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Securities Valuation Office

**Chris Evangel***Managing Director*

212-398-9000

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*

212-386-1949

dkarapip@naic.org

**Julius Vizner***Senior 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/svo\\_research/index.htm](http://www.naic.org/svo_research/index.htm)[www.naic.org](http://www.naic.org)

# SVO Research

## CDO/CBO/CLO 2002 Performance Review

*Dimitris Karapiperis, SVO Research Analyst***■ INTRODUCTION**

In 2002, in the midst of a struggling economy, the performance of collateralized debt obligations (CDOs), collateralized bond obligations (CBOs) and collateralized loan obligations (CLOs) mirrored the generally weak performance of the underlying portfolios. The market for CDOs/CBOs/CLOs experienced greater stress in 2002 than in previous years, as a direct result of the unusually high number of corporate defaults during the year combined with lower than normal recovery rates.

**■ 2002 CDO/CBO/CLO PERFORMANCE**

Although historically structured securities have exhibited very low ratings volatility, last year was a record year for downgrades. Standard & Poor's (S&P) downgraded 688 structured securities, of which 147 were in the CDO/CBO/CLO family. CBO transactions collateralized by high yield bonds, mostly rated during 1998, 1999, or 2000, clearly dominated the S&P downgrades. The other two asset classes that experienced high numbers of downgrades were synthetics CDOs.

Fitch reported<sup>1</sup> that the effect of the negative macroeconomic conditions and, especially, the adverse credit environment was most evident in the performance of CBOs (both high yield and investment grade) which represented about 74% of the total downgrades in the CDO/CBO/CLO sector recorded by the agency during last year. According to Fitch, leveraged loan CLOs fared much better in 2002 due to the relatively high recovery rates on the portfolio collateral while CDOs performed relatively well comprising the majority of the total CDO/CBO/CLO upgrades that Fitch reported.

These same trends affecting the CDO/CBO/CLO sector are reflected in the SVO designations actions that were initiated through 2002 up to the present time (Figure 1 on page 2). From the total 1013 transactions in the SVO's database a total of 85 were downgraded while 6 were

*(Continued on page 2)*<sup>1</sup> Fitch Global Structured Finance: 2003 Outlook and 2002 Review, January 28th, 2003.**Inside this issue:**

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## CDO/CBO/CLO 2002 Performance Review (Continued)

**Figure 1. SVO Designations (2002 - Present)**

	Upgrades	Downgrades
<b>CDOs</b> (345 issues)	1	17 (6 from investment-grade to high yield)
<b>CBOs</b> (415 issues)	3	61 (18 from investment-grade to high yield)
<b>CLOs</b> (253 issues)	2	7 (5 from investment grade to high yield)
<b>TOTAL</b> <b>(1013 issues)</b>	<b>6</b>	<b>85</b>

Source: National Association of Insurance Commissioners.

upgraded. From these 85 (less than 1%) downgrades 29 moved from investment grade down to high yield. CBOs dominated the downgrades with 61 issues (out of a total of 415) downgraded, from which, 18 issues lost their investment grade status possibly as a result of the significant credit slide experienced by some notable investment grade corporate obligors such as WorldCom.

### ■ U.S. INSURERS' CDO/CBO/CLO HOLDINGS

During the last 4-5 years U.S. insurance companies have steadily increased their involvement in structured securities; especially in CDOs, CBOs and CLOs. As of the end of the third quarter of 2002 life and property/casualty insurers held at least \$25 billion in CDO/CBO/CLO securities (Figure 2). Life insurers held the lion's share with \$23.5 billion, with CBOs dominating these investments with \$9.4 billion. P/C insurers held \$1.6 billion with their CLO holdings edging higher than the rest with \$624 million.

One of the most noticeable changes from 2001 (Figure 3) is the reduction of about one billion dollars in CBO

**Figure 2. Insurers' Investment in CDO/CBO/CLO Securities (2002 Year-End, Par Value)**

	Life	Property/Casualty
<b>CDOs</b>	\$8,379,087,509	\$464,642,913
<b>CBOs</b>	\$9,799,387,669	\$446,806,042
<b>CLOs</b>	\$5,276,422,243	\$461,569,790
<b>TOTAL</b>	<b>\$23,454,897,421</b>	<b>\$1,373,018,745</b>
<b>Grand Total: \$24,827,916,166</b>		

Source: National Association of Insurance Commissioners.

**Figure 3. Insurers' Investment in CDO/CBO/CLO Securities (2001, Par Value)**

	Life	Property/Casualty
<b>CDOs</b>	\$7,261,616,652	\$308,844,708
<b>CBOs</b>	\$10,358,563,602	\$644,446,635
<b>CLOs</b>	\$6,418,910,113	\$536,729,143
<b>TOTAL</b>	<b>\$1,490,020,486</b>	<b>\$24,039,090,367</b>
<b>Grand Total: \$25,529,110,853</b>		

Source: National Association of Insurance Commissioners.

investments, possibly due to downgrades and the overall weak performance of the CBO sector.

### ■ 2003 OUTLOOK

The market for CDOs, CBOs and CLOs is expected to continue to grow, even in this sluggish macroeconomic environment. According to Fitch, the 2003 outlook for this sector varies by asset class. Performance for cash and synthetic structures composed of corporate assets is expected to continue to mirror the continuing negative environment for defaults and recovery with some hints of stabilization as the default trend is reversed. Fitch maintains a negative to stable outlook for investment grade CBOs. CDOs and CLOs have a better outlook, although in the case of CDOs, subordinated classes will continue to be affected by trends within other structured finance sectors.

Recent activity in this market seems to offer a picture of a growing young market that is beginning to show some maturity. As the CDO and CBO market has matured, profit spreads from cash-flow deals (where the underlying notes, loans and bonds are actually transferred into a transformation vehicle such as a trust or an SPE) have thinned so that there is currently very new issuance activity being reported, except for re-securitizations, where previously issued tranches are being re-bundled and new notes being created. Alternatively, synthetic CDO and CBO deals (where the underlying asset is retained and credit default swaps on them are written by the transformer) are growing rather rapidly. CLO issuance is virtually nil and not really expected to rebound within the insurance industry as they have been largely supplanted economically by Replication Synthetic Transactions (RSATs)<sup>2</sup>.

<sup>1</sup> Driscoll, Kevin, "Replication (Synthetic Asset) Transactions," *NAIC SVO Research Newsletter* (December 2001).

# Credit Tenant Loans

Kevin Driscoll, SVO Senior Credit Analyst

## ■ INTRODUCTION

Between October 1994 and September 1995, the Valuation of Securities Task Force (VOS/TF) approved language for the *NAIC Purposes and Procedures Manual of the Securities Valuation Office* (the “P&P”), that established various categories, and defined the structural and legal characteristics of Credit Tenant Loans (“CTLs”). CTLs are mortgage loans that are made primarily in reliance on the credit standing of a tenant, structured with an assignment of the lease rental payments to the lender with real estate pledged as collateral.

By following these guidelines, many insurance companies have been able to invest in such loans without incurring traditional real estate risks while at the same time receiving comparatively favorable risk-based capital treatment. In many respects, the CTL guidelines have become somewhat of a “standard” for insurance industry investment in non-securitized commercial real estate.

## ■ SCHEDULE D VS. SCHEDULE B AND ASSOCIATED RISK-BASED CAPITAL REQUIREMENTS

### Schedule D vs. Schedule B:

The annual statement instructions provide reporting insurance companies with guidance for the categorization of insurance company investments. Schedule D is where bonds, preferred stock, and common stock are reported. However, other asset schedules include:

- Schedule A: Real estate owned
- Schedule B: Long-term mortgages
- Schedule BA: Other long-term invested assets
- Schedule DA: Short-term investments
- Schedule DB: Derivative transactions

The placement of an asset on a particular Schedule depends on the statutory definition of that asset. In many respects, CTLs have characteristics of both the statutory definition of “bond” and “mortgage loan”. For example, according to *Statement of Statutory Accounting Principle (“SSAP”) #26, “Bonds, excluding Loan-backed and Structured Securities”*:

“Bonds shall be defined as any securities representing a creditor relationship, whereby there is a fixed schedule for one or more future payments. This definition includes U.S. Treasury securities, U.S. government agency securities, municipal securities, corporate bonds, bank participations, convertible debt, certificates of deposit, and commercial

paper that have a fixed schedule of payments at maturity date in excess of one year from the date of acquisition.”<sup>1</sup>

On the other hand, according to *SSAP #37, “Mortgage Loans”* :

“For statutory accounting purposes, a mortgage loan shall be defined as a debt obligation that is not a security, which is secured by a mortgage on real estate. (A security is a share, participation, or interest in property or in an enterprise of the issuer or an obligation of the issuer that (a) either is represented by an instrument issued in bearer or registered form, or if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer, (b) is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment, and (c) either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations).”<sup>2</sup>

### Risk-Based Capital:

Although CTL investment is available to life, property/casualty, and health insurers, to date, the predominant investor group is life companies. Consequently, the life risk-based capital formula will be used for illustrative purposes. The five major categories of risks involved are: C0—Asset Risk – Affiliates; C-1—Asset Risk—Other; C-2—Insurance Risk; C-3—Interest Rate Risk and Health Credit Risk; and C-4—Business Risk.<sup>3</sup>

While all components are important in the calculation of the formula, particular emphasis is given to the “C-1—Asset Risk—Other” component when considering an investment. This component represents the risk of default for debt assets and loss in market value for equity assets. A company’s risk-based capital is calculated by applying “factors” to various asset, premium, claim, expense, and reserve items. The factor is higher for those items with greater underlying risk and lower for less risky items.

### Life Risk-Based Capital Factors:

- A. *Schedule D Bonds* — The bond factors are based on cash flow modeling using historically adjusted default rates for each bond, or NAIC Designation, category. The factor is then multiplied by the bond’s book/adjusted carrying value to arrive at
- (Continued on page 4)*

<sup>1</sup> NAIC Accounting Practices and Procedures Manual, As of March 2003, p. 26-3.

<sup>2</sup> Ibid, p. 37-3.

<sup>3</sup> 2002 NAIC Life Risk-Based Capital Report Including Overview and Instructions for Companies as of December 31, 2001, p.i.

## Credit Tenant Loans (Continued)

the risk-based capital requirement. The following are the bond factors (post-tax basis) for the statutory year ending (12/31) 2002<sup>4</sup>:

<u>NAIC Designation</u>	<u>Factor</u>
1 (AAA thru A-)	0.3%
2 (BBB+ thru BBB-)	1.0%
3 (BB+ thru BB-)	3.4%
4 (B thru B-)	7.4%
5 (CCC+ thru C)	17.0%
6 (CI, D)	22.1%

- B. *Schedule B Mortgages* — Mortgage loans on Schedule B are divided into the following types: a) Farm Mortgages; b) Residential Mortgages—Insured or Guaranteed; c) Residential Mortgages—All Other; d) Commercial Mortgages—Insured or Guaranteed; and e) Commercial Mortgages—All Other. These types are further subcategorized into the following broad credit quality indicators: a) In Good Standing; b) 90-Days Overdue, Not in Process of Foreclosure; and c) In Process of Foreclosure.

For the purposes of comparison, the category of Schedule B mortgage loan closest to a CTL is “Commercial Mortgages—All Other”, residing in the “In Good Standing” broad credit quality indicator. The corresponding factor for this type of Schedule B mortgage loan is 1.92%, for the statutory year ending 2002.<sup>5</sup> This factor is derived from a model that relates the probability of loss on an impaired mortgage to its contemporaneous loan-to-value ratio.

Clearly, this factor is almost twice the amount of the factor for a NAIC 2 bond and almost six times the amount of the factor for a NAIC 1 bond, hence, the attraction of a CTL qualifying for Schedule D treatment.

Finally, it should be noted, that in the absence of a quality rating system for Schedule B mortgages, the life risk-based capital formula also includes a moving eight- quarter average ratio of company to life industry experience with minimum and maximum limits. This Experience Adjustment Factor (EAF) is the moving average of a company’s normalized loss ratio divided by the moving average of the industry.

### ■ CREDIT TENANT LOANS

#### Definition:

The major premise of the CTL is that its primary risk characteristic is derived from the creditworthiness of the lessee (through the assignment of the lease rental payments

to the note or certificate holder) rather than from the traits of the mortgaged property. This key premise, or principle, is reflected in the general definition, accordingly:

“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, are referred to as a Credit Tenant Loan.”<sup>6</sup>

It is this underlying premise that is the primary rationale for Schedule D treatment. This overriding principle, which reflects the previously mentioned need to “draw a line”, is reinforced in the following, “If the analyst concludes that the transaction contains risks different from those normally associated with Schedule D, the transaction shall be rejected as ineligible for Schedule D reporting.” The phrase “rejected as ineligible for Schedule D reporting” means that the transaction, or loan, should be reported on Schedule B.

#### CTL Categories:

- A. *Bond Lease Based CTL*: as the name implies, a Bond Lease Based CTL is a transaction structured around the terms of a Bond Lease. A Bond Lease is:

“...a lease between a lessor and a lessee for a specified period of time with specified rent payments that are at least sufficient to repay the related note(s). The Bond Lease requires the lessee to perform all the obligations related to the lease premises. The investment community has historically defined a Bond Lease as a ‘hell or high water lease’, the general concept being that regardless of what occurs to the lease premises, the lessee is obligated to continue to pay its rent. Therefore, the focus is on the credit of the lessee (or of the guarantor of the lessee’s obligations) under the Bond Lease, not the real property characteristics related to the premises.”<sup>7</sup>

- B. *Credit Lease Based CTL*: a Credit Lease Based CTL is similar to a Bond Lease Based CTL with the exception of, “...the small set of landlord obligations or real estate risks that must be explicitly addressed through well-recognized mitigation methods...”. The investment community typically refers to Credit  
(Continued on page 5)

<sup>4</sup> “NAIC Life, Accident and Health Risk-Based Capital Newsletter, Volume 7.2, July, 2001 (updated 10/12/01), p.3.

<sup>5</sup> Ibid, p.3.

<sup>6</sup> Purposes and Procedures Manual of the NAIC Securities Valuation Office, December, 2002 Edition, Part Seven, Section 4(a)(i)(A).

<sup>7</sup> Ibid, Part Seven, Section 4(a)(ii)(A).

## Credit Tenant Loans (Continued)

Leases as “double-net” leases. Perhaps the most common landlord retained obligation of Credit Lease Based CTLs is the repair and maintenance of the property. In this case, funds need to be escrowed in an amount, on a substantially level basis, sufficient to pay such costs at the time they are expected to occur. The rationale for the establishment of a reserve fund is that to the extent the landlord has retained an obligation, failure to satisfy it could result in the termination of the lease, thereby, disrupting the flow of the assigned lease rental payments to the investor.

C. *Acceptable Credit Tenant Loan Variants (“ACVs”)*: an “ACV” is a transaction that, “... meets substantially all of the standards for a Bond Lease Based or Credit Lease Based CTL but that contains one or more of the variants described in the Guidelines for Acceptable CTL Variants...”<sup>9</sup> One of the most popular ACV’s is #1, “Transactions where lease payments are insufficient to cover required debt service. The shortfall would be covered fully by credit enhancement, cash escrow or excess rent asides.”<sup>10</sup> Over the past couple of years, the use of residual value insurance to mitigate lease payment shortfall has been fairly popular. It must be noted, however, that the rating of the residual value insurer cannot be substituted for that of the lessee.

D. *Multiple Property Transactions (“MPTs”)*: as the name implies, an MPT transaction is:

“...a series of single property Bond Lease Based CTLs or Credit Lease Based CTLs (but not both) combined in one transaction. The MPT category does not alter the fundamental structure or principles of either the Bond Lease Based or the Credit Lease based CTL. To qualify as an MPT CTL, each site or property must satisfy the existing Bond Lease Based or Credit Lease Based CTL definition on a stand-alone basis.”<sup>11</sup>

### ■ DESCRIPTION OF A HYPOTHETICAL CTL AND APPLICATION OF THE CTL GUIDELINES

A. Investment Objectives:

- Acquire long-term (e.g., 20 years) asset with minimal prepayment risk and a predictable monthly cash flow;
- Asset duration to match long-term liability structure, and;

- Achieve positive spread differential over lessee’s direct debt (e.g., Medium Term Notes) through added complexity of CTL structure.

B. Parties to the Transaction:

- Reporting Insurance Company ABC (CTL investor, pass-thru certificate holder)—Typically a life insurance company, however, CTL investments are not restricted to life companies.
- Special Purpose Vehicle (“SPV”) 123—Owner/Lessor; Issuer of pass-thru certificates (Note: Establishment of a SPV is not a prerequisite for CTL transactions. They are occasionally used to facilitate distribution of pass-thru certificates for larger transactions involving several investors).
- Regional Bank USA - Indenture Trustee
- XYZ Corp.—Lessee.

C. Transaction Description:

\$25MM Pass-Thru Certificates due February 10, 2023. Principal and interest will be payable monthly on the tenth day of each month. Proceeds will be initially used by SPV 123 to finance the acquisition of a store currently owned by XYZ Corporation. XYZ Corp.’s senior unsecured rating is A1 by Moody’s and A+ by Standard & Poor’s, the equivalent of a NAIC 1 Designation. The Bond Lease Based CTL structure will be used to issue subject pass-thru certificates.

XYZ Corp., current store owner, will transfer ownership of the store to SPV 123, accordingly: proceeds of the pass-thru certificates will be used by SPV 123 to purchase the store from XYZ Corp. Upon purchase, SPV 123 will become Owner and Lessor of the store and lease it back to XYZ Corp. (hence, a “sale-leaseback” will have occurred). Proceeds received by XYZ Corp. from the sale will be used to pay down existing long-term debt and for general corporate purposes. SPV 123, in turn, will grant a first mortgage on the store and assign the lease, and associated lease rental payment, to Regional Bank USA, the Indenture  
*(Continued on page 6)*

<sup>8</sup> Purposes and Procedures Manual of the NAIC Securities Valuation Office, December, 2002 Edition, Part Seven, Section 4(a)(iii)(A).

<sup>9</sup> Ibid, Part Seven, Section 4(a)(iv).

<sup>10</sup> Ibid, Part Seven, Section 4(a)(v)(A)(1).

<sup>11</sup> Ibid, Part Seven, Section , 4(a)(vi)(A).

## Credit Tenant Loans (Continued)

Trustee, for the benefit of Reporting Insurance Company ABC. Finally, from the proceeds of the lease rental payments, Regional Bank USA makes monthly payments due under the pass-thru certificates to Reporting Insurance Company ABC.

### D. Application of the Bond Lease Based CTL Guidelines to the Transaction:

#### a) *Legal Characteristics of the Bond Lease:*<sup>12</sup>

- (1) The lessee is responsible for every obligation related to the leased premises, such as the payment of all taxes and utilities, the performance of maintenance, environmental and ground lease obligations (if any) and the obligation that the lessee must indemnify the lessor against losses and claims relating to the leased premises. The lessor's only obligation may be to provide quiet enjoyment of the premises by the lessee:

This condition is satisfied in sections 8 ("Taxes"), 10 ("Utilities"), and 11 ("Repairs, Conformity With the Law") of the lease, dated 8/10/01, between SPV 123 (Lessor) and XYZ Corp. (Lessee).

- (2) The lessor makes no representations or warranties regarding the condition of the leased premises and the lessee accepts the premises "as is":

This condition is satisfied and evidenced by the estoppel certificate dated 8/10/01 and signed by XYZ Corp. This is significant to the extent that it evidences completion of a premise and acceptance and possession of it by the lessee. Its significance is demonstrated by the fact that it is usually a requirement of the lease itself as is the case with this lease (section 28. "Estoppel Certificate").

- (3) The lessee has no right to offset or abate rent or to terminate the Bond Lease upon the occurrence of obsolescence, condemnation, casualty or for any other reasons, except that the lessee may terminate the Bond Lease (i) at any time, if the termination coincides with the lessee's purchase of the leased premises, for an amount at least sufficient to pay the outstanding principal balance and accrued interest or (ii) during a period no longer than the last three years of the lease term without such purchase, in the event of a condemnation and casualty, if the insurance proceeds (or self insurance proceeds) and condemnation awards are payable to the lender/trustee and are in amounts sufficient to pay the loan in full.

This condition is satisfied per section 5. ("No Termination, Abatement, Etc.") of the lease.

- (4) The lessee is not required to occupy the leased premises if the occupant is a subsidiary or affiliate of the credit tenant. In these cases, the SVO may require additional information regarding the strategic importance of the leased premises.

For this hypothetical transaction, this is not applicable as XYZ Corp. (vs. a subsidiary or affiliate) is occupying the lease premises.

- (5) The lessee may assign and sublease if the lessee remains unconditionally liable for the performance of all lessee obligations.

This condition is satisfied per section 14 (d) ("Assignment and Subletting") of the lease.

- (6) The Bond Lease cannot be amended without the lender's consent.

Both the Deed of Trust and Assignment of Lease and Rents dated 8/10/01, do not allow any modification or amendment of the Lease without Reporting Insurance Company ABC's consent.

- (7) The Bond Lease or other relevant document(s) must specifically prohibit a merger of estates.

Although in this transaction the lease does not specifically prohibit a merger of estates, the Subordination, Non-Disturbance and Attornment Agreement (SNDA) dated 8/10/01, prohibits a merger of estates.

#### b) *Structural Characteristics of Bond Lease Based Transactions:*<sup>13</sup>

- (1) Payments under the note, including a balloon payment, correspond to a lease payment due from the lessee pursuant to the Bond Lease that is equal or greater than the note payment. The term "balloon" in the definition is intended to imply only a payment larger than previous payments and does not contemplate permitting transactions with refinancing risk:

This key matching principle is satisfied pursuant to the 8/10/01 Deed of Trust Note as the monthly note payments  
*(Continued on page 7)*

<sup>12</sup> Purposes and Procedures Manual of the NAIC Securities Valuation Office, December, 2002 Edition, Part Seven, Section 4(a)(ii)(B).

## Credit Tenant Loans (Continued)

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(\$25,408) are actually less than the corresponding lease payments (\$28,679) pursuant to section 2. (“Rent”) of the lease.

- (2) Neither the lease payments nor the debt payments need be level.

This condition is not applicable to this hypothetical transaction as the lease and debt payments are level.

- (3) The lessee is required to pay for all expense items.

See item #1 under “Legal Characteristics of the Bond Lease” section.

- (4) The lessee leases 100% of the real property securing the note.

This condition is satisfied pursuant to Exhibit A (“Description of Premises”) of the lease which legally describes the property as well as provides a map of the premises.

- (5) There is a valid first lien on the real property or the leasehold estate in favor of the lender/trustee.

This condition is satisfied pursuant to the Deed of Trust dated 8/10/01.

- (6) There must be in effect a fully executed irrevocable and perfected assignment of lease payments in favor of the lender/trustee and the lender/trustee must be directly collecting lease payments sufficient to fully pay each and every installment of debt service.

This condition is satisfied pursuant to the Assignment of Lease and Rents dated 8/10/01 and a “Rent Direction Letter” dated 8/10/01 between the lessee (XYZ Corp.) and the Indenture Trustee (Regional Bank USA).

- (7) To the extent the credit to be relied upon is that of a guarantor, the guarantee of the lessee’s obligations must be irrevocable and unconditional, and must guarantee performance of all obligations of the lessee

under the Bond Lease. The term “guarantor” excludes third party guarantees for purposes of credit enhancement but is intended to include support arrangements, which in the opinion of the SVO, are entered into as a regular part of the business of the lessee or the group of entities of which the lessee is a part.

This condition is not applicable as the lessee’s obligations under the lease are not being guaranteed.

- (8) Loan to value is not relevant and therefore not limited.

### E. Assignment of NAIC Designation:

Upon determining that the hypothetical CTL has satisfied the guidelines and, therefore, the \$25MM pass-thru certificates are eligible for Schedule D treatment, the next function performed by the SVO is assigning a NAIC Designation to the pass-thru certificates owned by Reporting Insurance Company ABC. Unlike traditional real estate investments which take into account the property’s value, typically expressed by the conventional loan-to value ratio, to the extent a CTL’s primary risk characteristic is derived from the creditworthiness of the lessee rather than from the traits of the mortgaged property, the lessee’s senior unsecured rating drives the NAIC Designation decision. Consequently, since XYZ Corp.’s senior unsecured rating is A1/A+, the pass-thru certificates would be assigned a NAIC 1 Designation.

### ■ CONCLUSION

Over the years, the CTL guidelines have provided many insurance companies an opportunity to invest in non-securitized commercial real estate while at the same time enabling them to benefit from comparatively lower risk-based capital charges. Although the guidelines were designed to accomplish regulatory/statutory objectives, a closer look at them reveals some flexibility. Moreover, their straight-forward nature provides for easy readability while the documentation requirements, for the most part, are no different than those associated with other commercial real estate transactions.

# Global Corner: Brazil Bounces Back as Investor's Confidence Returns

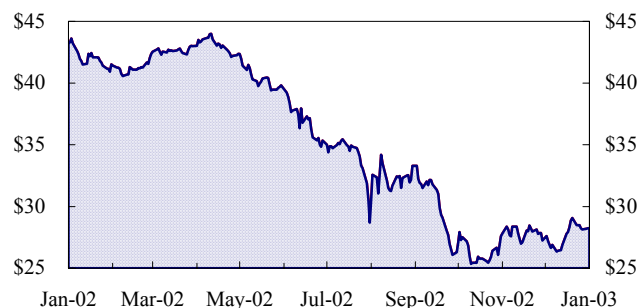
Gary Mescher, SVO Associate Credit Manager

In the run up to the Brazilian national elections last fall Brazil's economy, which had been performing moderately well, seemed to take a dramatic turn for the worse. Investors and market analysts, who had a generally positive view of the outgoing administration, suddenly lost confidence in Brazil. The real plummeted, losing almost 50% of its value against the dollar between May and October 2002 (Figure 1). Interest rates on Brazilian sovereign bonds more than doubled making it very difficult for the country to access the capital markets. Foreign direct investment decreased and bank interest rates shot up making it expensive for private businesses to borrow. The stock market plummeted losing over 40% of its value. Since much of Brazil's debt was in dollars, or indexed against the dollar, Brazil's debt burden ballooned in proportion to its gross domestic product. By the time the election neared in October many analysts were predicting that Brazil would default on its foreign currency debt within months. The rating agencies lowered their outlooks on Brazil to negative and warned of worse to come.

Many of Brazil's problems could be traced to investors negative perceptions of one man, Luiz Inacio Lula da Silva, known in Brazil simply as Lula. Lula is the head of the left wing Partido dos Trabalhadores or the PT. A former trade unionist, Lula has been involved in the far left politics of Brazil for most of his life. But in this election Lula changed his stripes and campaigned as a slightly left of center moderate mixing calls for social justice with promises to adhere to his predecessor's orthodox free market policies. As Lula improved his position in the polls throughout the fall, investors and market analysts became increasingly anxious, wondering just what a Lula victory would bring. Given his background, many observers feared that Lula would reject the free market approach in favor of old-fashioned South American populist and protectionist policies. The assumption was that once in power Lula would reject fiscal discipline and use up the primary budget surpluses to fund his favorite projects for the poor.

But a surprise was in store for many after Lula took power on January 1, 2003. In his first eight months he has looked very much like his predecessor, preaching fiscal austerity and the need to preserve Brazil's hard won financial

Figure 1. Currency Exchange Rate US \$ for Brazil \$



Source: Federal Reserve (H.10).

solvency. In a show of confidence, the finance ministry recently raised the country's primary budget target, a figure that the International Monetary Fund watches very closely. He has spoken of the need to use market-based solutions to lift Brazil's poor out of their deep poverty. He has taken on his own party in an effort to overhaul Brazil's bloated pension system, and has taken steps to improve Brazil's shaky transportation infrastructure and energy sector.

Predictably, investors are now returning to Brazil and many analysts have changed their outlook on Brazil's future. The real has regained much of its value, Brazilian debt is now trading at a much lower level, the stock market has recovered much of its value, and the foreign currency debt burden is now manageable. No one now speaks of an imminent default.

One reason for Brazil's quick turnaround is that its basic economy remained fundamentally sound throughout the crisis. Economic growth continued, industrial output increased, and the trade balance that had been solid improved further as the real fell in value.

In short, Brazil suffered from a crisis of investor confidence and not an economic crisis. When investors flee, self fulfilling prophecies tend to happen.

Lula still faces a number of daunting problems, many of them imposed by the radical wing of his own party. Bad things may still happen. But for now Brazil's recovery is one of the few bright spots in Latin America.

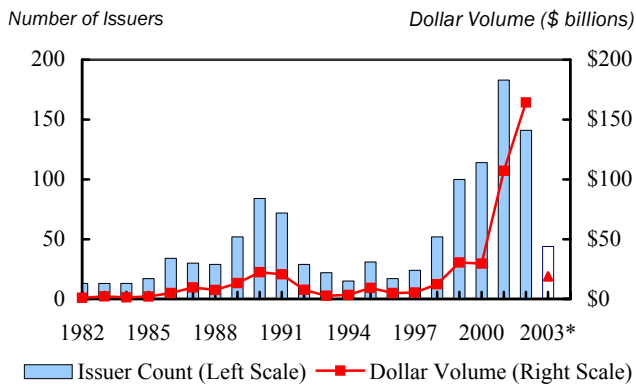
# Default Watch

Shanique Hall, SVO Research Analyst

According to Moody's Investor's Services (Moody's), the global speculative-grade default rate fell in June to 6.1% from 6.5% in May, marking the 17th decline in the last 19 months. During the first half of 2003, 44 corporate bond issuers defaulted on \$18.9 billion of debt (Figure 1) compared to 87 corporate bond issuers defaulting on \$76 billion of debt over the same period in 2002. The largest defaulters in the first half of 2003 were HealthSouth Corporation (\$3.4 billion), Fleming Companies (\$1.6 billion), and Magellan Health Services (\$1.3 billion).

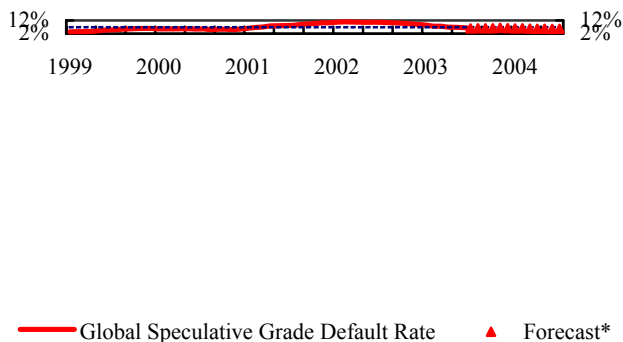
Meanwhile, thus far in 2003, there have been fewer downgrades and more upgrades compared to 2002. According to Standard and Poor's, the global credit ratio—the ratio of downgrades per upgrade—for all of financial and non-financial issuers was lowered to 3.1 in the second quarter of this year compared to 4.6 in the first quarter and 4.2 for the year 2002.

**Figure 1. Global Corporate Default Summary**



\* From January 2003—June 2003. Source: Moody's Investors Services, Default Research.

**Figure 2. Global Speculative Grade Default Rate**



\* Moody's Forecast. Source: Moody's Investors Services, Default Research.

**Figure 3. Recent U.S. Bankruptcy Filings**

Company	Type*	Date
1. Rome Cable Corp.	Private	07/30/03
2. Pillowtex Corp.	Public	07/30/03
3. LTWC Corp.	Public	07/23/03
4. Gibson Logging Enterprises	Private	07/22/03
5. Seitel, Inc.	Public	07/21/03
6. Cimarron Golf Club	Private	07/21/03
7. All-Star Gas Corp.	Public	07/21/03
8. Texas Petrochemicals, LP	Public	07/20/03
9. Loral Space & Comm.	Public	07/15/03
10. Com21, Inc.	Public	07/15/03
11. Prime Succession, Inc.	Private	07/14/03
12. Mirant Corp.	Public	07/14/03
13. Mego Financial Corp.	Public	07/09/03
14. Chart Industries, Inc.	Public	07/08/03
15. American Cherokee Co.	Private	07/08/03
16. Polstar Holdings, Inc.	Private	07/07/03
17. Top-Flite Golf Co.	Private	06/30/03
18. Crown Pacific Partners	Public	06/29/03
19. Waterlink, Inc.	Public	06/27/03
20. National Equipment Services, Inc.	Public	06/27/03
21. Deltagen, Inc.	Public	06/27/03
22. James Cable Partners, LP	Public	06/26/03
23. Amerco, Inc.	Public	06/20/03
24. Touch America, Inc.	Public	06/19/03
25. Engage, Inc.	Public	06/19/03
26. CopperCom, Inc.	Private	06/18/03
27. Read-Rite Corp.	Public	06/17/03
28. Creative.net, Inc.	Private	06/17/03
29. Cross Media Marketing Corp.	Public	06/16/03
30. FASTNET Corp.	Public	06/10/03
31. Summit Corp. of America	Private	06/06/03
32. MCSi, Inc.	Public	06/03/03
33. Bag n' Baggage	Private	06/03/03
34. Slater Steel US, Inc.	Public	06/02/03
35. Philip Services Corp.	Public	06/02/03
36. Paper Warehouse, Inc.	Public	06/02/03
37. Westpoint Stevens, Inc.	Public	06/01/03
38. The Penn Traffic Company	Public	05/30/03
39. Worth Media LLC	Private	05/29/03
40. Princeton Video Image	Public	5/29/2003
41. 3DO, Inc.	Public	5/28/2003
42. Sunshine Precious Metals	Private	5/27/2003

Source: BankruptcyWeek ([www.bankruptcydata.com](http://www.bankruptcydata.com)).

# Market Data Watch

Shanique Hall, SVO Research Analyst

Corporate bond yields have tapered noticeably over the past year falling more than 140 basis points from a year ago thanks mostly to treasury yields which are at 35-year lows according to Moodys. Moreover, spreads over Treasuries have tapered notably and are at their narrowest levels since the middle of 1998. Speculative-grade yield spreads have fallen from year-end 2002's 899 basis points to 604 points of June 30th.

Meanwhile, return on equities have increased in recent weeks. The NASDAQ is up over 20% for the year and the S&P 500 is up nearly 12% over the same period (Figure 2).

**Figure 1. Selected Key Interest Rates**

Rate	Aug. 6	Week Ago	6-Mths Ago	Year Ago
3-Month T-Bill	0.95%	0.92%	1.16%	1.56%
1-Year T-Notes	1.24	1.17	1.34	1.64
5-Year T-Notes	3.24	3.27	3.07	3.24
10-Year T-Notes	4.35	4.34	4.02	4.35
Treasury Long-Term T-Bond*	5.40	5.27	4.97	5.36
Moodys Aaa**	5.83	5.78	6.00	6.45
Moody's Baa**	6.97	6.89	7.13	7.70
Conventional Fixed Rate Mortgage	6.14	5.94	5.90	6.34

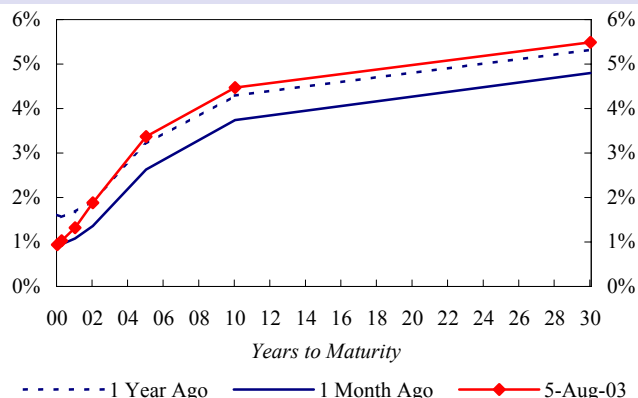
\*Average of 25 years and above. \*\*Corporate Industrial Bonds.  
Source: Federal Reserve Board (H.15).

**Figure 2. Selected U.S. Market Indices**

Indices	July 3	Week Ago	Year-to-Date	Last 12 Months
DJIA	9070.21	+0.90%	+8.85%	+0.17%
NASDAQ	1663.46	+2.35	+24.56	+20.53
S&P 500	985.70	+0.97	+12.03	+3.32
Russel 2000	456.35	+1.69	+19.12	+6.31
Wilshire 5000	9462.51	+1.11	+13.42	+5.16
S&P Insurance	267.41	+1.00%	+5.75%	-6.20%
S&P Energy	132.15	-0.46	+4.97	+4.72
S&P Financial	116.17	+0.20	+9.09	+8.42
S&P Telecom	57.81	-1.58	+19.22	+45.80
S&P Utilities	140.79	-0.54	+9.22	-1.19

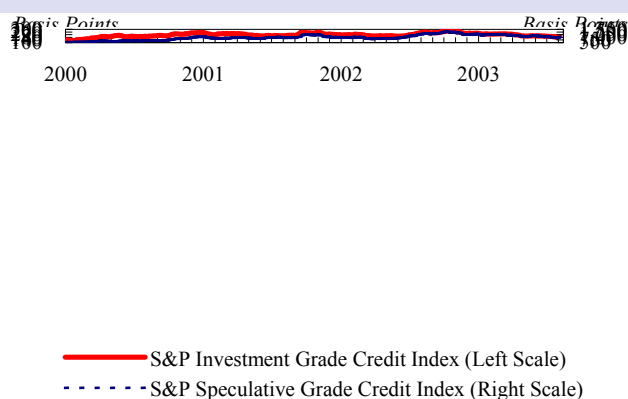
Source: Yahoo! Finance.

**Figure 3. Treasury Yield Curve**



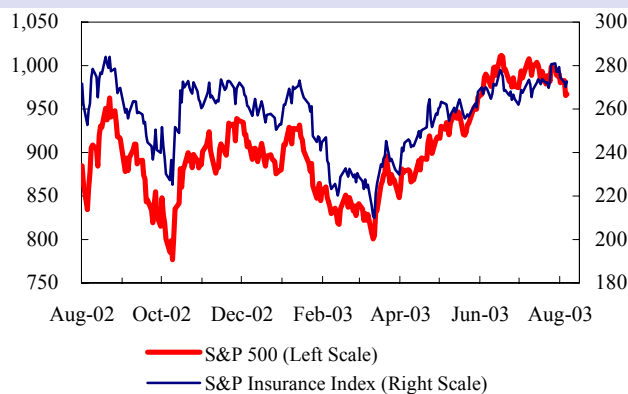
Source: Federal Reserve Board (H.15).

**Figure 4. S&P U.S. Industrial Credit Indices\***



\*Spread over U.S. Treasury Yield Curve. Daily data as of August 7, 2003.  
Source: Standard & Poor's (S&P Credit Indices).

**Figure 5. S&P 500 vs. S&P Insurance Index**



Daily data as of August 7, 2003. Source: Yahoo! Finance.

## Recent Rating Agency Actions for Insurance Companies

	<b>RATING AGENCY</b>	<b>DATE OF ACTION</b>	<b>ACTION</b>
General Electric Mortgage Insurance Corp.	S&P	6/30/2003	Placed its ratings on CreditWatch with negative implications
American International Group Inc.	S&P	6/27/2003	Affirmed its 'AAA' counterparty credit rating
Länsförsäkringar AB	Moodys	6/27/2003	Downgraded the issuer rating, the rating outlook is negative.
American Family Financial Services	Moodys	6/26/2003	Affirmed its Prime-1 commercial paper rating.
American International Group, Inc.	Moodys	6/26/2003	Affirmed its Aaa ratings and negative outlook on the senior debt.
Employers Reinsurance Corporation	AM Best	6/26/2003	Downgraded the financial strength ratings to A from A+
GE Edison Life Insurance Company	Moodys	6/26/2003	Placed its Aa2 insurance financial strength rating on review for possible upgrade.
GE Financial/P&C	AM Best	6/26/2003	Placed the financial strength rating of A of the members under review with developing implications.
Horace Mann Educators Corporation	Moodys	6/26/2003	Affirmed the A2 insurance financial strength ratings and Baa2 senior debt ratings.
The Kemper Insurance Companies	Moodys	6/26/2003	Downgraded the insurance financial strength ratings.
Gulf Insurance Group	AM Best	6/25/2003	downgraded the financial strength rating to A from A+ .
Tryg Forsikring	Moodys	6/24/2003	Confirms the A3 insurance financial strength rating and assigns a stable outlook.
Lloyd's Syndicates 839 and 44	Moodys	6/23/2003	Downgraded the B- Below Average performance ratings of syndicates 839 and 44.
Tenet Healthcare Corp.	Fitch	6/23/2003	Lowered senior unsecured debt and bank facility ratings to 'BB+' from 'BBB-'.
Lloyd's Syndicate 2001	Moodys	6/20/2003	Changed the outlook to positive from stable.
Penn Mutual Life Insurance Co.	S&P	6/20/2003	Affirmed its 'AA-' long-term counterparty credit and financial strength rating.
Lloyd's Syndicates 1007 and 2147	Moodys	6/19/2003	Changed the outlook.
Mitsui Mutual Life Insurance Company	Moodys	6/18/2003	Placed the Ba3 insurance financial strength rating under review for possible downgrade.
Montpelier Reinsurance Ltd.	Moodys	6/18/2003	Assigned an A3 ("Good") insurance financial strength rating.
The Chubb Corporation (Chubb)	Moodys	6/18/2003	Assigned a rating of A1 for up to \$460 million of senior notes, due 2006.
UnumProvident Corporation	Moodys	6/18/2003	Withdrawn the Prime-3 commercial paper (CP) rating and affirmed the credit ratings.
Ohio Casualty Corporation	Moodys	6/16/2003	Assigned prospective ratings

Sources: AM Best Company ([ambest.com](http://ambest.com)), Fitch, Inc. ([fitchratings.com](http://fitchratings.com)), Moody's Investors Services ([moodys.com](http://moodys.com)), and Standard & Poor's ([standardandpoors.com](http://standardandpoors.com)).

*Continued on next page*

## Recent Rating Agency Actions for Insurance Companies (Continued)

	RATING AGENCY	DATE OF ACTION	ACTION
Prudential Public Limited Company	Moodys	6/16/2003	Assigned an A3 rating, with stable outlook.
QBE Insurance Group Limited	Moodys	6/13/2003	Assigned prospective ratings.
The St. Paul Companies	AM Best	6/13/2003	Affirmed the financial strength rating of A.
Business Men's Assurance Company of America	Moodys	6/13/2003	Confirmed the A1 insurance financial strength (IFS) rating.
Lumbermens Mutual Casualty Co.	S&P	6/12/2003	Lowered its ratings to 'D'.
MBIA Inc	Moodys	6/12/2003	Assigned prospective ratings
MLMIC Group	AM Best	6/12/2003	Downgraded the financial strength rating to B from B++.
Winterthur Insurance Group	Moodys	6/12/2003	Affirmed its A1 insurance financial strength and A2 senior debt ratings.
Coface SA	Moodys	6/11/2003	Assign its A1 rating to the proposed new Euro 250 million senior bond.
Coventry Health Care, Inc.	Moodys	6/11/2003	Confirmed ratings.
Lloyd's Syndicate 0033	Moodys	6/11/2003	Changed the outlook on the A- Good performance rating.
Lloyd's Syndicate 0457	Moodys	6/11/2003	Changed the outlook on the B Average performance rating.
Lloyd's Syndicate 3000	Moodys	6/11/2003	Assigned a positive outlook.
Lloyd's Syndicates 623 and 2623	Moodys	6/11/2003	Assigned a positive outlook.
Worldwide Insurance Company	Moodys	6/11/2003	Downgraded the insurance financial strength ratings.
Alleghany Corporation	Moodys	6/10/2003	Affirmed the Baa2 issuer rating.
Kemper Insurance Companies	AM Best	6/10/2003	Downgraded the financial strength ratings to D from C++.
Princeton Insurance Co.	S&P	6/6/2003	Lowered its counterparty credit and financial strength ratings to 'Bpi'.
PMA Capital Corporation	Moodys	6/4/2003	Assigned credit ratings.
WellPoint Health Networks Inc	Moodys	6/4/2003	Confirmed the debt ratings.
The Allstate Corporation	Moodys	6/3/2003	Assigned credit ratings.
The PMI Group, Inc.	Moodys	6/3/2003	Affirmed the A1 senior debt rating and the Aa2 insurance financial strength rating.
Endurance Specialty Insurance Ltd.	S&P	6/2/2003	Assigned its 'A-' counterparty credit and financial strength ratings
GE Financial Assurance Holdings Inc.	S&P	6/2/2003	Affirmed its 'A+/A-1' counterparty credit rating
Kemper Investors Life Insurance Co.	S&P	6/2/2003	Placed its ratings on CreditWatch with negative implications
Kemper Surplus Notes	Fitch	6/2/2003	Downgraded the \$700 million of surplus notes issued by Lumbermens (Kemper Insurance Companies Group), to 'D' from 'C'.
Scottish Annuity & Life Holdings, Ltd.	Moodys	6/2/2003	Assigned credit ratings.

Sources: AM Best Company ([ambest.com](http://ambest.com)), Fitch, Inc. ([fitchratings.com](http://fitchratings.com)), Moody's Investors Services ([moody.com](http://moody.com)), and Standard & Poor's ([standardandpoors.com](http://standardandpoors.com)).

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- 1999 Holdings of 5\* and 6\* Securities as Reported
- Education and Training Programs Available for Insurance Regulators

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- Insurers Investment in European Sovereign Debt

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- Default and Market Data Watch
- Recent Rating Agency Actions for Insurance Companies

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### Special Update #2

- NTL, Inc., Metromedia International Group Inc., and KirchMedia

### Special Update #3

- Adelphia Communications Corporation

### Special Update #4

- Insurers’ Exposure to WorldCom, Inc.

### Special Update #5

- Insurers’ Exposure to Qwest Communications International Inc.

### Special Update #6

- Update on National Century Bankruptcy

**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**

1411 Broadway  
9th Floor  
New York, NY 10018  
Phone: 212-398-9000  
Fax: 212-382-4206

**Web Address:**

**[www.naic.org](http://www.naic.org)**

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