

A Statement on Classification Analysis

What Is Classification Analysis Classification analysis is an analytical procedure revolving around a framework that compares the economic characteristics of a given security with defined capital asset profiles to determine whether a security should be reported as debt, preferred equity or common equity for regulatory purposes.

Why Do We Conduct Classification Analysis

The NAIC/SVO conducts classification analysis solely to permit State insurance regulators *some* predictive measure of how a financial instrument is likely to behave *absent considerations of credit quality*. Classification allows regulators to identify the nature of the commitment made by the investor and consequently, the risk based capital charge that is most appropriate for the hybrid investment. A classification does not communicate that the investment is debt or equity. The classification communicates only that absent considerations of credit risk, the instrument would perform **like** the capital asset category to which it has been assigned.

How Does the Classification Process Work

The SVO conducts classification analysis in accordance with the procedure in Part Seven, Section 1 (c) of the *Purposes and Procedures Manual*. Classification analysis is intentionally grounded in US legal and business conventions. Accordingly, the procedure envisions a capitalization framework consisting of three capital asset categories; i.e., debt, preferred equity and common equity. Section 1 (c) creates an analytical framework consisting of three capital asset profiles, one for each of the aforementioned capital asset categories.

Five contractual rights common to all investments are used as classification criteria.¹ For each of these five contractual rights, a different investor expectation is assigned to each of the three capital asset categories. In this way, three “pure” (i.e., non-hybrid”) capital asset profiles are created. Importantly, while some of the investor expectations are closely associated with a given capital asset category, there is no specific weight given to any of the rights or expectations in the analysis. Weighting, either of rights or of investor expectations, depends on the specific facts (and their significance) in a given transaction.

The analytical methodology consists; first, in a comparison between investor expectations embodied in the hybrid instrument and those embodied in the profiles to determine the preponderant characteristic of the instrument (the preliminary assessment) and second, an analysis of the totality of the security and its economic context to determine whether other factors suggest a different classification. Accordingly, an analyst conducting classification analysis first reads the agreement that governs the hybrid security to identify the investor expectations for each of the five rights identified in Section 1 (c) and any other rights and expectations in the agreement. Once identified, the analyst compares each investor expectation in the agreement to the expectations in the three capital asset profiles to find the one that it most resembles. The

¹ The five rights identified in the Section 1 (c) are: 1) The holder’s legal claim as creditor or residual interest; 2) Whether the holder has the right to influence issuer management, 3) Whether there is a promise to make periodic payments and if so, whether it is deferrable and or cumulative/non-cumulative, 4) Whether there is a stated maturity date or an agreed upon basis for establishing maturity or redeeming the claim, and 5) The nature of a investors claim in an involuntary bankruptcy, liquidation or re-organization (i.e., is it a debt claim or a residual interest).

analyst then assigns the classification suggested by the comparison for that combination of right and expectation. When this process is completed for each right, the analyst notes which characteristics (debt, preferred equity or common equity) seem to predominate in the hybrid security. This preliminary assessment is not determinative of the classification. The analyst may not make a final recommendation to senior credit committee based on this comparison. The analyst is required to proceed to a determination whether any other considerations suggest or require the assignment of a classification different from the one suggested by the hybrid security's predominant characteristics. The objective here is to consider the economic context in which contractual rights and expectations will be asserted to determine the most likely behavior of the instrument.

As a third and final step, Senior Credit Committee then examines whether the classification determinations made by the analyst in the first step of the analysis demonstrate an understanding of the purposes and objectives of the process and whether they are otherwise reasonable; and whether the analysis reflects an understanding of the economic dynamics of the security.