



Securities Valuation Office

Chris Evangel*Managing Director*

212-386-1920

CEvangel@naic.org

Ray Spudeck, Ph.D.*Research Manager*

212-386-1978

RSpudeck@naic.org

Shanique Hall-Barber*Research Analyst*

212-386-1930

SBarber@naic.org

Dimitris Karapiperis*Research Analyst*

212-386-1957

dkarapip@naic.org

Julius Vizner*Associate Research Analyst*

212-386-1926

JVizner@naic.org

Anthony Urick*Credit Manager, SVO*

212-386-1938

Pradip Vyas*Credit Manager, SVO*

212-386-1950

Cathy Weatherford*NAIC Executive Vice President*

816-842-3600

Web Address:www.naic.org/1svo/index.htm

SVO Research

Preferred Creditor Status of Multilateral Development Banks

Gary Mescher, Associate Credit Manager

As the global nature of investments has expanded, a growing number of nations are taking advantage of market conditions to engage in market borrowing for domestic economic development. Insurers are becoming an important investor in these markets for sovereign debt. Analysis of the risk inherent in sovereign credits is a developing field and there are many unique risk components to consider. In this sometimes arcane world the large number of technical terms routinely used by credit analysts can be intimidating, and frequently confusing, to the non-specialist. As insurer involvement continues to grow, this seems like a good time to discuss one such concept, the "preferred creditor status" of multilateral development banks such as the World Bank, the International Finance Corporation, and the Inter-American Development Bank. Multilateral development banks are international lending institutions, financed and controlled by sovereign governments, that act as financing conduits for regional or sector-specific economic development. They were created to provide a stable and long-term source of funding at rates lower than developing countries normally obtain in the market place. The widespread instability of emerging markets during the 1990s, and the credit problems it produced, prompted multilateral banks, and the developing countries they serve, to search for ways to structure transactions that would produce credit ratings above and beyond particular sovereign ratings. Preferred creditor status is one mechanism that is becoming increasingly common in the marketplace. This report attempts to explain what preferred creditor status is and examines how it is used by multilateral banks to provide enhanced ratings for their developing country clients.

■ What Exactly is Preferred Creditor Status?

Preferred creditor status is the recognition that sovereigns place a higher priority on servicing the debt of multilateral banks than on commercial banks or bilateral lenders when they are having trouble servicing their debt. Experience has shown that as countries face a crisis they will assign the highest priority to those obligations from those lenders that have the greatest impact on their continued access to the financial markets. For most countries, highest priority is given to multilateral banks, given their central role in the world financial community. Preferred creditor status, then, is *de facto*, or based in practice. It is not based in law and enforced through legal covenants or restrictions.

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From the Director

Chris Evangel, SVO Managing Director

Expectations. “Where is the outrage”? This somewhat famous phrase was spoken in a different time, in a different place, and for a different event. But how appropriate for our current time—where *is* the outrage. A year ago, nearly all financial market pundits were speaking of the unstoppable economy fueled in large part by the stock markets with the Dow, NASDAQ and S&P 500 each reaching all-time highs in 2000. What a difference a year can make, or even the first quarter of this year.

As of this writing, the NASDAQ has dropped 67.5% from a high achieved on March 10, 2000; the S&P 500 has fallen 27.7% from a March 24, 2000 peak; and the Dow Jones Industrials has lost 18.8% from the January 14, 2000 all-time high. The Dow has not officially become a bear-market, which needs a 20% decline from the peak at the closing bell but did dip to this level during intra-day trading.

However, few investors need that official sanction to tell them these are troubled times for investors. A staggering figure released over the past month reported that the wealth of Americans dropped by 2% by year-end 2000.

Now, 2% may not sound like a very big number but when one considers this 2% represents \$2 trillion of wealth you could be talking about a very large sum by any measure. This begs the question, *where is the outrage?*

As discussed in a previous column, the question one must ask is what are the expectations?

Not all investors may be suffering in this downward equity market. Fixed income securities (bonds) may have fared well. One such area of attention lies in the Treasury market. Over the past 15 months, we have seen the Treasury yield curve change. During the first half of 2000, the yield curve was inverted (higher short-term interest rate and lower long-term rates). Currently, the yield curve reflects, what many consider, a normal curve, which slopes upward (lower short-term interest rate and higher long-term rates).

Holders of fixed income securities should have seen an increase in their holding value. Given that many insurance companies retain large Treasury positions, the value of their assets should have increased. When you isolate Treasury performance over the past six-months, October 3, 2000 to April 4, 2001, one finds substantive

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Preferred Creditor Status of Multilateral Development Banks *(Continued)*

This de facto recognition of the priority given to multilateral banks is born out by experience as several detailed default studies by rating agencies have demonstrated. These studies show that sovereigns are most likely to default first on obligations to commercial banks and official export credit agencies; they are most likely to default next on long-term bonds; and they are least likely to default on obligations to multilateral banks.

In practice, then, preferred creditor status can be seen as elevating multilateral debt to an unofficial senior lien in relation to other obligations. All of the rating agencies, and the SVO, recognize the reality of this status and this is reflected in the higher ratings that specific transactions receive. While the SVO recognizes the enhancement that preferred creditor status provides, the exact number of upward rating “notches” it deserves is determined on a case-by-case basis.

■ Why Do Multilateral Banks Receive Payment Priority from Sovereigns?

There are a number of reasons why sovereigns accord priority to multilateral banks, all of which relate to the critically important role they play in developing countries’ economic circumstances both present and future. First of all, multilaterals may be the only source of new funding for countries in trouble. In addition, this funding is likely to be cheaper and have more favorable repayment schedules than commercial debt. A default to a multilateral may endanger any new borrowing from them and could jeopardize the disbursement of other funds that have already been approved, which could be considerable.

A default to a multilateral could also have a direct impact on access to other financing. A default to one multilateral may lead to sanctions from others and may even be

Preferred Creditor Status of Multilateral Development Banks *(Continued)*

considered a cross-default. This situation would also make it much more difficult to obtain lending from commercial and bilateral lenders or to reschedule existing debt. Finally, a default could lead to a loss of valuable technical assistance from multilaterals. In summary, then, sovereigns tend to default on multilateral debt last because the economic consequences are the highest.

■ How Do Multilateral Banks Leverage Preferred Creditor Status Into Higher Ratings?

Multilateral banks employ preferred creditor status in several ways. The most common structure is something called an “A/B loan participation securitization”. This has been used most widely by the International Finance Corporation (IFC), a member of the World Bank Group, and the Inter-American Development Bank (IDB) to promote development in the private sector of developing countries. Under this structure the multilateral bank extends a loan to a company and retains a portion of it, the A portion, for its own portfolio. The B loan portion is then participated out to investors either directly or through a trust. The A loan, then, is funded by the multilateral and the B loan is funded by investors. The B loan is at parity with the A loan and the multilateral bank remains the lender of record for both portions. The B loan receives a credit enhancement because the sovereign in which the company is located is expected to make every effort to provide foreign currency to service the B loan because of the preferred creditor status of the multilateral. This effectively removes the constraint of the sovereign’s foreign currency ceiling and allows the transaction to be rated equal to the local currency rating of the company itself. Since this local currency rating is based on the financial performance of the company, the rating can be higher than the sovereign ceiling. In this way, the multilateral uses their preferred creditor status to extend a higher rating to the B loan, the investor funded portion of the loan.

A second structure that has become increasingly important is something called a “partial guarantee loan”. This has been increasingly used by the World Bank. Here the loan is issued directly to a sovereign and only the first several payments of the loan are guaranteed by the World Bank. As a payment is made, the guarantee then rolls to the next payment and so on. If the sovereign does not pay within a

defined period, the World Bank guarantee kicks in. After the World Bank is reimbursed by the sovereign the guarantee is reinstated. The sovereign is required to guarantee this reimbursement payment to the World Bank. Because of the World Bank’s preferred creditor status it is expected that the sovereign will assign a very high priority to this loan, thus keeping the guarantee alive to be rolled throughout the life of the loan. In this way, the World Bank leverages its partial guarantee for only several payments into an “implied guarantee” for the rest of the loan. This allows a particular transaction to achieve a rating that could transcend or “pierce” the sovereign’s normal rating ceiling.

■ Factors Considered in Rating Preferred Creditor Status Structures

In analyzing an issue with preferred creditor status, the analyst obviously must focus on the specific structure and mechanics of the transaction at hand to make sure that preferred creditor status will in fact work. But beyond this analysis, a number of other key factors must be considered to determine the strength of preferred creditor status in a particular situation.

If a loan is to a private company within a sovereign, such as the A/B loan participations issued by the IDB and the IFC, the financial health of the company is key to the analysis. If the transaction structure effectively removes concerns about the availability of foreign currency to service the debt then the focus falls on the local currency rating of the company itself.

If a loan is directly to a sovereign, the analyst’s first step is to determine the sovereign’s foreign currency debt rating. This rating measures the willingness and ability of the sovereign to service its foreign currency debt. After determining the rating, the analyst must also decide whether the sovereign’s credit situation is improving, deteriorating, or stable. Credit enhancement provided by preferred creditor status may provide little benefit if the credit situation of the sovereign itself is rapidly deteriorating. For example, over the past five months the economic and fiscal health of Argentina and Turkey have deteriorated noticeably. As a result, the outstanding preferred creditor status transactions of both have been lowered or are now under review to determine if they still

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Preferred Creditor Status and the Need to Monitor: Lessons from Argentina

This is a brief description of a recent preferred creditor status transaction. It illustrates the benefits that can be achieved through preferred creditor status in that it helped Argentina gain access to markets that would have otherwise been closed to it, while lowering borrowing costs at the same time. On the other hand, this example points out the need to diligently monitor the underlying credit of the sovereign involved in the transaction. Argentina's current problems bring this point home.

In 1999 the World Bank extended a series of partially guaranteed notes totaling \$1.5 billion to Argentina. The notes consisted of six series with the first series maturing in one year and the rest to mature one by one over the next five years. The World Bank's partial guarantee originally covered only the first note series but as the first note expired, the guarantee rolled to the second note series. Upon the maturity of the second series, the guarantee rolls to the third series and so on. As long as Argentina has properly reimbursed the World Bank for any payments made under the guarantee, the guarantee continues to roll to the next series. At the time of the transaction, the three largest rating agencies had Argentina's sovereign ceiling rating in the BB/Ba range, as did the SVO at a NAIC-3 designation. The two agencies that publicly rated the transaction assigned a AAA to the first series, reflecting the AAA rated World Bank's guarantee. The SVO agreed with a 1 designation. The five subsequent series were rated BBB by the agencies, reflecting the recognition of the World Bank's preferred creditor status. The SVO on the other hand rated the subsequent series only a designation of NAIC-3, equivalent to the BB level. While the SVO recognized the enhancement provided by preferred creditor status, in the SVO's judgement this was not enough to overcome the deterioration of Argentina's underlying credit quality that was beginning to appear. Since this transaction took place Argentina's economic and fiscal condition has deteriorated further, resulting in a weakening of its underlying credit quality. All three rating agencies have since downgraded the republic's foreign currency sovereign ceiling into single B territory. The SVO also lowered its designation to a NAIC-4. One of the agencies has lowered the rating on their transaction to BB. All Argentina ratings are now under review by the agencies for possible further downgrade. Although the SVO initially rated this transaction lower than the participating rating agencies, time has shown that the NAIC-3 designation was appropriate given the weakening outlook for Argentina. The SVO remains comfortable with the NAIC-3 designation.

work (see sidebar above). Another important factor is how well a particular country is integrated into the world economic system. If a country is economically and politically isolated and has little or no contact with multilaterals then the consequences of defaulting on multilateral debt may be relatively painless. The sovereign's debt structure is also an issue. If the concentration of multilateral debt is very high this may dilute the strength of preferred creditor status. The higher the proportion of preferred creditor debt, the harder it becomes to afford it preference.

The financial status of the multilateral lender is also a relevant factor. As with the sovereign, the creditworthiness of the bank itself must be assessed. The fiscal strength of the bank, reflected in credit ratings is a key consideration. Another consideration is the relative position of the multilateral bank in the world financial and economic community. A sovereign may accord higher priority to a large global bank such as the World Bank than it would to a small regional bank.

■ Conclusion

As insurer investment in sovereign debts can be expected to continue, an understanding of the unique features and considerations of these instruments is critical. Preferred creditor status, while not a legal principle, is an important *de facto* component in many sovereign securities. The concept of preferred creditor status may initially sound complicated, but it is based on a very simple principle: sovereigns afford multilateral development banks preferential treatment in debt payments because they place a premium on the critical role multilaterals play within their economies. This elevated status has allowed the multilaterals to devise and apply a number of structures to leverage their own credit strength in order to achieve higher ratings for sovereigns. The volatility of emerging markets in the 1990s led to a sharp increase in debt structures using preferred creditor status. If the volatility of these markets so far in 2000 and 2001 is any indication, demand for sovereign debt structures with preferred creditor status is likely to increase.

Changes in the VOS Database 1999-2000

Ray Spudeck, Research Manager, SVO

With the implementation of the provisional exemption guidelines for insurers and general changes in the composition of the fixed income securities market over the last year, a look at the changes in the SVO's VOS database from 1999 through 2000 is warranted. Changes in the total number of securities on file, the composition of those securities, and the number of provisionally exempt securities reported should be of interest to state insurance regulators and are reported below. For comparison purposes, the VOS database as reported on the 1999 Addendum CD-ROM is compared to the VOS database as reported on the 2000 Addendum CD-ROM (the latest available data as of this writing).

■ Number of Securities on the Database

Overall, the 2000 Addendum CD-ROM contains records on 189,718 securities held by insurance companies, down 14% from the 220,347 securities reported on the 1999 CD-ROM. Of the securities reported on the 2000 Addendum, 149,869 were processed through the more traditional securities filing process and 39,849 were reported as provisionally exempt. The initial reporting of provisionally exempt securities on the 2000 Addendum came from insurers voluntary reporting during two cycles in the last quarter of 2000. As a result of provisional exemption implementation, the total number of securities filed through the existing process for 2000 was down by 70,748, or 32%, from 1999. This reduction of filed securities is consistent with the anticipated result of the provisional exemption guidelines, although the final amount of reduction will not be known for some time yet.

■ Composition of Securities on the Database

Chart 1 shows the breakdown of securities on the database by NAIC designation. Notice that for the 2000 addendum, several new categories are present.

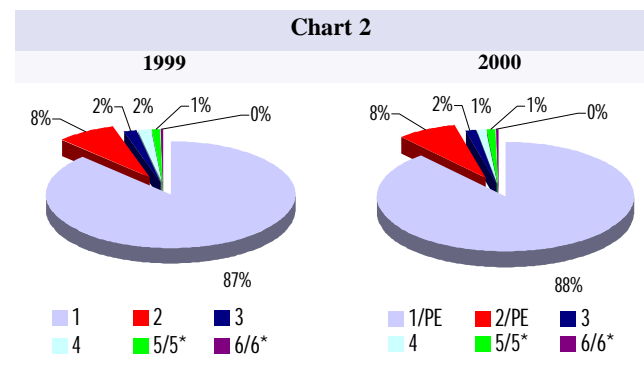
The provisionally exempt securities reported by insurers appear with the designations 1PE, 2PE, and the administrative symbol W. To recall, the W symbol appears whenever a security claimed as being provisionally exempt by an insurer cannot be verified as such according to a comparison of the ratings received by the SVO from the data feeds. The 2000 Addendum reports 8,152 "W"s (all categories), or about 20% of the securities reported as provisionally exempt.

If provisionally exempt securities are included, the distribution of securities on the database by NAIC

Designation	Addendum 2000	Addendum 1999	Change
1	131,558	192,800	
1PE	28,988	NA	
Subtotal 1's:	160,546	192,800	-32,254
2	10,977	17,065	
2PE	2,709	NA	
Subtotal 2's	13,686	17,065	-3,379
3	2,761	3,829	-1,068
4	2,260	3,944	-1,684
5	1,286	1,592	-306
5*	381	750	-369
6	629	365	264
6*	17	2	15
W's [†]	8,152	NA	
Subtotal Non-PE	149,869	220,347	-70,478
Total	189,718	220,347	-30,629

[†] Includes all W categories: W, 1W, 2W, 3W and 4W.

designation remains virtually unchanged from the 1999 Addendum to the 2000 Addendum. Chart 2 compares this breakdown for each year.



As more data become available, the impact of the provisional exemption process on the VOS database and the annual statements of insurance companies filing with the NAIC will continue to be monitored and the results will continue to be communicated to the regulatory community.

Debt-Equity Guidelines and The “Classification of Securities” Function of the SVO

Bob Carcano, Senior Counsel, SVO

Classifying a security for regulatory purposes remains a function an SVO analyst frequently performs which clearly distinguishes the role of an NAIC designation from a rating assigned by a rating agency. This classification may seem a bit odd to those not intimately familiar with developments in product design occurring in the global financial marketplace. After all, a bond is a bond, and a stock is a stock, right? Indeed, fifteen or twenty years ago this question would seem ludicrous. Today, a growing number of securities are intentionally structured to contain both debt (bond) and equity (stock) characteristics. These hybrid securities are the result of a number of factors, among them the:

- Ever present drive for greater financial efficiency and “market completeness”,
- Increased regulatory capital needs of international banks,
- Drive to optimize yields,
- Need to match unique liability exposures with comparable assets,
- Application of securitization technology to traditional corporate and municipal security structures, and
- The need to simultaneously comply with different accounting, tax and regulatory regimes.

In the face of this trend, with limited signs of abating, the simple description of the security frequently appears as an unreliable indication of how the security will perform or the regulatory framework appropriate to the security. Before processing an insurer-owned security, the SVO must carefully review the terms, structure, mechanics and legal profile of the security to determine whether the security is a Schedule D asset and, if so, whether it should be considered as a bond, a preferred stock or common equity for regulatory reporting and risk based capital purposes. The focus of the review is on the most likely economic performance of the security in the ordinary course of the issuer's business and in the event the issuer experiences financial distress. If, through the course of this review, a security is determined to be a preferred stock, the SVO is then further required to classify it as either redeemable preferred or a perpetual preferred. This article describes the SVO classification function, its regulatory objective, the issues associated with classification decisions and the impact of such decisions on insurers.

■ Core Concepts in the SVO Classification Scheme

Five major factors have, through research and experience, evolved as central to creating a proper security

classification scheme for the NAIC (see sidebar on next page). The five factors, listed below, are analytical starting points. They can and will be influenced by the other factors such as the underlying industry, the business profile of the issuer and the structure of the security. A fundamental underlying assumption is that the SVO uses the US capital structure/legal regime as a benchmark. Security characteristics are measured against three conceptual security models; i.e. the debt, preferred stock and common stock model.

The five criteria discussed below are deemed to be fundamental to the economic risk/return characteristic of each of the three types of transactions. Generally, no one factor is more important than another. In fact, the structure of the security could dictate that one factor predominates in a specific case. Further, the classification scheme is not an additive exercise. In addition to the individual characteristics, the SVO analyst looks for synergy between the various aspects of the security. The five major criteria central to the classification scheme are:

- **Contractual Promise** This factor defines the basic perspective of each type of capital. Debt is a contractual promise to make defined payments. On the other hand, equity is an ownership perspective that implies a residual claim to assets after creditors are paid. A preferred equity on the other hand is equity with a preferential status. As an analytical starting point, debt and preferred stock are viewed as closer in nature than debt and common. Both debt and preferred equity contemplate a par like claim and a periodic series of payments.
- **Rights** This factor lists the most basic rights that are given or denied to the security holder. The characteristics listed under this factor are probably the most instructive in making a classification determination.
- **Periodic Payment** In a debt contract a missed coupon payment gives the debt holder a right to trigger some mechanism either to step into the operations, influence issuer management or protect its investment. Deferral challenges this assumption. Consequently, the length, number and circumstances under which deferral is allowed are crucial considerations when this factor is considered.
- **Maturity/Redemption** Maturity and redemption are features associated with debt-like securities. However

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Debt-Equity Guidelines and The “Classification of Securities” Function of the SVO *(Continued)*

The following tables, from the *SVO Purposes and Procedures Manual*, Part Seven, Section 1 (c), highlight the factors considered when classifying a security for regulatory purposes.

I. CONTRACTUAL PROMISE	DEBT	PREFERRED	EQUITY
	Creditor status	Preferential status	Residual status
Comments:	<ul style="list-style-type: none"> An important component of creditor status is the right of acceleration upon missed payments. To be categorized as a debt instrument in the NAIC Financial Conditions Framework, the instruments must always have priority in all distributions over preferred and common equity. 	<ul style="list-style-type: none"> An instrument described as subordinate to all dated debt would warrant scrutiny for preferred treatment. To be categorized as a preferred instrument in the NAIC Financial Conditions Framework, the instrument must always have priority in all distributions over common equity. 	

II. RIGHTS	DEBT	PREFERRED	EQUITY
	No voting	Contingent voting rights	Voting rights
	No profit participation	No profit participation	Profit participation
	Cumulative payments	Cumulative or non-cumulative	Non-cumulative

III. PERIODIC PAYMENT	DEBT	PREFERRED	EQUITY
Payments	Scheduled	Scheduled with potential for deferral, or as declared - with the expectation that they are viewed as a fixed payment obligation by management.	As declared
Deferral	A deferral is typically viewed as a default.	Deferral is not an event of default. Allowed if no common dividend paid.	N/A
Obligation	Missed payment is an event of default and permits acceleration. <ul style="list-style-type: none"> Deferral does not preclude debt treatment. Issuer's discretion of deferral is limited--either to a specific period of time--or by specific triggers. Such triggers are generally limited to events that could give debt holders decision-making ability under covenants in a debt contract. 	Obligation may or may not be cumulative. <ul style="list-style-type: none"> Deferral or non payment allowed as long as dividends have not been paid on common equity. Issuer's discretion is limited only by the requirement to pay dividends if dividend is paid on junior capital. 	Missed payments are not cumulative. Complete discretion
Comments:			

IV. MATURITY/ REDEMPTION	DEBT	PREFERRED	EQUITY
	Contractually established date	May or may not have stated maturity, but anticipation of a future redemption with a potentially high degree of uncertainty.	No maturity and no redemption anticipated.
Comments:	<ul style="list-style-type: none"> A debt instrument may also have a maturity date which allows for some uncertainty as to when redemption will occur, for example: optional redemption tied to a step up in coupon, Dutch auctions, conversion at the option of the holder, or structures where redemption is driven from cash flows of a pool of assets. A perpetual security is not precluded from being categorized as debt. Redemption does not have to be in cash if it is at the option of the holder and if the redemption formula assures a minimum par. 	<ul style="list-style-type: none"> Any possible redemption must convey rights for the entire par or liquidation preference amount at the time of redemption. 	

V. INVOLUNTARY REDEMPTION	DEBT	PREFERRED	EQUITY
Claim	Debt claim for full par value, subject to availability of funds.	Claim preferred to all claims on common equity for full par value, subject to availability of funds after payment of all debt.	Purely residual interest with no minimum or maximum amount.
Principal Protection/ Loss Absorption	Full protection except for credit risk.	May contain loss absorption, but should maintain claim for liquidation preference.	No principal protection
Comments:	<ul style="list-style-type: none"> Mechanism providing for loss absorption may be allowed where terms of the mechanism do not create expectations different from those that predominate in an involuntary redemption scenario. Issuer's discretion will be significantly limited in loss absorption scenarios. In all circumstances voluntary redemption by the issuer is not allowed at less than par. 	<ul style="list-style-type: none"> Securities constructed to absorb losses in advance of debt securities will warrant scrutiny for preferred treatment. 	

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Debt-Equity Guidelines and The “Classification of Securities” Function of the SVO *(Continued)*

the absence of stated maturity or redemption is not determinative on its own. Often hybrid securities incorporate mechanisms, like the step - up feature, that could be read to create a *de facto* maturity or redemption.

- **Involuntary Redemption** This factor focuses on what happens to the face value and rights associated with the instrument in the event of an involuntary bankruptcy, liquidation, or re-organization. This is possibly the most complex area of analysis because the legal framework of the jurisdiction in which the issuer is domiciled may differ from one transaction to another. Additionally, one set of events may occur in a reorganization and a different set of events may occur if the issuer is to be liquidated. A finding that the holder’s claim under insolvency, reorganization or liquidation scenarios is at least equal to par (regardless of the actual value of the claim based on the issuer’s financial strength) is a strong debt-like characteristic.

■ Regulatory Objectives and Risk-Based Capital

The effort to classify securities as debt, preferred equity or common equity is directly related to the regulatory objectives of states that have adopted laws similar to the NAIC *Risk Based Capital for Insurer's Model Act*. SVO debt or equity classification decisions help ensure that securities carry the most appropriate reserve and risk based capital (RBC) charges. The effort to classify preferred stock as either redeemable or perpetual preferred is related to the accounting and valuation objectives of Statement of Statutory Accounting Principles No. 32 (SSAP No. 32) of the NAIC *Accounting Practices and Procedures* manual. SVO preferred stock classifications direct insurers to defined valuation methods. In this way, SVO classification decisions relate to financial solvency monitoring objectives of state insurance regulators.

The RBC required of an insurer varies in accordance with the risk it assumes in their insurance and investment operations. For example, Life RBC classifies all insurance company risk into four major categories, namely: asset risk, insurance risk, interest rate risk and all other business risks. Asset risk, defined as the risk of default or loss in market value, is the largest risk among the four life RBC risk categories. SVO classifications and NAIC designations work together to assign investment securities into the appropriate categories so that a proper Asset risk RBC can be calculated. The RBC factors for debt, preferred equity and common equity differ greatly. Bond holdings are split into 7 different risk categories. RBC bond factors 1-6 correspond to NAIC Designations

categories and the seventh RBC factor is for US government securities which are assigned a zero (0) risk weighting. The risk factors for bonds range from 0.003 (\$3 per \$1,000 of value) for NAIC 1 bonds to 0.300 (\$300 per \$1,000 of value) for NAIC 6 bonds. A decision to classify a security as a P1 or P2 preferred stock instead of an NAIC 1 or 2 bond means an RBC charge of .9% or 2.5% (\$9 and \$25 per \$1,000 of value) as opposed to a charge of .3 or 1% (\$3 or \$10 per \$1,000 of value). Classification of the same security as common equity means a 30% RBC factor for life companies, equivalent to the RBC for an NAIC 6 bond.

■ Factors That Influence the Creation of Hybrid Securities

Hybrid securities exist because legal, accounting, financial and securities frameworks differs from country to country. Specifically, not all countries have capital structure concepts that match the US model of debt, preferred equity or common equity. Also, issuers increasingly look to the national capital markets that offer the lowest cost financing at a given time. When that market happens to be the US capital markets, the security must comply with the US and the local accounting, regulatory, tax and/or corporate securities framework.

Some hybrid securities reflect an attempt to get as close to boundaries created by regulators as possible. For example, many hybrid securities link part of the return to equity markets. This often reflects an attempt to participate on the upside of equity markets while not triggering equity risk based capital charges.

The interaction between regulatory regimes also impacts how hybrid securities are structured. For example, before a bank regulator signs off on an institution's capital adequacy, the regulator will want to assess how capital's permanence the. The bank regulator naturally wants the bank to be able to rely on the capital obtained from issuing securities to absorb losses. However, the insurance regulator is interested in knowing whether the asset booked by the insurer as a result of the investment in the bank is available to pay claims. Resolving this tension in a manner satisfactory to regulators is an objective of many structures.

Consider the regulatory capital framework that evolved from the Basle Accords of 1988. The Accords tiers capital levels in accordance with the permanence of the capital to the bank. Tier I capital encompasses reserves, retained earnings, common equity, and non-commutative preferred

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stock and is the most permanent form of capital. Tier II capital, divided into Upper Tier II and Lower Tier II is less permanent. Attempts to resolve tensions between the foreign and US regulator lead to a spate of innovative structures. Generally, Upper Tier II lead to creation of subordinate debt securities redeemable only with regulatory consent, permitting the issuer to defer payment of interest without triggering a default. The more permanent such a security the easier it is to classify the security as preferred equity or common equity, depending on other factors. Lower Tier II criteria lead to creation of subordinate debt securities with maturity greater than five years. The fact that the issuer would ultimately be repaid could be a significant factor in determining that the security is debt-like, again, depending on other factors.

During the time period that foreign banks were seeking to increase their regulatory capital, the SVO saw a number of different ways security design was used to try to resolve the conflict inherent between competing regulatory paradigms. Some of these attempts include:

- Bonds with interest payments that, while cumulative (meaning they must be paid contractually at some point), had unlimited deferability.
- Bonds described as subordinated with interest payments contractually deferrable if the (bank) issuer fails to meet regulatory capital. These bonds also had no stated maturity.
- A bond characterized as a subordinated debt whose interest payments are deferrable if the (bank) issuer has no profits. No maturity is stated and there can be no redemption unless the bank has profits.

■ Developing Classification Criteria

The classification criteria employed by market participants in relation to any hybrid security will differ according to the objectives of the market participant. For example, rating agencies, whose focus is on the impact of a security on the issuer, would likely conclude that debt-like instruments, with their panoply of investor rights, are riskier to the issuer than instruments which provide the holder with little or no rights. The classification criteria employed by rating organizations when determining whether to attribute a specific issuance to capital would reflect this.

Most of the market participants interviewed in the process of developing NAIC classification guidelines agreed that

schemes to classify hybrid securities should employ a number of factors based from a US capital structure perspective. This means that the analyst frequently discounts the security description in favor of a thorough analysis of the structure and its constituent parts. The analyst's focus is on determining the likely economic behavior of the security. This requires an analysis of the how the security would perform in an insolvency. Knowledge of the regulatory regime tells the analyst what regulators can do to prevent regulated issuers from paying (or to force them to trigger deferral or other provisions) and whether they have other rights relative to the property of the issuer (i.e., the right to strip out certain assets, etc.). Many of the factors that govern how a security will behave only come into play when the issuer is facing financial distress. Most market participants also agreed that classification should depend on the preponderance of the characteristics.

■ Concluding Remarks

As financial markets continue to innovate, a simple description of a security as a debt, common or preferred equity becomes less useful to regulators trying to assess financial risks of the firms they regulate. Proper analysis requires moving beyond the descriptions to analyze the economic and legal characteristics of a transaction. This article has described the process used by the SVO on behalf of insurance regulators. The scheme used is based on the US capital structure concept of debt, preferred and common equity, with an additional distinction made between redeemable preferred and perpetual preferred equity. The major factors considered in making the determination are the contractual promises made under the security contract, the rights granted to the holder under the security contract, the nature of the periodic payments made to the holder of the security, the maturity/redemption features of the security, and the value and holder rights available under an involuntary redemption. It is critically important to note that no one of these factors dominates the others, and that all these factors are considered. Most importantly, these classification decisions are made on a case-by-case basis.

The design of financial securities will continue to evolve as new needs and demands will need to be met. At the same time, it is appropriate to bear in mind that concepts of risks and economic benefits associated with debt, preferred equity or common equity will also continue to evolve. As such, the classification function of securities performed by the SVO will continue to be an important component of insurance regulation, and will likely become more critical in the future.

From the Director *(Continued)*

gains. Remember that bond prices and interest rates work inversely to each other (bond price rise results in interest rate decline, while bond price drop results in interest rate rise.) Taking four Treasury bonds, due August 2002, May 2005, August 2010, and May 2030, each showed substantial gains.

If we ended the story here, one might conclude that portfolios containing these Treasury securities now appear as more “sound” given their higher prices, particularly since bond prices serve as the valuation basis for insurers holdings. These Treasury asset gains could aid an insurer’s solvency position for a particular point in time. Additionally, as long as a company does not sell those Treasury securities, in this case of October 3, 2000, their investment income (interest earning) remains the same.

However, investments do not remain static and the ultimate assessment of a particular portfolio relies on the

what one does with this current position. Will interest rates continue to drop causing further bond price gains; could Treasury prices flatten, as investors believe their Treasury position require a “re-balancing” of this portfolio and therefore may need to reduce these holdings, which may increase the supply and lowering the price; or could these current gains be leveraged (sold) for new investments with the expectation for further gains? The question again turns to what are the expectations. The interplay between varying expectations will guide investment decisions and, in turn, financial performance.

But reversal of fortune could happen, the frame of reference depends on one’s expectation. No one knows definitively when the equity market will return to sustainable growth trends, will interest rates continue to decline. Did anyone really believe we would be asking ourselves a year ago, how low can this market go?

	3-Oct-00	Yield	3-Apr-01	Yield	Bond Price Gain	Actual Yield Change	Bond Price Change
Aug '02	\$100.16	6.03%	\$102.21	4.11%	\$2.05	-1.92%	2.10%
May '05	\$103.59	5.85%	\$108.05	4.54%	\$4.46	-1.31%	4.30%
August '10	\$99.44	5.82%	\$105.09	5.03%	\$5.65	-0.79%	5.70%
May '30	\$104.44	5.93%	\$109.19	5.58%	\$4.75	-0.35%	4.60%

SVO Activity

In the continuing effort to keep state insurance regulators abreast of current financial market events and trends, as well as to enhance the awareness of the role and function of the SVO, a one day seminar in our New York office has been scheduled for Thursday May 17, 2001. The topical agenda for the seminar includes:

- **Overview of SVO Filing and Designation Process**
- **Provisional Exemption: Process, Responsibility and Issues**
- **Outlook and Issues 2001 (hear from a panel of financial market experts on the outlook for the rest of the year and new market and product trends)**
- **Advanced Credit and Structure Issues (for those familiar with the investment markets), or,**

- **Financial Markets Background and Regulatory Issues (for those relatively new to investments and investment portfolio analysis)**
- **SVO Research Function (find out what tools and services this new unit can provide to you)**

The seminar is open only to insurance regulators and space is limited to 30 seminar participants. Please contact Shanique Hall-Barber, SVO Research Analyst, at (212) 386-1930 or sbarber@naic.org to reserve your spot today. We will be happy to provide you with a list of nearby accommodations.

Hope to see you in May!

SVO Subscription Form

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NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Executive Headquarters

2301 McGee Street
Suite 800
Kansas City, MO 64108
Phone: 816-842-3600
Fax: 816-783-8175

**Federal and International
Relations**

Hall of the States
444 North Capital Street NW
Suite 701
Washington, DC 20001
Phone: 202-624-7790
Fax: 202-624-8579

Securities Valuation Office

7 World Trade Center
19th Floor
New York, NY 10048
Phone: 212-285-0010
Fax: 212-285-0073

Web Address:

www.naic.org

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