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

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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.