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IMPROVING TRANSPARENCY IN STATE REGULATION OF INSURER INVESTMENTS

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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IMPROVING TRANSPARENCY IN STATE REGULATION OF INSURER INVESTMENTS

Wednesday, September 20, 2006

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT-SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Kelly, Biggert, and Hensarling.

Chairman BAKER. I'd like to call the Subcommittee on Capital Markets to order. On behalf of Mr. Kanjorski, I wish to announce that he intended to be here, but he had matters that required his attention, and he will not be here on time. His office has given us the agreement to proceed with the hearing in the absence of a minority member for the hearing this morning. The rules require two members in participation, and so I thank Mr. Hensarling for his willingness to participate.

This morning the committee meets to consider the issues relative to State regulation of insurance products, improving transparency of the regulatory methodologies, and to better understand the work of the NAIC Securities Valuation Office. Created in 1907, the office was intended to provide oversight for securities issued in the insurance world, an important role, and a role which has value to the broader market.

Recent events, however, have brought a tension to regulatory decisions which had the unintended consequence of devaluing particular securities in the market, and then subsequently that rating or opinion being reversed having significant adverse consequence in the confidence of holders of this particular structure of securities device. The observations that I make this morning come from a review of testimony provided to date and correspondence with the office, but it becomes clear that some revision in current processes are warranted.

Today we will hear from stakeholders in the market, who will express their own views on the matter, as well as a representative of the NAIC, who has expressed a willingness and desire to work with the committee and others to ensure that the regulatory process is responsive to the identified problems.

The NRSRO's, which have the principal and primary duty for evaluations of securities in the broader market have a clearly-established process which is a stated methodology, and then an infor-

mal process by which, before making public their ratings to the broader market, will engage in discussions with management of the rated company to determine if the factual assessment made by the rating entity is in fact the circumstances that management would agree as to the underlying facts, not as to the conclusion reached by the rating agency but only as to the factual material.

Despite the fact that I have had my own views for need for reform of the NRSRO's, those two basic elements of their rating process appear to be absent from the Securities Valuation Office. In fact, there are quotes attributable to members of the NAIC which indicate that the SVO does not consider outside opinions in reaching their rating conclusions.

The result of this, I believe, has created unnecessary uncertainty in the markets about particular types of security structures. It is my hope today that we can reach some conclusions regrading disclosure of methodologies, as to the ability of the issuers of the rated securities to have an informal ability to communicate with the SVO prior to reaching a public stated position.

There is one other element that I would like to raise, however, that I do not think has been raised by any others in the public domain, and that is in the securities world if a person has information and acts on that information prior to general disclosure of that set of facts to the broader market, that creates or triggers certain regulatory concerns, and that really is at the base of my difficulty with this matter. It appears that the unintended consequence of the current valuation effort is to disclose a rating to a particular subset of market participants not concurrent with all market participants at the same time—not that it would be necessarily called insider trading, because this is a regulatory function, but as a matter of disclosure policy all stakeholders in the market, whether there is action to be taken that either increases or decreases the value of a public security, there should be an absolute essential requirement to make that type of determination and disclosure simultaneous to all affected stakeholders. That does not now appear to be the case.

I look forward to working with the superintendent going forward and to the NAIC and better understanding their concerns. I believe I do understand their stated purpose. I have actually gone to the Web site this morning and read through the Securities Valuation Office guidelines to make sure that I had an appropriate understanding, but there clearly is a need for modest reform here to provide for stability in market function, and I appreciate the panel's willingness to participate this morning and look forward to hearing your statements.

Mr. Hensarling, did you have an opening statement?

Mr. HENSARLING. Mr. Chairman, I would like to note that rarely has my presence been so welcome here before—

Chairman BAKER. I second that.

Mr. HENSARLING. I would just like to thank you and Ranking Member Kanjorski for holding this hearing. I think it is a very important topic that we will be discussing today. Clearly these classification decisions made by the SVO are critical in determining the amount of risk-based capital that our state-regulated insurance companies must hold, which consequently, of course, has to help

determine the asset base which these companies pay their claims as well as promoting a very efficient and transparent capital market.

It is not a matter that has previously been on my radar screen, but clearly the March 2006 decision of the SVO in their classification of the Lehman Brothers ECAP hybrid securities as common stock has raised the issue. We saw the impact that had within our capital markets, and clearly I think that this committee needs to look into how the decisionmaking process works, and as we all know, sometimes a little bit of sunshine goes a very long way in helping solve a certain amount of challenges that we have, so I look forward to hearing from the witnesses. Mr. Chairman, I yield back.

Chairman BAKER. I thank the gentleman for his statement and his presence this morning.

We will now proceed to our panel of witness. Let me first express our appreciation. In our general platform of operation, we request that your statement be limited to 5 minutes, if possible. Your full formal statement will be made part of the official record. Make sure that the button is pushed on the bottom of the microphone, and we appreciate your being here.

Our first witness is Mr. Kevin J. Conery, senior director of Merrill Lynch, but appearing here today on behalf of the Bond Market Association. Welcome, sir.

STATEMENT OF KEVIN J. CONERY, SENIOR DIRECTOR, MERRILL LYNCH, ON BEHALF OF THE BOND MARKET ASSOCIATION

Mr. CONERY. Good morning. Chairman Baker and committee members, thank you for holding this important hearing on transparency in the State regulation of insurer investments. My name is Kevin Conery, and I am a preferred securities strategist at Merrill Lynch. It is a pleasure for me to offer this statement today on behalf of the Bond Market Association, the trade association for the $46 trillion dollar global fixed income markets.

BMA members have high regard for the role of the NAIC, which is the primary focus of this hearing. The NAIC and its members, the State insurance regulars, play a critical role in assuring the solvency of the Nation's insurance industry. Recently, however, the NAIC Securities Valuation Office, or the SVO, put a chill in the market for hybrid securities by classifying as common equity a financial instrument well established as fixed income security. Insurance companies are an important source of demand for hybrid securities. The common equity classification from the NAIC would require a significantly higher capital charge against these securities for insurers. This caused both issuers and investors to retreat for a full 6 weeks in March and April of this year.

The price of the securities fell as insurance companies were faced with the prospect of higher capital charges. Always seeking the lowest cost of capital, issuers shied away from the uncertain U.S. markets and looked abroad. With tens of billions of dollars of hybrid securities in the pipeline, issuers are right to ask themselves a key question—which country offers the best environment to bring hybrid securities to market? As long as the threat of regulatory un-

certainty exists in the United States, issuers will consider the option of going to capital markets of the other countries.

Regulatory clarity is critical to maintaining the competitiveness of U.S. capital markets. We are pleased that the NAIC adopted an interim definition of hybrid securities at a meeting last week. The definition expires January 1, 2008, unless a permanent definition is crafted prior to that date. This development has encouraged insurance companies to return to the hybrid market in the near term at least. The overall experience, however, illustrates a fundamental problem with the SVO classification process. It lacks transparency.

A chief goal of BMA members is the development of policies and practices that promote efficient and transparent capital markets. A lack of transparency distorts prices, can cause a misallocation of capital, and generally leads to market inefficiency. Similar to what happened in March, if the NAIC without explanation classifies as common equity hybrid securities of the type long considered debt instruments, insurance companies have no choice but to withdraw from the marketplace. The loss of this key source of demand in turn would distort prices and lead to a less efficient allocation of capital.

If the SVO classification process were transparent, the rationale behind its March decision would have been made public, but far from being made public, this information was provided only to certain parties compelled to maintain confidentiality.

The SVO's reasoning still has not been publicly revealed. The BMA believes that the NAIC needs to acknowledge that SVO decisions can have a broad impact on the hybrid securities market. The NAIC should develop a system similar to that employed by other capital regulators, such as the Federal Reserve Board or the Securities and Exchange Commission, those that make clear what criteria are involved in evaluating securities in addition to publicly-announcing the valuation decision.

Such an announcement can come in the form of Web site postings or press releases, so long as the information is freely accessible to all market participants. Consider that rating agencies, while not a capital regulator, do make decisions and provide information that have broad effects on the market, including the market for hybrid securities. Rating agencies' decisions are always publicly available and their methodologies clearly disclosed.

We acknowledge that the NAIC has made some efforts to become more transparent at the industry's request. Since May the SVO has posted classification notices on its Web site. The reasons for these classifications unfortunately are still not made public. We hope to continue a dialogue with the NAIC as it moves towards consideration of how to create a more transparent classification process. Changes that lead to increased transparency, including the conveyance of information about decisions in policy, are best for all markets and all investors.

Mr. Chairman, thank you again for the opportunity to testify here today. I look forward to any questions that the committee may have.

[The prepared statement of Mr. Conery can be found on page 18 of the appendix.]

Chairman BAKER. Thank you for your statement, sir.

Our next witness is Mr. Michael J. Hunter, the executive vice president and chief operating officer for the American Council of Life Insurers.

Welcome.

STATEMENT OF MICHAEL J. HUNTER, EXECUTIVE VICE PRESIDENT AND CHIEF OPERATING OFFICER, AMERICAN COUNCIL OF LIFE INSURERS

Mr. HUNTER. Thank you, Mr. Chairman, and members of the committee. I am here today on behalf of ACLI's 377 members, which account for 91 percent of the industry's total U.S. assets. ACLI members offer life insurance, annuities, pensions including 401(k)s, long-term care insurance, disability income insurance, reinsurance, and other retirement and financial protection products.

As investors holding approximately $4.2 trillion of securities, or approximately 12 percent of the total investments in the United States capital market, actions and decisions regarding the regulatory oversight of our investments are critical to the business operations of ACLI member companies, the customers we serve, and arguably our Nation's economic stability.

As you know, the insurance industry is state-regulated. Companies operate under the supervision of each State in which they are licensed. The Securities Valuation Office is an instrumentality of the NAIC, which is an association of State insurance commissioners and is charged with examining the credit quality and value of insurers' investment portfolios.

We understand that one reason that this committee has called for this hearing is to better understand the decisions made earlier this year by the SVO regarding hybrid securities. These decisions created such a level of uncertainty in the capital markets that holders of these securities experienced a substantial decrease in market value as well as a limited ability to trade in the securities.

I believe a fundamental issue for the subcommittee to consider is what role the SVO should play in the ratings and valuations of securities held by insurers and exactly how that role should be carried out.

Before moving on, I want to acknowledge that as of today it appears that a very workable short-term solution to the hybrid securities situation has been reached. This was accomplished thanks to extraordinary efforts of both the industry and NAIC leadership over the last few months. I want to particularly compliment and commend Superintendent Iuppa on the vital leadership role he played to help us get to this positive outcome.

A bit of history. The SVO was formed by the NAIC in 1942 to value investments made in private and public companies. In the late 1990's, the NAIC realized that a more effective way of valuing securities would be to rely on the values provided by nationally-recognized statistical rating organizations—NRSRO's. So today insurers rely on NRSRO's to determine the value and classification of their securities. In the event that a security is not rated by an NRSRO or a State regulator requests the review of a previously-rated security, the SVO will value and classify that security.

To understand the importance of the classification of securities to an insurer, one must understand the NAIC's risk-based capital sys-

tem, or RBC. This system uses a formula to establish the minimum amount of capital necessary for an insurance company to support its business operations. Computing risk-based capital helps determine when and what actions regulators should take in the event a company's actual capital and surplus falls below its calculated minimum.

All securities are classified as either debt/preferred stock or common stock. A highly-rated debt instrument or preferred stock with a market value of a million dollars would require a company to allocate $3,000 for risk-based capital, while a common stock of equal market value would require that $300,000 be allocated.

Due to the extremely-high capital requirement for common stocks and the risk-averse nature of life insurers, ACLI member portfolios contain substantially more debt securities than common stock.

The SVO's recent actions on hybrid securities illustrate the effect its decisions can have on both insurers and the capital markets. We are concerned with the process and lack of transparency at the SVO and we call on the SVO to adopt and apply a more transparent, open process by which it classifies securities, disseminates those decisions to market participants, and provides clarity as to why and how these classifications are made.

When the SVO reclassified several securities from debt to common stock in March, investors were left to wonder what prompted the change. Industry immediately requested that the SVO communicate the additional risks it perceived the securities contained that are not considered in the rating process of the NRSRO's. As of today, the SVO has yet to respond to this request.

When the SVO acts on a request to rate a security, only the entity that made the request will receive the decision. Other insurers holding the security, issuers of securities, dealers and investors are not notified of the decision. We are at a loss to understand the public policy purpose behind this.

The SVO should disclose the basis for its decisions by public dissemination as such information is material to the market and information disclosed unevenly can certainly erode investor confidence.

Additionally, the entity receiving this information is prohibited from sharing the information with other investors or issuers. As insurers or other investors learn eventually of an SVO classification, they are unable to obtain a clarification as to what factors led to this decision. We do not see that a legitimate public policy purpose is served by this confidentiality.

In the case of hybrid securities, the SVO began a process by which all classification decisions are posted in a report on the NAIC Web site. We want to applaud this move and we strongly support it. However, the system is not in place for other SVO rated securities, and, as previously noted, the empirical basis for these ratings is not disclosed.

SVO staff has stated publicly that their designations are not suitable for use by anyone other than regulators. This is a completely unrealistic and impractical position to take, as we have recently seen SVO actions do have an immediate and significant impact on capital markets. This stance does nothing more than foster

a lack of confidence in the integrity of the process within the industry and the marketplace.

In summary, we would like to leave the subcommittee with three main points:

(1) Buyers and sellers of securities must know in advance when the SVO is analyzing a particular security or class of securities. This will provide stakeholders the opportunity to provide input to the SVO to ensure that a fully-informed decision will be made;

(2) The SVO must publicly communicate the empirical basis for all ratings decisions so that issuers of securities can understand what risk characteristics the SVO has identified that could lead to a different rating than that of the NRSRO's. Investors will then be in a position to assess their investment portfolios and make an informed decision as to whether they wish to continue to hold the security or securities in question; and

(3) The NAIC has shown a willingness to allow the use of NRSRO ratings and expanding that system is one option for consideration, leaving the SVO to focus solely on solvency issues. However, should regulators not be willing to cede all rating and classifications decisions to the NRSRO's, it is imperative that an open, transparent system for SVO action be implemented.

I thank the subcommittee and you, Mr. Chairman, for inviting ACLI to participate in the hearing, and I would be happy to answer any questions. Thank you.

[The prepared statement of Mr. Hunter can be found on page 34 of the appendix.]

Chairman BAKER. Thank you for your statement, sir.

Our next witness is the Honorable Superintendent Alessandro Iuppa, who appears here today in his capacity as president of the National Association of Insurance Commissioners.

Welcome, sir.

STATEMENT OF ALESSANDRO IUPPA, PRESIDENT, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. IUPPA. Chairman Baker, and members of the committee, thank you very much for providing me with the opportunity to present the views of the NAIC on transparency in the regulation of insurer investments. I also want to thank you for making the committee staff available to discuss some of the issues in preparation for this hearing.

The financial regulation of insurance is essential to consumer protection, and we do this job well. Without consumer protection afforded by financial regulation, an insurance policy may not be worth the paper it is written on. We serve the public by means of independent and honest financial oversight, safeguarding insurers' capacity to pay claims, and we welcome the chance to dialogue with Congress and the subcommittee on this complex issue.

I am confident that we would not be here today if not for recent NAIC decisions related to hybrid securities—highly complex, often customized, nonconventional financial instruments that are constantly evolving.

We stand by our recent analysis, both on substance and the process, and I will be happy to respond to your questions on those aspects. Nonetheless, like any effective organization working in a dy-

namic market, the NAIC membership has initiated a review with respect to the issues of disclosure and transparency of our classification process covering hybrid securities.

Following the concerns raised by the ACLI and the Bond Market Association about a complex product that in fact represents a small portion of the overall financial market, the NAIC responded by holding a public hearing in New York City to gather the perspectives of rating agencies, insurers, trade associations, and other interested parties. That particular hearing attracted over 200 attendees.

At that meeting, the NAIC leadership appointed a special working group led by the New York Department of Insurance to evaluate the appropriate risk-based capital treatment of hybrid securities and to develop both short and long term resolutions.

During our most recent national meeting at St. Louis, which was held last week, the NAIC adopted the short-term resolution for the year-end financial statement filing. That resolution essentially provides for the classification and reporting of recently issued hybrid securities as preferred stock and the regulatory with some adjustment to account for investment risks not accounted for by national credit rating agencies.

Going forward, the special hybrid Risk Based Capital Working Group will further study the characteristics of hybrid securities and develop a permanent solution. I hope you will agree that we have made good progress on a substantial financial issue in a short timeframe with the support of both the ACLI and the BMA.

In the interim 3 months, while the working group completes our review, there are other actions that market participants can take to improve the current situation within the existing regulatory framework.

First, I would strongly encourage insurers to use the SVO's Advance Rating Service. By using the ARS insurance companies and their financial advisors, you can eliminate most, if not all, surprises by learning in advance how these programs will be classified by the SVO. I would also encourage insurers and producers of hybrids to take advantage of the Automated Valuation Service, the AVS. Like federally-regulated rating organizations the NAIC offers a subscription service that allows subscribers to access SVO determinations as they are issued.

In response to the concerns of the Bond Market Association and others, we took the unusual step of posting a number of our rulings on hybrid securities on the SVO homepage and we did this without the normal subscription fee.

Finally, I would encourage the interested parties to continue their active engagement with the NAIC membership through our open and transparent process for establishing and amending policies and regulatory practices including those related to the SVO. Together we can make improvements that contain consumer protections and a dynamic market.

With respect to the issue of disclosure and transparency of the SVO's classification process covering hybrid securities, the NAIC's Valuation of Securities Task Force, which is comprised of financial solvency and investment experts, is evaluating the guidance provided through SVO analysts, as well as the communications prac-

tices revolving around those SVO classification decisions. I think it is safe to say that as a result of ongoing discussions, we better understand that the range of interested parties may very well extend beyond insurers, their financial advisors, and the regulatory community, and we look forward to reporting back to the subcommittee once the NAIC has reached its final decision on the regulatory treatment of hybrid securities.

I thank you and look forward to your questions.

[The prepared statement of Mr. Iuppa can be found on page 42 of the appendix.]

Chairman BAKER. Thank you very much, Mr. Iuppa.

Mr. Conery and Mr. Hunter, let me try to get a framework of the market effect of this decision, and then the ultimate reversal of the decision.

At the point at which it did become public, what is your assessment of the financial consequences in the broader market?

There's been references made to devaluation of these particular class of assets. Do either or both have some view as to what the broad market consequence was of this instability?

Mr. CONERY. If I may go first, Mr. Chairman, yes, there was clearly market instability, market confusion, because once again there was not any transparency as to why this decision was made.

Broadly speaking, any security that looked approximately like the Lehman ECAP structure also had its value decline. With the rationale being unclear, the market entered a phase, as I noted earlier, that it was largely shut down and there was very little trading volume going on for awhile because people were uncertain, so valuations were pretty wide, as often happens when liquidity becomes less in a marketplace. But I think that most people are thinking that the average cost for anything that looked to be similar to a Lehman ECAP structure was approximately at that time 30 to 40 basis points from most issues.

Chairman BAKER. And what in your estimate is the notional amount of this class of securities in the market? Any way to know that?

Mr. CONERY. Well, one of the things that became interesting, and this also goes back to the transparency issue as well, because it was unclear what they were specifically targeting, and initially when the market assumed, as did I individually, that it was the ECAP structure that was the problem that they were having, the market viewed it as a much more narrow problem, okay?

As time went on, and more classifications came out and became more apparent, especially into May and into June, and people recognized it was structures well beyond the Lehman ECAP structure, the market became much more concerned. So I would say initially we're talking about a market size that was probably only about $15 billion. By the time June was coming around, you were talking about in market size that I would conservatively estimate at about $100 billion.

Chairman BAKER. Mr. Hunter, can you add or expand on that view?

Mr. HUNTER. Yes. I think that nobody would challenge the proposition that markets respond negatively to two things, bad news and

uncertainty. And there was a mixture of both with regard to the SVO decision.

I think our research indicates that at the nadir of the activity with respect to these securities during the summer that portfolios decreased by about a billion dollars industry-wide. Portfolios have certainly rebounded but there were negative impacts on companies that haven't been remedied by the positive developments of recent weeks.

Chairman BAKER. Are we back to the pre-April market conditions?

Mr. HUNTER. It's not my belief that we have returned to pre-April. I'll let Mr. Conery opine on that as well.

Mr. CONERY. Right now it depends upon which segment of the market you are speaking about. I would say broadly you have largely recovered as of today, this morning, and for the past few days, pretty much where we were prior to April. However, certain segments of the market have not responded as favorably, basically, those that have more to lose by the interim solution, for example.

The way the interim solution works, if you still got classified as common equity initially and you had a Triple B rating, you would get hit harder, so consequently those issues have only recovered about half of what they lost, so they may have recovered 20 of those 40 basis points.

Chairman BAKER. Thank you. Mr. Iuppa, my reason for asking that line of questions of the other two witnesses is just to establish the market consequence of this regulatory action by the NAIC, that many years ago the scope of influence and residual effect in the market may in fact have been very minor, but today market consequences are quite different.

As you indicated, these are sophisticated and technical issues that require a level of sophistication in their assessment. That also leads me to conclude that the inter-related financial network that may be beyond the scope of the insurance regulatory purview was adversely affected, although unintentionally, by the rating for some duration in the market, and even today there are certain classifications that have not fully recovered.

I don't believe this is insoluable. I believe that the model that has been created by the actions of the NRSRO's generally is a blueprint for continuing this rating responsibility and engaging in it in a manner which would not necessarily roil the markets—primarily, the two issues being simultaneous disclosure of ratings to all affected parties and certainly not requiring confidentiality to those who benefit from the information, and secondly, some disclosure of empirical standards or methodology so that issuers can understand when we go out into the regulatory world here is what they are going to look at and here's the expectation so we can structure our deal to meet those regulatory expectations.

I know you have made a statement in your comment today that the NAIC is working toward resolution perhaps on both those ends. Can you represent to us today when you think that the regulatory revisions that you have described would actually be made effective or will there be some interim report?

I come to this with some trepidation. We have not always had a date certain target for other NAIC goals, and I just want to make

sure that this one of particular importance is targeted and is described for the broader market in a way where there can be a little more certainty about when this will be resolved.

Can you respond?

Mr. IUPPA. Yes, I think I can. As I noted, we have asked the VOS Task Force to come back to the broader membership with a report.

Chairman BAKER. Is there a deadline for that report?

Mr. IUPPA. I am getting to that.

Chairman BAKER. Okay. Thank you.

Mr. IUPPA. I believe the last day for the NAIC meeting in December is December 12th, so that NAIC leadership is expecting to have that by December 12th, so that if we can't take action in December, we can arrange to take action subsequent to that, but I think the key is the NAIC leadership and there is a commitment from the New York Department with regard to their role as chairing this group to deliver to the broader membership a report, and hopefully a recommendation, as to how to address some of these concerns.

As I noted in my commentary, as a regulator it is difficult at times to see beyond the regulatory blinders, if you will, and I think we have drawn some inferences and some conclusions that our actions do have a broader impact, and can have a broader impact, in the broader marketplace, and we have to take that into consideration as we look at the transparency and disclosure issues going forward.

Chairman BAKER. And I don't know the charge that the committee has been given for the issuance of the December report, but in the "for what it's worth" category, this simultaneous disclosure and disclosure of empirical methodologies is extremely important in order to have the SVO's mission and operations consistent with other securities regulators.

I hope that will be at the forefront of the committee's effort—and my time has long expired.

Mrs. Biggert?

Mrs. BIGGERT. Thank you, Mr. Chairman. While we heard that NAIC doesn't announce when the classifications are made and that parties that are interested in determining a current designation pay a fee to actively monitor a NAIC database, this materially makes material information non-public, which—can this benefit some of the market participants to the detriment of others then, the way that this was set up?

Mr. IUPPA. Would you like me—

Mrs. BIGGERT. Yes, Mr. Iuppa.

Mr. IUPPA. Well, I guess on a purely analytical response, I guess the answer is probably yes, because if some segment of the market doesn't have information that is available to others, those that have the information can be perceived to have been advantaged.

Mrs. BIGGERT. And you said that some of the classification changes have been put up on the Web site about some securities and not others. Does this make a difference then? How do you choose which one you are going to put up on the Web site?

Mr. IUPPA. Well, a couple of things. I want to clear up what may be one misconception. I have heard several times today that the NAIC reversed its initial analysis on some of the hybrids. That is not really what happened. We did not necessarily reverse those rul-

ings but we have worked towards a sort of interim solution with them.

With regard to the availability, like most of the rating agencies you can subscribe to get access to the information as it is issued, and that has been our general practice with regard to the ratings and classifications on securities.

In this particular case, as a result of some of the discussions we have had since I will say early June—in fact, I can recall sitting down with some of the CEOs and investment people at a meeting that ACLI organized here in Washington, talking about this early in June, we decided to go ahead and put some of that classification information regarding the segment of hybrids out on the Web site.

Typically, in the past, we would not have done that. That would have been available to those who subscribed to the service, so that that may ultimately be one of the ways to disseminate this information.

Mr. CONERY. If I may—

Mrs. BIGGERT. Mr. Conery.

Mr. CONERY.—just one point, just regarding fact. Thank you. We note very clearly it was a significant improvement to have the postings on the Web site, but we not only would challenge the point that some of the decisions regarding the actual classifications of certain issues were not reversed. I would agree with that point with respect to newer issues, but in some cases some of the classifications they were posting in fact were on securities that were issued 7, 8, 9 years ago that previously had been classified as either preferred stock or, in some cases, debt. So clearly there was a change in this whole methodology, which in part has created this whole concern about what is their methodology and lack of transparency.

Mrs. BIGGERT. Was there anything negative when something was not put on the Web site or was left off? Did people have concerns about the value of those hybrids?

Mr. CONERY. Well, it would be people who tried to make conjecture, and I would emphasize it was conjecture or market best estimate in terms of what other securities were likely to be impacted. I can say that most investors as well as most broker dealers have their own internally generated set of lists that they thought were likely suspects to be classified. But clearly everybody's list differed slightly.

Mrs. BIGGERT. Mr. Iuppa, you said that you had the special working group and asked for it. This was in July. Was this the time that you asked for a comment period, or was this earlier that there was a comment period open for people to talk about the hybrid securities and the classification?

Mr. IUPPA. It was actually earlier than the meeting itself, because we were getting comments broadly from interested parties subsequent to our June meeting, which was held here in Washington. But it was at that June meeting that we decided the need to have a special interim meeting of the VOS Task Force to air out and in a formal way obtain comments and input from interested parties. At that hearing on July 17th, I believe it was, is when the NAIC leadership directed that a special working group be put together that was tasked with what I would describe as financial and

investment experts within the regulatory community to work with the interested parties to develop a solution.

We didn't say develop a short and a long term. We said come to us with a solution. The consensus was the best way to deal with it is to deal in the short term with the financial reporting for risk-based capital and also to put together a long term solution as well.

Mrs. BIGGERT. Did you hear from a large number of the industry?

Mr. IUPPA. I estimated, and I believe it is conservative, that there were over 200 people at that meeting in New York. The real number was probably considerably higher than that.

Mrs. BIGGERT. I see.

Mr. IUPPA. The answer is yes.

Mrs. BIGGERT. Okay. I have one more question.

Mr. Hunter, it appears from the testimony that life insurers are major investors in hybrid securities. These securities seem to be very attractive to your member companies, but did this change, then, with—what effect did these regulations—or the reclassification, did that cause real angst that suddenly something that people thought was valued for a period of time—you know, the length of time that they would be held, how did that affect your companies?

Mr. HUNTER. Well, clearly insurers are significant consumers of hybrid securities. They are uniquely suited to the challenge that insurance companies have to comply and be in compliance with the risk-based capital systems that monitor reserves and because of the fact that so much uncertainty developed around these decisions, there was clearly a withdrawal from insurers investing in this marketplace and it—you know, capital flows freely, and I guess one of the unfortunate elements that maybe is of national concern is that you have these investments flowing into other parts of the world.

So there's clearly a very thoughtful and well-established mechanism and routine that was placed in some degree of disarray this past summer. As I said earlier, Congresswoman, we really want to give a lot of credit to the leadership of Superintendent Iuppa and others who have taken steps to provide a solution that provides more certainty in the marketplace with the hybrids.

Mrs. BIGGERT. So you think that the short-term proposal then will send the right message to the capital markets?

Mr. HUNTER. Well, it's been very helpful. You know, where we go from here, however, is critical. You know, my experience in government and the analog that I think is most applicable is that of a rulemaking or the promulgation of a regulation. You have adequate notice that's provided to stakeholders of regard to what's at issue. There is an opportunity for comment, possibly for hearings. And then you have a decision that is public and the rationale therefore is provided as a part of that decision. We think that very basic framework is one that will address concerns of our companies.

ACLI is every bit as committed to State regulation as they are to an initiative for an optional Federal regulator. We don't support an EFC, an Exclusive Federal Charter, just to make that record. We are going to have a number of companies chartered at both the State and Federal level, whatever happens going into the future,

so we are committed to this process and committed to working with the other commissioners in the States to improve it.

Mrs. BIGGERT. Thank you. Mr. Conery, do you think the proposal sent the right message to the capital markets?

Mr. CONERY. Well, clearly the insurance companies have begun to return to most areas of the market, so in that sense it has sent the right message, but people need to recall that it is an interim solution. It is a temporary solution. They have not yet said what that permanent solution will be relative to the temporary solution.

All along their dialogue has been saying that they are looking for a risk-based solution, which we are not sure exactly what that means, because they haven't chosen to define what risks they are talking about at this point in time, so it's certainly a move in the right direction relative to where we were back in May and June of this year, we're cautiously optimistic that it is the right solution for the interim, but we have a note of concern that it is a temporary solution.

If I could just make two quick clarifications on the characterization from the side of the BMA.

The BMA's position on the interim solution was not that we supported it, because we had our own proposal out there to the NAIC and to the working group. We did not object to the interim solution. I would say the same is still true. It is not that we support it as a solid risk-based solution, but we do not object to it, as we acknowledge that it is the least harmful of the other solutions that were out there.

I would also note, too, that while we have been open to talking with the NAIC, I would also recommend, too, that as we go forward and down this road with the NAIC, that probably it should be noted that working together should include less of a monologue and more of a dialogue.

Mrs. BIGGERT. Thank you. Thank you, Mr. Chairman. I yield back.

Chairman BAKER. I thank the gentlelady.

Mr. Iuppa, I want to return to an observation I made earlier, and didn't cover with you, and I believe I am understanding the existing process that constrains the disclosure methodology to a subscription base with the NAIC. Those are people to whom they pay a fee to which you give this opinion about financial quality, as contrasted with an NRSRO, who assesses a fee directly—in this case it would be on the insurance company, perhaps on the issuer—and there is no subscription base.

And so in looking at the model and potential revisions, if the NAIC was to move away from a subscription-based system to a fee-based system on the company and/or issuers, then there would not be this self-imposed constraint on who gets access to that data, and then the work would occur with the rated entity or rated product and prior to public disclosure some discussion takes place about how these conclusions were reached, not that that affects the ultimate decision by the SVO.

But then when the "final final" is made, it goes to everybody. That really is the NRSRO model and the only other addition would be just the disclosure of the empirical data that goes into the underlying assessment.

I may be well beyond my expertise on the subject, but that appears to be at least operationally what is causing this differential set of disclosure standards. So as you go forward, I would love to visit with your team better understand, and I did not request but would do so on the committee's behalf that at such time as you are final filed report is in receipt that the committee be given the opportunity to read and understand that set of findings as well.

We want to make sure going forward that we are working toward a mutual end goal that doesn't impair the NAIC's ability to protect the public interest, but we have a view toward stability in the capital markets. I have extreme concern about global competitiveness issues and particularly where I believe it to be a regulatory set of standards that causes people to make investment judgments elsewhere. We certainly want to do our best to mitigate those wherever possible.

But, as others have said, I want to express to you our appreciation for your courtesies, your staff meeting with ours was most helpful, we believe. We would like to continue in that manner going forward and to try to get resolution on this by the end of the year at the latest.

Unless there is anyone who has further comment—yes, sir?

Mr. IUPPA. If I may just a clarification. When I said that we hadn't reversed any of the decisions, I do want to point out that I, too, I guess may be in over my head a little bit, but there were about eight securities that were revised as a result, and these were older securities that have previously been in place.

I certainly appreciate, you know, the guidance that you are giving us with regard to moving forward. As I noted in my oral comments, I think that our definition of interested parties is probably a bit narrower than what may really be out there, and I think one of the challenges for us to reconcile our regulatory responsibilities with the broader responsibilities we have as financial regulators.

I certainly want to acknowledge and look forward to State insurance regulators being compared commensurately with the Federal Reserve and the SEC when we come before the committee in the future.

Chairman BAKER. Well, I would say that in the past some have described the "butterfly wing effect" that takes place somewhere around the world. What has happened to the SVO? They have now become the "elephant's foot" and they really have a direct and meaningful impact when that foot hits the ground, and we just want to make sure that we know where the elephant is, and where he is going, and we only want to feed it and make it happy. We don't want to cause people to take their capital and go elsewhere, perhaps to a less threatening environment, so we can get there, I think, and I appreciate the willingness to consider these proposals and to make whatever you think is the best regulatory judgment.

I thank our witnesses and our meeting stands adjourned.

[Whereupon, at 10:58 a.m., the hearing was adjourned.]

A P P E N D I X

September 20, 2006

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Statement of Kevin Conery
Senior Director and Preferred Securities Strategist
Merrill Lynch

On behalf of the Bond Market Association

Testimony before
Chairman Richard Baker
Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
U.S. House of Representatives

Hearing on Improving Transparency in State Regulation of Insurer Investments

September 20, 2006

Chairman Baker and Ranking Member Kanjorski, thank you for holding this important hearing on transparency in state regulation of insurer investments. My name is Kevin Conery. I am a preferred securities strategist at Merrill Lynch. It is a pleasure for me to offer this statement today on behalf of the Bond Market Association (BMA).

The BMA represents underwriters, dealers and investors in the $46 trillion global fixed-income market which includes both credit and interest rate products. One of our members' chief goals is the development of policies and practices that promote efficient and transparent markets. A lack of transparency can distort markets leaving issuers and investors with imperfect information that puts some participants at a trading disadvantage. It can cause securities to be priced inappropriately and capital to be misallocated.

BMA members have high regard for the role of the National Association of Insurance Commissioners (NAIC) which is the primary focus of this hearing. The NAIC and its members—the state insurance regulators—play a critical role in assuring the solvency of the nation's insurance industry. It is an important job that is essential to the U.S. economy.

On March 15, 2006, the NAIC's Securities Valuation Office (SVO) made a valuation ruling that had a chilling effect on the U.S. market for these securities. The BMA is pleased that the NAIC last week adopted an interim solution related to the capital

treatment of hybrid securities for U.S. insurance companies. This resolution increases the likelihood that insurance companies will return to their active roles in the hybrid securities market. We hope to continue a dialogue with the NAIC as it moves toward consideration of the broader question of the process by which securities risk valuations and classifications are decided and made public. Changes that lead to increased transparency, including in the conveyance of information about decisions and policy, are best for all markets.

Market observers believe there are tens of billions of dollars of hybrid securities currently in the pipelines. A key question these issuers must ask themselves is: In which country should these securities be brought to market? As long as the threat of regulatory uncertainty exists in the United States, issuers will consider the option of going to the capital markets of other countries.[1] Regulatory clarity is critical to maintaining the competitiveness of the U.S. capital markets.

NAIC Impact on the Market for Hybrid Securities

At present, the BMA's concerns with the NAIC's risk classification, securities valuation and the disclosure process are related primarily to the hybrid securities market.

As their name suggests, hybrid securities are debt-like instruments that afford their issuers some degree of consideration by rating agencies in the computation of capital or equity. Examples include trust-preferred securities and Yankee tier 1 securities. Over the past 10 years, the market has developed to the point where issuers, investors and rating agencies have become familiar and comfortable with certain variations of the instruments. All hybrid securities have a regular payment stream like a debt instrument or any other fixed-income security. The payments are similar to those of preferred stock in that they may be deferred and may or may not be cumulative. In addition, the payments associated with hybrid securities generally are subordinate to payments associated with more senior securities in a corporation's capital structure. These and other similar factors are considered by rating agencies in determining the credit quality of these assets from the perspective of the investor as well as how much "equity credit" the issuers of such securities should receive. "Equity credit" is a rating agency concept used in their credit analyses of issuers. It establishes a percentage amount of equity to assign to the security for purposes of conducting their internal credit analyses.

A principal role of the SVO is to recommend to state insurance regulators the levels of regulatory capital insurance companies must hold against particular investments. This oversight is important because it helps ensure that the capital charges associated with various investments are commensurate with their risks. It also helps ensure that insurance companies do not invest too much of their portfolios in risky assets by compelling insurance company investment managers to weigh capital charges against

[1] GE and Siemens sold nearly $4.5 billion in euro and sterling hybrids in early September. See *Hybrid Securities Grow in Popularity*, by Richard Beales, Financial Times, p. 26, September 12, 2006.

potential returns. Clearly, the determinations made by the SVO drive insurance company demand for particular assets. If the SVO assigns a high capital charge to a particular investment product, demand among insurance companies for that asset would wane.

Insurance companies are large investors in hybrid securities, and their actions significantly influence the market. Insurance company holdings can account for a significant amount of certain classes of hybrid securities. Insurance companies, for example, sometimes own as much as 80 percent of a particular issue of Yankee tier 1 securities. Any change to their risk-based capital charges is likely to affect insurers' interest in adding to or reducing their holdings and this influences the broader market. It may lead them to sell affected securities or refuse to participate in new issues.

Securities classifications by the NAIC's SVO are used in the NAIC's risk based capital (RBC) model. Broadly speaking, a security classified as debt or preferred is assigned an RBC charge that is based upon credit risk and is significantly lower than those for common equity. The risk of holding equity securities is based on the volatility of their prices. The risk of debt and preferred issues, in contrast, is based on the degree of certainty of their payment schedules and this produces lower risk factors for all securities that are not "in or near default." Thus, equity securities are assigned a higher capital charge by the SVO. This makes them less attractive to insurance companies which are an important segment of the hybrid securities market.

A common equity classification increases the risk-based capital charge for U.S. life insurance companies holding hybrid securities previously characterized as preferred equity or debt by 100 times—from a factor of 0.003 to 0.3. This is a significant negative change for many insurance companies. In response to such a classification, insurers are more likely to sell the affected securities, thus driving down the hybrid's prices and the prices of securities perceived by insurance companies to be similar.

The SVO, for many years, has rated many hybrid securities as debt or preferred shares in accordance with the debt/equity guidelines in the NAIC's SVO Purposes and Procedures Manual. Such a classification, as opposed to the category of common equity, makes the securities more attractive to insurers.

The NAIC's March 15, 2006 ruling disrupted the hybrid securities market by classifying Lehman ECAPS^{SM}, a type of hybrid security, as common equity. In the ensuing six weeks, the U.S. hybrid markets became virtually inactive. The NAIC did not publicly disclose its reasoning for this decision broadly, though a small number of insurance companies that appealed the ruling did gain access to this information. The information, however, was confidential. As a consequence of the classification, the prices of hybrid securities with features similar to ECAPS^{SM} and other hybrid securities with similar features dropped and their yields rose relative to other fixed-income securities. Investors—reasoning by analogy—viewed the securities as likely to suffer from a similar

drop in demand due to a similar SVO classification.[2]

ECAPS[SM] issued by Zurich Financial Services, for example, widened by as much as 45 basis points within two weeks of the Lehman ECAPS[SM] ruling.[3] Spread refers to the difference between the interest rate on a particular security and a common benchmark such as a Treasury bond. Widening spreads, then, represent higher interest rates or an increase in borrowing costs for issuers. It also means the value of hybrid securities held by insurance companies and other investors fell—by $159 million in the case of the Zurich issue.[4] Market participants reported that liquidity—the ability to easily buy or sell a security—declined dramatically in the wake of the March 15 classification. Where trades of as much as $50 million had been commonly available, only trades of no more than $10 million were possible.

The BMA—along with the American Council of Life Insurers—expressed its concern over what is viewed as an arbitrary classification system in a series of comment letters. Last week, on September 10, 2006, the NAIC effectively overruled the SVO by adopting an interim definition of hybrid security that made it clear such securities would not be classified as common equity. The NAIC's action—the definition expires at the end of 2007 or when a long term solution is agreed to—created a more certain environment for issuers and investors in the near term. Some observers are suggesting, as a result, that September and October could be the biggest months of 2006 for issuance of hybrid securities.[5]

The BMA is pleased this decision yielded a favorable—if interim—resolution to the industry's concerns. Despite this positive development, however, the fact does remain that the NAIC has never provided the market with an explanation for its initial classification of ECAPS[SM] common equity, or for the dramatic increase in such classifications. The same is true for other apparently arbitrary rulings that have cast the same issue of hybrid securities alternatively as debt, preferred equity and common equity.[6]

The BMA also notes the continuing need for a long-term solution. It would be appropriate for the NAIC to ultimately adopt the clear risk-based approach to these securities that it has applied to other assets and to initiate fair and timely public dissemination of the NAIC's valuation methodologies and ratings and classification decisions.

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[2] Spreads widened considerable for hybrid securities that are tax deductible with high equity content such as International Lease Finance Corporation ECAPS.
[3] A basis point is 1/100th of a percent.
[4] The market value of Zurich's ECAPS[sm] yielding 6.15% and 6.45% fell $71.38 million and $88.4 million respectively between March 13, 2006 and June 30, 2006. See Appendix 1.
[5] *Hybrid Securities Grow in Popularity*, by Richard Beales, Financial Times, September 12, 2006.
[6] In 1999, the NAIC rated a hybrid security issued by Dresdner as a bond. In 2005 it was reclassified as common equity and then in the summer of 2006 reclassified again as preferred equity.

Transparency

The SVO website makes it clear its rulings are intended for use by insurance regulators and insurers, and should not be relied on by other investors. But since information produced by the SVO can have a direct effect on the market it is not something investors can ignore. SVO classifications are material to all investors, not just insurance companies. In the case of the Lehman ECAPS[sm], approximately 90% of the securities were held by non-insurance companies that are not subject to the regulatory action that caused the value of the securities to decline.

While the NAIC valuation database system is public, accessing information is laborious and costly and functionally renders it non-public. Under the current system, some insurance companies have the option to do searches on portfolios of securities. Non-insurance companies generally need to search for a security by its unique identifying number or CUSIP. The NAIC charges a fee for each search and does not typically notify the public of reclassifications. Investors face the equivalent of paying to search for needles in a haystack. No one is told, however, when a new needle has been added. The system inhibits broad access to information as rulings are private. As a result, key securities valuation information is discovered by certain parties randomly and at different times. Trading on such information is contrary to a basic tenet of U.S. securities markets that all investors have equal access to material information.

Beginning in May, the SVO did begin posting notices of its classification, reclassifications and designations on its website for hybrid securities. This is a welcome development. It does not, however, respond to the requests for information about how and why these decisions are made.

In the case of disagreements with decisions of the NAIC, insurance companies owning an asset may submit an appeal of the decision. But this review process is limited to insurance companies that actually own the security. Only those insurers are entitled to receive information concerning the decision and they are required to hold it in confidence. They are prohibited from sharing it with any other party, including other insurers owning the asset, and most particularly with potential purchasers of the asset. This effectively sanctions the limited distribution of potentially material information to the investing public. Even more problematic is the possibility that insurers in possession of this information may be effectively prohibited from selling the asset because they may not disclose their reasons for selling to potential purchasers. This exposes them to needless risk.

Providing information to some market participants but not others also raises issues related to the insider trading rules of the Securities and Exchange Act of 1934. These rules prohibit market participants from engaging in securities transactions based on "material, non-public" information. To the extent that SVO decisions affect the pricing of

securities, information regarding those decisions may be "material." To the extent that that information is provided to only a select group of market participants, that information may be "non-public." Communicating the details of an SVO decision that could affect the prices of securities to only a select group of market participants could have the effect of prohibiting those market participants from trading the affected securities without violating the insider trading rules. If an SVO decision caused prices of securities to fall, the decision could have the perverse effect of preventing insurance companies who were informed of the decision from trading the securities.

Rating agencies such as Moody's and Standard & Poor's perform a function similar to the NAIC as they provide credit ratings that convey opinions of the likelihood of payment streams being realized. These firms distribute ratings changes through releases to the press and publication on their website. This is critical to the fair dissemination of information.

Given the broad effect of SVO rulings, it is clear the information should be publicly and broadly available. The NAIC valuation process and disclosure should be as transparent as that of credit rating agencies and other regulators of capital such as the Federal Reserve Board (Fed) and the Securities and Exchange Commission.

One of the best known examples of this in the hybrid market occurred in 1996. When banks sought a ruling from the Federal Reserve Board on the capital treatment of trust-preferred securities, the Fed made made its decision to allow trust preferred securities to comprise up to 25 percent of Tier 1 capital. The reasoning behind it was made known to all market participants in a timely and fair manner via a public letter. Other important Fed decisions and their rationales have similarly been conveyed through public letters. This is the manner in which any regulatory review process should function.

Enhancing Transparency

Given the impact NAIC decisions have had and can have on the financial markets, it would be in the best interest of market efficiency if the NAIC adopted more transparent policies to govern its disclosure of securities classification rulings as well as the criteria it uses to make these rulings. As the BMA has stated in comment letters to the NAIC, the SVO should adopt new disclosure policies for its securities valuation decisions.[7] Specifically, the SVO should make public the basis and rationale for its classifications and reclassifications and disclose its rulings uniformly through press releases and website postings.

Information on classifications, reclassifications and designations is material to all parties, not just insurance companies. To assure market efficiency, such information should be

[7] Letter with ACLI: Public Dissemination of Information Regarding NAIC Classification and Designations. May 17, 2006. See Appendix 2.

available and distributed to all market participants at the same time. The present disclosure system distributes material information to market participants inconsistently and results in unfair treatment of market participants.

The BMA has also called for better disclosure of the rationale behind the NAIC's classification decisions. To know the outcome of a classification decision is of limited value to the market if participants cannot comprehend how such decisions were made and whether there is any application beyond the immediate issue. Disclosure of rationale is standard among other capital regulators and credit rating agencies. We also propose that the NAIC produce such information for all securities it rates.

The NAIC would also reduce ambiguity and confusion in the market regarding how decisions are reached by withdrawing the SVO's Statement on Classification Analysis[8] released in the spring of this year. In the Association's view, the SVO's Statement, which was never adopted by the NAIC, creates unnecessary confusion and places new emphasis on subjective elements which provide no clarity to the market. The Statement should be withdrawn. If the NAIC believes it is necessary to review and update the existing objective and clear set of criteria for classification standards, it should do so. This will enable market participants to better structure new issuances and re-establish investor confidence.

Conclusion

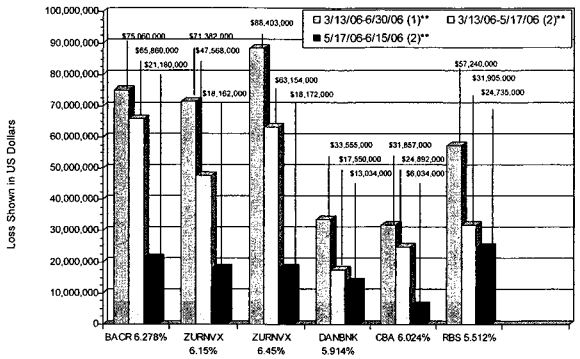
The BMA acknowledges the constructive working relationship the NAIC has maintained with the industry especially over the past six months, as well as the steps forward that they have taken. We continue to note, however, that more needs to be done in order to raise disclosure standards and practices to the higher levels held by other market participants. We appreciate the adoption of the temporary definition of hybrid securities because we recognize it has facilitated the return to the market of many issuers and insurance companies. As noted above, however, the market still strongly encourages the adoption of a long-term solution that uses a risk-based approach to the valuation of hybrid securities. The Association also urges the NAIC to develop a more transparent method of disseminating the basis for its determinations and its rulings as equal access to information for all investors is critical to efficient markets.

Thank you again for the opportunity to present this statement to the subcommittee.

[8] See: http://www.naic.org/documents/svo_statementonclassificationanalysis.pdf

Appendix 1

Loss on Certain Yankee Tier 1 and Equity-enhanced Hybrid Securities*



* Source: The Bond Market Association.

** Key dates: 3/15/06, Lehman ECAPS℠ were classified as common equity; 4/16/06, Report of SVO Classification Determinations, Report Number 1 was issued; 6/14/06, Report of SVO Classification Determinations, Report Number 2 was issued; and 6/27/06, Report of SVO Classification Determinations, Report Number 3 was issued.

(1) DANBNK 5.914% gives information for 3/13/06 and 6/29/06.

(2) BKIR 5.571% and DANBNK 5.914% give information for 3/13/06 and 5/19/06, and 5/19/06 and 6/15/06.

Appendix 2

The Bond Market Association
360 Madison Avenue
New York, NY 10017

American Council of Life Insurers
101 Constitution Avenue NW #700
Washington, DC 20001

May 17, 2006

Re: Public Dissemination of Information Regarding NAIC Classifications and Designations

Dear Officers and Members of the National Association of Insurance Commissioners:

The Bond Market Association (the "Association")[9] and the American Council of Life Insurers ("ACLI")[10] respectfully request that the National Association of Insurance Commissioners (the "NAIC") disseminate to the public information regarding (i) when any security is being reviewed by the NAIC for classification or reclassification purposes and (ii) any reclassification and the clearly articulated rationale for such reclassification (*e.g.*, disclosure of which features of the securities result in a particular classification and why).[11] We believe that such dissemination should be effected through a press release, easily accessible notice on the NAIC website or similar dissemination reasonably designed to provide broad, non-exclusionary distribution of the information to the public in a timely manner, as is the practice of other organizations that express opinions

[9] The Association is a trade association that represents approximately 200 securities firms, banks and asset managers that underwrite, trade and invest in fixed-income securities in the Unites States and in international markets. Fixed income securities include U.S. government and federal agency securities, municipal bonds, corporate bonds, mortgage-backed and asset-backed securities, money market instruments and funding instruments such as repurchase agreements. More information about the Association and its members and activities is available on its website www.bondmarkets.com.

[10] ACLI is the principal trade association of life insurance companies, representing 377 member companies that account for 91 percent of total assets, 90 percent of the life insurance premiums, and 95 percent of annuity considerations in the United States.

[11] For purposes of this comment letter, a reclassification occurs when (a) the classification of an existing security is changed from preferred equity or debt to common equity, (b) the classification of an existing security differs from the second lowest rating accorded such security by any NAIC recognized nationally recognized statistical rating organization ("NRSRO") or (c) a security is first rated by the SVO.

regarding credit which have market impact.[12] In addition, given the impact of NAIC decisions on the financial markets, we respectfully request that the NAIC provide greater clarity to the public regarding its basis for determining the general classifications of securities by withdrawing the Statement on Classification Analysis (the "Statement") issued by the NAIC Securities Valuation Office ("SVO"). For purposes of this comment letter, we illustrate the need for such dissemination and clarity on classifications and designations through the SVO's recent treatment of certain fixed income securities that have both debt and equity characteristics ("Hybrid Securities").

A. Material Information Should Be Disclosed To All Market Participants Equally.

NAIC classifications and designations of securities can significantly impact the market value of such securities, especially with respect to securities that are "filing exempt" under the Purposes and Procedures Manual of the SVO (the "Manual").[13] Such market-moving information should be distributed to all market participants real time. Currently, the NAIC disclosure system favors certain market participants to the detriment of others.

Public Policy Considerations; Federal Securities Laws. Public policy dictates that material information disclosed to one or more persons should be disseminated to the public simultaneously. Information transmitted unequally erodes investor confidence and gives privileged parties unfair advantages. The importance of this public policy is embodied by federal securities laws, which have established certain rules to protect investors and the market from such loss of investor confidence and unfair trading. For example, subject to certain exceptions, Regulation FD (fair disclosure) under the Securities Act of 1933, as amended (the "Act"), requires issuers and persons acting on their behalf to disseminate material information disclosed only to certain enumerated parties in a manner "reasonably designed to provide broad, non-exclusionary distribution of the information to the public." In addition, insider trading provisions such as Section 10(b) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Rule 10b-5 of the Exchange Act prohibit people who are likely to gain access to material information not broadly disseminated from trading with such inside information. These regulations exist because, among other reasons, the Securities Exchange Commission (the "SEC") wanted to level the playing field for all investors and eliminate selective

[12] We note that NRSROs, such as Moody's and Standard & Poor's, and the NAIC both essentially provide credit ratings. However, Moody's and Standard & Poor's, for example, issue press releases regarding their rating actions. The similarity between NRSROs and the NAIC is highlighted by the fact that the NRSROs' credit quality ratings of securities are automatically translated into their equivalent NAIC Designations (which are the NAIC's credit ratings) without any action by the NAIC. In addition, for securities owned by insurers but not rated by NRSROs, the SVO provides Designations and "classifies" securities as debt, preferred equity or common equity. Currently, the SVO rates approximately 5% of the 225,000 securities in its database.

[13] Generally, securities are "filing exempt" under the Manual if they have been assigned a current, monitored rating by a NRSRO.

disclosure of material information to parties likely to use the information in buying and selling securities, and to prevent parties from profiting unfairly.

NAIC Classifications and Designations Are Material Information. Pursuant to public policy considerations, the NAIC should disclose information regarding the classifications and designations of securities, including Hybrid Securities, and the reasons for such classifications by public dissemination because such information is material to the market and information disclosed unevenly can result in unfair profiting by parties with such information and can erode investor confidence. Information is generally defined to be material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[14] Insurance companies are large investors in Hybrid Securities, and their actions significantly influence the market; insurance companies typically represent approximately 10-30% of the holders of Hybrid Securities, depending on the specific Hybrid Security.[15] For instance, in the case of Rabobank Securities (as defined and discussed below), insurance companies held approximately half of such $1.5 billion outstanding Rabobank Securities at the time that the NAIC made its classification determinations. NAIC classifications significantly impact prices of individual securities and types of securities because they affect insurer demand for assets.[16] A common equity classification by the SVO increases the risk-based capital factor for U.S. life insurance companies holding Hybrid Securities previously characterized as preferred equity or debt by 100 times (from 0.003 to 0.3). Most insurance companies, unprepared for such a significant change, simply sell the affected Hybrid Securities.[17] This in turn influences the decisions of non-insurance companies. For example, in the case of ECAPS^{SM} [18] (as defined and discussed below), there was almost an immediate depreciation in the price of such securities despite the fact that approximately 90% of ECAPS^{SM} were held by non-insurance companies that are not directly subject to the risk-based capital calculations imposed on insurance companies. Indeed, the New York Insurance Department (the "NYID") has acknowledged that the NAIC's classifications have impacted the trading of the market, a benchmark for determining materiality.[19]

B. Current System Distributes Material Information Unequally.

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[14] *TSC Industries v. Northway, Inc.*, 426 U.S. 499 (1976).

[15] *Hybrid Bonds Widen on Equity Classification*, Reuters, March 15, 2006.

[16] For example, the Financial Times has reported that the ECAPS^{SM} ruling created "a potential damper on...appetite [of insurance companies] for future hybrid issues and hence a jolt for the market as a whole." The Financial Times, London Edition, April 25, 2006, at 43.

[17] The Wall Street Journal has noted that "The potential withdrawal of insurers has weighed heavily on hybrid securities in the secondary market." Aparajita Saha-Bubna, *Swiss Re Offering Tests Hybrid Market*, The Wall Street Journal, May 3, 2006, at C4.

[18] ^{SM} "ECAPS" is a service mark of Lehman Brothers Inc.

[19] "We realize fully that this determination [regarding the classification of ECAPS^{SM} as common equity] has had impact on both pricing of certain securities in the market and on new securities offerings in the pipeline." Superintendent Howard Mills, Remarks on joint NAIC and NYID call (April 19, 2006).

The current NAIC system inherently results in such material information being disclosed to some market participants before disclosure to others, and the impediments to obtaining such information make the information functionally non-public. The NAIC does not announce when designations change and anyone interested in determining a current designation, classification or price must actively and continually monitor the NAIC's database by either running searches on individual securities or, in the case of certain insurance companies, on portfolios of securities. Currently, there are approximately 225,000 securities listed in the NAIC's database. The fees payable to the NAIC for accessing the database for eight hours per day would be nearly $350,000 per year at current rates.[20] See Annex A attached hereto for more information. Given the cost and the labor involved, we believe that few if any insurance companies or non-insurance companies continuously monitor individual securities on the NAIC's database, and most insurance companies that can afford to maintain portfolios access the system quarterly at best. As a consequence, material information regarding the actual reclassification is transmitted randomly only to a participant who happens to be running a search on a particular security, rather than collectively to all market participants. The expensive, labor-intensive and speculative nature of the search process acts as a real barrier to obtaining material information. It effectively makes the information non-public. Accordingly, a more efficient and fair means of disseminating this material information is necessary. The need for information to be disseminated equally is especially acute when the SVO reclassifies a security because this has a large impact on capital computations. It is our understanding that the NYID, chair of the Valuation of Securities Task Force, has informally recognized the need for better dissemination of information. In connection with ECAPS^{SM} the NYID of its own volition attempted to notify the market that ECAPS^{SM} had been reclassified by informing some market participants, including non-insurance companies, of the change, rather than simply hoping that subscribers to the NAIC database would come across the reclassification through inquiries.

In addition, under the current system, information as to why a security has been reclassified is disclosed only to insurance companies, and at different times. For example, in the case of Rabobank Securities, insurers who heard of the decision were able to speak with the SVO to obtain clarifications, while other investors, although impacted by the decision, were unable to obtain any such clarifications directly from the SVO. This is because it has been the policy of the NAIC not to respond to non-insurers.[21] In fact, certain insurers who learned that the decision by the NAIC was based on a lack of information were able to provide the requested information to the NAIC, thereby causing the foreseeable outcome of a reversal of the NAIC decision. Due to the unequal distribution of information regarding the reasons for reclassification, some investors were able to determine whether the NAIC decision was likely to stand or to be overturned, thereby gaining an advantage over other investors.

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[20] The NAIC charges non-insurance companies an annual fee of $1,400, and $2.75 per minute. The calculation assumes an eight hour work day five days a week.

[21] "We do not concern ourselves with communicating with entities other than insurance companies." Robert Carcano, Senior SVO Counsel, Remarks on joint NAIC and NYID call (April 19, 2006).

C. Examples of Current System and Consequences of Failure to Broadly Disseminate Information.

As illustrated by the cases of Rabobank Securities and ECAPS[SM], the disclosure of information to certain parties rather than to all parties automatically preferenced such parties over other investors to the detriment of the market.

Rabobank Securities. A recent example of the harm resulting from unequal transmission of material information relates to the treatment of the Rabobank Capital Fund Trust III Non-Cumulative Guaranteed Trust Preferred Securities (CUSIP Number 74969AA3) (the "Rabobank Securities") which was initially reported as debt, subsequently classified by the SVO as common equity and then reclassified as preferred equity, all without notification or explanation of the reasons for the change in classification to the public. It is very possible that certain investors profited unfairly to the detriment of other investors as a result of the failure to disclose classification information to the public at the same time. We believe that, in addition to the problems of accessing information through the NAIC classification database, in this particular case, additional preferential treatment was conferred on a particular investor. We understand that one insurer, out of approximately 90 other insurance companies which held the security, was advised by the NAIC that unless the insurer provided certain information to it, the security would be classified as common equity. Thus, the insurer had prior knowledge that the NAIC would change its classification to common equity if it did not provide such information, and could have used such material non-public information to improve its investment strategy to the disadvantage of the rest of the market. The insurer declined to provide the information sought by the NAIC, and as indicated, the NAIC listed the security as common equity on its database. We understand that information regarding the reclassification was not known to market participants, other than the insurance company previously notified by the NAIC, for a full ten days after the change in classification. In addition, we understand that, after an insurance company stumbled upon such information through a routine search on the NAIC database, the information traveled in the market through word of mouth and email, thereby resulting in certain market participants receiving such material information before others. Investors armed with such information could sell or short Rabobank Securities in advance of the rest of the market, thereby profiting due to the unequal dissemination of information.

As a result of the lack of equal distribution in information and the reduction in insurer demand for Rabobank Securities due to the reclassification, investors lost confidence in the market. From the period of time that information regarding the classification was disseminated to the marketplace and the time the decision was reversed, we understand that spreads on Rabobank Securities widened by approximately 15 basis points. In contrast, during such period, spreads on corporate bonds widened by four basis points.[22] We understand that after the decision was reversed and such decision was known to the market, spreads on the Rabobank Securities were comparable to spreads for corporate bonds. In addition, due to the uncertainty regarding the reasons for

[22] Merrill Lynch U.S. Corporate Master Index.

the reclassification, during the period of time that information on the reclassification was disseminated to the time that the decision was reversed, there were no new issuances of Hybrid Securities targeting institutional investors.

ECAPS℠. A recent example of the harm resulting from lack of clarity regarding guidance on classifications, reclassifications and designations and how widespread communication to the public can restore confidence in the market is illustrated by the NAIC's March 15, 2006 reclassification as common equity of $300 million ECAPS℠ (52520YAA5) ("ECAPS℠") issued by an affiliate of Lehman Brothers Holdings Inc. The potential for reduced insurer demand for newly issued assets in itself depressed prices of existing Hybrid Securities, including the ECAPS℠, but the prospect of outright selling reduced prices even more. During the period of time from March 15, 2006 until May 14, 2006, spreads on ECAPS℠ widened by approximately five basis points, while spreads on corporate bonds for such time period widened by approximately two basis points. In addition, the SVO did not disclose specifics regarding the features of ECAPS℠ that it determined required the reclassification of common equity except to several insurance companies that indicated that they intended to appeal. As a consequence, Hybrid Securities with features similar to ECAPS℠ suffered from reduced prices and wider spreads as investors reasoned by analogy rather than with real insight.[23] As an example, the $600 million 6.15% ECAPS℠ issued by Zurich Financial Services widened by as much as 45 basis points within two weeks after the Lehman ECAPS℠ were reclassified as equity by the NAIC. Furthermore, we understand that, due to the lack of information about the features of the security that the NAIC determined justified treatment as common equity or the specific rationale for the classification as common equity, the market experienced a significant reduction in new issuances. Issuers were reluctant to sell new Hybrid Securities as they lacked guidance on how to structure such securities and investors were unwilling to buy new Hybrid Securities as they were concerned that such new Hybrid Securities might be classified as common equity and result in sales by insurers.[24]

D. Clarity on General Classifications Is Needed.

To avoid the ambiguities and confusion in the market as illustrated by Rabobank Securities and ECAPS℠ and in accordance with general principles of public policy, the NAIC should issue specific information regarding the reasons for a reclassification as discussed above, and maintain the general standards for determination of classifications as documented by the Manual, unless public comment is solicited and considered. While

[23] Spreads widened significantly for Hybrid Securities that are tax deductible with high equity content, such as the ECAPS℠ issued by International Lease Finance Corporation.

[24] "[H]ybrid offerings—particularly those with structures that carried a potential risk of being classified as common stock by the SVO—have been noticeably absent since March." Aparajita Saha-Bubna, *Swiss Re Offering Tests Hybrid Market*, The Wall Street Journal, May 3, 2006, at C4. The "market [for hybrid securities] has been uncertain since a surprise decision by insurance regulators in March discouraged insurers, who had been buying about 20 per cent of the [hybrid securities] issues, from owning them." Richard Beales, *New Issues: Swiss Re's Hybrid Issue*, Financial Times, May 4, 2006.

we note the SVO's attempt to provide additional guidance on classifications through the recent posting of the Statement, we believe that the NAIC should withdraw such Statement, subject to further review. The Statement creates unnecessary confusion and places new emphasis on subjective elements which provide no clarity to the market. In particular, the Statement mentions that the NAIC will base its classifications in part on the investor's expectation of its rights, which is an amorphous and unclear standard, and which could result in structurally similar securities receiving different treatment in the hands of different insurance companies. The Statement provides no examples or other forms of interpretation for its criteria. In addition, under the current regime, such a standard would further frustrate the goals of an efficient market; utilizing subjective factors in determining classifications while failing to articulate the rationale driving the classifications provides no guidance and creates more ambiguity. We believe that withdrawal of the Statement until due process has been undertaken will help provide some clarity regarding the NAIC's determination of classification standards and will enable market participants to better structure new issuances and re-establish investor confidence in Hybrid Securities.

E. Summary.

For the aforementioned reasons, we respectfully submit that the NAIC's decisions regarding classifications, reclassifications and designations, as highlighted through its treatment of Hybrid Securities, have far-reaching implications and are material information that should be disclosed to all market participants real time through a press release or other similar dissemination reasonably designed to provide broad, non-exclusionary distribution of the information to the public in a timely manner, as is the practice of other organizations that express opinions regarding credit which have market impact. We request that the NAIC permit all market participants to obtain such material information at the same time so that none has an unfair advantage over others. In addition, we respectfully request that further information regarding how classifications are determined be disclosed and clarified through the formal process set forth in the Manual, including adequate public review and comment, and that any such classification guidance provide information regarding particular features, including weighting of relevant features, which result in the classification of securities as debt, preferred equity or common equity.

* * * * *

We appreciate the opportunity to comment and we look forward to working with the NAIC, the SVO and other market participants on resolving these vitally important underlying public policy issues. If you have any questions concerning these comments, or would like to discuss these issues further, please contact Mary Kuan of The Bond Market Association at mkuan@bondmarkets.com or 646-637-9220, or Steven Clayburn of the American Council of Life Insurers at steveclayburn@acli.com or 202-624-2197.

Sincerely,

Mary Kuan
Vice President and Assistant General Counsel
The Bond Market Association

Steven Clayburn
Senior Director and Actuary
American Council of Life Insurers

Statement
of the
American Council of Life Insurers

on

Improving Transparency in
State Regulation of Insurer Investments

before the

Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises
of the
House Financial Services Committee
of the
United States Congress

September 20, 2006

Mr. Chairman and members of the Subcommittee, I am Michael J. Hunter, Executive Vice President and Chief Operating Officer of the American Council of Life Insurers (ACLI). I am here today on behalf of our 377 members which account for 91 percent of the life insurance industry's total U.S. assets. ACLI members offer life insurance, annuities, pensions (including 401(k)s), long-term care insurance, disability income insurance, reinsurance, and other retirement and financial protection products.

I would like to thank the Subcommittee for the opportunity to present the life insurance industry's views regarding the current regulatory oversight of investments held by insurance companies. As investors holding approximately $4.2 trillion of securities or approximately 12% of the total investments in the U.S. capital market[1], actions and decisions regarding the regulatory oversight of our investments are critical to the business operations of ACLI member companies, the customers we serve, and arguably to our nation's economic stability. As you are aware, the insurance industry is a state regulated industry with companies operating under the supervision of each state in which the company is licensed to operate. The NAIC is an association comprised of the state insurance regulators. The Securities Valuation Office (SVO) is an NAIC organization that is charged with examining the credit quality and value of insurers' investment portfolios.

We understand that one reason this Committee has called for this hearing is to better understand the decisions made earlier this year by the SVO regarding hybrid securities. Hybrid securities are structured with characteristics of both debt and equity. Each hybrid security is structured with unique characteristics that take into account capital treatment, rating agency concerns and tax treatment. These securities are widely issued by highly rated financial institutions, including insurance companies, to boost their capital positions and allow the issuer to defer coupon payments in times of financial distress. And,

[1] ACLI 2006 Factbook

because they tend to be high value and low risk investments, insurers often hold hybrid securities within their diverse portfolios. Insurers have generally classified these securities as bonds in their financial statements. This is consistent with the classifications of hybrids by the Nationally Recognized Statistical Rating Organizations ("NRSRO's"; ie, Standard & Poor's, Moody's, etc.), and with their structure (i.e. sold with par value as opposed to shares).

The decisions made by the SVO beginning in March created such a level of uncertainty in the capital markets that holders of these securities experienced a substantial decrease in their market value. The aggregate decrease in market value among all insurers was approximately one billion dollars. Additionally, insurers experienced a drastic reduction in the ability to trade these securities. Companies that previously could liquidate positions as great as fifty million dollars in a single day were only able to sell approximately ten million dollars in a day after the SVO's action. When these classifications were first made, there was universal disagreement with these decisions from buyers, sellers, rating agencies and even some regulators. Even with this disagreement, the SVO never reexamined its actions and instead went on an aggressive course of action that resulted in many additional securities being reclassified or classified incorrectly. Based on these factors, I believe a fundamental issue for this Subcommittee to consider is what role the SVO should play in the ratings and valuation of the securities held by insurance entities, and exactly how that role should be carried out.

I should acknowledge that as of today it appears that a workable short-term solution to the hybrid securities situation has been reached. We anticipate a favorable response to this solution by the capital markets and expect to experience a recovery of some of the market value and liquidity in the market for hybrids. This short-term solution was accomplished thanks to the extraordinary effort of both the industry and NAIC leadership over the last few months. I

compliment and commend Superintendent Iuppa on the vital leadership role he played to help us get to this positive outcome.

In 1907, the NAIC established a committee for the valuation of securities. That committee established uniform values for securities held by insurers by contracting with Moody's, Poor's Publishing and other rating agencies. Eventually, the NAIC felt that they could perform this function internally at a reduced cost and thus formed the SVO. In addition to lowering internal costs to the NAIC, the SVO was responsible for the valuation of investments made in private and public companies for which no value was obtainable from private statistical rating organizations. However, in the late 1990's the NAIC realized that a more effective way of valuing securities would be to rely on the values provided by Nationally Recognized Statistical Rating Organizations (NRSRO's), so today insurers rely on NRSRO's to determine the value and classification of most of their securities. With the SVO employing approximately twenty analysts and the NRSRO's employing approximately twenty thousand analysts, that decision resulted in a more efficient and reliable ratings process. In the event that a security is not rated by an NRSRO, the SVO will value and classify that security. Additionally, a state regulator may ask the SVO to value or classify any security that an insurer has in its portfolio.

To understand the importance of the classification of securities to an insurer, one must understand the NAIC's Risk-Based Capital (RBC) system. The RBC system uses a formula to establish the minimum amount of capital necessary for an insurance company to support its business operations. The system limits the amount of risk a company can assume by requiring higher amounts of capital for bearing higher amounts of risk. Computing risk-based capital helps determine when and what actions regulators should take in the event a company's actual capital and surplus falls below its calculated minimum.

All securities are classified as either debt/preferred stock or common stock. Within each of these designations, each security is assigned a classification ranging from a 1 (highly rated) to 6 (at or near default). While a highly rated class 1 debt instrument or preferred stock requires a 0.3% capital charge, a highly rated class 1 common stock requires a capital charge of 30%, or one hundred times higher than that of debt or preferred stock. To put this in another context, a highly rated debt instrument or preferred stock with a market value of one million dollars would require a company to allocate three thousand dollars for risk-based capital, while a common stock of equal market value would require three hundred thousand dollars be allocated. Due to the extremely high capital requirement for common stocks and the risk-averse nature of life insurers, their portfolios contain substantially more debt securities than common stock.

The SVO's recent actions on hybrid securities illustrate the effect that both classifications and reclassifications can have on both insurers and the capital markets. While our member companies had serious concerns with the underlying rationale for these decisions, our primary concerns with the SVO are those of process and transparency. We believe the SVO must adopt and employ an open, transparent process by which it classifies securities, disseminates those decisions to market participants, and provides clarity as to why and how these classifications are made.

It is also imperative that reclassifications not be made to securities previously classified by the SVO absent a material change in the structure of the security. Insurance entities purchased these with an expectation that the classification by the SVO would be consistent for the life of the security only to have the classification changed with no rationale provided for such change. Entities cannot effectively manage their investment portfolios with this level of uncertainty and lack of transparency. When the SVO reclassified several securities from debt to common stock in March, investors were left to wonder what prompted the change. Industry representatives immediately requested the SVO communicate

the additional risks it perceived these securities contained that are not considered in the ratings process of the NRSRO's. We commend the New York Insurance Department's recently drafted document identifying the risk factors they believe are inherent in hybrid securities. The SVO however, has yet to respond to industries repeated requests for this information, even though they are the ones making these decisions.

Further, when the SVO acts to a request to rate a security, the only entity that receives the decision on the classification is the entity that requested the classification. Other insurers may own the security, but have no way to know if it has been "downgraded" by the SVO. Similarly, issuers of securities, dealers and investors do not receive this information. By contrast, NRSRO's issue a press release with the rating of each new security along with the corresponding rationale for the rating given. We are at a loss to understand the public policy purpose behind this apparent intentional lack of transparency on the part of the SVO. The SVO should disclose information on its classifications and rating designations by public dissemination because such information is material to the market and information disclosed unevenly can erode investor confidence. Additionally, the basis for the SVO's decision on a particular security is only disclosed to the entity that made the request. The SVO considers this information privileged and confidential; the entity is prohibited from sharing this information with other investors or issuers of the security. As insurers and other investors eventually learn of an SVO classification, they are unable to speak with the SVO to obtain clarification as to why and how the decision was made. There is no legitimate public policy served by this secrecy.

In the case of hybrid securities, and as a direct result of all the recent confusion, the SVO has begun a process by which all classification decisions regarding these securities are posted in a report on the NAIC website. We applaud this move as a good first step in improving transparency and are strongly in support

of it. However, this system is not in place for other SVO rated securities and as previously noted, the empirical basis for these ratings is not disclosed.

SVO staff has stated publicly that their designations are not produced to aid in the investment decision-making process and, therefore, are not suitable for use by anyone other than regulators and the individual insurers affected. This is a completely unrealistic and impractical position to take. As we have recently seen, SVO actions do have an immediate and significant impact on the capital markets. This stance does nothing more than foster a lack of confidence in the integrity of the process, as well as within the industry and the market place.

It is important to understand that this is not the first time that the SVO's actions have been called into question. In fact, during the late 1990's the NAIC itself commissioned KPMG to conduct an extensive review of the SVO's operations. The findings in that report advised the NAIC that there were serious deficiencies in the SVO's work product. To our knowledge, however, the NAIC has taken no action to this day to implement the KPMG recommendations. Choosing not to act before now to address these problems almost certainly helped lead to the situation that surfaced this year regarding hybrid securities. Recently, NAIC leadership and other key regulators involved with SVO issues have stated their intent to perform a thorough review of all SVO process and transparency issues. We support the NAIC taking such action, and look forward to working with them in hopes of finding a system that works for all parties affected by SVO decisions.

In summary, we would like to leave the Subcommittee with three main points:

1. Buyers and sellers of securities must know in advance when the SVO is analyzing a particular security or class of securities. This will provide stakeholders the opportunity to provide input to the SVO to insure that a fully informed decision will be made;

2. The SVO must publicly communicate the empirical basis for all ratings decisions made so that issuers of securities can understand what risk characteristics the SVO has identified that could lead to a different rating than that of the NRSRO's. Armed with this information, investors will be in a position to assess their investment portfolios and make an informed decision as to whether they wish to continue to hold the security or securities in question;
3. The NAIC has shown a willingness to allow the use of NRSRO ratings, and expanding that system is one option for consideration, leaving the SVO to focus solely on solvency issues. However, should regulators not be willing to cede all rating and classification decisions to the NRSRO's, it is then imperative that an open, transparent system for SVO action be implemented.

I again would like to thank the Committee for inviting the ACLI to participate in this hearing.

Testimony of Superintendent Alessandro Iuppa
on behalf of the National Association of Insurance Commissioners (NAIC)
before the House Financial Services Subcommittee on
Capital Markets, Insurance, and Government Sponsored Enterprises
Washington, DC
September 20, 2006

Chairman Baker, Ranking Member Kanjorski and distinguished members of the subcommittee, thank you for providing me the opportunity to present the views of the NAIC on transparency in the regulation of insurer investments. The financial regulation of insurance is essential to consumer protection and we do this job well. Without consumer protection afforded by financial regulation, an insurance policy may not be worth the paper it is written on. We serve the public by means of independent and honest financial analysis to serve our regulatory duties of safeguarding insurers capacity to pay claims. The NAIC is continuously evolving and improving to keep up with the changing markets and I am confident in the integrity of our open and transparent processes. Nonetheless, like any good organization working in a dynamic market, we have initiated a review with respect to the issue of disclosure and transparency of our classification process covering hybrid securities. The NAIC's Valuation of Securities Task Force, comprised of financial solvency and investment experts, has pledged to evaluate the guidance provided to our analysts, as well as the communication practices revolving around our classification decisions. A final report on the Task Force's finding is expected by the NAIC's National meeting in December. We welcome the chance to have a dialogue with Congress on this complex issue.

We would not be here today if not for our recent decisions on hybrids. We stand by our recent analysis. The way we handled the issue is an example of how we are transparent and responsive in a dynamic marketplace. Following the concerns raised by the American Council of Life Insurers and the Bond Market Association about a complex

product that represents a small sliver of the market, the NAIC responded by holding a public hearing to gather the perspectives of rating agencies, insurers and trade associations. In mid July, the NAIC appointed a special working group to evaluate the appropriate risk based capital treatment of hybrid securities. During our national meeting in St. Louis last week, the NAIC adopted an approach for the year-end financial statement filing that essentially provides for the classification and reporting of recently issued hybrid securities as preferred stock in the regulatory filing with some adjustment in the rating classification to account for investment risks not accounted for by the national credit rating agencies. Going forward, this special hybrid Risk Based Capital Working Group will further study the characteristics of hybrid securities and develop a permanent solution. As you can see, we have made good progress under a short timeframe with the support of the ACLI and the BMA.

It is difficult to discuss transparency and the progress we have made in a vacuum so this testimony is broken down into four sections 1) the basic purposes of financial regulation and analysis, 2) a background and overview of the NAIC's role, 3) the SVO Classification Procedure (using hybrids as an example), and 4) some key questions regarding transparency that will highlight the key issues and myths in this discussion.

Purposes of Financial Regulation

The purpose and objective of the NAIC since its founding in 1871 has always been to assist state insurance regulators, individually and collectively, in serving the public interest and achieving fundamental insurance regulatory goals in a responsive, efficient and cost effective manner, consistent with the wishes of its members. Most relevant here, those objectives include promoting the reliability, solvency and financial solidity of insurance institutions.

The state system of financial regulation is robust and reflective of the financial risks inherent in the insurance business. An insurer will accept premiums today for the payment of benefits or claims that may not arise for 5, 10, 20 or 30 years, as in the case of a life insurance policy. Because of the nature of the business we regulate, our system

of regulation embodies a fundamental principle of conservatism. This principle is critical to the financial oversight of insurers because insurance liabilities are merely estimates made by management. Our conservative valuation procedures provide protection to policyholders against fluctuations in asset values and policyholder reserve levels.

The regulation of insurer investments is a critical part of our statutory framework. Generally, state investment laws apply standards that seek to balance the preservation of principal with the diversification of the type of investment, issuer and credit quality. Our investment laws also allow insurers to allocate investments in a manner consistent with principles of prudent investment management to achieve an adequate return so that obligations to insureds are adequately met and financial strength is sufficient to cover reasonably foreseeable contingencies. As such, state investment laws generally limit the amount of policyholder funds that may be invested in preferred stock and common stock.

The SVO plays an integral role is assisting the states in differentiating between debt and common equity securities. The determinations by the SVO are intended for regulatory risk assessment purposes. In the early 1990s we experienced the dramatic effect on insurer solvency brought on by the use of extensive holdings of junk bonds and other financially engineered products that did not serve policyholders. We also recognize that financial market participants are apt to differ on complex financial engineered products, such as hybrids.

We have a very open and transparent process. Our Advance Rating Services (ARS) is available to any insurance company for pre-purchase determinations. We engage in regular contact with insurance companies that submit securities to the SVO which allows us to perform our regulatory function of credit and classification analysis. I would also go as far to say that our credit assessment function, housed on Wall Street, should be viewed as a model for credit rating purpose absent of any conflicts of interest.

The fact is that the NAIC has a successful, open system. Our system is so successful that less than one half of one percent of the over 10,000 decisions that we make are appealed,

which is noteworthy for not only the small percentage, but for the fact that unlike other entities we have an appeals process.

NAIC Background, Processes, and Regulatory Significance

The NAIC has a clear and open process for developing financial regulation. The NAIC's positions represent a national regulatory consensus that can serve as guidance to state insurance departments and state legislatures. The NAIC conducts its work through committees and task forces composed of NAIC members, which meet in open session and with the participation of any interested persons. The two most relevant committees are described below.

- **The NAIC Financial Conditions (E) Committee** - The Financial Conditions (E) Committee maintains the regulatory framework needed to safeguard the financial condition of insurance companies. Study of specific financial condition regulatory issues is assigned to specific Task Forces charged with developing expertise in that subject. For example, the Capital Adequacy, Emerging Accounting Issues, Risk-Based Capital and Valuation of Securities Task Forces all report to the Financial Condition (E) Committee.

- **The Valuation of Securities Task Force** - The Valuation of Securities Task Force ("VOSTF") administers the NAIC policy related to: 1) the quality of investments (i.e. bonds, preferred stock, common stock whether issued by municipalities, structured finance vehicles, corporate entities or between affiliated entities and other similar investments) purchased by insurers (credit assessment), 2) the valuation of securities (the fair value at which the insurer should report the investment for regulatory purposes) and 3) the classification of securities (for risk-based capital purposes). The VOSTF also advises other E Committee Task Forces, as necessary and appropriate on issues related to their sphere of activity.

The NAIC Securities Valuation Office (SVO) is the entity that implements the guidance of the Financial Conditions Committee and the VOSTF. The SVO consists of NAIC professional staff assigned to the VOSTF and tasked with performing the day-to-day analysis necessary to fulfill NAIC policy objectives assigned to the VOSTF. NAIC financial solvency monitoring policy has long recognized that the quality of investments and their fair value provide a sound empirical anchor for regulatory functions related to financial solvency regulation. NAIC concerns with uniformity in the reporting of values and quality of investment assets began in 1907. The Association determined that calculations of fair value of invested assets would be conducted by state insurance regulators (or someone acting for them) for compilation in a book and distribution to insurers who would then be instructed to report the regulator determined values to their own state regulator in the financial statements they are required to file with regulators. Very early on, the NAIC also determined that if a security was "amply secured" it could be carried at an amortized (i.e., stable) value instead of being marked to market. The NAIC adopted or created opinions of credit quality came to serve as evidence of ample security. The Securities Valuation Office ("SVO") was established as a permanent staff function of the NAIC in 1945 and was charged with formulating credit quality opinions in support of the stable valuation methodology. Over time however, SVO acquired a variety of analytical and verification functions with its work product being directly linked to a number of state insurance regulatory mechanisms.

Since its inception, and with but few exceptions, distribution of NAIC SVO work product has been limited intentionally to state insurance regulators through NAIC controlled channels. SVO opinions are solicited by and, in the first instance, given to insurance companies in recognition that instructions in state law or procedure requires the insurer to obtain an opinion of credit quality from the SVO (called an NAIC Designation) and to report that opinion to the state insurance regulator. This pattern reflects that insurance companies *have already purchased* the security that they are required to report to the SVO. The SVO *does not* provide an opinion of credit risk with the intent that insurers consider the opinion as part of its investment decision. Rather, the objective is to provide the state insurance regulator with an independent, unbiased opinion of the quality, value

or risks inherent in the security the insurer has purchased. SVO opinions are created for the use of state insurance regulatory officials for specified regulatory objectives determined by them individually through state or collectively through NAIC, mechanisms. Thus the role of the NAIC fundamentally differs, *intentionally*, from that of nationally recognized statistical rating organizations (NRSROs) and other credit rating organizations or from investment advisors both of whom express opinions intended to be used in the formulation of investment decisions by investors. Because of this fundamentally different purpose of the NAIC SVO, we consistently recognize and disclosed in our written literature that state insurance regulatory objectives may introduce factors in SVO analysis that would have no bearing or relevance for an investor making an investment decision. Classification of securities is such an example since its objective is to relate highly engineered financial instruments back to a specific risk weighting framework containing traditional risk. In addition, we have made it clear that we do not participate in the structuring of securities.

The focus of NAIC SVO analytical efforts is credit and investment risks that have the potential to disrupt an insurer's investment cash flow expectations. NAIC SVO produces five identifiable analytical products; NAIC Designations (opinions of credit quality and corresponding credit risk); Unit Prices (i.e. surrogates for fair value); asset classification decisions (assessments of non-credit related embedded risks); insurer portfolio analysis and general and focused investment research. All SVO analysis is conducted in accordance with the general and/or special methodologies authorized in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office (hereafter the Purposes and Procedures Manual)* a document created and maintained by regulators through the NAIC process and associated with the VOSTF. The statutory risk based capital process is discussed below.

Regulatory Significance of NAIC SVO Work Product

When the law of the state so provides, NAIC Designations and Unit Prices assigned to securities and published in the Valuation of Securities (VOS) publication (a CD-ROM product) must be reported in Schedule D of the insurance company's financial statement

filed with the state insurance department. The NAIC Designation and the corresponding Unit Price (collectively referred to as an Association Value) then serve as triggers for a number of regulatory mechanisms, including statutory accounting, valuation rules, percentage limitations in investment laws, interest and asset valuation reserves and the determination of the appropriate risk based capital charge for an asset. Classification decisions are made for new Schedule D assets, Schedule BA assets claimed to have fixed income like characteristics and to distinguish between redeemable and perpetual preferred stock investments. Classification decisions focus on embedded (non credit) risks and thus affect the insurer by exposing the asset to the regulatory treatment accorded to the category of asset that is deemed most similar to the way the investment is likely to perform.

The SVO Classification Procedure

The classification procedure is found in Part Seven, Section 1 (c) of the *Purposes and Procedures Manual*. Section 1 (c) is called "Guidelines for Determining Status of New Instruments as Debt, Preferred Equity or Common Equity." The Valuation of Securities Task Force adopted the Guidelines, an expansion and revision of a previous classification procedure that was adopted in 1996, on October 5, 1999, effective January 1, 2000.

A review of the minutes contained in the NAIC Proceedings (a publicly available record of all NAIC proceedings since 1871) indicates that the VOSTF first encountered hybridization in 1994 in the form of mandatory convertible equity-linked securities. Regulators reacted with concern that hybridization could result in securities with features and risks that were not well understood and might not be captured by the existing regulatory framework or reflected in the *credit assessment opinion* of NRSROs or of the SVO. Regulators wanted to be sure that the SVO understood what the actual terms of the securities implied about the risk of cash flow being interrupted.

It was understood early on that credit opinions focus on the issuer's ability to make payments and not whether a payment is due under the terms of a security. Therefore it is

possible that a security designed to mimic common equity may not contain an issuer promise to repay.

Early hybrids were handled on a case-by-case basis until a specific procedure could be developed. On November 26, 1996 in a (public) meeting of the Invested Asset Working Group of the VOSTF, a general discussion of appropriate classification criteria for statutory purposes occurred. The SVO was subsequently instructed to reduce the criteria identified by the Working Group at that meeting to writing and to present it as a proposed amendment of the *Purposes and Procedures Manual* at the Working Group's next quarterly meeting.

The SVO document so produced uses contractual rights traditionally associated with debt and equity instruments as criteria to judge the extent to which the investor was agreeing to potential loss of interest/dividend payments and exposure of the principal investment to loss. Next to the criteria were the corresponding economic expectation for the debt and the equity category. For example, in a traditional debt instrument, the investor expects: 1) to be paid interest and principal on a scheduled basis and 2) to declare an event of default and to accelerate the obligation, if payments are not made when due. On the other hand, a holder of traditional preferred stock accepts the risk that dividends can be missed and failure to make those payments is not an event of default that permits acceleration.

The expectations shown for the debt and for equity created two external but permanent economic and legal profiles to be used as comparative benchmarks to examine new securities. Conceptually, the SVO analyst would read the terms of any given security and compare the rights held by the investor and the issuer to the external benchmarks to arrive at an overall determination of the predominant characteristics of the security under review. This classification procedure was adopted and published in the December 31, 1996 *Purposes and Procedures Manual*.

While this first classification procedure resolved a number of important concerns it proved less than totally satisfactory. For one thing, the criteria appeared alone, without an

explanation of how the process worked. For another, the language distinguished between debt and equity but not between preferred and common equity. Also, the criteria included concepts related to federal tax treatment of the security and this proved not to be useful to the issue of how the security would perform for an investor.

Therefore, a senior member of the staff who held, among other academic attainments, the Certified Financial Analyst (CFA) designation, lead an extensive research project to consider what revisions should be made to the classification criteria and process. As this project advanced, an enlarged senior credit committee was created and charged with responsibility for reviewing and finalizing all classification decisions to build up an expertise in the proper use of the relevant criteria. New filings fueled part of this effort but another part was fueled by a reclassification effort announced on June 22, 1998 (i.e. some securities classified under the previous approach were reviewed using the new proposed standards). The research effort culminated in a proposed amendment to the exiting criteria adopted by the VOSTF on October 5, 1999 and added to the December 31, 1999 *Purposes & Procedures Manual*. It is important to note that both insurance company representatives and members of the capital markets participated in the deliberations that lead to the classification process and its adoption and indeed, offered only minor comments to the staff developed procedure.

How Classification Is Done - Classification of a new instrument as debt, preferred or common stock is conducted because state insurance regulators require different reserve and risk based capital factors depending on whether an investment is a debt instrument, preferred equity or common equity. Hybrid securities have features that blur the distinctions suggested by these three classes and the function of the SVO is to categorize filed securities so regulators have a clear idea of risks that could disrupt cash flow to their regulated entities.

Like its predecessor, Section 1 (c) identifies contractual rights traditionally associated with debt and equity instruments. These rights serve as criteria in a process where for any given right the "investor's expectation" (as discussed above) differs with the type of

asset: i.e., debt, preferred equity or common equity. In this way, three distinct, external and neutral profiles are created to serve as a comparative benchmark. As in the earlier model, the SVO analyst reads the terms of any new security type and compares the rights held by the investor and the issuer to the external benchmarks to arrive at an overall determination of the predominant characteristics of the security. The final classification decision made by the SVO is based on the likely effect of different contractual provisions or characteristics within a security (including the rights of foreign regulators to the issuer's assets), the regulatory objectives of the NAIC and SVO exercise of analytical discretion.

The function of the analyst, in essence, is to reconcile the conflicting features of the security by determining the nature of the economic commitment made by the investor. For example, the holder of a debt-like instrument does not agree to participate in the equity risk associated with an enterprise. The bondholder bargains for a return on an investment and may get out of the transaction entirely (by exercise of a right of acceleration leading to repayment) if agreed upon payments are not made. By contrast, the holders of preferred stock and common stock agree to assume the risk that they may be called upon to absorb losses generated by the enterprise. In return for the potential of sharing in any upside, the holders of common stock agree to surrender full financial flexibility to management with respect, for example, to the payment or non-payment of dividends and the potential for loss of principal. The holder of preferred stock will typically limit management's flexibility not to pay dividends and negotiate protections against loss of principal. This limitation of management's financial flexibility is an important conceptual hallmark that assists the SVO analyst to identify preferred stock like risk. Any security where issuer management has unfettered discretion to use the investor's capital without legal or economic ramification is, conceptually speaking, very similar to common equity.

Risk Based Capital (RBC) - The NAIC risk based capital regime is in the nature of an early warning system. The RBC regime establishes a number of levels of regulatory intervention linked to defined RBC ratios. The insurer is required to report its Authorized

Control Level Risk Based Capital (ACL) to its regulator. ACL is the total RBC the insurer needs to avoid being taken into conservation by its regulator. The necessity for remedial action and the extent of such action depends on the level of RBC reported.

In general terms, a risk weighting is assigned to investment assets based on their credit quality and where the liability is in the issuer's capital structure (i.e., whether the investment is a bond, preferred or common stock or like any of these three asset classes.) Common stock is assigned a risk based capital factor of 30% while highly rated bonds are assigned a risk based capital charge of .3%. However, it is important to understand that the 30% *is imposed only by default* since insurers are allowed to use their own Beta factors to adjust the RBC factor, which can range from 15% to 30% for common stock. Also, the risk based capital charge is not a dollar for dollar charge to capital requirements - the book/adjusted carrying value multiplied by the RBC factor is taken through the covariance calculation which reduces the capital requirement. When the concern is a few securities out of an entire portfolio, even the use of the 30% factor should not impact a company's bottom line RBC result to the extent that the risk of incurring it should be determinative as to whether it should otherwise make the investment.

Credit Ratings Do Not Capture All Risks

Like federal financial regulators, the NAIC has concluded that credit opinions (whether those of an NRSRO or the SVO's own NAIC Designations) were not intended to and could not communicate information on all of the risks embedded in hybrid securities that could impact payment to holders. In a much publicized release in the early 1990s the Securities and Exchange Commission, discussing mortgage backed securities, noted that a "triple a" rating assigned to a security communicated the likelihood that the issuer will be able to pay any principal due, <u>not the likelihood that the investor will receive any principal payment, since the structure and contractual terms of the security would influence what was actually due to the holder</u>. This is the precise issue insurance regulators are trying to address with the classification process.

NRSROs acknowledge that because hybrid securities are structured to provide capital to the issuer, the investor bears considerable equity risk. However, they also urge that the rating reflects these risks already. One would therefore question why hybrid securities provide the investor with more yield than the issuer's traditional securities.

The underlying assumption of a rating is its correlation with historical default rates. NRSROs would argue that the statistical likelihood of default (at any given issuer rating level) for a given issuer is a reliable gauge whether the contractual provisions in a hybrid security of the issuer would expose the investor to equity risk. In other words, the underlying assumption of the credit rating methodology is that only a slide in credit quality would trigger these provisions and this is a remote event for a high credit quality issuer. However, this fundamental assumption may be inaccurate.

NRSROs (and the SVO) can compare the risk of default and the severity of loss given a default between non-hybrid bonds because non-hybrid bonds have features that are sufficiently similar to each other that they will react the same way to the manifestation of upside or a downside risk. In other words, there is sufficient homogeneity of terms that it is possible to understand the impact of specific terms on the behavior of an instrument and to predict how the same terms will impact other bond instrument (this is referred to as linearity). Linearity also exists between non-hybrid "traditional" preferred stock and between common stock. But hybrid securities blend debt, preferred and/or common characteristics in different ways and are governed by different legal and regulatory regimes. The result is not a new homogenous asset class with linearity but unique securities without linearity. The Wall Street Journal (07/05/2006 *U.S. Banks Seek Ways to Enhance Hybrid Formula*), recognized this when they said that "...no two hybrid structures are identical or contain the same risk and cost."

Some evidence that the market does not see a perfect correlation between traditional security transition speeds and transition speeds for hybrid securities emerged in context of European hybrid securities as reported by Bloomberg in *Hybrid Bonds Suffer Worst of Debt, Equity Convergence, June 6 2006*. Bloomberg reported that hybrid securities of

Bayer AG, Henkel KGaA and Thomson lost investors at least 170 million euros since Dec. 31 reflecting, in part, rating agency announcements of potential downgrades and general perceptions of a rising interest rate environment and the expectation that higher rates may cause defaults to increase from a 20-year low.

In a May 8, 2006 report, Standard & Poor's Ratings Services said that it had considered but abandoned an approach that would have taken historical rating transition statistics (i.e. the speed with which a rating moves from one rating grade to a lower rating grade) as a guide in assessing the likelihood that there could be erosion in credit quality sufficient to jeopardize payments on the hybrid. S&P found that it was not possible to implement the proposed methodology without significant refinement of its existing rating transition data. In particular, S&P noted that one practical challenge in interpreting the transition data is that over an extended period of time, for a variety of reasons, a significant percentage of all ratings are withdrawn.

In addition, S&P, Moody's Investors Service, Inc. and Fitch Rating Services acknowledge that in issuer financial distress, the transition speed for hybrid securities (here meant to indicate the speed with which an investor is exposed to equity like risk of loss of dividends and principal) will differ from those of the issuer's traditional securities. For example, in an article entitled: *Criteria: Assigning Ratings to Hybrid Capital Issues, 08-May-2006,* Standard & Poor's Ratings Services (S&P) said that it expects that ratings on hybrid securities would fall faster than the issuer's corporate ratings as credit quality deteriorated, e.g., the usual 2-notch difference could widen to 5-notches. In fact they acknowledge a statistical inability to measure how fast this transition is likely to be. S&P said: "When we have heightened concerns that the issuer may defer—whether due to the exercise of its right to defer optionally, the breaching of a mandatory deferral trigger, or the exercise of the prerogatives of a regulator—we increase the gap between the ICR (Issuer Credit Rating) and the issue rating, and we do not impose any arbitrary limit on the size of the gap." While the NAIC acknowledges that rating organizations generally and NRSROs in particular do a very good job of analysis, they are not infallible. The agency literature clearly permits us to question whether it is even possible to make

accurate or meaningful statistical predictions about the new iteration of hybrid security, especially given that it has been in existence for less than 1 year.

The view that the investor can rely on the rating may also be misleading for practical purposes. The investor may have no contractual right to exit a purchase and therefore cannot exert control as the issuer's credit quality declines, or, the price of the security may drop, and the investor may hold on rather than sell and realize a loss in value.

NAIC believes that it is equally if not more analytically appropriate to focus on the actual contractual rights of an investor (and by implication of the issuer) and the economic significance of these rights in both a non-distress and a distress scenario. The NRSRO rating model would lead one to expect that deferrals on dividend an interest payment on hybrids generally would be correlated with credit quality only. However, S&P has emphasized (*Financial Services Criteria: Equity Credit for Bank and Insurance Hybrid Capital, A Global Perspective, Feb 2006*), that U.S. bank regulators have directed banks to defer hybrid coupons even in cases where the banks have been in compliance with regulatory capital standards. Prominent cases in the U.S. cited by S&P include: Riggs National Corp., a bank holding company whose trust preferred securities deferred payment in December 2004 and resumed in June 2005; Bay View Capital Corp., a bank holding company that deferred payments on its preferred shares in September 2000 and resumed in 2002; and City Holding Co., a bank holding company that deferred payments on its preferred shares in July 2001 and resumed in July 2002. In Japan, two recent and prominent examples of interest deferral are: Resona Bank, whose perpetual preferred shares suspended payment in 2003; and UFJ, whose preference certificates suspended payments in mid-2005, prior to its merger with The Bank of Tokyo-Mitsubishi. In Germany, a prominent recent example is WestLB AG whose hybrid capital securities specific to the German market, silent partnership certificates called "stille Einlagen" (included in regulatory Tier 1), absorbed losses in 2003 and 2004, even though its other Tier 1 hybrids continued to pay coupons. The U.S., Bermudan, and Japanese insurance sectors have several cases of hybrid security coupon non-payments over the past five years, including Conseco Inc, La Salle Re Holdings, and Asahi Mutual Life. In fact, S&P

"expects to see a higher incidence of coupon deferrals and suspensions on hybrid securities of financial services companies in the future, as the amount of issuance grows and when the financial services industry experiences a cycle of weaker performance."

Filing Exemptions

Until January 1, 2000, all NRSRO rated securities were filed with the SVO and the SVO was required to assign a credit designation based on the NRSRO rating if it thought this appropriate (otherwise it would assign a lower Designation). The SVO was not required to consider classification of NRSRO rated securities, because this would have been inconsistent with resources. Because of this, new security products were usually bought to the attention of the SVO on a more or less real time basis either by insurance companies or by their investment advisors. This started to change in 1999 when the VOSTF adopted first the Provisional Filing Exemption (PE) (on October 5, 1999 effective Jan. 1, 2000) and subsequently the Filing Exemption (on June 23, 2003 effective January 1, 2004). Insurance companies were exempted from filing securities with the SVO if the security was rated by one or more NRSROs and the insurance companies themselves became responsible for making classification decisions, with the unwritten assumption that if they felt they could not they always retained the option of filing the security with the SVO.

Both the Provisional Filing Exemption and the Filing Exemption contained provisions that permitted the state insurance regulators or the SVO to require an insurance company to file an otherwise filing exempt security. Yet, when this authority was exercised by NY Insurance Department (NYID), it seems to have occasioned surprise among the investment banking community. Why this is so is unclear. The existence of these provisions and implications for hybrid securities purchased by insurance companies should have been known and understood by the investment banking community and disclosed to investors.

It is also unclear why insurance companies and their investment bank advisors have not utilized pre-purchase services offered by the SVO. Since the 1990s insurers have been

able to request that the SVO conduct a credit analysis of a security (the ARS process) and, since 1998 – insurance companies have been able to request that the SVO assess a transaction for structure, classification or other regulatory concern, both - prior to the time an insurer purchases the security. These processes permit the insurer applicant to evaluate the likely state based regulatory treatment of a security prior to purchase. Administratively, the insurance company would name an agent, typically an investment bank representative, to provide the SVO with information on the security and to communicate with the SVO during the analytical process. The ARS/EIV process concludes with a letter, sent to the insurer applicant and its agent, (unless the insurance company instructs the SVO not to correspond with the agent) of the decision taken. The letter specifically provides that either the insurer or its agent may show the letter to anyone, provided only that the entire letter is shown.

Key Questions about Transparency

1) The first question is what aspects of our process we deem to reflect transparency. The first issue we encounter is the need to define what transparency means in the context of the current debate. The SVO, an independent entity for over 60 years, and almost 100 years old from the inception of the VOSTF function, is transparent for the *context* in which it operates and for the role it is intended to fulfill within the NAIC.

All of the analytical procedures that govern the SVO are adopted by regulators in public hearings after extensive and lengthily public comment and in fact at times, negotiation with the industry and interested persons. SVO activities are subject to oversight within the staff executive function that links up with the NAIC Executive Committee (the regulatory body that has responsibility for managing the NAIC) as well as by direct oversight by the VOSTF. There are no constraints imposed on SVO discussions and communications with an insurance company on any security they own. There are also no constraints imposed on SVO discussions and communications with state insurance regulators regarding any issue they may wish to discuss.

Insurance companies can appeal SVO determinations directly. Allegations that an SVO determination was made in disregard of the facts, or contrary to the general procedure that is adopted by the regulatory community can be brought to and must be decided by the VOSTF. The rules that govern the SVO are set forth in the Purposes and Procedures Manual of the NAIC Securities and Valuations Office that is readily accessible.

Although the SVO was designed to evaluate securities only on an after acquired basis (and not as a part of the investment decision making process), insurance companies and their broker-dealer advisors have long had the ability to request a pre-purchase evaluation of a new instrument either for credit quality under the Advance Rating Service or to evaluate whether the existing state based regulatory system would accommodate a new asset class or if adjustments to that framework is necessary before an insurance company can purchase an instrument. If the SVO determines that the existing framework cannot accommodate the existing security, the SVO reports this to the VOSTF, which can invoke a procedure (the Z*/NR* process) to permit companies to purchase and report the security until a proper framework is devised.

All of these procedures and safeguards both define transparency in the context of state insurance regulation and evidence recognition by the regulatory community that it is essential that insurance companies understand the compliance criteria applicable to their operation.

Although the focus of insurance regulators is on insurance companies, interested persons representing the views of non-insurance entities are a fixture at hearings of the VOSTF, as indeed they are at other NAIC forums. Any concern they might raise, especially as it may affect the financial wellbeing of insurance companies, is treated with immediacy and seriousness. For example, the Bond Market Association (BMA) and the American Council of Life Insurers (ACLI) wrote us a letter on May 17, 2006 expressing concerns with transparency. Discussions about the concerns expressed therein began immediately between representatives of these organizations and the Chair of the VOSTF. Two weeks later, discussions of the issue dominated the agenda of the Summer National meeting of

the VOSTF. Within four (4) weeks of the national meeting the NAIC held a public hearing (July 13, 2006) in New York City to receive testimony regarding issues linked to hybrid securities. At that very meeting, the NAIC leadership moved to create a subgroup to discuss the immediate insurance regulatory issue - how to report hybrids for the 2006 year end and the VOSTF was instructed to hold meetings to discuss the transparency issue with a view to formulation of a recommendation to the parent body, not later than the winter national meeting in 2006. It is also worth noting that Mary Kuan, vice president and assistant general counsel at the Bond Market Association stated in recent press release that "In addition, we appreciate the opportunity to work with NAIC on the long-term solution, which we believe should be risk-based, and applaud them for engaging market participants in the process." This is not only a transparent system, but a very responsive system.

So what does transparency mean here? The BMA-ACLI letter defined transparency in a way that would render effective financial regulation of insurance companies almost ineffective. In addition to asking for the NAIC to change the manner in which the SVO operates from its current model of a centralized regulatory advisor on investment issues to a capital market oriented NRSRO type of organization, BMA-ACLI also insisted that the federally regulated broker-dealer community has a right to publicly comment on any analytical decision of the NAIC with which they do not agree. They have asked the NAIC to consider a public comment period. Although the BMA-ACLI request will be considered by the NAIC, it is difficult to see on its face, how such a process would quell disruptions in capital markets. The VOSTF and the Financial Condition (E) Committee are currently reviewing if such a model is in the best interest of the policyholders. The BMA-ACLI letter and the testimony of BMA and ACLI representatives at the NAIC public hearing of July 13, 2006, make clear that they define "transparency" as the ability of broker-dealers to be able to structure securities that can be sold to insurance companies.

Defining transparency in the NAIC-SVO context requires considerations of complex legal and administrative issues. The NAIC, although composed of state officials tasked

with regulating the business of insurance, is a not-for profit corporate entity, and the SVO are employees of that corporation. The function of the SVO is to research and analyze the financial status of issuers of securities and to opine on this issue to state regulators. This role requires the SVO to be unbiased and neutral. We do not represent the views of issuers and their investment advisors who want to sell securities and we do not represent the interests of insurance companies or other investors who want to buy securities. This model means the SVO obtains the information it uses in its analysis from the insurance company that has purchased the security. The SVO has no contact with the issuer of the securities (with the possible exception of ARS/EIV pre-purchase analysis services). In effect, the role of the SVO is to opine on the quality and other characteristics of what the insurance company has purchased. We find it difficult to envision that issuers of securities, who have had no contact with the SVO, would welcome SVO comments about their ability to repay obligations to insurance companies, or embedded risks in a security purchased by an insurer. This especially true given that the SVO process is linked to and serves statutory accounting purposes that differ from generally accepted accounting principles. Hence what would pose a significant legal issue for an issuer in a public context is now an insignificant issue when viewed as a private conversation between a regulator and an insurance company about the risks in a security. Does the state insurance regulator have a right to have this conversation with its regulated entities without the broker dealer community listen in? Many of the broker-dealer firms who today ask for public disclosure of regulatory conversations between the SVO as a stand in for regulators and regulated insurance companies may be the ones crying foul when such commentary reflects badly on their issuer or their security.

There is one final issue that must be considered regarding transparency. The SVO's primary credit assessment, valuation and classification activities focus on private securities, i.e. those not publicly traded or rated by an NRSRO. Beyond the obvious requirement that insurance companies have confidence that information they reveal to the regulatory community via the SVO be kept confidential, it is the legitimate expectation of issuers of such investment that their confidential and often proprietary financial products be treated confidentially.

2) The second question is where can the NAIC be more transparent? The analytical procedures that regulators determine on and entrust to the SVO are general in nature because of the nearly infinite variety of complex financial products that the market produces. It is the responsibility of the professional analyst to adjust the general procedure so that it can be applied to specific securities. For example, corporate methodologies rely to a significant degree on financial analysis. Different corporate industries require financial analysis to focus on different ratios and issues. A general corporate methodology must be tailored to the specific industry and perhaps to the specific transaction as well. The general procedure for municipal general obligation methodologies focuses on legal assessment of state taxing authority and constitutional constraints on the raising of debt. However, there are many types of obligations and states laws, political appetite for debt financing, municipal liability structures and other related factors important to analysis of general obligation securities differ. Municipal project finance relies on feasibility and demographic studies (as the basis for determining cash flow analysis), transaction structure, legal enforceability and other analysis specific to the type of project, which can range from natural gas projects to sports stadiums. Each requires a slightly different approach within the general accepted methodology for project finance. Structured securities require an analysis of asset quality, practical and legal segregation of assets from their originator, bankruptcy proofing, trust or LLC law, legal enforceability and other issues specific to the kind of assets used and or the governing jurisdiction.

Because the analytical procedures will be applied against a broad range of financial products, many of which may be new or variations on a previous product, it is necessary and appropriate for the proper functioning of the regulatory process for the analyst to have discretion in its application. The exercise of this discretion may render invisible to the public the precise process of the analyst. This may be called non-transparency by some. However, the SVO process provides that the SVO can and does communicate this thought process to any insurance company that owns the security. Such conversations are between the professional staff of the SVO and the analytical professional staff of the

insurance company. Some may consider this level of communication as non-transparent; I prefer to view it as prudent financial oversight by the functional regulator of the insurance industry.

3) The third question is whether there are any inherent impediments to transparency in NAIC procedures? We recognize a need to create a process that others can participant in with full confidence. The VOSTF and the regulatory system cannot function without transparency. Clearly, the Purposes and Procedures Manual must adequately communicate to insurance companies what is expected of them in the reporting of long-term invested assets.

The issue here is not about transparency of communication between insurers and their regulators; it is whether the federally regulated broker-dealer community has a right to listen in on regulatory conversations between the members of the NAIC and their regulated entities so that the broker-dealers can structure financial products to sell to insurance companies. The NAIC has publicly pledged to consider this issue.

Conclusion

The NAIC has an evolved financial regulatory system that is established and has proven it efficacy. We recognize that there is always room for improvement and we have a system that allows for change in a very open and transparent process. We encourage all interested parties to avail themselves of the NAIC's open and responsive system to make any needed improvements. This concludes my testimony and I would welcome the chance to answer any questions.

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