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# SVO Research Quarterly

## Private Placement Bonds

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Private placement bonds account for about 18% of all bonds held by the insurance industry with over half a trillion dollars owned at the beginning of this year. But, there is little written about the private placement market. This article sheds some light on the basics of private placements and analyzes their recent rates of default.

Private placement bonds are exempt from the Securities and Exchange Commission's (SEC) registration requirements. The Securities Act of 1933 exempted bonds sold to sophisticated investors in a nonpublic manner. This exemption attracted a steady supply of capital from institutional investors led by large life insurers in search of higher returns and long-term fixed-rate assets to match their liabilities.

Figure 1 on page 2, from a 1993 Federal Reserve study, describes the spectrum of credit market characteristics of small bank loans, private placements and large public issues.

One advantage of investing in privates is that the details of the bond contract are negotiable. Some private deals include covenants that restrict the borrower's financial ratios or the amount of additional debt it can issue. Also, lead investors can meet with the borrower's management and gain a better understanding of the credit risk involved. Large institutional investors can afford to allocate resources to the analysis and monitoring of private companies.

On the other hand, restrictive SEC rules regarding the resale of these securities make traditional private placements less liquid than public bonds. Even so, with a higher yield, a liquidity premium should compensate for the lack of a secondary market.

In order to deepen the market, the SEC adopted Rule 144A in 1991; the rule allows sophisticated investors to buy and sell private placements freely among each other. Although 'traditional' private placements can be traded after a two-year holding period, Rule 144A created a large secondary market for private placements, increased foreign access to the private placement market and is used by public companies often.

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## Private Placement Bonds (Continued)

**Figure 1. Credit Market Characteristics**

| <i>Characteristic</i>  | <i>Market</i>      |                          |                    |
|--|--------------------|--------------------------|--------------------|
|  | <i>Bank Loan</i>   | <i>Private Placement</i> | <i>Public Bond</i> |
| Maturity   | Short              | Long                     | Long               |
| Rate   | Floating           | Fixed                    | Fixed              |
| Severity of information problems posed by the average borrower | High               | Moderate                 | Small              |
| Average loan size  | Small              | Medium to Large          | Large              |
| Average borrower size  | Small              | Medium to large          | Large              |
| Average observable risk level                                  | High               | Moderate                 | Lowest             |
| Covenants  | Many, tight        | Fewer, looser            | Fewest             |
| Collateral   | Frequent           | Less Frequent            | Rare               |
| Renegotiation  | Frequent           | Less Frequent            | Infrequent         |
| Lender Monitoring  | Intense            | Significant              | Minimal            |
| Liquidity of Loan  | Low                | Low                      | High               |
| Lenders  | Intermediaries     | Intermediaries           | Various            |
| Principal lender   | Banks              | Life insurance cos.      | Various            |
| Lender reputation  | Somewhat important | Most important           | Unimportant        |

Source: Board of Governors of the Federal Reserve, *The Economics of the Private Placement Market*, Mark Carey, Stephen Prowse, John Rea, and Gregory Udell, 1993.

The bulk of capital earmarked for private placements by insurers' investment managers was allocated to the industrial and utility sectors—roughly 91%. The data in Figure 2 comes from Schedule D Part 1A Section 1 where insurers report total private placement investments. Insurers reported in a footnote at the bottom of the schedule that out of the \$505 billion in private bonds held

at the end of 2004, \$186 billion or 37% were Rule 144A bonds.

The analysis of insurer investment in privates in Figure 3 on the next page confirms the general characteristics of the private placement market—Rule 144A securities tend to be covered by ratings agencies while traditional private

(Continued on page 3)

**Figure 2. 2004 Private Placement Bonds by Issuer Type (\$ Millions)**

| <i>Issuer Type</i>  | <i>Private</i>   | <i>% of Total Bonds</i> | <i>Total Bonds</i> | <i>Privates/Totals</i> |
|---|------------------|-------------------------|--------------------|------------------------|
| Industrial & Miscellaneous  | \$426,595        | 84.5%                   | \$1,679,142        | 25.4%                  |
| Public Utilities  | \$34,414         | 6.8%                    | \$161,233          | 21.3%                  |
| Parents, Subsidiaries and Affiliates                                      | \$16,871         | 3.3%                    | \$21,427           | 78.7%                  |
| All Other Governments   | \$10,620         | 2.1%                    | \$59,348           | 17.9%                  |
| Credit Tenant Loans   | \$8,517          | 1.7%                    | \$9,086            | 93.7%                  |
| Special Revenue & Special Assessment Obligations etc., Non-guaranteed     | \$3,766          | 0.7%                    | \$502,633          | 0.7%                   |
| Governments   | \$1,860          | 0.4%                    | \$307,549          | 0.6%                   |
| States, Territories and Possessions, Guaranteed                           | \$1,674          | 0.3%                    | \$67,575           | 2.5%                   |
| Political Subdivisions of States, Territories and Possessions, Guaranteed | \$258            | 0.1%                    | \$82,037           | 0.3%                   |
| <b>TOTAL</b>  | <b>\$504,574</b> | <b>100%</b>             | <b>\$2,890,030</b> | <b>17.5%</b>           |

Source: 2004 Life and Property/Casualty Annual Statements.

## Private Placement Bonds (Continued)

**Figure 3.**  
**Private Bonds by Market and Rating Status**

|              | Number of Bonds |              |               |            | Book Value (\$ Millions) |                  |                  |            |
|--------------|-----------------|--------------|---------------|------------|--------------------------|------------------|------------------|------------|
|              | Not Rated       | Rated        | Total         | % Rated    | Not Rated                | Rated            | Total            | % Rated    |
| Traditional  | 10,805          | 291          | 11,096        | 3%         | \$216,994                | \$12,853         | \$229,847        | 6%         |
| 144A         | 1,164           | 6,287        | 7,451         | 84%        | \$19,028                 | \$194,080        | \$213,108        | 91%        |
| <b>TOTAL</b> | <b>11,969</b>   | <b>6,578</b> | <b>18,574</b> | <b>35%</b> | <b>\$236,022</b>         | <b>\$206,932</b> | <b>\$442,954</b> | <b>47%</b> |

Source: 2004 Life and Property/Casualty Annual Statements, Schedule D Part 1 and Standard & Poor's CUSIP\_db service.

placements do not. This data comes from Schedule D Part 1 on which insurers report each long-term bond they own by CUSIP.<sup>1</sup>

A further analysis by NAIC designation in Figure 4 shows that private placements are mostly investment grade. The current absence of insurers from below investment grade markets is well documented. The Federal Reserve observed a credit crunch in the 1990s in this class of debt.<sup>2</sup> And, one labor economist blamed insurers' flight to quality for America's decline in manufacturing. Her logic was that mid-size firms were shut out of speculative grade private funding thus forcing the industry to contract.<sup>3</sup> Whatever truth there is to this claim, the flip side can also be argued: regulatory incentives to shift assets into investment grade bonds saved the insurance industry a lot of money when many of those smaller firms went belly up a few years ago.

In any event, the intermediary role insurers play in capital markets does not go unnoticed.

Another characteristic of the private placement markets that shows up in Figure 4 is in the bottom line. Note that insurers own similar dollar amounts of rated and unrated private placements, yet the number of rated bonds on insurers' books is a lot less than not rated bonds. This discrepancy results from the small number of investors on a typical traditional bond deal that usually only carries an

(Continued on page 4)

<sup>1</sup> The totals do not match between Tables 1 and 2 because of the different sources. Data in Table 2 was obtained partially via a third-party that might blur the distinction between Rule 144A and traditional bonds.

<sup>2</sup> Board of Governors of the Federal Reserve System. *The Economics of the Private Placement Market*. Washington, 1993: 62.

<sup>3</sup> "U.S. Private Placement Debt Markets in the 1990s" – Tessa Hebb, John F. Kennedy School of Government, Harvard University. United States Steelworkers. Labor Capital Strategies.

**Figure 4.**  
**Schedule D Private Bonds by Rating Status and NAIC Designation**

| Designation | Book Value (\$Millions) |                  |                  | Number of Securities |              |               |
|-------------|-------------------------|------------------|------------------|----------------------|--------------|---------------|
|             | Not Rated               | Rated            | Total            | Not Rated            | Rated        | Total         |
| Blank       | \$24,855                | \$959            | \$25,814         | 3,402                | 112          | 3,514         |
| 1/1FE       | \$72,001                | \$128,543        | \$200,544        | 3,382                | 3,508        | 6,890         |
| 2/2FE       | \$114,955               | \$58,882         | \$173,837        | 3,299                | 1,595        | 4,894         |
| 3/3FE       | \$14,821                | \$9,706          | \$24,527         | 705                  | 593          | 1,298         |
| 4/4FE       | \$5,073                 | \$6,726          | \$11,799         | 546                  | 439          | 985           |
| 5/5*/5FE    | \$2,607                 | \$1,419          | \$4,026          | 370                  | 141          | 511           |
| 6/6*/6FE    | \$1,308                 | \$698            | \$2,006          | 243                  | 190          | 433           |
| NR          | \$287                   | 0                | \$287            | 22                   | 0            | 22            |
| <b>All</b>  | <b>\$235,907</b>        | <b>\$206,933</b> | <b>\$442,840</b> | <b>11,969</b>        | <b>6,578</b> | <b>18,547</b> |

Source: 2004 Life and Property/Casualty Annual Statements, Schedule D Part 1 and NRSRO data feeds.

## Private Placement Bonds (Continued)

**Figure 5.**  
**One Year Traditional Private Placement Default Rates, 2000-2004**

|                       | 2000  | 2001   | 2002   | 2003  | 2004  | Weighted Avg. |
|-----------------------|-------|--------|--------|-------|-------|---------------|
| NAIC 1                | 0.00% | 0.18%  | 0.17%  | 0.16% | 0.22% | 0.13%         |
| NAIC 2                | 1.20% | 0.57%  | 0.48%  | 1.11% | 0.08% | 0.69%         |
| NAIC 3                | 1.70% | 2.24%  | 9.89%  | 0.51% | 1.37% | 3.32%         |
| NAIC 4                | 3.77% | 5.51%  | 9.45%  | 4.93% | 3.49% | 5.53%         |
| NAIC 5                | 6.67% | 32.94% | 24.49% | 9.18% | 4.35% | 13.16%        |
| SVO Investment Grade  | 0.41% | 0.34%  | 0.29%  | 0.56% | 0.16% | 0.36%         |
| SVO Speculative Grade | 2.91% | 7.18%  | 11.35% | 3.31% | 2.59% | 5.47%         |
| Issuers               | 4,376 | 3,690  | 4,104  | 4,573 | 4,159 |               |

Source: NAIC Valuation of Securities database.

NAIC designation and no NRSRO rating. Rule 144A bonds are sold to a larger set of investors and are rated.

### ■ DEFAULT RATES

The Asset Valuation Reserve framework essentially treats private placements the same as public bonds by assigning them the same risk-based capital weights. The 1993 Fed study referenced above supports this policy; it mentions that investors believe their loss experiences on private and public bonds are the same within credit-rating categories.<sup>4</sup> A study done nine years later by the Society of Actuaries (SOA), however, found that from 1986 to 1998 private placements lost less money than public bonds.<sup>5</sup> This section attempts to reconcile perception with the data by picking up where the SOA left off and examining the default rates of insurer-owned private placement bonds from 1999 to 2004.

The default rate is the number of traditional private placement defaults in any given year divided by the number of issuers present in both starting and ending years.

It groups defaults by the NAIC designation in the year prior to default. For consistency, it takes the highest designation in cases where one issuer has multiple designations. The source is the SVO Valuation of Securities (VOS) database. One-year default rates in the period from 2000 to 2004 for insurer owned traditional private placements are shown in Figure 5.

As a comparison, the Moody's issuer-weighted default rates are shown in Figure 6. Moody's universe includes corporate issuers and excludes private placements. Figure 7 on the next page plots the SVO's traditional private placement default rates alongside Moody's public default rates by broad ratings category. One trend that is apparent during this time period is that public bonds do not default more than privates in each year. This result does not support the SOA's findings of lower default rates

(Continued on page 5)

<sup>4</sup> Board of Governors of the Federal Reserve System. *The Economics of the Private Placement Market*. Washington, 1993: 25.

<sup>5</sup> Society of Actuaries. *1986-98 Credit Risk Loss Experience Study: Private Placement Bonds*. Illinois, 2002.

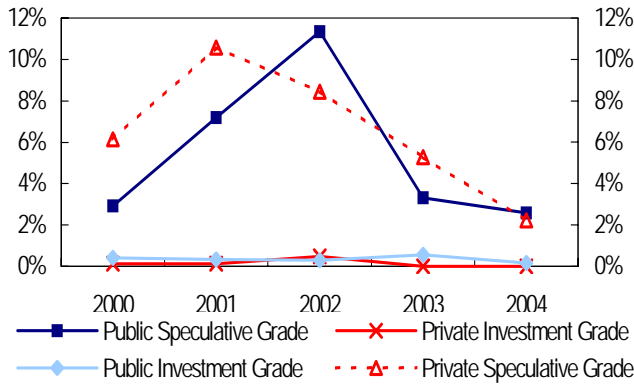
**Figure 6.**  
**Moody's One Year Default Rates**

|                           | 2000  | 2001   | 2002  | 2003  | 2004  |
|---------------------------|-------|--------|-------|-------|-------|
| Moody's Investment Grade  | 0.13% | 0.13%  | 0.49% | 0.00% | 0.00% |
| Moody's Speculative Grade | 6.14% | 10.58% | 8.45% | 5.27% | 2.23% |

Source: Hamilton, David H., et al. *Default and Recovery Rates of Corporate Bond Issuers, 1920-2004*, Moody's, 2005.

# Private Placement Bonds (Continued)

**Figure 7.**  
**Public vs. Traditional Private Default Rates**



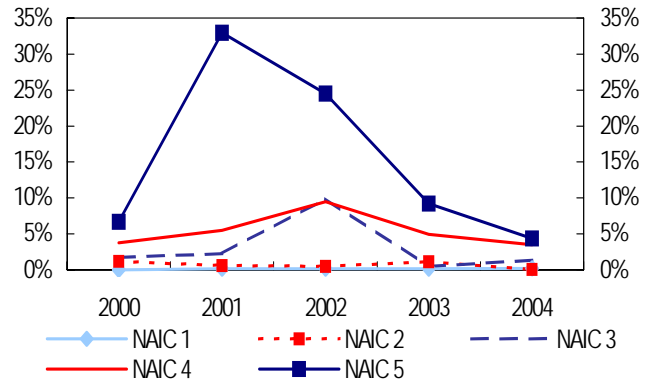
Source: Hamilton, David H., et al. *Default and Recovery Rates of Corporate Bond Issuers, 1920-2004*, Moody's, 2005.

losses in the private placement market. This could be due to differences in measurement between Moody's and the SVO.

Another trend is that both measures tracked general business conditions around the recession of 2001. This can be seen more clearly in Figure 8 which plots default rates of traditional private placements by NAIC designation. Rates diverged when the economy contracted only to converge again in a time of recovery. This data proves that issuers were put into designation categories based on their ability to withstand adverse economic conditions.

A long-term perspective tracking the default rates of all issuers present in the SVO database in 1999 and 2004 is

**Figure 8.**  
**Traditional Private Placement Default Rates**



Source: NAIC Valuation of Securities database.

provided in Figure 9. This table only includes those issuers on the VOS system in both years. In the 1999 cohort, traditional investment grade private placements defaulted more than public bonds, but not so with the lower rated issuers. Private placement default rates that are lower than the public market could be symptomatic of their decreased likelihood to land in bankruptcy courts on account of the covenants and tighter relationships between borrower and lender. **In any event, the skill of SVO analysts is proven by the data—default rates increase from NAIC 1 to NAIC 5.** This solid performance of NAIC designations is especially important for traditional private placement bond because they are rarely rated by NRSROs.

**Figure 9.**  
**5-Year Default Rates, 1999 - 2004**

|                   | Issuers in 1999 and 2004 | Number in default in 2004 | SVO Private Default Rate | Moody's Public Default Rate |
|-------------------|--------------------------|---------------------------|--------------------------|-----------------------------|
| NAIC 1            | 1,326                    | 12                        | 0.90%                    | 0.48%                       |
| NAIC 2            | 798                      | 30                        | 3.76%                    | 3.34%                       |
| NAIC 3            | 161                      | 24                        | 14.91%                   | 11.84%                      |
| NAIC 4            | 121                      | 23                        | 19.01%                   | 43.53%                      |
| NAIC 5            | 21                       | 12                        | 57.14%                   | 70.07%                      |
| Investment Grade  | 2,124                    | 42                        | 1.98%                    | 1.45%                       |
| Speculative Grade | 303                      | 59                        | 19.47%                   | 33.35%                      |

Source: Valuation of Securities database. Hamilton, David H., et al. *Default and Recovery Rates of Corporate Bond Issuers, 1920-2004*, Moody's, 2005.

# The SEC and the NRSRO Concept: Implications

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For almost three decades, the SEC has worked to incorporate credit ratings into federal regulations. Along the way, it has undoubtedly created a host of regulatory incentives not originally associated with private credit ratings. The agency has become embroiled in a public policy debate as to the need for regulation of the rating industry impelled perhaps by lack of appreciation of the limits of credit analysis. More recently, the SEC has been called upon to examine whether its use of the NRSRO concept stifles competition. Many of the problems the SEC complains about have their likely origin in the creation of the NRSRO concept. Yet, it is unlikely that the SEC will find it easy or cheap to create alternative mechanisms and so the chances are great that the discussion will continue.

The NAIC has always used NRSRO ratings for the purpose for which they were always intended, as one way to judge the likelihood that a debt obligation will be paid. And, until recently, the NAIC empowered its own credit expert to provide a measure of oversight into how NRSRO ratings were used in state insurance regulation. Whatever the SEC decision, the SVO will work closely with the Task Force to ensure that the interests of state insurance regulation are protected.

## ■ BEGINNINGS

The NAIC practice of using the ratings of the major credit rating organizations to assess the quality of insurer investments and set regulatory policy began in 1940. In that year, the NAIC adopted the New York approach that considered a security amply secured (and hence eligible for amortization accounting) if it was rated by one or more of the major rating agencies in the three highest categories. At the time and for the ensuing period, there was no question as to whose ratings should be used. The major, if not the only, rating agencies for a long time were Moody's Investors Service and Standard and Poors. In 1975, the United States Securities Exchange Commission (SEC) adopted the phrase "nationally recognized statistical rating organizations (NRSRO)" but did not define it. In the intervening years, the face of the securities landscape changed dramatically.

Complex investments, reflecting the growing ability to create products to suit every risk appetite, were becoming commonplace. This development required a corresponding state insurance regulatory response, which took the form of a total revision of the mission of the Securities Valuation Office (SVO). In place of a statistical credit rating approach and a two-symbol "amortization" decision, in

1989, the Valuation of Securities Task Force (Task Force) adopted a credit assessment methodology that relied on quantitative and qualitative judgments made by a professional credit staff. Reflecting long NAIC practice and a desire to conserve regulatory resources, the first step of the new methodology was to permit the SVO to translate the ratings of rating organizations into their equivalent NAIC designation. Attracted by this feature, new rating organizations, eager to exploit what was seen as a new business opportunity (i.e., state regulatory approval of the rating organization which could be marketed to insurance companies), and influenced perhaps by the SEC NRSRO process, asked to be "approved" by the NAIC. In this environment, the Task Force instructed the SVO to create and maintain a list of rating organizations designated as an NRSRO by the SEC. As a result, traditional alphanumeric rating of NRSROs on the NAIC list would be presumptively eligible for conversion into an NAIC Designation, subject to specified conditions, a status denied to rating organizations that were not SEC designated NRSROs.

At the time, and until December 31, 1999, the SVO was the intended beneficiary of the NAIC NRSRO decision. Insurance companies reported NRSRO rated securities they owned to the SVO and the SVO, wherever possible and after fundamental due diligence, translated NRSRO ratings into NAIC Designations. However, effective January 1, 2000, the Task Force adopted a provisional filing exemption (PE) and effective January 1, 2004, a filing exception (FE) that permit insurance companies to assign an NAIC designation equivalent to NRSRO rated securities, curtailing in one case and eliminating in the other, the requirement of a filing with the SVO. Insurance companies now conduct the translation of ratings into NAIC designations subject to oversight rules administered by the NAIC.

The use of public ratings by the NAIC has always reflected an understandable desire to conserve regulatory resources. Conservation is achieved when expenses incurred to obtain and integrate NRSRO ratings into the regulatory process produces a large number of ratings on insurer owned securities. An SEC administered rule that limits NRSRO status to a few well capitalized, known and respected organizations with national and international rating presence, capable of expressing credit opinions across the broadest segment of the universe of rated securities that insurers are likely to own clearly promotes resource conservation. Since 1991, however, developments within the rating industry and the manner in which the SEC administered its NRSRO rule ensured precisely this benefit. However, more recently, for a number of reasons, the SEC appears to be engaged in a process that could

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## The SEC and the NRSRO Concept: Implications (Continued)

result in the expansion of the NRSRO list. This shift could fundamentally alter the cost-benefit assumptions underlying the current NAIC process. This article seeks to place the SEC's NRSRO rule in its historical perspective, discuss possible implications of the recent proposal to formally define the phrase NRSRO in the federal securities law and offer some thoughts as to possible NAIC response options.

### ■ DEVELOPMENT AND EVOLUTION OF THE NRSRO CONCEPT

1. **1975—The Uniform Net Capital Rule** The phrase NRSRO was introduced into the federal securities laws in 1975 by the SEC as an amendment to the uniform net capital rules as a way of determining capital charges on different grades of debt securities. Broker-dealers could set favorable haircuts for proprietary positions in securities rated by at least two NRSROs in the highest rating categories.
2. **1992—Define or Regulate** Over time, use of the NRSRO phrase in federal regulation prompted several SEC Commissioners to call for legislation that would permit the SEC to regulate rating organizations. These Commissioners reasoned that the most analogous federal regulatory scheme, the Investment Advisors Act, applied “awkwardly at best” and that it was not “entirely certain” that the SEC could require rating organizations to register under the Act, given the US Supreme Court decision in Lowe V. SEC, interpreting the Act's publisher's exclusion. Only legislation could clarify these issues. However, SEC Chairman Richard Breeden and others did not believe legislation was needed or appropriate. They were concerned that market participants would rely on the regulator's approval, rather than their own assessment of the rating agency's quality. He wanted the SEC to focus on strengthening the market disciplines that would ensure rating agency quality.

In the absence of legislation, the SEC could only influence the industry via the no-action letter process it used to designate rating organizations as NRSROs under its net capital rules. Under the procedure, developed by the SEC's Division of Market Regulation (the “Division”), when an applicant met defined criteria, the Division drafted a letter stating that the staff “will not recommend action to the Commission if broker-dealers consider the particular rating agency an NRSRO for purposes of the net capital rule.” The Division would present the letter to the Commission for its review. If the Commission did not object, the Division would send the letter to the rating

organization. By 1991, the Division had an outline of criteria it could provide to applicants, the most significant of which was “national recognition, i.e. that the rating organization is recognized in the United States as an issuer of credible and reliable ratings by the predominant users of securities ratings. The development of the no-action process reflected the opinion of many that by then, the phrase NRSRO “... (had) in fact become such an integral part of the federal regulatory scheme... [that its]... discontinuation... (was) probably not a realistic alternative.”

3. **1994—The Concept Release** Responding to concerns over the continuing increase in use of the NRSRO phrase, on August 31, 1994, the SEC issued a concept release asking for comments on six basic questions: 1) should the SEC continue to use the term NRSRO in its rules; 2) should it adopt a definition and what criteria should be employed in such a definition; 3) was the current no-action letter process satisfactory; should it be formalized 4) was it appropriate for NRSROs to charge issuers for their ratings; 5) should limited scope ratings and those applied to structured securities, be encompassed within the NRSRO process; 6) should further steps be taken to increase regulatory oversight of NRSROs such as seeking additional legislative authority, requiring registration with the Commission or other similar measures.

Fitch responded that no one would purchase a rating deemed to be unreliable. So rating organizations had an incentive to keep rating quality high and themselves honest. Moody's urged the curtailment and eventual elimination of the NRSRO concept and the adoption of some other alternative. The concept erroneously implied that all rating agency ratings impact bond prices, correlate to actual default experience, or are congruent to the rating scales of other NRSROs. The concept also altered the focus of the user from market to regulatory considerations and introduced incentives that could erode analytical standards in favor of market share considerations. And, it wasn't even clear if reliance on ratings served or obscured actual regulatory needs. Finally, even if the SEC overcame the constitutional problem inherent in regulating first amendment speech, it could only create a “generally accepted rating practices” standard based on objective measures, in an area where subjective measures were of greater importance.

4. **1997—The Proposed Amendment - Definition of NRSRO** The SEC nevertheless determined that most 1994 Concept Release commenters supported the

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## The SEC and the NRSRO Concept: Implications (Continued)

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continued use of the NRSRO concept and wanted a more formalized NRSRO designation process. Accordingly, on December 17, 1997, it released a proposal to amend the net capital rule to add a definition of NRSRO in a new paragraph 13. The focus of the Commission's review would continue to be "US national recognition." Moody's reiterated its continued objection to the use by the SEC of ratings in regulation and again opined that the true measure of "national recognition" was whether an applicant's ratings: impacted bond prices; demonstrated a tight correlation over time with actual default experience and showed substantial congruence with that of other NRSROs. In the absence of such an approach Moody's urged that the only relevant criteria that could be employed was "recognition of the rating organization in the United States as an issuer of credible and reliable ratings by users of securities ratings." Duff and Phelps agreed with the proposed SEC approach but urged greater emphasis on certain criteria. Egan-Jones expressed concerns that the proposal would create insurmountable barriers to new competition. Nippon Investors Services, Inc. and the Japan Bond Research Institute thought the rule would increase clarity, limit arbitrariness and lend objectivity to the staff review process but that the US national recognition requirement would perpetuate an unworkable standard for foreign rating agencies. The Japan Credit Rating Agency ("JCRA") argued that the NRSRO designation process amounted to regulation and the SEC lacked authority to regulate NRSROs. JCRA also thought that placing regulatory authority in the hands of rating organizations was an inappropriate exercise of its authority. JCRA believed that the market alone should determine which rating agencies provide credible and reliable ratings and that the SEC should employ some other means to accomplish its regulatory objectives.

5. **2002—Public Policy Considerations - Barrier to Entry** In March of 2002, the SEC issued an Order of Investigation into the role of the rating agencies in the US securities markets. The SEC said it wanted information to help it determine whether to continue to use credit ratings in its administration of the federal securities laws. Later that same year, SEC Commissioner Isaac C. Hunt told a Senate Committee that the SEC intended to explore whether the national recognition standard was dampening competition in the industry. He explained that although the national recognition standard was adopted as a way to let the market and not the government identify who should be designated an NRSRO, many commenters criticized it because they believed it created a disincentive to the

use of non-NRSROs ratings. The SEC, he said, has therefore determined "to examine the competitive impact of the Commission's use of the NRSRO designation." Chairman Pitt confirmed these concerns in a speech before the Bond Market Association's Annual meeting later that year, stating that if hearings indicated that the NRSRO rule inhibits competition, "then we will either eliminate the rule or modify it to prevent an anticompetitive effect at the hand of the government."

In two days of hearings in November 2002, many market participants presented their view on the issues. Moody's highlighted the increasing and often conflicting uses and expectations of ratings. "Moody's ratings provide a predictive opinion on one characteristic of a corporate entity's financial enterprise—its likelihood to repay debt in a timely manner... However, our ratings... have become tools employed by... (many groups)... (and each) group has a different intended objective in using ratings. Thus the rating, ... has taken on multiple and sometimes conflicting roles and functions within the capital markets. (And)... the performance or "quality" of ratings has been subject to multiple interpretations, in some cases incompatible with the stated purpose of ratings... Furthermore, most market participants, ... express no desire... (in obtaining)... many ratings on a single instrument... What issuers desire is greater ability to select among ratings providers for purposes of having greater control over the ratings outcome, which they perceive will positively influence the marketability of their debt. Therefore, only a limited number of agencies will attain an issuer's business, regardless of the aggregate number of ratings competitors... (And since) ... new market entrants and marginal participants... make their products more attractive to issuers by offering higher ratings than do more established participants... Moody's believes that the usefulness of credit ratings in the aggregate... would decline in the event more (NRSROs) are established ..."

6. **2003—Report to Congress and Concept Release** In 2003 the SEC delivered its study of the credit rating industry. It concluded that as a technical matter, barriers to becoming a rating agency appeared to be quite small but barriers to "building a successful rating agency ... are substantially greater." The SEC also noted the widespread perception that the dominance of a few highly regarded, well-capitalized rating agencies was one of the most significant barriers. (The SEC nevertheless acknowledged that from relatively few rating agencies through the 1970s, there were more

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## The SEC and the NRSRO Concept: Implications (Continued)

than 100 active credit rating agencies worldwide.) The SEC noted that a wide range of observers criticized the NRSRO concept and particularly national recognition, as a “substantial” barrier to entry. Therefore, some suggested eliminating the NRSRO concept from regulation. The SEC then stated that while it had made substantial progress in understanding the role of the rating industry in the capital markets a number of issues still required study, including whether it should expressly permit a rating organization that covers specific market segments or those that confine their activities to limited geographical areas to be designated an NRSRO. In order to explore these issues, the SEC released a Concept Release on June 2003 in which it explained that a “fundamental threshold matter” was “... the appropriate degree of regulatory oversight that should be applied to credit rating agencies.” The SEC would receive 46 comments to its list of 56 questions.

7. **2005—Proposed Rule-Making** In order solely, “to address the meaning of NRSRO as it is used by the Commission” and in partial response to the 2003 Concept Release, on April 19, 2005, the SEC issued a proposal to define the phrase NRSRO in new Rule 3b-10 of the Exchange Act. Of the 46 persons who submitted comments in response to the 2003 Concept Release, “most supported retention of the NRSRO concept,” concerned both with market disruption and the cost and effort to replace it. And, most supported a clarification of the NRSRO designation process. Accordingly, the SEC proposed to define NRSRO as:

“an entity (i) that issues publicly available credit ratings that are current assessments of the credit worthiness of obligors with respect to specific securities or money market instruments; (ii) is generally accepted in the financial markets as an issuer of credible and reliable ratings, including ratings for a particular industry or geographical segment, by the predominant users of securities ratings; and (iii) uses systematic procedures designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of nonpublic information, and has sufficient financial resources to ensure compliance with those procedures.”

Perhaps predictably, given the nature of the comment process, small and foreign rating organizations agreed with the SEC that the rule should permit NRSRO designation on the basis of expertise in specific market segments or geographical areas. Some commenters thought the proposal was vague. Some, that the

proposed definition would entrench the current NRSROs who already met the desired attributes. Some, that the fundamental problem with NRSROs is the result of regulatory dependence on the concept. These commenters urged the SEC to: stop using the concept altogether, stop delegating safety and soundness decisions to private entities and start making appropriate changes to their internal regulatory process. Let the financial markets reach their own conclusions as to which organizations are reliable.

### ■ REGULATORY CONSIDERATIONS

The NAIC decision to create its own credit rating and investment specialist organization to assess credit quality of insurer owned investments reflects a regulatory decision to constrain insurer company investments by reference to credit quality, among other factors. The decision to use publicly available credit ratings of the major rating organizations reflects the need to conserve state regulatory resources by relying on the opinions of the most reliable and professional of such organizations. If the SEC were to discontinue the NRSRO concept, the NAIC would have to consider whose credit ratings to incorporate into its valuation process. However, the same challenge may be presented to the NAIC if the SEC adopts the proposed rule. We set forth some of the implications of the proposed definition.

1. **Regulatory Rating Profile** The SEC has identified what it thinks are the fundamental characteristics of ratings used for regulatory purposes. Such a rating would be: publicly available, security or obligation specific, a current assessment, produced by a rating organization with general acceptance in the financial markets by the predominant users of such ratings by the use of systematic procedures designed to ensure credible and reliable ratings, manage conflicts of interest and prevent misuse of non-public information. Public availability is deemed to guarantee broad market review and hence reliability. Only an obligation specific rating reflects the actual terms written into the security’s legal documentation. And only ratings actively monitored and updated on an appropriate basis provide the needed comfort to underpin regulatory decisions. Clearly any proposed definition would tend to be treated as a judgment as to best practices.
2. **Comparability of Ratings** The NRSRO designation process treats each agency’s rating scale as if similar levels of risk were associated with similar rating symbols. Many continue to argue that ratings symbols of organizations should be based on annual transition, default studies and criteria and methodology reports

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## The SEC and the NRSRO Concept: Implications (Continued)

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that describe the performance of ratings over time by ratings categories or other statistical studies. This suggests that as more NRSROs are designated, there would be a greater need for regulators to make adjustments between the ratings of different organizations to account for systematic differences. Without such a mechanism regulators may find it hard to justify that the rating systems of different NRSROs mean the same thing.

3. **Transparency** Some have argued that in order to judge whether a particular rating agency's credit opinions have value, one needs to understand how those opinions were formed. The larger the number of NRSROs opinions, the more likely that the process will require analytical intervention from the SVO decreasing regulatory efficiencies.
4. **NRSRO Creep** It is disingenuous to say that NRSRO status of specialty rating organizations would be limited to their area of expertise. A determination that users of ratings in a market segment believe a rating organization's ratings are "credible and reliable" is a judgment on the quality of the staff and the procedures and standards it adheres to. Why would someone say the organization would be any less credible and reliable as it expands into other business segments? Regulators could therefore expect to have to decide whether to prohibit the use of these ratings in specific markets or accept the development without an examination of the relative value of these ratings.
5. **Reduced Regulatory Conservation** The SEC clearly contemplates permitting rating organizations whose expertise is limited to a given market segment or geographical area to qualify as NRSROs. As the number of NRSROs increases, so does the likelihood that they will have varying degrees of coverage of insurer owned securities. The NAIC would want to consider whether the percentage of the total rated portfolio of insurer owned securities that is actually rated by any given NRSRO justifies the cost associated with obtaining the rating. And, among NRSROs with the same or similar ratings coverage, there is the

additional issue of redundancy. While it may be useful to have two or three opinions on an obligation, it is questionable whether 4, 5 6 or 10 such opinions add any additional value. In fact, it may complicate decision making significantly.

### ■ POSSIBLE RESPONSES

1. **Modify Current Rule by Adding Coverage Test** The NAIC could make it a condition for listing on the NAIC List that the rating organization have coverage of the rated securities markets that bears some reasonable relationship to the portfolio of assets held by an insurance company, either by degree, composition or percentage. The ratings of these rating organizations could be granted the presumption or convertibility so securities rated by these organizations could be eligible for the filing exempt rule. As a corollary, insurance companies could be permitted to use the ratings of any other or all other rating organizations subject to a requirement of an SVO review.
2. **Accept all Ratings** Accept the rating of any rating organizations but adjust the ratings equivalent table to ensure an appropriate correspondence between the meaning of a specific category of a rating organization and a corresponding NAIC designation definition. There would be no organized SVO participation under this option but regulators could instruct companies to file securities with the SVO for review if they were concerned with the ratings on those securities.
3. **Shift Analytical Burden to Insurers** Shift to insurers the obligation to provide evidence that a rating of a specific rating agency should be converted into a given NAIC designation. Require insurers to justify the use of a specific rating and to include the justification in documentation for examination. Provide standards delineating the requisite "quality" of ratings eligible for inclusion in this process. Require that as part of the examination process, a representative sampling of these justifications would be selected for review by the SVO.

# Collateralized Fund Obligations: A CDO Innovation

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## ■ INTRODUCTION

Collateralized debt obligations (CDOs) are a product of structural innovation borne out of the need to meet the diverse demands of an expanding investor base. CDOs are among the fastest growing segments in the asset-backed security market. While the majority of CDOs are backed, as the name suggests, by debt assets (i.e. bank loans and bonds) the newest CDO innovation, the Collateralized Fund Obligation (CFO), uses hedge funds and private equity as underlying assets.

## ■ THE STRUCTURE OF CFOS

Most collateralized fund obligations are structured similarly to market value<sup>1</sup> arbitrage CDOs<sup>2</sup> (Figure 1). A special purpose entity (SPE) is established offshore as a bankruptcy remote vehicle which purchases hedge funds, private equity funds or funds of funds (a fund that invests in other funds) that will serve as the underlying assets for the CFO. The acquisition of these assets is funded by issuing securities in the capital markets. These securities are issued in tranches bearing different ratings that reflect their respective risk/return features to appeal to a diverse

investor base. The ratings of the tranches are supported by the existence of certain credit enhancements, liquidity facilities, hedging and subordinated tranches. Just like in a market value CDO, the manager of a CFO strives to maximize total return gains by allocating the underlying assets accordingly, while restraining price volatility within the guidelines of the structure.

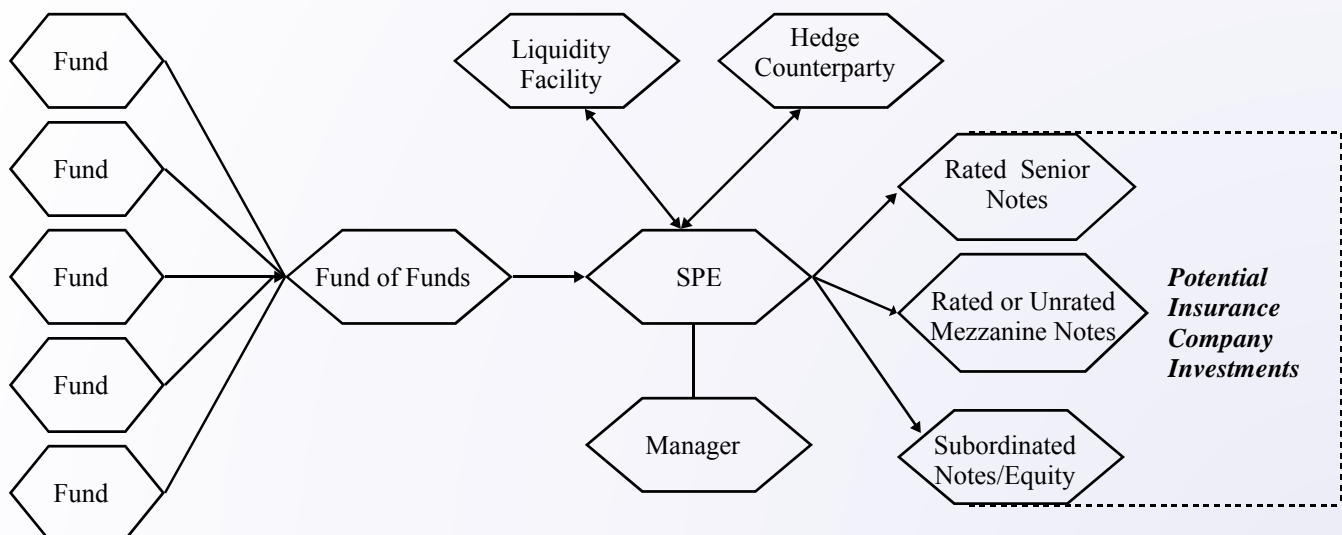
CFO investors receive interest payments that come from the realized capital gains on the underlying fund of funds. However, if the underlying asset is mostly private equity such coupon income as a result of market value gains is less common. Other sources for coupon payments are liquidity facilities (i.e. revolvers or cash reserve accounts) and unused proceeds.

The payments are prioritized according to the rated and the unrated tranches of the CFO. The credit rating agencies evaluate and assess the risk of the entire CFO and each of its tranches in order to issue ratings that accurately reflect such risks, from AAA in the top senior tranche to unrated in the bottom equity/residual tranche. By tranching the

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<sup>1</sup> In a market value CDO, payments to investors are contingent on the adequacy of the collateral's market value, which is periodically calculated.  
<sup>2</sup> "Moody's Approach to Rating Collateralized Funds of Hedge Fund Obligations," Moody's Investors Service (July 10, 2003).

**Figure 1. Basic CFO Structure**



## Collateralized Fund Obligations: A CDO Innovation (Continued)

CFO, the total risk is effectively redistributed from the senior tranches to the lower tranches allowing the CFO's AAA tranche to command a comparable yield to other AAA CDOs plus a premium.

The credit ratings of CFOs, as in market value CDOs, are based on advance rates<sup>3</sup>. The advanced rates for the CFOs are based on the historical price volatility of the underlying assets, liquidity features, formal simulations and a formal due diligence process. In the event of an overcollateralization test failure, i.e. when the liabilities exceed the market value of assets (discounted by the appropriate advance rates), the investment manager is afforded a certain pre-agreed time, a cure period, to take whatever remedial measures needed in order to restore the balance.

The only difference for CFOs is that cure periods are usually longer than other CDOs due to the lower liquidity of the underlying fund investments. In the case of private equity CFOs ratings are based more on stress simulations given the lack of real data to access historical price volatility.

### ■ PRIVATE EQUITY

The private equity "market" has grown significantly over the last decade—over \$400 billion has been invested in private equity funds since 1990—and has attracted the attention of many institutional investors. Although private equity has become an established asset class that is now well integrated within long-term institutional investment strategies, it is important to understand its unique nature and characteristics.

The world of private equity investments, whether through venture capital or buyouts, is highly opaque and frequently illiquid. Information on private equity does not flow as freely as information on the public markets. Private equity funds do not usually publish their returns. Non-disclosure is highly valued, especially by managers of the top-tier private equity funds eager to safeguard their competitive advantage over other funds.

The lack of free-flowing information, along with the absence of any meaningful publicly available pricing and monitoring system, suggests that there is no private equity "market" as such, at least in terms of secondary market activity. These non-market attributes of private equity add extra value to exclusive information allowing investors to reap higher returns—relative to public market investment—by capturing new and unique opportunities.

Investors usually cannot withdraw during a private equity fund's life due to the closed-end structure of these funds.

This illiquid nature of private equity investments makes liquidity risk one of the principal risks of this asset class meaning that private equity generally has a part mainly in a long-term investment strategy.

Investors in private equity are primarily motivated by the higher expected returns over public equities since historically, private equity returns have outperformed public equities. Also, another motivating factor is private equity's low correlation to other investments, suggesting that it can be a valuable portfolio diversifier.

Due to the many complexities and idiosyncracies of private equity investment, an appropriate way to capture the benefits of this asset class while reducing the risks is through a private equity fund of funds. A fund of funds allows for broader diversification and can provide investors with more ready access to the top-tier funds and professional monitoring services.

### ■ HEDGE FUNDS

Hedge funds have attracted, as S&P Structured Finance Ratings group has reported, the largest cash inflows in history.<sup>4</sup> Assets under management in the hedge fund industry, according to the TASS Asset Flows report, have grown from U.S. \$50 billion at the end of 1993 to around \$1 trillion so far this year and are expected to reach \$2 trillion by 2009.<sup>5</sup>

Although the interest in hedge funds by investors has slowed during the second quarter of 2005, posting the smallest net inflow since the fourth quarter of 2001, hedge funds still took in almost \$12 billion in new assets in the second quarter. This was markedly lower than the net gain of more than \$24 billion the industry recorded in the first quarter, but still significantly higher than the \$7 billion gain in the second quarter of 2004.<sup>6</sup>

While historically, hedge funds have performed impressively, with the Standard & Poor's Hedge Fund Index gaining 40.16% during the last five years, in a sharp contrast with the S&P 500 Index, which recorded a 16.55% loss for the same period, recently they have not fared quite as well. At the same time, hedge funds continue to provide positive returns posting a 1.96% year-to-date return (through September 28th) according to S&P Hedge Fund Index while the CFSB/Tremont Hedge Fund Index<sup>7</sup> is up 4.20% for the year (as of September 1<sup>st</sup>).<sup>8</sup> Institutional

*(Continued on page 13)*

<sup>3</sup> Advance rate is an asset-specific percentage of the collateral's market value and should always exceed the book value of the liabilities.

<sup>4</sup> "Hedge Fund of Funds to Tap into Securitization Technology," Standard & Poor's (May 2, 2004).

<sup>5</sup> "Hedge Fund Demand May Damp Overhaul," The Wall Street Journal (September 29, 2005).

<sup>6</sup> "Tremont Asset Flows," Tremont Press Release (August 3, 2005).

<sup>7</sup> Standard & Poor's Indices (September 29, 2005).

<sup>8</sup> CFSB/Tremont Hedge Fund Index Performance Review (September 1, 2005).

## Collateralized Fund Obligations: A CDO Innovation (Continued)

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investors are attracted by the portfolio-enhancing value of hedge funds. Alternative assets such as hedge funds and private equity can provide investors with the desired portfolio diversification because they have very low correlation to other asset classes.

In contrast with traditional investment funds, hedge funds are less transparent, less regulated and less constrained in their business activities and investing plans. The inefficiencies of the hedge fund market, especially the informational inefficiency create the potential of adding value through active management (i.e. achieving informational advantage). Skilled and sophisticated hedge fund managers enjoy a significant competitive advantage over their less experienced counterparts in adding value for the investors. It has become very difficult for a single investor to understand the dynamics and complexities of the hedge fund market in order to determine how to best devise an appropriate investment strategy.

Risk minimizing direct hedge fund investment strategy would require creating a diversified portfolio of hedge funds. The objective difficulties of implementing such an investment program (minimum investment requirements, selection, monitoring etc.) has turned investors to funds of funds, that can diversify away any idiosyncracies of single hedge funds, as the preferred investment vehicles for gaining exposure to a large pool of hedge funds. Given the high dispersion of returns among hedge fund managers, fund selection is an essential and critical value-added function. An experienced fund of funds manager can identify the best hedge funds and help investors maximize their returns.

The advantages in investing in a fund of hedge funds (adding value through hedge fund manager selection, portfolio construction and monitoring of investments) as opposed to a single hedge fund, have helped increase the assets that funds of funds currently manage (to approximately 25% of total hedge fund assets).

### ■ COLLATERALIZED FUND OBLIGATIONS

It is exactly this type of fund of funds (hedge fund, private equity or some mix of both) that serves as the underlying asset for the collateralized fund obligation (CFO). The lack of transparency, liquidity and credit protection that

characterize the private equity and hedge fund marketplaces has created the demand for the securitization of such alternative assets. By investing in a product with a similar capital structure to that of a CDO, but with a fund of funds as collateral, the investors can access the private equity and hedge fund markets without encountering many of the associated problems. The CFOs create a more transparent and efficient private equity and hedge fund market through the rating and monitoring of certain tranches by S&P, Moody's and Fitch.

CFOs can offer the fixed income investor predictable income and cash flows like any other fixed income product. The major distinguishing and novel feature of a CFO is that the underlying cash flows are dependent on the performance of an alternative asset as a fund of funds. Investors can, by investing in CFOs, take advantage of the unique risk, return and correlation characteristics of private equity/hedge fund of funds vis-a-vis traditional credit markets and thus diversify their portfolios.

Those investors that choose to invest in CFOs, instead of directly investing in a fund of funds, benefit from the embedded credit protection of the CFO structures. Investors are protected by a variety of tests (i.e. overcollateralization and coverage tests depending on the structure) performed to ensure the continuing health of these structured products.

The fund assets are tranching into different risk/return tradeoffs making them more appealing to many investors that would not otherwise be able to or interested in investing directly in the underlying asset.

### ■ CONCLUSION

The development of CFOs, as the newest financial innovation, opened up the hedge fund and private equity markets to institutional investors increasing capital flow to such funds. Just like CDOs, CFOs are expected to significantly impact the existing markets for the underlying assets by adding liquidity, transparency and expanding the investor base. CFOs allow institutional investors to indirectly gain access to alternative investments while mitigating the risks involved in investing directly in hedge funds and private equity.

# SVO CHEMICALS MEDIANS vs. Moody's and S&P

## *The Case for Investment Grade Ratings for Companies Considered Too Small by Moody's and S&P*

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### ■ DO SMALLER COMPANIES DESERVE INVESTMENT GRADE DESIGNATIONS?

When the NAIC-Securities Valuation Office 2004 medians for the Chemical Industry<sup>1</sup> are compared with those of Moody's and S&P, there are notable similarities and differences. One similarity is that for all three rating entities, there was a clear correlation between the ratios and the ratings assigned. Size, in terms of sales and equity, coverages, and cash flow-to-debt are all highest, and total debt to total capital, and debt-to-cash-flow are all lowest at the investment grade ratings level. And there is a clear progression at the other levels, too.

But, what is most noteworthy about the SVO medians are the differences in ratings distribution and size of company. A higher proportion of the NAIC chemicals universe is rated investment grade than for Moody's and S&P, and the companies are smaller. Is there a justification for the SVO to have more investment grade issuers or for smaller companies to receive an investment grade designation? Yes, as the rest of this study will demonstrate.

### ■ OVERVIEW

There are several reasons why the SVO chemicals universe has smaller-sized companies and a higher proportion of investment grade designations.

1. Moody's and S&P's preference for larger-sized companies could result in insurers having no investment grade credits.
2. The reported NAIC proportion of investment grade designations is distorted by the fact that not all of the companies in the NAIC universe are included.
3. The SVO universe has a higher proportion of European borrowers.
4. Private placements obtain tighter covenants than those for public offerings.
5. The SVO's private placements are concentrated in Specialty Chemicals companies, which are more stable than commodity chemicals.
6. Most importantly, the companies in the SVO chemicals portfolio show better performance in terms of cash flow to debt or interest expense, as measured by the following ratios: higher Cash Flow to Debt, higher Adjusted EBIT and EBITDA Interest Coverage, higher Return on Capital, and better profit margins.

### ■ RATINGS DISTRIBUTION

The sampling size for each rating entity was roughly similar in being under 100. S&P had the largest sample with 75 companies, compared to the SVO at 49, and Moody's at 44. But, the ratings distributions appear different. For both Moody's and S&P, 48% of their portfolios are rated investment grade, which is the equivalent of an NAIC-1 or -2. But, for the SVO, the proportion is 61%. What is the reason?

First, not all of the companies in the SVO universe are included; for certain low-rated companies (NAIC-5\*<sup>2</sup>, NAIC-6\*<sup>3</sup>, and NAIC-6), financials were lacking and calculation of medians was not possible. When compared to the full universe of 60 companies, the real proportion of investment grade designations could be much smaller, amounting to 50%. But, even if that were not the case, the SVO believes insurance companies seek the highest yields with the lowest RBC charge/highest NAIC designation possible. Third, in the overall Chemical Industry including both basic and specialty chemicals companies, a large proportion of these investment grade companies are either European companies or subsidiaries of European companies that are strong credits. Two-thirds of the issuers at the NAIC-1 level (as well as a third of the NAIC-2's) are European companies. Fourth, specialty chemicals, the bulk of the SVO portfolio, play key roles in product functionality but are relatively inexpensive; thus customers are more willing to pay the price for them, making these chemicals generally less cyclical than basic commodity chemicals and thereby deserving of higher ratings. Fifth, private placement debt usually has tighter bond covenants than public debt issues.

### ■ SIZE OF COMPANY

The chemicals universe rated by the SVO consists of smaller companies than those rated by Moody's and S&P. For S&P, the medians for revenue-size range from \$1 billion to \$5.8 billion, and for Moody's, which uses asset-size, the range is from about \$0.8 billion to \$8.4 billion. The SVO-rated companies are much smaller, ranging from about \$60 million to \$1.0 billion in revenue.

Should the SVO's size medians follow those of the NRSROs? First, if the SVO were to follow S&P medians for size, there would be absolutely zero investment grade

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<sup>1</sup>This report does not describe NAIC's rating process or the particular ratios used for rating designations, but instead reflects use of standard ratios in order to permit comparison with Moody's and S&P. Second, the ratio medians are not intended as a guide to determine the NAIC designation of any given issuer. Third, they have been computed after issue-specific adjustments made by the industry analyst. And finally, note that ratio analysis is only part of the NAIC rating process: qualitative factors, macro/micro economic and industry issues, and expected future performance are also considered as an integral part of the rating process.

<sup>2</sup>NAIC-5\* corresponds to NRSRO ratings in the CCC+-C range. The asterisk means either a full credit analysis could not be made due to lack of documentation or assigned pursuant to policy decisions adopted by the SVO.

<sup>3</sup>NAIC-6 corresponds to NRSRO ratings in the "In or Near Default" category.

## SVO CHEMICALS MEDIANS vs. Moody's and S&P (Continued)

### *The Case for Investment Grade Ratings for Companies Considered Too Small by Moody's and S&P*

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designations in the chemicals portfolio. For example, at the NAIC-4 level (equivalent to a single-B rating), S&P's median is \$1.0 billion, but for the SVO, that size, \$1.0 billion, fits the highest rating grade. Thus, if the SVO used the S&P size medians as criteria for its rating designation, all of the NAIC-1 rated chemical companies would become NAIC-4! Indeed, if S&P medians were used as benchmarks, then 82% of the SVO companies, which are smaller than \$1 billion in sales, would be rated NAIC-5.

There appears to be a sound justification for the higher ratings, despite the smaller size. The SVO is of the opinion that asset size alone should not be a primary factor or an arbitrary cut-off for an investment grade credit rating. The SVO views all aspects of an entity's credit to be important, particularly financial aspects.

In fact, the SVO portfolio generally shows better financial performance than in the NRSRO universe, particularly when cash flow is part of the credit assessment formula:

- Cash Flow to Debt: At the NAIC-1 level, SVO companies have a ratio of 48.1% versus S&P's 42.5% and at the NAIC-2 level, the SVO ratio is 26.3%

versus S&P's 22.3%. As the Moody's definition is somewhat different, a conclusion is not drawn.

- Rent-adjusted EBIT interest coverage. Overall, NAIC SVO shows higher medians than S&P. The Moody's definition is too different to comment.
- Rent-adjusted EBITDA interest coverage. Again, the NAIC SVO medians are higher than those of S&P. There is no data from Moody's.
- Return on Capital. The NAIC SVO universe shows higher return on capital in all rating categories, except at NAIC-1 level, than both Moody's and S&P.
- Profit Margin (loosely, "Operating Margin"). Remarkably, except for at the NAIC- 2 level, all of the NAIC SVO profit margin medians are higher than for the NRSRO rating levels.

Thus, companies in the SVO portfolio have higher Cash Flow to Debt, higher Adjusted EBIT and EBITDA Interest Coverage, higher Return on Capital, and better Profit Margins.

# SVO CHEMICALS MEDIANS vs. Moody's and S&P (Continued)

## The Case for Investment Grade Ratings for Companies Considered Too Small by Moody's and S&P

### APPENDIX: METHODOLOGY

#### THE SVO UNIVERSE

Included are most of the chemical companies in the SVO's private placement universe: 49 issuers based in Canada, Europe, and the United States.

#### RATIOS

The ratios used are defined as follows:

|                                   |  |
|-----------------------------------|--|
| <b>EBIT Interest Coverage (x)</b> | EBIT/Gross Interest Expense <sup>4</sup>         |
| <b>Fallback Coverage (x)</b>      | (EBITDA+1/3Rent)/(Gross Int Exp+1/3Rent)         |
| <b>Balance Sheet Leverage (%)</b> | (Debt+8*Rent)/(Debt+8*Rent +Equity) <sup>5</sup> |
| <b>Cash Flow-to-Debt (%)</b>      | FFO/Tot Debt (%) <sup>6</sup>                    |
| <b>Operating Leverage (%)</b>     | (Debt+8*Rent)/EBITDAR <sup>7</sup>               |
| <b>Return on Capital (%)</b>      | (EBIT+1/3Rent)/(Debt+8*Rent +Equity)             |
| <b>Profit Margin (%)</b>          | EBITDAR/Revenue                                  |

Not every issuer reported the necessary data for every credit ratio. In each case, the maximum available set of issuers that support the ratio in question was used.<sup>8</sup>

#### DESIGNATIONS

All of the issuers in the study have credit "designations" from the NAIC (the term "designation" is used to distinguish the NAIC's ratings from those of the NRSROs). The reported ratings refer specifically to the issuers' actual or implied senior unsecured designations as of December 31, 2004.

#### DATA USED

SVO Financial data for the NAIC SVO medians were taken from fiscal year-end filings from 2001-2003. First, three years of financial data for each issuer were inputted and calculated for three-year means. Then the means for each company were entered into another spreadsheet organized by rating level (NAIC-1, 2, 3, 4, and 5/6), which calculated the medians for each level.

In calculating the SVO medians for each ratio for each broad NAIC rating level from NAIC-1 through NAIC-5/6, a differentiation was not made in this study, as normally done internally, between an NAIC-2+, 2, or 2-. Also, the sampling size for the NAIC-5/6 categories is not representative of the actual number of Issuers in those rating categories: data was lacking because several NAIC-5 and NAIC-6 rated issuers did not have audited financials available.

*Moody's and S&P.* The S&P medians for Chemicals came from S&P Creditstats based on the three years, 2001-2003, which were available on their website as of July 12, 2005. The SVO included statistics for three countries: U.S., Canada, and Europe, as that matches the SVO universe. The Moody's data for the Chemicals industry came from their 2003 medians as published in late 2004.<sup>9</sup>

#### SUMMARY TABLE

All the medians from the three rating entities were then fed into the final summary page, which lists the SVO medians alongside those of the two rating agencies. This provided the necessary data for the comparisons and discussion in this paper. This table of comparative medians is presented on the next page.

<sup>4</sup> Gross interest expense includes capitalized interest and excludes interest income.

<sup>5</sup> FFO includes Net income +DA + deferred income taxes +other non-cash items; that is, the items before working capital changes in Cash Flow from Operations.

<sup>6</sup> Debt includes STD, LTD, and capitalized leases.

<sup>7</sup> EBITDAR is defined as earnings before interest expense, depreciation and amortization, and rent.

<sup>8</sup> Company data were adjusted for non-recurring items: we eliminated from both operating and pre-tax earnings such items as gains/losses on asset sales, and charges for asset writ downs. Net income was not adjusted. These adjustments affect all ratios except balance sheet leverage.

<sup>9</sup> "The Distribution of Common Financial Ratios by Rating and Industry for North American Non-Financial Corporations, Moody's, Dec. 04, p. 30.

# SVO CHEMICALS MEDIANS vs. Moody's and S&P (Continued)

## The Case for Investment Grade Ratings for Companies Considered Too Small by Moody's and S&P

|                          | S&P<br>(senior issuer)<br>Sample Size = 75 |       | SVO<br>(senior unsecured)<br>Sample Size = 49 |       | MOODY'S<br>(senior unsecured)<br>Sample Size = 44 |   |
|--------------------------|--|-------|---|-------|---|---|
|                          | Sales (\$MM)                               |       | Sales (\$MM)                                  |       | Total Assets (\$MM)                               |   |
| <b>S I Z E</b>           | 19   | 5,805 | 9   | 1,014 | 13  | 8,365   |
|                          | 17   | 2,151 | 21  | 682   | 8   | 2,308   |
|                          | 18   | 1,481 | 9   | 308   | 7   | 2,305   |
|                          | 21   | 1,006 | 3   | 288   | 11  | 857   |
|                          | 0  |       | 7   | 62    | 5   | 787   |
| <b>B A S I S</b>         | 19   | 38.6% | 9   | 35.8% | 13  | 46.6%   |
|                          | 17   | 46.8% | 21  | 49.3% | 8   | 50.7%   |
|                          | 18   | 62.4% | 9   | 72.4% | 7   | 60.4%   |
|                          | 21   | 78.4% | 3   | 72.5% | 11  | 81.3%   |
|                          | 0  |       | 7   | 81.8% | 5   | 125.2%  |
| <b>O P E R A T I N G</b> | 19   | 1.60x | 9   | 1.89x |   |   |
|                          | 17   | 3.20x | 21  | 3.01x |   |   |
|                          | 18   | 4.70x | 9   | 3.62x |   |   |
|                          | 21   | 6.70x | 3   | 4.77x |   |   |
|                          | 0  |       | 7   | 5.14x |   |   |
| <b>C A S H F L O W</b>   | 19   | 42.5% | 9   | 48.1% | 13  | 19.1%   |
|                          | 17   | 22.3% | 21  | 26.3% | 8   | 10.2%   |
|                          | 18   | 15.8% | 9   | 18.3% | 7   | 13.8%   |
|                          | 21   | 6.2%  | 3   | 8.5%  | 11  | 2.2%  |
|                          | 0  |       | 7   | 5.2%  | 5   | -0.5%   |
|                          |  |       |   |       |   | Moody's medians as published in "The Distribution of Common Financial Ratios by Rating and Industry for North American Non-Financial Corporations" (12/04), based on FY03 financials only |
|                          |  |       |   |       |   | SVO medians calculated from SVO-designated issuers, based on (up to) 3-yr avgs used for 2004 designation  |
|                          |  |       |   |       |   | S&P medians calculated from 3-yr avgs, as available on-line at 7-12-05 in Research "CreditStats: Chemicals" including U.S., Canadian, and European issuers                                |

|                                    | S&P<br>(senior issuer) |        | SVO<br>(senior unsecured)  |        | MOODY'S<br>(senior unsecured) |       |
|------------------------------------|------------------------|--------|----------------------------|--------|-------------------------------|-------|
|                                    | Common Equity (\$MM)   |        | Shareholders Equity (\$MM) |        |                               |       |
| <b>E A Z</b>                       | 19                     | 3,144  | 9                          | 603    |                               |       |
|                                    | 17                     | 966    | 21                         | 235    |                               |       |
|                                    | 18                     | 362    | 9                          | 40     |                               |       |
|                                    | 21                     | 216    | 3                          | 64     |                               |       |
|                                    | 0                      |        | 7                          | 26     |                               |       |
| <b>I C N O V</b>                   | 19                     | 6.30x  | 9                          | 6.19x  | 13                            | 4.64x |
|                                    | 17                     | 2.30x  | 21                         | 3.59x  | 8                             | 3.14x |
|                                    | 18                     | 1.50x  | 9                          | 2.50x  | 7                             | 1.98x |
|                                    | 21                     | 0.60x  | 3                          | 1.32x  | 11                            | 0.73x |
|                                    | 0                      |        | 7                          | 0.94x  | 5                             | 0.55x |
| <b>F C A O L V E R A A C G K E</b> | 19                     | 10.00x | 9                          | 10.13x |                               |       |
|                                    | 17                     | 4.40x  | 21                         | 5.33x  |                               |       |
|                                    | 18                     | 3.10x  | 9                          | 3.58x  |                               |       |
|                                    | 21                     | 1.80x  | 3                          | 2.23x  |                               |       |
|                                    | 0                      |        | 7                          | 1.85x  |                               |       |
| <b>R E C T A U P N T A O L N</b>   | 19                     | 12.0%  | 9                          | 10.6%  | 13                            | 8.7%  |
|                                    | 17                     | 7.7%   | 21                         | 9.9%   | 8                             | 7.6%  |
|                                    | 18                     | 8.1%   | 9                          | 11.8%  | 7                             | 9.7%  |
|                                    | 21                     | 5.0%   | 3                          | 8.3%   | 11                            | 3.1%  |
|                                    | 0                      |        | 7                          | 6.2%   | 5                             | 4.4%  |
| <b>P M R A O R F G I I T N</b>     | 19                     | 15.7%  | 9                          | 18.7%  | 13                            | 5.6%  |
|                                    | 17                     | 16.0%  | 21                         | 12.8%  | 8                             | 1.1%  |
|                                    | 18                     | 12.3%  | 9                          | 13.8%  | 7                             | 3.0%  |
|                                    | 21                     | 11.0%  | 3                          | 19.5%  | 11                            | -1.7% |
|                                    | 0                      |        | 7                          | 15.2%  | 5                             | -3.3% |

## SVO Staff Profiles (Continued)

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### **MARLENE LUNDBERG**

*Credit Analyst III*  
Credit & Regulatory Unit  
212.386.1957  
mlundber@naic.org

Years at the SVO: 15 years  
Years of professional experience: almost 25 years

*Marlene joined the SVO in 1990 as a Credit Analyst. She focuses on companies in the chemicals and pharmaceuticals industries.*

#### **RQ: What University did you attend?**

ML: I attended Indiana University where I received a Ph.D. in English Language and Literature in 1981.

#### **RQ: How did you end up with a career in Finance?**

ML: I applied to enter a special program at New York University designed specifically to help Ph.D.'s move from college teaching into the business world. My focus was on accounting and finance. Afterwards, I moved from rural northeastern Indiana to the greater New York area and started out in financial public relations. Soon, I realized that what I really wanted was securities analysis and I moved to Value Line as an equities analyst for three years. That led to my current position as a corporate credit analyst at NAIC's Securities Valuation Office.

#### **RQ: What do you like about being an Analyst at the SVO?**

ML: I enjoy doing research, analyzing information, and writing up the rationale for a conclusion. The time flies by. I also love the camaraderie and all of the wonderful people at SVO.

#### **RQ: Describe one of your more interesting designations?**

ML: In 1995, I had the privilege of rating a \$150 million financing of Reliance Industries, an Indian petrochemicals company. With sales at \$1.2 billion in 1994, Reliance was India's largest private sector company and the market value of its stock constituted about 20% of the entire Indian stock market. Mr. Ambani, founder of the company and his two sons flew in from India, as well as his financial advisor from London. It was exciting to meet the founder of a huge company, knowing that his business created jobs for people in a developing country.

When Credit Committee met to vote on my recommendation for a rating for Reliance, they postponed their decision, saying I would have to recommend a rating for India, too. But, the banker for Reliance was expecting to have a decision in time for closing the deal two days later. He said that any delay in release of our rating would imply to the market that something was going wrong for the Company.

I remember finishing the India sovereign analysis around 2 a.m. at the office. The next morning I was able to convince our director to hold a special credit committee meeting, so we could make the deadline. We decided to designate debt of India and of Reliance Industries at NAIC-2. The significance of our rating was that it helped the Company break into the U.S. institutional lending markets.

That was 10 years ago. Much has changed: the SVO has moved to three different locations since then; Reliance is now more than 10 times larger than when we rated it; Mr. Ambani passed away, and his two sons are fighting over the company.

*(Continued on page 19)*

## SVO Staff Profiles (Continued)

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**RQ: What projects/designations are you currently working on?**

ML: I'm currently working on designations on chemicals and biopharmaceuticals private placement debt as well as a presentation on NAIC-SVO Chemicals medians compared to those of Moody's and S&P

**RQ: Where were you on September 11th?**

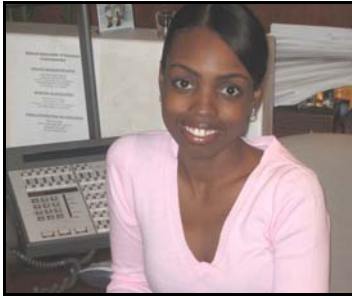
ML: I was in the subway headed to the SVO at 7 World Trade Center, when an announcer said that we all had to exit at Chambers Street because of a fire. I wasn't alarmed because subway fires had occurred before. But, when we came up to ground level, five blocks north of the WTC, both towers had huge black holes with flames emerging. At first I thought that once the fires were out, and since our building was not hit, we would probably be back at work the next day. I never saw even a brick from our building again.

**RQ: What do you do in your spare time?**

ML: I enjoy Foreign cinema, house plants, photography. I used to study Mid East dance and the Argentine Tango.

## SVO Staff Profiles

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### **JANELLE PARKER**

*Administrative Assistant II*

212.386.1959

[jparker@naic.org](mailto:jparker@naic.org)

Years at the SVO: three years

Years of professional experience: over six years

*Janelle started at the SVO in 2002 as a Receptionist/Administrative Assistant I. She was promoted to Administrative Assistant II last year. As the receptionist, Janelle has one of the most important jobs at the SVO. In addition to being the face of the SVO, she provides support to all the staff members, engages in public relations, and handles all billing and appointments.*

#### **RQ: What university are you currently attending and what is your major?**

JP: I'm currently attending Metropolitan College of New York. It is a private college located in Lower Manhattan and offers several schedules in order to cater to working students. I am currently completing my BA and will graduate in December 2005. Majoring in Business Administration has allowed me to take a variety of business courses ranging from business law to financial planning. In the Fall of 2006, I intend to pursue my MBA at Baruch College in Manhattan. Having the NAIC assist with my tuition has enabled me to continue my studies.

#### **RQ: What are some of your responsibilities at the SVO?**

JP: My responsibilities include processing all incoming invoices for payment and forwarding them to our Accounts Payable department. There is usually research that must be done before an invoice can be sent for payment such as price verification, service length, etc. The SVO subscribes to several datafeeds which assist in the analysis process. The most challenging part is keeping track of their payment schedules.

#### **RQ: Where did you work before joining the SVO?**

JP: I previously worked at a commercial production company. During my time there, the company shot commercials for several well-known companies. I was able to learn a lot about the commercial and film industries.

#### **RQ: What other companies have you worked for?**

JP: I spent a year working at the Fox News Channel. In my position, I regularly interacted with on-air personalities. I was there during the 2000 Presidential Elections and to say the very least, it was an experience I will never forget!

#### **RQ: Have you experienced any differences working at the SVO?**

JP: The people who work at the SVO come from several different backgrounds and cover varied industries. In my opinion, the work done here is a great service to the regulators and the insurance industry. The environment at the SVO is very close-knit and everyone is supportive of one another. I have learned a great deal about the insurance industry during my time here.

#### **RQ: Describe your interaction with Regulators.**

JP: I am in constant contact with Regulators from all over the country via telephone. I am also responsible for the coordination of the Valuation of Securities Task Force semi-annual meetings that are held at the SVO. It's great to be able to place faces to the names I come in contact with regularly.

*(Continued on page 21)*

## SVO Staff Profiles (Continued)

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**RQ: Do you have any hobbies?**

JP: When I have spare time I love to read and cook. In addition, I have a three-year-old son who, between my SVO responsibilities and my responsibilities as a full-time student, fills the rest of my time.

**RQ: Do you do any volunteer work?**

JP: When I am able, I volunteer at a soup kitchen during the holiday season.

**RQ: Do you speak any foreign languages?**

JP: I speak Spanish, although I am not as fluent as I would like to be.

# SVO Statistics

| <b>Figure 1.</b><br><b>SVO Performance Factors: Unrated ATFs*</b> |               |               |              |               |                    |
|---|---------------|---------------|--------------|---------------|--------------------|
|   | 2001          | 2002          | 2003         | 2004          | 2005<br>(10/04/05) |
| Initial Filing  | 3,293         | 4,521         | 3,378        | 3,396         | 2,712              |
| Annual Update   | 7,025         | 6,119         | 6,603        | 7,314         | 5,829              |
| <b>TOTAL</b>  | <b>10,318</b> | <b>10,640</b> | <b>9,981</b> | <b>10,710</b> | <b>8,541</b>       |

\*ATF denotes Authorization to File.

| <b>Figure 2.</b><br><b>SVO Completion Rate</b> |                                      |                                  |                        |            |                                |                        |           |                     |                        |            |
|--|--------------------------------------|----------------------------------|------------------------|------------|--------------------------------|------------------------|-----------|---------------------|------------------------|------------|
|  | Non-NRSRO*<br>Rated ATFs<br>Received | ATFs**<br>completed<br>≤ 30 days | 2004 <sup>1</sup><br>% | 2005<br>%  | ATFs<br>completed<br>≥ 90 days | 2004 <sup>1</sup><br>% | 2005<br>% | ATFs<br>Outstanding | 2004 <sup>1</sup><br>% | 2005<br>%  |
| Initial  | 2,608                                | 1,527                            |                        | 59%        | 235                            |                        | 9%        | 351                 |                        | 13%        |
| Annual   | 5,806                                | 4,066                            |                        | 70%        | 133                            |                        | 2%        | 645                 |                        | 11%        |
| <b>OVERALL</b>                                 | <b>8,414</b>                         | <b>5,593</b>                     | <b>53%</b>             | <b>66%</b> | <b>368</b>                     | <b>14%</b>             | <b>4%</b> | <b>996</b>          | <b>5%</b>              | <b>12%</b> |

\*NRSRO denotes Nationally Recognized Statistical Rating Organization.

\*\* ATF denotes Authorization to File.

<sup>1</sup> January 2004—October 3, 2004.

Data as of October 4, 2005.

# Chronological List of *SVO Research Reports*

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## SVO RESEARCH NEWSLETTERS

### Volume 1, Issue 1

- Provisional Exemptions Rules are Live
- Corporate Bond Defaults at Record High
- 1999 Holdings of 5\* and 6\* Securities as Reported
- Education and Training Programs Available for Insurance Regulators

### Volume 1, Issue 2

- Insurer Investment in Problem California Utility Bonds
- Credit Derivatives
- When Prizes and Settlements Become Securities
- SVO Activity

### Volume 1, Issue 3

- Preferred Creditor Status of Multilateral Development Banks
- Changes in the VOS Database 1999 –2000
- Debt-Equity Guidelines and the “Classification of Securities” Function of the SVO
- SVO Activity

### Volume 1, Issue 4

- Credit-Linked Notes
- Insurer Investment in Foreign Sovereign Securities
- Changes in the VOS Database from Year-End 2000 to Q1 2001.
- SVO Activity

### Volume 1, Issue 5

- Insurer Investment in Provisionally Exempt Bonds
- Convertible Bonds in Demand
- Insurer Investment in Catastrophe Bonds in 2000
- SVO Activity

### Volume 1, Issue 6

- Corporate Bond Defaults: Mid-Year Update
- Introduction to Equity-Linked Notes
- What’s an Industry” The North American Industry Classification System
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### Volume 1, Issue 7

- Argentina, the IMF, and Currency Boards
- Insurer Investment in Foreign Sovereign Securities: Canada
- Changes in the VOS Database: 3rd Quarter 2001
- SVO Activity
- SVO Lost Office on September 11th But Did Not Destroy Operations

### Volume 1, Issue 8

- Insurer Asset Exposure to the Enron Default
- Replication (Synthetic Asset) Transactions
- Foreign Sovereign Holdings by U.S. Insurers

### Volume 2, Issue 1

- The One-Year Anniversary of Provisional Exemption
- The Telecommunications Equipment Industry: Review & Outlook, January 2002
- Kmart and Global Crossing

### Volume 2, Issue 2

- Corporate Bond Defaults: First-Quarter Update
- Insurer Investment in Structured Securities
- Monoclonal Antibodies, Anyone? The Medical Biotechnology Industry

### Volume 2, Issue 3

- Chapter 11 for Nations?
- Synthetic Leases
- Insurance Industry Exposure to Tyco International Ltd.

### Volume 2, Issue 4

- Portfolio Composition of Insurance Companies
- Not-for-Profit Organizations: A Review
- Insurers Investment in European Sovereign Debt

### Volume 3, Issue 1

- Update: Insurer Investment in Catastrophe Bonds
- Semiconductor Industry: Review and Outlook
- Default and Market Data Watch
- Recent Rating Agency Actions for Insurance Companies

### Volume 3, Issue 2

- CDO/CBO/CLO 2002 Performance Review
- Credit Tenant Loans
- Global Corner: Brazil Bounces Back as Investor Confidence Returns
- Default and Market Data Watch
- Recent Rating Agency Actions for Insurance Companies

### Volume 4, Issue 1

- Life Insurance Securitization
- US Corporate Pensions
- Introduction to Credit Default Swaps
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- A Primer on Real Estate Investments Trusts (REITs)

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  - The Computer Industry in 2004: Review and Outlook
  - Insurance Industry Exposure to General Motors and Ford
  - SVO Analyst Profiles
  - SVO Statistics
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## **SVO RESEARCH SPECIAL UPDATES**

### Special Update #1

- NTL, Inc.

### 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

## Special Update #7

- Insurers' Exposure to UAL Corporation

## Special Update #8

- Insurance Industry Exposure to General Motors and Ford
- 

## **SVO STATENET (REGULATOR ONLY) RESEARCH NOTES**

### Research Note 04-01

- 2003 AVR Stress Testing

### Research Note 04-02

- 2003 Bond Credit Defaults

### Research Note 04-03

- Catastrophe (CAT) Bond Market Developments
- 

## **SVO RESEARCH SPECIAL REPORTS**

- Mortgage Backed Securities
- Introduction to Credit Linked Notes

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