SHORT TERM PROPOSAL FOR
REGULATORY TREATMENT OF HYBRID SECURITIES

Our July 28 Client Memorandum reported on the reaction of capital markets participants and the insurance industry to recent developments in the insurance regulatory treatment of certain hybrid securities. In March 2005, the Securities Valuation Office ("SVO") of the National Association of Insurance Commissioners ("NAIC") classified certain hybrids as common equity, which, according to interested parties, has created two issues in the market for such securities: (1) insurers have disfavored the securities as investments because common equity treatment adversely affects their risk-based capital ("RBC") calculations and (2) the SVO's classification disclosure procedures have led to inconsistencies in the availability of information to market participants. The NAIC has since formed the Hybrid RBC Working Group (the "Hybrid WG"), which, after receiving comments from interested parties, developed a proposal for the classification and RBC treatment of hybrids as of year-end 2006 (the "Short Term Proposal"). Upon final adoption of the Short Term Proposal by the full NAIC, hybrids generally will be classified as preferred stock, and certain hybrids will be subject to rating notches.

Background

The SVO and Securities Classification

The SVO performs credit quality assessments and valuations of securities held by insurers. Securities filed with the SVO for valuation purposes are assigned an NAIC rating designation (NAIC 1-6) unless the security is filing exempt ("FE"). Bonds or preferred stock with unqualified ratings from a Nationally Recognized Statistical Rating Organization ("NRSRO") (e.g., Moody's or S&P) and common stock publicly traded on a national exchange are FE.

In 1996, classification guidelines were developed by the NAIC in response to challenges presented by hybrids. Requests for the classification of a security as debt, preferred or common equity can be submitted to the SVO by regulators, issuers and insurers. The guidelines provide three securities profiles (debt, preferred or common equity), which an SVO analyst will use to compare five factors of a security: contractual promise, rights, periodic payments, maturity/redemption and involuntary redemption. The analyst also looks to the totality of the security and its economic context to determine whether other factors suggest a classification.

Securities classifications and rating designations affect the RBC factors applied to insurer investments. Insurer investments in securities are assigned risk factors under the RBC rules intended to capture the risk of default of interest or principal and fluctuations in fair value. RBC factors for debt/preferred stock are significantly lower than those for common stock. (For example, the RBC factor for unaffiliated debt held by a life insurer is 0.4% compared with a 30%

RBC factor for common stock.) In addition, RBC factors for highly rated securities, such as a security with an NAIC 1 Designation, are lower than those applied to lower rated securities.

Regulatory Developments and New Classifications

Prior to 2006, insurers generally reported hybrids as bonds. However, in the spring of 2005, the New York State Insurance Department ("NYID"), chair of the NAIC's Valuation of Securities Task Force (the "VOSTF"), expressed concern that insurers were improperly classifying hybrids. In the fall of 2005, the NYID asked a domestic insurer to file a particular hybrid security with the SVO for classification. On March 15, 2006, the SVO notified the NYID that the security in question should be classified as common equity. Thereafter the NYID instructed certain insurers to report other hybrid securities to the SVO for classification and requested that the SVO draft an explanation of its classification process, which was posted on the NAIC website (see "Statement on Classification Analysis" available at www.naic.org).[1]

Market Concerns Created by SVO Classifications of Hybrids as Common Equity

The NYID's direction to domestic insurers to reclassify certain hybrids in accordance with SVO guidance generated significant reaction from the financial press and from capital markets participants. Concerns were raised about the classification process for hybrids, the RBC impact of reclassifications, the disclosure of classification information, and the authority of the SVO to issue the Statement on Classification Analysis.

NAIC Response

The Short Term Proposal issued by the Hybrid WG, with input from interested parties, includes a definition of "hybrids" and a proposed RBC treatment for year-end 2006. The Hybrid WG's goal was to (i) adopt a definition encompassing the whole population of hybrids and (ii) identify the segment of such hybrids that should receive an additional risk-based capital charge under the Short Term Proposal. Although various interested parties testified that all risks presented by hybrids are captured in NRSRO credit ratings, the regulators believe that hybrids present additional risks. The following risks were identified by the NYID as not accounted for by the national credit rating agencies: the risk that any extension by the issuer making the hybrid a long-dated or perpetual security might adversely impact market value; the complexity, non-uniformity and lack of historical data on hybrids; the risk that the issuer's regulator will act to protect the issuer to the detriment of the investor; rating volatility; and price volatility. The Short Term Proposal is intended to include such investment risks in the RBC treatment of certain hybrids, and regulators indicated that the Short Term Proposal would lead to a long-term solution. The American Academy of Actuaries has reportedly formed a study group to be

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1 Since March, the SVO has issued eight reports detailing classifications and reclassifications of 88 hybrids performed in 2006, of which 31 were classified as common equity.

charged with studying the underlying risks associated with hybrids in order to develop a long-term solution.

The Short Term Proposal was adopted by the Hybrid WG and its parent committee, the Financial Conditions (E) Committee, (the "E Committee") at the Fall 2006 NAIC Meeting held in St. Louis. However, in order for the treatment to become operative, the Short Term Solution must be adopted by the full NAIC at a Plenary Meeting. The next scheduled Plenary Meeting will take place at the NAIC Winter National Meeting (December 9-12 in San Antonio).

A. Short Term Proposal - Definition of Hybrids

Under the Short Term Proposal, "Hybrids" are defined as:

> Securities whose proceeds are accorded some degree of equity treatment by one or more of the NRSROs and/or which are recognized as regulatory capital by the issuer's primary regulatory authority. Hybrid securities are designed with characteristics of debt and of equity and are intended to provide protection to the issuer's senior note holders. Hybrid securities products are sometimes referred to as capital securities. Examples of hybrid securities include Trust Preferreds, Yankee Tier 1s (with and without coupon step ups) and debt-equity hybrids (with and without mandatory triggers).
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> For 2006, this definition of hybrids specifically excludes:
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> - Surplus notes
> - Subordinated debt issues with no coupon deferral
> - "Traditional" preferred stocks, including (but not limited to) issues which:
>   - for U.S. issuers do not allow tax deductibility for dividends; and
>   - are issued as preferred stock of the entity or an operating subsidiary, not through a trust or a special purpose vehicle.
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> The 2006 exclusions may be modified during the long-term review of risk components.

B. Short Term Proposal - RBC Treatment

The following scenario for the reporting and RBC treatment of Hybrids was adopted by the regulators without significant objection from the industry. The Short Term Proposal will be effective on the date it is adopted by the full NAIC (or when adopted by the E Committee) (the "Effective Date"), and will remain effective until the earlier of January 1, 2008 or adoption of a long-term proposal by the NAIC.

Preferred Stock Classification of Hybrids - All Hybrids are to be reported as preferred stock, except that Hybrids classified by the SVO as debt in 2006 will be reported as debt. (Accordingly, Hybrids classified by the NAIC in 2006 as common will be reported as preferred stock.)

Notching of Hybrids Issued after August 18, 2005 and before the Effective Date - All Hybrids issued after August 18, 2005 and those Hybrids classified in 2006 by the SVO as common stock are notched down by one NAIC Designation. Those Hybrids classified by the SVO as debt or preferred stock will not be notched.

Classification and Notching of Hybrids Issued after the Effective Date - All FE Hybrids issued subsequent to the Effective Date will be reported as preferred stock and notched down one NAIC designation, except that such securities filed and classified as debt or preferred stock by the SVO will be reported as debt or preferred stock appropriately with no notching. An insurer holding a "notched" Hybrid issued subsequent to the Effective Date may request SVO review of the security in an attempt to eliminate the notch. For Hybrids filed with the SVO, the designation assigned by the SVO must be used by the insurer. As per normal practice, SVO classification will apply to all holders of the security.

C. Effect on Tax Treatment of Hybrids

For U.S. tax purposes an instrument is generally classified as debt or equity using criteria established 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." Although the IRS might seek to bootstrap an SVO equity classification as a factor in the tax analysis, the validity of Notice 94-47 is uncertain, and where the security's evaluation under another regulatory regime materially differs from settled tax principles, the relevance of the non-tax treatment is doubtful. Therefore, it seems unlikely that an SVO determination of equity status for a hybrid should bear significantly on the classification of the instrument for tax purposes.

Conclusion

The Short Term Proposal will very likely be adopted by the NAIC at the NAIC Winter National Meeting. In 2006, the Short Term Proposal permits insurers to classify existing Hybrids as preferred equity (or debt if so classified by the SVO in 2006). Notching applies to any Hybrid issued after August 18, 2005 and Hybrids classified as common stock by the SVO in 2006. In addition, Hybrids issued after the Effective Date will be notched unless filed for classification with the SVO or unless the SVO grants a request to eliminate the notch.

In the coming months, the NAIC will undertake the formulation of a long term proposal for the definition and RBC treatment of Hybrids. In addition, a preliminary proposal related to SVO transparency is scheduled to be presented at the NAIC Winter National Meeting. For the near-term however, given the general acceptance of the Short Term Proposal by interested parties it appears that, when adopted, the proposal will restore certainty and predictability to the treatment of Hybrids by insurers.

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If you have any questions regarding this memorandum, please contact Gregory B. Astrachan (011 (44) 20 7696 5442, gastrachan@willkie.com), Serge Benchetrit (212-728-8798, sbenchetrit@willkie.com), Leah Campbell (212-728-8217, lcampbell@willkie.com), Richard L. Reinhold (212-728-8292, rreinhold@willkie.com), or the attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

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