

NAIC

Securities Valuation Office

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After completing the NAIC committee process, the provisional exemption filing rule is now incorporated into the SVO's *Purposes and Procedures Manual*. The application of this rule will be seen as insurers begin to prepare their 2000 Annual Statements, particularly on their Schedule Ds. As we begin to work within the new guidelines, there are some responsibilities and issues required of both insurers and regulators.

Overview

Under the provisional exemption rule, an insurer initially determines if a security is eligible for exemption based on a three part test: a ratings test, an issuer test, and an optionality test (see sidebar on page 2). If the insurer claims the security is eligible, it may list the security on its Schedule D part 1 with an NAIC designation of 1 or 2 and the administrative symbol "PE." That information will be carried over to the SVO's VOS publication (the CD-ROM) and the declared provisionally exempt securities will carry the 1PE or 2PE designation. Regular updates of the data going into the VOS publication will validate the designation against reported ratings. Provisionally exempt declarations that do not match the ratings coming into the VOS publication will result in the "W" administrative symbol being assigned to the security in question on the database. The state insurance department has the responsibility for verifying or denying a company's declaration of provisional exemption for each security.

For Insurers

The use of the provisional exemption rule creates new responsibilities and raises new issues for insurers who use the exemption.

New Record-keeping requirements: For each provisionally exempt security, the insurer must maintain a record supporting their decision, including details of the terms of the security, documents verifying the security's rating, and documents evidencing the continued monitoring of the position.

Record-keeping requirement applies to all: Every insurer holding a provisionally exempt security and declaring it as such must maintain the records described above. Even though the VOS publication will carry the provisionally exempt designations, under the exemption rules established, a reference to the VOS publication alone will not suffice to prove exemption status.

SVO Absolved of PE Declaration: Under the exemption provisions, the SVO is specifically prohibited from aiding an insurer in the decision to declare a security provisionally exempt.

States Retain Authority to Require Filing Despite PE Declaration: States still reserve the right to require a security to be filed for designation with the SVO in some cases even if it appears that the security would qualify for provisional exemption.

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Web Address:www.naic.org/svo/svolist.htm

From the Director

To our state insurance regulatory community, as the Securities Valuation Office (SVO) Managing Director, I welcome you to the inaugural, and exclusively electronic, issue of this SVO Research publication.

Through the insightful vision of the commissioners, part of the SVO reorganization effort last year included the establishment of a SVO Research Unit. The unit will seek to provide commissioners and their state insurance regulators a means to gather, analyze, and disseminate information, in a cost-effective way, on the dynamic world of financial markets, based largely here in New York City.

We plan to publish monthly. In addition to financial market reviews, we also plan to include SVO overviews of certain noteworthy securities transactions our experienced team of seasoned analysts review here at the SVO.

We would expect this SVO Research publication not to be the definitive word for each financial topic, but an initiator of inquiry. In my experience within the financial credit markets, I have learned there are few, if any, absolutes – financial markets and their products remain dynamic.

Continued on page 7

Filing Exemption for Certain Securities is in Place (Continued)

States retain regulatory discretion: Each state insurance department has the responsibility to affirm or deny the provisional exemption designation for each security. At the margin, there may be some cases where a security is affirmed as provisionally exempt on examination in one jurisdiction, but denied in another.

have not yet begun, and some have chosen to continue filing with the SVO. There is going to be a steep learning curve for some insurers as provisional exemption becomes more widely adopted.

For Regulators

Regulators responsible for affirming or denying provisional exemption status: Each state insurance department has the responsibility to verify that the three part test for provisional exemption was satisfied for each designated security. This will require the departments to be familiar with current developments in the ratings process, security design and market development. The SVO can aid the departments in this process, but this review still ultimately remains each department's responsibility.

Development of new procedures needed: Regulators will need to focus attention on developing new procedures and standards to determine insurers' compliance with record-keeping requirements. As well, examiners will need to develop examination standards and processes for selecting, sampling, and verifying provisional exemption status.

State of Readiness

As the insurance community is in the inaugural phase of the adoption cycle for the provisional exemption ruling, the state of readiness of both insurers and regulators appears quite varied. Some companies have expended tremendous resources gearing up their processes to satisfy the provisional exemption requirements, many

Testing for Provisional Exemption Eligibility

The purpose behind allowing provisional exemptions was to expedite reporting process for high-quality assets of familiar design. To that end, under the new rules, government securities retain their previous exemption. Common stocks traded on the New York or American Stock Exchange or on the NASDAQ National market with no restrictions on transferability are also exempt. For corporate bonds, municipal bonds, asset-backed and residential mortgage-backed securities a 3-part eligibility test was constructed. The three parts are a ratings test, and issuer test and an optionality test. Summarized, they are:

- **Ratings Test:** For corporate, municipal and ABS/RMS, the security must be rated by two or more NRSROs not lower than a NAIC 2 equivalent or rated by one NRSRO as an NAIC 1 equivalent. Ratings are to be monitored.
- **Issuer test:** for non-US issuers, the issuer's country must be NRSRO rated for US dollar denominated debt and the NAIC designation on the issuer's bond cannot exceed the lowest NRSRO rating of the country's dollar denominated debt.
- **Optionality Test:** for corporate and municipal issues, principal and interest must be paid in US dollars, contract terms state that principal is repayable in full and the principal repayment schedule is fixed. Further the principal is set at closing, fixed in US dollars and coupon payments cannot be less than zero in any period.
- **Optionality Test:** for Asset-Backed/Residential Mortgage-Backed securities, the principal and interest must be paid in US dollars, and the coupon payment cannot be less than zero in any payment period. In addition, with the exception for credit enhancements, the timing and amount of cash flows to pay the obligation must depend on the timing and amount of cash flow from the assets underlying the bond. If the bond is prepaid immediately, the insurer must receive at least 98% of the purchase price. Finally, only the asset classes described in the *Purposes and Procedures Manual* may be used to support provisionally exempt Asset-Backed/Residential Mortgage-Backed securities.

Corporate Bond Defaults at Record High

Shanique Hall-Barber, Research Analyst

Overview

The number of corporate bond defaults this year is rising dramatically. Many of the bond defaults occurring now can be traced back to high-yield bonds issued in 1997 and 1998. The market's confidence and appetite for risk during this period increased so dramatically that very weak companies with marginal creditworthiness were allowed into the market. These companies, most with business models unable to cover their debt service under slowing economic circumstances, would have normally had a hard time selling bonds in the current environment. According to Standard & Poor's, more speculative debt (58%) was rated in 1997 than investment grade debt, crossing the 50%-50% mark for the first time in a decade. In 1998, that percentage moved up to 63% of all new ratings and stayed at that level in 1999.

Moody's November 2000 *Default Report* noted that 149 issuers have defaulted on long-term debt totaling \$44.6 billion, up from the 144 defaults on \$44.6 billion over the same 11 month period last year. Bond defaults this year have been concentrated in the following sectors: healthcare (14), telecommunications (12), and textiles, leather, and apparel (10). Additionally, the defaults have primarily taken place in the U.S.—Moody's reports that 115 of the 149 defaulting issuers this year are U.S. domiciled.

The Junk Bond Market

The junk bond default rate now stands at the highest level in nine years and, according to Standard & Poor's, is almost certain to exceed the amount of defaults experienced in 1999. Junk bonds, a.k.a. high-yield or low-grade bonds, are long-term IOU's issued by companies with non-investment grade credit ratings (Ba/BB or lower). Junk bonds offer higher promised returns to compensate investors for the extra risk. The rising level of corporate defaults has curtailed high-yield debt issuance. So far this year, only \$41 billion in junk bonds were issued, compared with \$95 billion last year and \$140 billion in 1998.¹

The average high-yield bond fund is off nearly 10% since January 1, 2000, according to Lipper Inc. Junk bonds and the funds that invest in them face certain unique challenges at this point in the business cycle. The first is liquidity;

Public Companies Filing Chapter 11

Year	# of Filings	Assets (\$ millions)
1991	104	\$82,056.00
1992	82	\$63,369.00
1993	74	\$12,630.00
1994	59	\$7,403.00
1995	74	\$21,611.00
1996	78	\$12,582.00
1997	73	\$16,265.00
1998	100	\$25,782.00
1999	130	\$55,420.00
2000*	149	\$69,911.00

Industry to date: Healthcare: \$13,574.00

Retail: \$12,796.00

* Through 11/11/00.

Source: BankruptcyData.Com - Boston, MA

sellers ability to liquidate junk bonds quickly and at fair market values has been seriously impaired. Furthermore, the number of publicly held companies filing bankruptcy protection this year is at a record high (see figure above). Investors disinterest coupled with record high default rates has resulted in plummeting prices, which in turn severely depresses returns on these securities.

Insurer Investment in Junk Bonds

According to end-of-year Schedule D reporting, the ratio of junk bond holdings (defined for illustration purposes as NAIC 3 or lower) to Surplus for Life Insurers averages 19%, with a high of 294%. Property/Casualty and Health companies reported less of a range (see table below). These averages and ranges seem to suggest that while most companies are conservatively managing their

Junk Bonds as a Percent of Surplus

December 31, 1999

	Average	High	Low	# of Companies
HMDI	3%	11%	0%	22
HMO	9%	26%	0%	19
Life	19%	294%	0%	495
P/C	6%	276%	0%	820

Source: NAIC.

¹ Sheer, Paul and Sapsford, Jathon. *Credit Grows Tighter, Posing a Risk to Weak Firms, Slowing Economy*. Wall Street Journal, December 1, 2000.

Corporate Bond Defaults at Record High (Continued)

investment risk exposure, some might be holding what would be generously considered aggressive portfolios. If default rates keep rising, a reasonable assumption suggests some companies on the bubble may face some level of solvency pressure. While simply looking at the ratio of junk bonds to surplus is no certain indication of the management of an insurer's portfolio, it may be an early warning signal, at least for some companies.

Corporate Loan Defaults and US Banks

Insurers have loaded up on junk bonds in a bid to boost yield. U.S. Treasury securities pay approximately 5.2% to 5.4%, while the average junk bond yields about 13.5% to 14.0%. While some analysts predict this trend to

continue, others argue that the pace of investment in junk bonds may slow as insurers re-examine their risk/return profiles in the face of current economic conditions.

Insurers are not the only financial institutions with corporate default risk exposure. The sharp rise in corporate bond defaults may be a leading indicator of future problems for U.S. commercial banks. It is clear that banks active in commercial lending are facing increasing problems as the economy slows and borrowers find it more difficult to repay debt. Earlier this month, Bank of America cut fourth-quarter profit projections, citing a rise in bad loans, with an expected write-off of approximately \$1.1 billion in bad loans in the fourth quarter, versus the \$435 million they wrote-off in the third quarter. The most recent problem for the bank was believed to be its share of a \$1.7 billion credit to troubled consumer products maker Sunbeam.

As the economy continues to show signs of slower growth, lenders become less confident of the borrowers' future earnings, and therefore their ability to repay. According to the Federal Reserve Board November 2000 Senior Loan Officer Opinion Survey on Bank Lending Practices, 44% of domestic and foreign banking institutions have tightened standards for commercial and industrial loans over the past three months. Additionally, the survey reported that more than half of both domestic

and foreign respondents indicated that they anticipate a further tightening of commercial and industrial loans by the end of 2001.

Furthermore, according to Standard & Poor's third quarter U.S. banking report, asset quality at U.S. commercial banks continues to deteriorate, in part because of the record junk bond defaults mentioned earlier. Standard & Poor's expects continued weakness in banks' asset quality, as higher interest rates and a slower economy hurt the more leveraged or marginal borrowing customers.

The Road Ahead

One of the more difficult parts of managing any fixed income investment portfolio is determining the level of credit risk inherent in the securities, both individually and as a portfolio. Bond ratings are an important aid to the investment community in this regard. Ratings do, however, have their own limitations. In the next issue, we will explore what bond ratings are intended to do, what they are often mistakenly thought to do, and what information in a rating opinion is important to making informed risk decisions. Using ratings within their proper framework is an important consideration for both insurers and regulators.

The state of the economy is much discussed and opined upon these days. While it is not clear if a recession is impending, current growth levels are slowing. The most recent measure of economic growth for the 3rd quarter of this year is 2.2%, well off the previous pace. During the last decade, the quest for yield was a major driver in many investment decisions. It may well be the case now that concern for safety, or the "flight to quality," may be underway.

The insurance industry has weathered many business cycles, with admittedly differing degrees of success. If an economic downturn is upon us, relative default risk for many kinds of asset investment could rise. Fortunately, insurers have been successfully managing and intermediating risk for a long time. It's unlikely that the decade long expansion has dulled their skills.

1999 Holdings of 5* and 6* Securities As Reported on Schedule D

Ray Spudeck, Research Manager

In an effort to expedite the filing and reporting process of Schedule D investments by insurers, in 1998 a modification was made to the SVO's *Purposes and Procedures Manual* allowing for 2 new class designations. An insurer may get a 5* designation on a security by filing a statement with the SVO affirming only that the issue is current on principal and interest payments. An insurer may claim a 6* designation, with no reporting to the SVO, if the security is carried at \$0 statement value. As these categories are new, it is worth reviewing the demographics of these designations to ensure that they are serving their regulatory role. To that extent, year-end 1998 and 1999 Schedule D information from insurance companies filing either Life or Property/Casualty blanks was compiled and the report that follows highlights some of the interesting features of these securities.

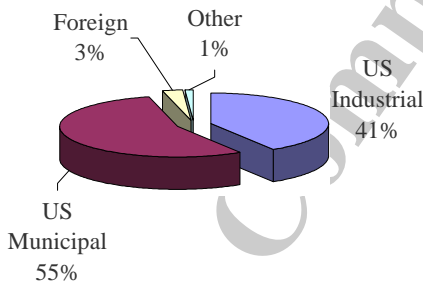
The data from the Life and Property/Casualty Annual Statements Schedule D reveals some interesting trends in the use of the 5* and 6* designation process. In 1999, 218 companies reported 5* holding on the Schedule Ds, up from 59 companies in 1998. These companies reported

1252 holdings (representing 1081 individual issues) at year end 1999, up from 168 holdings in 1998. In terms of size, the total statement value of the reported holding for year-end 1999 was about \$1.5 billion, up from roughly \$151 million in 1998.

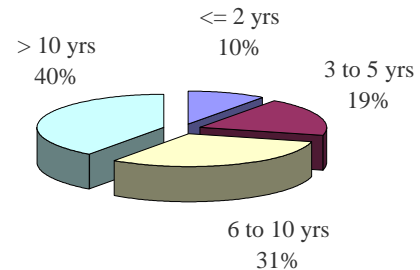
Looking at the composition of the year-end 1999 reported holdings of 5* securities also offers some interesting insights. Given the rationale for this designation, the perception may be that most of the securities holding a 5* designation might be from a foreign issuer. In fact, foreign securities made up only 3% of the total portfolio of 5* securities. The majority of securities holding a 5* designation in 1999 were issued in the US by US businesses (41%) and municipalities (55%). These securities do not appear to be either short-term instruments or securities near maturity. When weighted by total statement value, 5* securities maturing in 2 years or less constituted only 10% of the total 5* portfolio: 19% of the portfolio matures in 3 to 5 years, 31% matures in 6 to 10 years, and a somewhat surprising 40% of the 5* portfolio does not mature for over 10 years.

Continued on page 6

Distribution of 5* Securities by Type of Issuer

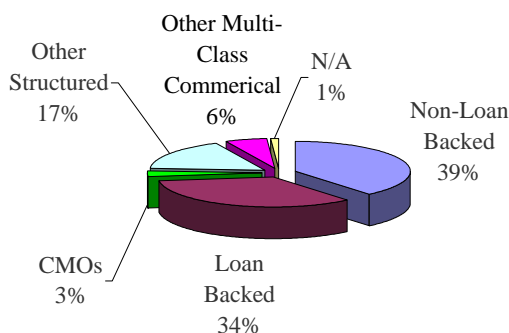


Maturity Distribution of 5*'s by Statement Value

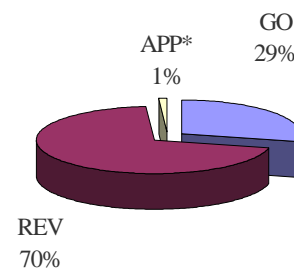


Total = \$1,224,006,681

5* US Industrials by Type of Issue



Distribution of 5* Municipals



* APP Denotes Appropriation Backed Municipal Bonds

1999 Holdings of 5* and 6* Securities As Reported on Schedule D (Cont'd)

For the municipal securities reported as 5*'s in 1999, 70% were revenue bonds, and 29% were full faith and credit general obligation bonds. For the US industrial 5* securities reported; only 39% were non-loan backed securities. Put another way, 61% of the industrial 5* reported in 1999 were some sort of an asset-backed, or other structured type of instrument. For the foreign 5* securities, two-thirds were from foreign industrial firms, and 23% were instruments issued by foreign governments.

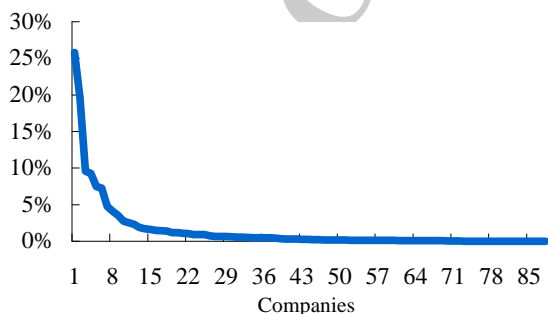
Determining the composition and distribution of the portfolio of reported 6* securities is more problematic than for 5 securities as only 3 securities with a 6* designation were reported on the VOS database as of the 3rd quarter of 2000. The annual statements from 1998 and 1999 do, however, show an increase in the size and frequency of 6* reported holdings. In 1998, 16 companies reported 6* holdings, compared with 121 companies in 1999. The number of reported holdings increased from 111 in 1998 to 381 in 1999. The statement value of reported 6* holdings rose from roughly \$244 million in 1998 to about \$663 million in 1999.

One aspect of possible concern to the regulatory community is the extent to which holdings of these 5* and 6* securities represent a solvency risk to insurers, as these securities by definition do not carry the highest designations and also

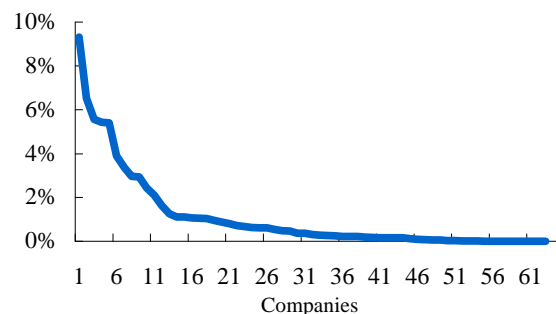
because very little is known by regulators about these securities. An examination of the ratio of statement value of a reporting company's 5* and 6* holding to reported surplus (in the charts below) reveals that, for the vast majority of companies, holdings of these securities represent only a very small proportion of surplus. In fact, for 5* designations, only 2 Property/Casualty and 6 Life companies reporting holdings that exceeded 10% of surplus. For 6* designations, only 8 Property/Casualty companies and no Life companies reported holdings in excess of 10% of surplus. There may be some cause for concern for some of these specific companies, but there does not appear to be a systemic issue for the industry as a whole.

The 5* and 6* designations are relatively new to the filing and reporting process used by insurance companies in conjunction with their statutory reporting requirements. This early data seems to suggest that these designations, largely chosen by the reporting insurers themselves, are growing dramatically in popularity. A comparison of the 1999 annual statements with the holdings from 2000 (which will be underway after the close of the annual statement reporting deadlines in March of 2001) will be enlightening to the extent that it may shed more light on whether this designation category will continue to grow rapidly or if most of the demand for this designation moving forward has already been captured.

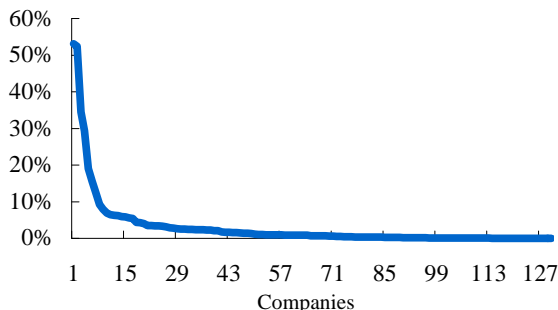
1999 P/C 5* Holdings to Surplus (Ratio)



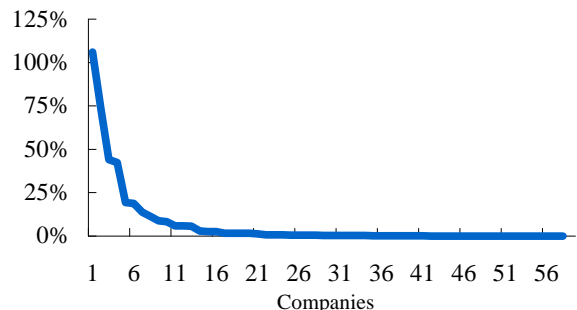
1999 P/C 6* Holdings to Surplus (Ratio)



5* to Surplus for Life Cos (%)



6* to Surplus for Life Cos (%)



From the Director (Continued)

Financial market players have a goal to combine buyers and sellers by addressing a client's need through a financial product that can be sold/purchased by financial market participants. The SVO Research Unit's goal is to foster that market knowledge to you.

The current issue includes three timely topics: provisional exemption rules now underway; 5*/6* securities holdings; and the large corporate bond defaults experienced during this still healthy economy.

In closing, I want to acknowledge the great effort of Ray Spudeck, Manager of the SVO Research Unit, and his highly enthusiastic staff, Shanique Hall-Barber and Julius Vizner for the creation and production of this SVO Research publication.

Chris Evangel

Education and Training Programs Available for Insurance Regulators

The investment world is growing ever more complicated. New products and security types are growing at an unprecedented rate. Truly, if "you can dream it, you can build it." The challenge for the insurance regulatory community is to keep up with these and other rapidly changing developments in the in financial markets. The newly formed Research unit of the Securities Valuation Office is pleased to offer its services to the state insurance regulatory community for exactly this purpose. In addition to this newsletter and periodic research reports on emerging issues in the financial markets and how they relate to the insurance industry, the Research unit is also available to provide education, training, and informational seminars to any department who would like to take advantage of them.

The Research unit can offer basic investments and investment analysis programs, more advanced programs on such topics as structured finance, securitization, the impact of provisional exemption on the examination process, or new trends in the fixed income market. Or, if a department prefers, the Research unit would be happy to create a customized program to suit your needs. As well, the Research unit is there for any data analysis or collection needs you may have.

For more information or to discuss a possible program or presentation, please feel free to contact Ray Spudeck, Research Manager, Securities Valuation Office at (212) 386-1978 or at rspudeck@naic.org.

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