, when did they know it. As a former full-time credit analyst, these are two initial questions one should ask. Perhaps the more challenging follow-up question to answer is when do you take the collective information, when do you signal to the financial markets an increased credit risk exists through a credit rating change.

Experience tells me credit analysts retain a wealth of information on their areas of coverage. Yet, the ability to act (through a "timely" revision) versus appearing re-active remains a constant real world challenge.

First some perspective, financial market credit ratings have evolved since their inception, in part, to meet the demands and, more importantly, the expectations of financial market participants. Previously, credit ratings generally followed an appearance as remaining static—limited changes occurring over the life of a rated security, which some may attest to the "buy-and-hold" nature of investors. Over the past 25 years, financial markets evolved in two meaningful ways: increased complexity of financial instruments sold in the market place; and, investors' increased penchant in trading these fixed income (bonds), which departs from the past's buy-and-hold philosophy.

Given the above view of the current marketplace, the matching of buyers and sellers requires an array of judgments with an important component in that investment decision involving an assessment of credit risk partly derived through credit ratings. However, investors typically look toward credit ratings, not as a scorecard of past performance, but the expectation a particular investment will meet the intended performance. Hence, those utilizing credit ratings view them, rightly or wrongly, as a predictive measure.

The question one should ask next is: since credit ratings seek to foretell the future (here, the future narrowly defined as meeting financial obligations), how reliable/accurate are these credit ratings. Well, here is one challenge for credit analysts—can prior performance accurately predict the future, the obvious answer is not with absolute certainty. Credit rating definitions speak of probability, the expected outcome—not a certain outcome. For example, flipping a quarter should result in an expected outcome—50 percent heads and 50 percent tails. While appearing to state the obvious, one must be vigilant in their understanding that two coin flips will not produce heads on one flip and tails on the other. A 1,000 coin flip could still produce an outcome where heads and tails do not equal 500 each, but one might expect after so many coin tosses the share of heads to tails should be close to 50–50, but could, in fact, in a particular test produce a result of 48 percent to 52 percent.

Why dwell on such a mundane thing as coin flipping? Well, it serves, as a simple example where when we have only one variable, we cannot with certainty predict the outcome of the next event. Credit analysis involves multiple variables (some known and some not known) and most without the benefit of predictive outcomes. One may consider the prior statement as an insurmountable dilemma but to the credit analysts' community, you often hear them explain the credit assessment process as part science, part

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The One-Year Anniversary of Provisional Exemption (Continued)

**Figure 1.
VOS-CD Comparison, 2000 to 2001**

Designation	Addendum 2001	% of Total	Addendum 2000	YOY % Change*
1	105,384	52.3%	131,558	-19.9%
1PE	58,550	29.1%	28,988	101.9%
Subtotal 1's:	163,934	81.4%	160,546	2.1%
2	12,093	6.0%	10,977	10.2%
2PE	3,249	1.6%	2,709	19.9%
Subtotal 2's	15,342	7.6%	13,686	12.1%
3	3,494	1.7%	2,761	26.6%
4	2,354	1.2%	2,260	4.0%
5	1,447	0.7%	1,286	12.5%
5*	533	0.3%	381	39.9%
6	1,289	0.6%	629	104.9%
6*	24	0.0%	17	41.2%
W's	13,062	17.5%	8,152	60.2%
Subtotal Non-PE	126,618		149,869	-15.5%
TOTAL	201,479		189,718	6.2%

Source: National Association of Insurance Commissioners.

■ Provisionally Exempt Securities

Figure 1 shows the increase in the use of the provisional exemption guidelines by insurers over the year 2001. Less than 29,000 securities were claimed as 1PE on the Addendum 2000 CD. The 2001 CD lists over 58,000 bonds claimed as provisionally exempt, an increase of over 100 percent. The total number of claimed 1PE securities on the database is now almost 30 percent of the total, up from slightly over 15 percent at the Addendum 2000. Less dramatically, the number of bonds claimed as 2PE rose from about 2,700 securities in 2000 to 3,249 in 2001, an increase of almost 20 percent. The total number of claimed 2PE bonds is now somewhat over 1.5 percent of the total database, compared with slightly less than 1.5 percent for 2000.

Another category of securities related to the provisional exemption guidelines is those securities carrying a "W" administrative symbol. To recall, securities that insurers have claimed as provisionally exempt, but which do not match the NRSRO ratings requirement when checked are

provided a "W" administrative symbol (W, 1W, 2W, 3W, 4W, 5W, 6W). As the number of securities claimed as provisionally exempt grew over 2001, it should be expected that the number of "W" securities should grow as well. Moreover, the decline in credit quality and increase in defaults observed in the markets last year would certainly be expected to cause a number of previously highly rated transactions to fall out of investment grade and become "fallen angels." Indeed, the California utilities that defaulted went from being eligible for provisional exemption in Mid-December 2000 to being non-investment grade by the end of the Addendum period in late January 2001.

From the Addendum CD 2000, a total of 8,152 securities claimed as provisionally exempt were assigned "W"s based on ratings mismatches. This represents a total of a little over 20 percent of the total number of securities claimed as provisionally exempt. From the Addendum 2001 CD, the total number of "W"s increased to over 13,000 but, because of the overall increase in the use of the provisional exemption guidelines, this total represents less than 17.5 percent of the total number of securities claimed by the U.S. insurance industry as provisionally exempt.

■ Concluding Comments

The size of the portfolio of securities comprising the SVO database grew by over 6 percent between year-end 2000 and year-end 2001. Despite the general decline in credit quality and sharp increase in credit related defaults observed in 2001, the overall distribution of NAIC designations has reacted only slightly.

As insurers have become more familiar with the provisional exemption guideline, and as they and their regulators have become more comfortable with the process for documenting, monitoring and managing a provisionally exempt portfolio, the number of securities claimed as provisionally exempt has grown considerably. This growth is especially true for those 1PE bonds with the highest investment grade ratings that would generally translate to an NAIC 1 designation.

This article has reviewed the distribution of NAIC designations and the use of the provisional exemption guideline from the viewpoint of the number of securities in the VOS database. Another interesting question is the economic or dollar-volume distribution of designations and the use of provisional exemption. As the 2001 annual statements arrive, are quality checked, and become available for use, this question will be addressed in a forthcoming article in this *Monthly Newsletter*.

The Telecommunications Equipment Industry: Review & Outlook, January 2002

John Quinn, Credit Analyst, NAIC/SVO

■ Introduction

With the passing of 2001, the telecommunication equipment industry (Industry Code 366) has just finished one of its most difficult years. Moreover, conditions are not expected to improve substantially in the near term. Telecommunications equipment includes not only the familiar telephone sets, but also all the equipment which serves as the building blocks for the communications infrastructure, including switching equipment built for various communications protocols, fiber-optic cable, central office equipment, base stations and transmission equipment.

The industry, which only a year or so ago was one of the most highflying industries of the late 1990s expansion, benefited from the expansion of long distance and wireless networks, as well as the growth of the internet. When the internet “bubble” burst, the telecommunications equipment industry (telecom equipment) took one of the hardest falls of all industry groups last year. In addition, current demand growth for wireline communications capacity (as opposed to wireless) proved to be well in excess of capacity already in place. The wireline telecom industry is currently suffering from large amounts of overcapacity, which will not be absorbed in the near future. As a result, difficult business conditions for equipment suppliers are expected to persist, at least for the remainder of 2002.

The insurance industry, as an institutional investor, is not immune from the problems facing this industry. At year-end 2000, for example, the U.S. insurance industry held slightly over \$3.8 billion in telecom equipment bonds, representing 367 different issuers.

■ Background

To understand how the telecom equipment industry arrived at its current economic situation, a review of recent events is useful. The beginning of the industry’s current cyclical expansion, which ended abruptly in late 2000, was triggered by several events occurring during the mid-nineteen-nineties. Telecom industry deregulation in the U.S., enacted during 1996, unleashed a rush to build long distance networks in order to take advantage of projected geometric expansion of demand for voice and data communications services. The rapid expansion of the Internet in the late 90’s further added to perceptions of exploding demand for band-width in long distance telecom networks. Dozens of telecommunications startups, having acquired seed financing from venture capital investments, were able to access the capital markets for equity and debt financing. This access was the result of an easing of the credit quality necessary to raise funds in the traditional

markets, which to a degree was encouraged by a generally friendly Federal Reserve monetary policy and strong performance of the equity markets. Late in the 1990s, as optimism about the boundless potential for the Internet continued to grow, dozens of dot.com startups, funded by eager equity investors, added to the demand for communications equipment in the form of switching arrays, increased demand for broadband capacity to serve graphics rich websites, and data storage capacity for their marketing efforts.

Another powerful driver propelling demand for communications equipment was the growth of wireless telephony. Technological breakthroughs made by cellular phone manufacturers (e.g. dramatic improvements in compactness, functionality, and attractiveness) stimulated worldwide demand for such devices during the late 1990’s. With strong consumer acceptance in Europe resulting in high penetration rates there, the U.S. markets, beginning from a much smaller base of penetration, began to almost exponentially expand as the U.S. cellular telephone networks were built-out, funded by then eager equity and debt investors. Worldwide mergers and acquisition activity, often financed with a large debt component, expanded as long distance and cellular providers assembled networks to obtain global reach. The increasing functionality of cellular networks, with voice and data capabilities, resulted in demand for more transmission frequencies in order to transmit broadband signals. The European nations auctioned 3-G licenses, during the year 2000, with an approximate \$100 billion price tag for the frequencies auctioned. These were largely debt financed, further leveraging already debt strapped telecom providers.

Cracks in the “bubble” appeared during late 1999 to early 2000, when indications emerged suggesting that demand for capacity was not growing as fast as had earlier been projected. Estimates of very low current capacity utilization rates for the fiber-optic networks began to circulate. Some excess capacity was expected. Telecom companies often bundled additional fiber-optic cables, which are intended for future use and only “lit” when needed, in the conduits as they built out their networks. In early 2001, estimates of utilization in the 3 percent to 10 percent range were being circulated.

With huge amounts of fiber optic capacity either built, or in various stages of build-out, along with downward revisions of potential demand growth being viewed as ever more credible, the financing spigots began to be turned off for all but the strongest telecom companies and Internet service providers. At about the same time, the credibility of the business models for dot.com companies came under

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The Telecommunications Equipment Industry: Review & Outlook, January 2002 (Continued)

scrutiny. The investment markets began demanding not only credible revenue growth from these companies, but also began looking for forecasts of profitability, which many could not provide. These revised expectations further reduced the potential near-term demand for telecom capacity, as some of these companies could not finance continued operations. In short, many of these firms simply ran out of cash and could not get more.

With working capital suddenly receding, as the investment community became more cautious, bankruptcies of less liquid dot.coms and telecom providers began to mount. According to Bloomberg, citing BankruptcyData.com statistics, 30 publicly traded telecom companies, with \$44 billion of assets, filed for bankruptcy protection in 2001.

2001 began with order levels for communications equipment falling dramatically. Year-over-year declines in new orders for telecom equipment of 67 percent were commonplace. According to the U.S. Department of Commerce, shipments, by the third-quarter of 2001, were 35 percent lower than in the corresponding quarter of 2000. High in-house inventory levels resulting from the sudden falloff in demand, combined with ready availability of many types of equipment in the aftermarket resulting from liquidations of failed dot.com companies, necessitated severe production cutbacks throughout the telecom equipment sector. The recession and the September 11th events introduced more uncertainty into the sector and capital spending plans of the telecom industry were reduced further. Wall Street estimates of year-over-year declines in telecom company capital spending continue in the 30 to 40 percent range into 2002.

■ Current Status and Outlook

When the sector will recover is still a matter of conjecture. Bloomberg recently cited Synergy Research Group, which is estimating that telecom equipment industry sales during 2002 will fall an additional 20 percent, after having fallen 23 percent in 2001.

The much-heralded transition to “3-G” service, which allows increased functionality of cellular devices through utilization of greater amounts of bandwidth, has been held back by delays in R&D breakthroughs in designing consumer friendly, and affordable, hand-held devices. As well, the potential demand for such devices is being called into question, since many consumers do not appear to be interested in extremely expensive and bulky multi-media hand held appliances, but rather are only

seeking convenient, pocket sized, affordable, voice communications devices.

Nokia Corporation, the Finland based industry-leading cellular phone manufacturer, with approximately a third of the world market, is estimating that in 2001, hand-held telephone sales experienced their first-ever unit sales decline (to 380 million, from 400 million sold in 2000). Nokia cited saturated European markets, the lack of attractive new mobile phone services and the reduction in subsidies for new handsets from European telecom service providers (who, as a group, are currently servicing much higher than historic debt levels). One sign that the worst may be over came from an announcement by Corning Inc., which is an industry-leading manufacturer of optical fiber. In early January, Corning announced that it will reopen four fiber manufacturing plants which had been idled for the three previous months. With excess inventory levels having been worked down, the Company is beginning to gradually resume production. According to KMI Research, cited by the *Wall Street Journal* on January 7, 2002, the world's fiber producers manufactured 81,500 miles of optical fiber during 2001, 32 percent more than the 61,700 miles sold last year. The research firm expects full year 2002 production to be 18 percent below that of 2001.

The outlook for the Telecommunications Equipment Industry for the year ahead, based upon the before-mentioned factors, is for a stabilization following several quarters of extremely negative year-over-year comparisons. Most industry analysts are unwilling to pinpoint when industry growth will resume, but the earliest estimates for such a turn are well into the second-half of 2002. Before increased production can occur, capital spending budgets of the already cash-constrained telecom providers have to begin recovering and excess inventories have to be further reduced.

Current indications that the U.S. economic contraction bottomed during the fourth-quarter of 2001, after only a mild three quarter recession, are hopeful signs for the cell phone industry, which is more sensitive to discretionary consumer spending conditions. Cell phone sales spurted briefly immediately after September 11th, and could resume a stronger growth track as economic conditions improve if attractive product offerings are available. Considerable sales potential is still indicated in the U.S., where market saturation levels reached the 40 percent range in 2000, but are still below the 60 to 70 percent saturation area where Standard & Poor's expects some leveling off in potential sales growth.

Kmart and Global Crossing

Ray Spudeck, Research Manager and
Julius Vizner, Associate Research Analyst

The recent economic slowdown and “tight” credit market has contributed to a string of high profile bankruptcies. Discount retailer Kmart Corporation and telecommunications provider Global Crossing Ltd. filed for Chapter 11 bankruptcy this January. These two events do, however, offer some interesting differences. Kmart’s bankruptcy follows a more conventional model of a financially distressed firm, whereas Global Crossing’s filing, in large part, reflects another impact of the “bursting” of the tech-bubble. Moreover, while Global Crossing’s bankruptcy has been frequently characterized as catching the investment community by surprise, Kmart’s decline took a longer amount of time. Finally, while Global Crossing’s market debt was of a traditional direct obligation variety, much of Kmart’s market debt was in the form of a less familiar structured finance product.

This article analyzes the exposure of U.S. insurers’ investment portfolios to the bankruptcies of both Global Crossing and Kmart. Differences between direct obligation debt and the structured product used by Kmart are highlighted. Similar to other bankruptcy related studies that have been published in this *Monthly Newsletter*, the aggregate impact of these events on insurer portfolios is minimal. In fact, the amount of the exposure relative to the absolute size of the outstanding market debt of these companies reflects largely on the bias of insurance company investment toward investment grade securities.

■ Background

Global Crossing Ltd.

The genesis of Global Crossing was an AT&T project to lay cable across the floor of the Atlantic Ocean. The company’s mission became to build an Internet Protocol broadband network around the world. The business strategy was to sell the use of this information pipeline and its related services. Investors welcomed the idea; euphoria over the Internet quadrupled the common stock’s IPO price in a matter of months. When market sentiment cooled toward “new economy” firms, the stock price plummeted. The company reacted by shifting its focus to providing services. However, oversupply and slowing demand

depressed the prices it could charge, which lowered revenues. The company’s stock was eventually de-listed and it filed for bankruptcy on January 28th, 2002.

At stake for the insurance industry is a potentially large hit to its earnings on fixed-income investments. Several scenarios are being discussed for the future of Global Crossing, one of which is liquidation. In that event, the potential difficulty of selling a global telecommunications network might adversely affect the recovery amount for bondholders. The 2000 Form 10-K filed with the Securities and Exchange Commission lists \$5 million in land, compared to \$6.9 billion in transmission equipment.

Kmart Corporation Inc.

Last December was not the first time Kmart flirted with bankruptcy. In 1995, Moody’s downgraded their ratings to one notch above junk. Weak sales and a deteriorating cash position made the second largest retailer’s financial position precarious in the eyes of the rating agency. It was able to avoid a crisis by eliminating dividends and negotiating with banks and insurers to remove covenants that would trigger an immediate bond repayment if downgraded to junk.¹

Fast-forward to May of 2000; a new management team implements an aggressive strategy to leapfrog Wal-Mart Stores Inc. by improving supply chain efficiency and customer service. Regardless of the internal gains, the harshly competitive climate in the retail industry suppressed profit margins enough to wipe out the added revenue of increased sales. As sales slipped during the post-September 11th period, Moody’s downgraded the credit to junk status. Losses in supplier and creditor confidence fed a downward spiral leading to bankruptcy. When it filed for bankruptcy on January 22nd, Kmart also blamed the high costs of surety bonds in light of the Enron controversy.²

Kmart distributes products through more than 2,100 stores. Most of these locations are leased. Kmart securitized some of the leases through Commercial Mortgage-Backed Securities (CMBS) and issued their mortgage loans in the form of Credit Tenant Loans (CTLs). A large source of the demand for CTLs is the insurance industry.

¹ The Globe and Mail, “Kmart rallies despite downgrade” (December 22, 1995).

² Dow Jones Newswires, “Rising Surety-Bond Costs in Light of Enron Hurt Kmart” (January 22, 2002).

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Kmart and Global Crossing (Continued)

■ Credit Tenant Loans and Direct Obligation Debt

Credit Tenant Loans are defined as “mortgage loans that are made primarily in reliance on the credit standing of a major tenant, structured with an assignment of the rental payments to the lender with real property pledged as collateral in the form of a first lien,”³ according to the July 2001 edition of the *Securities Valuation Office’s Purposes and Procedures* manual. That is, through the assignment of the lease rental payments the loans are not based on the value of the property *per se*, but on the credit rating of the lessee (e.g. Kmart). For the issuer, this reduces the balance sheet impact of financing real estate, thus adding a degree of financial statement flexibility.⁴

The advantage of buying CTLs from an insurer’s perspective primarily lies in their eligibility for Schedule D treatment, subject to the determination of the SVO. The four types of CTL recognized by the SVO for reporting on Schedule D are Bond Lease Based CTLs, Credit Lease Based CTLs, Acceptable CTL Variants (ACVs) and Multiple Property Transactions (MPTs). Insurance companies are large players in the market for such securities. Life and property/casualty insurers held about \$7 billion in statement value of CTLs last year according to an analysis of Schedule D Part 1A Section 2 of all Annual Statements filed with the NAIC.

The question of what happens to CTLs in bankruptcy proceedings is important, particularly for holders of Kmart CTLs. The answer depends on whether Kmart affirms or rejects the lease. If the lease is affirmed, the lessee would continue to make lease rental payments that would, in turn, be assigned to the insurance company investor. If the lease is rejected, Kmart would discontinue making lease rental payments, thus causing a lease default. The insurer investor then has an unsecured claim to the rent owed under the original terms of the lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years.⁵ The insurer could then exercise its right (though the mortgage) as a secured creditor, foreclose on the property and attempt to recover the amount of the original

Figure 1. Aggregate Kmart Holdings (\$000)

Schedule D Asset	2000	1999
Bonds (Statement Value)	700,275	785,848
Common Stock (Market Value)	5,717	9,419
Preferred Stock (Statement Value)	10,706	30,332

Source: National Association of Insurance Commissioners.

loan from the proceeds of a sale of the property. At the time Kmart decided to reject the lease, the CTL should be placed on Schedule B as the insurer is no longer relying on the creditworthiness of Kmart, through the assigned lease rental payments, but, in CTL parlance, “on the traits of the mortgaged property.”⁶

■ Data

Kmart Exposure

Figure one summarizes industry investment in securities issued by Kmart Corporation for the years 1999 and 2000. Included in the analysis are deals with significant exposure to Kmart’s real estate financing. Where Kmart issues were part of a pool of securities, as would be the case in a CMBS, holdings were weighted to reflect the proportion of Kmart exposure in the deal. Figure two displays the amount of buying and selling of Kmart debt during 2001. Figures are in terms of par value since this is how they are reported on the quarterly statements filed with the NAIC.

CTL exposure is difficult to isolate because deals based on Kmart property are not uniquely identified when reported. Moody’s estimates that U.S. life insurers hold \$434 million of investments based upon Kmart credit (and \$281 million of directly issued securities).⁷

Figure 2. Change in 2001 Kmart Bond Holdings (\$000)

Year-end 2000	726,879
<u>Net Change in 2001</u>	<u>(24,206)</u>
Balance as of 3Q-01	702,673

Source: National Association of Insurance Commissioners.

³ Purposes and Procedures Manual of the NAIC Securities Valuation Office (December 31, 2001 Update).

⁴ Moody’s Investors Service, “CMBS: Moody’s Approach to Rating Credit Tenant Lease (CTL) Backed Transactions” (October 2, 1998).

⁵ *ibid.*

⁶ The authors thank Kevin Driscoll, SVO Credit Analyst, for sharing his knowledge of CTLs.

⁷ Moody’s Investors Service, “Kmart and the U.S. Life Insurance Industry: Modest Credit Impact at Most” (February 2002).

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Kmart and Global Crossing (Continued)

Figure 3. Aggregate Global Crossing Holdings (\$000)

Schedule D Asset	2000	1999
Bonds (Statement Value)	645,642	470,143
Common Stock (Market Value)	298,680	1,925,547
Preferred Stock (Statement Value)	122,488	164,742

Source: National Association of Insurance Commissioners.

Global Crossing Exposure

Figure three shows aggregate preferred stock and bond holdings as measured in statement value and common stock holdings in terms of market value at the end of 1999 and 2000. What is most striking about Figure three is the dramatic drop in the market value of common stock. This was due to the sharp fall in the stock's price and the accompanying sell-off. The number of shares owned by life and property/casualty insurers declined from 39 to 21 million.

Although total bond exposure exceeded \$645 million in statement value, no insurer reported investing more than five percent of their bond portfolio in Global Crossing. According to the year-end 2000 Annual Statements, only two insurance companies had more than one percent of their total bonds invested in Global Crossing.

Figure four shows changes in insurer bond investment for the first three quarters of 2001 measured in par value. Insurers increased their overall position in Global Crossing debt through September 30th of that year.

Figure 4. Change in 2001 Global Crossing Bond Holdings (\$000)

Year-end 2000	654,137
Acquired	521,799
Sold	455,609
<u>Net Change</u>	<u>66,190</u>
Balance as of 3Q-01	720,327

Source: National Association of Insurance Commissioners.

■ Conclusion

The economic climate in existence for the last eighteen months has been difficult for many corporations. Corporate defaults have been relatively high by historical standards, while some evidence is suggesting that recoveries may be lower than usual.

This article highlights two very different firms that both wound up seeking bankruptcy protection due to very different reasons. The bottom-line impact for insurers holding the securities of either Kmart or Global Crossing is the same. While no insurer appears to be significantly exposed to either event, at least in their investment portfolios, losses will be incurred.

As with any credit event, the next phase of this process for investors, particularly bondholders, will be the negotiation and workout of the bankruptcies with a particular focus on recovery of invested dollars. The results may likely vary significantly between these two events.

From the Director (Continued)

art. The “art” part represents that portion of the process related to judgment. How one applies a judgment to each credit variable is difficult to assess and may not be uniform among credit analysts. Today, the information disclosure we continue to read about Enron should tell one the sheer enormity of credit variables. The Enron financial autopsy underway should continue to reveal many facts, but should one have known about them prior to their collapse? The short answer is perhaps.

A further but equal challenge in any credit analysis resides in when should one move a credit rating. Here, the judgment of timing a particular credit rating change could be as important as determination of weakened credit rating judgment. Here, we are left almost entirely to human judgment. Given the accepted principles stated above on the governance of credit rating agencies, I do not know how you create an alternative system for credit assessments, particularly when you need the participation of people, as credit analysts.

The post-mortem review of the credit rating agencies role in Enron could lead one to conclude in the affirmative on timeliness. However, just like the apparent predictability of flipping a coin, personal history tells me many deteriorating credits need not result in a downward spiral toward fiscal disaster. Remedies can be undertaken to avert a fiscal collapse, again the question unanswered is should each weakening credit factor result in a rating change.

Those who may believe altering the current credit rating system will be challenged in answering the prior questions: what information should they know, who should they ask about the reliability of the information, when should they know this information, when should they act upon this information through a credit rating. I would throw in one additional question, can you ever neutralize the human component in the credit assessment process?

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