

Hybrid Security Treatment Frequently Asked Questions as a Result of the Short-term Solution

The development of this document is in response to questions raised by certain parties as a result of the adoption of a short-term solution by the Financial Condition (E) Committee of the NAIC. The readers of this document should review the following URL for an understanding of the actual short-term proposal adopted by the Financial Condition (E) Committee of the NAIC on this topic.

http://www.naic.org/documents/topics_hybrid_exp_drfts_project_history_shrtterm_methodology.pdf

This document represents NAIC guidance from the Valuation of Securities Task Force that can be used in understanding the process or processes that are impacted as a result of the short-term solution for Hybrid securities. This document is guidance in that it has not been developed with the same process as other products of the Valuation of Securities Task Force. That is, the questions in this document were raised relatively late in the year and time did not allow full deliberation, or at least full exposure of the responses provided to the questions. Therefore the responses to these questions should be used to understand regulator preference, but are not required to be followed since this document has not been subject to the same requirements as changes to the Purposes and Procedures Manual of the Securities Valuation Office (the P&P Manual). This document is guidance and is not a part of the P&P Manual.

If you have questions regarding this document, please contact Chris Evangel at (212) 386-1920, or Dan Daveline at (816) 783-8402, ddavelin@naic.org.

1. Does the NAIC plan to compile its own list of hybrid securities? If not, how do you envision a company's hybrid securities would be identified and its portfolio examined?

The NAIC does not plan to compile a list of hybrid securities for companies to utilize in preparing their statements, but will be compiling a list to assist regulators once the year-end statements have been filed.

Part of the short-term solution for hybrid securities included developing a definition for such securities. Although this definition has provided clarity to all parties in understanding all of the various types of issues that can possess features of hybrid securities, the initial decision for determining if a security is a hybrid is made by the investor, based upon all relevant information. Because of this, and because there is no existing tag within the market for these types of issues, a process to develop and maintain a listing of all hybrid securities cannot currently be developed.

Having said the above, a list of potential issues that could be hybrids will be developed using certain information from Bloomberg. As such, its use should be limited (e.g., it will not be a complete listing since it will be based on CUSIPs filed in statutory financial statements in 2005/2006) but might provide some benefit to those parties who do not have direct access to certain information from Bloomberg.

2. How will the SVO process the Hybrid decisions and publish results? Will the VOSTF require all of these to be filed with the SVO, perhaps free of charge?

The NAIC notes that the SVO section of the NAIC website includes Lists 1 through 9 detailing the classification decisions made to date during 2006. List 9 is titled the "Final Report" for 2006, so that report will be updated with any remaining 2006 classification reviews. The SVO currently has 7 classification filings and indicate that 2 of those will be finalized and included in List 9 prior to December 31, 2006; the remaining 5 will receive Code 99 Letters, indicating that they will be finalized in 1st quarter 2007 but will still apply to December 31, 2006 annual statements.

3. Does the SVO have any plans to modify the data currently contained in VOS to reflect the hybrid common stocks as now being preferred stocks (with the applicable notch)?

The NAIC SVO believes there are two alternatives for the VOSTF to consider in terms of modifying the data currently contained within the database: 1) Not to modify the database at all and instead expand the List 9 on the NAIC website to include the additional information for the NAIC designation equivalent (including the notch when appropriate); or 2) to attempt to modify the database for these classification decisions. To modify the database, the classifications of common stock would need to be changed to preferred stock and the NAIC designation (including 1 notch when

appropriate) would be input along with some sort of indicator in the Issuer field to note that this security had been processed in response to the hybrid short-term treatment.

The VOS TF should make the determination of which method the SVO should utilize.

4. What will happen to those NRSRO rated hybrids which are currently contained in the FE database? If no changes are made, one should expect all of these securities to appear as exceptions on Jumpstart, correct?

NRSRO rated hybrids will continue to follow the procedures for FE, and as such will be contained in the FE database unless specifically rated by the SVO. The potential for misapplication of the FE rules will exist for these hybrids just as they do for other NRSRO rated securities. Assuming that all reporting entities appropriately notch all hybrid securities that are required to be notched, all such reporting entities will experience exceptions on the jumpstart report since the NRSRO feed will not have the same notching. The regulator reviewing the examination jumpstart report needs to recognize that all hybrid securities are to be reported in Note 21 of the 2006 financial statements, and that this list can be utilized to determine if some of the exceptions are possibly the result of the hybrid notching requirements, and thus valid. In addition, a list will also be created by the SVO after March 1, 2007, which will manually pull together the information from this Note 21.

5. As the SVO has said it does not plan to issue any additional hybrid reports, how does it plan to deal with the hybrid filings yet to be processed and how will it notify industry that it believes a filing meets the hybrid definition as outlined in the short-term solution?

As noted in the response to question 2, the NAIC List 9 is already available on the NAIC Web site. The NAIC notes that it intends to update this list up until December 31, 2006 with any new issues filed with the SVO, but as of the current date, only 7 such issues have been obtained. The SVO intends to provide a ruling on 2 of these issues before year-end, but believes the remaining 5 issues will likely not be completed by December 31, 2006. However, code 99 letters will be issued in early 2007 for the remaining 5 filings to provide classification decisions that are effective for year-end 2006.

6. How can a reporting entity be assured to be in compliance with the P&P Manual in determining if a hybrid security reported in Schedule D Part 2 Section 1 should be designated as redeemable preferred (RP) preferred stock or perpetual (P) preferred stock?

It should be noted that redeemable preferred stock is defined in SSAP No. 32 as preferred stock that must be redeemed by the issuing enterprise or is redeemable at the option of the reporting entity. For purposes of this short-term solution, if the issue has a final maturity date, it should be viewed to be redeemable and reported with the symbol (RP). Alternatively, if the issue does not have a final maturity date, it should be viewed to be perpetual and reported with the symbol (P).

7. How does the answer to question 6, as well as the overall definition of hybrid securities, impact the accounting for such securities.

Generally speaking, most of the discussion that occurred in developing the short-term solution was focused on the reporting and risk-based capital for hybrid securities. Consequently, it was never contemplated that such a change would result in a change in accounting, or at least discussed appropriately. As a result, the NAIC does not believe that reporting entities can be forced to change their underlying accounting systems for a particular security under the short-term solution. Therefore, although the reporting for a particular item may change from Schedule D Part 1 to Schedule D Part 2, Section 1, we believe reporting entities can continue to account for such items as a bond until a long-term solution is completed, or more fully discussed. Therefore, those issues that meet the definition of bonds under SSAP 26 can continue to be accounted for in accordance with those requirements. Alternatively, those issues that meet the definition of redeemable preferred stock or perpetual preferred stock, can continue to be accounted for in accordance with those applicable requirements.

8. It should be noted that some issues that meet the definition of hybrids are actually bonds, and will not have the same features as preferred stock as also reported on Schedule D Part 2 Section 1. For such issues, what should be reported in column 5 "Number of shares"? Similarly, what should be reported in column 6 "Par Value Per Shares"?

The NAIC understands that some issues reported as hybrid securities on Schedule D Part 2 Section 1 will not actually have shares. The NAIC notes however that the number of shares is information that is sometimes used along with SVO price in determining the fair value. Therefore, the NAIC recommends adjusting the number of shares to allow the fair value to be accurately reflected when utilizing the SVO price as listed on the NAIC *Valuation of Securities* products. That is, even though the security does not have an actual number of shares, the best information to report in this column would be an amount that allowed the correct fair value to be calculated across using the SVO unit price.

The NAIC notes that the Par Value Per Share column is similar, in that it would not exist for certain types of securities, but different in that it is generally not used indirectly in any of the other columns of the schedule. Consequently, to the extent the issue does not have a par value per share, it is suggested the reporting entity enter 1,000.