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THE BOND MARKET ASSOCIATION

Statement of Kevin Conery
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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.

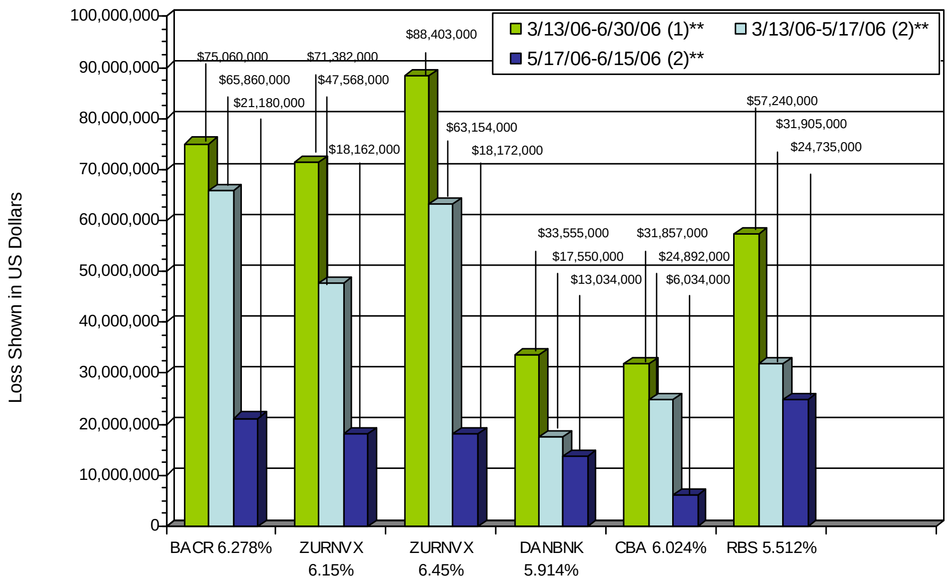
Conclusion

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

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



* Source: The Bond Market Association.

** Key dates: 3/15/06, Lehman ECAPS[SM] 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.

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

American Council of Life Insurers
101 Constitution Avenue NW #700
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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

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[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. <u>Material Information Should Be Disclosed To All Market Participants Equally.</u>

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

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[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℠ [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℠ 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. <u>Current System Distributes Material Information Unequally</u>.

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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℠ 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] ℠ “ECAPS” is a service mark of Lehman Brothers Inc.

[19] “We realize fully that this determination [regarding the classification of ECAPS℠ 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℠ the NYID of its own volition attempted to notify the market that ECAPS℠ 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^{SM}. 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^{SM} (52520YAA5) ("ECAPS^{SM}") 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^{SM}, 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^{SM} 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^{SM} 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^{SM} 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^{SM} issued by Zurich Financial Services widened by as much as 45 basis points within two weeks after the Lehman ECAPS^{SM} 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^{SM} 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^{SM} 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.

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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,

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