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

Capital Markets Special Report

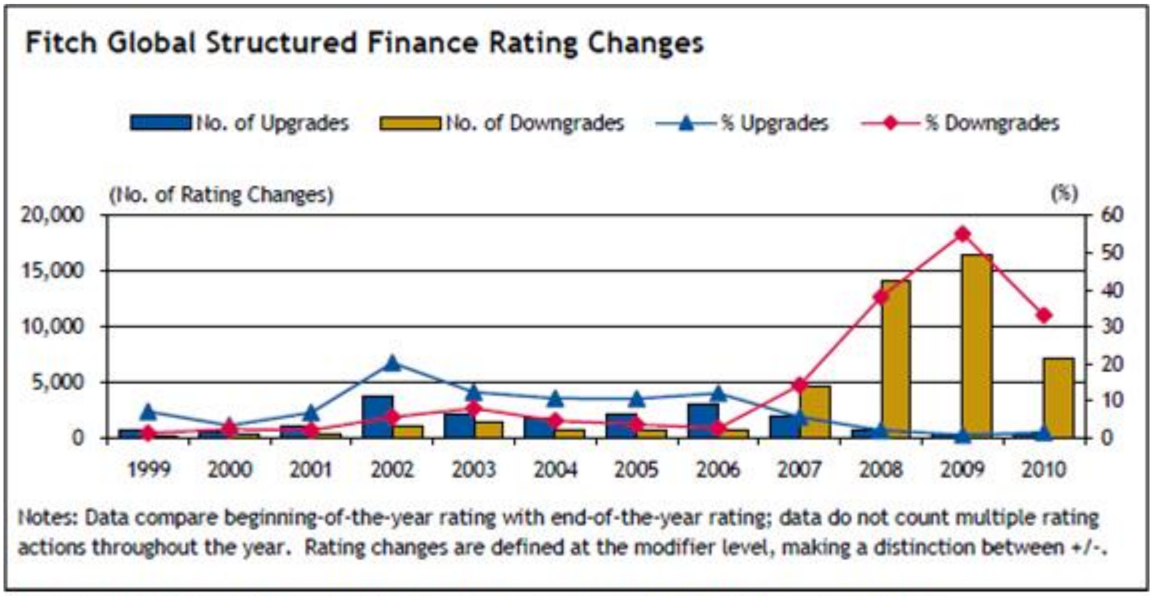
The **NAIC's Capital Markets Bureau** monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of US insurance companies. A list of archived Capital Markets Bureau Special Reports is available via the **index**

Global Structured Finance Rating Trends and Default Rates

As a follow-up to a previous special report titled, "U.S. Corporate Bond Default and Recovery Rates: Impact on Related Insurance Company Investments," this special report will focus on rating trends and default rates in global structured finance. Structured finance includes securitized asset classes — such as asset-backed securities (ABS), mortgage-backed securities (MBS), collateralized debt obligations (CDOs), collateralized bond obligations (CBOs) and collateralized loan obligations (CLOs) — all of whose cash flows depend on the cash flows of an underlying pool of assets. The three most common types of ABS are those backed by automobile loans, credit card receivables and home equity loans. MBS are instruments whose cash flow depends on the cash flows of an underlying pool of mortgages, either residential or commercial. Structured credit is a subset of structured finance and, in this special report, will include CDOs, CBOs and CLOs. The focus of this special report will be on ABS and structured credit. Residential mortgage backed securities (RMBS) and commercial mortgage backed securities (CMBS) are not the focus of this report, but are included in some of the statistics provided by the nationally recognized statistical rating organizations (NRSROs).

Credit Quality Improving

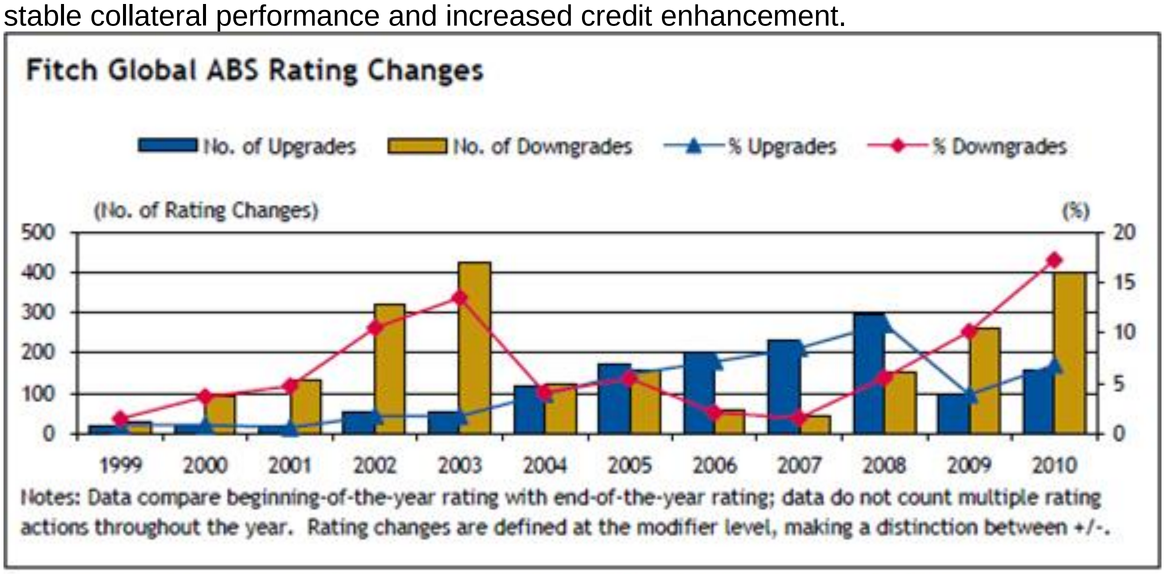
The credit quality of global structured securities began to stabilize in late 2010 into 2011. Rating downgrades subsided after a tumultuous period in 2008 and 2009, when credit quality was severely and negatively impacted by the economic and financial crisis in the United States. For example, on average, when Standard & Poor's (S&P) lowered ratings of global structured securities in 2010, they were downgraded 1.4 rating notches. This compares with 3.5 rating notches in 2009 and 3.2 rating notches in 2008, and reflects a lower severity of credit quality deterioration in 2010. A notch is one rating level; for example, one notch would be a downgrade from AA to AA- or an upgrade from BBB+ to AA-. In addition, as illustrated in the chart below, the frequency of rating downgrades remains at elevated levels, compared to downgrade activity from 1999 through 2006, but is beginning to decline. Fitch downgraded 57% fewer structured finance securities in 2010 than in 2009. However, with continued high unemployment rates in the United States and weakness in the U.S. housing market, it remains to be seen whether this trend will continue.



Source: Fitch Ratings Global Structured Finance 2010 Transition and Default Study, March 24, 2011.

Almost 75% of Fitch's rating downgrades of structured securities in 2010 were related to RMBS and CMBS. ABS represented only 5.6% of the downgrades and structured credit represented 20.4%.

Although ABS was affected the least by the latest credit cycle, rating downgrades for ABS increased year-over-year (as illustrated in the following chart) primarily due to revisions in how certain risks influence the performance of student loan ABS. However, ABS upgrades also increased year-over-year, with the majority of the upgrades in the auto loan sector as a result of stable collateral performance and increased credit enhancement.



Source: Fitch Ratings Global Structured Finance 2010 Transition and Default Study, March 24, 2011.

According to Fitch's rating transition matrix for ABS below, the BB rating category experienced the largest amount of credit quality deterioration, with 30.16% of ratings downgraded. The B, CCC and AA rating categories followed closely behind, with 27.45%, 26.92% and 26.76%, respectively, of ratings lowered. AA-rated ABS transactions suffered an unusually high percentage of downgrades to BBB and BB primarily as a result of a combination of 1) deteriorating performance in some private student loan deals and 2) revisions in how certain risks influence the performance of Federal Family Education Loan Program (FFELP) student loan deals. FFELP is one of the largest U.S. higher education loan programs under which private lenders make federally guaranteed student loans to parents and students. The BBB and AAA rating categories experienced the least amount of deterioration, with only 10.32% and 10.76%, respectively, of ratings downgraded. With the exception of the AA rating category, the investment grade rating categories enjoyed lower negative rating volatility than the non-investment grade rating categories.

Fitch Global ABS One-Year Transition Matrix: 2010

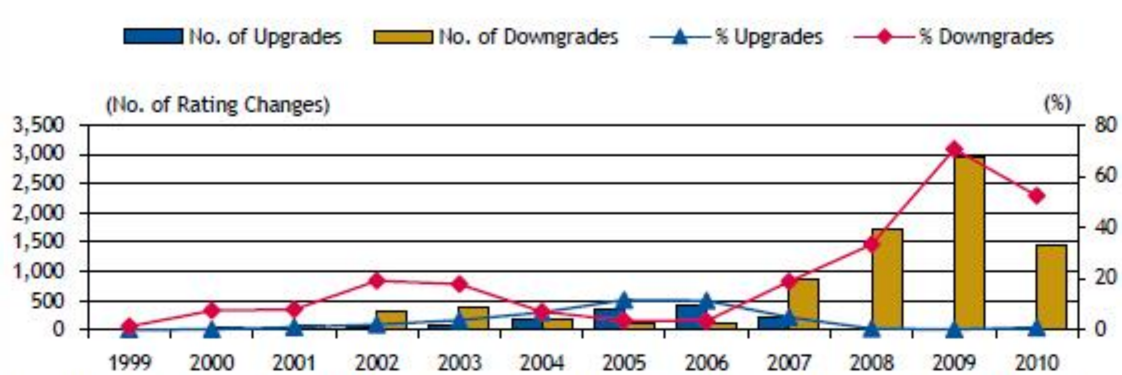
(%)

	AAA	AA	A	BBB	BB	B	CCC	CC and Below	Total
AAA	89.25	2.26	1.94	4.19	2.37	0.00	0.00	0.00	100.00
AA	14.65	58.60	5.10	10.19	10.83	0.64	0.00	0.00	100.00
A	1.76	7.84	72.55	8.04	3.33	5.29	0.39	0.78	100.00
BBB	0.38	0.58	4.04	84.62	6.35	2.31	0.77	0.96	100.00
BB	0.00	0.00	3.17	4.76	61.90	23.02	3.17	3.97	100.00
B	0.00	0.00	0.00	3.92	0.00	68.63	17.65	9.80	100.00
CCC	0.00	0.00	0.00	0.00	0.00	0.00	73.08	26.92	100.00

Source: Fitch Ratings Global Structured Finance 2010 Transition and Default Study, March 24, 2011.

Downgrades in structured credit at Fitch declined in 2010 after three straight years of year-over-year increases. The downgrades were attributable to 1) commercial real estate CDOs; 2) trust preferred CDOs; and 3) new ratings criteria for structured finance CDOs.

Fitch Global Structured Credit Rating Changes



Notes: Data compare beginning-of-the-year rating with end-of-the-year rating; data do not count multiple rating actions throughout the year. Rating changes are defined at the modifier level, making a distinction between +/-.

Source: Fitch Ratings Global Structured Finance 2010 Transition and Default Study, March 24, 2011.

Similar to ABS, securities with higher ratings tend to be more stable than their lower-rated counterparts. The AAA rating category saw 25.26% of ratings downgraded, while the CCC rating category suffered more severe deterioration, with 67.38% of ratings lowered.

Fitch Global Structured Credit One-Year Transition Matrix: 2010

(%)

	AAA	AA	A	BBB	BB	B	CCC	CC and Below	Total
AAA	74.75	9.60	3.79	6.06	5.05	0.76	0.00	0.00	100.00
AA	0.34	64.63	11.90	10.88	7.14	3.06	2.04	0.00	100.00
A	0.00	0.95	52.22	15.51	14.24	9.18	7.59	0.32	100.00
BBB	0.00	0.00	0.25	45.54	18.07	14.11	18.07	3.96	100.00
BB	0.00	0.00	0.00	1.53	43.77	21.63	16.79	16.28	100.00
B	0.00	0.00	0.00	0.00	0.87	34.42	22.94	41.77	100.00
CCC	0.00	0.00	0.00	0.00	0.20	0.59	31.84	67.38	100.00

Source: Fitch Ratings Global Structured Finance 2010 Transition and Default Study, March 24, 2011.

Given the continued high unemployment rate and weak housing market in the United States, collateral performance and, therefore, ratings will likely remain under some pressure. CreditWatch information provided by S&P provides insight into potential rating behavior for the near term. The following table shows that structured securities, in general, are at risk of continued downward ratings migration, as the number of transactions on CreditWatch with negative implications clearly outweighs those with CreditWatch developing or CreditWatch with positive implications. This data would look different, however, if the outlook for global corporate credit, unemployment rates, interest rates and/or the housing market changed dramatically.

Global Structured Finance On CreditWatch As Of March 2, 2011

Transaction-level

	No. of transactions		
Region/sector	**CreditWatch developing**	**CreditWatch negative**	**CreditWatch positive**
U.S. ABS	1	144	2
U.S. CDO	0	110	152
U.S. CMBS	0	27	1
U.S. RMBS	0	562	0
U.S. single-name synthetics	6	9	3
European ABS	0	153	0
European CDO	0	283	5
European CMBS	0	124	0
European RMBS	0	490	4
European single-name synthetics	0	38	0
Asia (non-Japan)	0	20	3
Australia/New Zealand	0	55	4
Canada	0	3	0
Japan	0	14	0
Latin America/emerging markets	0	4	1
Total	**7**	**2,036**	**175**

All CreditWatch placements are shown without collpasing 'AAA' rated classes. RMBS includes subprime mortgage transactions and ABS includes manufactured housing deals. CDO includes cash, synthetic, and market value CDOs as well as leveraged funds. CMBS includes Re-REMICS and CRE CDOs.

Source: Standard & Poor's Global Structured Finance Default Study — 1978–2010; March 28, 2011.

Impairment Rates

Global structured finance impairment rates, which include securities in default or near default, improved in 2010 as ratings volatility stabilized. According to Fitch, the impairment rate declined to 13.43% from 24.86% in 2009, with the impairments concentrated in non-investment grade securities. ABS experienced the lowest impairment rate of 0.94%, compared to 20.05% and 16.26% for structured credit and RMBS, respectively. The 2010 ABS impairment rate increased from 2009's rate of 0.68%, with investment grade ABS increasing to 0.34% from 0.14% in 2009 but non-investment grade ABS decreasing to 6.87% from 8.17%. Impairment rates for CDOs improved to 20.05% from 23.86% the prior year, primarily due to the significant improvement in investment grade credits from 16.70% in 2009 to just 1.06% in 2010. No impairments were evidenced in AAA ABS or AAA structured credit.

Fitch Structured Finance 2010 Impairment Rates

	Global SF	ABS	CMBS	RMBS	Structured Credit
AAA	0.24	0.00	0.06	0.42	0.00
Investment Grade	2.08	0.34	2.28	2.77	1.06
Non-Investment Grade	36.83	6.87	23.91	46.55	40.25
All	13.43	0.94	10.73	16.26	20.05

Source: Fitch Ratings Global Structured Finance 2010 Transition and Default Study, March 24, 2011.

Based on data provided by S&P, the manufactured housing, student loans and auto loans subsectors within ABS were the only major subsectors to experience any default rates in 2010. Manufactured housing had the highest level of defaults at 3.58%, while default rates on student loans and auto loans were less than 1%. These are significantly lower than default rates for

RMBS, CMBS and structured credit. The remaining major subsectors — including auto lease, credit card, equipment and commercial other — experienced no defaults or near defaults. CLO performance began improving in 2010 and is reflected in the relatively low default and near default rates in the table below.

Global Structured Finance 2010 Rating Transition By Subsectors*

Subsector	Beginning no. of ratings	Stable (%)	Upgrade (%)	Downgrade (%)	Near default (%)	Default (%)
ABS						
Auto lease	95	91.58	8.42	0.00	0.00	0.00
Auto loans	696	83.33	12.07	4.60	0.00	0.14
Credit card	686	85.71	8.60	5.69	0.00	0.00
Commercial other	21	100.00	0.00	0.00	0.00	0.00
Commercial paper	1	100.00	0.00	0.00	0.00	0.00
Consumer other	146	95.89	2.05	2.05	0.00	0.00
Covered bond	12	100.00	0.00	0.00	0.00	0.00
Equipment	199	93.47	3.52	3.02	0.00	0.00
Manufactured housing	279	62.37	3.94	33.69	0.00	3.58
Nonperforming	1	100.00	0.00	0.00	0.00	0.00
Other	248	87.90	8.87	3.23	0.00	0.40
Rental car	13	76.92	0.00	23.08	0.00	0.00
RV loans	19	73.68	0.00	26.32	0.00	0.00
Student loans	964	87.24	0.93	11.83	0.10	0.83
Trade receivables	22	100.00	0.00	0.00	0.00	0.00
Wholesale	46	93.48	0.00	6.52	0.00	0.00
CDO						
Cash flow CBO	196	52.04	0.51	47.45	10.20	7.14
Cash flow CDO of CDO	151	37.09	0.66	62.25	4.64	23.18
Cash flow CDO of CMBS	263	51.33	0.00	48.67	14.45	0.38
Cash flow CLO	4,062	42.00	6.08	51.92	0.47	0.10
Cash flow emerging market CDO	28	82.14	0.00	17.86	0.00	0.00
Cash flow high-grade CDO of ABS	609	73.89	0.00	26.11	7.72	12.64
Cash flow mezzanine CDO of ABS	1,074	60.89	0.47	38.64	13.59	6.89
Cash flow trust-preferred	288	34.72	0.00	65.28	5.21	2.43
Equity and hedge fund CFO	44	75.00	0.00	25.00	4.55	2.27
Hybrid CBO	27	25.93	0.00	74.07	3.70	0.00
Hybrid CDO of CDO	55	70.91	0.00	29.09	1.82	18.18
Hybrid CDO of CMBS	39	2.56	0.00	97.44	74.36	10.26
Hybrid CLO	50	24.00	0.00	76.00	4.00	0.00
Hybrid high-grade CDO of ABS	49	61.22	0.00	38.78	2.04	28.57
Hybrid mezzanine CDO of ABS	405	75.06	0.00	24.94	2.96	17.53

Source: Standard & Poor's Global Structured Finance Default Study — 1978–2010; March 28, 2011.

Insurance Industry Exposure to ABS and CDOs

As illustrated in the following table, the insurance industry's total exposure to ABS and structured credit as of Dec. 31, 2010, is $150 billion. The table provides the exposure by type of insurance company and by asset class. Life insurance companies account for the majority of ABS and structured credit exposure, with $119 billion or 79.5% of the industry's total exposure.

$ in millions	Life	P&C	Health	Fraternal	Title	Total
ABS						
Credit Cards	$20,753	$3,921	$460	$-	$288	$25,423
Auto Loans	10,406	6,400	723	4	294	17,827
Equipment	15,174	1,669	98	1	716	17,659
Student Loans	5,334	2,050	291	4	-	7,679
Aircraft	5,302	772	61	-	145	6,281
Utility	2,380	457	23	1	121	2,981
Manufactured Housing	1,832	328	6	-	41	2,207
RVs, Boats, Time Shares	1,212	83	7	-	30	1,332
Trade Receivables	811	78	5	-	-	894
Other	29,605	6,175	225	8	735	36,747
Structured Credit	26,156	3,444	123	15	794	30,532
Total	$118,966	$25,376	$2,023	$32	$3,165	$149,562
% of Total	79.5%	17.0%	1.4%	0.0%	2.1%	100.0%

Note: Columns and rows might not add up due to rounding.

Within the ABS asset class, the top three industry exposures are in the subsectors of credit cards, auto loans and equipment. According to the S&P data cited above, these subsectors experienced more upgrades than downgrades in 2010, as well as minimal to no defaults. The manufactured housing subsector's ratings, on the other hand, saw almost 34% of its ratings downgraded, and it had the highest default rate within ABS. The industry's exposure to manufactured housing totaled $2.2 billion, or 1.9% of the industry's exposure to ABS.

As discussed in a prior special report titled, "Insurance Company CDO Exposure," the insurance industry's largest exposure in structured credit is to CLOs. As of Dec. 31, 2010, almost 50% of the industry's structured credit exposure is in CLOs. According to the S&P default data cited above, CLOs in general experienced lower default rates than CBOs and the majority of CDOs.

In conclusion, the insurance industry's exposure to ABS and structured credit is comparable to the $190 billion and $128 billion exposures to CMBS and non-agency RMBS, respectively. ABS and structured credit, however, have experienced less ratings volatility and lower impairment rates than CMBS and non-agency RMBS.

Current Credit Spreads and Market Trends

The ABS sector has returned solid performance thus far in 2011. Modest improvements in employment, fewer bankruptcy filings and conservative underwriting standards have contributed to improving credit performance. Solid and improving credit performance is evidenced by credit spreads and trends. For example, the current indicative market spread for an AAA, fixed rate, three-year, prime auto ABS transaction is 29 basis points (bps). This is 8 bps tighter than the year-end 2010 spread of 37 bps and significantly tighter than the recent wide of 600 bps in November 2008. Similarly, credit card ABS have also performed well, as the current indicative market spread for an AAA, fixed rate, 10-year has tightened 10 bps since year-end 2010 to 45 bps from 55 bps. The recent wide for credit card ABS was 600 bps in October 2008.

Student loan ABS also has fared well. A typical AAA, 10-year FFELP student loan ABS transaction trades at 90 bps today — or 10 bps tighter than year-end 2010 and 385 bps tighter than the recent wide in October 2008. ABS backed by private student loans, which have no federal guarantee, also has performed well. A typical AAA, 10-year private student loan transaction trades at 275 bps today — or 95 bps tighter than year-end 2010 and 575 bps tighter than the recent wide of 850 bps in October 2008.

New issuance activity in the ABS market is comparable to last year, with almost $44 billion of new deals issued in 2010 vs. $45 billion in 2009. The majority of new issuance has been concentrated in the auto and student loan sectors. The auto subsector alone accounts for 65% of 2010's year-to-date new issue volume.

May 27, 2011								
Major Insurer Share Prices			**Change %**			**Prior**		
		Close	**Week**	**QTD**	**YTD**	**Week**	**Quarter**	**Year**
Life	Aflac	$48.05	(3.1)	(9.0)	(14.9)	$49.60	$52.78	$56.43
	Ameriprise	60.48	(2.9)	(1.0)	5.1	62.29	61.08	57.55
	Genworth	11.15	0.4	(17.2)	(15.1)	11.11	13.46	13.14
	Lincoln	28.90	(1.2)	(3.8)	3.9	29.26	30.04	27.81
	MetLife	43.92	(0.8)	(1.8)	(1.2)	44.28	44.73	44.44
	Principal	30.97	(2.2)	(3.6)	(4.9)	31.68	32.11	32.56
	Protective	24.17	(0.3)	(9.0)	(9.3)	24.25	26.55	26.64
	Prudential	63.39	(0.6)	2.9	8.0	63.78	61.58	58.71
	UNUM	26.13	(2.4)	(0.5)	7.9	26.77	26.25	24.22
PC	ACE	$68.50	(0.5)	5.9	10.0	$68.82	$64.70	$62.25
	Axis Capital	32.68	(2.0)	(6.4)	(8.9)	33.36	34.92	35.88
	Allstate	31.26	(2.3)	(1.6)	(1.9)	32.00	31.78	31.88
	Arch Capital	33.91	(1.9)	2.6	15.5	34.56	33.06	29.35
	Cincinnati	30.03	(2.1)	(8.4)	(5.2)	30.66	32.79	31.69
	Chubb	64.90	(1.3)	5.9	8.8	65.74	61.31	59.64
	Everest Re	89.42	(0.7)	1.4	5.4	90.05	88.18	84.82
	Progressive	21.57	(0.6)	2.1	8.6	21.70	21.13	19.87
	Travelers	61.54	(1.3)	3.5	10.5	62.38	59.48	55.71
	WR Berkley	32.73	(1.1)	1.6	19.5	33.08	32.21	27.38
	XL	23.25	(1.5)	(5.5)	6.6	23.60	24.60	21.82
Other	AON	$51.59	(1.4)	(2.6)	12.1	$52.33	$52.96	$46.01
	AIG	28.86	(6.2)	(17.9)	(40.2)	30.76	35.14	48.27
	Assurant	37.11	(2.2)	(3.6)	(3.7)	37.96	38.51	38.52
	Fidelity National	15.79	1.5	11.7	15.4	15.55	14.13	13.68
	Hartford	26.49	(2.1)	(1.6)	0.0	27.06	26.93	26.49
	Marsh	30.88	1.3	3.6	12.9	30.49	29.81	27.34
Health	Aetna	$43.75	(3.0)	16.9	43.4	$45.09	$37.43	$30.51
	Cigna	49.40	0.4	11.6	34.8	49.22	44.28	36.66
	Humana	79.37	(0.8)	13.5	45.0	80.05	69.94	54.74
	United	48.22	(3.3)	6.7	33.5	49.89	45.20	36.11
	WellPoint	77.56	(3.8)	11.1	36.4	80.64	69.79	56.86
Monoline	Assured	$16.68	0.4	11.9	(5.8)	$16.61	$14.90	$17.70
	MBIA	8.98	2.9	(10.6)	(25.1)	8.73	10.04	11.99
	MGIC	7.93	5.9	(10.8)	(22.2)	7.49	8.89	10.19
	PMI	1.39	0.0	(48.5)	(57.9)	1.39	2.70	3.30
	Radian	4.85	9.9	(28.8)	(39.9)	4.42	6.81	8.07
	XL Capital	23.25	(1.5)	(5.5)	6.6	23.60	24.60	21.82

May 27, 2011 Major Market Variables							
		Change %			Prior		
	Close	Week	QTD	YTD	Week	Quarter	Year
Dow Jones Ind	12,427.66	(0.7)	0.9	7.3	12,512.04	12,319.73	11,577.51
S&P 500	1,329.44	(0.3)	0.3	5.7	1,333.27	1,325.83	1,257.64
S&P Financial	210.92	(0.2)	(4.4)	(1.8)	211.36	220.71	214.77
S&P Insurance	189.13	(1.2)	(3.0)	0.5	191.45	194.96	188.22
US Dollar $		Change %			Prior		
/ Euro	$1.43	0.8	0.8	6.7	$1.42	$1.42	$1.34
/ Crude Oil bbl	100.37	0.9	(6.0)	8.8	99.49	106.72	92.22
/ Gold oz	1,534.30	1.4	6.6	8.0	1,513.50	1,438.90	1,420.78
Treasury Ylds %	%	Change			%	%	%
1 Year	0.16	(0.01)	(0.13)	(0.11)	0.17	0.28	0.27
10 Year	3.08	(0.07)	(0.40)	(0.22)	3.15	3.47	3.30
30 Year	4.24	(0.05)	(0.27)	(0.09)	4.30	4.51	4.34
Corp Credit Spreads -bp		Change %			Prior		
CDX.IG	78.02	2.3	(6.9)	(8.2)	76.27	83.81	85.00
CDX.XO	144	(11.9)	(24.9)	(24.9)	163.5	191.67	191.67

May 27, 2011
Major Insurer Bond Yields

	Company	Coupon	Maturity	Price			Spread	
				Current	Change	Yield	B.P.	Change
Life	Aflac	8.500%	5/15/2019	$124.02	($0.11)	4.83%	212	9
	Ameriprise	5.300%	3/15/2020	$109.44	$0.42	4.01%	114	2
	Genworth	6.515%	5/15/2018	$103.34	$0.44	5.92%	344	2
	Lincoln National	8.750%	7/15/2019	$129.52	$0.25	4.37%	165	6
	MassMutual	8.875%	6/15/2039	$142.49	$0.57	5.79%	159	5
	MetLife	4.750%	2/15/2021	$103.25	$0.20	4.34%	126	4
	Mutual of Omaha	6.800%	6/15/2036	$105.97	$1.50	6.32%	230	(6)
	New York Life	6.750%	11/15/2039	$118.55	$0.96	5.46%	125	3
	NLV Financial	7.500%	8/15/2033	$118.35	$0.45	5.99%	213	3
	Northwestern Mutual	6.063%	3/15/2040	$109.86	$1.02	5.39%	113	0
	Pacific Life	9.250%	6/15/2039	$134.27	($0.32)	6.56%	234	7
	Principal	6.050%	10/15/2036	$107.50	$0.96	5.50%	138	(1)
	Prudential	4.500%	11/15/2020	$101.03	$0.04	4.36%	134	5
	TIAA	6.850%	12/15/2039	$117.58	$0.85	5.61%	139	2
P&C	ACE INA	5.900%	6/15/2019	$114.54	$0.94	3.78%	112	0
	Allstate	7.450%	5/15/2019	$121.77	$0.62	4.20%	154	2
	American Financial	9.875%	6/15/2019	$125.99	$0.49	5.78%	311	5
	Berkshire Hathaway	5.400%	5/15/2018	$112.57	$0.26	3.36%	91	5
	Travelers	3.900%	11/15/2020	$98.35	$0.46	4.11%	112	1
	XL Group	6.250%	5/15/2027	$100.72	($0.27)	6.18%	259	9
Other	AON	5.000%	9/15/2020	$104.41	$0.29	4.42%	140	2
	AIG	5.850%	1/15/2018	$106.59	$0.02	4.68%	235	12
	Fidelity National	7.875%	7/15/2020	$111.13	($0.06)	6.25%	461	14
	Hartford	5.500%	3/15/2020	$105.55	$0.27	4.72%	186	5
	Marsh	9.250%	4/15/2019	$130.45	$0.83	4.59%	195	13
	Nationwide	9.375%	8/15/1939	$127.50	($0.40)	7.10%	289	8
Health	Aetna	3.950%	9/15/2020	$99.40	$0.46	4.03%	104	1
	CIGNA	5.125%	6/15/2020	$107.36	$0.51	4.14%	119	1
	United Healthcare	3.875%	10/15/2020	$98.75	$0.32	4.04%	101	3
	Wellpoint	4.350%	8/15/2020	$102.82	$0.53	3.98%	102	1

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