NAIC HOLDS HEARING ON THE REGULATORY TREATMENT OF HYBRID SECURITIES

On July 13, 2006, the National Association of Insurance Commissioners ("NAIC") held a public hearing to receive testimony on the regulatory treatment of certain hybrid securities that have been sold in SEC Rule 144A offerings.[1] The hearing was a joint meeting of the Valuation of Securities Task Force ("VOSTF") and the Capital Adequacy Task Force. The hearing addressed recent classifications of Hybrids by the Securities Valuation Office of the NAIC ("SVO") as common equity, which, according to interested parties, have created two issues in the market for such securities: (1) insurance companies - which historically have been significant purchasers of Hybrids - will disfavor the securities as investments because equity treatment adversely affects their risk-based capital ("RBC") and asset valuation reserve calculations and (2) the SVO's procedures for disclosing such classifications have led to inconsistencies in the availability of information regarding such classifications on the part of market participants. These two issues were at the forefront of the public hearing and will be explored in greater detail in this memorandum. Although no definitive answers arose from the hearing, the NAIC has since announced the creation of a working group to examine RBC factors as they pertain to the classification of Hybrids.[2]

Background

A. *What is a Hybrid Security?*

Hybrids are complex instruments structured with characteristics of both equity and debt. Each Hybrid is structured with unique characteristics in order to, among other things, address tax issues, rating agency concerns and issuer goals (such as capital treatment). Hybrids have been widely employed by highly rated financial institutions and insurance companies to bolster their regulatory capital bases and typically allow the issuer to defer payments (for either a certain period of time or indefinitely) during times of financial distress. Hybrids have an extended maturity (e.g., 50 years from the date of issue) or no maturity, and generally are callable at the issuer's option after a defined period of time. In the issuer's capital structure, Hybrids typically rank senior to common equity and may in some circumstances rank *pari passu* with preferred stock.

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1 The various hybrid instruments considered by the NAIC are referred to as "Hybrids" in this memorandum.

2 See *NAIC Creates Working Group to Address RBC Factors* (July 13, 2006), available at: http://www.naic.org/Releases/2006_docs/hybrid_wg_formed.htm.

B. *Current Treatment by the NAIC*

Due in large part to the unique nature of new securities, the VOSTF, in 1996, adopted Part Seven, Section 1(c) to the SVO Purposes and Procedures Manual ("PPM Part Seven") (amended in 1999) for classifying instruments as debt, preferred or common equity instruments in the portfolios of insurance companies holding such instruments. An SVO classification decision means "that on balance, and absent considerations of credit quality, the economic character of the hybrid *most resembles* that associated with a bond, preferred stock or common stock."[3] The classification is used primarily for RBC and Asset Valuation Reserve ("AVR") calculations.[4] According to its recent Statement on Classification Analysis, the SVO conducts this classification analysis solely to permit State insurance regulators *some* predictive measure of how a financial instrument is likely to behave *absent considerations of credit quality.*[5] As a result, the classifications assigned by the SVO differ from the ratings assigned by the rating agencies, which take into account the credit quality of the issuer. The SVO classification analysis can be likened to an analysis of structural subordination risk, which differs from credit risk in that it reflects the relative possibility of taking a primary loss position in the capital structure of the issuer in the event of credit deterioration, regardless of the probability of such deterioration occurring.[6]

PPM Part Seven provides an overview of the analysis used in classifying a security, but does not specify the combination of features that will result in a particular classification decision. At the hearing, members of the insurance industry and other interested parties indicated that this approach makes it difficult for issuers to tailor a particular security to obtain a desired classification. The SVO classifies each particular security as debt, preferred equity or common equity by taking into account five contractual rights common to all investments.[7] In its recent Statement on Classification Analysis, the SVO stated that the analytical methodology consists, first, of a comparison between investor expectations embodied in the hybrid instrument and those embodied in the profiles of either debt, preferred stock or common stock to determine the preponderant characteristic of the instrument (the preliminary assessment) and, second, an analysis of the totality of the security and its economic context to determine whether other factors suggest a different classification.[8]

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[3] *RBC Power Point for Agenda Item #2* (July 13, 2006), available at: http://www.naic.org/documents/topics_hybrid_ppt_RBC.pdf.

[4] Id.

[5] See *Statement on Classification Analysis*, available at: http://www.naic.org/documents/svo_statementonclassificationanalysis.pdf.

[6] See *SVO Prepared Comments Hearing on the Regulatory Treatment of Hybrid Securities* (July 13, 2006), available at: http://www.naic.org/documents/topics_hybrid_071306_svo_comments.pdf.

[7] The five rights identified are: 1) the holder's legal claim as creditor or holder of a residual interest, 2) whether the holder has the right to influence issuer management, 3) whether there is a promise to make periodic payments and if so, whether it is deferrable and/or cumulative/non-cumulative, 4) whether there is a stated maturity date or an agreed-upon basis for establishing maturity or redeeming the claim, and 5) the nature of an investor's claim in a bankruptcy, liquidation or reorganization (i.e., is it a debt claim or a residual interest). See Part Seven, Section 1(c) of the *SVO Purposes and Procedures Manual*.

[8] Id. Refer to Classification Analysis on SVO website.

C. *RBC Treatment*

As indicated above, the SVO classification process is used primarily for RBC and AVR reserve calculations. RBC establishes minimum capital and solvency requirements for U.S. insurers. Insurer investments in bonds, preferred stock and common stock, in each case of unaffiliated issuers, are assigned risk factors under the RBC rules which are intended to capture the risk of default of interest or principal (credit risk for bonds and preferred stock) and fluctuations in fair value (market risk for common stock). RBC factors for debt/preferred stock are significantly lower than those for common stock. For an NAIC 1 rated debt security held by a life insurer, the RBC factor is 0.4%; for common stock it is 30% (subject to adjustment up to 45% or down to 22.5%).[9] On or prior to March 1 of each year, insurers are required to file a report of RBC levels as of the end of the prior calendar year. Therefore, Hybrids held by insurers as of December 31, 2006 and classified as common stock will be subject to the RBC treatment described above unless RBC rules are amended with respect to Hybrids.

D. *Classifying Hybrids as Common Equity*

Prior to 2006, insurers generally reported ownership of Hybrids as bonds. In the fall of 2005, the New York State Insurance Department ("NYID") required a New York domestic insurer to file a certain hybrid security with the SVO for classification.[10] On March 15, 2006, the SVO notified the NYID that the security in question should be classified as common equity.[11] Since that time, the SVO has issued four reports regarding classification determinations of Hybrids in which Hybrids have been classified as common equity.[12]

Market Concerns Created by SVO Classifications of Hybrids as Common Equity

At the NAIC hearing, interested parties from various industries raised concerns about both the process for classifying Hybrids, the distribution of information regarding such classifications and the substance of the individual determinations. A panel of four insurer representatives and one investment banker raised concerns regarding the impact of SVO classifications on insurers and the market for Hybrids generally. Rating agency representatives from Moody's, Standard &

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9 See *NAIC Creates Working Group to Address RBC Factors* (July 13, 2006), available at: http://www.naic.org/Releases/2006_docs/hybrid_wg_formed.htm.

10 See *Report of SVO Classification Determinations Report #1* (May 16, 2006) available at: http://www.naic.org/documents/svo_ReportOfSVOClassDeterminationsNum1.pdf.

11 Id.

12 Id.; see also *Report of SVO Classification Determinations Report #2* (June 14, 2006), available at: http://www.naic.org/documents/SVO_ReportOfSVOClassDeterminationNum2.pdf; *Report of SVO Classification Determinations Report #3* (June 27, 2006), available at: http://www.naic.org/documents/SVO_ReportOfSVOClassificationDeterminationNum3.pdf; and *Report of SVO Classification Determinations Report #4* (July 7, 2006), available at: http://www.naic.org/documents/SVO_ReportOfSVOClassificationDeterminationNum4.pdf.

Poor's and Fitch discussed the approach they take in rating Hybrids. Members of the Bond Market Association ("BMA") and the American Council of Life Insurers ("ACLI") spoke about disclosure of SVO classification. Finally, members of various insurance organizations addressed the authority of the SVO to issue the Statement on Classification Analysis.

A. *Effect on Insurers*

Insurers argued that Hybrids should be treated as debt or preferred equity because they are traded like fixed income securities, analyzed internally as involving fixed income and function like fixed income securities in terms of regular periodic payments, a defined interest rate and the expectation that principal will be returned. Although it was conceded that in times of financial distress Hybrids function like common equity, insurers noted that the likelihood of financial distress in the highly rated issuers of Hybrids is remote enough that it should not be the overriding factor in the SVO's classifications. Thus, the insurance company representatives argued that the credit quality of the issuer should be factored into the SVO decision making process to a greater degree.

Interested parties argued that the continued classification of Hybrids as common equity places insurance companies at a competitive disadvantage with other investors in the marketplace. Due in large part to the RBC treatment of insurers' portfolios and the capital reserve requirements placed on insurance companies, investing in Hybrids, if they are treated as common equity, will require insurance companies to seek a much greater return than had been contemplated when the Hybrids were purchased. For smaller insurance companies, continued treatment of Hybrids as common equity could result in a downgrading of their portfolios despite the high credit rating of the securities they own.

B. *Effect on the Market for Hybrids*

Interested parties stated that insurers make up a large percentage of the current market for Hybrids, and with the uncertainty surrounding SVO classification, spreads have widened about 30 basis points since March. This has cost insurers who purchased Hybrids roughly $1 billion. Because insurers cannot achieve the returns necessary to justify holding a security treated as common equity, they have been forced to either sell off their holdings or not participate at all. One interested party noted that the widening spreads have created a market inefficiency which will likely be taken advantage of by hedge funds. In essence, insurers argued, there will be an unjustified wealth transfer as a result of the SVO classifications of Hybrids as common equity in the face of high ratings from rating agencies. The BMA and ACLI testified that reclassification of Hybrids results in the selling-off of securities, thus resulting in lower prices. In addition, large sell-offs affect the liquidity of the instruments. Reclassifications also can affect other securities perceived as similar to the reclassified one, and ultimately create uncertainty in the marketplace.

C. *Asymmetry of Information in the Marketplace*

The BMA and ACLI requested transparency in SVO operations for the benefit of market efficiencies and specifically asked for publication of SVO classifications in press releases and

website postings and increased disclosure regarding the rationale behind each such classification or reclassification. Under the current system, the SVO's classification of a specific security is provided to the entity that files the request for classification, and to insurance companies and state insurance regulators via proprietary electronic databases.[13] The BMA stated that it is extremely difficult for other investors to access this information. The BMA and ACLI argued that the current system, which allows one investor to receive material information that affects the market prior to the dissemination of the information to the market generally, allows for, and gives an advantage to, certain parties to trade on information that is not generally available to the public.

In some cases, issuers have remedied the inequality of information on an *ad hoc* basis by issuing press releases stating the classification determination by the SVO.[14] Furthermore, disclosure of the potential market risks associated with SVO classifications have surfaced in the form of risk factors in Offering Memorandums. Although disclosure of the potential risks and publication of the SVO classifications would combat the lack of transparency with which the SVO makes its determinations, practical timing issues associated with such communications are such that these *ad hoc* communications will not eliminate the market inefficiencies created by the current process.

D. *Effect on Tax Treatment of Hybrids*

The issue arises whether the SVO's classification of a Hybrid issued by a U.S. issuer as common equity may be seen to affect the treatment of the instrument for U.S. federal income tax purposes. In general, an instrument is classified as debt or equity for U.S. tax purposes based on a facts and circumstances test that looks to a variety of formal and substantive criteria laid down in a series of court decisions. In Notice 94-47, the Internal Revenue Service added to the list of criteria "whether the instruments are intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes." Thus, the IRS might seek to bootstrap an SVO classification of an instrument as common equity as a factor indicating equity status of a particular Hybrid. However, the additional criterion added by Notice 94-47 is not based on any precedent, and the relevance of an instrument's treatment under the requirements of a particular regulatory regime is not apparent. Given the uncertain status of the position taken in the Notice, it does not seem likely that an SVO determination of common equity status for a Hybrid would bear significantly on the classification of the instrument for U.S. federal income tax purposes. At the same time, however, the fact of the IRS position cannot be dismissed, leading to a conclusion that an SVO's classification could in some cases affect the tax treatment of the security issued by a U.S. issuer.

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[13] Some proprietary databases are accessible only by regulators while others are accessible by both regulators and insurance company representatives. See *SVO Prepared Comments Hearing on the Regulatory Treatment of Hybrid Securities* (July 13, 2006), available at: http://www.naic.org/documents/topics_hybrid_071306_svo_comments.pdf.

[14] Domestic issuers accomplish this by filing a Form 8-K, while foreign issuers have published press releases on company websites (or if they have U.S. listed securities, by filing a Form 6-K).

NAIC Response to the Hearing

Following the joint task force meeting, the NAIC announced the creation of a working group to address RBC factors as they pertain to the classification of Hybrids. Although insurance company panelists argued for a working group to be comprised of both regulators and industry professionals, the NAIC rejected the idea of including industry professionals in the subgroup. Instead, industry professionals and interested parties will be permitted to submit comments to the subgroup. The subgroup will be charged with reporting recommendations and clarification for the appropriate regulatory treatment of Hybrids to the Financial (E) Committee at the NAIC Fall National Meeting scheduled for September 9-12, 2006 in St. Louis, Missouri. In addition, the joint task force announced that the transparency issue raised by the BMA and the ACLI will be referred back to the larger Financial (E) Committee of the NAIC for resolution by year-end.

Conclusions

The joint task force hearing on the capital treatment and transparency of classifications of Hybrids provided an opportunity for the NAIC to gain real feedback from a variety of interested parties. The uncertainty that has surrounded Hybrids since the March decision by the SVO is a real concern for insurers and investors generally. The NAIC's goal is to clarify the regulatory treatment of Hybrids over the next several months. Whether insurers will maintain Hybrid investments will likely depend on the results of the NAIC's clarifications and guidance prior to year-end.

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