Project History of the Short-Term Statutory Treatment Methodology for Hybrid Securities

Hybrid securities are generically defined as securities including both debt and equity characteristics. Under NAIC guidance, an insurer is to apply various standards in determining whether the securities are to be reported as debt, as preferred stock or as common stock in statutory financial statements. Prior to 2006, insurers were mostly reporting hybrid securities as bonds, and some as preferred stock. Virtually all of the hybrid securities are rated by rating agencies. The SVO does not verify that insurers have properly reported rated hybrid securities in accordance with the aforementioned NAIC guidance, unless specifically requested by either a regulator or an insurer.

Insurance companies' holdings of hybrid securities increased in recent years, while their features became progressively more complex. Despite guidance which should have directed insurers to report most of their holdings in hybrids as preferred stocks, they continued to be filed as bonds. It was the reporting of recently issued hybrid securities (with more complex and equity-like characteristics and risks) as bonds that prompted the New York Department of Insurance regulators to request certain insurers to file their hybrid securities with the SVO for classification analysis. The Lehman ECAP issued on August 18, 2005, was reviewed by the SVO and determined to be common stock after a classification analysis. This was the genesis of the hybrid security concerns by investors, investment banks, and issuers.

Risk-based capital (RBC), which is the formula used to calculate the minimum capital and surplus requirement for insurers, carries a very low charge for highly rated bonds and preferred stocks (.3% and 1% for designations 1 and 2), with higher charges as the rating drops (20% for designation 6 securities for life insurers; 30% for designation 6 securities for property/casualty and health insurers). Unlike bonds and preferred stocks, common stocks do not receive credit quality designations; rather, the RBC charge is a fixed 15% for property/casualty and health insurers, and anywhere from 15% to 30% for life insurers (depending upon the life insurer's Beta experience calculation). Thus the SVO's common stock classification would cause a significant increase in the RBC charge for insurance company holders of the Lehman E-CAPs.

This common stock classification, and a simplistic understanding of the resultant increased RBC charge, caused significant concern in the insurance industry since it was not known how many other hybrid securities would be filed with the SVO and classified as common stock. In addition, other concerns, such as transparency of SVO processes and how the SVO communicates its decisions to the industry, were raised as a result of the hybrid security concerns.

The Financial Condition (E) Committee directed the Capital Adequacy Task Force and the Valuation of Securities Task Force to hold a joint hearing to identify the issues and concerns regarding hybrid securities. As a result, the Hybrid RBC Working Group was formed, reporting directly to the Financial Condition (E) Committee. This new Working Group was charged with formulating a short-term proposal to address the statutory treatment of hybrid securities for reporting in the year-end 2006 Annual Statement, and with constructing a long-term plan for the ongoing statutory treatment. The issue of transparency and communication of SVO determinations was charged back to the Valuation of Securities Task Force to resolve.

The Hybrid RBC Working Group held several conference calls, during which many different proposals were considered and debated. The short-term proposal was finalized by the Hybrid RBC Working Group and sent to the Financial Condition E Committee. It included a definition of hybrid securities, statutory reporting treatment that imposed an additional RBC charge for certain hybrid securities, and an initial draft of Notes to Financial Statement disclosure, to be finalized by the Statutory Accounting Principles Working Group. This short-term proposal was adopted by the Financial Condition (E) Committee at its September 12, 2006, meeting in St. Louis, Missouri. At a November 1, 2006, conference call, the Financial Condition (E) Committee adopted an effective date of December 31, 2006, for the short-term proposal.

The Hybrid RBC Working Group is now in the process of doing a comprehensive review of the risks in hybrid securities and establishing a long-term plan to address the ongoing statutory treatment of these securities, to include coordinating work with the Statutory Accounting Principles Working Group, the Blanks Working Group, the Capital Adequacy Task Force and the Valuation of Securities Task Force.

Short-Term Proposal Adopted by Financial Condition (E) Committee

Definition of Hybrid Securities:

Securities whose proceeds are accorded some degree of equity treatment by one or more of the nationally recognized statistical rating organizations and/or which are recognized as regulatory capital by the issuer's primary regulatory authority. Hybrid securities are designed with characteristics of debt and of equity and are intended to provide protection to the issuer's senior note holders. Hybrid securities products are sometimes referred to as capital securities. Examples of hybrid securities include Trust Preferreds, Yankee Tier 1s (with and without coupon step ups) and debt-equity hybrids (with and without mandatory triggers).

For 2006 this definition of hybrids specifically excludes:

- Surplus notes (file in Schedule BA)
- Subordinated debt issues which have no coupon deferral features (file in Schedule D - Part 1)
- "Traditional" preferred stocks (file in Schedule D - Part 2 - Section 1), including (but not limited to) issues which:
  a) for U.S. issuers do not allow tax deductibility for dividends; and
  b) are issued as preferred stock of the entity or an operating subsidiary, not through a trust or a special purpose vehicle.

The 2006 exclusions defined above may be modified during the long-term review of risk components.

Scenario 2D (Statutory Treatment):

Effective 12/31/2006, until the earlier of 1/1/08 or adoption of a long-term proposal by the NAIC, the following short -term proposal is recommended:

- All defined hybrid securities are reported as preferred stock.
- All hybrid securities issued after 8/18/2005 and those hybrids classified in 2006 by the SVO as common stock are notched down by 1 NAIC designation.
- Those hybrid securities classified by the SVO as preferred stock in 2006 will not be notched.
- Those hybrid securities classified by the SVO as debt in 2006 will be reported as debt and not notched.
- All future FE hybrids issued subsequent to the effective date of this proposal will be reported as preferred stock and notched down 1 NAIC designation, unless they are filed with the SVO and classified as debt or preferred stock by the SVO (in which case they are reported as debt or preferred stock appropriately with no notching).
- An Insurer holding a "notched" hybrid security issued subsequent to the effective date of this proposal may request SVO review of the security in an attempt to eliminate the notch. For hybrid securities filed with the SVO, the designation assigned by the SVO must be used by the insurer. As per normal practice, SVO classification will apply to all holders of the security.

Initial Draft Language for Notes Disclosure to Be Finalized by SAPWG by December 2006:

F. Hybrid Securities

During 2006, the NAIC held discussions regarding the appropriate reporting/classification of certain securities (Hybrid securities) on insurers' Schedule D. These discussions were primarily focused on determining the appropriate charge for Risk-Based Capital and the Asset Valuation Reserve for these securities. Although discussion on the issues will continue into 2007, the short-term reporting guidance on this issue can be found at the following URL:http://www.naic.org/committees_e_app_blanks.htm. Any hybrid securities that have been reported in Schedule D, Part 2, Section 1 to allow RBC and the AVR schedules to utilize the preferred stock factors does not necessarily indicate that the hybrid securities are actually preferred stock per the SSAP 32 definition. As it relates to this reporting, please disclose the following:

(1) An identification of each of the hybrid securities owned by the reporting entity including the CUSIP, name of the issuer, and a general description of the issue.

(2) The book/adjusted carrying value of each of the hybrid securities owned by the reporting entity.

It was further found that this note would not be required in the audited financial statements and that a change to SSAP No. 32 was not required; thus, this note requirement will only be found in the annual statement instructions.

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