Capital Markets Special Report

NAIC National Association of Insurance Commissioners & The Center for Insurance Policy and Research

The **NAIC's Capital Markets Bureau** monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of US insurance companies. A list of archived Capital Markets Bureau Special Reports is available via the **index**. This week's commentary (below charts) examines commercial mortgage-backed securities (CMBS) and their
role in the reserves of insurance companies.

CMBS Market Showing Signs of Life Despite High Delinquency Rate

Despite a rising delinquency rate in the underlying commercial mortgages, new capital has re-entered the U.S. commercial mortgage backed securities (CMBS) market with 2011 new issuance projected to be as high as $45 billion in 2011, up from $10 billion to $15 billion in 2010. The delinquency rate is defined as the percentage of commercial real estate loans that were 30 or more days past due or in foreclosure. The higher the delinquency rate, the more likely investors in these transactions will absorb credit losses.

Record-level delinquencies

Before mid-2008, the CMBS delinquency rate had stayed below 2% for the prior nine years. With the onset of the capital markets dislocation and the recession in 2008, delinquencies have risen steadily and significantly, and according to Trepp, a data supplier to the CMBS industry, the delinquency rate was 9.39% as of February 2011. This represents a 19 basis point (bp) increase from 9.2% in December 2010, but only a five bp increase from 9.34% in January 2011. A primary cause for the increasing delinquency rate has been the less stringent underwriting standards that were applied to commercial mortgage loans between 2005 and 2007. As the financial crisis evolved, borrowers of these loans experienced difficulty staying current with their payments. Consequently, over the past few years, the commercial mortgage loan delinquency rate has rapidly increased.

By property type, multifamily had the highest delinquency rate as of February 2011 at 16.6%; the next highest was in lodging/hotel at 14.6%.

Property Types - % 30+ Days Delinquent

	Feb-11	Jan-11	Dec-10	3 mo.	6 mo.	1 yr.
Industrial	10.44	10.12	8.97	6.64	6.56	4.75
Lodging	14.61	15.08	14.31	14.56	18.92	15.65
Multifamily	16.61	16.85	16.48	15.80	14.48	9.87
Office	7.10	6.88	6.93	6.95	6.57	4.33
Retail	7.81	7.72	7.86	7.59	6.77	5.74

Source: TreppWire, February Delinquency Report, March 2, 2011

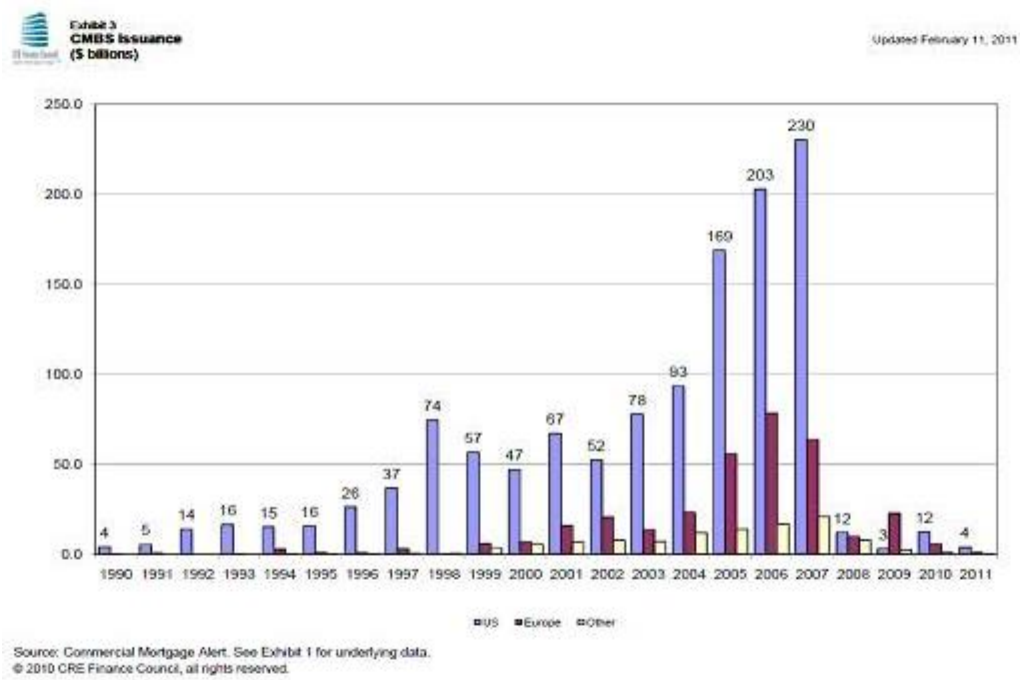
Downward pressure by loan modifications and liquidations

Loan modifications (that is, lenders agreeing to restructure commercial mortgage loans as a result of the borrower's inability to repay the debt as originally scheduled) contributed to downward pressure on the rising delinquency rates. The amount of modifications reached an all-time high in 2010. According to Fitch, $15.6 billion in loan principal balances were modified in 2010, up from $7.1 billion in 2009. Approximately half of the 2010 loan modifications included maturity extensions on performing loans that could not be readily refinanced due to the properties not meeting today's more stringent underwriting standards. The pace of loan modifications also has increased as special servicers — or companies that have specialized processes in place to deal with loans requiring special attention — became increasingly adept at managing these portfolios.

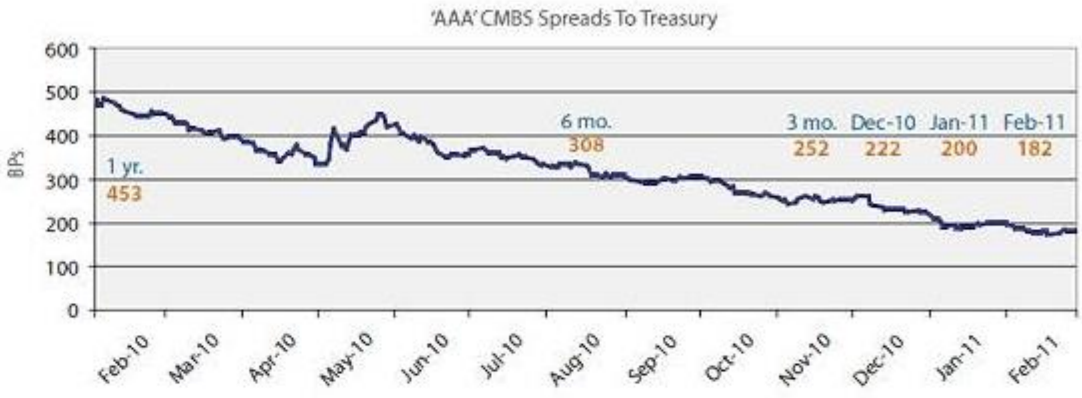
According to S&P, loan modifications in the form of maturity extensions represented a workout option that helped reduce the potential number of new defaults. In September 2009, new rules regarding loan modifications were implemented by the Internal Revenue Service (IRS) that promoted earlier communication between the borrower and servicer, and, in turn, enabled borrowers to seek loan modifications well in advance of default. Prior to these new rules, the borrower could not seek modification until the loan was already in default or determined likely to default by the servicer.

CMBS activity on the rise

In 2007, U.S. CMBS issuance was approximately $230 billion. During the financial crisis, new issuance during 2008 was minimal. Then, a once frozen market saw $2 billion to $3 billion in new issuance in 2009. In 2010, it jumped to $10 billion to $15 billion, as a modest measure of liquidity returned to the market due in part to low interest rates. New-issue U.S. CMBS is expected to be around $45 billion in 2011, according to J.P. Morgan projections.



Spreads on super-senior AAA CMBS, priced at about 100 bps over U.S. Treasuries prior to the financial crisis, gapped out in 2009, briefly approaching 1,200 bps, and have since experienced a steadily declining trend. They were approximately 180 bps over U.S. Treasuries in February 2011, down from 453 bps in February 2010. This means that investors have become more comfortable with the risk associated with these investments, and this trend has been, in part, driven by yield appetites.

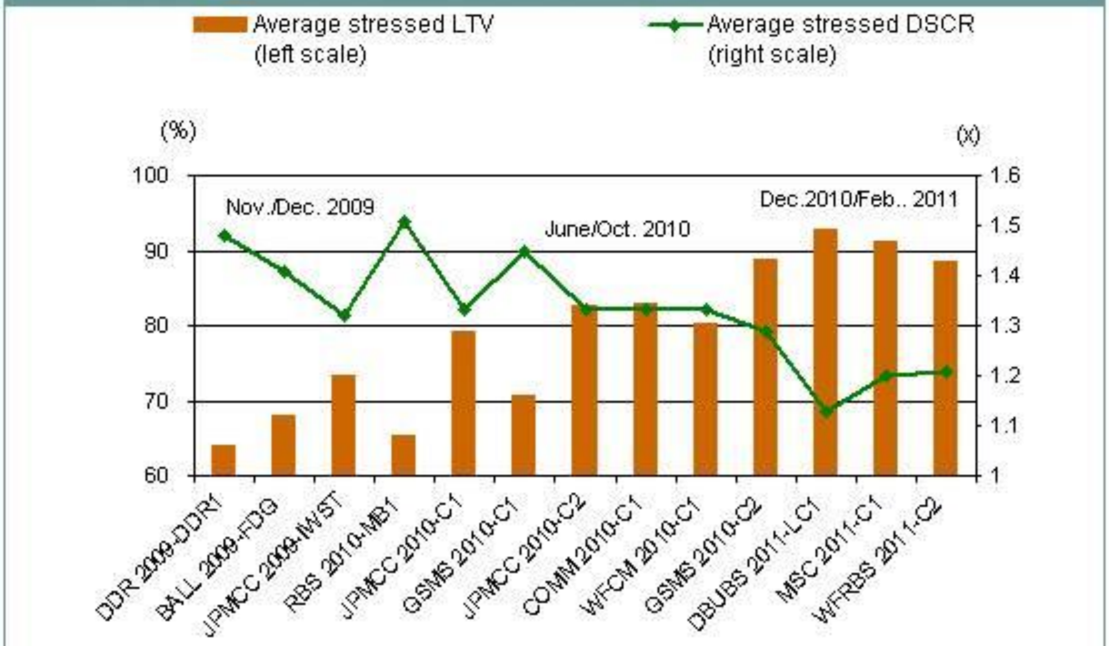


Source: TreppWire, February Delinquency Report, March 2, 2011

More conservative CMBS structures

Prior to 2009, CMBS had been structured with 11%–13% credit enhancement (i.e., loss protection) supporting all of the AAA-rated notes, which includes super senior (at the top of the capital structure), senior and mezzanine AAA tranches (just below the super seniors and seniors in the capital structure). These AAA notes are afforded loss protection by as many as 29 subordinated tranches with ratings ranging from investment grade down to below investment grade. The credit enhancement, or subordination, below all of the AAA notes means that the underlying portfolio of commercial mortgage loans would have to incur more than 11%–13% in collateral losses before the AAA notes were at risk of missing a principal and/or interest payment. More recent CMBS structures include 17%–18% credit enhancement/loss protection below all of the AAAs, with five to eight subordinate tranches — clearly more conservative structures given the additional credit support and, therefore, more attractive to investors.

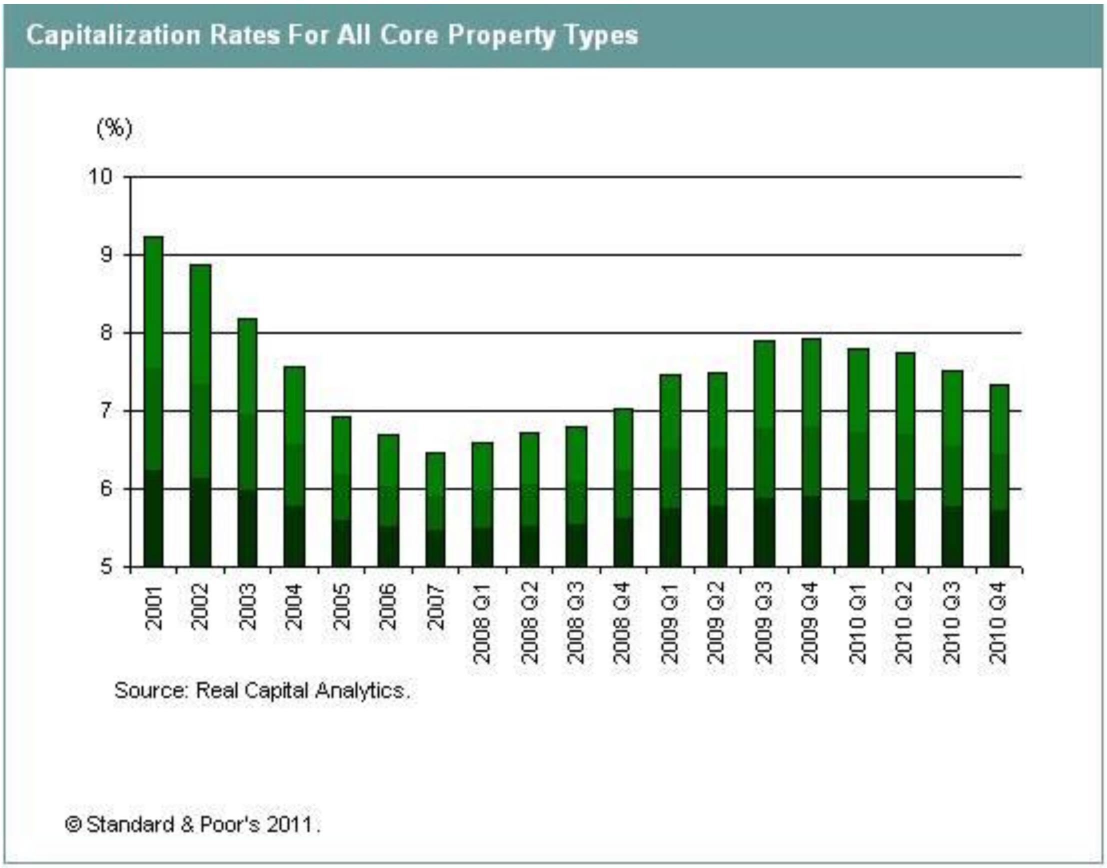
On a less positive note, according to recent S&P research, because the modest resurgence of CMBS issuance over the past 15 months (sometimes referred to as “CMBS 2.0”), loans in these transactions have been structured with higher LTV (loan to value) and lower debt service coverage. Analysts suspect that one likely cause of this aggressive trend is an increase in competition among originators; there were about 25 commercial mortgage loan originators as of year-end 2010, much higher than the handful of originators as of year-end 2009.



Rating Agency Stressed LTVs And DSCRs

Sources: Presales from S&P, Moody's, and Fitch. LTV--Loan-to-value. DSCR--Debt service coverage ratio.

In addition, S&P cites that the average national capitalization rate; that is, the rate of return on a real estate investment property based on the expected income that property will generate, was also on a downward trend by year-end 2010 after rising steadily in 2008 and 2009. This generally means that property values are increasing.



Insurance company exposure

As of year-end 2009, CMBS represented $189.8 billion (book adjusted carrying value; $197.7 billion par value), or approximately 4%, of all insurance companies' cash and invested assets. The majority of this amount, or approximately 85%, were held by life insurance companies, followed by property/casualty insurance companies at 14%. Also, CMBS were almost 30% of insurance companies' structured securities investments as of year-end 2009, and direct commercial real estate loans were approximately $450 million for the overall industry as of year-end 2009.

As the CMBS market evolves over the course of the year, we will continue to monitor its developments and trends, and we intend to provide more insightful research relative to this topic.

March 4, 2011

Major Insurer Share Prices

		Close	Change % Week	QTD	YTD	Prior Week	Quarter	Year
Life	Aflac	$57.42	(0.7)	1.8	1.8	$57.84	$56.43	$56.43
	Ameriprise	63.27	(0.4)	9.9	9.9	63.52	57.55	57.55
	Genworth	12.87	(3.2)	(2.1)	(2.1)	13.30	13.14	13.14
	Lincoln	30.92	(2.1)	11.2	11.2	31.58	27.81	27.81
	MetLife	45.57	(2.6)	2.5	2.5	46.78	44.44	44.44
	Principal	32.99	(2.8)	1.3	1.3	33.94	32.56	32.56
	Protective	28.18	(0.0)	5.8	5.8	28.19	26.64	26.64
	Prudential	63.87	(1.4)	8.8	8.8	64.77	58.71	58.71
	UNUM	26.02	(2.2)	7.4	7.4	26.60	24.22	24.22
PC	ACE	$62.69	(0.9)	0.7	0.7	$63.28	$62.25	$62.25
	Axis Capital	36.27	0.4	1.1	1.1	36.11	35.88	35.88
	Allstate	31.71	0.7	(0.5)	(0.5)	31.48	31.88	31.88
	Arch Capital	89.64	(0.3)	1.8	1.8	89.90	88.05	88.05
	Cincinnati	33.25	(1.3)	4.9	4.9	33.70	31.69	31.69
	Chubb	59.40	(1.2)	(0.4)	(0.4)	60.11	59.64	59.64
	Everest Re	87.20	(1.2)	2.8	2.8	88.23	84.82	84.82
	Progressive	20.88	2.2	5.1	5.1	20.43	19.87	19.87
	Travelers	59.18	(0.7)	6.2	6.2	59.60	55.71	55.71
	WR Berkley	29.57	(1.2)	8.0	8.0	29.93	27.38	27.38
	XL	22.95	(1.4)	5.2	5.2	23.28	21.82	21.82
Other	AON	$51.46	(2.0)	11.8	11.8	$52.49	$46.01	$46.01
	AIG	37.39	(3.0)	(22.5)	(22.5)	38.54	48.27	48.27
	Assurant	39.09	(3.8)	1.5	1.5	40.64	38.52	38.52
	Fidelity National	14.08	1.6	2.9	2.9	13.86	13.68	13.68
	Hartford	28.61	(2.8)	8.0	8.0	29.42	26.49	26.49
	Marsh	30.24	0.1	10.6	10.6	30.20	27.34	27.34
Health	Aetna	$38.34	2.7	25.7	25.7	$37.33	$30.51	$30.51
	Cigna	43.82	4.4	19.5	19.5	41.99	36.66	36.66
	Humana	64.56	3.1	17.9	17.9	62.60	54.74	54.74
	United	44.45	4.5	23.1	23.1	42.52	36.11	36.11
	WellPoint	67.99	2.2	19.6	19.6	66.52	56.86	56.86
Monoline	Assured	$13.82	(5.0)	(21.9)	(21.9)	$14.55	$17.70	$17.70
	MBIA	10.48	(7.3)	(12.6)	(12.6)	11.30	11.99	11.99
	MGIC	8.34	(2.7)	(18.2)	(18.2)	8.57	10.19	10.19
	PMI	2.92	(3.6)	(11.5)	(11.5)	3.03	3.30	3.30
	Radian	7.16	1.7	(11.3)	(11.3)	7.04	8.07	8.07
	XL Capital	22.95	(1.4)	5.2	5.2	23.28	21.82	21.82

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Major Market Variables

		Close	Change % Week	QTD	YTD	Prior Week	Quarter	Year
Dow Jones Ind		12,169.88	0.3	5.1	5.1	12,130.45	11,577.51	11,577.51
S&P 500		1,321.15	0.1	5.0	5.0	1,319.88	1,257.64	1,257.64
S&P Financial		222.13	(1.6)	3.4	3.4	225.73	214.77	214.77
S&P Insurance		197.60	(0.6)	5.0	5.0	198.78	188.22	188.22
US Dollar $			Change %			Prior		
	/ Euro	$1.40	1.7	4.5	4.5	$1.38	$1.34	$1.34
	/ Crude Oil bbl	104.42	6.7	13.2	13.2	97.88	92.22	92.22
	/ Gold oz	1,428.60	1.4	0.6	0.6	1,409.30	1,420.78	1,420.78
Treasury Ylds %		%	Change			%	%	%
	1 Year	0.24	(0.01)	(0.03)	(0.03)	0.25	0.27	0.27
	10 Year	3.49	0.08	0.20	0.20	3.42	3.30	3.30
	30 Year	4.60	0.10	0.26	0.26	4.50	4.34	4.34
Corp Credit Spreads -bp			Change %			Prior		
	CDX.IG	83.55	0.5	(1.7)	(1.7)	83.10	85.00	85.00
	CDX.XO	163.5	2.5	(14.7)	(14.7)	159.5	191.67	191.67

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Major Insurer Bond Yields

	Company	Coupon	Maturity	Price Current	Price Change	Price Yield	Spread B.P.
Life	Aflac	8.500%	5/15/2019	$124.00	($0.06)	4.90%	172
	Ameriprise	5.300%	3/15/2020	$106.18	($0.29)	4.46%	109
	Genworth	6.515%	5/15/2018	$100.28	($0.29)	6.46%	345
	Lincoln National	8.750%	7/15/2019	$126.33	($0.21)	4.86%	161
	MassMutual	8.875%	6/15/2039	$135.47	($0.45)	6.20%	161
	MetLife	4.750%	2/15/2021	$101.90	($0.57)	4.51%	98
	Mutual of Omaha	6.800%	6/15/2036	$94.76	($0.91)	7.25%	285
	New York Life	6.750%	11/15/2039	$115.30	($0.22)	5.66%	106
	NLV Financial	7.500%	8/15/2033	$115.76	($0.29)	6.19%	194
	Northwestern Mutual	6.063%	3/15/2040	$106.31	($0.38)	5.62%	101
	Pacific Life	9.250%	6/15/2039	$131.44	$0.39	6.74%	216
	Principal	6.050%	10/15/2036	$103.51	($1.04)	5.79%	132
	Prudential	4.500%	11/15/2020	$98.70	($0.40)	4.67%	117
	TIAA	6.850%	12/15/2039	$113.39	($0.85)	5.88%	126
P&C	ACE INA	5.900%	6/15/2019	$111.57	($0.37)	4.23%	102
	Allstate	7.450%	5/15/2019	$119.91	($0.47)	4.51%	132
	American Financial	9.875%	6/15/2019	$123.76	$1.87	6.16%	298
	Berkshire Hathaway	5.400%	5/15/2018	$110.59	($0.21)	3.71%	73
	Travelers	3.900%	11/15/2020	$94.94	($0.45)	4.55%	107
	XL Group	6.250%	5/15/2027	$98.00	$0.02	6.45%	244
Other	AON	5.000%	9/15/2020	$101.86	($0.47)	4.76%	130
	AIG	5.850%	1/15/2018	$105.58	$0.23	4.88%	198
	Fidelity National	7.875%	7/15/2020	$113.13	$1.44	6.02%	330
	Hartford	5.500%	3/15/2020	$102.77	($0.26)	5.11%	176
	Marsh	9.250%	4/15/2019	$127.08	$0.19	5.12%	191
	Nationwide	9.375%	8/15/1939	$118.99	($0.73)	7.72%	312
Health	Aetna	3.950%	9/15/2020	$96.09	($0.27)	4.46%	99
	CIGNA	5.125%	6/15/2020	$104.62	($0.41)	4.51%	110
	United Healthcare	3.875%	10/15/2020	$95.54	($0.50)	4.45%	98
	Wellpoint	4.350%	8/15/2020	$99.69	($0.21)	4.39%	97

Questions and comments are always welcome. Please contact the Capital Markets Bureau at **CapitalMarkets@naic.org**.