FINANCIAL CONDITION (E) COMMITTEE

W:\Dec09\Cmte\E\Contents.doc

Financial Condition (E) Committee
San Francisco, CA
December 8, 2009

The Financial Condition (E) Committee met in San Francisco, CA, Dec. 8, 2009. The following Committee members participated: Alfred W. Gross, Chair, Doug Stolte and David Smith (VA); Linda S. Hall and Gloria Glover (AK); Steve Poizner represented by Al Bottalico and Kim Hudson (CA); Kevin M. McCarty represented by Ray Spudeck (FL); Susan E. Voss and Jim Mumford (IA); Michael T. McRaith represented by Jack Messmore (IL); Glenn Wilson represented by Jaki Gardner (MN); Neil N. Jasey represented by Bob Kasinow (NJ); James J. Wrynn represented by Matti Peltonen, Joe Fritsch, Mike Moriarty and Lou Felice (NY); Joel Ario represented by Steve Johnson (PA); Joseph Torti, III (RI) and Leslie A. Newman represented by Larry Knight (TN).

1. Adopt Task Force and Working Group Reports

A motion was made by Mr. Moriarty to adopt the reports of the following Committee task forces and working groups: Accounting Practices and Procedures (E) Task Force; Capital Adequacy (E) Task Force; Examination Oversight (E) Task Force; Receivership and Insolvency (E) Task Force; Reinsurance (E) Task Force; Risk Retention Group (E) Task Force; Valuation of Securities (E) Task Force; Financial Analysis (E) Working Group (Attachment One); NAIC/AICPA (E) Working Group (Attachment Two); National Treatment and Coordination (E) Working Group (Attachment Three); Rating Agency (E) Working Group (Attachment Four); and Restructuring Mechanisms for Troubled Companies (E) Subgroup (Attachment Five). The motion was seconded by Mr. Bottalico and passed unanimously.

2. Guideline for Notice of Protection by Life and Health Insurance Guaranty Association

Commissioner Gross announced that this guideline was drafted by the Receivership and Insolvency (E) Task Force. He added that the guideline was supported by the American Council of Life Insurers (ACLI), as evidenced by their comment letter to the Committee (Attachment Six). A motion was made by Commissioner Voss to adopt the proposed guideline (Attachment Seven). The motion was seconded by Mr. Spudeck and passed unanimously.

3. White Paper on Alternative Mechanisms for Troubled Companies

Commissioner Gross announced that this white paper was drafted by the Restructuring Mechanisms for Troubled Companies (E) Subgroup. The Subgroup was formed by the Committee in 2007 to undertake a study on the various types of mechanisms used in dealing with troubled companies. The product of this study, the white paper, is now complete and ready to be considered for adoption by the Committee. A motion was made by Mr. Fritsch to adopt the *White Paper on Alternative Mechanisms for Troubled Companies* (Attachment Eight). The motion was seconded by Superintendent Torti and passed unanimously.

4. Presentation on U.S. Insurance Financial Solvency Framework

Commissioner Gross stated that a U.S. Insurance Financial Solvency Framework document had been prepared by Mary Weiss (NAIC) at the direction of selected members of the Committee. The document was needed in order to allow the U.S. to communicate its system to other functional regulators and international insurance regulators and, when completed, will address a charge previously provided to the Committee. Mr. Spudeck stated that he wished the document had been completed when the U.S. insurance regulators were communicating with the International Monetary Fund (IMF) on the Financial Sector Assessment Program (FSAP). Commissioner Gross stated that the document was available on the NAIC Web site, and comments should be submitted to NAIC staff by Dec. 17. He noted that comments will likely be discussed and considered on a January 2010 conference call. Ms. Weiss presented a summary of the document (Attachment Nine).

5. Residential Mortgage-Backed Securities (RMBS) Model Process Proposal

Commissioner Gross announced that the Valuation of Securities (E) Task Force adopted a position where they proposed the RMBS model process should be extended to first quarter 2010. Commissioner Gross explained that this is the same modeling process the NAIC Executive (EX) Committee/Plenary adopted on a Nov. 5 conference call for year-end 2009. He stated that if the Committee agrees with the position of the Task Force, it should be considered and voted on separately so that the position can be forwarded to Executive (EX) Committee/Plenary. A motion was made by Mr. Spudeck to adopt the position that the RMBS model process should be extended to first quarter 2010. The motion was seconded by Mr. Johnson and passed unanimously.

6. Any Other Matters

Ed Stephenson (Barnert & Associates, representing Jackson National Life) asked for clarification on two items as a result of the presentation provided by SVO staff to the industry on the RMBS process. He stated that, during the presentation, it was noted that the assumptions would be based on Pacific Investment Management Company's (PIMCO) base model, and that the intent of the model is to develop an economic expected loss. He asked for clarification regarding whether was correct. Mr. Peltonen replied that was the intent, although the expected economic loss would not be provided in the NAIC product, but rather the 10 price points that correspond to the NAIC designations. Mr. Stephenson asked if the intent of the SVO's review of the data from PIMCO was quality assurance only. Mr. Peltonen responded that was correct, noting that the SVO would be conducting reasonableness reviews of the data as a whole, as well as detailed reviews of individual CUSIPs on a selected basis. Mr. Stephenson asked the members of the Committee to clarify this to the SVO staff, and also to request the data be provided to the industry as soon as possible. Mr. Peltonen responded that SVO staff would do its best to get the file completed by Dec. 28.

Having no further business, the Financial Condition (E) Committee adjourned.

W:\Dec09\Cmte\E\12-Emin.doc

Draft: 12/8/09

Financial Analysis (E) Working Group
San Francisco, CA
December 7, 2009

The Financial Analysis (E) Working Group of the Financial Condition (E) Committee met in San Francisco, CA, Dec. 7, 2009. The following Working Group members participated: Roger Peterson, Chair (WI); Kim Hudson (CA); Kathy Belfi (CT); Linda Sizemore (DE); Robin Wescott (FL); Jim Hanson (IL); Bob Dynan (MA); Jacqueline Gardner (MN); Fredrick Heese (MO); Jeff Trendel (NC); Bob Kasinow (NJ); Mike Moriarty (NY); Dale Bruggeman (OH); Steve Johnson (PA); and David Smith (VA). Also participating was Louis Quan (CA).

The Financial Analysis (E) Working Group met in executive session pursuant to paragraph 3 of the NAIC Policy Statement on Open Meetings ("Specific companies, entities or individuals").

During the meeting, the Working Group heard presentations on nationally significant insurers and groups that were exhibiting characteristics of being potentially troubled.

Having no further business, the Financial Analysis (E) Working Group adjourned.

W:\Dec09\Cmte\E\wg\fawg\12-FinAnalysismin.doc

Draft: 12/10/09

NAIC/AICPA (E) Working Group
San Francisco, CA
December 6, 2009

The NAIC/AICPA (E) Working Group of the Financial Condition (E) Committee met in San Francisco, CA, Dec. 6, 2009. The following Working Group members participated: Doug Stolte, Chair (VA); Al Bottalico (CA); Al Franz (DE); Jim Armstrong (IA); Jim Hanson (IL); Judy Weaver (MI); Fred Heese (MO); Jim Nixon (NE); Thomas Burke (NH); Jim Everett (NY); Bill Harrington (OH); Russell Latham (OR); Steve Johnson (PA); and Jake Garn (UT).

1. Status Report of Recent AICPA Activities/Actions

Ed Metzger (KPMG) reported on current projects of the American Institute of Certified Public Accountants (AICPA). The AICPA report discussed the Auditing Standards Board's adoption of clarity drafting conventions to six Statements of Auditing Standards related to risk assessment. The report also discussed new Statements on Auditing Standards that have recently been proposed in the areas of audit engagement letters and written representations to be obtained during an audit.

2. Survey Results Regarding Implementation of the Model Audit Rule Revisions

Bruce Jenson (NAIC) discussed the updated results of a survey regarding the states' progress toward adopting the revised requirements for the *Annual Financial Reporting Model Regulation* (#205), commonly known as the Model Audit Rule. Based on the results of the survey, 36 states have adopted the revised requirements. Of the remaining states, 13 plan on adopting all of the revisions prior to year-end, with the other two states completing adoption within the first few months of 2010. For those states that will not complete adoption until early 2010, all of their domestic companies have agreed to comply with the new model requirements that are effective Jan. 1, 2010. NAIC staff will continue to track the states' progress toward adopting these requirements.

3. Discussion of Model Audit Rule Interpretation Issues

The Working Group discussed the impact that Statement of Standards in Attestation Engagements (SSAE) No. 15 could have on compliance with the Model Audit Rule. SSAE No. 15 provides guidance for auditors in attesting to the effectiveness of a non-public company's internal controls. At its last meeting, the Working Group concluded that insurers receiving an attestation of internal controls in accordance with this guidance should be able to utilize the attestation in complying with the Model Audit Rule requirements. However, the Working Group could not come to agreement on whether the filing of an SSAE No. 15 report, along with an addendum as required for Sarbanes-Oxley Section 404 report filers, would be acceptable without changing the language within the Model Audit Rule. NAIC Staff was asked to seek the opinion of the NAIC legal department on the matter, who concluded that as long as the SSAE No. 15 opinion complies with and contains the same information as is required in the Model, this report could be filed along with an addendum without adjusting the Model language itself. As such, on a motion from Ms. Weaver, seconded by Mr. Johnson, the Working Group adopted guidance for inclusion in the Implementation Guide indicating that an SSAE No. 15 report, along with an addendum as required for SOX Section 404 report filers, may be filed to comply with the Model Audit Rule requirements.

The Working Group discussed interpretations regarding bookkeeping services prohibited to be provided by external auditors under the new Model Audit Rule requirements. To answer questions as to whether annual statement preparation or audited statutory financial statement preparation would constitute bookkeeping services, the Working Group proposed changes to the Implementation Guide that were exposed for public comment over the past quarter. The changes interpret bookkeeping services to include work performed to prepare the annual statement. However, drafting of the audited financial report would not be considered a bookkeeping service, provided that the accountant does not assume decision-making authority in compiling the draft report. No comments were received on the proposed guidance during the exposure period. On a motion from Mr. Armstrong, seconded by Mr. Bottalico, the interpretation (Attachment Two-A) was adopted for inclusion in the Implementation Guide.

The Working Group discussed the "Group of insurers" concept included within the Model Audit Rule and its Implementation Guide. Based upon previous discussions of the Working Group, regulators had concluded that each control or process deemed significant to each legal entity exceeding the Model Audit Rule premium threshold should be subject to review and reporting requirements. This is due to the fact that the Model Audit Rule requires the insurer or "Group of insurers" to issue an assertion on the effectiveness of its internal control over statutory financial reporting, which is typically performed on a legal entity basis. In an attempt to clarify regulator expectations in this area, proposed changes to the Implementation Guide were exposed for public comment over the past quarter. Several comments letters were received during the exposure period.

As a result of the comment letters received and subsequent discussions between the commentators and regulators, a group of interested parties presented alternative language for inclusion in the Implementation Guide that attempts to incorporate the expectations of regulators into the Guide while clarifying issues of industry concern. This alternate language states that management is not required to perform testing that would be redundant for each legal entity included within the group of insurers when preparing to issue Management's Report of Internal Control over Statutory Reporting for a "Group of insurers." In addition, the alternate language states that a "Group of insurers" that has been granted approval to file audited statutory consolidated or combined financial statements may set the scope and level of testing for purposes of determining effectiveness of internal controls over financial reporting consistent with the basis on which the audited statutory financial statements for the Group are prepared. On a motion from Mr. Harrington, seconded by Ms. Weaver, the alternate language (Attachment Two-B) was adopted for inclusion in the Implementation Guide.

The Working Group discussed issues regarding frequently asked question (FAQ) #5 of the Implementation Guide. Interested parties had previously proposed changes to this FAQ to allow more flexibility for the lead audit partner to participate in insurance company audits. The proposal was exposed for public comment, with no comments being received. However, due to regulator concerns raised during the previous meeting of the Working Group, staff was asked to seek the opinion of the NAIC legal department on whether the proposed change would conflict with the guidance currently included within the Model Audit Rule. The legal department concluded that the proposed changes would directly conflict with the guidance already included within the Implementation Guide and suggested that regulators consider granting a waiver from the Model requirement in this situation. As a result of the legal opinion received, the interested parties proposed alternate language for inclusion in the Implementation Guide, suggesting that regulators consider granting a waiver from the audit partner rotation requirements for insurers in this situation. On a motion from Mr. Armstrong, seconded by Mr. Garn, the Working Group adopted the alternate proposal (Attachment Two-C) for inclusion in the Implementation Guide.

4. Any Other Matters

The Working Group discussed a referral received at its last meeting from the Risk Assessment Implementation (E) Subgroup regarding access to external audit workpapers when performing risk-focused examinations. The referral was the result of a survey of chief financial examiners regarding the implementation of risk-focused examinations. Most survey respondents indicated that external audit workpapers were useful in completing the risk-focused exam process; however, the timing of gaining access to workpapers was noted as a significant issue complicating the use of external audit work. As a result of the survey responses, the Working Group was asked to work with the CPA firms to determine whether the timing for the release of external audit workpapers to examiners could be improved and whether it might be possible for examiners and auditors to work concurrently in performing walkthroughs and reviewing controls of the insurer.

The Working Group agreed to research the issue further and provide the CPA firms with some background as to what situations generated these concerns. After a detailed review of survey responses, it was determined that the main concern is the conflict between the start of financial examinations and the completion of the statutory audit work. Many financial examinations begin in March, April or May of the year following the examination as-of date. However, much of the audit work is not finalized at this time, and examiners have had difficulty obtaining access to workpapers until after the audit report has been issued, which is required no later than June 1. The Working Group discussed the appropriateness of requesting that CPA firms attempt to complete their audit work as early as possible in those years that a financial examination is scheduled in order to facilitate timely sharing of workpapers. To ensure that the CPA firms are notified well in advance of the upcoming financial examination, the Working Group agreed to send a referral to the Financial Examiners Handbook (E) Technical Group to add guidance to the NAIC *Financial Condition Examiners Handbook* in this area.

The Working Group also discussed a new rule proposed by the Securities Exchange Commission regarding Board Risk Management and Executive Compensation. Mr. Stolte stated that the proposed rule has yet to be finalized by the SEC. After the rule has been finalized, Mr. Stolte stated that the Working Group will seek to work with the SEC to get a better understanding of the purpose of the rule and whether it should be considered for insurance regulatory purposes.

Deborah Whitmore (Ernst & Young) stated that representatives of the AICPA plan to once again obtain negative clearance from regulators that they will continue to follow the guidance contained in a letter dated March 9, 2005, indicating that "significant deficiencies" will not be required to be reported by external auditors to regulators as of Dec. 31, 2009. Ms. Whitmore indicated that this will be the last year for such a notification, as the revised Model Audit Rule requirements clarifying regulator expectations in this area will go into effect for next year.

Having no further business, the NAIC/AICPA (E) Working Group adjourned.

W:\Dec09\Cmte\E\wg\aicpa\12-aicpa.doc

23. Can Partner Little rotate from serving as the lead audit partner on insurance subsidiary B to serving as the lead audit partner on non insurance subsidiary E for the 2011 year end audit?

    Yes. However, Little can only serve for two years due to three years prior service as the lead audit partner on insurance subsidiary B (an insurance affiliate). The limitation initiates with serving as the lead audit partner on an insurer.

Prohibited Services (Section 7 G)

The Model does not allow the Commissioner to accept an Audited financial report prepared by an accountant who provides the insurer, contemporaneously with the audit, non-audit services as outlined within the Model. One of the prohibited services outlined in the Model consists of bookkeeping or other services related to the accounting records or financial statements of the insurer. The prohibition in this area should include, but is not limited to, services related to the preparation of the Annual Statement to be submitted by the insurer. However, the drafting of the Audited financial report would not be prohibited, provided that the accountant does not assume decision-making authority (e.g., approval of journal entries) in compiling the draft report.

Table of Contents

The Table of Contents for the Guide mirrors that of the Model. However, not all sections of the Model require interpretive guidance. Consequently, only those sections containing guidance are contained in the Guide. The presentation of the Guide is organized by the Section Title with the Section number of the Model appearing after the title.

Definitions (Section 3)

Certain terms and definitions contained in the Model need no further explanation. The Guide provides additional information for preparers and users for some definitions to facilitate their understanding.

"**Audited financial report**" (D), differs from the term "financial statements" in that the Audited financial report (see Section 5 of the Model) includes the financial statements plus the report of the independent certified public accountant. "Financial statements," therefore, excludes the report of the independent certified public accountant.

"**Group of insurers**" (H), as intended for use in the Model is to recognize the variety of structures that may exist. Companies within a holding company structure, or other set of insurers identified by management, may often share common management, systems or processes. Consequently, when management asserts to the effectiveness of their internal controls, it is appropriate to make such an assertion for those companies based upon the organization management determines to be most relevant to meet the reporting requirements. Because holding company structures, and other groups of insurers, can be complex and organized to meet corporate objectives, that structure may not align with the organizations that are responsible for managing and preparing the financial statements of the insurer. The Model provides flexibility to insurers to identify a "Group of insurers" for purposes of evaluating the effectiveness of their internal control over financial reporting. In determining the appropriate scope and level of testing for systems that are shared by a group of insurers, management is not required to expand the scope or perform additional testing that would be redundant for each legal entity included within the group of insurers. To the extent that a specific internal control or system is unique to and has a material impact on the preparation of the audited statutory financial statements of a legal entity included in a group of insurers and the legal entity exceeds the premium thresholds contained in Section 16, that control or system is to be included in management's evaluation of internal controls.

A "Group of insurers" that has been granted approval to file audited statutory consolidated or combined financial statements of a group of insurers (as described in Section 8) may set the scope and level of testing for purposes of determining effectiveness of internal controls over financial reporting consistent with the basis on which the audited statutory financial statements for the Group are prepared (i.e., at the combined or consolidated level).

The following example is intended to illustrate various ways that a "Group of insurers" could be determined. The example is not intended to be limiting in any way. Rather, it is intended to show the flexibility to be in compliance

Relief from the Lead Audit Partner Rotation Requirement (Section 7D)

The Model states:

> An insurer may make application to the Commissioner for relief from the above rotation requirement on the basis of unusual circumstances. This application should be made at least thirty (30) days before the end of the calendar year. The Commissioner may consider the following factors in determining if the relief should be granted:
>
> (a) Number of partners, expertise of the partners or the number of insurance clients in the currently registered firm;
>
> (b) Premium volume of the insurer; or
>
> (c) Number of jurisdictions in which the insurer transacts business.

The following examples illustrate circumstances that the Commissioner may consider in determining if relief from the lead partner rotation requirement shall be granted:

1. No other partners in the firm's local office have the qualifications to serve as lead audit partner and the use of a qualified partner resident in another location could result in increased audit risk and higher audit fees.
2. Limited number of partners in the firm that have the qualifications to serve as the lead audit partner.
3. Switching firms could result in increased audit risk due to the new engagement team's lack of familiarity with the insurer.
4. Limited availability of other firms in a particular location with the requisite expertise.
5. The regulator believes that complex issues at an insurer make a particular partner best suited to continue as lead audit partner
6. Short-term relief due to the occurrence of an unforeseeable event that renders a partner unable to continue as the lead audit partner on the engagement.
7. Short-term relief due to unexpected delays in the state's licensing or admission process that prevent the "new" lead audit partner from assuming that role.

Also, the granting of transitional relief may be warranted when the non-insurance parent or ultimate parent of an insurance company is an SEC registrant and the current lead audit partner on the SEC registrant has completed his or her rotation as the lead audit partner on insurance subsidiaries prior to completing his or her five-year rotation as the lead partner on the audit of the GAAP financial statements of the SEC registrant. In this situation the relief would allow the lead audit partner to complete his or her rotation on the SEC registrant as long as he or she no longer acts in the capacity of lead audit partner for any insurance subsidiaries and/or any downstream affiliates of the insurance subsidiaries.

Frequently Asked Questions (Section 7D)

Following are a series of frequently asked questions to assist companies and their independent accountants in interpreting this guidance. Dates provided refer to the year of financial statements under audit.

In determining when the lead audit partner must rotate, consecutive time served in the capacity of lead audit partner prior to the effective date of these rules would be counted (i.e., the lead audit partner is not afforded a "fresh start"). If the lead audit partner completed the two year break in service required by the previous version of the Model prior to the effective date of these rules, the partner is eligible to resume service as a lead audit partner for a five year period and need not wait additional years to accomplish a five year break in service.

1. 2010 would be the fifth year that a partner would serve as lead audit partner of an insurance company. Would that partner be able to complete the 2010 year end audit?

   Yes. The partner would be able to complete the 2010 year end audit; however, the partner would be required to rotate off the engagement after the 2010 year end audit.

2. 2010 would be the sixth or seventh year that a partner would serve as the lead audit partner. Would that partner be able to serve in that capacity for the 2010 audit?

Draft: 12/2/09

National Treatment and Coordination (E) Working Group
Conference Call
November 19, 2009

The National Treatment and Coordination (E) Working Group of the Financial Condition (E) Committee met via conference call Nov. 19, 2009. The following Working Group members participated: Jill Jacobi, Co-Chair (CA); Cindy Donovan, Co-Chair (IN); John Postolowski (CO); Maura Welch (CT); Libby Thompson (FL); Stewart Guerin (LA); Anne Morgan (NC); Adam Hamm (ND); Russell Latham (OR); Cressinda Bybee (PA); Eric Showgren (UT); Raquel Pino-Moreno (VA); Gayle Pasero (WA); and Linda Johnson (WY). Also participating was: Jeff Hunt (TX).

1. Receive Oct. 7 Minutes

Ms. Jacobi summarized the minutes from the Oct. 7 conference call regarding the pro forma, survey results and the drafting of a uniform affidavit of lost certificate of authority that was referred to the Issues (E) Subgroup. Ms. Welch asked for clarification on the discussion of the pro forma on the income statement referencing that "this form is limited in its current format because it is reported on a state-by-state level instead of nationwide," as this form is reported both ways. Mr. Hunt explained that this discussion was regarding the property/casualty pro forma for the expense allocation by line of business, which takes the percentage of expense allocated based on premium earned. The forms asked for specific state information by line, not nationwide. This is the last tab of the pro forma worksheet, not the income statement. Upon a motion by Ms. Pasero and a second by Mr. Showgren, the Working Group voted unanimously to receive the Oct. 7 Working Group minutes (Attachment Three-A).

2. Receive Issues (E) Subgroup Nov. 12 Summary

Ms. Donovan summarized the discussion of drafting a uniform affidavit of lost certificate of authority (Attachment Three-B). The Issues (E) Subgroup discussed the commonalities of the state-specific forms received with the completed surveys. The Subgroup will draft a form incorporating many of the elements from the samples received for consideration of the Working Group at the next scheduled conference call. The Subgroup also discussed drafting the wording to incorporate the accreditation standards that become effective Jan. 1, 2012, for the primary application in the *Company Licensing Best Practices Handbook*. The Subgroup will also be working on creating uniform guidelines for the UCAA pilot project and expedited licensing consideration by the Working Group. Ms. Jacobi and Ms. Donovan mentioned that member input is greatly appreciated during the drafting of these uniform standards. The Subgroup will meet via conference call Dec. 16.

3. Update on the Download Function

Ms. Jacobi mentioned that the NAIC is currently working on a download function that was discussed during a previous conference call. While they are making great progress, further updates on the completion date will be discussed in the very near future.

4. Discuss Drafts to the Pro Forma Worksheet, Form 13, P &C, Life & Health and Title

Mr. Hunt explained the proposed changes to the pro formas by business type, starting with the property/casualty form. The handwritten note on the bottom of the cover page recommends that the schedules at the very end of the worksheet for expense allocation by line of business net of reinsurance/direct business be deleted. The columns on this worksheet apply a percentage of expenses to business net of reinsurance, net business and direct business by line of business on a state basis. More focus for these expenses was placed on the income statement and cash flow area, which makes the schedules in the back of the pro forma less needed. The purpose for this recommendation is to see the expenses nationwide instead of by state. If a company not writing much business in one state but writing quite a bit nationwide goes "belly-up" in one state, they will most likely go belly-up in all states. If total expenses are not broken up between nationwide and state-wide, it is hard to make comparisons, and regulators may lose the benefit of judgment. The goal for the changes suggested for the admitted assets is liquidity—does the company have most of its assets in bonds, stocks, or cash equivalents? Does the company have a lot of affiliated investments, because the value of those can be unreliable. The same holds true for mortgage loans. Under capital and surplus, preferred and capital stock was combined to make room for the expanded admitted assets. Total liabilities and total adjusted capital was also removed, for the most part. This will be the same as the current total capital and surplus.

For the profit and loss statement, “other underwriting expenses incurred” has two asterisks (**) as a reference to itemize in assumptions. If the amounts are high in this area, the company will need to explain this in the assumptions of the pro forma. Per California’s request, items 15 through 22 are basically a statement of surplus to reflect surplus changes during the year. This addition will show money coming into the company and leaving the company through dividends, net income, and other increases and decreases. Everything else on this statement remains the same.

On the cash flow statement, the section from financing and miscellaneous sources was cleaned up to be more specific about money coming into the company. Many times in the projections, companies show money being infused into the company in year two and three. This section will show how money is coming in, either through capital and paid in surplus, surplus notes or borrowed funds and money leaving the company through dividends or other cash provided or applied.

For all the pro forma blanks, it is recommended to leave the years blank instead of prepopulated every January. If they are left blank, the applicant can begin their projections with the first year of operation. For example, if a company was looking to write Medicare, they would have to wait a year before they could begin writing business. There is no reason to have the first year of the projections with no new business. Ms. Jacobi expressed a concern raised in the past with an expectation that the company would commence writing business and if there would be any objections from the states if the first year is left blank, given market circumstances that you would be licensing a company that would not be writing for another year. Mr. Hunt said he believed that if given the dates, the company would be projecting in those given years when it does not expect to write until the second or third year. Ms. Donovan added that any explanation as to why the company is waiting a year to write should be explained in the narrative. Mr. Hunt explained that his intent was for the company to give three “full” years of projections, beginning with the first full year, not the next calendar year. Year two is a questionable year in the projections—this is when money would be plugged into the company, and that is a concern for Texas. Jane Conard (NAIC) mentioned that the company only has to put in the first full year of operation; year two and three will automatically populate from that date. All years are then carried forward into the spreadsheets. Ms. Pasero asked if there could be a drop-down box with selected years, so that the companies would not select the current year or type in the wrong year. Mr. Showgren added that with a selection box or drop-down box, the company could still select the wrong year or select the current year even though they do not intend to write business in Utah until a year later than they plan to with other markets included on the pro forma.

Mr. Hunt mentioned that the only difference on the balance sheet for Life & Health is a request from California to add a line for “separate account assets” before Total Admitted Assets and then offset with a line for “separate accounts liabilities” before Total Liabilities. For the profit and loss statement, a line for “net transfer (to) or from separate accounts net of reinsurance” before line 17–Total Expenses should be added. The cash flow is the same as the property casualty breaking out more detail on money coming into and out of the company. A line should be added on the analysis of operation by line of business (LOB) for “net transfer (to) or from separate accounts net of reinsurance” after line 16–Total Expenses. On both the nationwide and state-by-state planned premium volume by LOB, a line should be added for “deposit type contracts” before line 9–Total.

Nancy Stepanski (Westmont Associates) asked when these changes would become effective. Ms. Jacobi stated that once the proposed changes were approved by the Working Group, it would be the middle of the year at the earliest for the changes to be made to the spreadsheet and available for use.

The title, Form 13, profit and loss statement has title insurance and related income on line 1. Mr. Hunt said this should be broken out to reflect title premium earned, escrow charges, and other related income and to keep the pro forma more in line with the annual statement blanks. By breaking out title premium earned, a regulator could get a true loss ratio perspective, which is picked up in the later schedules. Lines 16 and 17 reflect two separate loss ratios to net losses incurred and net loss adjustment expenses. This should be consistent throughout the pro forma; the loss summary/ratio schedules should not include loss adjustment expenses; splitting out losses and loss adjustment expenses on the profit and loss statement and carrying that throughout the pro forma to the supporting schedules so the ratios do not include both loss and loss adjustment expenses. Losses incurred give an accurate loss ratio. The cash flow statement has the same break-out of cash coming in and out of the company as the property/casualty and life and health. The only other change was to remove the asterisk reference stating that this includes loss adjustment expenses (LAE) so that this will tie back to the annual statement blanks.

Ms. Pino-Moreno mentioned that the property casualty blank has common stock listed on the balance sheet page, but the other two blanks have it just listed as stock. Mr. Hunt explained that that was a typo and it should be listed as stock, to include all types of stock. Ms. Jacobi mentioned that the Working Group will have time to review the proposed changes and offer suggestions or questions by the next scheduled conference call. The deadline for submitting comments is Dec. 28.

6. Other Matters

Jane Conard (NAIC) mentioned that a survey was conducted by a third-party agency to the states requesting their preference of either hard-copy or electronic applications. The number of states that indicated their preference of hard-copy was surprising. Prior surveys to the states did not indicate that preference. Early next year the NAIC will send out another questionnaire to the appropriate state contacts requesting their needs and preference once the download feature has been released. Going forward, feedback from the regulators will be solicited for the electronic application so that their needs can be met. Ms. Jacobi stated that one of the main charges for the Working Group is to enhance the electronic application to increase usage by the industry and regulators. Next year's E-Reg Conference will focus on this. Ms. Donovan added that training may be an issue with staff turnover and prior issues with previous versions of the electronic application.

Ms. Stepanski gave a brief update on the Essent pilot project. Essent Guaranty's application has been approved in 36 states. There are 30 states in which the company has received a licensed: Arkansas, Arizona, Colorado, Connecticut, Delaware, the District of Columbia, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Massachusetts, Maryland, Michigan, Mississippi, Missouri, Nebraska, New Hampshire, New Jersey, New York, North Dakota, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Utah, Vermont and West Virginia. They are tentatively approved in six states: Alabama, Hawaii, Maine, Oregon, Rhode Island and Virginia. They have withdrawn their application in one state. They have provided their feedback to the chairs.

Hugh Alexander (Alexander Law Firm) stated that the UCAA merger application has received 32 approvals and only one state of concern—California—and John Hancock Life Insurance Company USA is working on that. There are also 32 state form approvals and only one state of concern, which is New Mexico.

The Issues (E) Subgroup will meet via conference call Dec. 16. The National Treatment and Coordination (E) Working Group will meet via conference call Jan. 6, 2010.

Having no further business, the National Treatment and Coordination (E) Working Group adjourned.

W:\Dec09\Cmte\E\wg\National\11-ntacwgmin.doc

Draft: 12/2/09

Issues (E) Subgroup
Conference Call
November 12, 2009

The Issues (E) Subgroup of the National Treatment and Coordination (E) Working Group of the Financial Condition (E) Committee met via conference call Nov. 12, 2009. The following Subgroup members participated: Cindy Donovan, Chair (IN); Jill Jacobi (CA); Joan Nakano (CT); Mary Mostoller (FL); and Jeff Hunt (TX). Also participating were: Cary Cook (AZ); Carrie Colborn (IN); Raquel Pino-Moreno (VA); and Gayle Pasero (WA).

1. Discuss Drafting Uniform Affidavit of Lost Certificate of Authority

The Subgroup reviewed sample affidavits from various states and discussed their common elements. Ms. Donovan noted that they all require notarization, and most have similar wording: "after diligent search in the event the certificate was located it was to be returned to the Department." In order to incorporate various state requirements, one sentence could be developed to incorporate all of the options. Oregon's affidavit stipulates that the license is the property of the state of Oregon; this is the only form that states that. All forms do not stipulate which officer should sign the affidavit or if it should be signed by someone "involved with the safekeeping of the certificate" or "someone with knowledge of the certificate". Some affidavits also request a certificate number and ask if it is a state requirement or part of a state form format.

Nancy Stepanske (Westmont Associate, Inc.) said it is difficult to obtain a certificate number if the certificate is lost, unless the company contacts the Department to obtain the number. Ms. Donovan asked if the date the license was issued should also be eliminated. Ms. Stepanske agreed that the actual date may be difficult to obtain if the certificate is not available. Ms. Jacobi asked if the NAIC CoCode should be added. Ms. Donovan agreed that the forms should be uniform with the other corporate amendment forms and include the company name, FEIN and NAIC CoCode in the header. This information would be useful when companies within a holding company group have similar names. Ms. Donovan suggested drafting a uniform form, which can be used with various corporate amendment applications.

2. Discuss Drafting Accreditation Standards to the *UCAA Manual* and *Company Licensing Best Practices Handbook*

Ms. Donovan summarized the recommendations made during the previous Working Group conference call by the Financial Regulation Standards and Accreditation (F) Committee regarding the New Company Licensing Accreditation Standards. Ms. Donovan added that the *Company Licensing Best Practices Handbook* would be the most appropriate place to include the new accreditation standards instead of the *UCAA Manual*. Ms. Jacobi mentioned that page 17 of the *Handbook* under the heading of Timeliness of Review is where the new standard should be included. She suggested that a bullet be added at the bottom of page 17 with the effective date of the new standard instead of rewriting the primary application section. Ms. Pasero agreed that this would be the best approach. Ms. Jacobi asked if this should also be included in the *UCAA Manual*. Ms. Donovan thought the Manual is more of an instructional manual for the person completing the application as opposed to the Handbook, which is a reference handbook for the person reviewing the application. Ms. Donovan added that the National Treatment and Coordination (E) Working Group will have the final say before adoption by E Committee. Ms. Jacobi suggested drafting the language for the Handbook before drafting language for the Manual for the primary application, as the Manual is intended for all types of applications. The co-chairs of the Working Group will draft the wording.

3. Discuss Drafting Requirements for the Expedited Licensing Program

The Working Group has received numerous applications for consideration as a UCAA Pilot project for expedited licensing. Ms. Jacobi added that prior requests have been considered more for Beta testing of the electronic application, which may have also included expedited treatment for market issues. Ms. Jacobi suggested that the Subgroup develop parameters for these requests; currently the Working Group reviews and votes on each request. Expedited review is not the sole purpose of these requests. Ms. Donovan and Ms. Jacobi agreed that guidelines should be developed for consideration of these requests for the Working Group. If the company requested "expedited" treatment, additional guidelines will need to be met. Ms. Pasero asked if there are guidelines in existence or if the Subgroup is starting with a blank slate. Ms. Donovan stated that there are no current guidelines. Not all requests are granted, and some companies that are seeking expedited status are denied based on several issues, such as workload or capitalization. Ms. Jacobi suggested that in addition to developing criteria for this process; would be to define what it means to be a pilot project. Feedback on the electronic application is critical to the acceptance into the pilot project.

Ms. Stepanske asked if the goal of the electronic application process is to reduce the amount of paper or to have the application reviewed faster, regardless if the submission is part of the pilot program. Ms. Jacobi agreed that there has been some confusion in the past that the UCAA electronic application is only for pilot or expedited licensing projects instead of for any expansion or corporate amendment application. Ms. Stepanske added that in order to increase usage, there should be some incentive or advantage to do so. As a third-party preparer, she has been asked by her clients what is gained from submitting the application electronically as opposed to in hard copy. The hope is that if the application is submitted electronically, it will be reviewed quicker by the state. Ms. Pasero and Ms. Stepanske agreed to work together to draft an outline of suggested guidelines.

The Subgroup will meet Dec. 16 to discuss the drafts for the Lost Certificate of Authority, the Accreditation Standards for the Handbook and to review the draft guidelines for the pilot project.

Having no further business, the Issues (E) Subgroup adjourned.

W:\Dec09\Cmte\E\wg\National\Issues SG\Issues Subgroup Summary11_12_09.doc

Draft: 10/27/09

National Treatment and Coordination (E) Working Group
Conference Call
October 7, 2009

The National Treatment and Coordination (E) Working Group of the Financial Condition (E) Committee met via conference call Oct. 7, 2009. The following Working Group members participated: Jill Jacobi, Co-Chair (CA); Cindy Donovan, Co-Chair (IN); John Postolowski (CO); Joan Nakano (CT); Libby Thompson (FL); Stewart Guerin (LA); Anne Morgan (NC); Carole Kessel (ND); Russell Latham (OR); Robert Brackbill (PA); Raquel Pino-Moreno (VA); Gayle Pasero (WA); and Linda Johnson (WY). Also participating were: Doug Hartman (AK); Cary Cook (AZ); Louis Quan (CA); Carol Anderson (ID); Carrie Colborn (IN); David Browning (MS); Lin Riippi (NV); Steve Johnson (PA); and Jeff Hunt (TX).

1. Discuss Aug. 26 Minutes

Ms. Pino-Moreno mentioned that Virginia did not participate on theAug. 26 conference call; therefore, their name will be removed from the minutes. Ms. Donovan asked if North Carolina researched their concern regarding the withdrawal form and outstanding claims that was discussed during the last call. Ms. Morgan was not able to research further and suggested tabling the concern. NAIC staff will follow-up on e-vote for removing the redomestication questions from the questionnaire, Form 8.

2. Discuss Survey Results for Change of Address, Form 14 Summary

Ms. Jacobi summarized that the purpose of the survey was to gather information regarding changes to the company contact information. The purpose of Form 14 was to reduce the number of state-specific forms. The states were asked whether the form was required or accepted and to provide details regarding statute or regulation supporting their request for information. The results indicated that more states accept the form instead of require it. Angela Gleason (American Insurance Association—AIA) asked if it would be possible to see which states are requiring the form as opposed to accepting or rejecting it, and to see if there is a pattern or if states are accepting straight across the columns. Ms. Donovan suggested forwarding the state responses. She added that the results may be misleading when a specific state may require Form 14 but may not require any type of notification for each contact listed on the form. Using Catastrophe/Disaster Coordination Contact as an example, a specific state wanted this added to the form, but this pertains mostly to coastal states. Ms. Jacobi said the results indicate that none of the states are requiring the amending of articles unless there is a change in the home state or the city. NAIC staff will forward the responses to Ms. Gleason.

3. Discuss Corporate Amendment Affidavit of Lost Certificate of Authority Survey Results.

Ms. Jacobi mentioned that of the responses received from the 34 states that participated in the survey, most of the states are requiring an affidavit. There are some differences in the signature requirements—who needs to sign it and whether it needs to be notarized. Ms. Jacobi suggested that this could be developed in conjunction with the withdrawal application. Ms. Donovan agreed that this could be developed as a form because there are other corporate changes that would require an affidavit of lost certificate of authority. She added that a grid of signature requirements could be developed and added to the UCAA Web site. Upon motion by Mr. Latham and a second by Ms. Pasero, the Working Group voted unanimously to refer the development of this form to the Issues Subgroup.

4. Discuss Updates to the ProForma Worksheet, Form 13, P &C, Life & Health and Title

Mr. Hunt summarized the comments received regarding updates or changes to the ProForma Excel spreadsheet used for forecasting projections. The purpose of the changes would be to better reflect regulatory focus on liquidity; limit tendency to understate expenses; and better evaluate the applicant's ability to fund the entity. He also suggested that the years not be pre-populated on the form. The company should begin their projections with the first full year of operation. Instructions should also be included on the first page indicating that the first year should be the first year of operation, not the calendar year the application is submitted. Companies writing Centers for Medicare and Medicaid Services (CMS) business most generally will not be writing business until one year after their application is submitted.

Mr. Hunt said the balance sheet for all three entities on the current form seems to focus on a split between affiliated and non-affiliated. In order to get a better idea of the applicant's liquidity position, the assets should be expanded more like the annual statement. This should include bonds, stocks, mortgage notes, real estate, cash/cash equivalents, and affiliated receivables.

He said the profit and loss statement should include more detail on the other underwriting expenses to break them out to include commissions, taxes, fees, other acquisition expenses, etc. This should include more than loss and loss adjustment expenses for companies expanding into various states. The start-up costs identified in the other expenses could be the downfall of a company not previously noticeable in the projections.

A suggestion made by California was to include a section for Statement of Changes in Capital and Surplus to capture components of unrealized capital gains or losses, changes in nonadmitted assets, shareholder dividends or capital contributions and reinsurance, etc.

Mr. Hunt said the cash flow statement breaks out cash provided and cash applied, which seems redundant. He recommended one line for cash provided and then including subsets of this line to include cash, surplus notes, contributed capital, and other cash source to evaluate where the source comes from.

He said the property/casualty Form 13, profit and loss statement, line 4–Direct Commissions & Brokerage should be changed to “Direct & Assumed Commissions & Brokerage” for clarification. The expense allocation to lines of business net of reinsurance/direct business form can be eliminated if the other underwriting expenses section on the profit and loss statement is expanded. This form is limited in its current format because it is reported on a state-by-state level instead of nationwide.

Mr. Hunt said the life & health Form 13, balance sheet, needs a line added for “separate account assets” before line 4–Total Admitted Assets and then offset with a line for “separate accounts liabilities” before line 12–Total Liabilities. For the profit and loss statement, a line for “net transfer (to) or from separate accounts net of reinsurance” before line 17–Total Expenses should be added. A line should be added on the analysis of operation by line of business (LOB) for “net transfer (to) or from separate accounts net of reinsurance” before line 16—Total Expenses. On both the nationwide and state-by-state premium LOB, a line should be added for “deposit type contracts” before line 9–Total.

The title, Form 13, profit and loss statement has title insurance and related income on line 1. Mr. Hunt said this should be broken out to reflect title premium earned, escrow charges, and other related income. Aggregating premium earned with other related income appears to skew the loss ratios and should be applied consistently across the ProForma. Line 16 and line 17 reflect two separate loss ratios to net losses incurred and net loss adjustment expenses. This should be consistent throughout the proforma; the loss summary/ratio schedules should not include loss adjustment expenses. He recommended splitting out losses and loss adjustment expenses on the profit and loss statement and carrying that throughout the proforma to the supporting schedules so the ratios do not include both loss and loss adjustment expenses. Losses incurred give an accurate loss ratio.

Ms. Jacobi asked Mr. Hunt if he could identify which changes were substantive and which were more technical. Mr. Hunt said the first few suggestions—the balance sheet, the profit and loss statement and the cash flow statement—were substantive, whereas the specific changes to each business type were more technical.

Nancy Stepanski (Westmont Associates) agreed with the suggested changes if they would make what the states want to review more apparent and would provide additional information that would be helpful. Ms. Donovan thought it would be helpful to see the suggested changes drafted on the form so the financial regulators could review the suggestions. Mr. Hunt agreed to mock up the proforma.

6. <u>Other Matters</u>

Ms. Stepanski gave a brief update on the Essent pilot project. Essent Guaranty’s application has been approved in the following states: the District of Columbia, Georgia, Illinois, Kansas, Kentucky, Michigan, Mississippi, Missouri, Nebraska, New Jersey, New York, North Dakota, Oklahoma, Pennsylvania, South Carolina, South Dakota, Utah, and West Virginia. They have received approval notification in Arizona and tentative approval in Hawaii, Maine, Massachusetts, and New Hampshire. They have withdrawn their application in one state and are currently working with another state regarding specific market requirements on a state level and not a national level. Ms. Donovan said Indiana has approved their application as well. Essent is now at the halfway mark for approvals.

Hugh Alexander (Alexander Law Firm) stated that the UCAA merger application was submitted two weeks ago and the policy forms have been sent. Currently, John Hancock has received 21 approvals and one rejection—from New Mexico—because the UCAA merger application has not been approved. They have also received one approval from Maine. Mr.

Latham asked for clarification on which application this was. Mr. Alexander stated that it was for John Hancock Life Insurance Company and John Hancock Variable Life, which are merging to form John Hancock Life Insurance Company USA. Ms. Donovan added that one of the challenges on the corporate side was with the effective date of the merger being Dec. 31. Some states may process the amendment and calendar it until the effective date, meaning that the change may be approved but not be finalized until that specific date. Mr. Alexander said he could provide a chart with the state approvals to distribute to the attendees on the conference call.

Ms. Jacobi gave an update from the Financial Regulation Standards and Accreditation (F) Committee with recommendations to the Working Group to add a reference in the *Uniform Certificate of Authority Application Manual* (Manual) regarding new accreditation standards involving the primary application. The standard is to be effective Jan. 1, 2012, and only applies to the primary application for new companies, not to redomestication, expansion, or corporate amendment applications. The standards include the goal of 90 days for review process. If the state does not already have a timing requirement included in statute or regulation, it should comply with the timing goal in the Manual. Julie Glaszczak (NAIC) added that the Financial Regulation Standards and Accreditation (F) Committee also recommends that the Working Group add a sentence or two in the Manual where it references the 90-day review period for the primary application: "Effective January 2, 2012, Company Licensing will be part of the accreditation program and if your state does not have timing requirements in statute or regulation the state will be expected to comply with the 90-day requirement for accreditation purposes."

Ms. Donovan suggested that the change be made to both the Manual and the *Company Licensing Best Practices Handbook* (Handbook). Ms. Jacobi suggested referring this task to the Issues Subgroup to draft wording for both the Manual and the Handbook.

Ms. Jacobi and Ms. Donovan asked the Working Group to consider drafting guidelines for the "pilot project" and changing the name to an accelerated licensing program for future companies that wish to participate. Since this is a vote by the Working Group members, the members should participate in drafting the required guidelines. Ms. Anderson agreed that this would be a good project for the Working Group. The Subgroup will make a first attempt to draft wording. Ms. Donovan requested any suggestions be sent to Jane Conard (NAIC) for distribution to the Subgroup.

Ms. Donovan asked if Mr. Hunt could have the proforma drafted by Nov. 19. He agreed to have a draft ready by the next call.

The Issues Subgroup will meet via conference call Oct. 29. The Working Group will meet via conference call Nov. 19.

Having no further business, the National Treatment and Coordination (E) Working Group adjourned.

W:\Dec09\Cmte\E\wg\National\10-ntacwgmin.doc

Draft: 12/14/09

Rating Agency (E) Working Group
San Francisco, CA
December 6, 2009

The Rating Agency (E) Working Group of the Financial Condition (E) Committee met in San Francisco, CA, Dec. 6, 2009. The following Working Group members participated: Michael T. McRaith, Co-Chair (IL); James J. Wrynn, Co-Chair, Matti Peltonen and Mike Moriarty (NY); Steve Poizner represented by Tomoko Stock (CA); Thomas R. Sullivan represented by Kathy Belfi (CT); Kevin M. McCarty represented by Ray Spudeck (FL); Neil N. Jasey represented by Bob Kasinow (NJ); Alfred W. Gross represented by Van Tompkins (VA); and Sean Dilweg and Roger Peterson (WI). Also participating was: Kent Michie (UT).

1. Adopt Interim Meeting Minutes

A motion was made by Ms. Belfi to adopt the minutes of the Working Group's Sept. 24 hearing (Attachment Four-B) and Nov. 18 conference call (Attachment Four-A). The motion was seconded by Mr. Kasinow and passed unanimously.

2. Discuss Draft of Final Recommendations Document

Director McRaith summarized the Dec. 1 draft of a final recommendations document directed to the Financial Condition (E) Committee from the Working Group. He highlighted the sections of the report dealing with the problems inherent in relying on ratings, the filing exempt process, the impact on risk-based capital, the rating agency shortcomings, current and potential future impacts of the ratings on regulation, and the impact of the those problems on perceptions from the public, as well as recommendations. He also highlighted some of the specific recommendations included in the draft report, including: 1) examining ways U.S. insurance regulators can reduce reliance on ratings; 2) expanding the use of the SVO and increasing regulatory reliance on the SVO for evaluating credit and other risks of securities; 3) if ratings of certain types of securities are still relied upon, requiring major revisions to the policies of rating agencies in order to maintain their status as acceptable rating organizations (ARO).

Mr. Moriarty discussed the reduction of reliance on ratings the NAIC had already taken as its adoption of the proposal developed within the Valuation of Securities (E) Task Force on residential mortgage-backed securities for year-end 2009. He stated that he looked forward to any input provided in the form of comments on the exposed document from both interested parties and regulators not involved in drafting the report. He noted that the Working Group never attempted to demonize the rating agencies during its review, and he believes the agencies do good work on the ratings of corporate securities. He discussed that the most specific takeaway from the Sept. 24 hearing was that the agencies all indicated that regulators should not rely solely on the product of the agencies for regulatory purposes. He stated that he believed regulators could continue to leverage off of some of the work performed by the rating agencies, but regulators must be diligent in determining where such leverage is appropriate and where such leverage can be enhanced with other tools or procedures. Mr. Peltonen said the NAIC had also added the first buy-side rating agency—Realpoint—as a new ARO, which also improves the process by increasing competition into the system.

Commissioner Michie discussed that rating agencies provide a very meaningful product to investors, and by and large they have generally done a very good job over the years. He noted that recent troubles within the economy highlight a point in time when the agencies have performed poorly with respect to a particular class of securities. He stated that the role of U.S. insurance regulators is to ascertain that insurers' investments are of value and that insurers have a sense of risk that is not outside of certain tolerance levels. He discussed how market inputs can provide a sense of the value of a particular investment, and ratings can provide a sense of the riskiness of that particular investment. He noted the approach taken by the rating agencies on mortgage and asset-backed securities and how that differed from what insurance regulators required. He added that insurance regulators need to educate themselves and consumers and be smart in how they utilize the rating agency's product.

Director McRaith asked Commissioner Michie to provide his insight, from over 35 years of experience in the municipal bond market, on the ratings of such products. Director McRaith discussed the current low default rates on these securities, and the current difficulties being faced by the municipal market because of the aging population and increasing pension obligations. He noted the enormous fiscal challenges faced by municipal issuers. Commissioner Michie responded that he had different views on the ratings of general obligation bonds versus special revenue bonds. He discussed the characteristics of both, and their differences, and how in the past he always thought a new quadruple-A category should be created for general obligation bonds. He discussed how the current economic conditions create challenges for taxing authorities and also the lack of appetite for such investments given the amount of investors that no longer can utilize the tax exempt status of bonds. Commissioner Dilweg stated that he believed the municipal discussion was good, and felt like the draft document fulfills the instructions given to the Working Group. Mr. Peltonen agreed, but noted that even if the market participants do not perceive the differences in default probabilities for different types of securities that carry the same rating to be a problem, because the NAIC designations assume that the ratings and the resulting RBC charge on all similarly rated securities to be the same, there may be a need to modify the scale of NAIC designations for municipal securities.

Director McRaith noted that Morningstar had announced its introduction into the ratings business, although it was relatively minor with approximately 100 securities.

Mr. Peterson stated that he believed the conclusions in the report and its recommendations were consistent with his expectations.

3. Next Steps

A motion was made by Mr. Spudeck to expose the Dec. 1 draft of the Final Recommendation document with a comment deadline of Jan. 6, 2010. The motion was seconded by Mr. Peterson and passed unanimously. Director McRaith stated that after the comments are received, a public conference call would be scheduled to discuss the comments. Parties wishing to provide oral comments should notify NAIC staff.

Having no further business, the Rating Agency (E) Working Group adjourned.

W:\Dec09\Cmte\E\WG\Rating Agency\12-ratingagency.doc

Draft: 12/2/09

Rating Agency (E) Working Group
Conference Call
November 18, 2009

The Rating Agency (E) Working Group of the Financial Condition (E) Committee met via conference call Nov. 18, 2009. The following Working Group members participated: Michael T. McRaith, Co-Chair (IL); James J. Wrynn, Co-Chair (NY); Steve Poizner represented by Tomoko Stock (CA); Kevin M. McCarty represented by Ray Spudeck (FL); Neil N. Jasey represented by Bob Kasinow (NJ); Scott H. Richardson (SC); Alfred W. Gross represented by Van Tompkins (VA); and Sean Dilweg (WI). Also participating was: Matti Peltonen and Mike Moriarty (NY).

1. Opening Statements

Director McRaith stated that the purpose of the call was to hear different perspectives from four different organizations related to the rating methodologies used to by the nationally recognized statistical rating organizations (NRSROs) for financial guaranty insurance, also known as monoline insurers, as well as the differences between the rating scales used on municipal securities compared to corporate securities. Director McRaith discussed the plans for hearing from each of the speakers, noting that Working Group members would be allowed to ask questions after each participant was completed, and to the extent time allowed, interested parties could ask questions after the questions from the Working Group. Director McRaith strongly encouraged any interested party to submit written materials to the NAIC. He stated that interested parties could submit comments until 5 p.m. CT Friday, Nov. 27. Any comments received would be posted to the NAIC Web site. He noted that comments received for this public hearing could not be retained as confidential.

Director McRaith stated that this hearing follows the public hearing conducted at the Fall National Meeting, which was focused on mortgaged-backed securities. He stated that, from his perspective, the one unanimous perspective from that hearing was that going forward regulators should reduce their reliance on rating agencies relative to those financial products. Commissioner Dilweg stated that he believed a good discussion occurred during the hearing at the Fall National Meeting, and stated that he believed this topic should also result in good discussion. Commissioner Dilweg noted that, since the Fall National Meeting, the NAIC had adopted a new process for residential mortgaged-backed securities (RMBS) that removes the reliance on NRSROs for that class of securities. He noted that the NAIC had selected a vendor to establish the cash flows used to determine the NAIC designations used for risk-based capital (RBC), and there would be a public conference call at the end of the month to understand some of the assumptions that would be used in the financial model by the vendor. He stated that the RMBS issue was one piece of this large puzzle.

Mr. Moriarty discussed that with the virtual collapse of the financial guaranty insurance industry, ratings have become more critical for municipalities, and insurance regulators that now rely on those ratings need to be sure that they understand how the rating agencies assess the municipal bond offerings and address the assertions used by those agencies. He discussed how the standards used differ from those used for corporate securities, and it is important for regulators to understand that point. Mr. Spudeck stated that he believed the issues that were part of this conference call were important to insurance regulators.

2. Comments from the NAIC Securities Valuation Office

Chris Evangel (NAIC) provided background information on the topic for the call. He stated that the NAIC has accepted the international ratings on municipal bonds since 2000. He noted that the NAIC SVO rates some municipal bonds, and in 2009 the number of such bonds had increased from approximately 700 to nearly 1,000. He discussed how the portfolio of municipal securities for insurance companies could be divided into two classes. Traditionally, they have been either triple-A or double-A, or single-A or triple-B. Consequently, most of the securities have a designation of NAIC 1. Mr. Evangel stated that until December 2008, the NAIC was precluded from providing a designation that was higher than the best rating from an NRSRO. The authority granted to the SVO in 2008 was specifically related to municipal securities where the financial guaranty insurer was downgraded, resulting in a drop in the NAIC designation. Given the downgrades of the municipal bonds, regulators were given authority by the Valuation of Securities (E) Task Force in December of 2008 to exceed the municipal rating within the NRSRO. Mr. Evangel discussed how, when reviewing the credit quality of municipal bonds, it is widely known that the probability of default is relatively small or negligible, or at least compared to a similarly rated corporate security.

Mr. Evangel said that if the NAIC made a decision to create more designations or different capital charges for the different gradations possible in a credit opinion, then it may be appropriate for the NAIC to address the impact of that on municipal securities. This is due to the fact that the RBC on most municipal securities is not currently greatly impacted by the different ratings criteria, because most of these securities are already NAIC 1 securities. Mr. Evangel explained that, with the downgrade of the financial guaranty insurers, there is the potential for a more profound affect on insurance companies; however, insurers now have two options to remedy this situation. The first option is that the insurer could try to get the rating agency to rerate the municipal bond without the financial guaranty wrapper. The second option that the insurer could submit the municipal bond to the SVO. He stated that the SVO had received close to 200 municipal bonds for rerating that are the result of the downgrade of some of the financial guaranty insurers. Mr. Evangel stated that approximately $26 billion of insurer holdings are guaranteed by the financial guaranty insurers, but the SVO has not determined how many of those have underlying ratings with the financial guaranty insurers that have been downgraded.

3. Comments from Allstate

Mary Jo Quinn (Allstate) provided background information on her company's view on the issues from the perspective of counsel for Allstate Investments. Ms. Quinn stated that Bob Zubak and Bill Grady, who co-manage Allstate's municipal bond portfolio of more than $20 billion, would provide a more investor-oriented perspective. Ms. Quinn discussed reform of the rating agency industry. She noted that Allstate had reviewed the topic extensively and supported improved transparency, as well as increased regulatory oversight and enforcement. She noted changes from U.S. House Bill 3890, as well as other recent proposed changes, would provide more meaning to ratings. She also discussed how improvements to the inherent conflicts of interest within the existing rating agency models would be helpful. She discussed that currently the ratings are embedded in a number of places in statutory requirements in contracts, and Allstate does not believe in going back and changing the statutory and regulatory provisions that rely on ratings, but rather making changes going forward — in particular, changing the existing oversight and enforcement of what the rating agencies should be doing. She noted that Allstate believes the conversation that insurance regulators already had about bringing in more information about RMBS is always helpful, but the triggers about rating agency downgrades are included in so many places that removing all references might not be practical.

Mr. Zubak discussed Allstate's views on global ratings. He discussed that, at the present time, Allstate does not believe in global ratings. He noted that since 1937 there have been 567 Chapter 9 bankruptcy filings by municipal entities, with multiples of that for Chapter 11 bankruptcy filings for corporate entities. He acknowledged that municipal defaults are bound to be rare, but discussed how municipal ratings are based on more than simply defaults of municipal bonds. He discussed the size of the market and how there are 55,000 municipal issuers of all different sizes and shapes, as compared to about 8,000 corporate issuers in the marketplace. He discussed how the corporate issuers are generally more sophisticated than municipal issuers, but also discussed the different types of regulatory oversight. He noted that municipal market disclosure is not as transparent as corporate disclosure, with specific reporting and quarterly reporting required of corporate issuers. He also discussed the significant differences between bondholders' rights in Chapter 11 for corporate issuers vs. Chapter 9 for municipalities and gave examples of some of those differences. He stated that not all municipalities can go into Chapter 9 and, more specifically, that states cannot be put into Chapter 9 and certain states have different rules regarding Chapter 9 on issuers. He contrasted this with how corporations can be forced into Chapter 11 by their creditors, whereas municipalities cannot be forced into Chapter 9. Mr. Zubak also discussed how the global ratings debate was being handled differently by the different rating agencies. He noted that because of the current recession, many of the state and local municipalities are under tremendous budget pressure. He noted that it appears that some of the agencies have put this issue on hold, noting how last quarter one agency upgraded 378 bonds and downgraded 27 bonds, or a 14-to-1 upgrade to downgrade ratio, while other agencies have taken no such action. He discussed how Allstate does not believe global ratings would be an appropriate move at the present time due to differences in regulatory issues, disclosure issues and bankruptcy laws.

Mr. Grady provided information about financial guaranty insurers and the ratings of municipal securities. He discussed how these insurers were established primarily in the late 1970s and early 1980s. He discussed how the growth of the business was driven by the fact that the insurers garnered triple-A ratings and were able to pass those triple-A ratings along to the municipal entities for a premium payment that was generally embedded in the cost of financing. He discussed how the current economic conditions have put severe stress on such insurers, which, in turn, have caused problems for the tax-exempt market, as the ratings on such securities have been downgraded — in some cases to below investment grade. The current problem is the situation where many of these municipal securities were sold without a rating on the municipality, and instead were only sold on the rating of the financial guaranty insurer. Allstate suggested that all the agencies rate the underlying debt on the bonds that have been either downgraded or have become unrated. He stated that the agencies collected a premium for rating these securities in the first place, and they hope such companies step up and rate the underlying debt for these issuers.

Many individuals who owned these bonds that were triple-A rated and have now gone to unrated have watched their price on the debt drop precipitously, in many cases 35, 45, even 50 percent. That is a big problem for individuals who are the lion's share of the municipal market and for them to continue to participate in this market. Commissioner Dilweg asked if Allstate believed the rating agencies should rate the underlying debt free of charge. Director McRaith asked if what was meant by "free of charge" in the sense that the service has already been paid for. Mr. Grady responded they didn't view as free of charge, because the agencies have, in fact, received a premium for rating this debt in the first place. In many cases, there are annual payments going to the agencies as well in order to maintain the outstanding ratings. Mr. Grady noted that this was not a "gift," and is something he thought the agencies should do because they received a premium initially to rate this debt.

Mr. Evangel asked if Allstate has a strategy in terms of reporting these securities for the current year. Mr. Zubak responded that Allstate was currently in the process of trying to get ratings on some of those issues or is in the process of selling some of these securities. Director McRaith asked if it was regulators' responsibility or objective to have an accurate understanding of the value of the underlying security or collateral. Mr. Zubak responded that Allstate believes the current rating system does that. The major difference is that municipals have a lower default history, but there are other factors in rating municipal bonds that make the current rating system correct. He added it would be a positive if some of the laws were modified and if better disclosure on municipalities were added. However, he said, at the present time that is a major debate item and until that happens, an investor cannot appreciate the current scale. Director McRaith asked Ms. Quinn if Allstate supported HR 3890 and enhanced transparency. Ms. Quinn responded it did. She noted that Allstate's support for HR 3890 is in the specific areas outlined previously. She stated that Allstate does not support every piece of HR 3890 but, generally, she said that a little more oversight would be helpful, as would trying to make the ratings have more meaning and transparency. Director McRaith asked if enhanced transparency and oversight would necessarily make the ratings more accurate. Ms. Quinn responded that Allstate hopes to have more understanding of what it was the rating agency looked at and, if there were a procedure that they looked at with every single underlying bond, then an investor would have more information to understand. She stated that she was not sure this would automatically make it more accurate but, with more information from the agency, a user could understand the information to compare one agency's ratings to another agency's ratings. Mr. Zubak stated that, as Allstate has gone through their credit analysis on the different issues, in most cases they generally agree with the ratings on municipal securities. Director McRaith asked Mr. Grady to respond to the apparent concern that municipal debt gets rated at the time of issuance but there is not a later review of the quality of that debt. Mr. Grady responded he was not sure it was a concern. He stated that he is not sure how best to look at some of these issues that have been dragged down by problems in other asset classes that have caused the triple-A ratings and the bond issuers to evaporate. Director McRaith stated he thought he understood Mr. Grady to say that what might have been a highly rated bond initially or at the time of issuance perhaps now years later and investor would like it to be rerated. Mr. Grady responded that was correct, noting that if he misunderstood the question he apologized. He added they would like to see that rating published going forward on an annual basis.

Ms. Stock asked if Allstate is recommending that the NAIC look into the issue of no annual reviews being conducted on the credit quality of the municipal securities. She stated she was not sure the NAIC knew enough about the ratings process to provide such and, suggested that if that was done, it would probably have to be studied more carefully by another NAIC group. Mr. Grady responded that many such securities only get reviewed periodically, and not annually. There are some gradations of quality where some securities are reviewed every year because they require a little more attention, while other securities might be reviewed every other year because investors are more comfortable with the underlying strength of those underlying ratings. That is how the current process works.

4. Comments from Frank Hoadley

Commissioner Dilwig introduced Wisconsin Capital Finance Director Frank Hoadley, who is responsible for all of the state's general obligation bonds and revenue bonds. He stated that Mr. Hoadley had been with the state for a long period of time and has also been a member of the Government Finance Officers Association (GOFA) since 1971. He is currently chair of GOFA's committee on governmental debt managements and is an active member of the Council of Infrastructure Finance Authorities.

Mr. Hoadley indicated he had been directly involved in the issuance of bonds as an investment banker and as an issuer for 28 years and stated that he had never experienced anything like the current bond market situation. He discussed how there were a lot crosscutting topics occurring today and if this were just a matter of discussing ratings, this would not be so difficult. Any one of those crosscutting topics would be easy to deal with, but when they are put together simultaneously, he said it creates a lot of variables that are bounding around and it is difficult to see the horizon at times.

Mr. Hoadley discussed how there were two defining characteristics of the municipal bond market. First, one typically thinks of a municipal bond as being exempt from federal income tax and so, by definition, these bonds are structured to maintain their tax exemption. Because the tax is federal income tax, the only logical investors of these bonds are federal income tax payers, which means it is a domestic market. The second characteristic is (as a previous speaker noted) that there are 55,000 or more issuers of such bonds in the United States. This is a market that is wide and thin compared to the corporate market; the average issuer has far less debt outstanding, but there are many times more issuers insuring the debt. Mr. Hoadley stated that the confusing aspect of this was the credit problems that exist in the tax-exempt bond market, for the most part but not exclusively, are not problems created by municipal governments. Rather, he explained, there is a particular class of borrower in the tax-exempt bond market called private activity borrowers, or borrowers who are working through or borrowing through a conduit issuer. This kind of issuer ranges from multi-family housing issuers to nursing home developers to hospitals and healthcare entities, and certain kinds of educational entities. Most institutional investors who are buying a municipal bond recognize that it is a different credit class altogether, and it is a credit class that definitely bears the label.

Mr. Hoadley noted that, related to the issue of corporate equivalent ratings, the GOFA policy on this topic is that there should be a method of determining the equivalency of ratings. He stated that he supported that position, but that he also questions whether it really matters, because it is not the same market. In other words, he said, tax-exempt municipal bonds are being sold in the municipal bond market and most investors do not care what the corporate bond market rating scale is. But there are certain situations where, at least to a municipal bond issuer, it does matter. For example, if a municipal bond issuer is issuing taxable debt, particularly if the taxable debt is being issued overseas. A second case is if the issuers are covered by bond insurance and the third instance is what is referred to as counterparty exposure. The last case is a situation where a municipal bond issuer enters into a contract with another party, such as a swap agreement or a guaranty investment agreement of some kind. During this situation, it is important to understand the exact credit relationship of the two entities involved so that when contractual triggers occur, one party is not unfairly penalized. In the case of bond insurance, it was important for issuers and investors alike to realize that a triple-A insured bond rating is not the same as a natural triple-A, but that really was a corporate bond rating and not a municipal bond rating when that triple-A was given to the insurance company. In the case of taxable debt, the municipal issuer issuing taxable debt in fact is competing directly with the corporate bond market, and it is important that the price competition be on exactly the same understanding.

Mr. Hoadley stated that, in his years with the state, he could only recall two or three instances where the state has sought bond insurance and that was at the direct recommendation of the underwriter of the bond issue. He discussed how Wisconsin prefers to sell its bonds through a competitive bond sale, where the state does not know who the underwriter is until the envelope is opened. He discussed how Wisconsin had a policy up until about five years ago where it prohibited the use of municipal bond insurance, because the state did not believe that bond insurance added true economic value to the value of those issues. He pointed out that it was the choice of the investor that those bonds be insured, not the choice of the issuer. Frequently bonds are insured in the secondary market by other parties in the bond sale transaction away from the issuer. It is not the issuer's decision and, in some instances, particularly the secondary market bond insurance, the issuer is unaware that the bonds have been insured.

Mr. Hoadley discussed how the demise of bond insurers has dramatically changed the market within the last two years. The market was previously dependent on bond insurance to provide a level of homogenization that allowed investors to not utilize credit analysis and simply relied on that financial guaranty to level the field. Today, with the demise of the financial guaranty industry and the lack of any reasonably priced financial guarantees, there is a reduced access (or much more difficult access) to the market by smaller issuers. With larger issuers, more frequent issuers like Wisconsin had been far less troubled by the lack of insurance, but small issuers in Wisconsin indicate it is much more difficult for those issuers to access the market on the same interest rate terms that they were able to achieve in the past.

Mr. Hoadley stated that, contrary to comments that were made earlier, the municipal bond market is a market that has a great deal of transparency. He acknowledged it does have a low-disclosure system, but noted that those disclosure systems are currently being made much more public. There is going to be and is now in practice the central collection of disclosure information, and any bond issuer is required to file an annual financial statement that will be available uniformly to the system going forward. Municipal bonds and municipal bond issuers are subject to Federal Communications Commission (FCC) regulatory provisions and, although they have been lax in the past at times about exercising their authority, the FCC is clearly doing more now.

Mr. Hoadley ended by stating that government must continue to operate. The solutions that are derived in the future must recognize the restrictions on government in terms of reporting or accounting or regulatory schemes are simply going to wind up as additional taxpayer costs, in one form or another. Commissioner Dilweg asked about the concern of a bond being issued and rated at inception, with no monitoring or change in that rating for 10 years. Mr. Hoadley responded that every time an issuer goes out with a new bond issue, the product that comes from the rating agency is a rating issued before that new bond issue plus a confirmation of the outstanding bond. He explained that it is simply a confirmation that the rating on the bond that was issued 10 years ago is still good, if that is indeed the case. There is no question that the smaller the issuer, they are simply not going to be in the market as frequently, their ratings are not going to be reviewed as frequently. The fact that it is not rated or not reviewed more frequently is not going to be a concern to a lot of investors. Mr. Peltonen stated that the rating scale does not matter, as long as the buyer and the market and the seller know what they are doing. He indicated that the regulators' problem is that it does matter, because regulators translate all those ratings back into RBC using a much less granular scale. So, the problem with the municipal ratings is that if the single-As are different from the other single–As, then our system currently does not reflect it.

5. <u>Comments from Association of Financial Guaranty Insurers</u>

Director McRaith introduced Bruce Stern, chair of the Government Affairs Committee of the Association of Financial Guaranty Insurers and executive officer, government and corporate affairs, for Assured Guaranty/Financial Security Assurance. Mr. Stern explained that he had been involved with the financial guaranty insurance industry for 24 years. Mr. Stern provided an overview of the financial guaranty insurance sector. He discussed the history of the financial guaranty insurance industry, including the products provided, and who those are provided to, and the recent problems by such insurers. He discussed the value of bond insurance for issuers, which reduces the interest rate to be paid. He discussed how bond insurance is purchased in the secondary market, although less common. He discussed how many investors view the products offered by financial guaranty insurers as providing diligence to the investment products sold, other than the diligence provided by the rating agencies. He discussed his company's continued writing within the market, but that the entire financial guaranty insurance products had decreased considerable due to the drop in the financial strength of many of the financial guaranty insurers.

Mr. Stern discussed his opinions on global ratings. He discussed the process used by the financial guaranty insurers to solicit input from investors on this topic years ago, and how those views were relayed to the impacted parties at that time. He noted that most of the investors encouraged the different scale to distinguish the strong and weak companies. Since that time, a number of things have occurred in the marketplaceHe discussed the different views of the rating agencies on the use of global ratings. He discussed how the financial guaranty insurance industry does not have any views on the topic, other than to support what investors want. He noted that the industry supports transparency in the rating agency process and discussed the difficulties that the lack of transparency brings to the industry.

Director McRaith asked Mr. Stern to respond to the comment previously by Mr. Hoadley related to taxable municipal securities, where he said it would be appropriate to have a rating system equivalent to a rating of corporate debt. Mr. Stern responded that it was really a question of what the investors want. He discussed different views, including those expressed by Allstate, which is one of the largest institutional investors, and noted that they were not confused by the rating system. He indicated his view that the purpose of the ratings is just to communicate information to parties. He noted that he understood the issues in the discrepancy of the rating scale and the potential confusion that a retail investor might have had and stated he did not have a strong view one way or another. He indicated that the question might be more important to the non-institutional investors, because they might not understand the ratings. He indicated that he thought people were more educated now than ever before, and understand that financial guaranty insurance is a second level of protection. Director McRaith asked if there was a reason not to have an equivalent rating system other than it would be different from what we have. Mr. Stern said that question was better directed toward the investors or users of the ratings, not to him as an employee of a financial guaranty insurance company. Director McRaith asked Mr. Stern's views on transparency of the process by which the rating itself is generated or transparency specific to the underlying issuer. Mr. Stern responded that he believed improvements to the transparency of the rating process of financial guaranty insurers would be a benefit.

6. Comments from Moody's Investor Services

Director McRaith introduced Laura Levenstein, senior managing director for the Global Public Project and Infrastructure Finance Group at Moody's Investor Services. Ms. Levenstein discussed how this group was responsible for issuing rating opinions on municipal bonds and had prepared written comments to be provided as written record for her presentation on the issue (Attachment Four-A1).

Director McRaith asked Ms. Levenstein what the impetus was for Moody's September 2008 proposal on a global rating scale. Ms. Levenstein noted that, as Mr. Stern had mentioned, Moody's has been having conversations with the market for years about what would be the most useful rating scale used in the municipal sector. Those conversations began in 2001 and have continued to the present. At one point, she said, Moody's was assigning dual ratings to issues that were taxable in the municipal market, so that where an issuer issued taxable debt, traditionally tax-exempt issuer issued taxable debt, and Moody's assigned those a municipal scale and a global scale rating. Moody's has continually gone to the market on a regular basis over the course of the past several years to get feedback from the market on which they would find most useful and what they would find the most useful scale for Moody's to use in the municipal sector. She noted they had seen the sentiment shift over the course of the past couple of years to a more prevailing sentiment that a global scale rating applied in the municipal market would be more useful. Mr. McRaith asked what she meant by the market. Ms. Levenstein responded the investor community, regulators, policymakers, politicians, issuers, anyone really engaged in the market, because ratings serve a number of constituents. Director McRaith asked if there were reasons for the September 2008 proposal other than the market. Ms. Levenstein responded that there was not. She stated Moody's had moved slowly toward providing more global scale ratings, particularly in cases where there was taxable debt. Initially, Moody's applied global scale ratings where an issuer issued taxable debt only overseas, and then moved to applying those to issuers who issued taxable debt anywhere issuers that were engaged in contracts where there was counterparty risk. As Moody's went back to the market repeatedly over the course of the past several years, the sentiment did shift to a preference for global scale ratings. What became evident, she said, was that the market did not want dual ratings, which is what Moody's initial plan was.

7. Other Matters

Director McRaith stated that the Working Group anticipates issuing as report on its efforts sometime before the Winter National Meeting.

Having no further business, the Rating Agency (E) Working Group adjourned.

W:\Dec09\Cmte\E\wg\Rating Agency\111809-ratingagency.doc

Statement of Laura Levenstein
Senior Managing Director
Moody's Investors Service

prepared for the National Association of Insurance Commissioners
Rating Agency Working Group
November 25, 2009

I. Introduction

The following statement is submitted by Moody's Investors Service ("**Moody's**") to the National Association of Insurance Commissioners ("**NAIC**") Rating Agency Working Group in connection with its public meeting held on November 18, 2009. We understand that the NAIC is reassessing the use of credit ratings, including ratings assigned to municipal bonds, in its risk-based capital regulatory framework and that it also is interested in learning more about our approach to rating financial guarantors. Moody's believes in the importance of the NAIC's ongoing dialogue with credit rating agencies ("**CRAs**"), insurance companies and other market participants about the nature of credit ratings and possible approaches to encourage more informed and careful use of them. We welcome this opportunity to contribute further to the discussion that is already under way regarding the CRA industry both at the NAIC and more generally.

This statement is organized as follows. In Part II, I will provide an overview of the municipal finance market and how it has evolved in recent years. In Part III, I will describe Moody's rating system for that market, how we monitor those ratings, and how the municipal rating system differs from our global rating system. I also will outline the changes we have made, and are planning to make, to our rating system for municipal bonds as a result of our ongoing dialogue with investors, issuers and other users of our credit ratings. In Part IV, I will provide an overview of our methodological approach to rating financial guarantors, describe how their experience in the past two years has provided significant, new information about the risks and opportunities in the financial guarantor business model and describe how we have incorporated this information into our credit judgments about these firms. In Part V, I will describe Moody's approach to rating transactions wrapped by financial guarantees. In Part VI, I will discuss Moody's efforts to enhance the transparency of our credit ratings and the rating process. Finally, in Part VII, I will summarize Moody's views on the regulatory use of credit ratings.[1]

II. Overview of the U.S. Municipal Finance Market

Moody's first began rating municipal bonds in 1918. Today, Moody's publishes ratings and research on a highly diverse group of issuers and securities, including bonds issued by states, cities, counties, school districts, special local government entities and pooled groups of issuers. Bonds may be backed by, among other things, taxes, leases, appropriations and/or land development fees. Many, but far from all, of these rated bonds are backed by a government issuer's "general obligation" pledge, meaning that all of the government issuer's pledged, tax revenue-producing powers are promised to satisfy the debt, including the government issuer's ability to levy taxes sufficient to pay such debt. These bonds are sometimes called "General Obligation" or "G.O. bonds".

We also assign ratings to another large and diverse group of bonds issued by public authorities and non-profit organizations, which we collectively refer to as enterprises. These issuers back their debt with a combination of tax revenues and user fees to, for example, finance colleges and universities, hospitals, housing agencies and a wide range of public

[1] These views are set out in more detail in the written statement provided by David Teicher to this Working Group in connection with its public hearing held on September 24, 2009.

infrastructure projects such as airports, ports, public power utilities, transportation facilities and water-sewer systems.[2]

A. Lower Overall Credit Risk than Other Credit Securities Markets

Historically, one of the most distinctive features of the U.S. municipal bond market has been the lower overall credit risk of most municipal bonds relative to other types of bonds. This has been especially true for G.O. bonds.[3] Four of the principal reasons for this are summarized below.

- *Municipalities typically are perpetual entities providing essential public services.* They do not need to generate a return on equity but merely to break even or generate a small surplus in order to continue operating.
- *Municipalities have the power to levy taxes or impose tax-like charges* for those essential services and can secure their bonds with a "general obligation" pledge.
- *Unique bankruptcy laws* for municipal entities contribute to the lower credit risk of these bonds. For example, involuntary bankruptcy filings are not permitted, the municipality's debts can be adjusted but it cannot be liquidated, and the municipality's powers are not affected by any bankruptcy filing. It can continue operating during a bankruptcy, giving it the ability to raise revenue and make payments on any defaulted debt.
- *A municipality in financial distress might never reach default* because there are many avenues of relief available to most municipalities and, in some cases, a higher level of government, *e.g.*, the state or a third party credit provider, might take steps that prevent default on outstanding obligations. While very few Moody's-rated bonds have experienced payment defaults, numerous issuers have experienced financial distress.[4]

Many other state and local government-related bond issuers, such as most water and sewer authorities and public university systems, have shared these low-risk characteristics because they possess dependable revenue streams and are very likely to receive financial support from their sponsoring authorities in the event of distress. By contrast, some tax-exempt issuers (such as not-for-profit hospitals and private universities) increasingly share certain "corporate-like" characteristics, in the sense that they are governed independently,

---

[2] I use the term "municipality" to refer to state and local governments as well as local authority issuers, which collectively comprise the overwhelming proportion, by number, of issuers in the U.S. public finance market. References to the "municipal market" or "municipal bonds" do not encompass tax-exempt industrial development bonds issued by corporations or bonds technically issued by governmental entities but backed solely by corporate entities such as financial institutions.

[3] Bonds issued by municipal authorities or other public sector authorities to finance healthcare, housing, higher education or certain types of infrastructure projects exhibit credit risk that is more comparable to that of similarly rated corporate bonds.

[4] In times of financial distress municipalities often can generate an internal solution to restore financial balance without involving a third party. However, there generally is a great deal of uncertainty with respect to the timing and content of the ultimate outcome.

they compete in a market for the users of their services to generate revenues and they receive fewer direct governmental subsidies.[5]

B. Evolving Interests of Municipal Bond Market Investors

In our experience, investors purchasing municipal bonds historically have done so with different perspectives and risk appetites than investors in corporate bonds, and our municipal ratings evolved to reflect those differences. For example, unlike corporate bond investors, municipal investors generally have been more risk-averse and have looked for tax-free alternative investment opportunities to U.S. Treasuries. Moreover, many of these investors historically were active solely in U.S. public finance markets and did not cross over to invest in other sectors. As a result, they have been less diversified in their investment portfolios, more concerned about the safety and liquidity[6] of their investments, and in the case of individuals, often more dependent on debt service payments as a reliable source of income.

In particular, municipal investors generally have been highly intolerant of any diminished value or reduced liquidity in their investment portfolios, which can occur as a result of an issuer's financial distress even if the bonds do not default. Despite the low risk of default, valuation fluctuations may occur when a municipal issuer faces financial stress, because attempts either to resolve financial problems or have a third-party rescue the issuer or its bonds generally occur only after lengthy political and policy negotiations. Consequently, municipal investors historically have looked to Moody's credit ratings for an opinion on the likelihood that a municipal bond issuer will experience financial stress.

In the late 1990s, however, we began to see municipal bonds increasingly traded by a wider range of multi-disciplinary investors who were active in the taxable and tax-exempt municipal markets as well as other bond markets. In addition, a number of larger issuers began issuing cross-border taxable bonds, which were targeted to foreign investors with limited knowledge of the U.S. municipal market. As I discuss in more detail in Part III.E below, these developments led Moody's to start exploring the utility of enhancing comparability between municipal and non-municipal bond ratings.

C. Overview of Current Credit Market Conditions

Some tentative signs are emerging to indicate that a slowdown in the deterioration of macro-economic conditions has begun in some countries, including the United States. Nevertheless, global credit markets and economic conditions are likely to remain stressed and affected by significant uncertainties into 2010. The downturn we are experiencing is unusual in several important respects in terms of its impact on municipal issuers. First, the recent recession has been the longest running in the United States since the Great Depression. Moreover, while prior recessions in the U.S. were mostly regional in nature or industry-based, this recession encompassed every state in the nation. Job losses, depressed consumer spending and declining housing prices have reduced governmental revenues from

---

5 There have been, however, some instances of governmental intervention to support these types of issuers when they are in financial distress.

6 Historically, less active issuers often addressed investors' concerns about the liquidity of their investments by obtaining bond insurance.

income taxes, sales taxes, corporate taxes and property taxes. Consequently, this recession has been longer, broader and deeper than prior, recent recessions. We expect the recovery of state and local governments, not-for-profit hospitals and universities to be delayed until well after the broad economy recovers. Moreover, even after the economic recovery begins, questions about the credit positions of these issuers are likely to remain unanswered for some time.[7]

Meanwhile, the severe disruption in the availability of short-term liquidity that developed in 2008 is continuing and has created significant, new challenges for many municipal issuers. Some issuers are finding it difficult to access short-term markets, facing rising interest costs or changing debt amortization terms, dealing with the consequences of financial counterparties that default or are downgraded, and/or finding it difficult to obtain credit enhancement.

Many issuers can alter their behavior and undertake alternative plans of action to mitigate the impact of the current and near-term environment and maintain their strong credit ratings. A number of significant uncertainties, however, continue to affect credit market conditions for U.S. public finance issuers. These include uncertainties regarding:

- the duration and severity of the economic downturn;
- when the current disruption to public finance credit markets will be resolved;
- the potential for unanticipated changes to market access for certain issuers;
- the weakening liquidity of some states and municipalities, which is exacerbated by the ongoing disruption to some issuers' access to capital markets;
- the availability of credit and/or liquidity facilities;
- the declining credit quality of certain key counterparties; and
- how the deployment of the federal fiscal stimulus will benefit particular public finance issuers.

In this environment, Moody's has been continuing its ongoing surveillance of rated municipal issuers, keeping market participants informed about issuer-specific, sector-specific and broader trends that have the potential to affect long-term credit fundamentals, refining our rating methodologies and reporting on trends in ratings performance. Our approach to monitoring municipal bonds is described in more detail in Part III.B below.

III. Moody's Approach to Rating Municipal Bonds

A. Key Analytical Factors for Municipal Ratings

As I stated earlier, Moody's assigns ratings on a number of different types of municipal bonds. Broadly speaking, the issuers of these bonds can be divided into two categories: (1) state and local governments; and (2) enterprises. Moody's ratings of municipal bonds issued by state and local governments are based upon the analysis of the primary factors relating to municipal finance: the economy, the issuer's finances, debt, governance/management strategies, and the bonds' structural features.

---

[7] See *Special Comment: Are U.S. Municipal Issuers on the Road to Recovery?*, August 2009 (Document 119381).

- *Economy*: Depending on the entity, we look at the breadth and diversity of the affected economy including its growth trends and comparative economic position to similar entities.
- *Finances*: We analyze information contained in audited financial statements as well as current budget information for the issuer and compare this information to sector statistics for comparable entities.
- *Debt*: Debt ratios are calculated to adjust for size (debt per capita) and wealth (debt to personal income or debt as a percent of full value), and are compared to sector medians.
- *Governance/management strategies*: We assess the type of governance, including legal powers to manage finances and any legal constraints on taxing, borrowing or spending.
- *Structural features of the bonds*: In addition to the fundamental credit analysis, Moody's analyzes the structure of the transaction, *e.g.*, the strength of the legal pledge of collateral to bondholders, the rights of other creditors and the nature and extent of external support.

All of these factors are important in assessing the entity's degree of financial flexibility to meet fiscal challenges and specific debt obligations. In each case, the factors are evaluated individually and for their interrelation with and impact on the other factors in the context of the municipality's ability to repay its debt and its relative degree of financial strength.

Moody's also rates enterprise bonds, such as bonds relating to the construction or improvement of airports, toll roads, water and sewer facilities, public power plants, and bonds issued by healthcare institutions, housing authorities, and higher education institutions. These enterprise ratings incorporate many of the same factors noted above, but they also take into account the financial and business activity characteristics of the public enterprise. For example, an analysis of bonds relating to the construction and operation of a toll road would look at vehicular traffic, competitive position (*e.g.*, the existence of competing toll-free roads), the local economy served by the toll road, the coverage of debt service by toll revenue and the obligation of the entity to raise tolls to ensure sufficient revenue to pay debt service on the bonds.

I discuss in more detail in Part V below Moody's approach to rating municipal bonds wrapped by financial guarantees.

B. Monitoring of Existing Credit Ratings

Once a rating is assigned to a municipal bond, it is monitored on an ongoing basis. More than 60 analysts are involved in monitoring Moody's ratings of municipal bonds. In general terms, the frequency with which Moody's periodically reviews the creditworthiness of issuers and obligations depends on the specific characteristics of each sector and asset class. In the U.S. public finance sector, the frequency of periodic reviews is linked to the complexity of the issuer or obligation being analyzed, the volatility of the sub-sector to which it belongs and the susceptibility of the credit to change. For example, there are certain issuers that are very active in the debt market, that are not highly rated and that are in a more credit-sensitive sector. These issuers generally have their ratings reviewed on a more frequent basis than those that, in contrast, are small issuers in less volatile sectors who access the market very infrequently and whose credit characteristics are not as complex as some of the larger issuers.

In between periodic reviews, ratings are reviewed when analysts receive information indicating that the fundamental creditworthiness of a security could be materially affected. For example, developing economic, financial or demographic trends within a sector or for a specific issuer as well as specific material events, such as natural disasters, could prompt a review of potentially affected ratings.

C. Low Credit Risk and Default Rates for Moody's-Rated Bonds

Based on the historic performance of the public finance securities we have rated and the municipal sector's inherent credit strength and extremely limited default and loss experience, Moody's believes that the credit risk of the rated portion of the sector, particularly in the general obligation and essential service revenue sub-sectors, is very low. Even in the cases where default does occur, the severity of loss suffered by the bondholder is likely to be limited. For example:

- Between 1970 and 2006, just 41 out of approximately 29,000 Moody's-rated municipal issuers defaulted. Twenty two of these defaults occurred between 2001 and 2006.
- Sixteen of the 41 defaults were for housing projects; eighteen were for healthcare and other not-for-profit institutions; and seven related to local governments and related public sector issuers.
- Only one of the defaults among Moody's-rated municipal issuers involved an issuer of general obligation bonds, and this issuer recovered quickly and paid its obligations in full.

D. Comparing Moody's Municipal Rating System with Moody's Global Rating System

Investors in corporate or structured bonds typically have looked to Moody's ratings for an opinion on whether a bond or issuer will meet its payment obligations. Our opinion takes into account both the probability of default and the expected loss if a default occurs. Historically, however, this analysis alone has not been as helpful to municipal investors. This is because, if municipal bonds had global ratings, the great majority of our ratings likely would fall within just two rating categories: Aaa and Aa. This would make it more difficult to differentiate among various municipal bonds, which is something that many investors indicated to us that they wanted our rating system to do.

Accordingly, Moody's municipal bond ratings developed so that they distinguished more finely among the various municipal bonds and ranked one against the other on the basis of intrinsic financial strength. Because the risk and potential severity of loss historically have been relatively low for governmental issuers, Moody's municipal ratings, taking into account the factors described in Part III.A above, principally have focused on the risk that an issuer will face financial stress.

E. Moody's Planned Recalibration of Our Municipal Ratings

As I noted in Part II.B above, beginning in the late 1990s, Moody's began to observe a growing number of "cross-over", multi-disciplinary investors becoming active in both the taxable and tax-exempt municipal markets as well as non-municipal bond markets. Consequently, to ensure that our ratings were continuing to meet the needs of market participants, Moody's consulted the market and made several changes to reflect this evolution in the market and the feedback we received.

- ***In 2001***, Moody's met with more than 100 market participants to understand their views on the need for and value of globally consistent ratings.[8] The vast majority of participants surveyed indicated that they valued our municipal ratings in their current form. Additionally, many market participants expressed concerns that any migration of municipal ratings to be consistent with our global ratings would result in considerable compression of ratings in the Aa and Aaa range, thereby reducing the discriminating power of the rating and transparency in the market. However, a segment of the market indicated that it would value a greater ability to compare municipal credits to other bonds in other markets.

- ***In 2002***, we published a default study that highlighted the limited default experience in the Moody's-rated market for public finance bonds,[9] and we noted that some taxable bonds were starting to be placed outside of the United States. To accommodate the latter trend, we began:

  1) offering entities issuing tax-backed or essential service revenue-backed taxable bonds outside the U.S. the opportunity to request that, in addition to our municipal ratings, a global rating also be assigned; and

  2) providing broad guidance on how our municipal ratings would translate into our global ratings. In particular, we stated that it would be reasonable to conclude that nearly all Moody's-rated general obligation and essential service revenue bonds would be rated at or near the top of the global scale.

- ***In 2006***, we published a *Request for Comment* asking market participants whether they would value greater transparency about the conversion of our municipal ratings to global ratings. We received more than 40 written responses and had telephone and in-person discussions with many other market participants. Generally, the majority indicated that they valued the distinctions the municipal ratings provide in terms of relative credit risk, but that they would endorse the expansion of assigning complementary global ratings to taxable municipal bonds sold inside the U.S.

- ***In 2007***, based on the feedback described above and to further improve the transparency of our long-term municipal bond ratings, we:

  1) implemented a new analytical approach for arriving at the complementary global rating, thereby enabling investors to compare municipal bonds to corporate bonds

---

8 See *Special Comment: Moody's Municipal Default Study Highlights and Next Steps*, June 2002 (Document 75249).

9 It is important to note, however, that the time period studied did not include a period of extreme financial distress such as the Great Depression and the study covered only Moody's-rated bonds. Default experience in the unrated portion of the market is considerably higher.

while maintaining the existing municipal ratings that investors and issuers told us they valued; and

2) announced that, when requested by the issuers, we would assign a global rating to any of their taxable bonds, regardless of whether the bonds were issued within or outside the United States.[10]

- ***In 2007 and 2008***, the market continued to evolve. In early 2008, prompted by recent market events and developments in market sentiment, Moody's again proposed recalibration of its municipal ratings to align them with our global ratings and actively reached out to a wide range of constituency groups to ensure that the feedback we received represented all users of credit ratings.[11] The comments we received on our *Request for Comment* publications and in our outreach efforts showed that a larger portion of the market sought comparability between municipal ratings and those in other sectors.[12] Feedback from nearly 200 market participants – including issuers, bankers, financial advisors, trade associations and major institutional investors with substantial positions in U.S. municipal bonds – indicated that:

  1) recent market conditions had resulted in a greater interest in rating comparability between municipal and non-municipal bonds; and

  2) ratings that facilitated such comparability would be preferable.

As a result, on September 2, 2008, we announced our intention to recalibrate our municipal ratings. In mid-September, however, and for reasons unrelated to our announcement, global credit markets experienced a sudden and severe dislocation that sent shock waves around the world. We recognized that proceeding with our plans in the midst of such credit market turmoil could unintentionally lead to confusion and/or further market disruption. Consequently, on October 7, 2008, we announced that conditions in the credit markets would delay our planned recalibration of U.S. public finance ratings. The temporary suspension of the recalibration process remains in effect today because of ongoing volatility in municipal credit markets. Nevertheless, Moody's remains committed to our plan to apply our global ratings to U.S. public finance bonds, and we intend to move forward swiftly with the recalibration process once macro-economic conditions and credit markets stabilize.

We expect that the recalibration of our municipal ratings will begin and be completed sometime in 2010. We intend to make a public announcement approximately four weeks before we begin the recalibration to: (i) announce when the recalibration process will begin; and (ii) provide an estimated timetable for completion of that process. In

---

[10] To put the demand for global ratings by municipal issuers into context, since we first began offering global ratings for taxable securities in 2002, approximately 25 issuers have requested that Moody's assign a global rating to their bonds.

[11] See *Request for Comment: Assignment of Global Ratings to Tax-Exempt Municipal Obligations*, March 2008 (Document 108116); *Special Comment: Assigning Global Scale Ratings to Municipal Tax-Exempt Obligations, April 2008* (Document 108470); and *Announcement: Moody's Extends Comment Period on U.S. Public Finance Rating Scale*, June 2008 (Document 109143), all of which are available at moodys.com.

[12] See *Announcement: Moody's to Recalibrate its U.S. Municipal Bond Ratings to the Company's Global Rating Scale*, September 2008 (Document 110987), available at moodys.com.

addition, before we begin the recalibration, we plan to publish a methodology that provides more details to the market about how we plan to recalibrate municipal ratings to the global scale and explains how we will assign ratings to new issues during the migration. Once we begin, we expect that the recalibration of all the municipal ratings to the global scale will take approximately four to six weeks to complete.

IV. MOODY'S APPROACH TO RATING FINANCIAL GUARANTORS

A. Overview of Moody's Rating Methodology

Moody's approach to assigning insurance financial strength ratings ("**IFSRs**") to financial guarantors is designed to assess the ability of a financial guaranty operating company to pay senior policyholder claims and obligations in a timely manner.[13] The methodology focuses on five key factors: (1) franchise value and strategy; (2) portfolio characteristics; (3) capital adequacy; (4) profitability; and (5) financial flexibility. These interdependent factors form the basis of a financial guarantor's operating dynamics and, in the aggregate, provide a comprehensive picture of its overall credit profile. As part of our evaluation, we consider the risk that such operating dynamics could change materially as a result of internal or external pressures, thereby altering the guarantor's credit profile.

Of the five factors outlined above, capital adequacy receives the greatest weight in our analysis, and the developments of the last two years have reinforced its importance since other factors, such as financial flexibility and franchise value, have been observed to shift in response to deteriorating capital positions. Moody's principal tool for measuring capital adequacy is a simulation model that projects portfolio losses based on credit assessments of each underlying exposure.[14] Since late 2007, in view of the exceptional performance of mortgage-related exposures, we have supplemented this model's output with individual, expected and stress case evaluations of residential mortgage-backed securities ("**RMBS**") and related risks.

B. Re-examination of Key Rating Factors in Light of the Profound Dislocation Experienced by This Industry in the Past Two Years

Historically, high ratings within the financial guaranty sector had been based on the industry's strategy of insuring investment grade transactions with modest performance volatility, thereby producing a well-diversified portfolio of low risk, insured exposures supported by strong, risk-adjusted capitalization levels. For years, this highly focused business model generated stable, risk-adjusted returns for shareholders and created substantial franchise value that validated and reinforced the industry's operating strategy. The preservation of a low-risk business profile was held to be a core objective, given the importance to the overall business of maintaining a high level of creditworthiness. This, in turn, created a powerful incentive for a guarantor to take whatever actions feasible to preserve its credit profile and ability to pay claims.

---

13 The IFSR is a rating for the stand-alone entity before consideration of parental support. Other ratings that may be assigned within the group (*e.g.*, to securities issued by the guarantor or its parent company, or sister entities that operate in other regulated markets but are supported by the main operating company) typically are derived from the IFSR.

14 See *Moody's Portfolio Risk Model for Financial Guarantors*, July 2000.

Recent events, however, altered significantly these operating dynamics. The severe dislocation in credit markets over the past two years has left many financial guarantors in precarious financial condition as a result of losses on mortgage-related exposures. The most adversely affected guarantors had large exposures to collateralized debt obligations of asset-backed securities (“**ABS CDOs**”) in addition to direct RMBS risks. The weak direct RMBS performance and the RMBS concentration and leverage in ABS CDOs contributed to large paid and projected losses at most guarantors. Of the eight Moody’s-rated guarantors active in 2007, only one group, Assured Guaranty (now with its FSA subsidiary), actively writes business today. Berkshire Hathaway Assurance Corporation, a recent entrant, is the only other potentially active guarantor. The other guarantors are essentially in a suspended state of operations.

The events of the past two years have illustrated that a guarantor’s franchise value is extraordinarily sensitive to changes in its risk profile, where even a moderate decline in financial strength may have a dramatic impact on a guarantor’s future business prospects. The high level of operating leverage associated with the financial guaranty business model increases the potential for such changes, especially given the significant correlation and volatility associated with certain exposures. As a result, there is a fine line between a thriving franchise and one with limited value for shareholders. In contrast, most highly-rated companies in other industries have franchises that are much more resistant to broad-based erosion in product demand.

The financial flexibility of many guarantors suffered in 2007-2008, leaving them with capital shortfalls relative to levels necessary to retain their customers’ confidence and thereby damaging future business prospects. This made it much more difficult for many firms to raise funds at reasonable cost and increased incentives for existing shareholders to withdraw capital.

Despite some positive signs in the broader economy, credit conditions have not improved sufficiently to provide a clear path to recovery for financial guarantors. Uncertainty about ultimate losses is such that many of the guarantors we rate have outlooks that are either developing or negative. The most common uncertainties relate to the actual performance of the guarantors’ insured portfolio, as exemplified by the wide spread between expected and stress losses on RMBS-related exposures or on the actual risk of commercial mortgage-backed securities resecuritizations. Other insured segments also may be exposed to some deterioration. Additionally, the outcome of some ongoing litigation could have substantial consequences for some firms’ credit profiles.

The magnitude of the stress faced by the industry has increased market skepticism about the guarantors’ business model. The remaining uncertainty about ultimate credit losses also is contributing to market discomfort. Some segments of the municipal market, such as large investors and strong municipal issuers, currently show limited interest in the product, and structured finance opportunities are rare as well.

The financial guarantors’ experience over the past two years has provided significant, new information about the risks and opportunities inherent in their business model. While we continue to rate financial guarantors based on our assessment of their positioning on the five key rating factors described in Part IV.A above, our views on those factors have changed in some respects and can be summarized as follows:

- **Franchise Value and Strategy.** The level of demand for financial guaranty insurance in the near to medium term is less certain than in the past. While there continues to be a market for municipal bond insurance, prospective opportunities in this sector may be narrower than in the past due to changing perceptions about municipal risk among buyers, lower confidence in the financial guaranty industry broadly and a trend toward alternative forms of execution, including the issuance of uninsured paper. However, credit enhancement for smaller or more complex credits and the benefits of third-party due diligence and liquidity are likely to continue influencing investors' demand for wrapped transactions in the future. This demand, however, may be unstable, with a sharp fall-off in demand possibly resulting from even a moderate decline in a guarantor's credit profile, creating a "demand cliff" beyond that observed in most other industries. Consequently, our assessment of franchise value in the current operating environment tends to fall in the A to Aa range for the best-positioned financial guarantors. By contrast, companies with Aaa ratings typically have franchises that are extremely resistant to erosion in product demand over time.

- **Portfolio Characteristics.** The leverage and complexity of some structured finance products made it difficult for the guarantors, like other market participants, to estimate accurately losses for certain segments of the insured portfolio. This is compounded by the fact that large and potentially correlated risk exposures can have a materially negative impact on a guarantor's financial strength should the performance of those exposures deteriorate. In contrast, the guarantors' municipal and infrastructure finance portfolios are generally seen as less exposed to correlation risk, except in the most severe stress scenarios, although large transaction sizes and rising credit pressures in a down credit market could prove problematic in certain instances. Accordingly, our appraisal of the industry's aggregate portfolio credit characteristics has shifted.

- **Capital Adequacy.** Historically, Aaa-rated companies generally maintained total capital ratios in the range of 1.4 to 1.6 times, providing them with a cushion above Moody's 1.3 times Aaa "target" level threshold. As the credit crisis unfolded, however, guarantors with significant mortgage-related exposures saw their risk-adjusted capital positions fall sharply due to the erosion of credit protection with certain exposures, as well as the realization of actual losses in some cases. At the same time, credit deterioration among financial guaranty reinsurers resulted in less reinsurance benefit for those primary companies that were heavy users of third-party reinsurance as a form of capital relief. Consequently, most firms in the industry have seen their capital ratios fall to levels that are no longer consistent with Aaa ratings. It is also clear that capitalization is subject to far greater volatility than we had previously anticipated.

- **Profitability.** The current volatility in the guarantors' profitability resulting from large mortgage-related losses creates a stark contrast to the historically stable profits enjoyed by the industry for years. We expect this volatility to continue over the near to medium term. While there may be some near-term opportunities for improved pricing on public finance business, over the longer term, public finance premium rates are likely to revert to historical levels and could even fall further as surviving guarantors and new entrants compete in the mature U.S. municipal market. Consequently, the guarantors' ability to earn returns that are consistent with historical levels without taking undue risks could become more challenging.

- **Financial Flexibility.** Moody's longstanding view, based on observed experience, had been that the financial guarantors would: (1) be extraordinarily motivated to raise capital if they needed to bolster their financial resources; and (2) have broad access to a variety of financing sources, whether from committed owners or public markets. Recently observed performance and behavior no longer support these expectations. Consequently, Moody's currently views financial guarantors as having less financial flexibility than they had exhibited prior to the credit crisis. Even the best-positioned firms can experience a dramatic constriction of financing options if material losses occur or uncertainty about potential losses is high. Such sensitivity to event risk and market confidence typically is associated with financial strength scores falling below the Aaa level.

In light of these factors, since 2007, Moody's has downgraded all of the rated primary guarantors. Our current financial strength ratings on the U.S. financial guarantors are as follows:

Company Name	IFSR	Outlook	Last Action
Ambac Assurance Corporation	Caa2	Developing	7/29/2009
Assured Guaranty Corporation	Aa3	Review for downgrade	11/12/2009
Berkshire Hathaway Assurance Corporation	Aa1	Stable	4/8/2009
CIFG Assurance North America, Inc.	Withdrawn after downgrade to Ca		11/11/2009
Financial Guaranty Insurance Company	Withdrawn after downgrade to Caa3		3/24/2009
Financial Security Assurance Corporation	Aa3	Negative	11/21/2008
MBIA Insurance Corporation	B3	Negative	2/18/2009
National Public Finance Guaranty Corp.	Baa1	Developing	11/7/2008
Radian Asset Assurance Inc.	Ba1	Stable	3/12/2009
Syncora Guarantee Inc. (formerly XL Capital Assurance Inc.)	Ca	Developing	3/9/2009

Several market participants have formed, or proposed to form, separately capitalized "municipal-only" entities. While a municipal-only guarantor likely would have a lower risk profile than a guarantor exposed to structured risks, municipal markets are not immune to downward pressure. Furthermore, the susceptibility of product demand and financial flexibility to changes in risk profile is particularly pronounced in the municipal sector. Such a narrow business strategy in a mature market could also generate increased competitive pressures, which could be anticipated, over time, to degrade profitability and underwriting discipline. For these reasons, achieving a stand-alone Aaa rating for a municipal-only guarantor likely would be difficult absent the entity's ability to defend against product encroachment, secure reliable access to new funding in stress scenarios, and protect against the removal of capital and risk management resources in a run-off scenario.

V. Moody's Approach to Rating Transactions Wrapped by Financial Guarantees

A. General

Both rated and unrated municipal bond issuers can choose whether or not to obtain credit enhancement for their bonds. Credit enhancement is available in different forms, such as guarantees, letters of credit and bond insurance. The decision to purchase bond insurance rests solely with the municipal issuer, which weighs the costs and benefits of insuring its bond against its various other alternatives.[15]

When an insurer requests a credit rating for a wrapped bond issuance, Moody's analyzes the bond insurance policy to determine whether or not there has been full, effective credit substitution. Full credit substitution should insulate the investor from the issuer's financial condition, as well as from any legal or other risks associated with the mechanics of the transaction. Moody's examines the documentation for the transaction to determine, for example, whether all parties to the transaction have clearly defined responsibilities and whether the insurer is obliged to make timely payments on the security if the issuer does not make the required payments as scheduled. If the bond insurer's standardized policy includes any changes or endorsements, Moody's analyzes them to determine whether or not they create credit risk for the bondholder. If Moody's concludes that the structure of the bond provides for full, effective credit substitution, the bonds will receive the bond insurer's financial strength rating.

An issuer that proposes to issue a wrapped bond may ask Moody's for a rating only on the wrapped transaction. An issuer can also ask Moody's to provide a separate opinion about the underlying bond without factoring in the bond insurance. In such circumstances, the bond will then have two credit ratings – one for the underlying bond and one for the wrapped bond. At the time the issuer is informed of Moody's rating for the underlying bond, the issuer can decide whether or not it wants to have that rating published.[16]

B. Treatment of Insured Municipal Ratings When a Financial Guarantor's IFSR Drops below Investment Grade

Moody's long-term ratings address the possibility that a financial obligation will not be honored as promised. With respect to securities wrapped by financial guarantors, the financial obligation will be honored unless two events happen: (i) the underlying obligation defaults; and (ii) the guarantor defaults. Therefore, when the published rating on the underlying obligation of a wrapped transaction is higher than the guarantor's financial strength rating, the wrapped rating of the transaction can be higher than the guarantor's rating.[17] Accordingly, Moody's practice has been to assign the higher of the IFSR and the published underlying rating to any insured, non-structured instruments, where both the IFSR

---

15 Insurance can also be purchased by investors in the secondary market, after the bonds have been issued.

16 Moody's, however, always reserves the right to exercise its editorial discretion and publish any rating without the issuer's consent.

17 With respect to municipal bonds, if the wrapped rating is driven by the guarantor's rating, it is understood to have a meaning consistent with Moody's global rating scale. If the rating is driven by an underlying municipal rating, it is understood to have a meaning consistent with Moody's municipal rating scale.

and the underlying, published rating are of investment grade. In respect of insured, structured instruments, Moody's practice has been to assign the higher of the IFSR and the published or unpublished, underlying rating.

In 2008 and 2009, Moody's downgraded many of the stand-alone ratings of the financial guarantors to below investment grade. Meanwhile, the vast majority of wrapped transactions, especially in the U.S. municipal market, international public finance market and certain sectors of the structured finance market, have an underlying credit obligation of investment grade quality. We do not believe it serves the market to maintain a rating on an instrument that is, in all likelihood, an inaccurate (*i.e.*, overly conservative) reflection of its credit risk. Therefore, in circumstances where we have downgraded financial guarantors below the investment grade rating range, we have withdrawn the wrapped ratings for non-structured instruments that do not have published, underlying ratings.[18] For insured, structured securities, Moody's policy is to publish the underlying rating except in limited circumstances (*e.g.*, if the issuer or arranger had requested that the guaranty constitute the sole credit consideration).[19]

It has been our understanding that many investors have portfolio guidelines that compel them to sell securities if their ratings fall below investment grade, but that they may be able to continue holding the securities if they are unrated. Because investment policy guidelines are not uniform, we recognize that our policy may inconvenience some investors while benefiting others. On the whole, however, we believe, based on our discussions with market participants, that investors are better served by the withdrawal of wrapped ratings for non-structured securities upon a financial guarantor's downgrade below investment grade than by a downgrade of those ratings to the IFSR level.

VI. MOODY'S EFFORTS TO ADVANCE THE TRANSPARENCY OF CREDIT RATINGS AND THE RATING PROCESS

Moody's employs, or is in the process of introducing, a wide range of measures to enhance the transparency of its credit rating process, the ratings themselves and ratings performance.[20] One of the most significant ways Moody's promotes transparency is through the many publications we make available to the public free of charge. These include credit ratings, methodologies, rating performance reports, ratings history data and a number of our policies and procedures. For example:

- **Methodologies:** All of Moody's rating methodologies are made freely available to the public and are disclosed on moodys.com. In addition, any material modifications to methodologies and related significant practices, procedures and/or processes are

[18] Although Moody's reserves the right to publish ratings without an issuer's consent, we generally receive the issuer's consent before publishing an underlying rating. In response to the downgrades and rating reviews of financial guarantors, a number of issuers of wrapped instruments requested that Moody's publish their underlying ratings, which we have done.

[19] With structured securities there is, in effect, no issuer to consent and, therefore, we decided that it was appropriate to publish the underlying Moody's rating except in limited circumstances.

[20] My colleague David Teicher's written statement provided to this Working Group in connection with its public hearing held on September 24, 2009 describes an even wider range of measures Moody's has adopted, or is adopting, to promote quality and independence as well as transparency in the rating process. See also *Moody's Special Comment: Strengthening Analytical Quality and Transparency*, November 2009 (Document 119843).

published on our website; those that have a particularly broad reach also may be announced via a press release. After a new or revised methodology has been developed internally, Moody's may publish it as a Request for Comment to solicit the views of market participants prior to final adoption and implementation. In addition to promoting transparency, this process enables us to arrive at a more fully informed methodology.

In the past two years, Moody's also has taken a number of additional steps to facilitate market participants' access to our rating methodologies, particularly those concerning structured finance products. For example, we have posted files on moodys.com that represent an organized view of our rating methodologies and provided homepage dropdown links on moodys.com to "Rating Methodologies". We publish on moodys.com detailed summaries of our methodologies for rating U.S. RMBS and CDOs. We now issue press releases on at least a quarterly basis that summarize incremental changes to methodologies and rating procedures in the Structured Finance Group that have not been previously published. We also recently launched *Structured Finance Quick Check*, a weekly overview of structured finance rating activities, methodology changes and ratings criteria updates.

- **Credit Rating Announcements:** Our credit rating announcements are disseminated publicly and free of charge on moodys.com and distributed to major financial newswires. These announcements include the current rating action and our rationale for it. Subject to certain exceptions, they also reference the date of the last associated credit rating announcement, if any, and the principal action it announced. In addition, in recognition of how important methodological transparency is to the financial markets, subject to certain exceptions MIS also indicates in its credit rating announcements the principal methodology or methodology version that was used in determining the credit rating and where a description of that methodology can be found. Moody's also explains if a credit rating is based on more than one principal methodology and if a review of only one methodology might cause financial market professionals to overlook other important aspects of the credit rating. Moody's also indicates in the credit rating announcement where different methodologies and other important aspects factored into credit ratings can be found.

- **Ratings Performance and Ratings History:** Moody's analyzes the overall performance of our credit ratings to provide ourselves and third parties with information regarding the predictive quality of our credit ratings in the aggregate. Our published performance metrics generally relate to the two attributes of our credit ratings that we believe are the most important for market participants: (i) accuracy (*i.e.*, the correlation between credit ratings and default events); and (ii) stability (*e.g.*, frequency of credit rating changes).[21] In addition, we now publish credit ratings histories in a downloadable, machine-readable file for a random sample of 10% of our credit ratings. We also maintain ongoing dialogues with regulators, academics and credit market participants to understand their perspectives on Moody's credit ratings performance and to communicate our own views.

---

21 MIS's corporate bond ratings are intended to be "accurate" and "stable" measures of relative credit risk, as determined by each issuer's relative fundamental creditworthiness and without reference to explicit time horizons.

- **Rating Process Policies:** We make a number of our significant rating process policies available to the public without charge, including our policy on *Designating Issuers That Do Not Participate in the Rating Process,* our policy on *Designating Unsolicited Credit Ratings*, our *Guidelines for Withdrawal of Ratings* and our *Core Principles for the Conduct of Rating Committees*..

In addition to the measures described above, we have recently undertaken a number of additional steps to promote transparency, including the following:

- **Transforming moodys.com:** We recognize that our website is an important mechanism in our transparency initiatives. To that end, we are completely revamping it to make it easier to use, with more powerful search capabilities, integrated content and more intuitive navigation. We also are reorganizing our page layouts to make it easier to find and view our content more efficiently.

- **Providing Additional Information on Structured Finance Credit Ratings:** Moody's has made the following enhancements to our structured finance credit ratings to enhance transparency and show the market that the information we use in assigning credit ratings to structured finance products is of sufficient quality to support a credible credit rating.

  - **V Scores and Parameter Sensitivities:** We have introduced two new risk measures for new issuances of structured finance securities. V Scores address the degree of uncertainty around the assumptions that underlie our structured finance credit ratings.[22] Although our credit ratings already emphasize lifetime expected credit loss rates, V Scores are designed to signal to users of Moody's credit ratings which types of structured finance securities have greater exposure to data limitations and modeling assumptions. Parameter Sensitivities address the sensitivity of our credit ratings to changes in our key assumptions. They are designed to measure how the initial credit rating[23] of a security might have differed if key credit rating input parameters were varied, as opposed to how a credit rating might migrate over time.

  - **Increasing Transparency about Historical Performance Data for Underlying Assets:** As part of the disaggregation of the V Score, we have improved our disclosure concerning the limitations of the historical performance data used in rating structured finance securities. In particular, we disclose through the V Score, when applicable, those instances where we believe that there is limited historical data for the assets in the underlying pool.

  - **Loss Expectations and Cash Flow Analysis:** Moody's publishes information relating to initial loss expectations and cash flow analysis with respect to our structured finance credit ratings, as appropriate.

---

[22] See *Special Comment: Updated Report on V Scores and Parameter Sensitivities for Structured Finance Securities,* December 2008 (Document No. 112998).

[23] Parameter Sensitivities only reflect the ratings impact of each scenario from a quantitative/model-implied standpoint. The results generated by quantitative models are one of the many inputs to the credit rating process. Qualitative factors are also taken into consideration in the credit rating process, so the actual credit ratings that would be assigned in each case could vary from the information presented in the Parameter Sensitivity analysis.

- **Key Statistics and Severity and Default Assumptions:** We have begun publishing key statistics and severity and default assumptions for all new structured finance credit ratings and for surveillance rating actions in major asset classes. We also now disclose information relating to pool losses. For certain sectors, such as RMBS, these disclosures are made in Special Comments. Where we have not published a Special Comment, we make the disclosures in the relevant press release.

We also engage in dialogue on an ongoing basis with issuers, investors and other users of our credit ratings to gain insight on how we can enhance further transparency in our rating methodologies, rating opinions and research, rating practices and ratings performance.

VII. THE USE OF RATINGS FOR REGULATORY PURPOSES

As we noted in our previous written statement submitted to the NAIC, the use of credit ratings in prudential regulation and other standards is understandable from a public policy standpoint. Identifying and using objective, widely accepted standards for financial markets can facilitate efficient regulation. Credit ratings are useful in this regard because they are broadly disseminated, independent and reliably predictive opinions about relative creditworthiness.

Notwithstanding these benefits, however, we have long been concerned about the regulatory use of ratings. As we summarized in David Teicher's prior written statement, we have serious concerns about how the widespread, regulatory use of ratings can adversely affect the behavior of market participants as well as regulators.

Consequently, Moody's supports efforts to discontinue or limit the use of ratings in regulation. We appreciate the efforts undertaken by the Rating Agency Working Group and the NAIC to analyze carefully the potential consequences of continuing, modifying or ceasing the regulatory use of ratings in insurance regulation. We support the healthy dialogue that meetings such as this one can foster.

VIII. CONCLUSION

Moody's is strongly committed to meeting the needs of investors, issuers and other participants in credit markets for assessment of the relative creditworthiness of issuers and obligations. In our ratings of municipal issuers, financial guarantors and every other type of issuer and issuance we rate, we are firmly committed to meeting the highest standards of integrity in our rating practices, quality in our rating methodologies and analysis, and transparency in our rating actions and rating performance metrics. In that regard, we welcome continued engagement with the NAIC as it continues to reassess its use of credit ratings and evaluates possible approaches to encourage informed and careful use of credit ratings.

Draft: 11/11/09

Rating Agency (E) Working Group
Washington, DC
September 24, 2009

The Rating Agency (E) Working Group of the Financial Condition (E) Committee held a public hearing in Washington, DC, Sept. 24, 2009. The following Working Group members participated: Michael T. McRaith, Co-Chair (IL); James J. Wrynn, Co-Chair (NY); Steve Poizner represented by Louis Quan (CA); Thomas R. Sullivan (CT); Kevin McCarty represented by Steve Parton and Belinda Miller (FL); Neil N. Jasey represented by Bob Kasinow (NJ); Alfred W. Gross represented by Van Tompkins (VA); and Sean Dilweg (WI). Also participating were: Kathy Belfi (CT); Kevin Fry (IL); Glenn Wilson (MN); Hampton Finer and Mike Moriarty (NY); Kent Michie (UT); and Kim Shaul (WI).

1. Opening Statements

Superintendent Wrynn noted that state insurance regulators are responsible for ensuring the solvency of regulated insurance companies. As part of this process, he explained that the NAIC and the states use ratings to determine the risk-based capital (RBC) charge for rated bonds, as well as to set limits on insurance company investment risk exposures. It is imperative, therefore, that regulators have confidence in the rating process. The economic crisis has resulted in steep rating downgrades and drops in asset values, causing regulators to question whether the traditional ratings model adequately measures risk, especially the risk of structured securities. The U.S. Treasury Department, The Group of Twenty (G-20) Finance Ministers and Central Bank Governors, and the rating agencies themselves have recently questioned the reliance on credit ratings by regulators around the world. Regulators must now ask themselves whether, to what extent and in what manner ratings from credit rating agencies should continue to be relied upon. Superintendent Wrynn then informed that the hearing was separated into three panels. The first panel will help regulators explore the history and the traditional role of ratings in insurance regulation. The second panel will explore what went wrong during the recent financial crisis in regard to credit ratings, what changes credit rating agencies have made in response, and what still needs to be done to correct the problems. The third panel will include a discussion by regulators of recommendations and suggested alternatives to the traditional rating system. Superintendent Wrynn introduced the members of the Working Group and noted that biographies of each of the panelists were included in the meeting materials (Attachment Four-B1).

2. Panel 1: Use of Ratings in State Insurance Regulation

Written testimonies or presentations were submitted by Chris Evangel (NAIC) (Attachment Four-B2), Nancy Bennett (American Academy of Actuaries—AAA) (Attachment Four-B3), Mr. Moriarty (Attachment Four-B4) and Birny Birnbaum (Center for Economic Justice—CEJ) (Attachment Four-B5). An oral presentation was provided by Eric Steigerwalt (Metropolitan Life Insurance Company).

Mr. Steigerwalt provided a company perspective of this issue. He discussed how insurers' capital and surplus requirements have always been an important issue, but with changes in the economy and the limited availability of capital, these matters have been raised in their importance. He noted the desire for all parties to have adequate capital requirements in place that reflect the risk of the insurer. He discussed the challenges faced by regulators in addressing these issues. Mr. Steigerwalt discussed that one area that requires review is the risk charge for residential mortgage-backed securities (RMBS), because the charge is linked to the ratings by the agencies. As has been well documented, RMBS have had significant downgrades that have resulted in such ratings no longer reflecting the expected loss on an individual security, because the rating only reflects the probability of default, not the expected severity of the loss. Mr. Steigerwalt discussed that RMBS are still an appropriate asset class to invest policyholder monies. He noted that the agencies translate their ratings based on a first-dollar-of-loss principle, which does not reflect the wide range of loss severity across the tranches of the securities. Mr. Steigerwalt noted that a B-rated RMBS security under the rating agency model might be expected to receive all of its principal and interest, but carry a 10% capital charge for a 0% expected loss. A CCC-rated RMBS could lose as little as $1 of principal — and, in many cases, less than 5% of its principal — but receive a 23% capital charge. Mr. Steigerwalt stated that a more refined system to address this problem does not mean "blanket relief" for the industry, but, rather, is intended to better align the capital charge with the actual expected losses on a given security. Mr. Steigerwalt stated that the industry supports the regulators' review of this issue, and he hopes a proper balance will be struck to reflect the proper risk related to these types of securities.

Superintendent Wrynn noted that Mr. Birnbaum had testified that regulators should not delegate their responsibilities to private entities, and that regulators should instead expand the use of the NAIC Securities Valuation Office (SVO).

Superintendent Wrynn asked Mr. Evangel to comment on the realities of that suggestion and the impediments to such a proposal. Mr. Evangel noted there are several impediments, most notably cost. He indicated that the SVO consists of 50 individuals, of which 35–40 are analysts. He noted that the SVO office rates just more than half a trillion dollars in insurer investments, compared to the more than $2.2 trillion in insurer investments rated by the nationally recognized statistical rating organizations (NRSROs). Mr. Evangel discussed how the SVO would have to change its operations to pick up those responsibilities. He noted that, in particular, the NRSROs have access to the issuer and certain issuer information that the NAIC does not have access to, because the NAIC's analysis is done post-sale. He discussed the difficulties that would be encountered should the SVO's rating differ from one of agencies' ratings. In summary, Mr. Evangel noted that this would require an enormous increase in costs for staffing, which would be passed on to the insurance companies. Mr. Evangel noted that there would be a trade-off for the benefits derived for those costs, but he could not say what the appropriate point would be related to that trade-off. He added that the benefits would primarily exist in market downturns.

Commissioner Michie asked Mr. Evangel if it would be possible for the SVO to rate the securities currently rated by the NRSROs. Mr. Evangel stated that it would be possible if enough resources were dedicated to the task. He discussed that, as a former employee of Moody's, there was no "magic" to performing credit analysis — but noted that the expertise could not be gained overnight. As comparison, he mentioned that it took Fitch Ratings (Fitch) a number of years to build themselves up to be one of the big three rating agencies.

Commissioner Michie then asked any member of the panel to explain how a rating is established. More specifically, he noted that it was his understanding that the rating is based on the ability of an issuer to make full and timely payment. He also noted that for RMBS, there were a number of issuers; therefore, it was his understanding that a partial payment would exist, because some individuals would pay full and timely and others might not. Mr. Birnbaum noted that the agencies have a different priority for rating than regulators. He noted that Mr. Steigerwalt's comments reflect that insurers and regulators are looking for two different types of products. Mr. Birnbaum suggested that regulators should be thinking about the issue in a different way than the agencies. He noted that regulators should not "pick and choose" when agency ratings are used and when they are not. That is, what is established by regulators should be consistent with the requirements for state-based regulators. He stated he thought it was great that the industry and the regulators had a dialogue concerning capital for the industry, but pointed out that he had yet to see a time when the industry came to the regulators stating that the capital requirements were not high enough. He noted that when rules were in place, there would always be exceptions. Ms. Bennett indicated that the purpose of an agency rating is to predict when a default might occur and, because of this, it necessitates looking into the future, which requires a great deal of judgment. Mr. Moriarty explained how structured securities were different than corporate debt. He discussed how there could be defaults on some of the collateral, but much of it could pay as expected. He noted that, because structured securities are bought at a discount that is factored into the rating. He stated that, in his opinion, if structured securities had been around in the mid-1990s at the volume they exist at today, the credit rating itself might not have been used for purposes of determining capital for insurers, and perhaps some other method would have been used. Commissioner Sullivan asked Mr. Moriarty if the level of confidence that exists on corporate debt exists on a structured security. Mr. Moriarty responded that it did not; i.e., the two are different because there are numerous assumptions that factor into determining the rating for a structured security. Commissioner Sullivan noted that it appeared that the ratings on structured securities were either not adequately monitored or were improperly assessed from the beginning. He asked Mr. Moriarty if the ratings were correct today. Mr. Moriarty responded that — while almost no one could have foreseen the problems with the mortgage industry — clearly, the assumptions made were not valid, and the market and the assumptions went the opposite way of what was expected.

Director McRaith asked Ms. Bennett if there was an implication about RBC not evolving appropriately. Ms. Bennett noted that the formula on the asset side has not changed since the inception of RBC. She stated that, as an actuary, she would like to see the formula have more sophistication. However, such a change would move regulators away from the current formulaic approach, which would diminish its audit ability. She discussed the preferred use of a total balance sheet approach and the increased costs associated with such an approach.

Director McRaith asked Ms. Bennett about her history in enterprise risk management, particularly for insurers' use of rating agency input for enterprise risk management with what has occurred in the market. Ms. Bennett said she believed that companies were being forced to focus more on fundamental risk analysis, not to say this was not occurring within the industry prior to the current economic downturn. Ms. Bennett noted that, to the extent that regulators do not move away from some of the current reliance and formulaic approaches used for capital, there will be an increase in the divergence that exists between the manner in which an insurer manages its capital and the capital requirements for insurers. Director McRaith noted that was a broad regulatory topic that probably could not be addressed today.

Director McRaith asked if there had been any attempts by insurance regulators to diminish the reliance placed on the agencies by developing alternatives. Mr. Moriarty noted that up until the financial crisis, he believed the rating agencies had done a good job of rating securities, other than some notable anomalies (e.g., Enron, WorldCom). He stated that recent events had brought to light certain issues related to the rating agency model. He said part of the problem is that capital markets somewhat require a barometer for credit quality. He noted that many of these agencies recognize this fact — as well as the fact that there is no “plan B”. Mr. Moriarty discussed that things, such as a buyer-side model or the American Council of Life Insurers (ACLI) model, are attempts at a plan B. Given the recent financial crisis, he said he believes that these rating agency model issues had become clearer, and that the issue of reliance needs to be reviewed.

Commissioner Sullivan asked Mr. Moriarty about the rationale to adopt the current filing-exempt (FE) status. He asked if it was a timing or volume issue, if there were backlogs, etc. Mr. Moriarty responded that it was a resource issue, as there were more than 225,000 individual securities owned by insurers. He said he felt it was unreasonable to expect the SVO, with its staff of only 35–40 analysts, to be able to review and monitor all of those securities. He added that the rating agencies were well staffed with smart, well–compensated employees, which is why the decision was made to leverage their work.

Director McRaith asked Mr. Steigerwalt to describe his prior position at MetLife, where he was responsible for strategic management of relationships with rating agencies. Mr. Steigerwalt responded that, in that position, he was responsible for interacting with the agencies on any number of metrics that the agency uses to determine its rating of the insurer and its corporate debt.

Ms. Shaul asked Ms. Bennett about her statement that ratings were used as the default costs in the establishment of principle-based reserves. Ms. Bennett responded that was correct. Ms. Shaul asked Mr. Evangel to compare and contrast the work he performed at Moody’s with the work done at the SVO. Mr. Evangel explained that credit ratings are “part science and part art”. He also noted that SVO analysts go beyond just rating each security; they review whether the security should be an admitted asset, as well as how it should be classified. He discussed that at the SVO they do not worry just about payment ability; they also want to make sure that the transaction is not circular within the insurance holding company. He noted that the concept of market share, about the competitor, had never come up in a credit committee meeting at the NAIC because those incentives do not exist for the SVO. He discussed that at Moody’s, there was always pressure to make sure you did not lose the business of the client, which meant always looking over your shoulder to see what the other rating agencies were doing. He discussed how when he worked at Moody’s, there was always an eye on who was first with a rating upgrade, or who was first with a rating downgrade. This created the need to balance the credit point of view with what the competitors were doing. At the SVO, the clients are the insurance regulators — and that this is an important distinction. Mr. Evangel discussed how the SVO has no relationship with the brokers and no real relationship with the issuer; i.e., everything at the SVO is dependent upon the insurance company submitting the requisite information. Commissioner Sullivan asked if the race to be first still exist today. Mr. Evangel responded that, for example, when one rating agency takes action at 9 a.m. and another rating agency takes action at 4 p.m. that same day, you have to wonder if that type of competition still exists today. He discussed that the race to be first puts pressure on the analyst, and any movement by a competitor results in questions to the analyst of why the issue was not caught beforehand.

Commissioner Sullivan asked Ms. Bennett about RBC use as a regulatory tool, noting that issues with RBC are brought up by insurers on nearly every public conference call. Ms. Bennett responded that when RBC was first introduced, it was intended to be a regulatory tool to define weakly capitalized companies, as well as to allow regulators to take various levels of action. She noted there were not too many other similar tools at that time in the early 1990s. She discussed how companies would disclose their available capital, which could be three, four or five times the regulatory capital required. She noted that what is being discussed on the analyst calls tends to be in regard to available capital, as opposed to the bottom threshold.

Superintendent Wrynn asked Mr. Steigerwalt if it would be wise to rely on the agencies’ ratings for some securities, but not others. Mr. Steigerwalt noted that the industry is looking for a balance. So, for RMBS, severity of loss is taken into consideration. He stated that regulators would have to get comfortable with that decision in order to get that balance.

Ms. Tompkins asked Mr. Moriarty what changes should be made to the FE rule. She noted there was no pre-filing process and no requirement for new products, and asked how the FE rules could be tightened. Mr. Moriarty responded that a first good step is RMBS, because it has shown the most volatility. He stated that it behooves the NAIC to consider the proposal from the ACLI as an alternative to developing a capital standard. Mr. Moriarty stated that such an action would be a short-term response, but that in the long-term, a more comprehensive review must be taken by the NAIC.

Director McRaith noted that any interested party who would like to submit comments on any topic discussed during the hearing should submit such comments to NAIC staff by commencement of business Oct. 7.

3. Panel 2: Rating Agencies – What Happened?

Written testimonies were submitted by David Teicher (Moody's) (Attachment Four-B6), Grace Osborn (Standard & Poor's—S&P) (Attachment Four-B7), Keith Buckley and John Olert (Fitch Ratings) (Attachment Four-B8), Mary Keogh (DBRS) (Attachment Four-B9), Jerome Fons (Fons Risk Solutions) (Attachment Four-B10) and David Marks (CUNA Mutual Group) (Attachment Four-B11). An oral presentation was also provided by Josh Rosner (Graham Fisher & Co.).

Mr. Rosner provided a brief historical perspective of what happened with structured securities, noting that the rating agencies as gatekeepers were only one element of the problem, and there was plenty of blame to go around. He stated that many of the problems with structured securities could be directed to the lack of standards in the RMBS marketplace, noting that none of those problems had yet to be addressed. He discussed how the rating agencies waited until the later part of summer 2007 to begin their process of downgrading the mortgage-backed securities, which was about nine months after the market had begun to recognize this credit-quality determination. He pointed out that when the agencies finally downgraded these securities, they did so on a mass basis. He also discussed the international standards placed on rating agencies relative to diligence, as well as one of the agency's positions that they had no duty to verify the accuracy of the data used in assigning their ratings. He suggested that the agencies' role needs to be redefined, particularly as it pertains to structured securities because the agencies have largely been "learning by doing". He discussed how many of the structures used within the latest round of structured securities never existed before the current mortgage cycle, nor did they have the subprime quality of collateral. Mr. Rosner discussed how the rating agencies made assumptions about subprime quality based on prime information, which ended up being inadequate. He provided seven specific recommendations to the NAIC: 1) Charter constrained investors should have the limited ability to buy non-exchange traded securities or a requirement that there are disclosure requirements on what they buy. 2) The rating agencies need to be required to apply their newer models in the re-ratings in the secondary market; 3) In the secondary market, the rating agencies should be required on an automated basis to apply their original assumptions to the monthly servicer remittance data on a real-time basis to redraw the curve. 4) The informational advantage the rating agencies have had over the broader marketplace because of the U.S. Securities and Exchange Commission's (SEC) Regulation Fair Disclosure (FD) restrictions should be reconsidered in support of broader disclosure to the markets. 5) There should be industry standards developed for analyst training because there currently are none. 6) Revolving-door practices that allow an analyst to work for a firm they rated should be restricted for a one-year or two-year period, and 7) Each agency should be require to maintain an Office of Chief Statistician and Models who reports to an independent committee of the board of directors, and that office should be taken completely out of the business line of the company to avoid any pressure.

Mr. Rosner discussed his views on buy-side or investor-side, noting that he did not believe this was the problem, and there were other alternatives to address the conflicts. He discussed the need to have a data library that allowed an individual to inspect the collateral.

Director McRaith observed that every agency encouraged reduced reliance on ratings and asked if anyone on the panel disagreed. Ms. Osborn said S&P's opinion is that a rating is independent and forward-looking and, to the extent you consider it a useful tool in decision-making, then it has a valuable place. Director McRaith responded that he would not ask at this time about S&P's opinion that rating agencies are independent, but he said it sounded as if the agencies were all in agreement that regulators should not rely solely on the use of ratings. Mr. Buckley responded that the use of ratings can assist different users in different ways, including regulators. He added that naïve use of ratings, or misuse of ratings can hurt those users; therefore, Fitch encourages more insightful use of ratings. That is, Fitch believes ratings should be complemented with other tools, and Mr. Buckley stated that it would be ideal for users to do their own homework.

Director McRaith asked Mr. Teicher that, if there were a reduced reliance on ratings, would that reduce the significance of the work performed by the agencies — and, if that is the case, would that result in a reduction of fees paid to the agencies. Mr. Teicher responded that rating agencies provide opinions on creditworthiness of issuers and debt instruments; i.e., ratings should be understood as being opinions about credit; they are not opinions about liquidity or market value. Director McRaith noted that Mr. Teicher indicated previously that a rating was an opinion about probability of loss and severity of loss, if that loss were to occur. Mr. Teicher responded that ratings speak to expected loss, in that they assess probability of loss and how much would be lost if there were to be a default. Director McRaith noted that all of the rating agencies here today seem to be indicating that regulators might be over-relying on the work product of their agencies, and asked if that was a fair statement. He noted that every one of the representatives today had indicated they were a tool, but that there should be other information and analysis relied upon. Mr. Teicher agreed, noting that the rating agencies should not be relied upon exclusively. Director

McRaith stated that he was looking for a response to the question of whether regulators should rely less upon the tools provided by the rating agencies. Mr. Teicher responded that Moody's believes that the use of ratings in regulation should be reduced. Mr. Olert noted that he believed a couple of things were being missed in the proposition. Specifically, he indicated that it suggests that the only product offered by the agencies were ratings. Mr. Olert noted that there has been a great deal of work that has gone into supporting those ratings. For example, he said, to make the rating more transparent and unlock some of the distinction, Fitch has rating scales that speak to loss severity; these are known as recovery ratings. Director McRaith noted that, with respect to transparency, he heard Mr. Fons, Mr. Marks and Mr. Rosner provide their opinions on transparency of the underlying collateral, and he will ask the panel to those issues shortly. Right now, Director McRaith said he wanted to focus on a much more mundane question, which is one of resources. Director McRaith noted that it did not appear that the panelists from the agencies were being as explicit now as they were in their prepared comments. He stated that he had heard Mr. Teicher say that regulators might have grown over-reliant on ratings, and regulators should look at other information. Director McRaith stated that, if that was the case, it decreases the value of the rating agencies' work product. Mr. Buckley disagreed, noting that what the agencies were trying to say was that their work product adds value; for example, rating agencies can provide insights into probability of default and potential recoverability — but it probably works better if regulators perform additional work. He added that the rating agencies are not suggesting that regulators substitute, but rather supplement, the rating agencies' work. Director McRaith said understood the point, but indicated that his question is regarding what the result of this will be on the bottom line of the agencies, which would ultimately result in fewer resources. He noted that there have already been issues raised about resources by a former Moody's employee. He suggested that fewer resources could have an impact on the products developed by the agencies. Ms. Osborn indicated that S&P is well positioned and staffed to perform their work, and the agencies will continue to make sure they have the appropriate criteria, methodology and assumptions employed, as well as oversight making sure we perform our duties as promised. This represents a commitment to analytical rigor and analytical excellence, and she said S&P does not anticipate that changing. Director McRaith noted that reduced reliance within the insurance industry on the rating of structured securities would likely result in reduced value of the product produced by the firms. Mr. Olert indicated that Director McRaith's statement assumes that all other users would use the ratings as an insurance regulator would; i.e., as an input into a capital model. He noted that the agencies have a lot of other users (some of which are insurance companies) that use the products for different purposes.

Superintendent Wrynn noted that he was hearing inconsistencies. He mentioned the reliance on ratings by all types of regulators, not just insurance regulators, and also spoke of the public's demand to rely less on the agencies and more on the quality of the product. He asked Mr. Teicher how both could be done. Mr. Teicher responded that the regulatory, or other use of the product, creates a demand that can be based not on the rating quality, but only to satisfy regulatory purposes. He noted that the focus should be on finding the best-quality ratings. Superintendent Wrynn asked Mr. Teicher what their recommendation would be on how and in what way regulators could reduce their reliance on ratings. He asked if there were particular ratings that should be relied on and others that should not. Mr. Teicher responded that negative aspects that can result when regulators make a decision to measure those risks. Superintendent Wrynn noted that, in the past, an AAA rating provided comfort, but that no longer seemed to be the case. Mr. Teicher responded that he was not in the best position to answer that question. He noted that he believed Moody's ratings were reliably predictive opinions about credit risk. He stated that the user of the ratings should decide how best to utilize the ratings, because the user would know what source of information and what tools best serve their purpose. Superintendent Wrynn asked Mr. Teicher if he was suggesting something akin to "buyer beware". Mr. Teicher responded that the user has to determine what risks they are attempting to capture and he does not believe he can make that decision. Mr. Buckley noted that ratings need to be used as complementary products. He also noted that there is concern when ratings are misused, not necessarily by regulators, but by any market participant that believed the rating measured more than what was contemplated, such as market risk or liquidity risk. Mr. Buckley provided an example relative to RMBS and noted that if the regulators were more concerned about the expected loss, as opposed to the chance of loss, the rating is not as useful. But if that rating is combined with the products Mr. Olert described, such as severity ratings, then you can get the product you need. Mr. Buckley began to discuss broader market use of ratings in a complicated world when Director McRaith asked him for more explanation. Mr. Buckley responded that, in the context of measurements of probability of defaults and loss severity, a better way is to measure both factors. Director McRaith asked if Mr. Buckley's answer was that regulators should become more reliant upon other products offered by regulators. Mr. Buckley responded that Fitch offers products that might be more helpful to regulators.

Commissioner Sullivan indicated that he wanted to get a deeper understanding of the organizational culture issues that exist at the rating agencies. He described his past experience working in the corporate environment, and noted that he believed the types of solutions that the agencies have included in their written testimony are akin to "sprinkling magical pixie dust" at the problem. Commissioner Sullivan asked Mr. Teicher if he was aware that a former colleague of his was scheduled to testify before Congress today. He then read from some of the written remarks prepared by Eric Kolchinsky (Moody's). Commissioner Sullivan then requested a response from Mr. Teicher and Mr. Fons (a former employee of Moody's) regarding how the behavioral practices within the organization would change, given that those types of changes typically evolve over many years. Mr. Teicher responded that Moody's has had many procedures and processes in place, such as separating the analysts from fee negotiations. He indicated that Moody's has had those for years, but they have enhanced the credit committee processes, cross-rating teams, the transparency, the separation from compensation — all of which are designed to get at the items in question. Commissioner Sullivan asked, more directly, if he were to take an analyst from their organization and "remove the cloak that silences him", what would that analyst say. He specifically mentioned the perceived bullying within the corporate culture at Moody's. Mr. Teicher repeated that Moody's has many policies and procedures in place to promote the integrity of the process — and that his experience was that the analysts freely expressed their opinions before a decision was made by the rating committee. Commissioner Sullivan interrupted Mr. Teicher to ask Mr. Fons to provide his impressions regarding his days as an employee of Moody's. Mr. Fons said he was appreciative of the opportunity to comment on the item, noting he had to be careful about what he said. He indicated he didn't see the bullying but there is a corporate culture at Moody's that dictates things. He discussed how it starts at the top, with the board of directors, and noted how the membership of that board had remained unchanged since his time. He discussed how upper senior management was also largely unchanged since his time as an employee. He agreed it will take time to make changes. He noted that they are a profit-sharing entity and he believes that is the primary problem with the current rating agency model. Mr. Fons agreed with Mr. Teicher that there was a free flow of information within the rating committees, but there are issues that can arise because of the lack of independence at the top. He noted that the compliance function was probably not independent either. Mr. Fons reiterated his statements that a for profit firm is not up to these types of challenges and cannot cope with these pressures. Commissioner Sullivan asked if Mr. Kolchinsky was a credible man and whether his statements could be relied upon. Mr. Fons indicated he did not know Mr. Kolchinsky that well but believed he was telling the truth about what he has gone through. Commissioner Sullivan noted certain body language from Mr. Teicher and asked him if he did not believe Mr. Kolchinsky was a credible person. Mr. Teicher responded that he had no personal knowledge of the situation that Mr. Kolchinsky is alleging.

Commissioner Dilweg noted that he had visited with the rating agencies a number of times as it relates to stressed companies, and said that he found the agencies' perspective helpful. He noted that what regulators are struggling with is the perception of certain authority being given over to the agencies and how best to address that issue. He asked the agencies to respond to the comparison of corporate ratings vs. municipal ratings, given the lower default pattern of municipals and the amount of each type of securities that are held by insurers. Mr. Buckley noted that he was not a municipal analyst, but indicated that he did have some experience with that issue as the manager of the ratings on financial guaranty insurers, as such insurers guaranteed a great deal of municipal debt. He discussed that the municipal scale has evolved into one that was more of a relative ranking as opposed to one that was comparable to what is used on the corporate side, which are based more on pure default risk. Mr. Buckley explained that the reason this became was that there was a belief that many of the municipals would be rated on the highest range, resulting in so much compression of ratings that there would be no way to differentiate different municipalities. He discussed that this situation was not different than what is faced in a number of developing markets, where national ratings are provided, again based on a relative scale as opposed to default experience. In those situations, the ratings provide differentiation, just at the low end of the scale. Mr. Buckley noted that this was something that is understood by all market participants of the capital markets, including the municipal issuers. He noted that this was something that was adjusted for in their own internal models; i.e., Fitch would reduce the requirements for entities that held such investments, knowing that the default experience was lower. He also discussed that the market has asked the agencies to realign this process with the corporate process. He said it was his understanding that many agencies were moving toward realigning, but when the economic crisis hit, a decision was made that now was not the appropriate time to make this change, at least not until the default experience for the current market became known.

Director McRaith asked all of the panelists when it became clear that there were problems with the RMBS to the proportions that the problem became; e.g., vintage year 2005, 2006, 2007. Mr. Buckley responded that 2006 and 2007 vintages were the worst performing, based on the stress testing that Fitch was performing for insurers. Director McRaith noted that was consistent with his understanding. Mr. Rosner noted that, in all fairness, there were mistakes made on all sides. He discussed that, until recently, there was no real history for subprime lending. He provided some context by indicating that he had personally placed about 50% of all of the equities of the subprime lenders that went public in the mid-1990s, and nearly all of them went bankrupt in 1998 and 1999. The reason for this was because, at that time, subprime lending was a small market and was a traditional product offered to issuers with lower credit scores. He discussed that these ended up getting funded through securitization in the wake of the Russian debt crisis, but eventually investors could see the volume was bogus and, as a result, the companies went out of business. He discussed how in 2001 and 2002, the large lenders began to get into the business of subprime lending, which was a different concept of subprime than we know today. It expanded the market by offering interest-only loans to consumers, along with other new products. Because the agencies used discount rates on historical performance, and made certain assumptions about borrower behavior that simply were not accurate, in the third quarter of 2005, it became apparent that credit quality was deteriorating. Mr. Rosner noted that if the agencies were using the monthly servicer admittance data, they would have made this same observation. He discussed that part of the problem is that the rating agencies have historically underspent on the resources used for secondary markets, because it was not a large revenue-generator for them. Mr. Rosner indicated that underspending in this area was a huge cause of the problem. He discussed that if the payment method is rethought, and state insurance regulators want to require something specific of the agencies they use, the agency can charge whatever it wants on the initial filing and the secondary filing, but where the performance falls short of expectation, the agencies' income will be reduced in that period proportionally with the performance.

Director McRaith asked why the agencies' ratings were slow to the reality of what was occurring in the market. He asked whether mistakes were made and, if so, what they were. Mr. Olert responded that some of the assumptions taken were probably not as robust as they needed to be. He discussed that there were a number of areas where the agencies saw risky areas, but chose not to rate, such as certain Alt-A securities. Director McRaith asked if there had been any internal changes with how the securities are rated. Mr. Olert noted there have been a number of broad-based changes; e.g., by putting new people in these areas to bring new perspectives. Fitch also has improved some of their modeling and has broken down some internal "silos" so that the people, processes and culture are changed. He discussed that entire changes to some methodologies have changed — for example, in the area of corporate collateralized debt obligations, where the historical default rate had not changed, but the underlying data was different.

Commissioner Dilweg asked for a response on the impact of the downgrade of the financial guaranty insurers on the underlying securities. He noted a timing delay with respect to this downgrade. He asked if the agencies would not perform as detailed an analysis if a particular security was guaranteed by a financial guaranty insurer. Mr. Buckley responded that the analysis to determine a rating on a nonguaranteed issue was no different than the analysis to determine a rating on a guaranteed issue.

Director McRaith asked Mr. Marks, Mr. Rosner and Mr. Fons to provide comments on the issue of transparency. Mr. Marks noted that there have not been near as many problems on the corporate side as the structured security side because of disclosure. He discussed how there was information available on anything available publically on an issuer, including public financial statements, cash flows, debt servicer coverage, Bloomberg or other electronic mechanism. He said not only was the information not as available on the structured market side, but it is also hard to analyze. For example, he said, if you look at a pool of mortgage securities geographically dispersed, it would take a tremendous amount of effort in order to underwrite one of those securities or collateral positions, which is not being done. He discussed that the same was the case on the commercial mortgage-backed security (CMBS) side, where generally only the top 10 properties are reviewed in underwriting a CMBS. He discussed the need to have all of this information available to the public, regardless of any delay in the offering; however, the problem with obtaining such data is being able to understand all of the detail in the data.

Mr. Rosner stated that public disclosure was an important issue and said he believed the goal of state insurance regulators should be to relegate the agencies down to a role that is the equivalent of a traditional sell-side equity analyst, because that is all that it should be. He discussed that part of the problem is lack of data, and that market participants need to have an opportunity to inspect the collateral on a deal before it comes to market. Mr. Rosner discussed the need for standards and standard definitions, such as definitions for delinquency and default. In addition, he noted that pooling and servicing agreements differ widely, and said there must be some consistency in those agreements.

Mr. Fons noted, in response to a comment in the first panel by Mr. Evangel, that he believed an agency's access to an issuer is overrated. Mr. Fons noted that little valuable information is gained from the issuer and, in fact, if nothing else, the issuer is more likely to misdirect the agency and the ratings would be better if the agencies never had a conversation with the issuer. Mr. Fons noted that all securities rated should be publicly registered and held to high disclosure standards. He discussed that best practices for the rating agencies relative to RMBS is to examine loan-by-loan data with more than 100 fields of data on every loan. Mr. Fons noted that rating agencies obtain this information at origination and suggested this information be standardized and made available to any party requesting it. Mr. Fons noted that with changes to this data, and its standardization, models could then be developed with different assumptions that actually captured the risks of the securities. He commented on the use of performance data, as suggested by Mr. Rosner, noting that such information was backward-looking and that there is no updated information on the FICO scores, appraisal values or other information in order to capture the change in risk at that level, unlike the quarterly information that is available on issuers of corporate securities.

Director McRaith asked for Ms. Osborn's reaction to the discussion on transparency and disclosure. Ms. Osborn indicated she could not respond on the suggestions regarding structured securities, because that was not her area of expertise. She noted that Standard & Poor's had increased their transparency to regulators, policymakers and market participants. She stated that she believed there was value in the agencies sharing their criteria and assumptions used, so that investors who agree or disagree can consider that appropriately in their decisions. Further improvements in the area of applying such methodology consistently are also important to the ratings process. Director McRaith discussed those comments and contrasted those views with the original views, and the modification of those views by Mr. Buckley, and reiterated the Working Group's desire to determine the appropriate amount of insurance regulatory reliance on such ratings.

Director McRaith asked Mr. Teicher to comment on having information available to the public on a loan-by-loan level. Mr. Teicher responded that Moody's agrees that it would be beneficial for the market if there was more disclosure in the structured finance market and if the disclosure was more fulsome, so that market participants could review the same information as the agencies and, therefore, perform their own analysis and reach their own conclusions. Mr. Teicher stated that Moody's believes this increased transparency would increase the quality of ratings, because it would result in investors coming to their own conclusions on the quality of the related ratings from the agencies.

Director McRaith asked Mr. Buckley and Mr. Olert to provide their views on the transparency issue. Mr. Buckley said Fitch endorses the idea of the information available to agencies on structured securities also being made available to investors, because they do not want to compete with others on the basis of information, but rather the quality of their analysis and research. Mr. Buckley noted that they believe it could enhance the value of ratings, because it would also increase the use of unsolicited ratings, which Fitch believes would enhance ratings because it could result in different views, which could then lead investors to make their own assessment of the quality of each agency's ratings. In summary, he said Fitch believes that openness of data and more ratings per transaction is good for the marketplace.

Director McRaith discussed the use of disclaimers used by the agencies. He asked that each agency's disclaimer be added to the record. Director McRaith asked Mr. Teicher to explain why the following was necessary to include in the Moody's disclaimer:

> "Under no circumstances shall Moody's have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of Moody's or any of its directors or officers.."

Director McRaith explained that each of the agencies disclaimers were similar, but noted that Moody's was unique, as it included the phrase "negligent or otherwise". Mr. Teicher responded he was not a member of Moody's legal department and, therefore, was not in the best position to answer questions regarding the disclaimer language. Mr. Teicher stated that Moody's ratings are opinions, and it was hard to imagine an industry where individuals can express independent views if there is ability by market participants who simply disagree with the rating to be able to bring lawsuits. Director McRaith responded that, as an attorney, he understands what the words of those disclaimers mean, but yet it is difficult to compare with the reality of their use, especially in a complicated market. Mr. Rosner noted that there has been some case law that argues they are not just opinions. He noted that, in other industries, for example, General Motors would create its own securities — but that structured securities are, instead, created by the rating agencies. As such, he stated that because the agencies define the structure of payment, it is questionable whether they represent opinions, because they are part of an interactive process to structure the deal. Mr. Fons added that the use of ratings in regulation is a "double-edged sword", because it allows agencies to charge high prices and have high margins. He discussed that the agencies use what they refer to as a "demand/pull model", in which when investors want ratings, issuers are then required to purchase them. On the other hand, the ratings themselves lose their independence; for example, he described situations where, in the current market condition, ratings were kept artificially high at the investment-grade level in order to prevent the onslaught of problems that would occur with a downgrade. These problems are exasperated by the use of ratings in legal documents, swap contracts and other areas that led to the demise of the firms.

Commissioner Dilweg notes that it has been argued recently that the designation by the U.S. Securities Exchange Commission (SEC) should have some meaning and asked how much blame should be placed on the SEC in the evolution of the rating agencies. Mr. Fons discussed that prior to the SEC's use of ratings, the NAIC used ratings and the Federal Reserve used ratings; therefore, it is difficult to place all of the blame on the SEC. However, once the SEC created its designation, it became codified in numerous areas, such as ERISA and other laws. Therefore, it is hard to know how things would have evolved had the SEC not created the designation, but it was a big part of the term being included in various documents and laws.

Director McRaith asked Mr. Fons to clarify what he meant by a previous statement that the agencies play off each other to increase market share. Mr. Fons responded that this is also known as “rating shopping”, in which, without the disclosures previously suggested, results in originators shopping for the best opinion from the agencies. Mr. Fons noted that he believes this has lead to a “race to the bottom”, and has resulted in a fight for market share by the agencies.

Director McRaith asked Mr. Marks to expand upon his idea of an independent third-party rating agency funded by the insurance industry. Mr. Marks discussed the amount of securities held by the U.S. insurance industry and noted that he had discussed the current issues for the insurance industry with 11 other chief investment officers from the industry — and they all agreed that something has to be done. He discussed that the industry would be willing to spend money to create an alternative that would support a process requiring an independent referee that was not affiliated with the insurance industry. He noted that there might be some antitrust issues to be addressed with such a concept, but he assured the Working Group that the industry would be willing to facilitate this with the people and process.

Superintendent Wrynn asked Mr. Marks for his opinion on the role of rating agencies. Mr. Marks responded that he saw rating agencies as one source of information among many, similar to an equity analyst opinion. He discussed his organization’s use of ratings as one piece of information, noting that they also perform their own independent analysis. He discussed that the insurance industry would be better off in an attempt to address some of the issues that have been brought up during this hearing.

Superintendent Wrynn asked Mr. Rosner for suggestions regarding employees of the agencies. Mr. Rosner noted that, with respect to the conflicts of interest, there should be an independent ombudsman within each agency that does not report to a business line manager — but instead to an independent committee of the board of directors that is responsible for the statistical modeling of the agency. Mr. Rosner also suggested prohibiting the “revolving door” practice, where a rating analyst leaves the agency to work for an issuer, for a period of one to two years. Superintendent Wrynn asked about profit -haring plans or certain benchmarks based on revenues. Mr. Rosner responded that those are common-sense best practices.

Director McRaith asked Mr. Rosner to discuss the ability to inspect. Mr. Rosner noted that what he was discussing was the idea of a data repository for each deal, so that investors could log into an issuer’s Web site prior to the current practice of four hours before a deal is completed. This would allow for an inspection of collateral, perhaps as low as at the loan level, for a period of time before the deal comes to market. This would allow investors to have input into the pricing of a deal. Director McRaith asked Mr. Fons to state his opinion. Mr. Fons noted that this level of deal was appropriate, because the agencies had this level of information. Director McRaith asked for Ms. Keogh’s opinion. Ms. Keogh responded that loan-level information was the appropriate best practice for credit ratings on structured securities, adding that she believed there should be broad disclosure of the information provided to the rating agencies. Ms. Keogh said that would result in unsolicited ratings, which would be good for the market, and would allow other market participants to perform their own analysis on the available information. She noted that their review was done at the loan level. She discussed DBRS also has a structured finance information review policy.

Mr. Fry asked Ms. Osborn to explain their capital model for their insurers, and asked how the ratings of the structured securities were factored into the ratings of the insurers. Ms. Osborn explained that they consider a wide range of asset classes in their analysis. They have used a RBC model since the mid-1990s and enhanced those factors in 2006, which incorporated a more updated view of volatility in all asset classes. The also make distinctions of maturity distributions within each of those asset categories. With respect to RMBS, recognizing the current stressed environment, S&P in February added incremental stresses to more than 80% of the insurers’ asset classes. This recognized that in the short-term, they have risks, but they are also engaging in additional risks on a daily basis. These stresses focused on the expected losses, based on regional classifications by using additional information from the issuers.

Director McRaith asked Mr. Teicher to explain the difference between creditworthiness and expected loss vs. the services that Moody’s provides. He noted that these were not different items, but rather different ways of describing the same process. To describe expected loss — which represents the combination of the probability of loss and how much is lost if a default occurs — is a way of measuring credit risk, because it represents the risk that not all contractual cash flows will be received as originally contemplated. Director McRaith noted that the distinction did not appear to be significant. Mr. Teicher responded that there are different ways of expressing opinions about credit.

Director McRaith asked Mr. Marks about one of his ideas for the industry to be able to collaborate on shared opinions on individual credit risks. Mr. Marks noted that he thought he heard in the first panel that this idea was turned down by the NAIC in the 1990s. He discussed that what this contemplates would be a less expensive way for regulators to approach this subject; i.e., if there was an independent referee that was not related to the industry. Many members of the industry prepare their own analysis, and what this idea contemplates is submitting this information to the SVO, and — to the extent there are differing views from different members of the industry — the SVO would act as that referee. The industry would still consider the agencies as one source of information, similar to an equity analyst opinion. Mr. Ronsner noted that a lot of the securities that are at the root of the issue are unique; therefore, the process suggested by Mr. Marks would not work.

Director McRaith asked Mr. Rosner to provide a comment on how much agencies should be relied on based on a scale from one to 100. Mr. Rosner noted that, if all of the information previously discussed was available to the general public, and the benchmark they use is also available, there would be no need for the rating agencies. He discussed the difficulty, however, with the agencies' models and benchmarks being available, noting that an investor could not use what they make available today and come to the same rating. He discussed that, if this occurred, the only question would be whether the regulators would retract that requirement. Mr. Rosner noted there would be no need for reliance. Mr. Fons agreed with Mr. Rosner, that if all of the information was publicly available, then the agencies would be redundant.

4. Panel 3: Recommendations and Alternatives to How the NAIC Uses Ratings

Written testimonies or presentations were submitted by Rod Dubitsky (PIMCO Advisory) (Attachment Four-B12) and Robert Dobilas (Realpoint LLC) (Attachment Four-B13). Oral presentations were provided by Mani Sabapathi (Prudential Insurance), Matt Richardson (New York University) (Attachment Four-B14), Heather Brilliant (Morningstar, Inc.) (Attachment Four-B15) and Michael Macchiaroli (SEC).

Mr. Sabapathi provided a different company perspective of the issue. He discussed the need for adequate capital charges to address risk. He discussed how RBC is based on ratings that are established using probability of loss, as opposed to severity of loss. He discussed the shortcomings of credit ratings for structured securities, noting the priorities given to senior securities over subordinate securities, and how the ratings on the two classes might be the same, even though the risk is much higher on the subordinate security. He noted that the ratings also do not reflect the risk associated with a comparable corporate security. Mr. Sabapathi discussed the ACLI proposal submitted to the Valuation of Securities (E) Task Force. He discussed that although the proposal from the ACLI only addresses RMBS, it could be modified to address other structured securities. He provided an overview of the ACLI proposal, noting that the regulators would be in control in developing the assumptions, and, ultimately, the RBC factors would be aligned with risk factors of the comparable corporate security based on loss expectations. He noted that, although the proposal would result in a decreased RBC for the industry as a whole, the NAIC might want to consider other similar changes in the future to better address the risk of subordination. He discussed the challenges faced by insurers in holding RMBS securities, and noted the impact this has had on the liquidity of the RMBS market.

Mr. Richardson restricted his comments to the question of whether ratings are sufficient to measure the credit risk of fixed-income securities. He said default risk, market risk and liquidity risk are the components of risk inherent in fixed-income securities. He stated that he did not believe that ratings on structured securities were comparable with corporate securities. Mr. Richardson stated that it was important for insurance regulators to realize that ratings are estimates — and that ratings of structured securities are inherently more volatile that corporate securities. He discussed how market risk was particularly high for a structured security, compared to a corporate security. With respect to liquidity risk, he noted that structured products are highly illiquid securities, even during the best of times. He concluded by stating that, even if all of the problems with the rating agency models were addressed, regulators must still consider the precision of the ratings and, more important, the liquidity and market risk of the security. He suggested that regulators develop tools to address each of these risks when considering how to reduce reliance on ratings, as each of these risks can impact an insurer when there are solvency concerns.

Ms. Brilliant discussed the services and history of Morningstar. She discussed how Morningstar's guiding principle was to put investors first, and how the current rating agency model did not align with that principle. She discussed the lack of true competition within the credit rating agency market, and how this issue needs to be addressed. She contrasted the business environment for Morningstar compared to the credit rating agencies, and the lack of choices in the latter. She discussed the use of ratings in banking and insurance RBC. She discussed the "economic moats" built around the rating agency models, and the resultant significant economic profits of the agencies. Ms. Brilliant contrasted the market's reaction to misguided opinions from stock analysts to the same from rating agencies. She discussed the systemic risk that can result from the actions of the agencies, because the three largest agencies generally follow each other in their actions. The agencies have become gatekeepers of what is allowable in the debt markets of the global economy. Ms. Brilliant stated that, if the goal of the insurance industry was to have better ratings, then Morningstar suggests diversifying the source of ratings. More specifically, she stated that Morningstar suggests the use of other rating agencies with different business models — such as companies that rely on market-based symbols, structural models or credit default swap spreads, as opposed to only traditional credit analysis — and encourages market participants who encourage more timely rating changes. She discussed how Congress and the SEC could not legislate good research, no matter how many rules are laid down for credit-rating firms or how many forms are required. She stated that the only way to address the errors that occur is to diversify ratings, and that the worst thing that could be done was to nationalize ratings. Ms. Brilliant discussed that competition would result in more recognition by the market of the agencies that produce the highest quality ratings, but new entrants to the market would only occur if changes were made. Ms. Brilliant stated that Morningstar proposed 1) elimination of the three-year waiting period to become an NRSRO and separate applications for separate product types (corporate, financial); 2) refrain from imposing additional red tape on the rating agencies; 3) allow all credit firms access to data to rate structured securities; and 4) continue to reduce references to NRSRO ratings in statutes and regulations.

Mr. Macchiaroli discussed his own views of the issue, noting they were not the official views of the SEC. He provided some history as an individual that had been with the SEC for some time. He said the term NRSRO was added in 1975, and the term "statistical rating organization" had already been in use. The SEC added "nationally recognized" in order to clarify the expectations, noting at that time there were only two rating agencies: Standard & Poor's and Moody's. He discussed that the term was added to help establish capital requirements for broker-dealers. He discussed that the term was not a problem until the U.S. Congress incorporated the term into the Secondary Mortgage Market Enhancement Act of 1984. He noted that the SEC warned Congress of the problem this would create. He noted that the SEC approached the securities firms to express their desire to remove the term, but the firms were opposed. The firms stated that the term was an objective way to calculate needed capital, despite the fact that the alternative might have reduced the firm's capital requirements. Mr. Macchiaroli stated that because of the action taken by Congress, companies began to apply to the SEC for NRSRO status. The SEC had no procedures for how to address the situation, but created a process whereby the SEC would not oppose the application if the broker-dealers relied on them. He stated that the SEC previously provided no action letters for a number of others, but many of those were purchased by other agencies. Despite efforts by the SEC to remove the term, they were unable to do so, and there were no changes to the system or processes until the adoption of the Credit Rating Agency Reform Act of 2006. That act was designed to increase competition, reduce conflicts of interest and increase transparency. He discussed changes recently made that will result in the required sharing of information by the issuer on structured securities with all agencies, to encourage unsolicited ratings. This was not extended to be broader, because that would constitute a public offering, and most of these deals are nonpublic. He noted that there were 10 NRSROs, seven of which were issuer-pay and the remaining three were subscriber-pay. The number of ratings by all of the agencies in 2008 was 3,123,748, with 98% of the ratings issued by three agencies. The number of analysts working at the rating agencies is 3,642. Approximately 90% of the agencies' revenues are created by the three largest agencies. He discussed that six of the broker-dealers determine their required capital based on internal models, and discussed the challenges created by such a method. He explained that the SEC never viewed that companies should rely on the agencies' ratings, and, at best, they should only be used as a comparison to their own analysis. He indicated that the SEC recently completed its annual report on the Credit Rating Agency Reform Act, noting that there are a number of user perspectives on Pages 19 and 20.

Superintendent Wrynn asked Mr. Macchiaroli to respond to the various rules within the SEC guidance and how the SEC justifies. Mr. Macchiaroli responded that he was only aware of two such references. The first is a net capital rule that was put in place for securities firms to assist examiners in their evaluation of the company's capital adequacy. The concern was mostly a resource issue, as the SEC did not believe they could review the internal models of all 200 firms with such models to determine their necessary capital. The SEC does review such models for the largest firms, but does not believe they would be able to do so for all 200 firms. He discussed that the securities firms actually wanted to keep this process, even though the use of the agencies requires more capital to be held than under an alternative internal model. Superintendent Wrynn noted that, as a result of the SEC's actions, the requirements are now included in investment guidelines, contracts and other areas. Mr. Macchiaroli noted that these things were in bylaws and contracts, and noted that the SEC picked up an exiting industry standard in 1975 and continued it because that is what the industry relied on, and the SEC made a decision to continue to rely on it. Mr. Macchiaroli said the SEC is expected to consider the deletion of the term NRSRO from all of its rules. He noted that there has been considerable opposition to this idea in the past, not because parties were partial to the agencies, but because these parties believed that the agencies knew more than they did. In summary, the use of NRSRO ratings has been incorporated to provide an objective standard for the companies that are regulated, even though they realize that utilizing such an approach requires them to hold more capital than under the alternative. Director McRaith asked Mr. Macchiaroli to clarify a statement he made relative to broker-dealers. Mr. Macchiaroli noted that some do not do their own credit analysis and, in his view, this is inadequate.

Commissioner Dilweg asked Mr. Macchiaroli to provide a better understanding of their oversight of the rating agencies. Mr. Macchiaroli responded that initially the SEC had no inspection authority over the agencies; despite their desire to have this authority from the day they began to regulate them. He discussed that, during this time, the SEC would inspect the agencies, but didn't have the authority to take any enforcement action. Mr. Macchiaroli noted the SEC now has rulemaking authority, as well as the authority to inspect and take enforcement action on a continuous basis, although they may not interfere with rating methodology.

Director McRaith asked Ms. Brilliant questions about her use of the word "competition" in her testimony. He asked if Morningstar was considering getting into the credit agency business. Ms. Brilliant responded it was something that Morningstar was considering, but they have to weigh all of the opportunities against the regulatory costs of doing so. She said she believed the NRSRO status should be eliminated altogether; if not, she said the three-year waiting period should be eliminated. Ms. Brilliant noted that she believed additional entrants to the marketplace would force the rating agencies to produce a better product, thereby improving the marketplace, because it would highlight those firms that rated issues higher than what was appropriate. Director McRaith asked Mr. Dobilas to provide comments on how additional entrants into the market would improve the product and asked what would drive competition. Mr. Dobilas stated that what he believed was occurring in the marketplace now is an evolution of the agencies, moving away from the reliance on two ratings is an improvement, and the SEC has done some things to improve the landscape. Mr. Dobilas stated that RMBS and CMBS are two different products, with different assumptions used to produce each type of rating. Mr. Dobilas noted that he believed the three-year rule was a good rule, because it helps identify those firms that really want to be in the business. He discussed that Realpoint had been in existence since 2001, and noted they did not apply to be an NRSRO until one year ago. He discussed that increasing competition would be valuable on the subscription model, as they are 100% compensated by the investors. It needs to be noted, he said, that a company can be successful using the subscription model. Ms. Brilliant stated that she believes if there were more companies like Realpoint, it would put more pressure on the big three to not let money drive the process. Mr. Dobilas agreed, noting that it would discourage rating shopping. He also noted that an important step in the process it to make sure the agencies are qualified — and he believes that some of the changes the SEC has made will improve the quality of ratings. Mr. Macchiaroli indicated that the SEC recently enacted a rule that every agency is now required to provide a history of ratings by looking at the transition on 10% of each class of rating. Director McRaith stated that the purpose of this hearing was to determine if and how state insurance regulators should reduce their reliance on ratings, and noted that he did not believe competition would help such a decision.

Director McRaith asked Mr. Richardson to provide additional details on the three areas of risk that regulators should consider in their processes. Mr. Richardson discussed default, market and liquidity risk. Director McRaith asked Mr. Richardson to describe which of those risks are addressed by the agencies, and to provide his opinion on whether the agencies adequately address those risks with their products. Mr. Richardson noted that default risk is the only one of the risks that are subject to review by the agencies, and that it is clear from this crisis that the agencies have not done a good job of addressing that risk. He discussed the "serious problems" inherent in the rating agency model, including the oligopoly of the NRSRO status, the conflict of interest in the issuer-pay model and the fact that the agencies are involved in the structuring of the securities themselves. He noted, however, that in the case of a complex structured security, it resembles a chaotic system, and such chaos is sensitive to initial values. He discussed the significance of insurer investments in bonds, and to have the opportunity to guide firms toward what is measurable.

Director McRaith asked Mr. Richardson to comment on what degree regulators should rely upon a product of the rating agencies, on a scale between 1 and 100. Mr. Richardson responded that he would try and fix the rating model first, because that would result in the ratings having some value. However, with respect to the ratings on structured securities, a lot of reliance cannot be put on them, because they are sensitive to too many unknown events. He stated that if insurance regulators' primary purpose is ensuring an insurance company's solvency, then the regulators have to put an asterisk on the rating of these types of securities, as well as liquidity risk and market risk. Superintendent Wrynn asked Mr. Richardson if the agencies could provide a product that addressed all three types of risks with respect to structured securities. Mr. Richardson replied that NYU currently attempts to measure default risk, liquidity risk was fairly measurable, but market risk was a bit "tricky". He noted that NYU's model needed to change to better address default risk. He commented that this most recent economic crisis has shown companies "trolling" to exploit capital requirements and that the regulator needs to be more involved to prevent that.

Director McRaith asked Mr. Dubitsky to respond to when he realized the structured security was an issue. Mr. Dubitsky responded that the amount of fraud in loans made during 2005 and 2006 made responding to this question difficult, but operating with changes in all of the inputs that go into a model subjects itself to potential problems. He stressed the need for more interaction in the monitoring of those models. Director McRaith asked Mr. Dubitsky if he believed the rating agencies have some responsibility to review the securities on a loan-by-loan review, as one of the other panelist suggested. Mr. Dubitsky agreed, noting that when he was at Moody's, they relied on representations and warranties. He stated that one problem was that there was no enforcement mechanism to question the information. More specifically, there was no independent party that policed the representation and warranties requirements of the seller. He explained that under these requirements, if it is found later that the characteristics of the loan are different than what was disclosed, the seller is required to buy the loan back. Mr. Dubitsky suggested that what the agencies should have done is to require someone independent from the investment banker and independent from the originator to review the loans, and then require the seller to buy them back when things were different than previously disclosed. This would have had the impact of reducing some of the fraud that occurred in 2005 and 2006. Mr. Dubitsky said he believed that the agencies should be basing their assumptions used in their models upon fact, and they should perform due diligence to ensure that a process exists that will result in accurate information being provided to them. He noted that the agencies had the ability to impose greater standards on the originator, but were not doing so.

Director McRaith asked Mr. Dubitsky to explain the issuer-pay/investor-select model that he favored. Mr. Dubitsky explained that the conflicts with the issuer-pay model were clear but, given that there are too many investors to support a issuer-pay model, the issuer-pay/investor-select model is based on the idea that the issuer selects one or two agencies, and the third agency has the opportunity to approve the agency, which takes the control away from the issuer. He noted that the issuer-pay model is easier if the conflicts could be addressed, whereas there were other problems with the investor-pay model. Director McRaith asked if these changes addressed issue regarding reliance on ratings. Mr. Dubitsky stated that, as a user of ratings, there probably is an over-reliance on ratings, but said he was unsure what the repercussions would be if ratings were completely eliminated. He stated that there was nothing that prevented companies from doing their own analysis and to dismiss the ratings from the agencies.

Director McRaith asked Mr. Sabapathi to provide his opinion on the requirement that an independent third party provide the assessment used under the ACLI proposal submitted to the NAIC. Mr. Sabapathi stated that he believed it was important for regulators to have a source to rely on. He discussed the need for an additional layer of review to make sure that what is produced makes sense, and he agreed that the use of agencies as another source of information was acceptable. Mr. Sabapathi discussed the need for the industry to understand the direction of the regulators. He discussed that macroeconomic drivers will impact what is developed by this independent body, and how there will be imperfections, but with the additional layer, regulators will have the ability to limit the impact. Director McRaith asked Mr. Sabapathi about Mr. Mark’s idea of having an independent third-party organization that is funded by the insurance industry. Mr. Sabapathi noted it was an idea to consider, but that he had concerns with regulatory reliance on one entity. He also noted that it was important for regulators to control the process, and suggested that an aggregation of views might be more appropriate. Director McRaith asked Mr. Sabapathi about his company’s ability to utilize loan-level information. Mr. Sabapathi noted that his firm does review loan-level information, or at least this has become a practice over the past few years, as more information became available. Director McRaith asked Mr. Sabapathi if he had any sense of the percentage of the ACLI members that would also be able to perform the same. Mr. Sabapathi responded that he could not answer that question, as he was not aware of those facts. He noted, however, that the industry exposure to RMBS shows that the industry’s exposure was primarily to the higher-quality loans, as the industry was concerned about the risks with some of the thinner mezzanine tranches.

Director McRaith asked Mr. Dobilas about a statement made in their press release from earlier this year about rating shopping. Mr. Dobilas responded that the information obtained initially was vast, but private, information. He discussed the information they receive, such as rent rolls, tenant information and price per square foot, which is information that borrowers would not want public and, therefore, would not be good for the capital markets. He discussed how he views an NRSRO as a gatekeeper of information, and distributor of information that can be used by market participants as information. He discussed that new issuers can no longer rating shop, but can now sell their product to investors. He discussed the need for investors to spend money to demand high-quality investment research. He also stated that he believed the new process from the SEC would result in a decrease in rating shopping.

Director McRaith asked Mr. Macchiaroli to provide any closing statements he would like to make. Mr. Macchiaroli discussed the introduction of language for rating agencies was to help to regulate securities firms. He noted that he was as concerned with this issue as the insurance regulators. Mr. Macchiaroli stated the SEC continues to use the term NRSRO for examination purposes, and also because the securities firms prefer its use, even though this requires them to hold higher capital than other internal models. He discussed that the rules the SEC have enacted relative to mark-to-market help to address some of the issues for securities firms. He suggested that corporate securities have not been a problem, and advised more focus on structured securities. Mr. Richardson agreed with Mr. Macchiaroli and stated that insurance regulators need to reduce their reliance on rating agencies.

5. Other Matters

Director McRaith indicated the Working Group would be receiving comments on the topics discussed during the hearing until Oct. 7, 2009. The Working Group received a comment letter from the American Academy of Actuaries (Attachment Four-B16)

Having no further business, the Rating Agency (E) Working Group adjourned.

W:\Dec09\Cmte\E\wg\Rating Agency\092409 Public Hearing.doc

National Association *of* Insurance Commissioners

2009 Fall National Meeting
Washington, DC

RATING AGENCY (E) WORKING GROUP HEARING
ROLE OF RATING AGENCIES IN STATE INSURANCE REGULATION
Thursday, September 24, 2009
8:30 a.m. – 4:00 p.m.
Gaylord Convention Center—Maryland Ballroom D—Ballroom Level

BIOGRAPHIES

PANEL 1: USE OF RATINGS IN STATE INSURANCE REGULATION

CHRIS EVANGEL
Managing Director
NAIC Securities Valuation Office

For the past decade, Chris Evangel has served as managing director of the NAIC Securities Valuation Office (SVO) in New York City. He oversees the entire SVO operation, including credit quality function, office administration, financial operations and the staff management of 50 employees. Evangel also serves as senior chair of the SVO Credit Committee.

Prior to joining the NAIC, Evangel was a senior vice president with Moody's Investors Service for nearly 15 years. While at Moody's, he served as a senior chairperson of the Moody's Rating Committee and headed several of Moody's regional credit groups. Prior to joining Moody's, Evangel was with the federal Office of Management and Budget (OMB) during the early 1980s and held oversight responsibilities for several bureaus of the U.S. Department of the Treasury and the U.S. Federal Emergency Management Agency (FEMA). Evangel also held the inaugural position as the operating budget manager for the New Jersey Transit Corporation (the state's mass transit agency.) Upon completing his graduate work, Evangel was selected as a presidential management intern and worked with the National Aeronautics and Space Administration (NASA) at the Kennedy Space Center in Florida.

Evangel earned a master in public administration (MPA) degree from Harvard University's John F. Kennedy School of Government and a bachelor's degree from Rutgers University.

NANCY BENNETT, FSA, CERA, MAAA
Senior Life Fellow
American Academy of Actuaries

Nancy Bennett is the senior life fellow for the American Academy of Actuaries. Bennett is responsible for helping communicate the Academy's message on life actuarial issues to the public and to public policymakers. Bennett interacts directly with federal and state regulatory and legislative officials, other public policy and trade organizations, and the news media on life insurance topics.

From 2005 to 2008, Bennett was employed by Ameriprise Financial, most recently as vice president and head of enterprise risk management. Bennett led the effort to implement Ameriprise's enterprise risk management processes. Ms. Bennett also had responsibility for several key risk management systems, including the company's corporate modeling system (MoSes). In addition, Ms. Bennett manages the company's interest rate risk (ALM). Previously, Ms. Bennett was responsible for managing Ameriprise's equity risks associated with variable annuities.

From 1999 to 2005, Bennett was a consulting actuary at Milliman, Inc., and Aon. Her consulting practice focused on financial risk management, including asset liability management, investment strategy development, corporate modeling, risk management and financial performance assessment. Bennett managed consulting engagements involving corporate modeling, such as investment strategy analysis, performance measurement, strategic projections, embedded value analysis, appraisals,

enterprise-wide financial analysis, cash-flow testing and profitability analysis based on transfer pricing. Bennett assisted companies in enhancing their financial management infrastructure by integrating their investment management, ALM and risk management, financial reporting, pricing, modeling and strategic planning processes.
Before that, Bennett was employed by Minnesota Mutual for 18 years. Following eight years in individual life product development and division management, Bennett built the company's Corporate Actuarial Department and was the company's appointed actuary. Bennett's responsibilities included cash-flow testing, strategic planning, capital budgeting and financial forecasting, the coordination of investment policy and product design, and the analysis of portfolio performance and interest rate risk. Bennett was responsible for overseeing the integration of financial management functions among all the Company's divisions. Bennett communicated with various groups including the company's Board of Trustees and rating agencies.

Bennett is a frequent speaker at industry conferences, the Society of Actuaries (SOA) and NAIC meetings. Bennett is a member of the American Academy of Actuaries (AAA) Life Practice Council, chair of the AAA Life Capital Adequacy Subcommittee, chair of the AAA Stochastic Modeling Group, chair of the AAA Economic Scenario Implementation Work Group, chair of the AAA Invested Asset Work Group and a member of several other AAA groups, including the Principle-Based Approaches Steering Committee, Risk Management & Solvency Committee, Financial Regulatory Reform Task Force, Public Interest Committee and Federal Agenda Task Force. Bennett was elected to the SOA Investment Council for the 2004–2007 term. Bennett also has been involved with organizing seminars for the SOA, including serving as chairperson of the 2006 and 2007 SOA Investment Symposium.

Bennett earned a bachelor's degree in mathematics and economics from the University of Northern Iowa. She has been a fellow in the SOA since 1988, a member of the AAA since 1989 and a chartered enterprise risk analyst since 2008.

MICHAEL MORIARTY
Deputy Superintendent
New York State Insurance Department

Michael Moriarty is the deputy superintendent for property and capital markets, with responsibilities that include overseeing the licensing, examination and regulation of all property/casualty insurers and related entities, as well as oversight of the capital markets and risk-management activities of insurance companies. Deputy Superintendent Moriarty also oversees the regulation of captive insurance companies in New York. As deputy superintendent, he has played an integral role in issues arising from the financial crisis, including the restructuring of bond insurers and American International Group (AIG).

Deputy Superintendent Moriarty began his career at the department in 1979, after earning a bachelor's degree in accounting from the City University of New York. Since then, he has served in a number of positions, most recently as director of the department's Capital Markets Bureau. The Capital Markets Bureau has been operational since 2000 and oversees the capital markets and risk-management activities of New York-licensed insurers.

He has worked on the development of new initiatives to enhance the financial solvency oversight of licensed insurers in New York, including accelerating the trend toward reliance on risk-based analyses/examinations and coordinating the department's policy on investments, derivatives and insurance securitization. Prior to that, Deputy Superintendent Moriarty served as the assistant chief examiner of the Property Bureau. In that position, he coordinated the financial analysis of the property/casualty industry in New York.

Deputy Superintendent Moriarty actively participates in task forces and working groups of the NAIC. He represented New York as chair of the Risk Assessment Working Group, which developed the national risk-focused approach to financial solvency regulation, and as chair of the Valuation of Securities Task Force, which establishes policy on the regulation of insurance industry investments. Deputy Superintendent Moriarty was the 2005 recipient of the NAIC Robert Dineen Award for outstanding service and contribution to the state regulation of insurance, the most prestigious honor bestowed by the NAIC to an individual.

National Association *of* Insurance Commissioners

ERIC STEIGERWALT
Senior Vice President and Chief Financial Officer
Metropolitan Life Insurance Company

Eric Steigerwalt is senior vice president and chief financial officer for the U.S. business organization at MetLife. Appointed to this position in August 2009, Steigerwalt is responsible for the financial management of MetLife's domestic protection, retirement, corporate benefit and auto & home businesses.

Prior to his current role, Steigerwalt was MetLife's treasurer since April 2007. He was responsible for managing the company's liquidity and capital positions, risk-based capital analysis, capital planning, cash management and investor and rating agency relations.

From 2003 to 2007, Steigerwalt was chief financial officer for MetLife's individual business. In this role, he had responsibility for the division's financial plan, earnings analysis, pricing oversight, expense management, distribution finance and financial projections.

Previously, Steigerwalt was vice president, investor relations, and was heavily involved in the company's initial public offering in 2000. Prior to MetLife's IPO, he managed many of the operational aspects of MetLife's demutualization and coordinated financial management initiatives in preparation for public company financial reporting.

Before joining MetLife, Steigerwalt was vice president of investor relations at the Equitable Companies. In this position, he was responsible for the company's interaction with the Wall Street community, including equity holders, debt holders and research analysts.

Steigerwalt began his career with Fossett Corporation in 1985. He was a derivatives firm trader in addition to his role as an options specialist on the New York and American Stock Exchanges.

Steigerwalt graduated *cum laude* from Drew University with a bachelor's degree in economics.

BIRNY BIRNBAUM
Consulting Economist
Center for Economic Justice

Birny Birnbaum is a consulting economist and former insurance regulator whose work focuses on community development, economic development and insurance issues. Birnbaum has served as an expert witness on a variety of economic and actuarial insurance issues in California, New York, Texas and other states. Birnbaum serves as an economic adviser to and executive director for the Center for Economic Justice (CEJ), a nonprofit organization whose mission is to advocate on behalf of low-income consumers on issues of availability, affordability and accessibility of basic goods and services, such as utilities, credit and insurance.

Birnbaum has authored reports on insurance markets, insurance credit scoring, insurance redlining, title insurance and credit insurance for CEJ and other organizations. He serves on the NAIC Consumer Board of Trustees. Birnbaum has been particularly active on issues involving credit and insurance availability, including credit insurance, insurance credit scoring and territorial rating. He has authored reports to numerous public agencies, including the California Department of Insurance, the Florida Insurance Commissioner's Task Force on Credit Scoring, the Ohio Civil Rights Commission and the cities of New York and Philadelphia. Birnbaum served for three years as associate commissioner for policy and research and as chief economist at the Texas Department of Insurance. At the department, Birnbaum provided technical and policy advice to the commissioner and performed policy research and analysis for the department. Birnbaum also was responsible for the review and approval of rate filings for auto, homeowners and credit insurance. Prior to joining the department, Birnbaum was chief economist at the Office of Public Insurance Counsel (OPIC), working on a variety of insurance issues. OPIC is a Texas state agency whose mission is to advocate on behalf of insurance consumers.

NAIC National Association of Insurance Commissioners

Prior to OPIC, Birnbaum was a consulting economist working on community and economic development projects. He also worked as business and financial analyst for the Port Authority of New York and New Jersey.

Birny earned a bachelor's degree from Bowdoin College and two master's degrees from the Massachusetts Institute of Technology (MIT), in Urban Management and Urban Planning with concentrations in finance and applied economics.

PANEL 2: RATING AGENCIES – WHAT HAPPENED?

DAVID TEICHER
Managing Director
Moody's

David Teicher directs a team of rating agency professionals who implement regulation at Moody's Investors Service. Previously, Teicher headed Moody's residential mortgage-backed securities (RMBS) team. Prior to that, Teicher was head of the collateralized debt obligation (CDO) surveillance team. He joined Moody's in 1996 as an analyst on the RMBS team and later moved to the derivatives group. Before coming to Moody's, Teicher practiced law in-house and in private practice. He earned a law degree and an MBA from the University of Chicago and earned a bachelor's degree in physics from Wesleyan University.

GRACE OSBORN
Managing Director
North American Head of Insurance Ratings
Standard & Poor's

Grace Osborne is a managing director in financial institutions ratings. As the lead analytical manager of North American insurance ratings, Osborne leads a team of 70 professionals who provide ratings and credit analysis on insurance and reinsurance companies and their related debt, health plans, insurance-linked securities and natural peril catastrophe bonds. Osborne joined Standard & Poor's in 1996 after 13 years in various financial reporting and planning roles in the life and property/casualty insurance industry. She also worked on the audit staff for Peat, Marwick, Mitchell (predecessor to KPMG Peat Marwick). Osborne graduated *summa cum laude* with a bachelor's degree in accounting from Fordham University and is a certified public accountant.

KEITH BUCKLEY
Group Managing Director
Head of Insurance Group
Fitch Ratings

Keith Buckley is group managing director of Fitch Ratings' global insurance rating group. The global insurance group includes 80 professionals who provide financial strength ratings for life/annuity, property/casualty, financial guaranty, health/HMO/managed care, title and mortgage insurers, fixed-income ratings for insurance holding company debt, hybrid securities, preferred stock and commercial paper programs, and ratings of insurance-linked securitizations. Buckley also is a member of Fitch's Corporate Finance Criteria Committee. He was a senior vice president and head of U.S. insurance for Duff & Phelps Credit Rating Co.'s insurance rating group prior to its merger with Fitch IBCA. Prior to joining the firm, Buckley served as director of financial analysis for Shand Morahan & Co., where his duties included security reviews of insurance and reinsurance companies, and rating agency presentations. He has been an insurance analyst since 1984. Keith earned a bachelor's degree in finance, with highest departmental distinction, from the University of Illinois and holds the chartered financial analyst designation. He is a member of the CFA Institute and CFA Society of Chicago.

NAIC National Association *of* Insurance Commissioners

JOHN OLERT
Group Managing Director
Head of ABS and Structured Credit Group
Fitch Ratings

John Olert is a group managing director and head of the U.S. asset-backed securities and structured credit group at Fitch Ratings. Olert led the updating of Fitch's criteria across structured credit in 2008, was co-head of Fitch's corporate finance group for the Americas and has served as a member of Fitch's Credit Policy Board. Previously, Olert served as co-head of Fitch's North American financial institutions group, after leading Fitch's finance and leasing team and its efforts in rating U.S. real estate companies, real estate investment trusts and related transactions. Earlier, he analyzed and rated domestic money centers and regional and community banks. Before joining Fitch in 1995, Olert was a second vice president at Chase Securities Inc., where he handled credit analysis and approval for fixed-income counterparties. His earlier responsibilities included credit analysis and portfolio administration of domestic financial institutions at Chase Manhattan Bank. He also completed Chase's wholesale credit training program. Olert has completed Harvard Business School's Advanced Management Program, earned an MBA in finance from Fordham University, and earned a bachelor's degree in finance from the State University of New York at Geneseo's Jones School of Business.

MARY KEOGH
Managing Director
Global Regulatory Affairs
DBRS

As managing director, global regulatory affairs, Mary Keogh is responsible for leading global legislative and regulatory initiatives that impact DBRS. This includes obtaining and maintaining global regulatory approvals and recognitions and for relationship management with legislators, regulators, trade organizations and other policymakers in Canada, United States, Europe and other jurisdictions. Keogh also assists in ensuring DBRS' governance framework continually reflects regulatory requirements and best business practices to meet high standards of independence, integrity and transparency.

Before joining DBRS in November 2004, Keogh was a financial services advisor at PricewaterhouseCoopers in the areas of regulatory compliance, risk management and the federal Sarbanes-Oxley Act of 2002. Prior to that, Keogh spent 11 years at CIBC, one of Canada's leading banks, in a number of progressively senior roles — including vice president of the fixed-rated investment portfolio business, global regulatory compliance, operational risk management, corporate lending and management and financial reporting.

Keogh earned a bachelors degree in commerce (with honors) from the University of Toronto and is a chartered accountant in Canada. She also sits on the User Advisory Council for the Canadian Accounting Standards Board.

JOSH ROSNER
Managing Director
Graham Fisher & Co.

Joshua Rosner is managing director at independent research consultancy Graham Fisher & Co., where he advises regulators and institutional investors on housing and mortgage finance issues. Previously, he was managing director of financial services research for Medley Global Advisors and was an executive vice president at CIBC World Markets. Rosner was among the first analysts to identify operational and accounting problems at the government-sponsored enterprises and one of the earliest in identifying the peak in the housing market, the likelihood of contagion in credit markets and the weaknesses in the credit rating agencies' assumptions for collateralized debt obligations (CDOs).

Rosner's work on the government-sponsored housing enterprises, credit rating agencies and mortgage markets has resulted in invitations to present to the Forecasters Club of New York, Professional Risk Managers International Association, ABSummit Geneva, National Association of Business Economists, Financial Roundtable, American Enterprise Institute,

National Association *of* Insurance Commissioners

American Real Estate and Urban Economics Association, Global Fixed Income Institute, CFA Institute, Hudson Institute, The New America Foundation, The Chicago Fed Annual Bank Structure Conference, The Institutional Investor Legal Forum and Fixed Income Forum. He regularly presents his research to leading global policy makers, legislators, central bankers and regulators. Rosner has authored several papers on housing, structured securities and rating agencies. He has been interviewed on PBS, CNBC, Bloomberg, NBC, CBS and is frequently quoted in other national news outlets.

JEROME FONS
Principal
Fons Risk Solutions

Jerome Fons, Ph.D., is principal of Fons Risk Solutions, a firm providing advisory services in the areas of measuring and pricing credit risk, developing statistical credit risk models, and Basel II implementation. Fons also advises asset managers on investment strategies with respect to rating agencies. Prior to starting his own firm in August 2007, Mr. Fons was the managing director of credit policy at Moody's Investor Service. He was chair of Moody's Fundamental Credit Committee, a member of Moody's Credit Policy Committee and a member of Moody's Country Risk Committee. Fons joined Moody's in 1990 as vice president/economist. At that time, he authored Moody's corporate bond default studies, served as the chief mortgage economist for the MBS group, developed a rating methodology for structured finance products, and assigned and monitored ratings for MBS.

DAVID P. MARKS
Executive Vice President and Chief Investment Officer
CUNA Mutual Group

David Marks is the chief investment officer for CUNA Mutual Group and CUNA Mutual Life Insurance Company. He also serves as the president and chief investment officer for MEMBERS Capital Advisors, the registered investment advisor affiliate of CUNA Mutual Group.

Marks came to CUNA Mutual Group in September 2005 from Citigroup Insurance Investments, where he was chief investment officer and senior executive vice president. While there, he led a staff of nearly 300 that tended $55 billion in global assets under management.

Prior to his work with Citigroup, he was the chief investment officer for CIGNA Corporation, where he oversaw the management of $44 billion in assets for insurance and third-party clients. Before that, he was a partner in buy-out firm Green Mountain Partners. From 1991 to 2001, he was president and chief investment officer for Allianz of America, where he managed $25 billion in assets for Allianz's North American institutional clients and pension plan sponsors.

Marks earned a bachelor's degree and a master's degree from the University of Connecticut. He also earned an executive MBA from the Tuck Business School at Dartmouth College.

PANEL 3: RECOMMENDATIONS AND ALTERNATIVES TO HOW THE NAIC USES RATINGS

MANI SABAPATHI, CFA, FSA
Principal Structured Product Research
Prudential Insurance

Mani Sabapathi is principal in Prudential Fixed Income Management's Structured Product Research Team, responsible for a portfolio of subprime home equity and non-agency securities. He has been investing in ABS securities since 1998, prior to which he worked in various areas in Prudential under a management development program for four years. Sabapathi serves on the board of directors of the American Securitization Forum, representing investor interests. In April 2008, Sabapathi was nominated for "Investor of the Year" by *Total Securitization & Credit Investment* magazine, a division of *Institutional Investor*, for being a "tireless and outspoken advocate for investor interests through the American Securitization Forum and

NAIC National Association of Insurance Commissioners

other venues." In addition to being invited to speak at industry conferences, Sabapathi has been sought by policymakers (including the Financial Accounting Standards Board, Federal Deposit Insurance Corporation and U.S. Treasury Department) to provide feedback regarding investor views and the implications of policy actions on the securitization market. He earned a bachelor's degrees in systems engineering and finance, as well as a master's degree in computer science, from the University of Pennsylvania. He also is a chartered financial analyst (CFA) and a fellow of the Society of Actuaries.

ROD DUBITSKY
Executive Vice President
PIMCO Advisory

Rod Dubitsky is an executive vice president and global structured finance specialist at PIMCO Advisory. Prior to joining PIMCO in 2009, he was managing director and head of asset-backed securities research at Credit Suisse, where he helped create residential mortgage-backed securities (MBS) surveillance and analytics systems. He was ranked as a leading analyst in asset-backed securities by *Institutional Investor* magazine from 2002 through 2008. Dubitsky was previously a senior analyst focusing on MBS at Moody's Investors Service and an agency MBS portfolio manager at BankAmerica. Before that, he was chief investment officer of a savings and loan and also worked at the U.S. Office of Thrift Supervision during the savings and loan crisis. He has 22 years of investment experience and holds an MBA from the Fuqua School of Business at Duke University and a bachelor's degree from the State University of New York, Binghamton.

ROBERT DOBILAS
President and CEO
Realpoint LLC

Rob Dobilas is chief executive officer and president of Realpoint LLC. Dobilas is an active participant in regulatory- and industry-sponsored efforts focused on rating agency reform. Most recently, Rob participated in the U.S. Securities and Exchange Commission's "Roundtable on the Oversight of Credit Ratings Agencies," and testified at the hearing on "Approaches to Improving Credit Rating Agency Regulation" before the U.S. House of Representatives' Financial Services Committee Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises. Before becoming CEO of Realpoint, Dobilas was the managing director in charge of business development, technology and sales for Capmark Investments, formerly GMAC Institutional Advisors. During his tenure at Capmark, Dobilas created and managed the Realpoint division, which eventually became Realpoint LLC. Prior to joining GMAC in 2000, Dobilas was a senior associate in Donaldson, Lufkin & Jenrette's (DLJ) Real Estate Research Group. While at DLJ, Dobilas was responsible for analyzing and researching all types of real estate debt securities, including commercial mortgage-backed securities (CMBS) and real estate investment trust (REIT) debt. He also was instrumental in the development and implementation of new product lines, such as a small balance loan program and the introduction of environmental insurance to the CMBS industry. Prior to joining DLJ, Dobilas was an associate in the Real Estate Finance Group at Standard & Poor's. He was responsible for evaluating and structuring CMBS and developing proprietary software models for debt sizing, loss analysis, underwriting, collateral valuations and surveillance deal tracking. Dobilas earned a bachelor's degree in economics from Rutgers University and an MBA from Monmouth University.

MATTHEW RICHARDSON
Professor of Applied Financial Economics
Charles E. Simon Professor of Financial Economics, Director, Salmon Center
New York University

Matthew Richardson is the Charles E. Simon Professor of Applied Economics in the Finance Department at the Leonard N. Stern School of Business at New York University. He is the Sidney Homer Director of the Salomon Center, which is a leading financial research center. In addition, he is a research associate of the National Bureau of Economic Research.

National Association *of* Insurance Commissioners

Richardson teaches classes at the MBA, executive and doctorate level. His MBA classes cover the area of fixed income. He is serving, or has served, as associate editor for the *Review of Financial Studies*, *Journal of Finance* and *Journal of Financial and Quantitative Analysis*. He has published papers in a variety of academic journals, including, among others, *Journal of Finance*, *Journal of Financial Economics*, *Review of Financial Studies* and *American Economic Review*.

Richardson earned a bachelor's degree and a master's degree in economics concurrently at the University of California, Los Angeles. He earned a doctorate degree in finance from the Graduate School of Business at Stanford University.

HEATHER BRILLIANT, CFA
Director of Stock Analysis
Morningstar, Inc.

Heather Brilliant is the director of equity analysis at Morningstar, Inc. She returned to Morningstar in 2005 after having spent a year as a senior equity research analyst at Coghill Capital Management. Before originally joining Morningstar in 2003, she spent several years as a research associate covering European and Canadian equities at Driehaus Capital Management, and two years as a corporate finance analyst at Bank of America. Brilliant holds a bachelor's degree in economics from Northwestern University and an MBA from the University of Chicago Graduate School of Business. She also is a chartered financial analyst.

MICHAEL MACCHIAROLI
Associate Director
Division of Trading and Markets
United States Securities and Exchange Commission

Michael Macchiaroli is associate director, Office of Risk Management & Control, Division of Trading and Markets, U.S. Securities and Exchange Commission. He is responsible for the broker-dealer financial responsibility program, which deals with capital recordkeeping, reporting and customer-protection rules. Macchiaroli joined the SEC in 1970 and has worked in the Division of Trading and Markets since 1978. Macchiaroli is a graduate of St. Joseph's College in Philadelphia and Villanova College.

W:\Dec09\Cmte\E\wg\Rating Agency\Att B01 RAWG Hearing 092409 Bios.doc

Rating Agency (E) Working Group of the Financial Conditions (E) Committee

A Public Hearing –
The Role of Ratings in Insurance Regulation
September 24, 2009

Panel 1 – NAIC Use of Ratings In Regulation

Chris Evangel, Managing Director, SVO
CEvangel@naic.org
212 386-1920

The Securities Valuation Office (SVO)

- Is the professional staff of the VOS Task Force
- Does the day-to-day work of analyzing, classifying, and pricing securities
- Insurers are required to report all securities not rated by an NRSRO
- Conducts Investment Research
- Investment experts for State Insurance Regulators
- Located at 48 Wall Street, NYC
- Provides a number of services to state insurance regulators.

Staffing

FTE 2008 – 48

- Average Tenured SVO Analyst
  - Work Experience: 25+ years
  - Financial Services Experience: 20+ Years
- Example of Prior work experience:
  - Standard & Poor's, Moody's, FitchRatings, Citibank, JP Morgan Chase, Merrill Lynch, Credit Suisse, NY State Department of Insurance

Purposes and Procedures Manual of the NAIC SVO

- Instructions of the Task Force to the SVO and the Industry
- Administrative Instructions of SVO to Industry
- Explains analytical methodologies
- Official NAIC communication

Operational Comparison of Transparency NRSRO and SVO Existing Business Model

NRSROs

- Capital market pre-purchase focus
- Capital allocation function
- Global/national coverage
- Credit ratings only
- Obtains information from the issuer
- Structures trans. w issuer advisors
- Sells subscriber services
- Monitors all markets & developments
- Regulatory objectives do not inflect analysis
- Benefits from federal securities laws exemption
- Enjoys 1st Amendment privileges – shields from tort liability
- Regulatory framework in transition

SVO

- Regulatory post-purchase focus
- Limited state insurance financial solvency role
- Ratings, classification, valuations, portfolio analysis, other
- Information provided by insurer – including its own analysis
- Distribution to NAIC community
- No monitoring of capital markets
- State regulatory objectives are relevant to and inflect analytics
- Never positioned and not structured as financial newspaper
- Not in legal relationship with insurer

5

SVO Designations and NRSRO Rating Equivalents

External Rating	NAIC Designation
AAA to A-	1
BBB+ to BBB-	2
BB+ to BB-	3
B+ to B-	4
CCC+ to CCC-	5
CC+ to D	6

6

Risk Based Capital Reserve Requirements (Percent)

Class	*Life*	*P/C*	*Tax-Adjusted % Difference*
NAIC 1	0.4%	0.3%	0%
NAIC 2	1.3%	1.0%	0%
NAIC 3	4.6%	2.0%	70%
NAIC 4	10.0%	4.5%	64%
NAIC 5	23.0%	10.0%	70%
NAIC 6	30.0%	30.0%	-27%

Source: NAIC Life Risk Based Capital Report: Overview and Instructions for Companies, 11/8/2007;
NAIC Property/Casualty Risk Based Capital Report: Overview and Instructions for Companies, 11/8/2007

7

Distribution Of Issuers by Designation Filing Exempts (FEs) - All

	12/31/2007	12/31/2008	**2007 vs. 2008**
Designation	**Total**	**Total**	**Change**
1FE	90.8%	82.3%	-9.7%
2FE	5.1%	11.6%	125.9%
3FE	1.6%	1.9%	14.6%
4FE	1.3%	1.5%	10.1%
5FE	0.7%	1.2%	61.2%
6FE	0.4%	1.6%	290.4%
Overall Totals	**100%**	**100%**	**-0.4%**

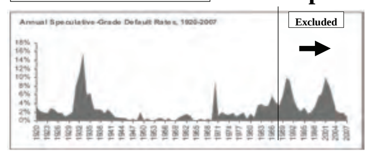
8

Distribution Of Issuers by Designation Filing Exempts (FEs) – Municipals Excluded

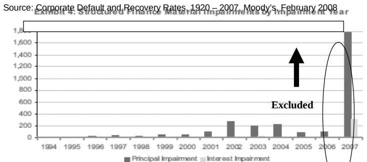
	12/31/2007	12/31/2008	**2007 vs. 2008**
Designation	**Total**	**Total**	**Change**
1FE	73.8%	64.8%	- 11.3%
2FE	13.5%	15.7%	17.0%
3FE	5.0%	5.7%	15.2%
4FE	4.3%	4.8%	11.1%
5FE	2.0%	3.8%	91.6%
6FE	1.3%	5.3%	312.4%
Overall Totals	**100%**	**100%**	**1.0%**

9

Default Rate Assumptions of Risk-Based Capital



Source: Corporate Default and Recovery Rates, 1920 – 2007, Moody's, February 2008



Stress Test Captures Increased Present vs. Past Corporate Default Rates

Stress Test <u>Does Not</u> Capture Structured Finance Default Rates

Source: Default and Loss Rates of Structured Finance Securities, 1993 – 2007, Moody's, July 2008

10

Insurers' Securities Held Year-End 2008

- **Value of Securities Rated by NRSROs –Filing Exempt (FE)**

Industry	Corporate	Municipal	Structured	Total
$ Millions:				
Life	$1,090,414.4	$ 37,432.6	$336,198.2	$1,464,045.3
P&C	$ 292,981.7	$ 375,723.3	$ 63,362.8	$ 732,067.7
F,H&T	$ 60,508.8	$ 14,335.8	$ 12,803.8	$ 87,668.0
FE Total:	**$1,443,904.9**	**$ 427,491.7**	**$412,364.8**	**$2,283,781.0**

- **Value of Securities Rated by NAIC/SVO – VOS**

	Corporate	Municipal	Structured	Total
Life	$ 350,979.2	$ 728.5	$ 9,815.7	$ 361,523.5
P&C	$ 96,462.5	$ 4,398.0	$ 63,362.8	$ 101,584.6
F,H&T	$ 16,914.6	$ 82.8	$ 12,803.8	$ 29,801.2
SVO Total:	**$ 464,356.3**	**$ 5,208.7**	**$412,364.8**	**$ 480,388.8**

11

Percentage of Insurer Fixed Income Assets Rated by NRSROs

NRSRO	Total Securities	**NRSRO Only Rated Issues & Issuer**	Exposure NRSRO Only	**%Rating Total / Sole Rater**
Moody's	183,182	33,272/7,998	$66.4 Billion	77.4% /14.1%
S&P	154,788	13,503/5,441	$88.0 Billion	65.4% / 5.7%
Fitch	100,573	4,526/1,408	$19.1 Billion	42.5% / 1.9%
DBRS	8,451	1,317/287	$5.6 Billion	3.6% / 0.5%

12

Surveillance Report on Rating Migration
Changes from YE 2007 to YE 2008

Corporate Industrial Bonds

% of # Issues

From / To	1	2	3	4	5	6	
1	**88.87%**	7.46%	0.70%	0.48%	0.51%	1.98%	100.00%
2	2.71%	**91.71%**	3.60%	0.35%	0.46%	1.18%	100.00%
3	0.28%	9.08%	**64.81%**	7.00%	4.92%	13.91%	100.00%
4	0.00%	0.54%	9.23%	**65.34%**	19.74%	5.15%	100.00%
5	0.00%	0.00%	0.28%	8.40%	**74.51%**	16.81%	100.00%
6	0.00%	0.00%	0.00%	0.00%	2.56%	**97.44%**	100.00%

2008 YE $

From / To	1	2	3	4	5	6	Total
1	**$573,614.7**	$39,632.3	$1,537.9	$308.9	$204.7	$401.6	$615,700.3
2	$13,429.6	**$345,863.7**	$9,631.9	$139.7	$334.7	$41.3	$369,441.0
3	$21.6	$4,921.4	**$29,397.6**	$2,421.9	$1,228.2	$559.3	$38,549.8
4	$0.0	$218.6	$3,461.1	**$16,123.7**	$2,368.4	$163.8	$22,335.6
5	$0.0	$0.0	$16.6	$670.2	**$3,277.1**	$175.4	$4,139.3
6	$0.0	$0.0	$0.0	$0.0	$0.2	**$26.3**	$26.4
						$1,373.7	**$1,050,192.3**

NAIC National Association of Insurance Commissioners 13

Surveillance Report on Rating Migration
Changes from YE 2007 to YE 2008

Structured Securities

% of # Issues

From / To	1	2	3	4	5	6	
1	**87.67%**	5.19%	2.22%	2.11%	1.60%	1.20%	100.00%
2	2.51%	**76.13%**	6.37%	3.69%	3.31%	8.00%	100.00%
3	0.19%	3.00%	**66.42%**	6.00%	4.32%	20.08%	100.00%
4	0.00%	0.00%	0.96%	**60.45%**	9.32%	29.26%	100.00%
5	0.00%	0.00%	0.85%	2.54%	**52.54%**	44.07%	100.00%
6	0.00%	0.00%	0.00%	0.50%	0.50%	**99.00%**	100.00%

2008 YE $

From / To	1	2	3	4	5	6	Total
1	**$434,308.7**	$21,705.7	$5,863.7	$4,791.5	$2,691.2	$429.7	$469,790.6
2	$1,065.8	**$32,153.6**	$1,155.5	$136.2	$165.2	$51.3	$34,727.5
3	$1.0	$366.3	**$1,909.8**	$125.4	$15.4	$54.2	$2,472.0
4	$0.0	$0.0	$15.2	**$617.0**	$68.8	$22.2	$723.3
5	$0.0	$0.0	$0.2	$2.3	**$174.3**	$16.3	$193.0
6	$0.0	$0.0	$0.0	$7.3	$2.2	**$105.2**	**$114.8**
						$684.9	**$508,021.2**

NAIC National Association of Insurance Commissioners 14

Surveillance Report on Rating Migration
Changes from YE 2007 to YE 2008

Corporate Industrial Bonds

2008 YE $

From / To	1	2	3	4	5	6	Total
1	**$573,614.7**	$39,632.3	$1,537.9	$308.9	$204.7	$401.6	$615,700.3
2	$13,429.6	**$345,863.7**	$9,631.9	$139.7	$334.7	$41.3	$369,441.0
3	$21.6	$4,921.4	**$29,397.6**	$2,421.9	$1,228.2	$559.3	$38,549.8
4	$0.0	$218.6	$3,461.1	**$16,123.7**	$2,368.4	$163.8	$22,335.6
5	$0.0	$0.0	$16.6	$670.2	**$3,277.1**	$175.4	$4,139.3
6	$0.0	$0.0	$0.0	$0.0	$0.2	**$26.3**	$26.4
						$1,373.7	**$1,050,192.3**

Structured Securities

2008 YE $

From / To	1	2	3	4	5	6	Total
1	**$434,308.7**	$21,705.7	$5,863.7	$4,791.5	$2,691.2	$429.7	$469,790.6
2	$1,065.8	**$32,153.6**	$1,155.5	$136.2	$165.2	$51.3	$34,727.5
3	$1.0	$366.3	**$1,909.8**	$125.4	$15.4	$54.2	$2,472.0
4	$0.0	$0.0	$15.2	**$617.0**	$68.8	$22.2	$723.3
5	$0.0	$0.0	$0.2	$2.3	**$174.3**	$16.3	$193.0
6	$0.0	$0.0	$0.0	$7.3	$2.2	**$105.2**	**$114.8**
						$684.9	**$508,021.2**

NAIC National Association of Insurance Commissioners 15

Surveillance Report on Rating Migration
Changes from YE 2007 to YE 2008

Corporate Industrial Bonds

% of # Issues

From / To	1	2	3	4	5	6	
1	**88.87%**	7.46%	0.70%	0.48%	0.51%	1.98%	100.00%
2	2.71%	**91.71%**	3.60%	0.35%	0.46%	1.18%	100.00%
3	0.28%	9.08%	**64.81%**	7.00%	4.92%	13.91%	100.00%
4	0.00%	0.54%	9.23%	**65.34%**	19.74%	5.15%	100.00%
5	0.00%	0.00%	0.28%	8.40%	**74.51%**	16.81%	100.00%
6	0.00%	0.00%	0.00%	0.00%	2.56%	**97.44%**	100.00%

Structured Securities

% of # Issues

From / To	1	2	3	4	5	6	
1	**87.67%**	5.19%	2.22%	2.11%	1.60%	1.20%	100.00%
2	2.51%	**76.13%**	6.37%	3.69%	3.31%	8.00%	100.00%
3	0.19%	3.00%	**66.42%**	6.00%	4.32%	20.08%	100.00%
4	0.00%	0.00%	0.96%	**60.45%**	9.32%	29.26%	100.00%
5	0.00%	0.00%	0.85%	2.54%	**52.54%**	44.07%	100.00%
6	0.00%	0.00%	0.00%	0.50%	0.50%	**99.00%**	100.00%

NAIC National Association of Insurance Commissioners 16

Report on Rating Migration

Structured Securities YE ''08 to September '09

% of # Issues							
From / To	1	2	3	4	5	6	
1	**70.78%**	8.42%	5.63%	5.15%	7.49%	2.53%	100.00%
2	0.96%	**46.66%**	9.23%	13.76%	17.76%	11.64%	100.00%
3	0.10%	0.76%	**33.75%**	11.69%	22.24%	31.46%	100.00%
4	0.12%	0.12%	0.36%	**26.02%**	29.26%	44.12%	100.00%
5	0.00%	0.00%	0.00%	0.00%	**24.27%**	75.73%	100.00%
6	0.00%	0.00%	0.11%	0.00%	0.22%	**99.67%**	100.00%

2008 YE $							
From / To	1	2	3	4	5	6	Total
1	**$345,923.1**	$26,539.6	$17,524.3	$16,273.9	$25,442.1	$4,792.3	$436,495.4
2	$1,082.7	**$33,653.3**	$2,540.8	$5,188.9	$7,360.1	$2,374.0	$52,199.9
3	$4.2	$64.5	**$2,630.0**	$948.4	$2,748.7	$2,541.5	$8,937.3
4	$41.0	$69.8	$0.7	**$1,184.3**	$2,388.9	$2,325.1	$6,009.6
5	$0.0	$0.0	$0.0	$0.0	**$1,132.0**	$2,064.8	$3,196.8
6	$0.0	$0.0	$23.9	$0.0	$4.9	**$659.9**	**$688.7**
						$14,763.6	**$507,527.6**

NAIC National Association of Insurance Commissioners 17

2004-2006 Industrial Median Averages
NAIC Rated vs. S&P Rated

Designation	No. of Companies	As % of Total	EBITDA/ Int	EBIT/ Int	FFO/Debt %	Debt/EBITDA	ROC %	Debt/Capital %
NAIC-1	60	8.6%	13.0x	10.4x	61.8%	1.4x	16.4%	26.2%
AAA	6	0.6%	31.0x	27.3x	174.2%	0.5x	25.2%	12.6%
AA	15	1.5%	21.4x	18.0x	74.3%	1.0x	25.4%	36.1%
A	118	11.5%	12.8x	10.4x	50.7%	1.6x	19.7%	38.4%
Subtotal	***139***	***13.5%***						
NAIC-2	315	45.3%	8.2x	5.6x	34.9%	2.3x	14.7%	44.6%
BBB	213	20.8%	7.6x	5.9x	35.9%	2.2x	15.1%	43.7%
NAIC-3	127	18.2%	5.3x	3.4x	25.5%	3.0x	12.0%	54.4%
BB	297	28.9%	4.6x	3.4x	24.9%	3.2x	12.5%	51.9%
NAIC-4	111	15.9%	2.8x	2.0x	14.4%	4.4x	10.8%	67.2%
B	345	33.6%	2.3x	1.5x	12.0%	5.4x	8.8%	74.9%
NAIC-5	83	11.9%	1.6x	0.9x	7.2%	5.6x	7.1%	75.4%
CCC	32	3.1%	1.2x	0.5x	4.5%	7.7x	5.2%	100.6%
Total # of Companies								
NAIC Rated	**696**	**100.0%**						
S&P Rated	**1026**	**100.0%**						

2005-2007 Industrial Median Averages (NAIC rated vs. S&P Rated)

Designation	No. of Companies	As % of Total	EBITDA / Int	EBIT / Int	FFO/Debt %	Debt / EBITDA	ROC %	Debt/Capital %
NAIC-1	60	6.5%	12.9x	10.0x	61.7%	1.4x	17.1%	32.7%
AAA	6	0.6%	32.0x	26.2x	155.5%	0.4x	27.0%	12.3%
AA	14	1.3%	19.5x	16.4x	79.2%	0.9x	28.4%	35.2%
A	111	10.2%	13.5x	11.2x	54.5%	1.5x	21.8%	36.8%
Subtotal	***131***	***12.1%***						
NAIC-2	352	37.8%	8.1x	5.9x	39.4%	2.1x	14.8%	42.2%
BBB	213	19.6%	7.8x	5.8x	35.5%	2.2x	15.2%	44.5%
NAIC-3	161	17.3%	5.3x	3.5x	26.2%	3.1x	12.8%	55.0%
BB	306	28.2%	4.8x	3.4x	25.7%	3.1x	12.4%	52.5%
NAIC-4	189	20.3%	3.0x	1.9x	14.1%	4.8x	9.8%	65.8%
B	354	32.6%	2.3x	1.4x	11.5%	5.5x	8.7%	73.2%
NAIC-5	168	18.1%	1.5x	0.8x	6.3%	5.7x	6.2%	75.6%
CCC	22	2.0%	1.1x	0.4x	2.5%	8.6x	2.7%	98.9%
Total # of Companies								
NAIC Rated	930	100%						
S&P Rated	1086	100%						

NAIC National Association of Insurance Commissioners 19

W:\Dec09\Cmte\E\wg\Rating Agency\Att B02 RAWGHearingPanel1CEvangelPresent2.pdf

Use of Rating Agency Ratings in State Insurance Regulation

Public Hearing of the
NAIC Rating Agency (E) Working Group

September 24, 2009

Nancy Bennett, FSA, CERA, MAAA
Senior Life Fellow,
American Academy of Actuaries
Chair, Life Capital Adequacy Subcommittee

Use of Ratings in Insurance Industry

- **Background on Risk Based Capital (RBC)**
- **Minimum Capital Requirements for Assets**
- **Determination of Capital (Total Adjusted Capital)**
- **Other Uses of Ratings**
- **Limitations of Ratings**

Background on RBC

- **Purpose of RBC is to identify weakly capitalized companies.**
  - Regulatory tool
  - Regulatory action is based on RBC ratios
  - RBC ratios are not designed to compare capital strength of companies
  - Three RBC formulas are used: life insurers, health insurers, casualty insurers. Asset requirements similar for all insurers.
  - Introduction of more sophisticated methods has sometimes met resistance from insurers due to the increased cost and time to implement.
- **Generally, minimum capital requirements are expected to be sufficient to protect insurer solvency 95% of the time.**

Background on RBC (cont.)

- **RBC factors were established to capture risk levels above the levels captured in reserves.**
- **Constraints**
  - Data sources are publicly available from statutory financial statements
  - Factor-based for C-1, C-2 and C-4
  - Model-based for C-3 for some liabilities (FAs, VAs, and SPL)
  - Factors do not vary by company

Use of Ratings in Insurance Industry

- **Background on Risk Based Capital (RBC)**
- **Minimum Capital Requirements for Assets**
- **Determination of Capital (Total Adjusted Capital)**
- **Other Uses of Ratings**
- **Limitations of Ratings**

Minimum Capital Requirement for Assets

- **Asset risk- affiliate (C0)**
  - Risk of default of assets for affiliated investments (e.g., downstream insurance subsidiaries)
  - Parent is required to hold an equivalent amount of risk-based capital to protect against financial downturns of affiliates.
  - For life companies, off-balance sheet items are included in this risk component including non-controlled assets, derivative instruments, guarantees for affiliates and contingent liabilities.
- **Asset risk – common stock (C1-cs)**
  - Risk of market value loss for certain equity assets
  - Unaffiliated Common Stock and Affiliated Non-Insurance Stock

Minimum Capital Requirement for Assets (cont.)

- **Asset risk – other (C1-o)**
  - Risk of default for debt assets
  - Fixed income assets include bonds, mortgages, short-term investments, etc.
  - Equity assets include preferred stock, real estate, long-term assets, derivative transactions, etc.
  - All insurance companies are subject to an asset concentration factor that reflects the additional risk of high concentrations in single exposures.

Determination of C1-o Factors

- **Factors are applied to carrying value of asset as classified in the statutory financial statement**
  - Book value for bonds (public corporate, private placement, CMO, CBO/CLO, agency and non-agency mortgage pass-through, RMBS, CMBS, hybrid security, preferred stock, commercial paper);
  - US Treasuries and GNMA required capital = zero; FNMA and FHMLIC included in NAIC Class 1.
  - Bonds in default are carried at market value, written down for impairment.
  - Amortized cost for mortgages
- **Factors developed in 1991**
  - Not updated for any changes in the bond market (e.g., introduction of structured products)
  - Not changed for more recent default experience
  - Current factors may still be appropriate since factors are intended to capture "tail risk", or extreme experience above that captured in reserves

Determination of C1-o Factors: Bond Factors

- Factors based on simulations of a bond portfolio of 1300 securities where future cash flows are projected assuming realistic economic cycles and interest rate changes. Simulations cover ten-year period.
- Simulations did not reflect:
  - The impact of large issuer concentrations in a bond portfolio
  - Different default experience for private placements
  - Loss recoverability from contract holders
- "Base" required capital = amount of initial funds (initial surplus plus interest) necessary to protect the bond portfolio from expected losses.
- RBC factors based on adjustment to the base factors adjusted for the number of issues in an insurer's portfolio, excluding government-backed issues.

Determination of C1-o Factors: Bond Factors (cont.)

- **Projected future defaults are based on Moody's Default Study**
  - Study measured defaults based on current rating rather than the rating at issue.
  - Experience based on number of defaulted issues, rather than the par value of defaulted issues.
  - "Select and Ultimate" experience was available; therefore, ratings transitions are reflected in the development of RBC factors.
  - Expected loss severity assumes principal recovery for basic bonds based on Moody's experience. RMBS expected loss does not reflect loss severity.
  - Moody's rates were adjusted for the worst economic environment to reflect conservatism.

Bond Factors (pre-tax)

	SVO Bond Rating Category	Annual Statement Source	Book / Adjusted Carrying Value		Factor		RBC Requirement
	Long Term Bonds						
(1)	Exempt Obligations	AVR Default Component Column 1 Line 1	$0	X	0.000	=	$0
(2)	Asset Class 1	AVR Default Component Column 1 Line 2	$0	X	0.004	=	$0
(3)	Asset Class 2	AVR Default Component Column 1 Line 3	$0	X	0.013	=	$0
(4)	Asset Class 3	AVR Default Component Column 1 Line 4	$0	X	0.046	=	$0
(5)	Asset Class 4	AVR Default Component Column 1 Line 5	$0	X	0.100	=	$0
(6)	Asset Class 5	AVR Default Component Column 1 Line 6	$0	X	0.230	=	$0
(7)	Asset Class 6	AVR Default Component Column 1 Line 7	$0	X	0.300	=	$0
(8)	Total Long-Term Bonds	Sum of Lines (1) through (7)	$0				$0
	(Column (1) should equal Page 2 Column 3 Line 1)						

Ratings Translation for Bonds

- NAIC 1 = AAA/Aaa, AA/Aa, A/a
- NAIC 2 = BBB/Baa
- NAIC 3 = BB/Ba
- NAIC 4 = B/B
- NAIC 5 = CCC/Caa
- NAIC 6 = in or near default

Determination of C1-o Factors: Mortgage Factors

- **Mortgage factors are based on 3 groups:**
  - in good standing
  - 90 days overdue
  - in process of foreclosure
- **No ratings exist for mortgages; therefore, factors were developed on the basis of experience on the entire mortgage portfolio.**
- **Factor based on insurer's mortgage experience relative to industry experience (i.e., MEAF)**
  - If company experience is worse than industry experience, capital charge will be higher than for an average portfolio.
  - MEAF falls between 0.5 and 3.5 for mortgages in good standing.
    - Note: MEAF factors have been reduced to (1.25 – 0.75) on an interim basis.
  - MEAF falls between 1.0 and 2.5 for mortgages in default

AMERICAN ACADEMY *of* ACTUARIES

Determination of C1-o Factors: Derivatives Factors

- Required capital for derivatives reflects the amount held on the balance sheet exposed to loss upon default of the Over-the-Counter (OTC) counterparty or exchange.
- OTC derivatives are carried at market value with RBC factors based on bond factors.
  - Factor for exchange-traded derivatives = NAIC Class 1 Bond Factor
  - Factor for OTC derivatives based on NAIC Class 1-6 Bond Factors

AMERICAN ACADEMY *of* ACTUARIES

Determination of C1-o Factors: Derivatives Factors (cont.)

- Replicating transactions (Schedule DB)
  - A replication (synthetic asset) transaction increases the insurer's exposure to one type of asset, the replicated (synthetic) asset, and may reduce the insurer's exposure to the asset risk associated with the cash market components of the transaction.
  - Required capital on a replicating transaction is the net amount of exposure times the RBC factor for a Schedule DB asset (i.e., NAIC Class Bond Factors 1-6)
- A mandatorily convertible security is a security that is mandatorily convertible at prices different from the market prices at the time of conversion;
  - Such securities are classified on the annual statement by ignoring the conversion feature. RBC is adjusted upward if the security that results from the conversion is more risky than the original security.
  - Required capital on mandatorily convertible securities is based on the RBC factor for NAIC Class Bond Factors 1-6

AMERICAN ACADEMY *of* ACTUARIES

Use of Ratings in Insurance Industry

- **Background on Risk Based Capital (RBC)**
- **Minimum Capital Requirements for Assets**
- **Determination of Capital (Total Adjusted Capital)**
- **Other Uses of Ratings**
- **Limitations of Ratings**

AMERICAN ACADEMY *of* ACTUARIES

Total Adjusted Capital (TAC)

- TAC = unassigned surplus
  + Asset Valuation Reserve (AVR)
  + (0.5) * Dividend Liability
- AVR is considered to be "assigned" surplus or a reserve for defaults.
  - Provides cushion to surplus from wide swings.
  - The AVR is an estimate of the portion of policy reserves attributed to defaults.
- AVR is required for assets classified as Bonds and mortgages.
  - Annual contribution to AVR based on the same asset classifications (i.e., NAIC 1-6) used in RBC plus capital gains minus capital losses.
  - Total AVR is capped; Once cap is reached there are no further flows into AVR.
- The level of AVR is based on the same asset classifications (i.e., NAIC 1-6) used in RBC.

AMERICAN ACADEMY *of* ACTUARIES

Use of Ratings in Insurance Industry

- **Background on Risk Based Capital (RBC)**
- **Minimum Capital Requirements for Assets**
- **Determination of Capital (Total Adjusted Capital)**
- **Other Uses of Ratings**
- **Limitations of Ratings**

AMERICAN ACADEMY *of* ACTUARIES

Other Uses of Ratings by Insurers

- **Actuarial Modeling of Projected Defaults**
  - Regulatory Cash Flow Testing and the determination of asset adequacy
  - Capital requirements for C3 Phase I and II
  - Risk Management modeling
- **PBR for Life Insurance**
  - Rating Agency ratings are the basis for prescribed default costs and investment spreads for fixed income assets modeled in the calculation of life insurance reserves based on PBA methodology.
- **Investment Restrictions per NAIC Model Laws**

  and/or state laws

AMERICAN ACADEMY *of* ACTUARIES

Use of Ratings in Insurance Industry

- **Background on Risk Based Capital (RBC)**
- **Minimum Capital Requirements for Assets**
- **Determination of Capital (Total Adjusted Capital)**
- **Other Uses of Ratings**
- **Limitations of Ratings**

s

AMERICAN ACADEMY *of* ACTUARIES

Limitations of Using Rating Agency Ratings in RBC

- **RBC calculation linked to financial statement classification.** Risk information is lost in the mapping of ratings to NAIC classes.
- **Certain investment risks are not captured in the ratings and therefore RBC (extension, market, event, liquidity)**
  - Factors are based on average experience across many types of securities with different risk profiles
  - New features in securities will not be reflected until experience emerges (can be a long time)
- **Broad industry averages may not represent credit risk for an individual company's portfolio, as techniques for mitigating portfolio credit risk are not reflected in RBC (e.g., derivatives).**
- **Broad industry averages may not be consistent with internal ratings assigned by company's analysis of credit risk.**

American Academy *of* Actuaries

Concerns with Ratings from an Actuarial Perspective

- **Rating methodologies and underlying assumptions differ by security type** (e.g., frequency of factor update, RMBS factors do not reflect severity)
- **Ratings are not consistent between different securities**
  - Agencies will rate securities differently
  - Securities with similar risk profile will get different ratings
- **Ratings process is not transparent**
- **The stated purpose of RBC (identify weakly capitalized companies) naturally forces a balance between reflecting more complete information and the cost of implementation.**
  - Introduction of more sophisticated methods has sometimes met resistance from insurers due to the increased cost and time to implement

American Academy *of* Actuaries

TESTIMONY

TO THE NAIC RATING AGENCY WORKING GROUP

HEARING ON THE
"ROLE OF THE RATING AGENCIES IN STATE INSURANCE REGULATION"

BY DEPUTY SUPERINTENDENT MICHAEL MORIARTY

NEW YORK STATE INSURANCE DEPARTMENT

THURSDAY, SEPTEMBER 24, 2009

NAIC FALL NATIONAL MEETING
WASHINGTON DC

I would like to thank Co-Chairmen James Wrynn and Michael McRaith and members of the NAIC Rating Agency Working Group for inviting me to testify today at this hearing on the "Role of the Rating Agencies in State Insurance Regulation.".

My name is Michael Moriarty and I am Deputy Superintendent for the New York State Insurance Department.

Chris Evangel, Director of the Securities Valuation Office ("SVO"), has already given a comprehensive description of the role that the SVO plays with respect to assisting state regulators in their oversight of the financial condition of insurance companies. My particular focus today is on the changes made in 2004 regarding the process by which insurance companies file investment securities with NAIC Securities Valuation Office.

At the time New York was (and still is) the chair of the NAIC Valuation of Securities Task Force, which is the NAIC group that is charged with overseeing the SVO.

NAIC's Reliance on Rating Agencies for Capital Requirements

Beginning in 2002, the Securities Valuation Oversight Working Group (which has since been folded into the Valuation of Securities Task Force) began to review a series of initiatives intended to enhance the effectiveness of the processes at the SVO.

The goals of the review at that time were the following:

1. Continuation of reforms initiated in late 1999 as a result of the Effectiveness and Efficiency initiative; continue to improve the SVO process that is relied on by state insurance regulators to monitor insurance company investments.
2. Produce timely and accurate credit ratings and valuations for bonds, preferred stock, and common stock.
3. To the extent appropriate, leverage off ratings and valuations already provided by third parties such as the Nationally Recognized Statistical Rating Organizations (S&P, Moody's and Fitch), and market facilitators, such as stock exchanges and valuation services.

As a result of this review, the following proposals were developed for the Working Group's consideration:

- Exempt All Rated Securities from Filing with NAIC Securities Valuation Office.
- Establish Procedure for Direct Regulatory Input in the Utilization of Research Unit.
- Consider Alternatives to the Filing of Securities Not Rated by an NRSRO, Including Allowing Insurers to "Self-Rate" Securities

After deliberation the first two proposals passed. The last one did not. Thus, beginning in 2004, any investment security rated by an NRSRO need not be filed or reviewed by the Securities Valuation Office. Insurance regulators explicitly relied on the rating agencies for determining the creditworthiness of entities issuing debt in the capital markets. This had the direct impact of calculating the capital an insurer would need to support such investments.

The rationale at the time was fairly straightforward. NRSRO ratings were deemed sufficient to establish credit quality of assets. SVO work in this area seemed redundant and would add minimal additional value to the state regulatory process. Furthermore, utilization of NRSRO ratings would eliminate the manual process whereby companies print and mail forms for submission to the SVO. This saved insurance companies and SVO staff time and money for activity that often results in the same end product; that is an NAIC designation equivalent to the NRSRO rating. That is because prior to the explicit recognition of the ratings by NRSROs, there had always been the implicit use of ratings. The NAIC has limited resources. Rating agencies play an important role in the capital markets arena. Reliance on them in terms of rating individual securities was seen as an efficient use of resources.

So even before the explicit recognition of ratings that resulted in the Filing Exemption ("FE") rule, securities that were rated and had to be filed with the SVO almost always received the same NAIC designation equivalent to the rating. Thus, the FE rule was seen as recognition of a practice that already existed and eliminated the need to file securities with the SVO and the attendant cost to the industry.

At the time the rule was passed there was a recognition that the regulators and the SVO should have flexibility to override an NRSRO rating and the ability to do so was incorporated into the rules.

Summary

NAIC reliance on ratings by NRSROs was seen as practical, efficient and effective use of limited resources. The reliance was not based on a detailed review and an affirmation of the methodology used by the rating agencies. The NRSROs were relied upon by many capital markets participants, were overseen by the U.S. Securities and Exchange Commission, and had a track record of reliability.

The events of the past few years, especially in the mortgage backed structured security sector, require a thorough and deliberate review of this policy.

W:\Dec09\Cmte\E\wg\Rating Agency\Att B04 Moriarty Testimony - Rating Agency WG - 9-24-09.doc

Testimony of Birny Birnbaum
Center for Economic Justice

Before the NAIC Rating Agency Working Group
September 24, 2009

The Role of Credit Rating Agencies in Insurance Regulation

Much has been written about the role of the credit rating agencies in the financial crisis. A few things are clear. The rating agencies erroneously gave AAA ratings to hundreds of billions of dollars of residential mortgage-backed securities (RMBS) from 2005 to 2007. The agencies had, and continue to have, a conflict of interest because of the way they are compensated – paid by the entities issuing the securities. The consequences of this market structure are well documented – rating agencies competed for market share and profit by giving AAA ratings to pretty much any mortgage-backed security that walked through the door.

The problem is a structural one for which no conflict of interest policy within the rating agencies can counter the market incentives created by the issuer-pays model.

It is clear the rating agencies did not know what they were doing when they initially rated the RMBS issued from 2005 to 2007. The vast majority have been downgraded with most to below investment grade ratings. But, if the rating agencies did not know what they were doing a few years ago, why do we have any confidence that they know what they are doing today? Insurers who wanted regulators to accept the rating agencies' RMBS ratings a few years back, now want the regulators to ignore those ratings.

The faulty ratings of RMBS are not the only problem identified with the national rating agencies. There appears to be a double standard for rating municipal bonds versus corporate securities – with lower municipal bond ratings than for corporate bonds with comparable historical and expected levels of default.

The evaluation of securities is a critical part of insurance solvency regulation. The risk associated with a particular security held as an investment by an insurer has implications for the financial strength evaluation and capital requirements of those insurers. Insurance regulators have incorporated this evaluation of financial strength into financial surveillance tools, such as the risk-based capital ratio.

There is one group of insurers for whom the evaluation and rating of securities is even more important – bond insurers who guarantee the securities.

Rating agencies are free to offer ratings and be compensated in the manner they choose. **But state insurance regulators should not be delegating their regulatory responsibilities to private entities, particularly to private entities whose incentives are not aligned with those of the public function.** We are gravely troubled by the fact that regulators did in fact delegate a critical public role to private entities. What makes this action even more inexplicable is that the regulators had and continue to have a tool to provide evaluation of securities specifically for the purpose of insurance regulation – The Securities Valuation Office.

Our concern with regulators' delegation of a critical financial solvency role to private actors is compounded by the actions of regulators in the past year to change accounting and reserving rules to provide "capital and surplus relief" to insurers. After loudly proclaiming that, because of state regulators' efforts, insurance companies were and remain financially strong, regulators have been changing the rules to allow insurers to hold less surplus and reserves and, more ominously, change the definition of surplus to, for example, include more non-liquid assets that provide no protection for policyholders.

On Tuesday, we heard the life insurers ask the regulators to ignore the rating agencies' ratings of RMBS – that these ratings were too low, based on a faulty methodology and that regulators should use an alternative rating methodology designed by the industry itself. If adopted, the change would provide $10 billion in capital relief. This request is, of course, quite troubling. If the credit rating agency ratings are not reliable for some securities, why would regulators believe that the ratings for other securities are reliable? Should insurers be able to pick the source of ratings for regulatory purposes?

In reviewing some of the other testimony for today's hearing, I note that Moody's cautions strongly against regulatory use of its and other credit rating agency ratings for regulatory purposes – arguing that the use of ratings as a regulatory tool for the oversight of regulated entities can adversely affect the behavior of market participants as well as regulators." Among other problems, Moody's says that issues may be encouraged to shop for the highest rating among the credit rating agencies – a result, I suggest, is directly attributable to the issue pays market structure.

Regulators should utilize and, if necessary, expand the capacity of the SVO so regulators can have an independent means of evaluating the risk of securities for regulatory purposes. This would not only strengthen financial surveillance of insurers, but would also be highly cost effective action for the insurance industry.

To date it seems as if regulators are moving from one industry request for relief to the next with no overarching strategy to address the fundamental problems. CEJ, along with other consumer groups have long taken strong financial oversight of insurance companies as a given. Our confidence has been shaken in the past year. Now you have both the opportunity and responsibility to make the structural changes needed to strengthen state-based regulation. Please don't waste this opportunity.

W:\Dec09\Cmte\E\wg\Rating Agency\Att B05 birnbaum cej naic rating agency hearing 090924.rtf

Statement of David Teicher
Managing Director
Moody's Investors Service

before the National Association of Insurance Commissioners
Rating Agency Working Group Meeting
September 24, 2009

I. Introduction

The following statement is submitted by Moody's Investors Service ("**Moody's**") to the National Association of Insurance Commissioners ("**NAIC**") Rating Agency Working Group in connection with its public meeting scheduled for September 24, 2009 on the role of credit rating agencies ("**CRAs**") in state insurance regulation. Moody's believes in the importance of the NAIC's ongoing dialogue with CRAs, insurance companies and other market participants about the nature of credit ratings and possible approaches to encourage more informed and careful use of ratings. We welcome this opportunity to contribute further to the discussion that is already underway both at the NAIC and more generally regarding the CRA industry.

The current economic downturn has exposed vulnerabilities in the infrastructure of the financial system. Important lessons for market participants have emerged from the rapid and dramatic market changes. While we remain proud of our 100-year track record, Moody's is well aware of the loss of confidence in the credit ratings industry, driven in large measure by the performance of credit ratings for certain vintages of U.S. RMBS and related securities. To address these concerns, we have undertaken a number of initiatives to enhance the quality, independence and transparency of our ratings.[1] These enhancements build on Moody's existing practices and processes through which we continually seek to ensure the credibility of our ratings.

While we believe that we have made good progress on these initiatives, more can be done. We expect to continue developing and modifying our approach in step with market needs, as well as regulatory expectations. In an effort to respond to and comply with regulatory requirements and changes in the regulatory landscape, we communicate regularly with regulators and other policymakers around the world. We welcome reform efforts that are likely to reinforce high quality ratings, improve market transparency and enhance accountability without intruding on the independence of rating opinion content.

This statement is organized as follows. In Part II below, I briefly provide some background information on Moody's, the nature of our credit ratings and our role in the capital markets. In Part III, I describe Moody's analysis and actions with respect to developments in U.S. sub-prime RMBS markets, focusing on the period 2003-2007. I then describe the steps we have taken since then to help restore confidence in our credit ratings. In Part IV, I discuss Moody's views on two issues relating to ratings comparability across sectors, *i.e.*, whether there should be greater comparability between U.S. public finance ratings and other ratings, and/or whether structured finance ratings should be differentiated in some way from other ratings. Finally, in Part V, I discuss Moody's views on whether ratings should continue being used for regulatory purposes.

II. BACKGROUND ON MOODY'S INVESTORS SERVICE AND THE ROLE OF CREDIT RATINGS

The credit rating business has its roots in the American tradition of the marketplace of ideas. In 1909, American entrepreneur John Moody published a manual,

[1] Please see our updates on *Strengthening Analytical Quality and Transparency*, which we began publishing in August 2008 and continue to update periodically.

Analyses of Railroad Instruments, which introduced a system of opinions about the creditworthiness of railroad bonds. Today, we are one of the world's most widely used sources for credit ratings, research and analysis.

Moody's occupies an important but narrow niche in the information industry. Our role is to disseminate opinions about the relative future creditworthiness of, among other things, bonds issued by corporations, banks and governmental entities, as well as pools of assets collected in securitized or "structured finance" obligations. We sift through the vast amounts of available information, analyze the relative credit risks associated with debt securities and/or debt issuers, and provide our analysis to the investing public for free. By making these opinions broadly and publicly available, we help to level the playing field between borrowers (debt issuers) and lenders (debt investors) by reducing information asymmetry.

We believe it is essential for investors and others to understand the role of CRAs and what credit ratings can and cannot do. Moody's has always been clear that our ratings should be used primarily as a gauge of relative default probabilities and expected credit loss. We inform the market that our ratings should not be used as indicators of market value, as measures of liquidity, or as recommendations to buy, sell or hold securities – all of which are influenced by factors other than credit. Moody's ratings are not designed to address any risk other than credit risk and should not be assigned any other purpose.

Moody's success depends on our reputation for issuing objective and predictive ratings. The strong performance of our ratings is demonstrated, over many credit cycles on the hundreds of thousands of securities we have rated, in our default studies and periodic ratings performance reports, which we post on our website, www.moodys.com. These default studies show that both our corporate and structured finance ratings have been reliable predictors of default over many years and across many economic cycles.[2]

Nonetheless, there always will be unanticipated developments in the markets that affect the credit risk of securities – and we have seen this starkly over the past two years. Indeed, because of events that occur at different times in different sectors and that will never be perfectly predictable, default rates by rating category vary widely from year to year across regions and industries within the corporate sector, as well as within various structured finance sectors.

III. MOODY'S EFFORTS TO ADVANCE THE QUALITY AND TRANSPARENCY OF CREDIT RATINGS

The various contributors to the recent market crisis are by now well-chronicled, starting with the performance of U.S. sub-prime home mortgages and then of mortgage-backed and related securities originated primarily in 2006 and early 2007. Moreover, it is now clear that significant, latent vulnerabilities had been developing in the infrastructure of the global financial markets, and that once exposed, these weaknesses could, and

[2] See, *e.g.*, *Moody's Special Comment: Turning the Corner? Ratings Suggest an Upturn*, Sept. 21, 2009, in which we show that, during the deepest trough in the economic cycle since the Great Depression, Moody's ratings of non-financial corporations in the Americas have remained stable indicators of relative credit risk, with ratings volatility and accuracy holding to long-term patterns.

would, have severe and reverberating consequences.[3]

A. Moody's Analysis and Actions Relating to Sub-Prime Mortgage Portfolios

Between 2003 and 2006, Moody's observed an increase in the risk profile of sub-prime residential mortgages that we were asked to rate. In response Moody's undertook several actions that identified the growing risks, although they did not fully capture the magnitude or potential severity of those risks:

1) **We began commenting about risk in the housing market starting in 2003:** Our commentary included warnings about the deterioration in origination standards and inflated housing prices. We began publishing these warnings in 2003 and continued in 2004, 2005 and 2006.[4] In January 2007, we published a special report highlighting the rising defaults in the 2006 vintage subprime mortgages[5] and thereafter we continued to publish on their increasingly deteriorating performance.

2) **We tightened our ratings criteria:** We steadily increased our loss expectations on pools of subprime loans and the levels of credit protection required for a given rating level. Our loss expectations and enhancement levels rose by about 30% between 2003 and 2006. As a result, RMBS issued in 2006 that were backed by subprime mortgages and rated by Moody's had more credit protection than bonds issued in earlier years. In practical terms, this meant that by 2006 more than half the mortgages in a pool could default and suffer a 50% loss in foreclosure without the Aaa tranches defaulting.

3) **We took rating actions as soon as the data warranted it:** The earliest loan delinquency data for the 2006 mortgage loan vintage were largely in line with the performance observed for the 2000 and 2001 vintages, during the last U.S. recession. The 2006 Aaa-rated RMBS had sufficient credit protection to withstand such performance. As soon as the more significant loan performance deterioration in the 2006 vintage became evident, we took prompt and deliberate action on those transactions showing evidence of significantly heightened risk. Several rating actions were taken in November 2006, with broader actions beginning in April 2007.

4) **We conducted loan modification surveys:** Finally, in an effort to gauge the potential impact that loan modifications might have on reducing losses on defaulted loans, especially in light of interest rate resets when monthly payments increased, Moody's began conducting surveys of the modification practices of

---

[3] Some of these weaknesses include exceptional leverage and business models that relied on secondary markets for liquidity of complex instruments in periods of stress; the interaction of asset valuation and capital; insufficient risk management practices; interlinked market participants; and limited transparency.

[4] See, *e.g., 2004 Review and 2004 Outlook, Home Equity ABS*, January 20, 2004; *The Importance of Representations and Warranties in RMBS Transactions*, January 14, 2005; *An Update to Moody's Analysis of Payment Shock Risk in Sub-Prime Hybrid ARM Products*, May 16, 2005; *The Blurring Lines between Traditional Alternative-A and Traditional Subprime US Residential Mortgage Markets*, October 31, 2006.

[5] *Moody's Special Report: Early Defaults Rise in Mortgage Securitization*, January 18, 2007.

sixteen subprime mortgage servicers. These servicers together constituted roughly 80% of the total subprime servicing market. The results of our first survey, published in September 2007,[6] suggested that, on average, subprime servicers were not focused on modifying loans and had only modified approximately 1% of their serviced loans that had experienced an interest rate reset (increase) in the months of January, April and July 2007. We published follow-up surveys in December 2007 and July 2008.[7]

In summary, Moody's took steps to watch, warn and react. Like many other market participants, however, we did not anticipate the magnitude and speed of the deterioration in mortgage quality or the suddenness of the transition to restrictive lending. We were far from alone in that regard, but we believe that we should be the leading edge for predictive opinions about future credit risks, and we have learned important lessons from that experience.

B. Efforts to Restore Confidence

The past two years have reminded all market participants how rapidly and dramatically markets can change. Throughout this period, Moody's has – in an effort to enhance accountability – reached out to market participants and policymakers globally for feedback regarding the utility of our ratings and ratings system. Based on the feedback we have received and our own deliberations, Moody's has adopted, or is in the process of adopting, a wide range of measures to enhance the quality, independence and transparency of our credit ratings, including the following:

1) **Strengthening the analytical quality of our ratings:** including creating permanent, internal methodology review and model verification and validation processes; continuing the separation of original rating and surveillance analysts; reinforcing the independence of the Credit Policy function; implementing methodological modifications; enhancing our existing professional training program; and formalizing model error discovery procedures.

2) **Enhancing consistency across rating groups:** including incorporating common macro-economic scenarios in rating committees, broadening cross-disciplinary rating committee participation; and improving surveillance coordination across rating groups.

3) **Bolstering measures to avoid conflicts of interest:** including codifying the existing prohibition against analysts providing recommendations or advice on structuring securities; prohibiting fee discussions by ratings managers as well as analysts (who were already subject to such a prohibition); changing rating committee composition to enhance independence and objectivity; conducting "look-back" reviews when analysts leave to join organizations with potential conflicts; revising our Securities Trading Policy; retaining and reviewing complaints about analysts made by third parties; reinforcing independence and

6 *Special Report: Moody's Subprime Mortgage Servicer Survey on Loan Modifications*, September 21, 2007.

7 *Special Report: US Subprime Market Update: November 2007*, December 17, 2007; and *Special Report: Moody's Subprime ARM Loan Modification Update*, July 14, 2008.

objectivity through analyst compensation policies; and adopting a stricter prohibition on Moody's analysts receiving gifts (to supplement our existing Moody's Corporation policy on this matter).

4) **Improving transparency of ratings and the ratings process:** including enhancing disclosures on incremental changes to methodologies; publishing detailed summaries of our methodologies for rating U.S. RMBS and CDOs; enhancing the review of loan originators in U.S. RMBS transactions and asking issuers for stronger representations and warranties relating to those transactions; providing additional information on structured finance ratings (V Scores, Parameter Sensitivity analysis, loss expectation and cash flow analysis, and key statistics and assumptions); enhancing disclosures regarding attributes and limitations of credit ratings in each rating announcement; and pursuing efforts to discourage rating shopping.

We believe we have made good progress with respect to augmenting the analytical framework and credibility of our ratings, and we continue striving to enhance our policies and procedures even further.

IV. RATINGS COMPARABILITY ACROSS SECTORS

Recent market events have led policymakers and market participants (including CRAs) to consider issues of ratings comparability across fixed income capital market sectors. In particular, questions have been raised about whether there should be greater comparability between U.S. public finance ratings and other ratings, and/or whether structured finance ratings should be differentiated in some way from other ratings. I discuss these two specific issues below before discussing the more general question of whether the market would benefit from rules that mandate ratings comparability or differentiation across sectors.

A. Comparability between Municipal and Non-Municipal Ratings

Moody's first began rating municipal bonds in 1918. Today, Moody's publishes ratings and research on a highly diverse group of issuers and securities, including bonds issued by states, cities, counties, school districts, special government entities and pooled groups of issuers. Bonds may be backed by, among other things, taxes, leases, appropriations and/or land development fees. Many, but far from all, of these rated bonds are backed by a government issuer's "general obligation" pledge, meaning that all of the government issuer's pledged, tax revenue-producing powers are promised to satisfy the debt, including the government issuer's ability to levy taxes sufficient to pay such debt. These bonds are sometimes called "General Obligation" or "G.O." bonds.

We also assign ratings to another large and diverse group of bonds issued by public authorities and non-profit organizations, which we collectively refer to as enterprises. These issuers back their debt with a combination of tax revenues and user fees to, for example, finance colleges and universities, hospitals, housing agencies and a wide range of public infrastructure projects such as airports, ports, public power utilities, transportation facilities and water-sewer systems.

Throughout our history, Moody's has sought municipal market investors' and issuers' views on which attributes would make our municipal bond ratings most useful, and we have adjusted our rating system to respond to the changing needs of market participants over time. For many years, investors and issuers in this market indicated that they wanted our ratings to draw finer distinctions among municipal bonds, which generally have had lower credit risk when compared to Moody's-rated corporate or structured finance obligations.[8]

It was not until 2008 that a larger portion of the market indicated to Moody's that they sought comparability between municipal and non-municipal ratings. Taking into account these views, Moody's announced in early September 2008 our intention to recalibrate our long-term municipal bond ratings to our global ratings in order to enhance comparability between municipal and non-municipal ratings. In mid-September 2008, an extraordinarily severe market dislocation was triggered by events unrelated to our announcement. Because of the severe turmoil that resulted from that dislocation, we determined it would be prudent to suspend the recalibration process until the market stabilized. We were concerned that pursuing our plans during such turbulence could unintentionally lead to confusion and/or further market disruption. The temporary suspension of the recalibration process remains in effect today because of ongoing volatility in credit markets. We remain committed, however, to implementing our plans and are monitoring market conditions closely as we look for an appropriate time to begin the recalibration process.

B. Differentiation of Structured Finance Ratings

Moody's has been engaged in dialogue with market participants and policymakers about whether additional analysis and greater transparency around our structured finance ratings and/or the use of a different symbols (or suffixes) for structured finance securities could help draw investors' attention to differences in the risk characteristics of structured finance products. Based on market participants' feedback indicating a strong interest in having Moody's provide additional analysis and greater transparency around our structured finance ratings, in late 2008 Moody's introduced two new risk measures for structured finance securities: V Scores and Parameter Sensitivities.

- V Scores address the degree of uncertainty around the assumptions that underlie our structured ratings. Although Moody's ratings already express our opinion about expected lifetime credit losses, V Scores are designed to signal to users of Moody's ratings which types of structured finance securities have greater exposure to data limitations and modeling assumptions.

[8] Investors in corporate or structured bonds typically have looked to Moody's ratings for an opinion on whether a bond or issuer will meet its payment obligations. Our opinion takes into account our forecasts of both the probability of default and the loss if a default occurs. Historically, this analysis has not been as helpful to municipal investors. This is because, if municipal bonds had global ratings, the great majority of our ratings likely would fall within just two rating categories: Aaa and Aa. This would make it more difficult to differentiate among various municipal bonds, which is something that many investors indicated to us that they wanted our rating system to do. Accordingly, Moody's municipal bond ratings developed so that they distinguished more finely among the various municipal bonds and ranked one against the other on the basis of intrinsic financial strength. Because the risk of default and potential severity of loss historically have been relatively low for governmental issuers, Moody's municipal ratings principally have focused on the risk that an issuer will face financial stress.

- Parameter Sensitivities address the sensitivity of Moody's ratings to changes in our key assumptions, and are designed to measure how the initial rating of a security might have differed if key rating input parameters were varied, as opposed to how a rating might migrate over time.[9]

We continue to monitor market developments as well as the policymakers' ongoing debate about the appropriateness of using a single rating scale for both structured and non-structured securities. Differentiation of structured finance ratings from other ratings, possibly through the use of a different symbol system or a suffix, has been mandated in the European Union and it is possible that similar requirements will be adopted in some other countries, including in the U.S. Moody's is assessing how best to implement the new EU requirements and monitoring regulatory developments in other jurisdictions.

C. Should Rules Mandate Greater or Lesser Ratings Comparability across Sectors?

From Moody's perspective, it is of paramount importance that we can express our opinions about the creditworthiness of securities and obligors in a manner that users of our credit ratings find informative. Since insurance companies are one of the largest groups of users of our ratings, we are very interested in their, and the NAIC's views, on this subject.

We also believe that the market benefits from diversity of independent opinions and methodological approaches. Legislation or rules, therefore, that mandate ratings comparability across sectors (*e.g.*, between municipal sectors and other securities) or conversely, that require differentiation of ratings (*e.g.*, differentiation of structured finance ratings from non-structured finance ratings) raise a number of issues. Below, we have briefly outlined some of these issues for consideration, among others:

- Legislation or rules that mandate a particular approach to ratings comparability may have the effect of freezing current preferences in time. This, in turn, could make it more difficult in the future for CRAs to innovate and compete on the basis of providing ratings that meet the evolving needs of investors, issuers and other users of credit ratings.
- Legislation or rules that mandate a particular approach to ratings comparability would involve substantive regulation of the content of credit opinions and rating methodologies, which could adversely affect CRAs' ability to make diverse, independent opinions available to the market.
- Differences in approach from one jurisdiction to another could make it more difficult for CRAs to adopt a globally consistent approach to ratings. Global comparability of ratings is one of the key attributes of ratings that market participants have valued.

[9] Parameter Sensitivities only reflect the ratings of each scenario from a quantitative/model-indicated standpoint. The results generated by quantitative models are one of many inputs to the rating process. Qualitative factors are also taken into consideration in the rating process, so the information presented in the Parameter Sensitivity analysis is not necessarily indicative of the ratings that actually would be assigned in each case.

V. THE USE OF CREDIT RATINGS FOR REGULATORY PURPOSES

Policymakers at both the national and international level are examining the use of ratings in regulation. As we discuss in more detail below, Moody's supports efforts to discontinue or limit the use of ratings in regulation since we have long held – and expressed – concerns about the potential negative effects that such use can unintentionally produce. We also recognize, however, that in light of current market conditions, eliminating or reducing ratings-based criteria should be pursued judiciously as financial markets continue to show signs of weakness and volatility.

I discuss below how ratings historically were used by market participants, why regulatory use of ratings may have developed and how the use of ratings as a regulatory tool can affect the way ratings are used by regulated entities, such as insurance companies, the factors that influence how issuers choose CRAs and the ways CRAs compete with each other.

A. Market Use Model

Historically, under the "market use" model, two important groups of market participants were interested in ratings.

- Initially, investors (who were primarily institutional, rather than individual, investors) used credit ratings as an objective, "second opinion" against which to gauge their own views. In other words, credit ratings constituted an additional source of information that either supported or refuted, but did not supplant, the investors' own research, analysis and opinions. In general terms, the attributes of ratings that these investors found useful were as follows:
  - **Independence:** While investors might disagree with CRAs' opinions, they believed that these opinions were not biased toward a particular set of interests.
  - **Reliable, predictive content:** Over time, the ratings performance of certain CRAs demonstrated that their ratings generally served as reliable predictors of relative credit risk.
  - **Breadth of coverage:** Globally active CRAs published ratings on a large and diverse group of entities and obligations. This breadth of coverage enabled investors to compare and rank credit quality across issuers, industry sectors, asset classes and jurisdictions.
  - **Rating stability:** As they began incorporating ratings-based criteria into their investment and portfolio composition guidelines, most investors also came to value not only rating accuracy (*i.e.*, predictive content) but also rating stability for the securities they owned.
  - **Simplicity:** Rating symbols condensed a great deal of analysis, research, judgment and opinion into easy-to-use symbols.
- Issuers sought ratings to increase their investor base and marketability of their debt. Because of the rating attributes identified above, credible ratings could facilitate issuers' access to capital markets. Issuers naturally wanted to obtain the highest possible rating and exercise maximum control over the rating process. Since,

> however, investors demanded credible ratings, issuers were motivated to seek ratings from CRAs that had the best reputations among investors since such ratings would facilitate better access to capital markets. This was a form of "rating shopping" since issuers had a range of CRAs to choose from and could "shop" for the CRA that best served their objectives.[10]

Likewise, CRAs competed to deliver credible (*i.e.*, objective, reliable and relatively stable) ratings. This is because, under the market use model, the credibility that they built with investors provided them with a competitive edge.[11]

B. Regulatory Use of Ratings – and Potential Negative Effects

The attributes of ratings described above developed over a century of evolution in line with market-based needs. These attributes, however, have also led to the use of ratings for a variety of additional regulatory and market-based purposes. For example, leveraging the market's use of ratings, regulators in the U.S. and globally have incorporated ratings into regulations and rules. This is sometimes called the "regulatory use" model. Some market commentators have the impression that regulatory use of ratings and the establishment by the U.S. Securities and Exchange Commission ("**SEC**") of the Nationally Recognized Statistical Rating Organization regime caused the development and success of the CRA industry. That impression, however, misconstrues the history of the use of ratings in federal securities laws, which occurred *because* CRAs already were providing a well-known and valuable product to market participants.

The appropriation of credit ratings for prudential and other standards is understandable from a public policy standpoint. As noted above, rating symbols are easy-to-use, and rating opinions are independent and relatively stable. Importantly, ratings have also demonstrated predictive ability to distinguish relative creditworthiness among securities and issuers. Moreover, ratings provided by the major CRAs are published for the equal benefit of all market participants, not just a select group of subscribers.

Notwithstanding these benefits, Moody's has long been concerned about the regulatory use of ratings. In various public communications, we have reiterated our concerns about the use of ratings in regulation.[12] Specifically, we have discussed how the use of ratings as a regulatory tool for the oversight of regulated entities can adversely affect the behavior of market participants as well as regulators. Summarizing some of the views we have expressed in other publications:

---

10 In recent decades, the term "rating shopping" has developed a negative connotation because, typically, the term has come to describe the practice where issuers "shop" for a CRA that will provide the highest rating, even if that rating is unlikely to be the most accurate rating. Shopping for a rating, however, occurs because there is competition among CRAs, and it is often suggested that more competition in the CRA industry would be beneficial. Neither rating shopping nor greater competition among CRAs, however, is intrinsically harmful or beneficial to investors and the markets generally. As discussed in more detail below, it all depends on which attributes of ratings are shopped for or along which CRAs compete.

11 CRAs also may have competed for business on the basis of factors such as price, accessibility and service but we believe that credibility with investors was the preeminent, market-based attribute along which CRAs competed.

12 See generally *Moody's Investors Service Comment Letter re Files S7-17-08, S7-18-08 and S7-19-08: References to Ratings of Nationally Recognized Statistical Rating Organizations* (September 5, 2008) and *Moody's Investors Service Comment Letter re File S7-11-09*, available on moodys.com and SEC's website.

- Entities that are required to, or receive regulatory benefits from, holding securities that have an "approved" credit rating may have less of an incentive to conduct their own credit analysis and may be encouraged to over-rely on credit ratings.
- Issuers may be encouraged to "shop" for the highest rating among the officially recognized CRAs because, at least in the short term, credibility with investors is supported by official recognition of certain CRAs.
- The incentives for officially recognized CRAs to compete on the basis of ratings quality and performance may be diluted.
- The regulators' interest in comparable ratings can pressure CRAs to produce homogenous opinions and undermine their ability to provide diverse, independent opinions.
- Market participants may mistakenly perceive that ratings have a "government seal of approval" and inappropriately rely on them as a proxy for risks not measured by credit ratings (such as market value and/or liquidity risk).

As noted above, Moody's recognizes that there are benefits from identifying and using objective, widely accepted standards for financial markets because this can facilitate efficient regulation. Credit ratings can be useful in this regard because they are easy to use, broadly disseminated, independent and reliably predictive opinions about relative creditworthiness. Nevertheless, we continue to believe that widespread regulatory use of ratings can unintentionally produce negative effects and create harmful incentives.

We believe that these views are consistent with current global efforts, including those of the NAIC, to identify ways to rely less on ratings and explore how they can be removed from regulation in the least disruptive and most effective and efficient manner.[13] Moody's fully supports these efforts.

C. Moody's Recommendations

We encourage the Working Group and the NAIC to analyze carefully the potential, direct and indirect consequences of continuing, modifying or ceasing the regulatory use of ratings in insurance regulation. We support the healthy dialogue that meetings such as this one can foster and believe such dialogue can help to encourage all users of ratings, whether they are market participants or regulators, to consider carefully: (1) what are the desirable attributes of a CRA's ratings that make them useful in the first place; (2) what are the risks that the user is seeking to measure and manage in using the CRA's ratings; and (3) whether the CRA's ratings performance merits such ratings' continued used for regulatory and other purposes. In our view, this type of analysis should be conducted periodically, since new risks can emerge, the relative importance of

[13] Of course, introducing a new use for ratings does not necessarily exclude other existing uses. Ratings continue to be sought for other reasons. Accordingly, the incentives for issuers to seek ratings that are credible with investors and for CRAs to meet high performance standards have continued to operate and exert market discipline on the industry. If, however, these dynamics change, the incentive effects generated by the regulatory use of ratings may have a greater impact on the behavior of investors, issuers and CRAs. The effects of these incentives can be detrimental, if, for example, the regulatory use of ratings commoditizes ratings, puts pressure on CRAs to homogenize their rating methodologies the CRA that will demand the least amount of information.

risks can change, new assessment tools are developed, and the needs of market participants and regulators can evolve.

Ultimately, ratings are simply one tool that is available to market participants and regulators. We do not believe, and never have recommended, that they should be used as anything but an opinion on credit risk. We expect that the reassessment of the use of ratings by the Working Group and the NAIC will help reinforce this concept.

VI. CONCLUSION

Moody's has always believed that critical examination of the CRA industry and its role in the broader market is a healthy process that can encourage best practices, support the integrity of our products and services, and allow our industry to adapt to the evolving expectations of market participants. Many necessary actions can and have been taken at both the firm and industry level, and policymakers at the domestic and international levels have proposed a host of constructive reform measures for our industry and credit markets generally. Moody's wholeheartedly supports constructive reform measures and we are firmly committed to meeting the highest standards of integrity in our rating practices, quality in our rating methodologies and analysis, and transparency in our rating actions and rating performance metrics.

I am happy to respond to any questions.

W:\Dec09\Cmte\E\wg\Rating Agency\Att B06 Moody's Statement for NAIC Meeting.pdf

WRITTEN STATEMENT OF GRACE OSBORNE
MANAGING DIRECTOR AND
LEAD ANALYTICAL MANAGER FOR NORTH AMERICAN INSURANCE RATINGS

STANDARD & POOR'S RATINGS SERVICES

BEFORE THE MEETING OF THE RATING AGENCY WORKING GROUP OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

SEPTEMBER 24, 2009

Good morning. My name is Grace Osborne. I am a Managing Director and the Lead Analytical Manager for North American Insurance Ratings at Standard & Poor's Ratings Services ("S&P"). I am pleased to appear before you today.

We understand that the Rating Agency Working Group ("Working Group") has been formed by the National Association of Insurance Commissioners ("NAIC") to consider and reevaluate the ways in which the NAIC utilizes credit ratings of Nationally Recognized Statistical Rating Organizations ("NRSROs"). We appreciate the opportunity to provide information in connection with this project.

Obviously, the Working Group's study comes on the heels of serious difficulties in the credit markets and our economy as a whole, and in the wake of considerable criticism of NRSROs, primarily directed at their ratings of certain mortgage-backed structured finance products. As head of our North American Insurance Ratings group, my focus is on our insurance company ratings, and I am not involved in S&P's ratings on structured finance securities. However, I can tell you at a very broad level that we at S&P are keenly aware that confidence in our ratings has been diminished. We are committed to restoring that confidence and have already undertaken a series of important measures designed to enhance the quality, independence and transparency of our credit ratings and credit ratings process. I will describe some of these changes as part of my statement here today.

I would like to begin, however, by summarizing some key points related to our insurance company rating opinions and our process for arriving at those opinions.

S&P's Insurance Company Ratings

S&P's RBC Adequacy Model

The Working Group has expressed interest in understanding how NRSROs arrive at their insurance company ratings and, specifically, whether those ratings result from "stress testing" of an insurer's capital adequacy.

The rating drivers of financial strength ratings, which reflect our opinion of an insurer's ability to meet its policyholder obligations, include both quantitative and qualitative factors. To determine a rating, an analyst will assess an insurer's competitive position, management and corporate strategy, operating performance, investments, liquidity, capital, financial flexibility, and enterprise risk management.

S&P's insurance company ratings have long utilized our proprietary risk-based capital ("RBC") adequacy model. The RBC model is a quantitative tool that helps our analysts evaluate an insurer's ability to absorb losses at varying levels of confidence. Put simply, the model seeks to estimate the amount of capital that is necessary to cover losses at varying confidence intervals, subject to a wide array of risks over the expected life of an insurance company's portfolio.

As part of our ratings process, each risk variable in the model is evaluated using confidence levels derived from our empirically observed cumulative five-year default rates for each rating level. While the RBC model is an integral part of our evaluation of capital adequacy, we do consider other significant factors as well, including qualitative considerations such as the level of reinsurance dependency and reserve adequacy. Our rating committees evaluate all these factors, and more, to help form a comprehensive opinion on a company's level of capitalization.

Accounting for "Downward Spirals"

The Working Group has also asked NRSROs to address the possibility of a "downward spiral" on insurance company subsidiaries that might result from the downgrade of a parent company or other developments. As we have stated, S&P recognizes that the insurance industry has long been sensitive to market perception of credit quality. As a result, the speed with which the market can lose confidence in an insurer is an important factor in our view of the insurer's creditworthiness. If there is a crisis in confidence — whether from problems at a parent company or some other factor — an insurer without sufficient resources to cover all contingent calls on liquidity could quickly become insolvent, despite having otherwise healthy business operations and strong capital. Any problem that erodes confidence in financial institutions that have not sufficiently anticipated liquidity needs in times of stress could have the potential to lead to a downward spiral with severe consequences -- *e.g.*, a run on the bank scenario.

Thus, when evaluating an insurance company's financial strength or the creditworthiness of an insurance holding company, we consider a number of relevant factors including the existence of ratings-related triggers, financial benchmark triggers, material adverse condition (MAC) clauses, or other covenants. Even in "normal" times, we evaluate how an insurer is positioned to handle stress scenarios, balancing sources of liquidity available in these scenarios against its liability structure and potential liquidity calls.

It is also important to note that our process for insurance company ratings generally incorporates S&P's new credit stability criteria, which address whether, in our view, an issuer or security has a high likelihood of experiencing unusually large adverse changes in credit quality under conditions of moderate stress. One example of this broad-based criteria enhancement in the insurance company context is our incremental stress analysis, first applied last year, which is designed to permit enhanced assessments of capital adequacy. As part of this process, we assume higher levels of stressed loss for certain asset classes that we believe may be subjected to unprecedented stress for some time to come.

Sensitivity Analysis for Structured Finance Exposure

In connection with its study, the Working Group has also asked NRSROs to address the degree to which their sensitivity analysis of insurers addresses the market risk of structured finance investments. In our case, S&P may lower an insurance company's rating if we believe that the insurance company will likely suffer sharp and substantial economic unrealized investment losses as a result of investments in structured finance or other securities. However, if we believe that an insurance company has sufficient liquidity, quality asset/liability matching, modest needs for additional financial flexibility, and the ability and willingness to hold such securities to maturity, the market risk of those securities would not likely be a driver for rating actions, although such action may still be considered.

Criteria for Portfolio Concentration

The Working Group has also inquired about whether NRSROs have developed criteria to address risks associated with portfolio concentration. S&P does look to investment concentrations in assessing the risks of an insurer and maintains criteria regarding an insurance company's portfolio concentration in particular asset classes. Specifically, we review unusual concentrations, such as by asset type, industry sector, or individual companies. In our view, the essence of building a portfolio is diversification, and any concentrations could subvert the benefits of diversification. We closely examine issues that might not appear to be correlated but in fact are, such as common and preferred stock issued by the same entity and perhaps convertible or senior debt also issued by the same entity or a closely related family member. To facilitate this analysis, we have developed a formula for evaluating levels of capital adequacy and investment concentrations in our rating process.

I would be pleased to elaborate further on this formula, along with any of these insurance-related subjects, during the question and answer session.

Recent Performance of Structured Finance Ratings

As the Working Group is well aware, credit ratings on certain structured finance securities have recently received a significant amount of negative attention. While I am not a structured finance analyst, and am not familiar with the details of particular transactions, I would like to make some comments at a general level.

First let me say that S&P has a long and successful history issuing rating opinions on a wide array of issuers and debt securities, including structured finance securities. We began our credit rating activities more than ninety years ago, in 1916, and since that time our ratings have served as valuable independent opinions in the U.S. debt market. More than any regulatory framework or NRSRO recognition, the market's recognition of our independent opinions and our commitment to analytical excellence have been the primary drivers of our success over these ninety-plus years.

Although credit ratings have been -- and will continue to be -- an extremely useful tool in understanding credit risk, we have repeatedly cautioned market participants, regulators and policymakers alike to be aware of what credit ratings are intended to address. S&P's ratings reflect our current opinions regarding the creditworthiness of issuers or debt securities. At their core, they represent our opinion of the likelihood that a particular obligor or financial obligation will pay principal and interest in a timely manner. Ratings are not "buy," "sell," or "hold" recommendations and they do not address whether any particular rated securities are suitable investments for a particular investor or group of investors, or whether the price of the security is appropriate or even commensurate with its credit risk. Put simply, if regulators and policymakers choose to incorporate ratings in their rules as benchmarks, the use of additional benchmarks may also be warranted.

In terms of our track record, S&P's ratings, including in the area of structured finance securities, have historically performed very well. Indeed, S&P has been rating structured securities for thirty years and has developed industry-leading processes and models for evaluating the creditworthiness of a wide array of structured transactions. Since 1978, only 1.1% of structured finance securities rated by us 'AAA' have ever defaulted.

Of course, as I noted, we do recognize that the performance of our ratings from certain recent Residential Mortgage Backed Securities ("RMBS") vintages and other securities related to them has been inconsistent with this track record. While much of the recent difficulty in these markets has related to the price of these securities -- a factor that ratings do not, and are not intended to, address -- defaults and ratings volatility have been much higher with these securities than we anticipated or intended. We have been disappointed -- and we understand that the market has been disappointed -- with the extent of volatility in this area. Although we conducted robust analysis of transactions and based our ratings on historical data, including market events going back as far as 75 years to the Great Depression, we (along with many other market participants and regulators) never expected such severe, negative performance in the housing and mortgage markets.

We have learned hard lessons and, consistent with our constant desire to enhance our ratings process and analytics, have taken a number of important steps that we believe will help improve the quality of, and confidence in, our ratings. These fall into four broad categories: (i) promoting the integrity of the ratings process; (ii) enhancing analytical quality; (iii) providing greater transparency to the market; and (iv) more effectively educating the marketplace about ratings.

To date, we have made significant progress implementing these changes in several areas. For example, we have:

- Invested significantly in our compliance function;

- Established an Office of the Ombudsman to address concerns related to potential conflicts of interest and analytical and governance processes that are raised by issuers, investors, employees and other market participants across S&P' businesses. The Ombudsman has oversight over the handling of all issues, with authority to escalate all unresolved matters, as necessary, to the CEO of McGraw-Hill and the Audit Committee of the Board of Directors;

- Implemented "look back" reviews to confirm the integrity of ratings, whenever an analyst leaves to work for an issuer;

- Instituted a rotation system for analysts;

- Established an enterprise wide independent Risk Assessment Oversight Committee. The Committee will assess risks that could impact the integrity and quality of the ratings process. This committee will also assess the feasibility of rating new types of securities;

- Implemented procedures to collect more information about the processes used by issuers and originators to assess the accuracy and integrity of their data and their fraud detection measures so that we can better understand their data quality capabilities;

- Created a separate Model Quality Review Group to independently analyze and validate models used in the rating process, developed by S&P or provided by issuers;

- Updated our analytical methodologies and assumptions, including for certain structured finance products;

- Increased our analyst training programs;

- Expanded our two-way communication to listen to the concerns of market participants and better explain our ratings;

- Published a series of articles addressing certain "what if" scenarios, including with respect to structured finance ratings.

- Published a "Guide to Credit Ratings Essentials" that provides important information about ratings and their role in the markets.

In our view, these steps will help enhance our processes and better educate market participants on what ratings mean and how to use them. Restoring confidence in the credit markets will require a systemic effort, and S&P is just one part of the equation. We believe that appropriate government action, as well as meaningful private-sector initiatives, are essential to accomplishing that goal. For its part, S&P is committed to restoring confidence in ratings and we believe that ratings will continue to play an important role in the capital markets going forward.

Conclusion

I thank you for the opportunity to participate in this public meeting. I would be happy to answer any questions you may have.

W:\Dec09\Cmte\E\wg\Rating Agency\Att B07 Grace Osborne Statement.pdf

FitchRatings

Submitted Statement of Fitch Ratings
As Delivered By
Keith Buckley, Group Managing Director and John Olert, Group Managing Director
To The
National Association of Insurance Commissioners'
Public Hearing on Credit Rating Agencies
September 24, 2009

The global capital markets have experienced unprecedented levels of stress and volatility since the beginning of the "credit crisis" in the summer of 2007. As Fitch has noted previously, many factors contributed to the initial credit crisis. These have been broadly analyzed and debated by market participants, the media, and within the policy-making and regulatory communities. Key underlying factors include historically low real interest rates, greater global demand for higher-yielding and relatively riskier assets, significantly higher degrees of systemic leverage, lax underwriting standards in the mortgage origination markets, inadequate discipline in the securitization process, insufficient risk management practices at financial institutions, an outmoded global regulatory framework, and credit ratings in RMBS and CDOs that have not performed as originally intended.

While overall macro-economic conditions remain difficult, it seems the period of most intense market stress has passed. This is due to both a variety of government initiatives here and abroad aimed at restoring financial market stability as well actions taken by companies individually to shore up their balance sheets and reduce risk. Having said that, important sectors in the fixed income markets struggle to re-open, and certain asset classes, such as commercial mortgage-backed securities, are experiencing greater performance strain on their underlying assets.

During this time, the focus of Fitch Ratings has been on implementing a broad and deep range of initiatives that enhance the reliability and transparency of our rating opinions and related analytics. More specifically, our primary focus is on vigorously reviewing our analytical approaches and changing ratings to reflect the current risk profile of securities we rate. We are releasing our updated ratings and research transparently and publicly and we are communicating directly with the market the latest information and analysis we have.

In parallel, we have been introducing a range of new policies and procedures – and updating existing ones – to reflect the evolving regulatory frameworks within which credit rating agencies operate globally. In each of these areas, we have been as transparent as possible and broadly engaged with a wide range of market participants, including policy makers and regulators. We are happy to expand upon any of these topics in the discussion today.

In the NAIC's invitation to Fitch, it noted it intended to seek testimony from different organizations on three primary subjects:

1. the reliance of insurance regulators on ratings and the difficulties encountered by regulators as a result of this reliance;

2. the performance of the NRSROs in the years leading up to the financial crisis and the reasons for recent rating volatility; and

3. regulatory alternatives to reliance upon NRSROs and recommendations for next steps.

With respect to the first topic, Fitch believes it is more appropriate for market participants, in this case primarily regulators and their regulated entities, to offer their perspective on the advantages and limitations in using the ratings of NRSROs. While Fitch is certainly aware of the ongoing dialogue in the market with respect to such topics – including discussions among the NAIC, the ACLI, rated insurers and other insurance industry participants regarding the use of credits ratings and their impact on capital charges -- we have been focused primarily on initiatives that enhance the reliability and transparency of rating opinions and related research.

In terms of the second topic (recent performance of the ratings of NRSROs), we would offer a number of observations. From the perspective of a credit rating agency, and as Fitch has noted in multiple public forums in the last few years, the credit crisis primarily began with pronounced asset quality deterioration in the U.S. subprime residential mortgage market. As a result, the market prices and credit ratings declined significantly in related RMBS (subprime and Alt-A) and certain CDO securities. A dramatic reduction in the market price for all forms of structured securities followed reflecting, in large part, concerns that ultimate credit losses would be significantly greater than anticipated in all asset classes.

As time has progressed, the market stresses have become more broad-based – by asset class, institution and geography – and emanate from a global reassessment of the degree of leverage and appropriateness of short-term financing techniques inherent in today's regulated and unregulated financial companies. Deleveraging is dramatically reducing liquidity and contributing to price volatility – both for individual securities and for the institutions that own or insure them. Credit ratings generally do not address market risk or liquidity, and to the extent that certain market participants may have inappropriately used ratings as a proxy for those variables, the flaws in that approach have become apparent.

In retrospect, too many of our structured finance credit rating opinions have clearly not performed as well as originally intended. We have downgraded significant numbers of structured finance securities due to the performance of underlying assets and structures of the deals, and in many cases by multiple notches or even rating categories. Originally, this affected primarily subprime RMBS and CDOs. It has since also affected Alt-A and even prime RMBS securities. While significant rating actions themselves do not necessarily imply realized losses, in many cases the magnitude of the rating downgrades and the levels of the current ratings do in fact correlate with not only a greater probability of default but also the prospect of significant losses for many low rated securities. Other structured asset classes, such as CMBS and ABS, have been more resilient, but these are also facing real credit headwinds as the macro-economic environment deteriorates. Strains in the commercial real estate sector may affect the ratings of CMBS – in particular the junior tranches. However, TALF-eligible ABS assets such as credit cards, auto loans and student loans continue to be among the most resilient classes.

Fitch has previously acknowledged that while we were aware of, and believed we accounted for, many various risks posed by subprime mortgages and the rapidly changing underwriting environment in the U.S. housing market in our models and analyses, we did not foresee the magnitude or the velocity of the decline in home prices, nor the dramatic shift in borrower behavior brought on by the changing practices in the market. Nor did we appreciate the extent of dubious mortgage origination practices and fraud – by lenders and borrowers – in the 2005-07 period.

Structured securities are specifically designed for lower-rated, riskier and therefore higher-yielding bonds to absorb losses first. However, radically and rapidly changing markets have led to dramatic rating changes that have affected even highly rated bonds. The worsening economic environment accelerates the deterioration of the underlying assets, and combined with forecasted further economic stress, is consistent with broad-based negative ratings migration. Building complex highly tranched securities on historical default probabilities does not always provide enough cushion for extraordinarily variable economic and asset performance.

Certain structured assets have represented a major portion of asset losses and write-downs. They are one of the original catalysts for today's financial crisis, but that is not a complete picture. Derivative exposure relating to these and other assets has created major stress. Balance sheet leverage was too high for the volatility we experienced and the ongoing deleveraging process is dramatically pressuring markets and prices. Further, the leverage from synthetic exposures that normally is not transparent became painfully transparent as counterparties lost confidence in each other and required physical collateral to protect positions. Consequently, many global financial institutions have found themselves experiencing material balance sheet stress, severe losses, equity market pressures, and a lack of confidence that has precipitated various government intervention programs here and abroad.

While a credit rating is a forward-looking opinion, one of the primary ways by which we assess the performance of our ratings over time is through the publication of our transition and default studies. In structured finance over the last decade, upgrades actually exceeded downgrades in every year from 1999 forward until 2007. In 2008 the pace of downgrades accelerated, particularly in RMBS and CDOs, as the credit crisis progressed. Even so, 87% of structured securities rated "AAA" at the beginning of 2008 remained "AAA" at year end. However, continued stress on the performance of underlying assets and our evolving perspectives on the fundamental economic drivers have led to significant additional rating actions across global structured finance thus far in 2009, including larger numbers of downgrades to "AAA" securities. Our credit ratings denote probability of default, not expected loss, so a ratings downgrade logically indicates a greater probability of default. A bond that remains rated investment grade reflects our opinion that the odds of default remain low, but further actions into non-investment grade categories increase the odds of default and with it the probabilities of loss. Such loss estimates can vary widely by asset class, region, structure and collateral, so Fitch has introduced loss severity ratings and recovery ratings in structured finance to provide our perspective on this dynamic as well. That said, we fully recognize that there are a range of material regulatory capital issues, fair value accounting issues, and changes in market price and liquidity that are associated, if not fully correlated, with credit rating actions taken by NRSROs.

Our corporate finance ratings portfolio (financial institutions and non-financial corporates) tells a different story. While the majority of ratings by par value at origination are "AAA" by design within structured finance, it is different in corporate finance. The average financial institutions rating tends to be in the "AA" to "A" categories, while the average non-financial corporate rating tends to be in the "BBB" category. There are a relatively limited number of "AAA" rated issuers. Interestingly, 86% of Fitch's corporate issuers rated "AAA" at the beginning of 2008 remained "AAA" at year end, and of those, none were downgraded below "AA." At the same time, the number of downgrades significantly exceeded the number of upgrades in 2008, trends that have continued during the first half of 2009.

Given the above, over the last two years, Fitch has made a broad range of changes and refinements across nearly all dimensions of our company – both at our own initiation and in response to various regulatory changes. Broadly speaking, we have: (1) implemented a series of important analytical refinements and new initiatives; (2) adopted a host of policy, procedure and organizational changes; (3) introduced a number of new or revised tools and analytical offerings that complement our "traditional" credit ratings; (4) engaged constructively with policy makers and regulators; and (5) continued our active dialogues with market participants who are affected by our actions and interested in our opinions.

At the end of this statement, attached is publication, "Ensuring Reliability and Transparency in the Ratings Process," which we released in February of this year. It provides a rather comprehensive summary of Fitch's approach and actions given our overarching objective to enhance the reliability and transparency of our ratings and research and to contribute to the rebuilding of confidence across the global debt capital markets.

Analytically, Fitch has pursued action on many fronts. Philosophically, we have made clear that we need to re-emphasize the "art" of fundamental credit analysis as learned through our experience as an appropriate complement to the "science" of modeling and quantitative analytics. Our rating opinions must be more predictive and our research and analysis must be insightful and forward-looking. Simply put, we must endeavor to provide the market with a clear and balanced opinion about what may happen tomorrow instead of just a review of what happened yesterday. In so doing, our objective is to offer ratings that are more stable and reliable, combined with transparency in our analysis and modeling techniques, so investors and all market participants can understand and use our ratings to supplement their own risk analysis and decision making. This applies to all of our ratings – structured, corporate and public. Importantly, we remain committed to the highest standards of integrity and objectivity in all aspects of our work.

Practically speaking, from 2007 forward we have built significantly more conservatism into our analytical approach as we reassess our current portfolio of ratings or consider ratings on new securities. Specifically, we have conducted extensive rating reviews across most asset classes, revised our ratings where necessary – and in some cases significantly, and updated our criteria and models with new approaches and assumptions. We have also focused on publishing frequent, timely and relevant research on the performance of asset classes and individual issuers.

Fitch has been reviewing and making appropriate changes to policies, procedures, and organizational structures to manage better conflicts of interest and so that Fitch's operations are consistent with the revised rules put forth by global regulators. By way of example, Fitch has implemented an updated and IOSCO-compliant Code of Conduct, and IOSCO itself has noted our conformity with the standards they have set forth. We have already implemented, or are in the process of so doing, a range of policies that will enable compliance with the SEC's recently announced final rules for NRSROs. Organizationally, we have implemented a number of senior management changes. We have created new positions of chief risk officers within each of the rating groups. We have introduced additional measures to ensure the full separation of our rating analysts from any commercial considerations for issuers they cover. In addition, we have created even greater separation of our analytical activities from our commercial activities by moving our complementary products and services into a new entity – Fitch Solutions.

Recent experience also suggests that the market benefits from additional information beyond the core rating. In an effort to meet the evolving needs of investors and increase transparency in the debt capital markets, Fitch has developed and introduced a range of new tools and analytical offerings over the last year or so, such as recovery ratings in structured finance and "RMBS LossMetrics."

While our own judgment and experience have informed many of the actions we have taken to date, we have also greatly benefited from our regular interaction with market participants globally, and in particular from our dialogue with policy makers and regulators. We recognize the complexity of many of the issues facing the policy makers and regulators with respect to credit ratings. We may occasionally differ in our respective opinions, or disagree with certain characterizations of the quality of our efforts, but we share the same objectives of enhanced stability, greater ratings reliability, and improved confidence in the markets.

Lastly, we have always maintained an open and active dialogue with investors, intermediaries and issuers – and that has not changed despite recent market developments. We host a variety of teleconferences, webcasts, one-on-one meetings and conferences to maintain this dialogue. In addition, we issue commentary, publish special research reports and participate in speaking panels and interviews with media outlets worldwide. Throughout the crisis, Fitch has frequently and proactively reached out to its investor base through these communication channels to provide credit opinions, disseminate information, respond to market inquiries and solicit feedback.

With respect to the third primary topic, Fitch has previously offered its perspective on a number of salient points related to so-called "regulatory alternatives."

A recurring theme in such regulatory discussions is the management of conflicts of interest. The majority of Fitch's revenues are fees paid by issuers for assigning and maintaining ratings. This is supplemented by fees paid by a variety of market participants for research subscriptions. The primary benefit of this model is that it enables Fitch to be in a position to offer analytical coverage on every asset class in every capital market – and to make our rating opinions freely available to the market in real-time, thus enabling the market to freely and fully assess the quality of our work. Fitch has long acknowledged the potential conflicts of being an issuer-paid rating agency. Fitch believes that the potential conflicts of interest in the "issuer pays" model have been, and continue to be, effectively managed through a broad range of policies, procedures and organizational structures aimed at reinforcing the objectivity, integrity and independence of its credit ratings, combined with enhanced and ongoing regulatory oversight. In recent months, Fitch has introduced new policies, and revised many existing ones, focused on these issues. No payment model would be completely immune to conflicts of interest, whether from investors, issuers, governments or regulators. An "investor pays" model also contains direct conflicts, given that most major investors have a vested financial interest in the level of ratings and many are rated entities. A move to a complete "investor pays" model, by definition making the ratings a subscription product, could also remove ratings from the public domain. This would conflict with investor and policymakers' call for ratings to be broadly available, thereby allowing the market to openly judge ratings performance.

More broadly, and stated simply and clearly, Fitch supports fair and balanced oversight and registration of credit rating agencies and believes the market will benefit from globally consistent rules for credit rating agencies that foster transparency, disclosure of ratings and methodologies, and management of conflicts of interest.

Interestingly, the overall dialogue on changes to rating agency regulation continues to follow two primary – and not necessarily consistent – themes. The first is the imposition of additional rules and regulations that are manifested in a range of new or enhanced policies and procedures. This has been the primary thrust of recent SEC rulemaking and of the recently passed EU rules. Fitch is or will be fully compliant with these new rules.

At the same time, a number of commentators – including the NAIC -- have spoken on the topic of the market's perceived over-reliance on credit ratings. To a certain extent, we agree with this premise, in so far as some market participants clearly used ratings as a substitute for – as opposed to a complement to – their own fundamental credit analysis. One proposed remedy for this is to eliminate the use of ratings in regulation or to eliminate the NRSRO concept altogether. While deceivingly simple, we believe this proposal warrants several comments. Ratings have been used constructively in many places in regulation, as they are an important common benchmark. From a regulatory point of view, the question of what would be used in place of credit ratings is rarely answered satisfactorily. Simply having regulators “do it themselves” has a range of practical implications and unintended consequences. As does the notion of allowing regulated financial entities to assess the credit risk of the securities completely on their own without reference to any independent external risk benchmarks. In many cases, if you eliminate the use of “NRSRO” ratings in regulation, company and industry participants will likely develop or maintain their own guidelines and use credit ratings anyway. We believe they will default to the largest “brand name” rating agencies (Moody’s and S&P), which is not a positive if one of your objectives is increasing competition and thereby fostering a better work product. Note that the SEC proposed a variation on this theme in 2008 with respect to money market funds and their use of ratings but chose not to move forward, in part based on significant feedback supporting the use of ratings in money market regulations from the fund industry itself. Some have suggested replacing ratings with market prices for debt – either bond spreads or CDS spreads. While these may reflect the market’s sense of price at a given point, recall from the events of the last two years that not all securities are liquid, that bid-ask spreads can widen materially in times of stress and that market prices by definition are inherently more volatile than a fundamentally driven credit rating. Note also the ongoing debate relative to fair value accounting (and standards of international convergence) and the difficulties of fostering widespread consensus on the key parameters of market prices and when they should or should not be used, let alone the dynamics of procyclicality.

However, if one is serious about eliminating ratings in regulation, we suggest that you transition to elimination over an intermediate time frame with careful consideration of each regulation, rather than wholesale elimination. Fitch continues to believe that a better solution is continued recognition and oversight of NRSROs with the goal of improving the performance and usefulness of ratings.

In conclusion, Fitch continues to engage broadly and deeply with important market participants around the globe. We seek to share our latest thinking and also solicit ideas and answer questions. Fitch believes that we have responded in many good and productive ways, and anecdotal feedback from market participants is consistent with that view. That said, while the crisis has eased, we clearly have more to do, but we believe we are on the right path.

Appendix 1: Ensuring Reliability and Transparency in the Ratings Process (February 2009)

[See attached document.]

Global
Special Report

Ensuring Reliability and Transparency in the Ratings Process

Media Enquiries
David Weinfurter
+1 212 908-0336
david.weinfurter@fitchratings.com

Related Research
Fitch Updates Market on Steps to Enhance Transparency and Restore Confidence,
29 May 2008

Fitch Ratings Update on Key Initiatives

The unprecedented events that have taken place illustrate the sensitivity and interdependence of credit events on the world's financial markets. As market conditions have evolved, Fitch Ratings has taken numerous steps to enhance the quality and transparency of its credit ratings and to help restore confidence to the credit markets. This document provides an update on the range of initiatives that the agency has implemented.

Stephen Joynt, President and CEO of Fitch Ratings, commented on November 12, 2008 that "Fitch recognizes that strengthened market confidence in the opinions of rating agencies is an important aspect of working through these challenging times."

Fitch has focused primarily on ensuring the reliability and transparency of its credit analytics. Fitch conducted extensive rating reviews across asset classes, revised ratings where necessary, and updated criteria and models with new factors and assumptions. Fitch has also focused on publishing frequent, timely and relevant research on the performance of asset classes and individual issuers and has launched new tools and analytics to further enhance transparency.

Fitch has also been working closely with investors, policy makers and regulators on a range of proposed modifications to restore and maintain confidence in the credit markets. Fitch has been reviewing and making appropriate changes to policies, procedures, and organizational structures so that Fitch's operations are consistent with the revised rules put forth by global regulators.

What follows are: (I) a summary of key analytical initiatives; (II) a recap of updated policies, procedures and organizational changes; (III) a description of Fitch's new tools and analytic offerings; and (IV) an overview of Fitch's real-time engagement with the capital markets. This document complements Fitch's May 2008 update on key initiatives, as well as previous public statements to authorities such as the European Commission, US Congress and US SEC.

Fitch will continue to update the market on the measures outlined below and on the progress of its commitments. Updates to policies, processes and the Fitch Code of Conduct are available on Fitch's public web site at www.fitchratings.com.

Fitch Ratings' Key Initiatives

I. Analytical initiatives to enhance transparency and provide the highest quality credit ratings and research:

Fitch has focused on ensuring the reliability and transparency of its credit analytics. Each ratings group has focused on:

- Conducting extensive rating reviews and, where necessary, taking rating actions
- Updating methodologies and models
- Performing deterministic stress analyses
- Publishing extensive timely and relevant research

Examples of key credit initiatives within each rating group are included below.

Structured Finance

- Developed Structured Finance Ratings Outlooks. To better signal concerns about potential ratings pressure, Fitch launched Structured Finance Rating Outlooks in June 2007 in Europe, followed by the US in May 2008 and Latin America in January 2009. Rating Outlooks are an early indicator of a potential rating change over the next one- to two-year period. Fitch is the first agency to provide this information.
- Strengthened Structured Finance Originator Evaluations. Acknowledging the key role of the originator in influencing the level of risk and expected performance of a transaction, Fitch has strengthened its existing originator evaluation processes globally for structured finance issuers. The evaluation determines Fitch's ability to rate a transaction as well as positive or negative adjustments to the credit enhancement levels based on the originator's operational risks.
- Proposed Complementary Ratings Scales for Structured Finance. In an effort to add greater transparency and capture additional risks, Fitch has explored a range of potential complementary rating scales for structured finance securities. Based on market feedback, Fitch is continuing to review the potential for an additional scale on loss given default. Loss Severity Ratings would attempt to quantify the recoveries on a tranche-level basis that a creditor would likely receive in the event of default.

Residential Mortgage Backed Securities (RMBS)

- Updated US RMBS Criteria and ResiLogic Model. Fitch completed a full review of its US RMBS rating criteria and announced revisions to ResiLogic, Fitch's mortgage default and loss model for US RMBS prime, Alt-A and subprime transactions, in July 2008. Updated criteria reflect new assumptions for factors such as falling home prices and loan performance, as well as substantial changes in mortgage originations.
- Incorporated New Procedures for Information on US RMBS Transactions. In December 2008, Fitch announced new procedures related to US RMBS ratings. These procedures are intended to ensure that Fitch is relying on the most complete and accurate information when assessing the credit worthiness of a US RMBS transaction:

- Originator Reviews. Fitch now requires originator reviews, which provide an indication of the risk attributable to an originator's level of risk management and disclosure. Fitch will decline to a rate transaction if the origination practices do not meet the agency's standards.
- Loan-level Reviews. Loan-level reviews must be conducted by an independent third-party to better identify poor underwriting practices. Fitch will not rate a transaction if the results of the loan-level review are unacceptable.
- Representations and Warranties. Representations and warranties in RMBS transaction documents must meet Fitch's elevated standards. Fitch will not rate a transaction whose representations and warranties are not acceptable.

- Revised US RMBS Surveillance Criteria. Revisions have also been made to surveillance criteria. Fitch's methodology for reviewing US prime criteria was published in August 2008, followed by updated criteria for US subprime announced in November 2008 and US Alt-A in December 2008.
- Published EMEA RMBS Criteria. Fitch also published its criteria for rating residential mortgage securitizations in EMEA emerging markets (September 2008) and the treatment of Automated Valuation Model (AVM) property valuations for residential mortgages in EMEA (November 2008).

Collateralized Debt Obligations (CDO)

- Reviewed CDO Rating Methodology. In November 2007, Fitch announced a full review of its CDO rating methodology and placed a moratorium on new CDO issuance until this review was complete.
- Revised CDO Rating Criteria. Following this review, Fitch announced updated global criteria for market value structures (April 2008), corporate CDOs (April 2008), project finance CDOs (August 2008) and structured finance CDOs (December 2008).
  - A review of the impact of Fitch's updated corporate CDO criteria in November 2008 notes the resiliency of ratings under the new criteria and demonstrates that the new criteria effectively highlight industry and/or obligor concentrations and adverse selection.
- Evaluated Credit Risk Inherent in CPDOs (Constant Proportion Debt Obligations). In April 2007, Fitch concluded that first generation CPDOs did not merit high investment grade ratings and, as such, did not rate any public CPDO deals.

Commercial Mortgage Backed Securities (CMBS)

- Conducted Stress Testing. Fitch conducted extensive stress tests on "at risk" CMBS deals across the US and Europe and then changed rating outlooks and took rating actions where appropriate.
  - Findings from these stress tests were subsequently published to help investors quantify the risks that potential property-specific and macroeconomic stresses may present to ratings (e.g., "Fitch Stress Testing: Expected Losses in US CMBS – 2006 & 2007," dated 31 July 2008).

- Completed Model Updates. In January 2008, Fitch announced a number of updates to its multi-borrower rating model.

Asset Backed Securities (ABS)

- Conducted Stress Testing. Fitch conducted stress tests on certain key ABS areas (e.g., student loan auction rates) and continues to monitor credit card and auto transactions, with a focus on unemployment levels and the impact of house price declines and energy costs.
- Reviewed ABCP Programs. Fitch has reviewed all ABCP program ratings. ABCP programs with exposures to RMBS, CDO and financial guarantors continue to be reviewed on a weekly basis, followed by the publication of Fitch's associated commentary.

Financial Institutions

- Conducted Portfolio Reviews and Rating Actions. Considering the evolution of recent market events and their impact on financial institutions, it is important to remember that banking is a confidence-sensitive industry, so a sudden erosion of confidence can overwhelm the fundamentals of an issuer in a short period. Nonetheless, Fitch has focused on providing timely, relevant credit opinions and rating actions in this sector. Apart from emerging markets, negative rating actions have been largely concentrated on complex and wholesale banks and have generally been relatively modest (one to two notches). Most banks remain relatively highly rated ('A' or above), although Fitch expects that ratings pressure will remain in place for a number of developed and emerging market banks throughout 2009.
- Reviewed Impact of Sovereign Rating Actions on Emerging Market Banks. Emerging markets have not escaped the financial crisis, and banks in a number of countries have been experiencing liquidity and funding difficulties. Following a review of the sovereign ratings and outlook for 17 major emerging market economies, a large number of actions were taken on the ratings of banks in various countries.
- Conducted Stress Testing on European Banks. Given the impact of the economic slowdown in Europe and the number of banks exposed to the mortgage and consumer sectors, Fitch has conducted stress test reviews of banks' mortgage portfolios in the UK, Spain and Ireland.
- Monitored Liquidity Positions. Fitch continues to closely monitor the liquidity position of all wholesale banks and those mortgage banks that have been more reliant on securitization and have long-term funding requirements.
- Published Timely Research on Key Issues. Fitch published, and continues to publish, updated research and commentary on key issues affecting financial institutions, such as: macroeconomic conditions; consolidation within the industry; government intervention; and liquidity challenges. Research is published by both country/region (e.g., "Japanese Major Banks: Semi-Annual Review and Outlook," dated 9 December 2008) and sector (e.g., "Fitch Sees Elevated Risk of Bank Hybrid Capital Coupon Deferral in 2009," dated 4 February 2009; "Converting to Bank Holding Company Status," dated 21 January 2009; "Bank Ratings, Confidence Sensitivity and Support – Cliffs and Safety Nets," dated 17 October 2008).

- Reviewed and Published Bank Rating Methodology. In November 2008, Fitch published its bank rating methodology to provide greater transparency on Fitch's analytical process and ratings rationale.

- Heightened Surveillance Efforts for Money Market Funds and Closed-End Funds. As market conditions evolved, Fitch enhanced its surveillance efforts for money market funds and closed-end funds, focusing on liquidity and performance issues, as well as the impact of various government-led initiatives.

- Revised Closed-End Fund Criteria for Leveraged Loans. In light of the heightened market price volatility of closed-end funds' portfolio holdings and a broader initiative across Fitch to update its market value criteria, Fitch updated its criteria for rating securities issued by leveraged closed-end funds in December 2008.

- Proposed Revisions to Global Money Market Fund Rating Criteria. Fitch recently solicited feedback on proposed changes to its global criteria for rating money market funds. Primarily focusing on "prime" funds, criteria changes include: a more direct recognition of potential institutional support; a closer alignment of portfolio liquidity and the potential for high redemptions in times of stress; the introduction of new diversification guidelines and a Portfolio Credit Factor (PCF) matrix; and a revised ratings scale that adds a MMF subscript and eliminates existing MMF Volatility ratings.

- Expanded Covered Bonds Group. Fitch supplemented its widely respected European covered bonds team with additional resources. Additionally, a covered bonds team was established in the US, consistent with government efforts to develop this market. In September 2008 Fitch published a special report providing an introduction to US covered bonds, comparison relative to US RMBS and European covered bonds and discussion of key factors issuers and investors should analyze when considering this sector ("ABCs of US Covered Bonds," dated 3 September 2008).

Insurance

- Conducted Stress Tests. Over the course of the past year, Fitch has focused on stress testing insurers' investment and liquidity exposures, focusing on capital levels as well as the impact of possible government support.

- Continued Ongoing Sector Reviews. Fitch conducted ongoing insurance sector reviews with a focus on the expected impact of realized and unrealized investment losses on insurers' capital levels and profitability. As a result of this analysis, Fitch placed all insurance sectors globally on Negative Outlook in October 2008. Further rating outlook rationale by sector is provided in recently published 2009 sector outlooks, and Fitch continues to actively screen the entities it covers.

- Published Special Reports on Key Issues. As market conditions have unfolded, Fitch has also focused on providing timely commentary on key topics affecting the insurance industry. Examples include: "US Mortgage Insurers – 2008 Review and 2009 Outlook (Continued Losses and Capital Demands)," dated 13 January 2009; "Presentation: How Credit/Market Crisis Impacts Life Company Ratings," dated 18 November 2008; and "Property/Casualty Insurer Asset Risk (Growing Investment Loss Concerns)," dated 4 November 2008.

- Enhanced Rating Methodology for Health Insurers. In December 2008, Fitch announced an enhancement to the methodology it uses to measure financial leverage of US Health Insurers, placing greater emphasis on various cash flow measures and less emphasis on balance sheet ratios.

- Completed Targeted Review of Bond Insurers. Fitch announced a formal review of all 'AAA' rated bond insurers in November 2007, with a special focus on portfolios of structured finance collateralized debt obligations (SF CDOs) that contain subprime collateral. At the conclusion of this analysis, several insurers were identified as having material capital shortfalls relative to Fitch's 'AAA' standards and three downgrades took place — the first among the industry. In February 2008, Fitch launched a second phase of analysis due to the speed and magnitude at which the US real estate market continued to deteriorate. This phase included not only an updated capital analysis, but also close scrutiny of the escalation of expected losses and expected future claim payments, and resulted in additional market-leading rating actions.

Corporates

- Conducted Portfolio Reviews. Fitch has focused on providing timely credit opinions and rating actions that reflect the severity of market conditions. Fitch continues to actively monitor rated entities, assessing both ongoing factors, such as capital management, and emerging factors, such as new terms in loan agreements that banks are now requiring of corporate borrowers. Fitch is also in the process of reviewing distressed debt exchange and recovery ratings in light of the robust data coming in during this economic environment.

- Produced Special Reports on Key Issues. Fitch issued hundreds of special reports over the course of the past year, commenting frequently on key performance issues across Corporate Finance, Global Infrastructure and Project Finance, Global Power and Leveraged Finance. Reflecting the wide range of published research, examples of 2008 special report topics ranged from Fitch's analytical approach to liquidity and bank agreements given the impact of the credit crunch ("Corporate Liquidity: Bank Agreements and Refinancing Risk," dated 22 August 2008) to niche sector- and regional-specific analysis (e.g., "Infrastructure Finance in India: Lessons from the Front Line," dated 25 November 2008).

- Published Criteria. Fitch also published criteria pieces throughout the course of the year to communicate key characteristics taken into account when rating specific sectors (e.g., "Rating Food Companies," dated 5 November 2008; "Rating European Telecoms," dated 20 August 2008) and/or to reflect recent criteria updates (e.g., "Equity Credit for Hybrids and Other Capital Securities," dated 25 June 2008).

- Published Revised Sector Outlooks. Additionally, Fitch published revised sector outlooks reflecting updated expectations for credit performance given recent market events.

Sovereigns

- Published Relevant Research on Sovereign Creditworthiness and Ratings. The intensification of the global financial crisis has prompted much more extensive government and central bank intervention and financial support to stabilize domestic banking systems. The size of contingent liabilities for governments and the fiscal cost of such interventions resulted in market and media commentary on the risks to sovereign credit worthiness and ratings. In addition to affirming 'AAA' ratings as appropriate, a vital pillar of maintaining confidence in ratings has been the publication of insightful and accessible research. As such, Fitch has focused on producing key research pieces in support of 'AAA' ratings. For example: "Finance Sector Support and the US's 'AAA' Rating," dated 3 October 2008; "Sovereign Implications of the Financial Crisis," dated 8 October 2008; "Sovereign Implications of European Bank Bailouts," dated 29 October 2008.

- Conducted Review of Emerging Markets Sovereigns. In November 2008, Fitch assessed from a sovereign credit perspective the vulnerability of major investment-grade emerging market economies to various negative external shocks and their capacity to absorb them. The sovereign ratings of 13 major emerging market economies were affirmed, four were downgraded and the rating outlooks on seven were revised to Stable or Negative.

- Worked with Financial Institutions Group to Assess Guaranteed Bank Debt. The Sovereign and International Public Finance Groups have been actively working with the Financial Institutions Group on the assignment of ratings to new bank debt guaranteed by sovereign governments, notably in the UK and France.

Public Finance

- Evaluated and Proposed a Recalibration of the Municipal Rating Scale. After an extensive review, in July 2008 Fitch proposed a recalibration of its municipal ratings to denote a comparable level of credit risk relative to its international ratings scale for corporate, sovereign and other entities. Given continued market turmoil, Fitch decided to defer its final determination on municipal recalibration, which will be revisited in first-quarter 2009.

In addition to the examples above, each of the rating groups has completed 2009 sector rating outlooks, which provide analysis on trends and issues from both industry and credit rating perspectives. These are available on Fitch's public web site under Outlook Reports for 2009.

II. Updated policies, procedures and organizational changes to ensure the integrity of the ratings process and manage potential conflicts of interest:

In addition to the analytical initiatives within each of the rating groups, Fitch has also taken actions at the corporate level to further reinforce the objectivity and integrity of its ratings.

Updated Policies and Procedures

Fitch has reviewed all existing practices and is in the process of implementing appropriate changes to policies, procedures and internal controls. Changes recently introduced include:

- Revised Code of Conduct. Fitch recently revised its Code of Conduct to conform to changes made to the IOSCO code published in May 2008. Fitch's updated Code of Conduct reflects both the spirit and the letter of the IOSCO code and continues to focus on four key areas: (1) the quality and integrity of the ratings process; (2) independence and avoidance of conflicts of interest; (3) responsibilities to the investing public and issuers; and (4) disclosure of the code and communication with market participants. It also states clearly what Fitch expects of issuers in the rating process.

- Updated Policy on Fee Negotiations. Fitch updated its policy regarding fee negotiations to ensure a clearer separation between analytical and business development activities. The policy affirms and provides further guidance on: (1) who may conduct fee negotiations; (2) the internal dissemination of, and access to, fee information; (3) analyst and business development interactions with issuers, intermediaries and investors; and (4) participation at conference and business networking events.
- Published Statement on the Definition of Ancillary Business. In order to clarify what is and is not included in Fitch's core business offerings, Fitch has published its definition of an "ancillary business," which is any business other than providing independent analysis and rating opinions regarding a variety of risks in the financial markets. Any ancillary business within the Fitch Group of companies is provided by separate companies outside the ratings group or by separate divisions, all of which are subject to Fitch's Firewall Policy.

In the coming months, additional changes will be incorporated into Fitch's policies such as: Confidentiality, Conflicts of Interest and Securities Trading; File Maintenance and Record Keeping; and Firewall.

Furthermore, Fitch intends to implement additional measures consistent with final rules expected from worldwide regulators.

- Fitch is supportive of the US SEC's regulatory changes that improve ratings quality, increase disclosure and transparency, and address potential conflicts of interest among the credit rating agencies.
- Fitch is also supportive of the efforts of the European Union to introduce a regulatory framework with a consistent rating agency registration and surveillance process. While Fitch will continue to search for common ground on a few key provisions in the proposals, the agency will engage in a balanced and constructive way with the European Commission, the European Council and the European Parliament as the approval process moves forward.
- Fitch is working closely with legislative and regulatory bodies in other regions as they establish new guidelines and regulations.

Long-Standing Practices to Manage Conflicts of Interest

In addition to the policy and procedural changes noted above, Fitch continues to maintain established practices to manage potential conflicts of interest. For example:

- Business development is separated from credit analysis to keep each group focused on its core task.
- Individuals involved in the assignment of credit ratings do not participate in any fee discussions with issuers or arrangers.
- No analyst or group of analysts is compensated on the revenues related to their credit analysis.
- Ratings are determined using a committee structure, not by a single analyst. These committees include independent members who do not participate in recommending the rating to the committee.

- All ratings criteria are reviewed by cross-group committees that include independent members drawn from the senior analytical staff.

Organizational Updates

Fitch has also made organizational changes that enhance the independence and analytical oversight of the rating agency. These changes better align Fitch resources with current market conditions and associated initiatives:

- Launched Fitch Solutions. In January 2008, Fitch Group created a new division, Fitch Solutions, which is managed separately from Fitch Ratings. Fitch Solutions reinforces the independence of the rating agency and creates a more focused grouping of products and services. The division includes all non-ratings products and services, product development and product sales, as well as Fitch's training business. The creation of Fitch Solutions allows for even clearer separation of non-ratings products and services from the rating agency. Following the creation of Fitch Solutions, Fitch Group now has three separately managed divisions: Fitch Ratings, Fitch Solutions and Algorithmics.

- Introduced Group Credit/Risk Officers. Group Credit Officer and Portfolio Risk Officer roles have been added to the Corporates/Financial Institutions, Public Finance and Structured Finance areas. The roles were added to bring enhanced analytical oversight, experience and training to the analytical groups. The Credit and Risk Officers focus on criteria updates, model reviews and important thematic research. They also work with each group to identify important trends and to ensure that Fitch's analytical process is both rigorous and balanced.

- Ensured Appropriate Staffing Levels. Fitch conducted a review of its staffing throughout the course of the year and, where necessary, took actions to ensure the most appropriate level of resources with the skill sets and expertise required under current market conditions and expected analytical needs.

- Increased Structured Finance Surveillance Resources. Fitch has focused on ensuring the appropriate resourcing and independence of analytical resources dedicated solely to surveillance work on individual Fitch-rated structured finance transactions. Surveillance teams have been enhanced with more senior resources, and staff has been increased. Surveillance teams are focused on monitoring the effects of recent market dynamics and publishing the most timely and relevant ratings and research.

- Enhanced Training Initiatives. Fitch has continued its commitment to learning and development, increasing both the number and types of courses offered — ranging from mandatory compliance training to technical and analytical topics.

III. New tools and analytic offerings to provide investors with additional information and insight:

In an effort to meet the evolving needs of investors and increase transparency in the debt capital markets, Fitch Ratings has developed new tools and analytical offerings throughout the course of the year. Examples include:

- ResiEMEA. Released in February 2008, ResiEMEA is an analytical model for the risk assessment of residential mortgage loans in accordance with Fitch Ratings' RMBS criteria. ResiEMEA helps determine expected default probability, loss severity and recovery on a loan-by-loan basis for transactions.

- RMBS Loss Metrics. In December 2008, Fitch announced the launch of RMBS Loss Metrics, an enhanced surveillance offering comprised of key loss and performance metrics across the universe of approximately 40,000 US RMBS bonds rated by Fitch.

- EMEA CMBS Surveillance Reporting. Fitch Ratings also launched enhanced surveillance reporting for EMEA CMBS in December 2008. Surveillance pages on the Fitch Research web site now provide advanced EMEA CMBS performance metrics and analysis in a standardized form.

- Projected Loss Analysis. As an additional supplement to Fitch's Structured Finance CDO surveillance, in August 2008, Fitch introduced asset-level projected loss analysis (PLA) — a new analysis that builds off of Fitch's RMBS mortgage loss assumptions to estimate the impact to structured finance CDOs.

- SMART for Covered Bonds. Fitch Ratings introduced a new surveillance and research service for the covered bonds market called SMART (Surveillance, Metrics, Analytics, Research and Tools) for Covered Bonds in March 2008. The product provides investors with periodic data on cover pools and information about discrepancies in maturity, interest rate and currency between cover pools and corresponding covered bonds. Fitch is the first credit rating agency to have developed this type of service for this sector.

- Fitch Ratings Web Site. Beginning in January 2008, Fitch has made updates to its web site to better meet the needs of issuers and investors. In particular, Fitch integrated cutting-edge search and information access capabilities, redesigned market sector and market focus pages, and updated tools and features so that users can more easily access Fitch's research, data and content.

Fitch Solutions has also developed tools and analytics for further transparency in the market. For example:

- Liquidity Measures. In December 2008, liquidity scores and percentile rankings for widely traded credit derivative assets were introduced to help banks identify their exposure to the most liquid and least liquid assets and strengthen their liquidity risk management procedures.

- Fitch Risk and Performance Platform. In June 2008, a new platform was launched that provides market-based credit risk analytics, credit default swap pricing and fundamental ratings content. The platform incorporates new tools for quickly reviewing credit performance within a user's portfolio.

- Portsmouth Financial Systems. In May 2008, Fitch Solutions announced that it had partnered with Portsmouth Financial Systems (PFS), a next generation provider of structured finance analytics, to provide a comprehensive suite of data, analytics and cashflow solutions for the global structured finance market. In January 2009, an early access program was introduced for Fitch Deal View, a desktop product developed in conjunction with PFS that provides detailed collateral analysis, public and legible waterfall models, loan-level prepayment and default modelling, and scenario analysis for mortgage-backed securities.

IV. Real-time engagement, reflecting Fitch's ongoing commitment to maintaining an active dialogue with market participants:

Fitch has always maintained an open and active dialogue with investors, intermediaries and issuers. Fitch hosts a variety of teleconferences, webcasts, one-on-one meetings and conferences to maintain this dialogue. For example, in 2008, Fitch's Global Structured Finance group held over 1,700 meetings and hosted over 40 conferences with nearly 3,500 participants. To gain additional feedback, Fitch also established an Investor Advisory Council in both the US and Europe.

In addition, Fitch issues commentary, publishes special research reports and participates in speaking panels and interviews with media outlets worldwide. In 2008, Fitch frequently and proactively reached out to its investor base through these communication channels to provide credit opinions, disseminate information, respond to market inquiries and solicit feedback.

Fitch has also been actively engaged in dialogues with policymakers, regulatory bodies and other market participants on both ratings-specific topics and market-wide initiatives. This includes global entities, such as the Bank for International Settlements (BIS), as well as regional authorities. For example, in the US Fitch has maintained constructive dialogues with Congressional staff, the Treasury Department, the Federal Reserve and the SEC, among others. In Europe, Fitch has remained in close contact with pan-European bodies such as CESR and the European Commission, as well as country-specific authorities such as the UK's FSA and France's AMF. Similarly, Fitch has maintained active dialogues with international regulatory authorities and policymakers as they continue to evolve their regulatory regimes.

Fitch is encouraged that, in most cases, the policymaking community's response to current events has recognized the importance of preserving the independence and flexibility of credit opinions. Fitch will continue to work with relevant regulatory agencies to implement any final rules set forth.

Next Steps

Restoring confidence in rating agencies is an important step to stabilizing the debt capital markets. As such, Fitch will remain focused on, and committed to, providing the highest quality ratings and research. This will include: continuing to update its criteria; taking rating actions where appropriate; publishing timely research and credit opinions; introducing new tools for the investor community; and implementing policies and procedures to comply with regulatory requirements.

FitchRatings
KNOW YOUR RISK

Mary Keogh
Comments to NAIC
September 24, 2009

DBRS is pleased to have the opportunity to participate in this hearing regarding the role of rating agencies in state insurance regulation.

I would like to first provide a brief overview of DBRS.

DBRS is a Toronto-based credit rating agency established in 1976 and still privately owned by its founders. With a U.S. affiliate located in New York and Chicago, DBRS analyzes and rates a wide variety of issuers and instruments, including financial institutions, insurance companies, corporate issuers, issuers of government securities and various structured transactions. The firm currently maintains ratings on approximately 44,000 securities around the globe. Since its inception, DBRS has been widely recognized as a provider of timely, in-depth and impartial credit analysis. DBRS operates on an "issuer-pay" model, which means that its ratings are available to the public free of charge.

In 2003, DBRS was designated by the SEC as a full-service nationally recognized statistical rating organization (NRSRO) -- the first non-U.S. based rating agency to attain that designation. Four years later, DBRS became registered as an NRSRO under the regulatory regime adopted pursuant to the Credit Rating Agency Reform Act of 2006 (Rating Agency Act). In addition to its NRSRO registration, DBRS was approved by the NAIC as an Acceptable Rating Organization or ARO and has achieved broad recognition by regulators globally, including recognition as an External Credit Assessment Institution (ECAI) in the U.S., Canada, Switzerland and the European Union.

DBRS has always been committed to ensuring high standards of independence, integrity and transparency. DBRS maintains a governance structure that includes a Business Code of Conduct in accordance with the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies that also reflects current SEC rules as well as best business practices. Over the past two years, DBRS has spent considerable time and resources to implement policies, processes and procedures to ensure analytic independence, the publication of high quality ratings and insights and on increasing public transparency and disclosure regarding its rating methodologies, policies and processes and information about how its ratings have performed over time. Most recently, DBRS implemented the requirement for a 10% sample of its ratings history in a user-friendly, searchable format that allows investors to compare DBRS' ratings to those of its competitors. As a result of recent changes to SEC rules, DBRS will soon publish additional ratings history information as well.

DBRS understands the current sentiment to review the use of ratings. It believes there has been an over-reliance on ratings. A key area of focus for DBRS has been on clarifying its role to ensure that the use of credit ratings is properly framed in policy and decision-making. Credit ratings can continue to serve as a reference point for assessing credit worthiness but as only one source and should work as a complement to assessment by internal management, boards of directors and other tools. DBRS believes this holds true for use in state insurance regulation and suggests that the use of multiple rating agencies enhances the quality of ratings being reported by insurers.

I would be pleased to answer any questions you might have.

W:\Dec09\Cmte\E\wg\Rating Agency\Att B09 DBRS comments - NAIC hearing- September 24 2009.doc

Statement Before The NAIC Working Group on Rating Agencies

September 24, 2009

Jerome S. Fons
NERA Economic Consulting and Fons Risk Solutions

I am pleased to be invited to share my views on the NAIC's use of ratings as part of its oversight of the insurance industry. By way of background, I am an economist with 17 years experience at Moody's Investors Service. My career there brought me in contact with nearly every aspect of the ratings business. When I left the firm in 2007, I was Managing Director, Credit Policy. I currently consult on rating agency issues.

This particular panel is titled "Rating Agencies – What Happened?" and seeks answers to a number of important questions. I will try to address some of these in my comments that follow.

The reputations of the major rating firms were built on a solid track record – at least up until the mid 1990s – of rating corporations. Bond defaults by highly rated corporate issuers were few and far between. During that time, the ratings business grew in importance and became increasingly profitable. Although a number of missteps in the early part of this decade triggered alarm bells and spawned investigations, the influence of ratings continued to expand.

In more recent years, the major rating firms served as catalysts for the spread of complex and opaque securities, many of which were exempt from securities registration requirements. These structured securities were highly profitable for the major raters. However, it was extremely difficult to independently verify the quality of the ratings analysis, as there was little public access to the underlying details of a transaction. Market participants relied on ratings as a substitute for proper disclosure and took comfort from the notion that rating firms would not risk their reputations.

Unfortunately, the major rating firms willingly traded their reputations for short-term profits. They allowed themselves to be played off of one another in an effort to maintain (or perhaps increase) market share. Assumptions underlying many rated structured products were not challenged or updated. Even as the housing market began to lose steam, the major raters did not incorporate this development into their models.

The result has been the destruction of wealth and the destruction of reputations. I am doubtful that the major rating firms will ever regain the public's trust. Denial, blame shifting and a refusal to address the causes of the crisis leave little room for sympathy. To this day, they have not acknowledged the fact that many structured products are inherently un-ratable.

The role of a rating agency is to provide a fair, unbiased assessment of value in order to improve the efficiency of credit markets. But powerful interests prefer inefficient markets so that they can extract returns from the less informed. It takes heroic discipline to stand up to these interests, and in my view, for-profit rating firms are not up to the task. The stakes are too high and to be successful, an honest rater will make many people angry. It is very difficult to run a business when your customers hate you. And they will hate you when you cost them money.

The challenge is to devise a plan that moves us away from the current system, with its dependence on the integrity of a select number of conflicted players. For one thing, I would like to see greater emphasis on defining and measuring rating quality. The NAIC is in a position to get us there.

Acceptable rating organizations should provide a full history of their ratings to a central depository. This data would be used to calculate and compare the historical accuracy of rating organizations across asset type. Accuracy measures indicate the ability of a rating system to separate, *ex ante*, those issuers and obligations that subsequently default from those that do not default. These measures should be prepared by an independent body, rather than by the rating firms themselves. And only the performance measures, not the underlying rating histories, would be disclosed publicly.

I also believe that rating firms should rate only fully registered securities, and that these securities should meet very high disclosure standards. Current proposals requiring originators to share new-issue data among rating firms do not instill public confidence, nor do they provide the ability to verify independently whether a rating is reasonable. As long as ratings serve as a substitute for adequate disclosure, investors and others will not be able to perform their own analysis.

Finally, although we are perhaps too far down this road, regulators and lawmakers must reduce their reliance on credit ratings as tools of public policy. Until a viable alternative emerges, progress in this area is likely to be spotty. But I believe something will emerge to fill the void.

With that, I am happy to answer any questions. Thank you.

NAIC Rating Agency Working Group Hearing

September 24, 2009

Testimony of David Marks, CUNA Mutual Group

Good morning and thank you for the opportunity to present my views to the NAIC Rating Agency Working Group.

My name is David P. Marks and I am an Executive Vice President and Chief Investment Officer of CUNA Mutual Group and President of Members Capital Advisors the investment subsidiary of CUNA Mutual Group. With more than $3 billion in revenue, CUNA Mutual Group is the premier insurance company in serving credit unions and their members. We sell 45+ insurance, investment and service related products to credit unions and their members' world wide. We are based in Madison, Wisconsin and have offices in Iowa, Texas, the Caribbean, Ireland, Canada and Australia.

I have a BA in Chemistry and Physics, an MBA, and a Chartered Financial Analyst certification. I have also earned an executive MBA. I have 38 years of investment experience and have been the Chief Investment Officer (CIO) of 4 major insurance companies including CUNA Mutual Group. The others include: Travelers Life/Citigroup, CIGNA and Allianz of America.   All of my investment experience has been investing the policyholder surplus and the insurance premiums for companies within the insurance industry.

For 35 of my 38 years, the investment organizations that I worked for or led used rating agency ratings as one of the proxies for quality when underwriting public bond purchases, sales, swaps or valuations.   We no longer use those rating agency ratings as we now rely on our own independent research staff that must rate and sign off on each security that we purchase,

value or sell prior to the transaction. We now rigorously update those ratings quarterly.

Based upon my experience and contacts with other CIO's of insurance companies, most firms have primarily used independent research staffs on private placements, commercial mortgages and some difficult to determine types of illiquid investments like private equity or alternative investments for over 30 years. But, most insurance companies and other financial services investment organizations relied on the major rating agencies for at least corroboration or verification of the credit quality of most public bonds they held or were buying or selling. These securities are separated into a series of ratings with investment grade securities rated AAA all the way down to BAA- or BBB- depending upon which firm performed the rating. In the non-investment grade category or High Yield Markets, ratings (which went from BA+ to CCC or below) were also used to verify the quality of the underlying company or security prior to a decision or approval for purchasing or selling.

Structured Securities

For difficult to underwrite Structured Securities (a financially engineered security made up of pieces of other types of asset or securities), ratings were still used to a greater degree even though the industry began to move away from almost sole reliance in the early 2000 time frame after the Enron, World Com, Adelphia frauds impacted the bond market. When one buys a public corporate bond, a majority of the detail behind the essence of the company, its cash flows, its financial performance and in some instances even its management is readily available using

Bloomberg, SEC filings, etc. However, in many types of Structured Securities information is not readily available about the collateral or pools of collateral (including residential or commercial mortgages) that support the structure nor are the details about the underlying holdings listed comprehensively in an organized manner in any offering memorandum or available on Bloomberg or other readily available sources.

For those of you who might be unfamiliar with Structured Securities here is the SEC definition:

U.S. Securities and Exchange Commission (SEC) Rule 434[1] (regarding certain prospectus deliveries) defines structured securities as "securities whose cash flow characteristics depend upon one or more indices or that have embedded forwards or options or securities where an investor's investment return and the issuer's payment obligations are contingent on, or highly sensitive to, changes in the value of underlying assets, indices, interest rates or cash flows."

A healthy and vibrant securitization market needs to operate in a marketplace where the ratings on the pools can be trusted and remain in place for a good majority of the maturity of the transaction. The offering brochure of these pools is generally drafted by the selling agent—usually an investment banker as the issuer (i.e. the seller of the securities or pool of securities). That information is provided to the rating agencies to evaluate before it is rated, priced and sold. The fees paid to rating agencies are also paid by the seller in conjunction with the investment banker.

Errors in Ratings

Historically, when a rating agency rated a security AAA, the market and the buyers understood that it was of the highest quality with a 1-in-10,000 probability of default. This was clearly not the case with billion of dollars of Collateralized Debt Obligations (CDO's), Sub Prime Residential Securities or Alt-A securities many of which went from AAA to below investment grade in a short period of time and have now either defaulted or are priced at pennies on the dollar. It also was not the case for more engineered structures like CDO squared, Re-remics and other financially engineered structures. Most, if not all of the latter, have been downgraded to junk status and many have traunches that have already gone into default or are heavily impaired.

Just last week on September 17th, California Attorney General Edmund Brown, Jr. said, "At the peak of the housing boom, these agencies gave their highest ratings to complicated financial instruments-- including securities backed by subprime mortgages--making them appear as safe as government-issued Treasury bonds."

According to Attorney General Brown, the agencies downgraded the credit ratings of $1.9 trillion in residential mortgage-backed securities. This statistic prompted him to raise questions on whether the rating agencies understood the risks of the debt they rated.

Is he right or are these types of securities extremely difficult to analyze and were there other complicating factors involved in this misalignment of risks and ratings?

In my opinion, there was a lack of understanding by many parties of what the underlying collateral was supporting: the value of the pool or the entire security. Furthermore, there was no reliable historical loss statistics for the collateral in question. The sellers failed to adequately disclose the underlying collateral and the existing Nationally Recognized Statistical Rating Organizations (NRSROs) probably failed to apply conservative enough loss factors to the securities they rated.

There were, of course, multiple parties at fault, in my opinion, and I am sure there will be many books written on the subject. In my opinion, everyone is culpable to some degree including the issuers, the investment bankers, the mortgage brokers, the banks who lent the money to unqualified borrowers, the individual borrowers who felt that housing prices only went higher, the rating agencies and lastly the buyers of these securities who honestly felt that if they bought a AAA quality investment it was a good investment.

In terms of understanding risk, there was a recent study done by Summit Real Estate Advisors of 25 major Commercial Mortgage Backed Securities (CMBS) sold by one major investment banker rated AAA or AA by the major rating agencies, in which only 6 remain investment grade today. That banker and rating agencies did not understand the quality of the entire pool of properties because, according to Summit, a majority of the underwriting completed by both organizations only focused on the top 10 properties in each pool. While those top 10 properties were generally well underwritten, the remaining properties went into default or foreclosure and the entire structure collapsed as there

was not enough collateral value to cover the interest or principal within the entire structure. These deals, originally rated AAA or AA in 2006 and 2007, have been significantly downgraded and certain traunches are now in default.

Within the insurance industry, billions of dollars of Residential Mortgage and Commercial Mortgage Backed Securities have been downgraded by the rating agencies not less than 3 years after they were first rated A to AAA forcing the insurers to either write down those investments or impair them. When ratings of individual pools of securities all move down multiple letter grades over a short period time one has to ask the question: Were these securities rated properly to begin with?

How the NAIC and the Insurance Industry Can Help

The real issue or question should be: Is there a better or more logical process to the ever important rating function? Not every investor or firm has the capability or staff to fully underwrite and rate these complex securities. Plus, the NAIC and our independent auditing firms base their audits and valuations to some degree on other verifiable "independent" rating systems. I believe this is an area where NAIC can help the industry improve the system.

Here are some logical suggestions for the NAIC Working Group to consider:

1. **In order to align interests, the buyer should pay for the rating of each particular security. This would be a welcomed change.**
2. **There should be a requirement that ratings be updated continually to reflect any material developments. We do this today at our company.**

3. **Rating agencies should detail their track record of how many securities retain their original ratings 1, 3, 5, 7 and 10 years after originally rated. This record should be included in every prospectus or offering memo and should be classified by asset class or sub sector. How many of the CDO's, and Sub Prime Residential Mortgage Backed Securities pools, Alt-A, CMBS securities have retained their original rating now, 2-3 years after issuance? These are just score keeping statistics that all rating firms should detail for buyers of any type of security as an indication of a performance track record; just like we do when we measure our total return results versus our benchmarks. This idea enhances what the SEC proposed on September 17th to bolster oversight of credit ratings agencies by enhancing disclosure and improving the quality of credit ratings.**

4. **In any type of financially engineered security structure, the issuer/investment banker should file all the information on the underlying collateral pools and assets with the SEC in an SEC file open to the public so everyone can view it. This is normal in the rating process for new issue corporate bonds. Why can't it be similar for structured products? Assuming this does not delay the sale of the security, this should be part of every offering.**

5. **The NAIC, the SEC and all of our auditing firms should allow and accept ratings from other NRSROs and others who meet certain performance standards.**

6. **One idea to consider Allow insurance companies to submit their own internal ratings of Securities to an independent, self-regulating body to both share ratings across the industry and to referee differences between companies. This low-cost alternative depends on companies to policing themselves based upon guidelines, models and other tests like cash-flow coverages, debt-service coverages, debt/equity ratios, appraised collateral value coverages, etc. To avoid internal conflicts, the referee should not be affiliated with any insurance company and should have the final say if there were an impasse on a rating. The beauty of this approach is that each insurance company would also need to justify the rating through their investment committees and auditors.**

7. **Lastly, another approach would have the insurance industry create an independent not-for-profit rating agency. The agency could be funded and staffed by the insurance industry based upon either size of assets and/or amount of securities purchased or sold or a combination of these and other factors. The fees would be paid by the buyers and the process, and, hopefully, the resulting ratings would be sound, verifiable, replicable and independent. Certainly anti-trust issues would have to be addressed, but my point is that alternative approaches should be examined.**

8.

I hope you find these comments helpful. And, I would again like to thank the NAIC and the Working Group very much for the opportunity to express my views on the Structured Securities marketplace and the role of rating agencies.

W:\Dec09\Cmte\E\wg\Rating Agency\Att B11 NAIC Hearing Draft 4.doc

A company of Allianz

Pacific Investment Management Company LLC, 840 Newport Center Drive, Newport Beach, CA 92660, 949-720-6000

A PIMCO Advisory Presentation to NAIC:

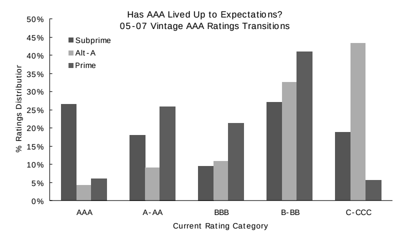
If Ratings Agencies Didn’t Exist, Would We Invent Them?

September 24, 2009

Advisory_NAIC(09-23-09)

AAA Through the Crisis – 05-07 Vintage RMBS Ratings Downgrades

- Only 25% of subprime bonds remain AAA, while 46% are below investment grade
- Only 4% of Alt-A remain AAA, while 76% are below investment grade
- Only 6% of prime RMBS remain AAA, while 47% are below investment grade



SOURCE: PIMCO, Moody's and Intex (as of August 09).

What Do We Do Today?

- Problem:
  - Very high percentage of originally AAA ratings are clustered in below investment grade ratings category
  - These ratings generate very high capital charges despite the fact that they are in senior positions and would likely enjoy a high recovery. Further there is great variation in expected recoveries within a rating category
- Potential solutions:
  - Reremic: elevates a large proportion of bond to AAA
  - Ignore ratings and use purely expected loss approach based on 3rd party generated model forecasts
  - Notch ratings higher for below investment grade ratings where the recovery is expected to be high
  - Treat like whole loans: given that most senior securities are expected to take a loss, the treatment for capital purposes should be no worse than that for a comparable whole loan pool
  - Important to consider carrying value of the bonds as it may vary by institution. Capital % held against a bond carried at 50 for Institution A, should be less than capital against the same bond carried at 70 by Institution B

Refer to Appendix for additional outlook information.

What Do We Do Today?

- Additional Issues – forecasting the future:
  - Forecasting methodology: Roll rates vs. econometric model? Can the two be combined?
  - Model Validation: How do we know a model is accurate? What are the methods for validation? Judgment based validation or statistical based validation?
  - Macro assumptions: A well specified model can be undermined by poorly specified macro forecasts (home prices and unemployment)
  - Base case losses vs. tail: The tail risk of the bond may be underestimated relative to a base case only (e.g. a mezz bond may be protected in base case, but wiped out in stress case)
  - Judgment overlay:
    - Can models produce good results purely by the magic of statistical gymnastics?
    - Or do real world practitioners need to tune the model?
    - How can models incorporate government policy impact?
    - How do users inject judgment into a statistical model?

How Stable Are the Expected Bond Losses? – A Framework for Capital Allocation

- Table shows the distribution of expected bond losses in base case vs. pessimistic case using PIMCO's RMBS model. This is a representative sample of bonds
- Table illustrates how levered bond is with respect to losses. Green means the bond isn't so sensitive to losses, while Red means the bond is more highly levered
- Example: 46% of bonds that take a 5-15% loss range in the base case take a 15-25% loss in pessimistic case while 5% take a loss in the 45-55% range in the pessimistic scenario

Bond Losses in Base Case Range	Bond Losses in Pessimistic Case Range											
	0-5	5-15	15-25	25-35	35-45	45-55	55-65	65-75	75-85	85-95	95-100	Total
0-5	79%	13%	4%	1%	1%				1%			100%
5-15		23%	46%	21%	3%	5%	2%					100%
15-25			3%	40%	27%	23%	3%				3%	100%
25-35					43%	43%	6%	6%		3%		100%
35-45					8%	25%	58%				8%	100%
45-55							43%	29%	14%		14%	100%
55-65							10%	60%	10%		20%	100%
65-75								29%	29%		43%	100%
75-85									67%	33%		100%
85-95										100%		100%
95-100											100%	100%
Total	51%	11%	8%	6%	6%	6%	3%	2%	2%	2%	3%	100%

As of June 2009
SOURCE: PIMCO
Hypothetical Example for illustrative purposes only.
Refer to Appendix for additional hypothetical example information.

How RMBS Ratings Process Failed

- Lack of due diligence: Ratings agencies don't do due diligence and they relied on 3rd party due diligence that was severely flawed and conflicted.
- Overreliance on models, with flawed assumptions: While models should be an important part of ratings process, failure to reality check the models resulted in dramatically inflated ratings; particularly for CDOs where correlation assumptions were wildly optimistic.
- Failure to understand the business: Structured finance analysts tended to be too far removed from the actual business underlying the loans. They failed to fully understand the changes in business practices, failed to properly understand the role of due diligence firms and they missed the extent of the fraud that was occurring. The blowups in Franchise and Manufactured Housing revealed that prior lessons weren't learned.
- Fraud and Misrepresentations: A significant percentage of the loans had features that were dramatically different than those represented to ratings agencies and investors. Occupancy and income fraud were particularly pronounced.
- Competitive landscape: Limited incentives of ratings agencies to be more conservative. Incentives were distorted up and down the securitization food chain.

CDOs: Collateralized Debt Obligations

Future Role of Ratings Agencies: What are the Issues?

Rating Agency Reform – 4 Themes

- Skin in the Game: Rating agencies need to have more skin in the game. One way is for them to assume more liability
- Enhanced Disclosure: Methodology and changes need to be disclosed regularly
- Increased Regulatory Oversight: Stronger regulatory oversight is needed and it's likely that some variation of government approved rating agencies will be needed
- What is the basic framework for RA oversight?: limited number of approved ratings agencies, with continuation of issuer pay model, but with buy side input into rating agency selection

Should Government Bless RAs?
Let's Call the RAs Independent Risk Evaluators or IRE

- <u>Two ends of the spectrum:</u> 1) Free unregulated market vs. 2) limited set of government regulated and blessed RAs – which is the best model?
- <u>What if we had no ratings agencies?:</u>
  - Would all investors have to do their own analysis?
  - What about smaller investors who don't have the capacity to evaluate investments?
  - Assuming most investors can't evaluate securities on their own, isn't a 3rd party still needed?
  - How would smaller investors compare independent 3rd parties?
  - For large investors, even if capable of performing their own analysis (e.g. internal risk/ratings based approached), who would evaluate their results? How would I compare my corporate bond portfolio to brand X?
  - How do third party users of financial statements evaluate financial statements and investment risk absent 3rd party evaluation (e.g. ratings)?
- <u>Plenty of examples where ratings aren't directly used:</u>
  - Bank balance sheet loans, unrated private placements, equity, etc.
  - If it works for these assets why not structured finance bonds?

8 PIMCO

Skin in the Game: RAs Publishing Companies or Fiduciary?

- Ratings agencies traditionally have viewed their ratings as an opinion generally protected under First Amendment
- Is the free press argument consistent with the critical role ratings agencies play in the global capital markets?
- Is there a middle way? More liability than today, but less than what other fiduciaries are exposed to?
- We note a recent court ruling may call into question ability of rating agencies to use First Amendment rights

9 PIMCO

How to Quantify Ratings: Or the Meaning of AAA

- In order to assess the role of ratings in risk management, it's important to <u>translate the letter rating to something that is comparable across</u> all IREs/RAs
- AAAs represent the lion's share of a securitization and it's therefore <u>important to get the meaning of AAA right</u>
  - <u>Quantitative definition of AAA Example (rating agency)</u>: .006bps expected annual losses over a 10 year period
  - <u>Qualitative definition</u> – eg should withstand a severe economic stress comparable to the Great Depression
- <u>A related question is: how sensitive do we want the ratings to be?</u>
  - When asked if we want timely ratings updates, most would say yes
  - When asked whether ratings should be relatively stable and not frequently change, we would also say yes
- We want ratings to be stable but updated on a timely basis.
  How should we balance the competing needs?
- Regardless of the answers to the above, we <u>need to ask what we want of ratings</u> in order to properly chart the course forward

10 PIMCO

How Many IREs or RAs?

- The greater the number of IREs, the more difficult it is for the investment community to manage and the more challenging it becomes to avoid rating shopping
- If there were 10 ratings agencies offering structured finance ratings and issuers followed the typical path of selecting the 2-3 IREs with lower credit support, it's likely the structured finance ratings debacle would have been far worse
- Having a limited number of IREs or RAs may be unappealing from a free market standpoint, but having an unlimited number would render ratings shopping difficult to control and would make it harder to compare ratings across deals

11 PIMCO

Who Pays?

- Issuer pay vs. Investor pay is a red herring issue
- There are conflicts in any of the alternative approaches and the key is to manage the conflicts
- Investor/subscriber based model:
  - Can investors influence ratings?
  - I.e. Can investor shop for favorable ratings by terminating subscription with vendor who provides unacceptable ratings
  - Do investors have incentives to have inflated ratings or deflated ratings (i.e. a hedge fund shorting a bank)
- Conflicts can't be eliminated, only managed

12 PIMCO

Disclosure

- Ratings agencies should be required to disclose detailed rating methodology, and the methodology should be updated annually
- Further, updates to methodology or credit enhancement levels should be subject to immediate disclosure prior to being used on actual ratings
- By requiring IREs to publicly disclose changes in methodology, it will be harder for them to win market share by lowering credit enhancement levels
- When IREs can lower credit enhancement levels under cover of the night, under pressure from investment banks, ratings shopping and conflicts of interest can more easily corrupt the ratings process
- If IREs had to disclose the rationale for ratings changes prior to them taking effect, it would reduce temptation to lower credit enhancement in order to win business

13 PIMCO

Ratings Shopping

- Ratings shopping was a major issue during the crisis
- The ability of bankers/issuers to put ratings agencies "in comp", resulted in undue pressure for ratings agencies to lower credit enhancement levels
- Ratings shopping risk increases proportionately with the number of "approved" ratings agencies
- Unless issuers are required to hire all agencies, ratings shopping needs to be controlled
- Ratings shopping could be controlled by:
  - Using all ratings agencies:
  - Random selection of ratings agencies:
  - Issuer paid/investor selects: Allow investors to select via consortium one of the ratings agencies on a deal. So perhaps issuer selects one, investor selects another, but issuer pays for both

14 PIMCO

Regulatory Oversight

- The framework for overseeing the role of RAs or IREs needs to be significantly strengthened
- The approval process and oversight of RAs is enormously complicated and requires sufficient resources including data modelers, industry experts, etc.
- Non- NRSRO entities can be leveraged to provide input to the regulatory bodies, but the regulator needs to sufficient expertise as well
- Given the global nature of capital flows, it's important for international regulatory bodies to reach consensus on the role of RAs in the global capital markets

15 PIMCO

Appendix

Past performance is not a guarantee or a reliable indicator of future results.

Hypothetical Example
Hypothetical and simulated examples have many inherent limitations and are generally prepared with the benefit of hindsight. There are frequently sharp differences between simulated results and the actual results. There are numerous factors related to the markets in general or the implementation of any specific investment strategy, which cannot be fully accounted for in the preparation of simulated results and all of which can adversely affect actual results. No guarantee is being made that the stated results will be achieved.

Outlook
Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

W:\Dec09\Cmte\E\wg\Rating Agency\Att B12 pimco.pdf

STATEMENT

of

ROBERT G. DOBILAS,

PRESIDENT & CEO

REALPOINT, LLC

before the

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

PUBLIC HEARING OF THE RATING AGENCY (E) WORKING GROUP

September 24, 2009

Washington National Harbor

Thank you for this opportunity to participate in the NAIC Public Hearing on Credit Rating Agencies. Realpoint is the most recent company to be designated by the Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (NRSRO). Realpoint is designated as an NRSRO for asset-backed securities or "structured finance" as it is often called. Our market specialty within structured finance is rating commercial mortgage-backed securities. ("CMBS") Realpoint is one of the five companies designated by the Federal Reserve Board as an eligible rating agency for securities being issued under the Term Asset-Backed Securities Loan Facility (TALF).

By way of additional background, Realpoint has approximately 50 employees and is located in suburban Philadelphia. Realpoint operates as an independent, subscriber-premised business. This means that our revenues are derived primarily from investors, portfolio managers, analysts, broker/dealers and other market participants, which, incidentally, is how Moody's, S&P and Fitch all operated for the first 75 years they were in business.

Our work product is based on post-sale data and consists of in-depth, monthly ratings reports on all current CMBS transactions (over 700), for which subscribers are assessed on a quarterly or other recurring basis. These reports, which are distributed to over 200 clients, include analytical performance summaries, "watch-list" alerts and other information about a rated security or the underlying collateral for that security such as the property-level reports for CMBS.

Your notice of hearing specified four principal areas of examination:

- The historical reliance of insurance regulators on ratings and the impact of this reliance;
- Issues concerning ratings, particularly related to structured securities and municipal bonds;

- Recent systemic remedies or procedural changes enacted by NRSROs; and,
- Recommendations and alternatives to NRSROs for prudential regulation.

The Role of Ratings in Insurance Regulation

With respect to the traditional usage of credit ratings by state insurance regulators and the institutions operating under their authority, the pattern has been largely similar to that of financial markets generally, namely independent credit ratings are an essential part of the regulatory process. This is why these ratings have to be both accurate and timely.

As has been universally recognized, however, the structured finance ratings of the major credit rating agencies have failed these tests. The Congressional Oversight Panel established as part of TARP found that the "major credit rating agencies played an important—and perhaps decisive—role in enabling (and validating) much of the behavior and decision making that now appears to have put the broader financial system at risk."[1] A more specific examination of issuer-paid ratings by the SEC concluded that these ratings were not merely inaccurate, but that there were serious questions about the "integrity of the ratings process as a whole."[2]

This should not come as a surprise when just three companies have come to dominate a market in which virtually all new offerings utilize two ratings. When private sector companies receive business without really having to compete in terms of either price or quality, there is very little incentive to rise above the bottom line.

1 Special Report on Regulatory Reform of the Congressional Oversight Panel (January 29, 2009) at Page 40.

2 Summary Report of Issues Identified in the Commission Staff Examinations of Select Credit Rating Agencies by the Staff of the Securities and Exchange Commission (July, 2008).

Specifically with respect to insurance regulation, accurate ratings of CMBS and other assets are essential for state insurance regulators. Ratings that are too high or too low impair the established regulatory structure in two principal ways:

- Evaluating Risk-Based Capital**,** which reflects the strength of insurers, calculated annually; and,
- Evaluating the Asset Valuation Reserve for life insurers.

In both instances, credit rating deficiencies impair the ability of even the most properly designed and administered system to differentiate between insurers that are well-capitalized and those that are potentially troubled.

As is the case under the federal system, there is also a process within the NAIC for individual credit rating agencies to be "recognized" as an Acceptable Rating Organization (ARO). Under one process, the Valuation of Securities Task Force (VOS/TF) may approve an application of a rating organization to be placed on the ARO List if the rating organization has been designated a NRSRO and it assigns and monitors ratings for at least ten percent (10%) of the dollar value of all assets owned by insurance companies. In addition to these general guidelines, there is also discretionary authority within the VOS/TF for adding a rating agency to the ARO list if it is determined that the ratings of that rating organization are necessary for the administration of any component of state-based financial solvency monitoring of insurance company investments. Realpoint is very pleased to have been included on the ARO list by vote of the VOS/TF this week, and we are confident that our ratings will contribute positively to advancing the NAIC's goal of promoting greater accuracy in ratings performance.

Issues Related to Structured Securities and Municipal Bonds;

As noted, the performance of the major ratings agencies in structured finance has, simply stated, been terrible. The SEC recently published data showing that Moody’s has had to downgrade 94.2 percent of all the subprime residential mortgage backed securities it rated in 2006. This trend is being repeated in the CMBS market for all three of the major rating agencies. For example, the three major rating agencies downgraded a total of 3,405 CMBS bond classes during the first half of the year and upgraded only 82, for the most lopsided upgrade-to-downgrade ratio in the history of the sector. Moody's Investors Service led the charge, downgrading a 2,212 bond classes while upgrading only 52.

The reason for these wholesale downgrades is that the ratings were artificially high when initiated due to lack of competition and, just as importantly, lack of adequate monitoring after sale because the current industry fee structure places too much emphasis on new issue ratings as opposed to ongoing surveillance. This is unacceptable when dealing with debt obligations of ten, twenty years or even longer maturities.

The market for municipal securities is not our area of particular expertise, but the trouble in this market is directly related to structured finance because state and local issuers have relied for credit enhancement on bond insurers such as MBIA, ACA, and FGIC whose status has been severely impaired by their ventures into the business of guaranteeing mortgage backed securities. In essence, these public entities are now confronted with problems emanating from the financial weakness of the very companies which were thought to be assisting the marketability of their securities. If nothing else, this phenomenon shows the inter-connectedness of our modern financial system.

By contrast, Realpoint's initial ratings and ongoing analyses have been consistently lower and more stable than those of our larger, issuer-paid rating agencies. Even during these unprecedented times, downgrades at Realpoint stand below the 30 percent level and have occurred six to 12 months sooner than the corresponding rating actions taken by Moody's, S&P and Fitch.

It may be helpful at this point to discuss why the ratings of the major companies have been so widely "off the mark." Unlike corporate bonds, which may be rated using publicly-available financial information, an initial issuance of structured finance bonds is rated by a rating agency selected by the issuer using information disclosed by the issuer to the rating agency. For a new CMBS offering, for example, the issuer generally starts the process of selecting its issuer-paid rating agencies by providing data (property information and existing mortgage loan terms) to three selected NRSROs. These NRSROs then analyze the largest properties, and a sample of the other properties, to provide preliminary feedback regarding proposed tranches (i.e., the subordination level attachment points) for the securities to be backed by the pool.

Since higher ratings generally equate to lower borrowing costs, there is a strong inclination for the issuer to select the NRSROs that provide favorable preliminary feedback to rate the new issue. As a consequence, an NRSRO that provides less favorable preliminary feedback may not be hired by the issuer. This practice is most often referred to as "ratings shopping" and it clearly impedes independence, accountability and transparency with respect to the new-issue ratings.

Realpoint has been the major proponent in testimony before the Congress and the SEC in ending this practice of confining the flow of both presale and ongoing credit information only those NRSROs hired to rate the issuance. As we tried to put it in commonly understood language at a recent congressional hearing:

> This is not a complex problem and, in fact, it is not that different from when we were all in high school and everyone sought out the teachers who were known as "easy-graders." This is what drove the massive level of high-grade defaults during the last two years and it still driving the remainder of the pre-sale process today.[3]

At a Commission meeting held just last week, the SEC addressed this issue by adopting new rules requiring any issuer or other sponsor of a security seeking a credit rating from an NRSRO to disclose the same financial information given to its solicited NRSRO to all other NRSROs designated to offer ratings for that particular type of security.[4] We deem this to be one of the most important reforms undertaken by the government in response to the credit crisis and would strongly urge the NAIC to consider a comparable approach with respect to its ratings agency procedures as it considers ways to improve competition in the highly concentrated credit ratings industry.

Recent Systemic Remedies and Changes Adopted by NRSROs

In response to the industry's performance shortcomings, the major credit ratings agencies have reshuffled management and announced a number of industry "best practices" to address the loss of credibility in the marketplace. Included among these measures are:

- Enhanced review of the due diligence process conducted by originators and underwriters;
- Enhancement of analytical methodologies;
- Providing more clarity about the credit characteristics of structured finance ratings;
- Promoting objective measurement of ratings performance;

---

[3] Statement of Robert G. Dobilas, *Hearing on Approaches to Improving Credit Rating Agency Regulations*, 111th Cong. 1st Sess. (May 19, 2009).

[4] SEC Press Release 2009-200 (September 17, 2009).

- Enhancing investors' understanding of the attributes and limitations of credit ratings;
- Rotation of analysts; and,
- Establishment of Ombudsman to manage conflicts.

Certainly these are welcomed actions, but in terms of the trillions of dollars in losses incurred by investors and now taxpayers as a consequence of the federal government's corporate rescues and more general financial market support programs, they are totally inadequate. In the words of Representative Paul Kanjorski (D-PA), who chairs the House Financial Services Subcommittee with jurisdiction over ratings agencies: "We must consider radical reforms aimed at improving accountability, reliability, transparency, and independence.…We therefore should no longer pursue only modest modifications in regulating this problematic industry." [5]

The new Administration's Treasury Department has made the same point in testimony before the Congress:

> "But flaws and conflicts revealed in the current crisis highlight the need for us to go further as more needs to be done. Our legislative proposal directly addresses three primary problems in the role of credit rating agencies: lack of transparency, ratings shopping, and conflicts of interest."[6]

Another way to view the need for significant regulatory intervention in this process is to consider the current status of the CMBS market. As the State Insurance Commissioners are well aware, the broad decline in real estate values continues and commercial mortgage loan delinquencies are projected to exceed historical averages over the next few years. Concurrently,

---

[5] Opening Statement , *Hearing on Approaches to Improving Credit Rating Agency Regulations, supra* n. 3

[6] Statement of Michael Barr, Assistant Secretary for Financial Institutions, *Examining Proposals to Enhance the Regulation of Credit Rating Agencies.* 111th Cong. 1st Sess. (Aug. 5, 2009).

billions of dollars of commercial mortgage loans are scheduled to mature over the next few years while the CMBS market remains essentially at a standstill. There have been very few new issuances since June 2008 even with TALF assistance in place. In our view, unassisted investors both here and especially abroad are not going to be satisfied with self-imposed industry improvements and they will not return to the market until confidence in ratings has been restored through meaningful remediation directed from both state and federal governmental authorities.

Recommendations and Alternatives to NRSROs for Prudential Regulation

No recommendations in the credit rating industry will ultimately succeed unless the current situation -- where two companies control 80 percent of the market and third company holds the next 15 percent of the market share -- is both reformed and opened to more competition. Fortunately, a number of independent companies like Realpoint have emerged in recent years using the subscriber-based business model where the incentives between the investing public and the rating agency are properly aligned. At Realpoint, if we do not produce accurate and timely ratings, we would lose our subscribers. Under the currently dominant issuer-paid model, the record shows that there are no adverse consequences for being wrong. Almost ten years ago, for example, the major rating agencies were assessing the debt of Enron, WorldCom, and Global Crossing at investment grade practically to the point at which these companies filed for bankruptcy. Yet, in the ensuing years, the profits of these same rating agencies rose and their market share remained unchanged.

The public benefits of having six or seven independent and qualified credit ratings, rather than just the two selected and paid by the parties selling the securities, are obvious, immediate and manifest. For this reason, we respectfully urge the NAIC to continue to review its ARO procedures and promptly take whatever steps are deemed prudent to allow other qualified NRSROs participate.

Specialized assets also require specialized expertise, analytical models and supervision by management experienced with Mortgage-Backed Securities (MBS), including CMBS. Insurance companies, themselves, understand the importance of accurate, up-to-date, impartial supervised ratings for MBS, which is one of major reasons why the leading investing insurers retain Realpoint as an independent rating agency to assist in rating and monitoring the securities they hold. Particularly for complex assets, many insurance companies believe that prudence mandates that independent third-parties evaluate the assets they hold, over and above the analyses they perform internally.

Operating under the subscriber-paid business model, Realpoint made its reputation as an independent provider of CMBS ratings and analysis through ongoing surveillance of the underlying real estate collateral. This requires access to the trustee, servicer and special servicer reports, as well as all property-level due diligence information and reports (such as operating statements, appraisals, re-appraisals and inspection reports) provided by third-party vendors to the issuers. Thus it is critical that actions taken to prevent ratings-shopping cover not just presale activity, but all ongoing reports and information through legal documentation which would memorialize this requirement.

Another proposal which should be considered is one suggested recently by Senator Charles Schumer (D-NY) which would require every 10th credit rating issued by an NRSRO to carry another rating from a separate independently designated agency. As he described it, the purpose of these "randomized" ratings is to "receive a second, independent rating from a different credit rating agency than the one initially hired by the issuer."[7] The effect of this proposal would likewise be to broaden market opportunities for independent companies.

I would also like to comment in opposition to a "reform" initiative gaining momentum in some quarters that is focused on the judicial aspects of the ratings industry. This is the First Amendment or "freedom of speech" defense which has traditionally been invoked to defeat civil claims for rating failures. Resorting to the courts for effective remedy resolution is not what we need in the business community. Credit ratings are opinions regarding the likelihood of payment of a financial obligation in accordance with the stated terms of the debt agreement; we are not and cannot be financial guarantors either directly or indirectly.

By way of example, at Realpoint, we have issued outstanding ratings on approximately $780 billion of CMBS. The idea that our modest company could be confronted with potential liabilities on this scale does not align with our business model. Even if we could afford it, no company would or should commit to that level of errors and omissions insurance. Whether or not the larger companies could manage that risk is for them to determine, but, in our view, the removal of our liability protections would have the opposite effect of promoting competition.

Conclusion

AAA investors abandoned the MBS market and they are not coming back until the system is changed. The SEC has taken an important step in this direction in mandating that the issuers' pre-sale and ongoing information be made available to all qualified rating agencies.

[7] Press Release: *Schumer Proposes New Backup Rating System to Keep Conflict-Riddled Credit Rating Firms Honest* (August 5, 2009).

However, this is only a first step. Competition can be further enhanced by having securities which are held by insurance companies and other regulated financial institutions rated co-equally by subscriber-based rating agencies. As it has often done in the past, the NAIC can help establish these higher levels of regulatory and fiduciary standards and we strongly encourage you do so.

Thank you for the opportunity to appear at this hearing and I look forward to responding to any questions you may have.

W:\Dec09\Cmte\E\wg\Rating Agency\Att B13 NAIC Statement (Realpoint).doc

Remarks on "Recommendations and Alternatives to How the NAIC Uses Ratings"

for NAIC Rating Agency Working Group.

By Matthew Richardson[1]

Given that the main responsibility of state insurance regulators is to protect the insurees, there is perhaps no agenda item more important than helping promote standards to ensure the solvency of insurance companies. This is not just because of the guarantees provided by the State guaranty funds (and possibly by the Federal government for Tier-one companies), but also the possible systemic effects a failure one insurance company could have on the sector as a whole.

As insurance companies are one of the largest investors in fixed income securities, it is crucial that regulators understand the risk of these investments and the potential for how a negative realization of the risk may lead to financial distress. In particular, if the insurance company has losses in its investment portfolio and/or problems with higher than expected claims, then the question arises whether the company has enough capital to cover policyholders. In addition, if the firm is interconnected to other firms (via reinsurance or through providing financial guaranties), or is large enough that a fire sale of its assets could cause a liquidity spiral, or is subject to a "bank-like" run on its liabilities, then its distress could have far-reaching effects.

Given these issues, the reliance on ratings by regulators to measure the risk of insurance company's fixed income portfolios is inadequate. Even if the rating agencies had emerged from the current crisis unscathed, with their reputations intact, this statement would still be true.

Of course, a number of economists for years have criticized the rating agency system in the United States, and, in particular, the NRSRO status afforded some companies. On the one hand, a rating agency oligopoly, facing a severe conflict of interest in the issuer-pays model, led to a race to the bottom, and provided little incentive to either innovate or produce high quality product. This effect was amplified by having to rate complex products like the structured securities at the heart of the crisis. On the other hand, regulated investors, some insurance companies included, skirted regulatory capital requirements by trolling for the highest-rated high yielding securities. Regulators need to be more dynamic and flexible in their evaluation approach to risk.

Although the following comments hold generally for all securities, I will illustrate the ideas using structured securities as an example.

1. Ratings are not sufficient to measure the risk of fixed income securities. There are three risk components that need to be evaluated in the context of an insurer's investment portfolio:
    a. *Default risk.* We don't know enough yet about the process by which the rating agencies evaluated the default probability and expected losses of structured securities. Was their analysis ex ante poor quality or are we simply judging them

[1] Charles E. Simon Professor of Financial Economics, Director of Salomon Center, NYU Stern School of Business, and NBER.

in hindsight? Clearly, the conditions were ripe for abuse – the economics involved with rating structured products, the involvement of the rating agencies in structuring the products, the aforementioned conflict of interests and so on. But I will leave this issue aside.

Instead, I want to focus on whether structured products can really be rated in a comparable manner. I think the answer is no, and regulators need to build this into the way they treat structured products as possible investments in the insurance industry. Structured securities are a portfolio of loans/bonds/mortgages that are issued on a prioritized basis, known as tranches, against the portfolio. Mathematically, the payoffs on these structured securities resemble those of option combinations on the underlying portfolio. If one were to further structure the tranches, the so-called CD0[2] formulations, then the payoffs resemble options on options, defined as compound options in the academic and practitioner literature.

Understanding this connection to options is very useful. There is an extensive literature that shows valuation is very sensitive to the volatility of the underlying asset for option combinations, and to the volatility of volatility for compound options. So, for structured products, unless the analyst has near certainty about the volatility and correlations of the underlying loans in the portfolio that he/she will have to input into their ratings model, the output from their model will be quite unreliable. In fact, in a very simple framework, a recently published article that simulates the sensitivity of the ratings of structured products to assumptions about default correlations and default probabilities makes this very point.[2]

Ratings are an estimate of the likelihood of default and the losses associated with default. Estimates can be precise or imprecise, and this needs to be incorporated into the regulator's perspective on risk. The point here is that there is no way around this issue. Even in a world where the analyst has modeled the structured product perfectly, small changes in the underlying assumptions can have dramatic effects. This makes these securities have fundamentally different properties that the plain vanilla corporate and municipal bonds previously rated by the NRSROs.

b. *Liquidity/funding risk*. Securities with fundamentally the same risk can offer different rates of return due to different levels of liquidity. Well-known examples are the off-the-run versus the most recently issued (on-the-run) treasury security. Liquidity is priced because there are times, such as a crisis, when investors need to convert the securities into cash, and some securities reside in markets where this is difficult to do. Structured products definitely fit into this class, and help explain why some of the so-called super senior AAA-tranches offered higher yields. Historically, insurance companies were holders of illiquid securities because their funding source, i.e., policyholder premiums, was relatively sticky and their overall investment portfolio risk was low. This is no longer necessarily

[2] Coval, Joghus, Jakub Jurek, and Erik Stafford, "The Economics of Structured Finance", 2008, forthcoming *Journal of Economic Perspectives*.

true anymore. For example, as life insurers have become subject to runs due to the possibility of policyholders cashing in, and the risk of their investment portfolios have increased due to holdings of variable annuities, concentration of fixed income portfolios in illiquid securities may be problematic. Certainly, the regulator should incorporate liquidity into his/her thinking.

c. *Market risk*. Even if securities have the same probability of default and expected loss, and have the same liquidity, these securities can offer different rates of return due to their level of market risk. Market risk is especially damaging to insurance companies because the company gets hit both by their fixed income securities falling in value along with their other investments and because their premiums (and therefore funding) begin to dry up as consumers and businesses try to conserve cash. Structured products, especially the safer AA- and AAA-tranches, are particularly unique in this respect. Almost all the risk of these securities is market risk as individual risks of the individual loans/bonds/mortgages have been diversified away. Only in a rare event in which there are widespread defaults will the securities bear losses, but, of course, this is when the company can least afford it. Therefore, a corporate bond with the same default probability and expected loss as a structured security should be considered less risky as much of its risk is diversifiable.

2. Some suggestions:
    a. Clearly, the rating agency model needs to be fixed. This has been talked about for years and the current crisis shows these concerns to be valid. The focus should be on revamping the system which will increase competition (and therefore improve quality), and fixing the conflict of interests. There are a number of suggestions to do this.[3]

[3] See, for example, Richardson. Matthew and Lawrence J. White, "The Rating Agencies: Is Regulation the Answer?", chapter 3 in *Restoring Financial Stability: How to Repair a Failed System*, 2009, John Wiley & Sons. The article discusses one approach to fixing the rating agency's business model of "issuer pays." The main idea is that the regulator should create a department that houses a centralized clearing platform for ratings agencies.

1. A company that would like its debt rated goes to the centralized clearing platform. Depending on the attributes of the security (i.e., type of debt, complexity of firm and issue, whether other debt outstanding is already rated, etc…), a flat fee would be assessed.

2. From a sample of approved rating agencies, the centralized clearing platform chooses which agency will rate the debt. While this choice could be random, a more systematic choice process could enhance beneficial competition. The choice would be based on the agency's experience at rating this type of debt, some historical perspective on how well the agency rates this type of debt relative to other ratings agencies, past audits of the rating agency's quality, and so forth.

3. For a fee, the rating agency would then go ahead and rate the debt. This model has the advantage of simultaneously solving (i) the free rider problem because the issuer still pays, (ii) the conflict of interest problem because the agency is chosen by the regulating body, and (iii) the competition problem because the regulator's choice can be based on some degree of excellence, thereby providing the rating agency

b. But this is not sufficient going forward. Understanding risk is just not about an estimate of expected losses, but also about when those losses occur (i.e., market risk), when the portfolio may become impaired (i.e., liquidity), and how accurately we measure those losses ex ante. The regulator needs multidimensional inputs to judge the prudence of the insurance company's investment portfolio:
    i. Along with the rating, a measure of the ex ante accuracy (or confidence) of the rating. It may well be the case that certain structured products should not be rated.
    ii. Along with the rating, and its precision, a measure of the securities' liquidity in the secondary market.
    iii. Along with the rating, its precision, its liquidity, a measure of its market risk.
    As an illustration, the AAA-tranche of a $CD0^2$ on a mortgage pool would get, in addition to its AAA-rating, a mark of high imprecision, illiquidity and market risk.
    iv. Additional useful information would be current market prices of various related securities. There is extensive evidence that market prices tend to have more information about default probabilities and losses than those implied by ratings.

with incentives to invest resources, innovate, and perform high quality work. It does, however, put tremendous faith in the ability of the regulator to monitor and evaluate the rating agencies' performance.

Comments provided by Heather Brilliant, Director of Equity Analysis at Morningstar, Inc., before the NAIC hearings on credit ratings on September 24, 2009

I'd like to thank the NAIC for the opportunity to appear at these hearings. My name is Heather Brilliant and I am the Director of Equity Analysis at Morningstar, an independent research firm that offers research and data on stocks, mutual funds, hedge funds, ETFs, and other investments. We were founded in 1984 and now cover 325,000 securities worldwide. In addition to institutional investors, we serve more than 6 million individual investors through our website, Morningstar.com, and 260,000 financial advisors. Our guiding principle is to put investors first. We always strive to give investors the tools, analysis, and data they need to make sound investment decisions.

It's that same guiding principle—investors first--that informs our comments today. The structure of the credit rating industry is not one designed to put investors first.

We think there is a lack of true competition in the credit rating market. This, in our opinion, is what must be addressed.

The Ratings Business: No True Competition

I'd like to contrast the credit ratings business with the ratings business Morningstar operates in. Morningstar rates thousands of stocks, mutual funds, ETFs, and other investment vehicles. We're well-known to investors through our star ratings, which rank investments by risk-adjusted returns. We're so well-known as a ratings firm, in fact, that people often ask us why we don't do credit ratings.

But the ratings business Morningstar operates in is a world apart from that of the credit rating industry. No one is obligated to use a Morningstar rating. Investors, when they consider buying Morningstar's equity research, are weighing us against sell-side research, their own internal research analysts, and a host of other independent research firms. Our clients have a real choice.

There's no such choice in the ratings business. Yes, there are credit rating firms aside from S&P, Moody's, and Fitch. But a combination of factors has relegated those firms to a tiny role, and has caused others who might enter the business to stay on the sidelines. Most important, S&P, Moody's, and Fitch were the only game in town for 30 years—they had NRSRO status to themselves. As Frank Partnoy at the University of San Diego and others have shown, this created an intricate web that wove these companies into the fabric of America's financial industry. Banks and insurance companies rely heavily on S&P and Moody's as inputs to determine risk-based capital levels. Thousands of investment policy statements require NRSRO ratings, and many of those explicitly mention S&P and Moody's by name.

There's a lot of inertia in the system. When we analyze banks, our analysts often refer to how consumer inertia helps boost banking profits. Once you have a checking account at one bank, set up your automatic account debits for a dozen different bills, it's a hassle to switch to a competing checking account at another bank. It's similar in the credit rating industry. The financial industry has written S&P and Moody's into so many processes that it would be a huge hassle to erase their names and start over.

Thanks to all these regulations and policy statements, S&P and Moody's possess what we call wide economic moats. Based on their profit margins and ROICs, they're some of the most profitable businesses in the U.S. In 2008, when the financial world was melting down, Moody's posted an operating margin of 41%, and a return on invested capital of more than 90%. We estimate that S&P,

Moody's, and Fitch control 93% of the market for credit ratings. Their wide moats are a result of the regulatory and investment policy web that has been spun around them for the past 30 years, ever since the 1970s when NRSRO language started to get written into every nook and cranny of the investment landscape.

Why is More Competition a Good Thing?
Yes, S&P and Moody's got structured products wrong. But the real issue is not that they got it wrong—everyone gets it wrong on occasion. The real issue is that they're the only game in town. If Morningstar or Sanford Bernstein or others get every one of its stock calls wrong, the equity markets will continue to function. Any one researcher is just one voice among hundreds of others. But if S&P and Moody's get it wrong, they can bring down the entire financial system. We've just seen it happen. That's not a healthy situation.

Successful leaders—whether they be portfolio managers, generals, or presidents—seek out divergent opinions. They don't want to rely on information produced by a single person, or by a group of people who all think alike. But, you might say, there are 3 large rating agencies—isn't that choice enough? The answer's a resounding no. The large rating agencies have identical business models, identical clients, and virtually identical methodologies. In the investment world, it's what we call systematic risk. If S&P is wrong, chances are Moody's and Fitch will be wrong in exactly the same way. There's no diversification of those errors throughout the entire system. We've created a world where three very similar firms are the gate-keepers to what's allowable in investment portfolios throughout a large chunk of the global economy.

So if the goal of the insurance industry is to have better ratings, the answer, in our opinion, is to diversify the sources of ratings. Include companies that pursue other business models. Consider companies that rely on market-based signals—structural models or CDS spreads--as opposed to traditional credit analysis. Encourage market entrants who focus on more timely rating changes.

It's only through diversity that we'll likely see good outcomes. Congress and the SEC can't legislate good research. No matter how many rules are laid down for credit rating firms or how many forms they're made to sign, the government can't ensure that the actual research is any better. Credit research involves making forecasts about future cash flows. Such forecasts are subject to error. Even if you could wave a wand and make every conceivable conflict of interest disappear, you would still have errors.

The important thing is to diversify away those errors. The worst possible outcome of the current focus on credit rating reform would be to nationalize credit ratings and have a single organization pick what types of ratings get used. Such an outcome would exacerbate the key problem of the current system—its exposure to systematic risk. One can easily imagine such a system being co-opted to serve political ends. Given the government cheerleading that went on during the housing bubble, how could any government-sponsored entity have stood up to say that mortgage-backed securities were a ticking time bomb?

If we do see new entrants to the credit ratings business, of course some of them will not be very good – that is to be expected. In a competitive ratings market like those that Morningstar operates in, we come across lousy research all the time. But market participants quickly learn to tell good research from bad. If there are good and bad NRSROs, the market will look at which NRSROs an issuer uses, and punish those that use the bottom-tier firms—those that are easier on issuers—with a higher cost of debt.

But even more important, the over-riding priority of reform should be to lessen the financial system's reliance on 2 or 3 firms that are so similar in business model and methodology. We need to diversify so that if the Big 3 credit rating firms blow it, the whole system doesn't blow up with them.

The best metric for measuring progress in this area isn't the raw number of NRSROs, but how diversified the revenue is across all those NRSROs. Today, the top 3 NRSROs get more than 90% of the revenue.

Reduce Both Barriers to Entry and Barriers to Success

To increase competition, steps must be taken to reduce both barriers to entry and barriers to success. The barriers to entry include the increasing regulatory cost of becoming an NRSRO, the 3-year waiting period, and the specter of increased legal liability. But becoming an NRSRO is peanuts compared with the challenge of making a credit ratings business successful—what we call the barriers to success. And the most important barrier to success is simply inertia.

That's one reason we're here. One entity that's capable of overcoming this inertia is the insurance industry, given what a large presence it has in the bond markets. No one has more to gain from a more diversified lineup of credit rating providers than the insurance industry: the public depends on the claims-paying ability of insurers, and that ability depends on the quality of insurers' balance sheets. Given the stated mission of the NAIC to protect consumers, anything that helps ensure the claims-paying ability of insurers is right up its alley.

In closing, we would highlight four ways in which true competition could be fostered in the credit rating space.

1. We would propose eliminating the 3-year waiting period for NRSRO status. We would also eliminate separate applications by product type (corporate, financial institutions, structured, etc). Firms with expertise in one area should be encouraged, not dissuaded, from entering other lines of business. These two changes alone would without doubt spur more competition in the ratings business.
2. Refrain from imposing more red tape on firms with NRSRO status. After any crisis, there's a knee-jerk reaction to create more rules, but these solve nothing. In fact, they simply make it less attractive for new firms to apply for NRSRO status and widen the moat of the incumbent firms even further. What disturbs us about so many of the ideas floating around is that they would actually further entrench the Big 3 ratings agencies and deepen the market's reliance on them. For every dollar in extra regulatory cost imposed on NRSROs, that's one extra dollar in cost a possible new entrant has to cover when considering whether to enter the market.
3. Allow all credit rating firms access to the data used to rate both newly issued structured products as well as legacy products that are sitting on the balance sheets of thousands of institutions worldwide. Given the exposure of the insurance industry to structured products, this is a natural area in which the NAIC could take a leadership role. We fully support the SEC's recent decision to allow more NRSROs access to the data needed to rate newly issued structured products. But given the vast number of these products on balance sheets worldwide, and given the dramatic changes in structured ratings methodologies coming out of the Big 3, it's important to allow more firms to rate legacy products as well. We think the NAIC could be a strong advocate for greater transparency and disclosure.

4. Continue to remove references to NRSROs from regulations and laws. One of the many lessons of the financial crisis is that our system is too dependent on the ratings of a small handful of government-sanctioned firms. It’s too easy to fall back on NRSRO ratings as an excuse not to do one’s own credit research, but that’s a dangerous shortcut. In fact, we would go so far as to say that the best outcome would be the eventual elimination of the NRSRO concept altogether. If a bond buyer or an industry regulator like the NAIC wishes to outsource credit research, fine. But encourage each entity to pick its own list of preferred providers rather than enshrining a select few in our Federal laws and regulations.

These four recommendations would go a long way toward promoting a more diversified set of credit ratings for use by the insurance industry and other market participants.

W:\Dec09\Cmte\E\wg\Rating Agency\Att B15 naic - M presentation FINAL.doc

AMERICAN ACADEMY *of* ACTUARIES

October 1, 2009

Ms. Anne Kelly
Chair, Property/Casualty Risk-Based Capital Working Group
Capital Adequacy (E) Task Force

Mr. Alfred W. Gross
Chair, Solvency Modernization Initiative (EX) Task Force

Mr. Michael McRaith and Mr. James J. Wrynn
Co-Chairs, Rating Agency (E) Working Group

National Association of Insurance Commissioners
2301 McGee Street
Suite 800
Kansas City, MO 64108

Re: Property/Casualty Risk-Based Capital and the Current Financial Crisis

Dear Sirs and Madam:

Risk-Based Capital (RBC) provides regulators with an important solvency management tool. The Property-Casualty Risk-Based Capital Committee of the American Academy of Actuaries[1] has often advised the National Association of Insurance Commissioners (NAIC) on meaningful improvements to the RBC methodology.

The current global financial crisis has provided a strong reminder of the role that Risk-Based Capital plays in the property/casualty insurance market. It has also raised the issue of whether the NAIC P/C RBC formula properly incorporates interdependent systemic risks.

The time is ripe to provide a comprehensive review to identify potential improvements to the property/casualty RBC formula.

The attached paper prepared by the Committee outlines some of the areas for further examination, ranging from the analysis of specific interdependent risks affecting the property/casualty insurance industry to the stochastic modeling approaches in solvency regulation. It identifies specific steps that could be taken to ensure that the property/casualty Risk-Based Capital mechanism provides regulators with adequate tools to manage the risk of potential insolvencies.

[1]The American Academy of Actuaries ("Academy") is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

AMERICAN ACADEMY of ACTUARIES

The Committee appreciates the opportunity to share its suggestions with the NAIC. We look forward to your questions and comments.

Sincerely,

Alex Krutov

Alex Krutov, Chair
P/C Risk-Based Capital Committee
American Academy of Actuaries

AMERICAN ACADEMY *of* ACTUARIES

PROPERTY/CASUALTY RISK-BASED CAPITAL AND THE CURRENT FINANCIAL CRISIS

October 2009

This document was prepared by the Academy's P/C Risk-Based Capital Committee.

Alex Krutov, Chair
Robert Butsic
Nicole Elliott
Sholom Feldblum
James Hurley
Gerald Kirschner
Ramona Lee
Franco Lepera
Sarah McNair-Grove
Christopher Nyce
Tony Philips
Mark Verheyen
Navid Zarinejad

1850 M Street NW   Suite 300   Washington, DC 20036   Telephone 202 223 8196   Facsimile 202 872 1948   www.actuary.org

Property/Casualty Risk-Based Capital and the Current Financial Crisis

The current global financial crisis has provided a strong reminder of the role that risk-based capital plays in the insurance market. Systemic risk, which tends to affect most firms in the same sector simultaneously, has dealt the banking industry a savage blow. The U.S. property/casualty industry has its own interdependent risks that may lead to a solvency crisis.

The current National Association of Insurance Commissioners (NAIC) Risk-Based Capital (RBC) formula does not fully account for these interlinked risks. Updating the formula to properly reflect these risks would give regulators a better solvency management tool.

In addition to addressing interdependent risks, it is time to provide a comprehensive review of the property/casualty RBC formula to see whether the formula needs to be adjusted and whether RBC determination for insurers could be enhanced in other ways. A growing worldwide body of research and risk management applications provides fertile ground for potential RBC improvements.

The brief discussion below provides the rationale for updating the formula and potential issues that could be addressed.

General Improvements to the RBC Methodology

The main goal of the RBC regulation is to provide regulators with a tool to: (a) identify companies that may be in financial trouble; (b) take corrective action; and (c) limit the exposure of guaranty funds. The RBC framework has been successful in meeting this goal, but it could be improved to capture a more complete picture of risk and give regulators a more powerful solvency management tool.

RBC is intended to serve as a benchmark for minimum capital levels, not for actual levels of capital to be held by insurance companies. RBC is not directly related to financial strength ratings assigned by rating agencies. However, since the RBC formula was first adopted by the NAIC, rating agencies have modified their approaches to capture a more comprehensive picture of risk. In general, rating agencies now require a higher capital level for a company to maintain the same rating. On the other hand, the RBC formula has changed little. One of the perhaps unintended consequences is that companies may pay less attention to NAIC RBC levels, since their own capital levels are largely determined by rating agency requirements and internal insurer models. It may be useful to determine whether the current RBC threshold levels are still appropriate (and rating agencies may have become more conservative) or whether the levels should be changed. It is possible that the current formula has not kept pace with the industry's developing understanding of its risks.

Solvency concerns in other financial sectors have served as a reminder that it is time to carry out a comprehensive review of the property/casualty RBC approach. Without such a review, certain deficiencies may only become evident if the industry experiences severe distress. Under normal circumstances, if a component of the RBC methodology is flawed, limited harm is usually done, and it can be quickly modified to remedy the exposed flaw. However, if a solvency crisis occurs, the damage caused by a flaw in the RBC methodology may be severe. Potential improvements could include recalibrating the factors in the RBC formula, changing the way the factors are calculated, adjusting the way diversification benefits are taken into account, incorporating risk sources that are not being fully considered, and making structural changes to the overall approach.

RBC and Interdependent Risks of the Property/Casualty Insurance Industry

Since a significant percentage of industry capital must be used as protection against the type of large events that have not occurred in the past, it may be helpful to reconsider how the RBC factors are set and how to determine their relative importance. To do this, it is necessary to model events that could cause widespread insolvencies of property/casualty insurance companies. Such modeling may produce significant changes to the RBC factors. For example, if property/casualty company insolvencies are isolated and relatively rare (only a few per year), then non-affiliated reinsurer failures will rarely produce primary insurer insolvencies. However, if a major loss event occurs, prompting many reinsurer defaults, such defaults may trigger further primary insurer insolvencies. Thus, the appropriate RBC for reinsurance credit risk may be different than that of the current calculation.

Generally, as discussed above, routine causes of insolvency, such as random claims fluctuations or mismanagement, result in limited strain on industry capital. Routine causes of insolvency are most often independent events. *Interdependent* events, on the other hand, affect many insurers simultaneously and may require additional capital.

The Academy's Property/Casualty Risk-Based Capital (RBC) Committee has identified the following main sources of industry risk interdependence (not in any order).

1. Natural catastrophes. A major hurricane, fire, or earthquake is likely to affect most insurers, although not uniformly. An especially large event may affect the economy, impairing asset values.

2. Claim values. Conditions like high inflation or an adverse legal climate can increase losses by many insurers simultaneously. Such conditions may be correlated with declines in asset values, compounding the harm.

3. Underwriting cycles. At the down phases of underwriting cycles, high competition leads to downward pressure on the rates charged by insurers. In addition, during these periods, reserves of the property-casualty insurance industry generally weaken, further increasing the likelihood of insolvencies.

4. Asset meltdowns. A financial crisis may simultaneously affect investment portfolios of many insurance companies.

5. Deep recessions. Policyholders may resist premium increases and/or become more likely to drop coverage. Meanwhile, as often happens in a recession, claim levels may increase.

Recommendations

The Property/Casualty RBC Committee of the American Academy of Actuaries has often advised the NAIC on meaningful improvements to the RBC methodology. Accordingly, in light of the above discussion, and prompted by the current financial crisis, the Committee proposes a series of projects to be done in stages. Depending on the level of the NAIC's interest and support, the Committee can provide assistance in carrying out the projects. They are:

1. *Preliminary report*. This paper would develop more detail and background for the topics addressed in the above discussion. It would discuss the economic theory underpinning capital adequacy and the role of regulation. It would cite other solvency studies and provide additional background material, such as historical insolvency data. It would also explore other potential improvements to the RBC analysis, not directly related to interdependent risks of individual companies. Further, it would focus on the lessons learned from the current banking industry crisis and how those lessons affect property/casualty insurance RBC. This paper would provide a general outline of potential improvements to the NAIC property/casualty RBC formula and solvency management process.

2. *Analysis of solvency crisis-triggering events*. This analysis would comprehensively address the idea that a solvency crisis would likely be precipitated by a "perfect storm" emanating from multiple simultaneous sources. It would discuss financial crises that seemed impossible (e.g., October 1987 stock crash, the current credit crisis) until they occurred. It would analyze in detail each precipitating event including natural catastrophes, pricing cycles, retroactive or unanticipated coverage (e.g., environmental), asset crashes, recessions, and others. This analysis would also address how a crisis might occur from a single source, like a prolonged down underwriting cycle.

3. *Analysis of guaranty funds*. The combination of the RBC mechanism and the guaranty fund system is designed to manage the risk of insurance insolvencies and their negative impact on society. Since part of the analysis includes the study of mass insolvency events, it is important to understand the process by which one large event could overwhelm the guaranty fund system and leave policyholders with unpaid claim costs. This analysis would describe the sequence of events following insurer insolvencies, and estimate the ability of the funds to provide payment under conditions of severe crises.

4. *Review of the stochastic modeling approaches to solvency regulation.* This review would provide an overview of stochastic modeling approaches and the ways they can be used in solvency regulation of property/casualty insurance companies. It would examine whether and how such approaches could be used within or in addition to the existing property/casualty RBC framework in the U.S. Such a review would analyze advantages and disadvantages of stochastic modeling in the solvency regulation of property/casualty insurance companies.

5. *Examination of the role of reinsurance.* This examination would analyze reinsurance in an insurance solvency crisis. It would add considerable background and detail to the ideas described above. It would discuss the complexity of reinsurance contracts and compare them to the credit derivative market. Using highly-summarized data from actual primary and reinsurance companies, it would quantify the potential effect of reinsurer failures on primary insolvencies. It would also provide recommendations to improve the annual statement accounting data to facilitate a stronger estimate of RBC.

6. *Evaluation of potential improvements to the NAIC property/casualty RBC methodology, including a determination of RBC for interdependent risk.* This is potentially a vast undertaking, especially if we apply methods to all U.S. insurers. The most accurate method may be to simulate macro events, like recessions or natural catastrophes, and then, for each simulation, determine the individual insurer losses. This would provide a basis for RBC factors to be identified by risk category. Another method would be to develop a small set of scenarios, and allocate the results of each scenario to the insurers.

Conclusion

The current financial crisis has provided a reminder that it is risky to rely solely on historical results in setting standards for risk-based capital.

In addition to properly reflecting interdependent risks in the RBC formula, the current general approach would benefit from incorporating new data and ideas that may better capture the total risk in analyzing a property/casualty insurance company. The property/casualty RBC mechanism should provide regulators with adequate tools to manage the risk of potential insolvencies.

To put the urgency of this topic in perspective, the property/casualty insurance industry is currently experiencing two critical risk-interdependent phases: a downward pressure on asset values and an underwriting cycle downturn for many lines of business. Additionally, climate change could be dramatically affecting natural disaster frequency and severity. These and other factors, taken together, could mean that the chance of an insurance solvency crisis is the greatest it has ever been.

Draft: 12/16/09

Restructuring Mechanisms for Troubled Companies (E) Subgroup
San Francisco, CA
December 4, 2009

The Restructuring Mechanisms for Troubled Companies (E) Subgroup of the Financial Condition (E) Committee met in San Francisco, CA, Dec. 4, 2009. The following Subgroup members participated: Kathy Belfi, Chair (CT); Kim Hudson (CA); Linda Sizemore (DE); Robin Westcott and Wayne Johnson (FL); Jim Mumford (IA); Patrick Hughes (IL); Francesca Bliss and Joseph Fritsch (NY); Joseph Torti, III (RI); and David Smith (VA).

1. Adopted the *White Paper on Alternative Mechanisms for Troubled Companies*

Ms. Belfi stated that the *White Paper on Alternative Mechanisms for Troubled Companies* was exposed for the last time after minor additions and revisions were adopted during the Nov. 23 conference call. Ms. Belfi requested any comments or suggested revisions to the white paper from Subgroup members, interested parties or interested regulators, and received none. Mr. Hudson moved and Ms. Westcott seconded a motion to adopt the *White Paper on Alternative Mechanisms for Troubled Companies* for consideration by the Financial Condition (E) Committee. The motion carried unanimously.

Ms. Belfi stated that the Subgroup had worked diligently over the past two years on the white paper, despite numerous issues in the marketplace that required the regulators’ more immediate attention. In addition, Ms. Belfi offered her appreciation to those interested parties who contributed to the drafting of the white paper: Wayne Mehlman (American Council of Life Insurers—ACLI); Steven Smith (Amsted Industries Incorporated); Michael Lusk (Archer Daniels Midland Company); William Goddard and Harold Horwich (Bingham McCutchen, LLP); Patrick Cantilo (Cantilo & Bennett, LLP); Paula Arbry (ConocoPhillips Corporate Insuance); Benedick Lenhart (Covington & Burling LLP); Richard Grey (E&J Gallo Winery); Ron Hallenbeck (EMC Insurance Companies); Paul Taylor (Financial Services Authority-UK); Doug Hartz (Insurance Regulatory Consulting Group); Mike Walker (KPMG LLP); Claudia Temple (Kraft Foods); David Wirt (Locke Loard Bissell & Diddell LLP); James Veach (Mound Cotton Wollan & Greengrass); Roger Schmelzer and Mark Steckbeck (National Conference of Insurance Guaranty Funds—NCIGF); Joni Forsythe (National Organization of Life & Health Insurance Guaranty Associations—NOLHGA); Property Casualty Insurers Association of America (PCI); Matthew Wulf and Tracy Laws (Reinsurance Association of America—RAA); Vivian Tyrell (Reynolds Porter Chamberlain LLP); Bill Gillett (Riverstone Resources, LLC); James Schacht (The Schacht Group/SMART); and John Fielding (Steptoe & Johnson).

2. Adopted Nov. 23 Conference Call Minutes

Ms. Belfi requested any comments or suggested revisions to the Nov. 23 conference call minutes from Subgroup members, interested parties or interested regulators, and received none. Mr. Hudson moved and Mr. Hughes seconded a motion to adopt the interim minutes (Attachment Five-A). The motion carried unanimously.

Having no further business, the Restructuring Mechanisms for Troubled Companies (E) Subgroup adjourned.

W:\Dec09\Cmte\E\SG\Restructuring Mech.doc

Draft: 12/2/09

Restructuring Mechanisms for Troubled Companies (E) Subgroup
Conference Call
November 23, 2009

The Restructuring Mechanisms for Troubled Companies (E) Subgroup of the Financial Condition (E) Committee met via conference call Nov. 23, 2009. The following Subgroup members participated: Kathy Belfi, Chair (CT); Al Bottalico (CA); Dave Lonchar (DE); Robin Westcott and Wayne Johnson (FL); Kim Cross (IA); Pat Hughes (IL); Joseph Torti, III (RI); and David Smith (VA).

1. Discussion of Comments Received on Draft *White Paper on Alternative Mechanisms for Troubled Companies*

Ms. Belfi said two comment letters were received on the draft *White Paper on Alternative Mechanisms for Troubled Companies*. Susan Charlton (Covington & Burling LLP) said a comment letter was submitted by Covington & Burling on behalf of clients Exxon Mobil Corporation, Goodrich Corporation, Textron Corporation and ITT Corporation. (Attachment Five-A1) Ms. Belfi said the first comment in the letter was with regard to defining a "troubled" insurer. Ms. Belfi responded that she feels the title of the white paper speaks for itself. Because this white paper is for informational purposes for use by U.S. state insurance regulators, and regulators recognize there are a variety of reasons an insurer might be troubled, Ms. Belfi said she does not feel additional text needs to be incorporated.

Ms. Belfi said the second comment was regarding adding words to the draft urging the NAIC to strongly oppose UK-like solvent schemes of arrangements. She said it has been the philosophy of the Subgroup in developing this white paper to only include facts and reasonable observations regarding advantages and disadvantages. She said the Subgroup is not in a position to formally state an opposition to one specific mechanism vs. another. Ben Lenhart (Covington & Burling LLP) said the "Key Considerations" section of the white paper outlines core principles. If the Subgroup is not able to say it opposes UK-like solvent schemes of arrangements, he asked whether the Subgroup could state that the way these schemes are set up violate the core principles. For example, he said, the schemes violate fundamental concepts of contracts in the U.S.

David Vacca (NAIC) suggested that under Section III.D, the Subgroup could add this observation as a disadvantage without stating the observation in absolute terms. Mr. Vacca also suggested adding text within Section III.D. to address Covington & Burling LLP's fourth observation regarding Chapter 15 of the U.S. Bankruptcy Code. Mr. Lenhart agreed with that suggestion. He said as far as he is aware there has never been a contested Chapter 15 proceeding. American policyholders have contested three solvent schemes in UK courts, of which all were won. A Chapter 15 proceeding in the U.S. only occurs if the scheme is contested in the UK and lost. Mr. Vacca said the Subgroup is trying to avoid drawing any conclusions in the white paper, but rather allow the reader to come to their own conclusions after reading the facts, advantages and disadvantages.

Ms. Belfi said the third comment was with regard to the Rhode Island statute not being limited to troubled companies. Superintendent Torti clarified that, technically, the statute is not limited to troubled companies. He said it is not Rhode Island's intent to use the statute in a way that would be detrimental to the policyholders of a solvent company. Mr. Lenhart said Covington & Burling LLP believes it is not a valid statute and would not pass muster in front of the U.S. courts.

Superintendent Torti said it is not technically true that the statute allows for the ring-fencing of assets and cutting off paying claims. There are circumstances where many could agree that a solvent scheme in the UK was warranted and the right thing to do, and perhaps a Rhode Island style run-off might be warranted and the right thing to do as an alternative to the ultimate liquidation of a company, where policyholders would get far less than they would get under a Rhode Island restructuring. There are certain circumstances where the Rhode Island restructuring would not be against the core principles. The fact that the schemes were overturned in the UK is positive, in that it cut off the scheme when it was not doing what it should. It has not been tested yet in Rhode Island. Superintendent Torti said he could envision circumstances where it would be beneficial to the policyholders to do a restructuring rather than liquidation. — but to blatantly say the Rhode Island plan is against the core principles is inaccurate.

Mr. Vacca suggested adding text in Section III.C. that notes the Rhode Island law could be used for other than troubled companies and also adding a disadvantage regarding the possibility that U.S. courts might not approve a restructuring under the Rhode Island plan. Superintendent Torti said he had no problem with this suggestion. He said there have been several articles written saying it is uncertain what would happen if one of these is performed in Rhode Island, whether Rhode Island courts would approve it and if it would be recognized in other states. He said the white paper should be factual.

Ms. Belfi said the final comment was to add an executive summary. Mr. Lenhart said Covington & Burlington LLP did not feel strongly about this comment. Ms. Belfi noted that the table of contents is detailed and readers can find what they are looking for by reviewing the table of contents.

Mr. Vacca summarized that in response to Covington & Burlington LLP's comment letter, NAIC staff would draft statements of fact or disadvantages related to sections two, three and four of the comment letter. Ms. Belfi agreed.

Ms. Belfi said a comment letter was received from James Veach (Mound, Cotton, Wollan & Greengrass), which suggested clarifications to Section III.B. of the white paper. (Attachment Five-A2) Ms. Belfi asked for observations from the Subgroup. Hearing none, she said the revisions would be incorporated into the draft white paper.

2. <u>Discussion of Updated Section V.C. and New Case Study of Draft *White Paper on Alternative Mechanisms for Troubled Companies*</u>

Ms. Belfi said Patrick Cantilo (Cantilo & Bennett, LLP) and the Reinsurance Association of America (RAA) submitted revisions to Section V.C. related to non-U.S. reinsurers (Attachment Five-A3). Ms. Belfi said that, with regard to the first sentence of the second paragraph, "Of greater concern in this section is the impact on U.S. policyholders and creditors of the restructuring of a non-U.S. insurer or reinsurer outside the U.S.," she would propose slight revision to this sentence. Mr. Cantilo said the intent of the sentence was not to be normative, but perhaps it should have said the paper "focuses more" on the impact on U.S. policyholders and creditors of the restructuring. Mr. Cantillo suggested a change to the beginning of the sentence to "What this section examines is…" Ms. Belfi agreed with the change. Matt Wolf (RAA) said he approves of how the section was revised and feels the draft came out well. Ms. Belfi asked for Subgroup member and interested party comments. Hearing none, Ms. Belfi directed NAIC staff to incorporate the revisions into the white paper.

Ms. Belfi said a portfolio transfer case study was submitted by Vivian Tyrell (Reynolds Porter Chamberlain LLP) as specifically requested by the Subgroup. Ms. Belfi asked for Subgroup member and interested party comments. Hearing none, Ms. Belfi directed NAIC staff to incorporate the case study into the white paper.

Ms. Belfi stated that she anticipates these revisions to be the last changes and hopes to adopt the white paper at the Winter National Meeting. Following adoption by this Subgroup, the white paper will be forwarded to the Financial Condition (E) Committee for consideration.

Having no further business, the Restructuring Mechanisms for Troubled Companies (E) Subgroup adjourned.

W:\Dec09\Cmte\E\SG\Restructuring Mech\RMTC_Minutes_112309.doc

Alternative Mechanisms for Troubled Companies: An NAIC White Paper (October 2009 Draft)

Comments by Certain Policyholders

Submitted by
Exxon Mobil Corporation, Goodrich Corporation, Textron Corporation, and ITT Corporation
November 11, 2009

The following comments are provided in response to the October 2009 draft White Paper, "Alternative Mechanisms for Troubled Companies," by the NAIC's Restructuring Mechanisms for Troubled Companies ("RMTC") Subgroup. These comments are intended to supplement those previously provided to the Subgroup via live testimony and/or written submissions by one or more of the companies noted above.[1]

As an initial matter we note that, by its own terms, the White Paper applies only to "troubled insurers" (as defined therein) and not to financially stable insurers. While this key limitation is apparent from a full reading of the White Paper, we believe this implicit point should be made explicit. Thus, we recommend that the White Paper state clearly and up front that: (a) it applies only to "troubled insurers" (based on the amended definition suggested below); (b) the restructuring mechanisms (including solvent schemes of arrangement) discussed in the White Paper do not apply to any insurer that is not "troubled;" and (c) the NAIC opposes the use of such mechanisms for any insurer that is not "troubled."

1. "Troubled" but Solvent Companies Should Not Be Allowed To Behave Like Insolvent Companies.

The White Paper refers throughout to "troubled" but solvent companies, without specific parameters on just how "troubled" a company must be before it may avail itself of various alternative mechanisms for running off claims and winding down its business. At one point, the current draft refers to a "troubled" insurer as one that is in a "financially troubled condition which could potentially lead to an insolvency in the foreseeable future." This formulation, we submit, is unduly vague and subjective, and could conceivably include insurance companies that are not only solvent but able to pay their claims in full as they become due. We suggest, instead, that the White Paper amend the definition of a "troubled" insurer to include only those insurance companies that have been downgraded to a Best's "D" rating or below (or comparable rating) and are in *imminent* danger of insolvency in the *immediate* future.

[1] See e.g., Goodrich Corp., Exxon Mobil Corp. and Textron Corp.'s "Response by Certain Policyholders to Call for Comment," submitted May 2008 ("May 2008 Comments"), attached hereto.

DC: 3374105-1

Furthermore, the suggestion that solvent companies can or should be treated in the same way as insolvent insurers is problematic. Solvent and insolvent insurers face entirely different -- indeed polar opposite -- operating environments and cash flow considerations. Insurers that are, in fact, insolvent are incapable of meeting their financial obligations and have a need for mechanisms to marshal limited assets, pay creditors in an orderly fashion, and limit expenses while winding up their affairs. In contrast, there is no reason that a solvent insurer, which by definition has sufficient assets to meet its financial obligations, should not continue to honor its contracts and pay claims in full as they arise in the normal course of business.

The White Paper does not adequately address these distinctions, particularly in its recitation of the advantages and disadvantages of solvent schemes. The White Paper's lack of specificity regarding "troubled" but still solvent companies creates a dangerous slippery slope that could allow solvent companies to behave like insolvent companies, winding up their business and cutting off their obligations to policyholders prematurely, without judicial review or other safeguards to achieve consumer protection and satisfaction of policyholder obligations.

Because of the key differences between solvent and insolvent insurers, we recommend modifying Sections II (General Advantages and Disadvantages for Utilizing Alternative Mechanisms for Troubled Companies), III (Types of Alternative Mechanisms for Troubled Companies), and VI (Conclusions) of the White Paper to: (a) more clearly distinguish between insolvent and solvent insurers, and (b) make clear that many of the alleged advantages associated with the various restructuring options presented in these sections of the White Paper apply only to insurers that are insolvent.

2. Solvent Companies Must Not Be Permitted To Utilize "Schemes of Arrangement" or Similar Alternative Mechanisms to Cut Off Policyholders' Rights.

We continue to urge the NAIC to strongly oppose UK-style cut-off schemes of arrangement for solvent insurers, regardless of whether they are "troubled." As the White Paper concludes, "it is the responsibility of regulators to protect insurance consumers." The Paper recommends that regulators place consumers' and policyholders' rights ahead of investors and other interests. Therefore, in carrying out their responsibilities, regulators must see to it that restructuring mechanisms meant for *failing* insurers do not become a tool for *solvent* insurers to "strip policyholders and claimants of their policy rights so that value can be returned to investors." Yet this is exactly what solvent schemes do. Solvent schemes are antithetical to the overriding principles articulated by the White Paper. We believe these points should be emphasized.

In the Key Considerations outlined by NAIC's current draft White Paper (Sections IV.B. and V.C.3), the NAIC sets out "core principles" that any alternative mechanism must achieve. These core principles include:

- Honoring contractual obligations
- Policyholder claim priority
- Right to vote and to opt out
- No "cram down" on dissenting policyholders

- Meaningful notice and information sharing
- No compulsory retransfer of risk back to policyholders
- No involuntary loss of coverage
- Guaranty Association coverage
- Court oversight

Solvent schemes violate nearly every one of these principles. Solvent schemes do *not* honor contractual obligations, do *not* ensure policyholder claim priority, do *not* allow dissenting policyholders to opt out of the scheme, do *not* ensure continuation of coverage; do *not* include a "safety net" of guaranty association protection, and do *not* allow a policyholder to seek judicial review of its claims against the insurer.[2]

In addition, while it is true that there have been many solvent schemes in the UK, it as also true that in every instance when policyholders have mounted serious opposition, the UK courts have ruled in the policyholders' favor. In particular, objecting policyholders (which have included the companies on whose behalf these comments are being submitted) have successfully challenged the BAIC, WFUM and Scottish Lion solvent schemes in the UK courts. These are the only solvent schemes involving direct policyholder coverage that have been challenged to date, and all three have resulted in court rulings favorable to the policyholders. In fact, no UK court has agreed to sanction a solvent scheme in the face of policyholder opposition. The White Paper should acknowledge these facts, and recognize that UK style solvent schemes rest on highly suspect legal grounds. Furthermore, although no UK solvent scheme has yet been challenged under Chapter 15 of the U.S. Bankruptcy Code, the White Paper should also address the distinct possibility that such challenges may arise, and that U.S. bankruptcy courts will likely reject solvent schemes (see Comment 4, below).

Despite all of the problems with solvent schemes and their ilk, the current draft of the White Paper does not expressly oppose them. It should. Solvent schemes go against the core principles and values that the NAIC supports (see above). As such, we believe the White Paper (Section V, Conclusions) should expressly recommend that regulators ***not*** adopt solvent schemes, or any other similar plans (like Rhode Island's), as alternative mechanisms for handling troubled but solvent insurance companies.

3. Rhode Island's Law for Voluntary Restructuring of Solvent Insurers Cuts Off Policyholders' Rights and Should Be Rejected

Rhode Island's "commutation plan" statute[3] is a domestic version of the UK's solvent schemes, and presents substantially similar problems. Indeed, all of the disadvantages of solvent schemes noted above apply equally to the Rhode Island system. Moreover, Rhode Island's plan is not limited to "troubled" companies; thus, any insurer with concerns about profitability could

---

[2] For a more complete description of the myriad problems with solvent schemes, *see* May 2008 Comments, attached hereto.

[3] R.I. Gen. Laws § 27-14.5-1 *et seq*

conceivably use this mechanism to ring-fence its assets and cut off paying claims. We note that, despite the statute's enactment in 2002, no insurer has availed itself of the statute, and no other U.S. state has adopted a similar law. For reasons set forth elsewhere in this and earlier submissions to the NAIC, we believe that the courts in the US -- whether Rhode Island state courts, other state courts, or federal courts -- will not approve any solvent scheme proceeding under the Rhode Island plan. For these reasons, we believe that the NAIC White Paper should adopt a position unconditionally opposed to the Rhode Island approach.

4. Chapter 15 of the US Bankruptcy Code Does Not Support Solvent Schemes.

The White Paper should note that there has never been a contested chapter 15 proceeding involving a solvent scheme with direct policyholder opposition. For reasons amply set forth in the attached article, we believe UK-style solvent schemes do not meet the requirements of chapter 15 and that such schemes, if contested, would not be enforceable in the US.

5. **Executive Summary.**

Finally, a minor point, but given the length of the current draft of the White Paper, we believe that it would benefit from an executive summary at the front of the document.

We ask that these additional comments be considered along with the earlier oral testimony and written submission made by the companies noted above.

Thank you very much for your consideration of these matters.

Ben Lenhart,
Covington & Burling LLP
(On behalf of Exxon Mobil Corporation, Goodrich Corporation,
Textron Corporation, and ITT Corporation)

Restructuring Mechanisms for Troubled Companies (E) Subgroup

Response by Certain Policyholders to Call for Comment

Submitted by Goodrich Corporation, Exxon Mobil Corporation, and Textron Corporation

Solvent schemes of arrangement in the UK have harmed American policyholders by unilaterally terminating years of valuable insurance coverage while allowing fully solvent carriers to back out of unprofitable insurance contracts. Our experience in the UK has shown that, rather than improving efficiency in the insurance market, solvent schemes are being abused by profitable carriers to extinguish coverage while paying little or no compensation to American policyholders. The reality of solvent schemes in the UK illustrates two important lessons for American regulators – (1) restructuring mechanisms meant for *failing* carriers must not become a tool for *solvent* carriers to transfer value away from policyholders, and (2) solvent schemes imposed by foreign jurisdictions should be opposed by US regulators as unfair to policyholders.

We therefore encourage the NAIC to ***strongly oppose solvent schemes*** *by (1) adopting a resolution objecting to solvent schemes, (2) participating as amicus in future legal challenges to solvents schemes, both in the UK and in US Bankruptcy Court, (3) adopting a white paper that critically assesses solvent schemes and their negative effect on American policyholders, and (4) any other means that the NAIC deems appropriate against solvent schemes.*

What Is a "Solvent Scheme of Arrangement"?

A solvent scheme of arrangement is a procedure whereby solvent and profitable insurance companies doing business in the London Market have used a provision of UK law (known as Section 425 of the Companies Act of 1985) to extinguish years or decades of valuable coverage held by US policyholders while paying little or no compensation in return.

Schemes generally operate like insolvency or restructuring proceedings. First, a carrier proposes a "scheme" to commute coverage under certain policies and notifies affected policyholders, who are invited to vote on whether to approve the scheme. If enough voters approve, a UK court will sanction the scheme. Next, all affected policyholders – regardless of whether they voted for the scheme – are required to submit claims for coverage by a bar date. Finally, the carrier evaluates and pays the claims, and the coverage is extinguished forever. But unlike an insolvency or restructuring in the US, fully *solvent* carriers are making use of these schemes to extinguish liabilities, with virtually no judicial – and no regulatory – oversight to protect policyholders.

How Solvent Schemes Offend Public Policy

- **Schemes undermine the value of insurance contracts.** The fundamental basis of insurance business is a contract where by a policyholder pays to transfer risk to an insurance company. For this contract to have value, regulators and the state must be willing to enforce the contract, even when one side (the carrier) decides it would rather cut its losses by changing the bargain mid-stream. Solvent carriers must not be allowed to back out of policies unilaterally and forcibly transfer risk back onto policyholders.

- **Lost coverage hurts policyholders at the expense of American citizens and the economy.** The policies at issue provide billions of dollars in coverage for long-tail liabilities – such as asbestos and environmental claims – that have proven onerous to American companies, large and small. The prudent American companies that insured against these risks are now seeing their insurance assets steadily eroded by solvent schemes. Preserving these assets helps ensure (1) full compensation of claimants, (2) financial health of American policyholders facing large covered risks, and (3) effective risk management that benefits not only the policyholders, but also their employees, customers, suppliers and shareholders.

- **Schemes pose a formidable collective action problem.** Each individual scheme is often organized against tens of thousands of potential claimants whose claims, on an individual basis, are often relatively small. Frequently, notice to policyholders fails to convey the true extent of the threat posed by the scheme to their insurance coverage. Furthermore, the cost and effort involved in mounting a formal opposition to a solvent scheme is quite high. For these cost/benefit reasons, many policyholders opt not to oppose a scheme, and the scheme goes through unchallenged. In short, solvent schemes pose a classic collective action problem for which regulatory oversight is uniquely suited to prevent industry overreaching.

- **Schemes undermine the reliability of insurance institutions.** Any regime that allows solvent carriers to walk away from their obligations undermines policyholder confidence and, ultimately, undermines the long-term reliability of the insurance market.

Debunking the Purported "Advantages" of Solvent Schemes

Proponents of solvent schemes in the UK often tout the "efficiency gains" from a centralized claims adjudication process. These include the cost saving of consolidating and cutting off future claims and the prospect of accelerated cash payments to policyholders. In our experience, however, the "advantages" flow exclusively to carriers at policyholders' expense.

- **"Efficiency" gains are merely cost savings for insurers at the expense of policyholders.** Insurers are expected to pay their own costs of handling claims as part of the business of selling insurance. Just because it would be less expensive for an insurer if fewer claims were made does not mean that extinguishing coverage – to the great disadvantage to policyholders – is a legitimate way to increase efficiency.

- **"Accelerated payments" for policyholders rarely (if ever) provide full value.** Compensation for incurred but not reported ("IBNR") claims is often inadequate, as policyholders are forced to prove the value of highly contingent claims. And compensation is *non-existent* for the loss of coverage of unknown liabilities. While solvent schemes may accelerate some payments, this "acceleration" does no good for IBNR policyholders who are forced to accept a small fraction of fair value in exchange for termination of their valuable occurrence-based coverage. Getting ten percent or less of the fair value of a claim now – on an "accelerated" basis – is of little comfort when the insured would far prefer to keep the coverage in place so that it would be there to pay claims when they mature. That is, after all, why the policyholders purchased the insurance in the first place.

- **Any "efficiencies" are *already* available through voluntary policy commutation.** Virtually every claimed efficiency or cost-saving benefit of solvent schemes is already available through freely negotiated, voluntary policy commutation. The only "advantage" from a solvent scheme is that carriers can unilaterally impose commutations that they would otherwise be unable to negotiate if policyholders had equal bargaining power. Commutations regularly happen in the marketplace today – and they happen when both sides deem the deal to be fair.

UK Solvent Schemes in Practice – Specific Harms to American Policyholders

Our experience with solvent schemes reveals that, in practice, they are fundamentally unfair to policyholders and offend basic notions of due process and fair play.

- **Cram down.** First and foremost, US policyholders are harmed because they have no ability to opt out of a scheme. Once a scheme takes effect, the coverage is lost regardless of whether the policyholder wants to keep the coverage, and regardless of whether fair compensation is paid to the policyholder. One might expect this outcome in an insolvency setting, but not with a highly solvent and profitable insurer.

- **Unequal treatment of policyholders.** In our experience, the unequal treatment of policyholders begins even before a scheme is launched as insurers strike early deals with individual policyholders with the largest claims or that are otherwise deemed more likely to object. In contrast to insolvency or bankruptcy proceedings in the US, where the claims resolution process is transparent and all such settlements must be vetted with stakeholders and ultimately approved by a court, solvent schemes face little or no judicial scrutiny.

- **Inadequate notice to policyholders.** Because the policies at issue were written over period of decades to tens of thousands of policyholders, notice is often deficient, largely due to incomplete or stale contact addresses and a lack of incentives diligently to attempt notice. And when notice is provided, it often fails to convey the full extent of the threat posed. Indeed, experience has shown that scheme proponents will fail to disclose the valuation methodologies that are actually used, both in discounting votes, and in discounting claims.

- **Cherry-picking and overreaching.** Solvent schemes in the UK do not require, as an insolvency or restructuring in the US would, that all of a company's policies be included, or that all policyholders be treated equally. Insurers are free to select which lines of coverage are "schemed." This leads to strategic selection of those policies least likely to attract attention and most likely to maximize value at policyholders' expense. And this is a one-way street – if a proposed scheme ends up attracting too much negative attention or appears likely to involve costly claims, the insurer, at its sole option, may abandon the scheme entirely.

- **Lopsided and unrepresentative voting.** For a scheme to be approved, it must receive both a majority of the total votes cast, and 75% of the votes cast by claim value. However, experience has shown that scheme proponents will often manipulate the vote in two ways.

    - *First*, schemes will define voting classes to combine policyholders with contingent IBNR claims – who stand to lose the most from a solvent scheme – with non-policyholders like reinsurers, arbitrageurs, syndicates, and policyholders holding mature or liquidated claims – all groups much more likely to favor policy commutation.

- *Second*, schemes will arbitrarily alter the *value* of the votes submitted to reduce the impact of negative votes and inflate the value of votes of creditors favoring the scheme. In the WFUM case, the scheme proponents actually *lost* the initial vote, but went on to "win" the vote after the scheme adjusted vote values.

- **Burden shifting to the policyholders.** Throughout the process, the policyholders bear the entire burden of proving claims, including highly contingent liabilities, and valuing hypothetical exposures that may arise in the future. This process involves sorting through complex scheme documents, gathering massive amounts of data, and hiring consultants to prepare, estimate, and provide support for claims – all on an abbreviated timetable and on terms set by the carrier.

- **Long-tail coverage undervalued.** Schemes require policyholders to prove all past, present and future claims at once. This is problematic for policyholders with contingent IBNR claims because, while it is difficult enough to estimate the value of IBNR claims arising from identified risks (like asbestos), it is *impossible* to know what other unknown liabilities might materialize in the future for which coverage would no longer be available under policies schemed out of existence. The result is undervaluation of contingent claims, and zero valuation for lost coverage of unidentified risks.

- **Arbitrary (and downward) adjustment of claims.** After claims are filed, they are discounted by a carrier-selected "independent" adjuster (most of whom do a large amount of repeat business with scheme proponents) who applies estimation and allocation methodologies that are often at odds with applicable US law governing the policies and that consistently draw disputed assumptions in favor the carrier on key coverage and exposure variables. There is no right of appeal, and no judicial review of these private adjudications, which are most often carried out by persons with no training in US coverage law.

UK Solvent Schemes and the US Chapter 15 Process

The unstated – but unquestioned – rationale behind solvent schemes is to cut off US policyholders' coverage for liabilities arising from the US tort system. A crucial aspect of that effort is to gain US court recognition in order to make those schemes binding in the US.

- **US Policyholders and Coverage Targeted.** Experience has shown that solvent schemes single out policies held primarily by US policyholders and that provide coverage for long-tail liabilities primarily emanating from US operations.

- **Abuse of US bankruptcy process.** To cut off US liabilities effectively, scheme proponents seek out US bankruptcy court recognition under Chapter 15 of the US Bankruptcy Code, which was originally designed to facilitate cooperation between US bankruptcy courts and foreign courts presiding over cross-border *insolvency* proceedings. But so far, US courts, hearing no opposition from policyholders, have granted this recognition to solvent schemes.

- **Lack of policyholder opposition.** To date, there has been no meaningful policyholder opposition to solvent schemes in a Chapter 15 recognition process. Nevertheless, there are compelling arguments that solvent schemes are not eligible for Chapter 15's protections.

Few Schemes Face Sustained Policyholder Challenges, But Those That Do Fail

In the few cases where policyholders have mounted serious opposition, objecting policyholders have successfully demonstrated the fundamental unfairness of solvent schemes.

- **The BAIC Case.** The UK High Court rejected the proposed scheme of British Aviation Insurance Company as an unfair forced revocation of policies by a solvent carrier. In rejecting the scheme, Justice Lewiston (UK) explained:

> *[I]t seems to me to be unfair to require manufacturers who have bought insurance policies designed to cast the risk of exposure to asbestos claims on insurers to have that risk compulsorily retransferred to them.*

- **The WFUM Case.** In a complex scheme involving some fourteen different insurance companies, the UK High Court again sided with policyholders who objected to the scheme's proposed voting class structure, which would have grouped policyholders with IBNR liabilities into a single omnibus class with other policyholders holding mature and liquidated claims – a group with very different interests. The same court later expressed misgivings about the scheme proponents' radical downward adjustments in the values assigned to the claims of creditors who had voted against the scheme. Before that issue could be fully aired, however, WFUM settled with the objecting creditors to take the issue off the table.

The Appropriate US Regulatory Response

We encourage the NAIC to **strongly oppose solvent schemes** and to publicly adopt the following basic policy positions:

- Insurance carriers must honor their policies in the jurisdictions in which they sell insurance.
- Insolvency and restructuring mechanisms meant for *failing* carriers must not become a tool for *solvent* carriers to take coverage away from policyholders.

We encourage the NAIC to **take the following steps** to advance these positions:

- Adopt a resolution objecting to solvent schemes;
- Participate as amicus in future legal challenges to solvents schemes, in the UK and in Chapter 15 proceedings in US bankruptcy courts;
- Adopt a white paper that critically assesses solvent schemes and their negative effect on US policyholders; and
- Take any other steps the NAIC deems appropriate to oppose solvent schemes and defend the rights of US policyholders.

Why U.S. Courts Should Deny or Severely Condition Recognition to Schemes of Arrangement For Solvent Insurance Companies

SUSAN POWER JOHNSTON

Over the last decade many insolvent U.K. insurance companies have proposed "schemes of arrangement" under section 425 of the U.K. Companies Act, 1985.[1] Section 425 provides an expeditious means by which companies organized under the laws of England may reach binding agreements with their shareholders or creditors to restructure their affairs, if the necessary majority of creditors vote in favor of the schemes and the English High Court approves them.

Solvent insurance companies have seized on section 425 as a device by which they can terminate their long-term, incurred but not yet reported (IBNR) obligations to owners of occurrence insurance policies, enabling them to release reserves previously maintained for the benefit of their policyholders to their equity holders. Although the solvent scheme documents promise payment in full of allowed claims, in practice once the schemes are approved in the U.K. the scheme proponents typically challenge the IBNR claims for lack of evidentiary support. Because the schemes deny policyholders judicial review of adverse decisions on their claims, the policyholders are without recourse if the scheme proponents reduce the claims to unacceptable levels.

The majority of occurrence policyholders affected by these schemes are U.S. entities, and to be effective the schemes require U.S. enforcement under the U.S. Bankruptcy Code, enjoining policyholders' suits against the insurers based on the contractual rights extinguished by the schemes. Enforcement of a scheme against a U.S. debtor, who may rely

Ms. Johnston is of counsel to Covington & Burling LLP, where she practices in the area of bankruptcy and creditors' rights. Covington & Burling LLP represented objectors to the U.K. solvent insurance schemes proposed by the British Aviation Insurance Company and the WFUM Pools, and the article draws on materials prepared for the cases by a number of Covington attorneys.

heavily on such insurance assets to satisfy creditors, may have serious consequences for the debtor's possibility of rehabilitation.

This article contends that, because solvent schemes are not by definition foreign proceedings under section 101(23) of the Bankruptcy Code,[2] because solvent schemes violate the fundamental U.S. policies of sanctity of contract and due process,[3] and because of the extreme prejudice to U.S. policyholders caused by these schemes,[4] U.S. courts ought to refuse to recognize solvent schemes under Chapter 15 of the Bankruptcy Code.[5] If inclined to grant recognition, the courts ought to condition recognition on substantial protection for U.S. policyholders.

BACKGROUND

The Nature of Occurrence Policies and IBNR Claims. The insurance policies procured by U.S. companies from the London insurance market that are targeted by solvent insurance schemes are "occurrence" policies. Coverage under occurrence policies is triggered when certain defined events occur during the policy period, even though the actual claims may not arise until many years in the future. These policies differ from more restrictive "claims-made" policies, which only provide coverage if claims are actually asserted during the coverage period.

The purpose of occurrence-based coverage is to protect the insured against latent injury claims that may take years, or even decades, to become manifest. The policies provide unlimited prospective coverage against IBNR claims, as long as the underlying occurrence happened during the relevant policy period. Such coverage, which is not available in today's insurance market, is particularly valuable for products liability, asbestos, chemical exposure, and environmental pollution risks, because claims for exposures to such risks may arise for many years and because large numbers of claims of varying magnitudes can and do arise very suddenly with little or no claims history. Because policyholders could not predict what liabilities they would face in the future, they historically were willing to pay substantially higher premiums to secure this type of coverage than the more restrictive claims-made policies.

Section 425 and Solvent Schemes. From time to time, insurance companies elect to stop writing certain types of coverage, and go into "run off," meaning that the company ceases to provide the type of coverage, but it continues to remain bound by its preexisting contractual commitments under the policies it issued, and as long as claims continue to be presented and the company remains solvent, the claims will continued to be met in full. Notably, run-off does not mean the company is insolvent, merely that it declines to write new business.

Run-off of occurrence policies can take a long time to administer because claims may be presented for many years. If a company wants to expedite the process, it may offer to commute its obligations to its insureds, exchanging early payout for cancellation of the insurer's future obligation to pay claims as they arise in the ordinary course of business. Commutations are frequently based on actuarial calculations of the present value of future claims, determined in accordance with historical claims experience. An insured may be willing to accept a commutation of its policy rights if the amount of the early payout is sufficient, but only if the insurer is in a formal statutory winding up or liquidation procedure can it compel the policyholder to enter into a commutation.

A policy holder with IBNR claims might refuse to commute its policy because of the extraordinary difficulty it would face in reaching agreement with the issuer about the value of its claim. The estimation of potential future toxic tort and environmental claims is difficult at best, particularly when there is no historical claims experience.[6]

To expedite the run off process and terminate their longstanding contractual commitments to their policyholders without entering into a formal insolvency or liquidation proceeding, and without paying their policyholders for the fair value of their policy rights, as they would have to do in commutation, a number of solvent U.K. insurance companies have proposed schemes of arrangement under section 425 of the Companies Act, 1985. These schemes amount to forced commutations with no judicial review.

Section 425 proceedings are markedly different from insolvency or reorganization proceedings in the U.S. and the European community, which typically involve an entity in financial distress that places its business and its assets under the jurisdiction of a court or administrator, which is then responsible for supervising the marshalling of assets, the maximization of value, and the equitable distribution of that value to creditors.[7] In contrast, section 425 does not involve judicial or administrative supervision or jurisdiction over the businesses or assets of the debtor, nor over the distribution of value to creditors. Instead, in a section 425 proceeding, the scheme proponent devises its scheme without any statutorily required input from creditors and then requests the U.K. High Court to permit it to convene a meeting at which its creditors will vote on the scheme. At that initial stage the court considers whether the scheme proponent has correctly designed the class structure. If so, the court permits the scheme proponent to send the scheme out for vote. If the creditors vote in favor of the scheme, the court holds a second hearing to consider whether the scheme should be sanctioned, considering among other issues whether the scheme is fair to creditors. If the court sanctions the scheme, the court's role is then complete. It plays no role in the subsequent adjudication of claims or the distribution of value to creditors. Absent manifest fraud, the creditors have no right of recourse to the court on any issues following scheme sanction, including no right of appeal to the judicial system from adverse claims determination.

As PricewaterhouseCoopers has stated in promotional materials directed to solvent insurers that want to extinguish their contractual asbestos liabilities without paying the costs that commutation would entail, solvent schemes are able to "deal[] with long tail liabilities emanating from North American policyholders" and to "achieve certainty, finality and the possible release of capital otherwise tied-up that could be better employed elsewhere."[8]

COMMON ISSUES OF CONCERN REGARDING SOLVENT INSURANCE SCHEMES

Most solvent schemes share certain common objectionable elements, a number of which appeared in the only two solvent schemes to which IBNR policyholders have objected in the U.K.,[9] the 2005 scheme proposed by BAIC[10] and the scheme proposed in 2006 by the WFUM Pools.[11] The BAIC and WFUM schemes illustrate the problems that solvent schemes pose.

Solvency and Cherry-Picking. Frequently the scheme proponents are solvent companies who place only some of their lines of business in the schemes, while continuing solvent run-off for other lines, or, in some cases, continuing to operate more profitable lines of business going forward.[12] For example, at the time BAIC proposed its solvent scheme in early 2005 it had been engaged in a solvent run-off for a number of years and was paying its obligations in the ordinary course as they came due. Its scheme documents represented that it was capable of meeting its liabilities under all issued and outstanding policies in full.[13] According to the December 2003 financial statements accompanying the scheme documents, BAIC had net assets above its liability reserves of at least £104 million (about $190 million).

Similarly, all but one of the companies included in the 2006 WFUM scheme were solvent. In the course of this argument in the U.K. proceedings that the U.K. court had jurisdiction over three non-U.K. scheme companies, WFUM's counsel repeatedly asserted, unequivocally and emphatically, that solvent schemes in general, and the solvent WFUM schemes in particular, had nothing to do with financial rehabilitation:

> [S]chemes in the majority of cases are solvent and nothing to do with reconstruction or anything of that sort. They are to do with all sorts of other types of things, often to do with shareholders.
>
> [T]he sanction of a scheme is not an intervention in the companies' affairs by the court. It is simply a necessary step in giving statutory force to a creditor's composition or agreement or re-arrangement....
>
> [T]here is no [judicial] intervention simply by sanctioning a Scheme. But even if there were any doubt about that, we do respectfully stress that in the case of a solvent scheme such as this, it is absolutely clear that it does not meet the words "an intention to preserve or restore the financial situation." That is plainly not what a solvent scheme of this sort is about....
>
> There is no conceivable basis, we would respectfully submit, that on the facts of this case it could be said that the scheme has anything to do with an intention to preserve or restore the financial position. There is absolutely nothing wrong with the financial position of these companies.
>
> [C]an your Lordship imagine that a solvent company with published accounts would enter into a proceeding that is listed insolvency proceeding....
>
> It is just inconceivable that as a practical matter that a large profitable company is going to enter into a [Company voluntary arrangement, or CVA] even for a part of its business.[14]

Inadequate Notice. Experience suggests that scheme proponents are not successful in providing adequate notice to their many thousands of policyholders. For example, in BAIC there were only 72 allowed votes, out of 17,500 policyholders.[15] In WFUM, with 17 scheme companies, and 13,806 identified policyholders,[16] only 604 scheme creditors actually voted.[17]

Policyholders may also find it difficult to determine exactly which policies are included in the schemes, which would make it impossible to cast an accurate vote or to file an accurate claim. For example, WFUM involved a complex series of interlocking schemes proposed by 16 original insurers (who because of name changes over the years have been known by 46 different names), who included some but not all of the occurrence policies they had issued and who employed cryptic and often illegible "stamps" as a key factor in determining whether the policies were in or out of the scheme. The last 122 pages of the 500 page scheme document represent WFUM's attempt to explain which policies were included. The document is dense, and the 247 stamps to which it refers are often illegible. Images of 12 of the stamps are missing entirely.[18]

Class Issues. A creditor class under section 425 is improperly constituted where there is not a sufficient commonality of rights among the class members to enable them to decide what is in their collective best interest.[19] The solvent schemes typically propose to lump all policyholders, whether they are also reinsurers of the scheme proponent, direct insureds, affiliates of the scheme proponents, holders of liquidated claims, or holders of IBNR claims, into one voting class, regardless of their divergent rights.

For example, the BAIC scheme proposed a single voting class to include affiliates, policyholders with mature claims (including those who had reached commutation agreements with the scheme proponents), IBNR claims, and reinsurance claims.[20] Similarly, the WFUM scheme proposed a single voting class for IBNR, reinsurance, and current creditors. In both cases the courts refused to approve a single voting class.[21] In BAIC, Mr. Justice Lewison noted that the reinsurers who were also policyholders accounted for only 8% of the company's estimated scheme liabilities, their economic interests were completely different from the interests of the direct insureds, and two of the votes cast were cast by subsidiaries of BAIC's parent company. He concluded that the votes cast did not adequately represent the views of the creditors.[22]

Similarly, in WFUM, after a six-day hearing, Mr. Justice Warren ruled that the scheme must be amended to provide for two classes to enable the IBNR creditors to vote separately from those creditors whose claims were actual or outstanding.[23]

Questionable Vote Devaluation. In both BAIC and WFUM, the scheme proponents devalued the votes cast by certain IBNR policyholders, usually those who voted against the schemes, transforming defeat of the schemes into victory for the proponents. In BAIC, in which there was only one voting class, the 72 allowed votes were comprised of 38 insureds and 34 reinsureds. Eleven of the 38 direct insureds voted in favor of the scheme. One of the largest had no IBNR claims. Two others did not allocate their claims between accrued and IBNR claims but were allowed to vote their claims in full. All but two of the holders of IBNR claims who voted in favor of the scheme had their claims allowed in full for voting purposes. Twenty-two direct insureds voted against the scheme. The insureds with IBNR claims who voted against the scheme had their claims substantially reduced for voting purposes and in six cases their claims were disallowed completely. Of the 34 reinsureds, 33 voted in favor, one against. Sixteen of the reinsureds were also reinsurers of the company, and the majority of the reinsureds had no or only modest IBNR claims.[24]

Mr. Justice Lewison was skeptical about the validity of the devaluation of the IBNR claims:

> [Counsel for the scheme proponents] also submitted that the valuation of an unliquidated or uncertain claim at a nominal amount [as was done by the scheme companies following the vote] is common practice in schemes of this kind.... In the context of a scheme of arrangement this practice is beneficial to a creditor because it allows his vote to be counted in assessing whether the numerical majority of creditors has been reached, even though his vote may count for little in assessing the majority of creditors by value. In many cases, this may well be true. But in the context of the present scheme it is common ground that the "big numbers" relate to IBNR claims. These "big numbers" do not seem to me to have been reflected in the amounts for which opposing creditors were admitted to vote. The company's own estimates of its liabilities include amounts allocated on account of IBNR claims. They appear to have been used in agreeing the claims of Honeywell and Viacom, who supported the scheme. If an actual claim by a disease-ridden mechanic materializes against any of the policyholders who claim to have IBNR claims, it is inconceivable that such a claim would only be worth $1. The attribution of $1 to IBNR claims effectively means that the Company has treated the probability of an actual claim arising as being virtually nil. I have a very uneasy feeling that these IBNR claims were simply brushed aside.
>
> .... The real problem is that the votes of the policyholders with IBNR claims have to be estimated using sophisticated and controversial actuarial techniques. In such a case it seems to me that the court must be especially wary of simply waving through a vote in which so many of the dissentients have had a nominal value placed on their claims.[25]

In WFUM, 10 of the 11 solvent schemes lost the vote based on the 75% by value test for the IBNR classes—the dollar vote in the solvent IBNR classes was $67 million in favor of the schemes and $158 million opposed. After the scheme proponents and the vote adjudicator "adjusted" the votes, the vote value was $50 million in favor of the solvent schemes and $3.2 million opposed.[26]

The WFUM objectors sought discovery regarding the methodology used to adjust the votes and requested additional time to submit their opposition to the scheme, to permit them to incorporate the information learned through discovery in their opposition. In his decision granting additional time, Mr. Justice Warren expressed concern about how the votes were adjusted:

> Following the class meetings, from the end of October to mid-March 2007, the chairman assisted by the adjudicator and PRO and their solicitors reviewed the votes. The result was a substantial change. Mr. Sheldon sets out a table at a paragraph of his skeleton argument. The percentage votes in favour are transformed into votes all of over 90 per cent in favour of the scheme, save for one company where it is 89.9 per cent. In relation to the one company where a majority in number had not been achieved, the debts of those voting against and one of the debts of those voting for the scheme seem to have been reduced to zero, leaving only one creditor who voted in favour.
>
> These changes are startling. They cry out, to my mind, for an explanation. It may be that the explanation is that the creditors put in unreasonably high estimates and/or insufficient supporting information. On the other hand, it may be that the change results from an inadmissible methodology being applied. There is a possibility of a straightforward error, but that is not prima facie a plausible explanation across the board in this way.[27]

Faulty Claim Adjudication Processes. The schemes typically require policyholders to provide substantial evidence of their claims, without which the claims will be disallowed. Policyholders with liquidated or mature claims, or even policyholders who have merely received notice of claims, are generally able to generate reliable claims estimates not readily susceptible to challenge. In contrast, policyholders with IBNR claims have little or no information with which to generate a claim other than their contractual rights to coverage up to the policy limits. Instead, they must rely on complex actuarial calculations provided by experts, which take considerable and expense time to prepare.

The schemes do not provide for judicial review of claims adjudication, nor do they typically provide for neutral claims adjudicators. Instead, the scheme proponents select, retain, and commonly pay the claims adjudicators, who are U.K. actuaries or insurance professionals and have neither legal training nor any expertise in the U.S. state laws governing the insurance contracts at issue. Policyholders can not challenge his impartiality or appeal his rulings.[28] In the vast majority of schemes both solvent and insolvent the same claims adjudicator has been selected by the scheme proponents to decide disputes between the policyholders and the scheme administrators.[29]

Extraordinarily short timetables are commonly provided, including truncated claims bar dates, which do not provide IBNR policyholders with adequate time to develop values for those exposures with sound actuarial analyses.[30]

The WFUM Scheme proposed an estimation methodology which would be binding on scheme creditors, who can challenge its application to their claim but not the methodology itself.[31] The methodology applies exclusively to the IBNR claims, as it is not necessary to estimate accrued but unpaid claims nor is any methodology required to reach agreement on outstanding claims. The methodology section covers some 42 pages but ultimately fails to provide clear guidance to creditors as to how IBNR claims will be treated. On its face it demonstrates the extreme difficulty of estimating IBNR claims.

No Judicial Scrutiny of Scheme Companies' Businesses. The scheme managers typically have no obligation to report to creditors on the size of the schemes' estates, the progress of the claims adjudication, settlements or commutations reached with other policyholders or creditors, the compensation for the scheme administrators, or the disposition of estate property once all claims were paid. The policyholders, moreover, have no right to discovery to obtain any of this information.

Throughout the scheme process the scheme proponents are not constrained in any way with respect to asset transfers or the manner in which they conduct their businesses, and the courts have no jurisdiction over the scheme companies' assets and business. The WFUM scheme companies' barrister admitted in the English proceedings that WFUM's scheme is not a judicial proceeding and that the English court's sanction of the scheme does not constitute "judicial intervention":

> [T]he sanction of a scheme is not an intervention in the companies' affairs by the court. It is simply a necessary step in giving statutory force to a creditor's composition or agreement or re-arrangement, whatever the particular scheme happens to be about. [32]

Ultimately the High Court of Justice refused to sanction the BAIC scheme on the ground that it was fundamentally unfair to the policyholders facing unknown IBNR claims:

> In the end, though, the most powerful consideration is that it seems to me to be unfair to require the manufacturers who have bought insurance policies designed to cast the risk of exposure to asbestos claims on insurers to have that risk compulsorily retransferred to them. The Company is in the risk business; and they are not. This is not a case of an insolvent company to which quite different considerations apply. On the evidence presented to me the Company is able to meet its liabilities under such policies as and when they fall due. The purpose of the scheme is to allow surplus funds to be returned to shareholders in preference to satisfying the legitimate claims of creditors. No matter how usable and reasonable an estimate may be, the very fact that it is an estimate is likely to make it an inaccurate forecast of the actual liabilities of policyholders. If individual policyholders wish to compound the Company's contingent claims to them, and to accept payment in full of an estimate of their claims, there is nothing to stop them doing so. But to compel dissentients to do so would, in the words of Bowen LJ, require them to that which it is unreasonable to require them to do.[33]

In the WFUM matter, after the U.K. court supported the policyholders' objection to a single class, and issued an order calling into question the devaluation of the IBNR votes on the scheme, WFUM settled with the objectors. The WFUM scheme was sanctioned in the U.K. on September 17, 2007. At the date of this writing the hearing on approval of its Chapter 15 petition is scheduled for October 23, 2007, in the U.S. Bankruptcy Court for the Southern District of New York.

POTENTIAL GROUNDS FOR OBJECTION TO SOLVENT SCHEMES UNDER CHAPTER 15

Because so many of the policyholders are U.S. companies, and because of the explosion of tort claims in the U.S., the U.S. is the "one jurisdiction which really matters usually," as counsel for the WFUM Solvent Scheme Companies admitted in the English WFUM proceedings.[34] The scheme proponents must obtain relief from the U.S. bankruptcy courts under Chapter 15 if the schemes are to be effective.[35] No IBNR policyholders have opposed section 425 solvent schemes in the U.S., and the U.S. courts have routinely approved the uncontested schemes, both solvent and insolvent, under section 304 and now under Chapter 15.[36]

Many compelling bases for opposition to recognition of solvent schemes under Chapter 15 nonetheless exist.

Solvent Schemes Are Not "Foreign Proceedings." Section 101(23) of the Bankruptcy Code defines "foreign proceeding" as "a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation." Solvent schemes are not foreign proceedings because: (a) they are not a collective judicial or administrative proceeding, (b) because the assets and affairs of the scheme companies are not at any time subject to control or supervision by a foreign court, and (c) because the solvent schemes do not relate to reorganization or liquidation.

Section 1501 states that its purpose "is to incorporate the Model Law on Cross-Border Insolvency so as to provide effective mechanisms for dealing with cases of cross-border insolvency with the objectives of," among other things, "cooperation between… the courts and other competent authorities of foreign countries involved in cross-border insolvency cases," "fair and efficient administration of cross-border insolvencies that protects the interests of all creditors, and other interested entities, including the debtor;" and "facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment."[37] Although the House Report stated that "the scope of the Model Law and chapter 15 are not limited to proceedings involving only debtors who are technically insolvent," it also observed that the scope "broadly includes all proceedings involving debtors in severe financial distress, so long as those proceedings also meet the other criteria of section 101(24)."[38] This language demonstrates unequivocally that Chapter 15 is intended to address entities in financial distress involved in insolvency cases. Solvent companies that are neither in nor anticipate financial distress, and that do not file insolvency cases, which seek Chapter 15 relief solely to terminate contractual obligations are not included.

The legislative history of Chapter 15 contains no suggestion that Congress intended for financially healthy foreign entities to use this nation's bankruptcy courts to extinguish their contractual liabilities to U.S. citizens for their own benefit and the benefit of their equity holders. Chapter 15 is thus consistent both with the purpose of the Model Law discussed supra, and with its predecessor, section 304, which constituted an explicit Congressional recognition of "the importance of the principles of international comity in transnational insolvency situations."[39]

The UNCITRAL "Guide to Enactment" of the Model Law on Cross-Border Insolvency, on which Chapter 15 is predicated, also supports the exclusion of solvent schemes from Chapter 15 protection. The Guide, in explaining the scope of the Model Law, states that a "foreign proceeding" must:

i. have a "basis in insolvency-related law" of the foreign country;

ii. require the "involvement of the creditors collectively;"

iii. involve the "control or supervision of the assets and affairs of the debtor by a court or another official body;" and

iv. have as its purpose the "reorganization or liquidation of the debtor."

The UNCITRAL Guide explains that the term "insolvency" as used in the Model Law "refers to various types of collective proceedings against insolvent debtors," and includes among those "proceedings aimed at reorganizing the debtor and proceedings leading to a liquidation of the debtor as a commercial entity."[40] This includes "a variety of collective proceedings... be they compulsory or voluntary, corporate or individual, winding-up or reorganization. It also includes those in which the debtor retains some measure of control over its assets, albeit under court supervision (e.g., suspension of payments, 'debtor in possession')."[41]

Three of these four factors are missing in solvent schemes. Section 425 is not an insolvency-related law, neither a court nor any other official body has control or supervision of the assets and affairs of the debtor, and solvent schemes do not have as their purpose the financial reorganization or liquidation of the scheme proponents.

Scheme proponents may contend that these schemes nevertheless constitute "reorganizations" within the meaning of section 101(23).[42] The reasoning set out in an analogous case, *In re Petition of Rose*,[43] makes such a contention untenable. There, the representatives of U.K. insurers argued that section 101(23) and section 304 were sufficiently broad to encompass a transfer scheme under Part VII of the U.K. Financial Services and Markets Act 2000, whereby the assets and liabilities of twelve insurance companies were to be transferred to a thirteenth, all of them solvent. The Court held that the former definition of a "foreign proceeding," read as a whole, meant a foreign bankruptcy case:

> Because the term "reorganization" is not specifically defined in the Code, Mr. Rose argues that the term has only one meaning and that *any* type of corporate restructuring within *any* type of foreign

> proceeding falls within the parameters of Code § 304....[emphasis in original].
>
> This court disagrees with Mr. Rose's characterization of the meaning to be ascribed to the term "reorganization." It is true that the code does not specifically define that word. When interpreting a statute, however, the court must first look to the plain meaning of the particular statutory language at issue, as well as the language and design of the statute as a whole. *Kmart Corp. v. Cartier, Inc*, 486 U.S. 281, 291, 108 S.Ct. 1811, 100 L.Ed.2d 313 (1988). The meaning of a particular section in a statute should be understood in context with and by reference to the whole statute, by appreciating how sections relate to one another. In other words, the preferred meaning of a statutory provision is one that is consonant with the rest of the statute. *Robinson v. Shell Oil Co.*, 519 U.S. 337, 341, 117 S.Ct. 843, 136 L.Ed. 2d 809 (1997) ("The plainness or ambiguity of statutory language is determined by reference to the language itself, the specific context in which that language is used, and the broader context of the statute as a whole."). The Court must also review the statute pursuant to the reasonable interpretation "mandated by its grammatical structure." *United States v. Ron Pair Enterprises*, 489 U.S. 235, 109 S.Ct. 1026, 103 L.Ed. 290 (1989).[44]

The Court observed that the Bankruptcy Code is concerned with the restructuring or liquidation of companies in financial distress:

> In this instance, the court finds that Mr. Rose's attempt to isolate the words "reorganization" from the words liquidation," "adjusting debts" and "discharge" does not reflect the statute's intent, which indicates that a "reorganization under this section should have characteristics of proceedings of the type that the adjectives immediately preceding that word have, as well as have characteristics of proceedings of the type described elsewhere in the Code, such as a Chapter 11 reorganization.
>
> ...
>
> The reorganization of a corporation in bankruptcy, however, is a different concept. As "commonly understood, [it] is distinguishable from a consolidation or a merger. It is not ordinarily the combination of existing corporations, but is simply the completion by proper agreements and legal proceedings, of a business plan or scheme for winding up the affairs of, or foreclosing mortgages upon the property of insolvent corporations, and the organization

> of a new corporation to take over the property and business of the distressed one." [citation omitted].[45]
>
> The Court dismissed the petition:
>
> The court understands that this is the only court with the authority to issue a United States nationwide injunction. It is unfortunate that Mr. Rose is uncertain of the effect of the UK Final Order in the United States. However when all is said and done, Mr. Rose is asking the court to do what it cannot - to enter an order allowing him to use the bankruptcy law to enjoin potential lawsuits in the United States so he can effect a corporate financial restructuring of a group of foreign insurance companies unrelated to any foreign insolvency proceeding. This court does not have the authority to enter any order, no matter what the ramifications to the Corporations, which exceeds the scope and jurisdiction of the statute that it is interpreting. [46]

Rose's reasoning is equally applicable to Chapter 15 petitions for recognition of section 425 solvent schemes, in which solvent foreign insurance companies, unrelated to any foreign insolvency proceeding, attempt to invoke U.S. bankruptcy court jurisdiction to ensure the enforceability against U.S. policyholders of solvent schemes that are unrelated to foreign insolvency proceedings. Their purpose is not to ensure equitable distribution of limited assets of a debtor among its creditors, as is generally contemplated by insolvency laws, but rather to terminate unprofitable or potentially unprofitable lines of business, while continuing solvent run off of other lines, or, indeed, continuing in business in other profitable lines. As *Rose* held, the use of U.S. cross-border insolvency proceedings is inappropriate where the requisite connection to a foreign insolvency proceeding is absent.[47]

The definition of foreign proceeding was amended in significant ways when Chapter 15 was enacted in 2005,[48] but many of the section 304 cases that analyze the criteria for a foreign proceeding remain instructive. Under section 304, courts typically focused on the critical characteristics of appropriate procedural safeguards and judicial oversight. For example, in *Petition of Tam*,[49] the court held that the liquidation of a Cayman Islands corporation pursuant to a "winding up" proceeding was not a foreign proceeding. Although creditors were permitted to petition the court for review of the liquidators' actions and the Cayman Registrar of Companies was required to review those actions, the liquidators essentially operated free from supervision and control of the Cayman courts. "Under the Companies Law, creditors have no right to be heard on matters relating to the conduct of the winding up and are not entitled to discovery respecting the actions undertaken by the liquidators in connection therewith. The liquidators are under no obligation to report to creditors unless the proceeding continues for more than one year." The Court also observed that the "winding up" was conducted "without oversight from the Registrar, or any other Cayman governmental agency, instrumentality or authority. As such, the Cayman Liquidation is distinguishable from those cases involving nonjudicial liquidations in which § 304 relief, or its equivalent has been granted" and the Court held it was not a "foreign proceeding" for purposes of section 304.[50]

Chapter 15 Petitions Filed by Solvent Companies for the Sole Purpose of Terminating Contractual Obligations with U.S. Policyholders Are Filed in Bad Faith. When there is a genuine foreign proceeding, one in which a court or other official body takes jurisdiction over a debtor's assets and affairs to encompass its reorganization or liquidation, Chapter 15 presumes the foreign proceeding will be recognized and affords a streamlined procedure to provide U.S. enforcement. In considering whether to recognize a foreign scheme, however, a U.S. court must still be mindful of whether the scheme is abhorrent to U.S. law and policy. Courts may consider the motives behind a Chapter 15 in deciding whether and how to grant it recognition. See, e.g., *In re SPhinX, Ltd.*,[51] in which the court refused to recognize a Cayman Islands proceeding as a foreign main proceeding, when the sole purpose of the petition was to secure a litigation advantage in another U.S. bankruptcy case.

While insolvency is not a mandatory prerequisite to bankruptcy relief in the U.S., the courts have categorically rejected the proposition that financially healthy debtors can use the bankruptcy courts for the purpose of capping or limiting their contractual liabilities to creditors for the sole benefit of their equity holders. "It is not the objective of the bankruptcy laws to confer windfalls on debtors."[52] Indeed,

> When a debtor is solvent... the presumption is that a bankruptcy court's role is merely to enforce the contractual rights of the parties, and the role that equitable principles play in the allocation of competing interests is significantly reduced.[53]

In solvent debtor cases, "rather than considering equitable principles, courts have generally confined themselves to determining and enforcing whatever pre-petition rights a given creditor has against the debtor."[54]

Chapter 11 petitions filed by solvent debtors to defeat their contractual obligations have often been dismissed as filed in bad faith.[55] In *In re SGL Carbon Corp.*,[56] the court held that where the company was financially healthy, had a healthy balance sheet, had the ability to raise money and to meet its debts as they came due, had no overdue debts, had no defaults, and there was no evidence of a valid reorganizational purpose, the petition should be deemed to have been filed in bad faith, despite the possibility that the company might in the future suffer a potentially crippling judgment in a pending class action litigation. Thus, even where a solvent company bases its need for Chapter 11 protection on anticipated future obligations, the courts demand that it also demonstrate current financial difficulty to prove that its petition was filed in good faith.

Numerous other courts have similarly dismissed as "antithetical to the structure and purposes of the Bankruptcy Code"[57] petitions that simply seek to cap claims against a solvent debtor, or to remake contracts the debtor in retrospect considers unfavorable, principally for the benefit of its equity holders.[58] It is an "axiomatic principle of business law" that "because equity owners stand to gain the most when a business succeeds, they should absorb the costs of the business' collapse—up to the full amount of their investment." The *Integrated Telecom* court "emphatically reject[ed]" the idea that Integrated's attempted use of the bankruptcy court to try to force a better settlement with the claimants in the suits against it was a valid or legitimate use of bankruptcy proceedings.[59] The court also rejected Integrated's attempt to claim as legitimate, good faith purposes for its petition its intended dissolution, intended distribution of assets, or its "purpose of obtaining a quick, efficient, and orderly winding down" of its business. After noting that neither "dissolution" nor "distribution" alone is a valid bankruptcy purpose under the Bankruptcy Code, the court held that while the Bankruptcy Code "allows for a distribution of the debtor's estate pursuant to a valid plan of reorganization or liquidation," a distribution that "simply facilitates dissolution on terms favorable to equity interests" cannot be considered a good faith purpose sufficient to withstand dismissal of the debtor's petition.[60]

Filing Chapter 15 petitions to enforce solvent schemes against U.S. policyholders for the purpose of terminating contract rights would constitute bad faith under the principles discussed in these cases. Indeed, the relevance of the petitioner's motive in filing a Chapter 15 was central in the court's decision not to grant recognition to a foreign proceeding as a main proceeding in the *SPhinX* case.[61] A good faith standard should be applied to Chapter 15 petitions, and should result in dismissal of solvent schemes that fail to protect IBNR policyholders.[62]

Solvent Schemes Are Manifestly Contrary to the Public Policies of the U.S. Section 1506 authorizes U.S. courts to deny recognition to a petition if the encompassed scheme "would be manifestly contrary to the public policy of the United States." Notably, the House Report does not include the UNCITRAL Guide's restrictive statement that relief under 1506 be granted under the provision only in "exceptional circumstances" and uses the phrase "fundamental policies" rather than "matters of fundamental importance" to delineate the provision's reach. The provision is entirely consistent with long-standing U.S. comity jurisprudence, pursuant to which comity should not be "extended to contradict the forum state's law or policy."[63]

The sanctity of contract rights and the obligation to provide due process before depriving contract parties of those rights are without question among the fundamental policies of the U.S. Solvent schemes, which deny U.S. policyholders of valuable contract rights without adequate consideration and without due process of law, violate these fundamental and manifest public policies.

Sanctity of contract is without any doubt a fundamental policy of the U.S. See *Morta v. Korea Ins. Corp.*[64] ("Despite recent cynicism sanctity of contract remains an important civilizing concept."); *University of Dist. of Columbia Faculty Ass'n/NEA v. Board of Trustees of University of Dist. of Columbia*[65] (describing sanctity of contract as a "core value of American society"). Respect for the sanctity of contract renders courts unwilling to intervene to relieve a party of an improvident bargain: "[T]he general rule of freedom of contract includes the freedom to make a bad bargain.... It is a fundamental principle of contract law that [w]ise or not, a deal is a deal."[66]

Bankruptcy courts honor the sanctity of contracts.[67] As the court stated in *In re Schenck Tours, Inc.*,[68] in denying a vendee's motion to cancel a land sales contract with a debtor on the ground of frustration or mutual mistake where the land was later found to be contaminated:

> Sanctity of contract constitutes the most fundamental underpinning of commerce. The community's legitimate need for the stability of business dealings requires the enforcement of contracts according to their terms. This need finds cogent expression in a strong public policy of upholding the validity of freely negotiated contracts, even unwise ones. Courts do not generally relieve a party competent to contract from an improvident agreement in the absence of fraud, misrepresentation or bad faith.[69]

Solvent schemes ask the U.S. courts to do exactly what *Morta* and *Schenck* held violated the sanctity of contract: relieve parties from their valid contractual obligations simply because they have come to believe that they entered into a bad deal.

The guarantee of procedural due process is also undeniably a manifest and fundamental policy of the U.S.[70] Foreign insolvency proceedings must comport with U.S. notions of fairness and due process.[71] In *Interpool Ltd. v. Certain Freights of the M/V Venture Star*,[72] the court noted that the provision of adequate procedural rights to creditors in a foreign proceeding is of "paramount importance" and that "before a § 304 Petition may be granted, this Court must be convinced that the foreign Court has or will abide by fundamental standards of procedural fairness." Having determined that "the procedural protections available to creditors in the United States were not given to the United States creditors in Australia. This is a serious omission" and that "the laws and the public policy of the United States will be violated if the case is permitted to proceed under Australian law," the court held that it did "not intend to stand idly by while United States[] citizens and creditors are harmed."[73]

Due process requires a fair and impartial process, including a neutral and independent decision maker.[74] Solvent schemes deny due process to IBNR policyholders in a number of ways: (a) there is no proper and adequate advance notice of the scheme; (b) the votes of many of the IBNR creditors are devalued in a secretive and self-interested process that would not be countenanced in a U.S. court (and is not countenanced in U.K. courts when policyholders object, as evidenced in BAIC and as suggested in the WFUM discovery order); (c) there is no fair, honest and open proceeding before an impartial decision maker regarding the valuation of claims; (d) there is no visibility regarding the acts and omissions of the scheme's proponents to enable policyholders to determine whether the scheme is being fairly and equally applied; (e) contrary to the requirements of the contracts, the U.S. policyholders are denied a U.S. forum and the application of U.S. law to determine the legitimacy of claims under the policies; and (f) there is no judicial review of decisions that deprive policyholders of millions of dollars of promised insurance proceeds.[75]

The principal scheme representatives responsible for estimating IBNR values are not qualified, neutral, and independent decision makers. They are instead U.K. actuaries chosen by the scheme proponents in their sole discretion, and paid by the scheme companies. It is not unreasonable to expect that these persons may act in the interest of the scheme companies—either deliberately or subconsciously—if they want to continue to obtain these assignments. Certainly there is an appearance of bias when the same individual is selected in at least 27 solvent and insolvent schemes.

The inherently unfair nature of the claims process is exacerbated by the denial of judicial review of the scheme adjudicators' claims decisions. In a proceeding under the Bankruptcy Code, in contrast, while the trustee or debtor in possession is charged with the duty of examining the claims of creditors and, if necessary, disputing those claims, the final decision regarding the valuation and allowance of disputed claims always lies with the bankruptcy court and is subject to appeal to higher courts. As Judge Politan stated in *Interpool*, the courts cannot stand by while U.S. citizens and creditors are harmed by procedurally deficient schemes.[76] The Bankruptcy Code recognizes that the right of judicial review in the claims reconciliation process is a basic right derived from fundamental U.S. policies regarding fairness and due process. A foreign proceeding that does not guarantee such fundamental due process is contrary to the public policy of the U.S. and should be denied recognition under section 1506.[77]

Courts Should at a Minimum Condition Recognition of Solvent Schemes on the Provision of Due Process Protections for the Policyholders. Section 1522 of the Bankruptcy Code provides the court with discretion to condition relief granted to the petitioner to ensure that the interests of creditors are protected. In *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*,[78] Judge Lifland recently admonished U.S. bankruptcy courts not to rubber stamp Chapter 15 petitions. Accordingly, even in the absence of objection, the courts should scrutinize the petitions filed by solvent scheme proponents. Assuming the courts conclude that the schemes do not violate manifest U.S. policies under section 1506, and otherwise qualify for Chapter 15 relief, they should nevertheless consider whether substantial and meaningful conditions to that relief should be imposed.

Section 1522 provides explicitly that the court may grant relief under section 1519 or 1521, or may modify or terminate relief under subsection (c), only if the interests of the creditors and other interested parties, including the debtor, are sufficiently protected.[79] This provision directs the courts to consider whether the schemes do in fact adequately protect the rights of U.S. policyholders. The court may also subject relief granted under section 1519 or 1521, or the operation of the debtor's business under section 1520(a)(3), to conditions it considers appropriate, including the giving of security or the filing of a bond.[80] Finally, the court may, at the request of the foreign representative or an entity affected by relief granted under section 1519 or 1521, or at its own motion, modify or terminate such relief.[81]

While no U.S. court has considered the imposition of conditions on a solvent scheme for the protection of U.S. policyholders, in 2004 a Canadian court demanded that a solvent reinsurance scheme incorporate new protections for Canadian policyholders. In *Re Cavell Insurance Co.*,[82] although the court granted recognition to a solvent reinsurance scheme over policyholder opposition, it required the scheme adjudicator to reach a valuation of claims based on the Canadian rules applying to such valuations. It also imposed a right of judicial appeal if the scheme adjudicator failed to apply the Canadian rules, and it explicitly required the scheme administrator and the scheme adjudicator to act in good faith and to treat the Canadian policyholders fairly.[83]

Certainly U.S. courts should be no less aggressive in protecting U.S. policyholders from solvent schemes. A wide variety of conditions to Chapter 15 relief could be imposed to achieve this end.

For example, a U.S. court could require as a condition to approval of a solvent scheme under Chapter 15 that all claims determinations of U.S. policyholders will be made by the U.S. bankruptcy court, or alternatively by a claims resolution facility, administered by persons trained in the relevant legal standards, with right of judicial review.

A court might require instead that in the event of a dispute about the value of a claim, the parties must mutually select a neutral and independent claims adjudicator with legal training, again with right of judicial review from a disputed adverse decision.

At a minimum the court should require that the law specified in the policies will control the claims determination, and the correlative requirement that persons trained in that law will make the claims decisions, rather than U.K. actuaries, coupled, again, with a right of appeal to a court of law from a disputed adverse decision.

Alternatively, a court might require that the scheme proponent establish a fund to protect the policyholders with future claims whose claims are disallowed by the scheme proponents as being insufficiently supported, in the event that the claims ripen into liquidated claims in the future.

The court might also require that the scheme include an opt out provision so that any policyholder who is aggrieved by the claims dispute resolution procedure can opt out of the scheme and would be free to pursue its remedies against the insurer in any appropriate forum in the U.S.

Some combination of these procedural protections are essential to ensure that the contract rights of U.S. policyholders—some of whom may well be debtors now or in the future—are not eviscerated by solvent insurance schemes.

NOTES

1. Section 425 provides in pertinent part:

(1) Where a compromise or arrangement is proposed between a company and its creditors, or any class of them, or between the company and its member, or any class of them, the court may on the application of the company or any creditor or member of it, or in the case of a company being wound up [or [in administration], of the liquidator or administrator], order a meeting of the creditors or class of creditors, or of the members of the company or class of members (as the case may be), to be summoned in such manner as the court directs.

(2) If a majority in number representing three-fourths in value of the creditors or class of creditors or members or class of members (as the case may be), present and voting either in person or by proxy at the meeting, agree to any compromise or arrangement, the compromise or arrangement, if sanctioned by the court, is binding on all creditors or the class of creditors or on the members or class of members (as the case may be), and also on the company or, in the case of a company in the course of being wound up, on the liquidator and contributories of the company.

*****

(6) In this section and the next—

(a) "company" means any company liable to be wound up under this Act, and

(b) "arrangement" includes a reorganization of the company's share capital by the consolidation of shares of different classes or by the division of shares into shares of different classes, or by both of those methods.

2. See 11 U.S.C.A. § 101(23).
3. See 11 U.S.C.A. § 1506.
4. See 11 U.S.C.A. § 1522(a).
5. 11 U.S.C.A. §§ 1501 et seq.
6. This difficulty is alluded to in Mr. Justice Lewison's discussion of the alternatives to a solvent scheme in the case of the British Aviation Insurance Company, Limited (BAIC):

Under the scheme, a policyholder with an accrued claim will have that claim paid in full. If the scheme is not approved, he will still have his claim paid in full. The measure of the claim will be the amount for which he is entitled to indemnity under the policy in respect of the known claim. By contrast, the position of a policyholder with an IBNR claim is different. Under the scheme he will be entitled to have his contingent claim valued. He will then be entitled to be paid the full amount of the valuation (less a discount for the time cost of money). Although a valuation of a future (and contingent claim) can be made, and may even be described as a fair valuation, it is only a valuation. It is not an indemnity. Indeed, whatever else one may be able to say about a valuation of a future contingent claim the one thing that one can say with near certainty is that, barring a miracle, the valuation will *not* be the same amount as the indemnity. If, on the other hand, the scheme is not approved, the Company will remain in run-off. It will pay claims as and when they arise; and the measure of the payment will be the full indemnity to which the policyholder is entitled. It may be that anticipated claims by some policyholders will never arise; in which case the Company will not have to pay. But that is what insurance is all about. The policyholder bargains for the insurer to bear the risk of a contingency materialising. The insurer is in the risk business; and the policyholder is not.... The essence of the scheme is that it retransfers the risk from the insurer (who had contracted to bear it) to the policyholder (who did not). Thus the rights of a policyholder with an IBNR claim are fundamentally different under the scheme from the rights that he would have in the absence of the scheme.

In the Matter of the British Aviation Insurance Company, Limited, [2006] 1 BCLC 665, [2005] EWHC, ¶ 83, http://www.bailii.org/ew/cases/EWHC/Ch/2005/1621.html. Discussion and acknowledgment of the difficulties of estimating IBNR claims appears throughout the judgment. See also In the Matters of Sovereign Marine & General Insurance Company Limited and Others, [2006] EWHC 1335 and [2007] 1 BCLC 228, at ¶ 170.

7. See for example European Union Regulation on Insolvency Proceedings, Council regulation 1346/200, 29 May 2000, on insolvency proceedings, 200 O.J. (L160), Article 1(1): "This Regulation shall apply to collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator." Notably, the EU regulations do not apply to proceedings relating to insurance "since they are subject to special arrangements and, to some extent, the national supervisory authorities have extremely wide-ranging powers of intervention." Similarly, the U.S. Bankruptcy Code does not permit domestic insurance companies and foreign insurance companies doing business in the U.S. to seek liquidation under Chapter 7, see 11 U.S.C.A. § 109(b), although section 1501(c)(1) does permit foreign insurance companies, like solvent schemes, to seek Chapter 15 relief. See 11 U.S.C.A. § 1501(c)(1).

8. See PricewaterhouseCoopers, "Solvent Schemes of Arrangement for Discontinued Insurance Business," at pp. 1, 2, http://www.pwcglobal.com/uk/eng/ins-sol/publ/brs/SolventSchemes04.pdf.

9. It is not clear why more objections have not been posed to these schemes. Some schemes may be more egregious on their face than others. Some, while claiming to be solvent may in fact be financially distressed, so that the policyholders may be well advised to accept even a forced commutation at virtually any level. It is also possible that many policyholders take the schemes' assurances of payment of allowed claims in full at face value, not realizing that once the scheme is sanctioned they have no judicial recourse and consequently very little if any leverage in negotiating with the scheme proponents about what their allowed claims should be. In many cases the amount of available coverage for each policyholder may not justify the exorbitant expense of mounting a challenge to the schemes.

10. In the Matter of the British Aviation Insurance Company, Limited, [2005] EWHC 1621 and [2006] 1 BCLC 665, ¶ 7, http://www.bailii.org/ew/cases/EWHC/Ch/2005/1621.html and Proposal in Relation to a Solvent Scheme of Arrangement, Pursuant to Section 425 of the Companies Act of 1985, between the British Aviation Insurance Company Limited and its Scheme Creditors, January 21, 2005 (the BAIC Scheme). BAIC wrote aviation insurance and reinsurance. Over 90% of its policyholders were U.S. citizens. It stopped writing new aviation insurance in 1990 (although it continued to write other kinds of business—it only included its aviation insurance lines in the proposed scheme) and entered "run-off," in which it paid its aviation insurance obligations as they arose. BAIC was a highly solvent entity that candidly admitted its goals were to end the administrative costs of running off its aviation lines and to cut off its long-term IBNR liabilities under its aviation policies so that it could dividend funds to its shareholders that it would otherwise be required to reserve for IBNR claims.

11. See generally WFUM Pools Scheme: A Proposal in Relation to Scheme of Arrangement Pursuant to Section 425 of the Companies Act of 1985 Concerning Business Underwritten And/Or Administered By Willis Faber (Underwriting Management) Limited ("WFUM"), Devonport Underwriting Agency Limited (Dual) And Willis Faber & Dumas Limited (WF&D) On Behalf Of The Scheme Companies Referred To Below, Together With Other Liabilities Of Sovereign Marine & General Insurance Company Limited And Its Subsidiaries As Defined In Appendix A To The Scheme At Pages 275 To 279 And Described In The Explanatory Statement At Pages 62 To 69 Between Sovereign Marine & General Insurance Company Limited (By Way Of Amendment To An Existing Scheme Of Arrangement Dated 15 October 1999) Allianz Cornhill Insurance Plc Oslo Reinsurance Company (U.K) Limited Allianz Global Corporate & Specialty (France) Sovereign Insurance (U.K) Limited Atlantic Mutual Insurance Company Sphere Drake Insurance Limited Continental Reinsurance Corporation International Limited The Ocean Marine Insurance Company Limited Greyfriars Insurance Company Limited The Sea Insurance Company Limited Heddington Insurance (U.K.) Limited Tokio Marine Europe Insurance Limited Hibernian General Insurance Limited Wausau Insurance Company (U.K.) Limited Mitsui Sumitomo Insurance Company (Europe), Limited And Their Respective

Scheme Creditors (As Defined In The Scheme), dated 31st July 2006 (the "WFUM Scheme"), https://www.wfumpools.com/wfumdc/WFUM%20Pools%20Scheme%20Document.pdf.

12. In the Matter of the British Aviation Insurance Company, Limited, [2005] EWHC 1621 and [2006] 1 BCLC 665p. 5, http://www.bailii.org/ew/cases/EWHC/Ch/2005/1621.html; WFUM Scheme at 15-16, https://www.wfumpools.com/wfumdc/WFUM%20Pools%20Scheme%20Document.pdf. It is conceivable, of course, that a scheme could be proposed by an insurance company that purports to be solvent but which is truly in financial distress. In that case, as suggested in n. 7 supra, policyholders may well be advised to accept the forced commutation of their contracts.

13. BAIC Scheme p. 11.

14. 4th May 2006 Transcript, at p. 660; 664-66; 668, In the Matters of Sovereign Marine & General Insurance Company Limited and Others, High Court of Justice, Chancery Division, Companies Court (Warren, J.) [Unreported].

15. In the Matter of the British Aviation Insurance Company, Limited, [2005] EWHC 1621 and [2006] 1 BCLC 665 pp 8-10, 31, http://www.bailii.org/ew/cases/EWHC/Ch/2005/1621.html.

16. First Witness Statement of David John Guy Hunt, dated March 3, 2006, ¶ 70, In the Matters of Sovereign Marine & General Insurance Company Limited and Others, High Court of Justice, Chancery Division, Companies Court, Claim Nos. 1611, 1618, 1621-22, 1624-26, 1628-30, 1632-35, 1647 and 1648 of 2006.

17. Chairman's Report, March 19, 2007, ¶ 4.3 at p. 25, In the Matters of Sovereign Marine & General Insurance Company Limited and Others, High Court of Justice, Chancery Division, Companies Court, Claim Nos. 1611, 1618, 1621-22, 1624-26, 1628-30, 1632-35, 1647 and 1648 of 2006.

18. WFUM Scheme at 378-500, https://www.wfumpools.com/wfumdc/WFUM%20Pools%20Scheme%20Document.pdf.

19. See, e.g., In re Board of Directors of Hopewell Intern. Ins. Ltd., 238 B.R. 25, 34 Bankr. Ct. Dec. (CRR) 1273 (Bankr. S.D. N.Y. 1999), order aff'd, 275 B.R. 699, 48 Collier Bankr. Cas. 2d (MB) 362 (S.D. N.Y. 2002), citing Sovereign Life Assurance Company v. Dodd [1892] 2 Q.B. 573, 583.

20. In the Matter of the British Aviation Insurance Company Limited, [2005] EWHC 1621 (Ch). and [2006] 1 BCLC 665, pp 22-26, http://www.bailii.org/ew/cases/EWHC/Ch/2005/1621.html. As Mr. Justice Lewison noted in the BAIC case, reinsurers "have vested interests in commuting their reinsurance obligations to the Company, because such commutations typically cap the exposure that they would otherwise have under their treaties and facultative reinsurance certificates if the Company were to continue to run-off its long-tail claims in the normal course. They have a vested interest in ascribing a low or nil value to future claims because this limits their exposure as reinsurers.... Unlike the direct insureds, the reinsurers are in the risk business. Given the uncertainties of the extent of potential exposure to asbestos and other long-tail claims, it makes perfect sense for them to be keen to cap their liabilities. If the Company's liabilities are capped, so are their liabilities as reinsurers. Their mutual liabilities are to be set off under the scheme. This does not apply to the direct insureds, who remain liable to those who contract asbestos diseases." In the Matter of the British Aviation Insurance Company Limited, [2005] EWHC 1621 and [2006] 1 BCLC 665, ¶ 120-121 http://www.bailii.org/ew/cases/EWHC/Ch/2005/1621.html.

21. In BAIC the objecting policyholders did not object at the stage of the initial convening hearing, but the Court permitted them to raise the class arguments at the sanction hearing. In the Matter of the British Aviation Insurance Company Limited, [2005] EWHC 1621 and [2006] 1 BCLC 665, http://www.bailii.org/ew/cases/EWHC/Ch/2005/1621.html.

22. In the Matter of the British Aviation Insurance Company Limited, [2005] EWHC 1621 and [2006] 1 BCLC 665 ¶ 124-125, http://www.bailii.org/ew/cases/EWHC/Ch/2005/1621.html.

23. In the Matters of Sovereign Marine & General Insurance Company Limited and Others, High Court of Justice, Chancery Division, Companies Court, [2006] EWHC 1335 and [2007] 1 BCLC 228. Neither Mr. Justice Lewison nor Mr. Justice Warren accepted the objectors'

argument that reinsurers who were also policyholders and affiliates should not be included in the IBNR class.

24. In the Matter of the British Aviation Insurance Company Limited, [2005] EWHC 1621 and [2006] 1 BCLC 665, ¶¶ 41-44, http://www.bailii.org/ew/cases/EWHC/Ch/2005/1621.html

25. In the Matter of the British Aviation Insurance Company Limited, [2005] EWHC 1621 and [2006] 1 BCLC 665, ¶ 109, 110, http://www.bailii.org/ew/cases/EWHC/Ch/2005/1621.html.

26. In the Matters of Sovereign Marine & General Insurance Company Limited and Others, High Court of Justice, Chancery Division, Companies Court (Warren, J.) Judgment dated 16th May 2007 [Unreported] ¶¶ 9-10, 18.

27. In the Matters of Sovereign Marine & General Insurance Company Limited and Others, High Court of Justice, Chancery Division, Companies Court (Warren, J), Judgment dated 16th May 2007 [Unreported] ¶¶ 18-19.

28. BAIC Scheme, 5.2.14: "Insofar as the law allows, any determination of the Scheme Adjudicator on any matter referred to him or under this Part 5 generally shall be final and binding on the Company and the relevant Scheme Creditor and there shall be no right to appeal form such decision. Neither the Company, the Scheme Manager or any Scheme Creditor shall have any right to make any claim or bring any Proceeding against the Scheme Adjudicator in any capacity in respect of any decision or determination in relation to any Scheme Liability or any matter upon which the Scheme Adjudicator has made a determination."

WFUM Scheme § 6.4.9: "So far as the law permits, a Scheme Adjudicator's and the Actuarial Adjudicator's determination in respect of the matter referred to him shall, in the absence of Manifest Error, be final and binding on the Scheme Company and the relevant Scheme Creditor and subject to the provision of clause 6.6 there shall be no right of appeal or review therefrom or to make any claim in respect thereof."

29. The Scheme Adjudicator proposed in both WFUM and BAIC , BAIC Scheme 5.1.2, 5.1.5; WFUM Scheme § 2.4, https://www.wfumpools.com/wfumdc/WFUM%20Pools%20Scheme%20Document.pdf., also served as Scheme Adjudicator for at least 27 other solvent and insolvent schemes. See curriculum vitae of Peter Matthews, included in the WFUM scheme documentation at https://www.wfumpools.com/wfumdc/SchemeDocumentation.aspx. In both BAIC and WFUM it was proposed that he would decide, in his sole discretion, whether the schemes or the creditor must pay his costs and expenses. BAIC Scheme 5.2.8.; WFUM Scheme § 6.5 at p. 191. In neither case was his compensation or his decision that a creditor pay his costs subject to judicial review.

Mr. Matthews' personal integrity is not in question. The problems with his repeated selection by the scheme proponents as scheme adjudicator are: (a) the appearance of bias that arises because of his frequent retention by scheme proponents, (b) his lack of training in applicable U.S. law, and (c) the policyholders' lack of voice in the selection of the person who will adjudicate their claims.

30. Mr. Justice Lewison indicated that had he approved the BAIC scheme, he would have directed that the bar date would be one year after the scheme became operative, not 120 days as the scheme proposed. In the Matter of the British Aviation Insurance Company Limited, [2005] EWHC 1621 and [2006] 1 BCLC 665, ¶ 127, http://www.bailii.org/ew/cases/EWHC/Ch/2005/1621.html. The bar date in the WFUM Scheme is 180 days after the scheme's effective date. WFUM Scheme p. 126, https://www.wfumpools.com/wfumdc/WFUM%20Pools%20Scheme%20Document.pdf.

31. WFUM Scheme Appendix B, pp. 280-332, https://www.wfumpools.com/wfumdc/WFUM%20Pools%20Scheme%20Document.pdf.

32. 4th May 2006 Transcript, at p. 664, In the Matters of Sovereign Marine & General Insurance Company Limited and Others, High Court of Justice, Chancery Division, Companies Court (Warren, J).

33. In the Matter of the British Aviation Insurance Company Limited, [2005] EWHC 1621 and [2006] 1 BCLC 665 ¶ 143, http://www.bailii.org/ew/cases/EWHC/Ch/2005/1621.html.

34. 4th May 2006 Transcript, at p. 34, and see p. 75, p. 342, In the Matters of Sovereign Marine & General Insurance Company Limited and Others, High Court of Justice, Chancery Division, Companies Court (Warren, J.).

35. Schemes typically provide that they will not be effective until after the U.S. bankruptcy court has granted relief. See, e.g., WFUM Scheme p.2, https://www.wfumpools.com/wfumdc/WFUM%20Pools%20Scheme%20Document.pdf, providing that the effective date of the scheme will occur after the hearing on the Chapter 15 petition in the U.S.

36. In re Board of Directors of Hopewell Intern. Ins. Ltd., 238 B.R. 25, 34 Bankr. Ct. Dec. (CRR) 1273 (Bankr. S.D. N.Y. 1999), order aff'd, 275 B.R. 699, 48 Collier Bankr. Cas. 2d (MB) 362 (S.D. N.Y. 2002), was the first, and one of the few proceedings brought under section 304 or Chapter 15, involving a "solvent scheme" by foreign insurers. It was a "cut-off" scheme of arrangement under Bermuda law and did not involve section 425 of the Companies Act. Although the court regarded Hopewell as technically solvent, some evidence rendered questionable its continuing solvency, and many of its retrocessionaires which insured a significant percentage of its exposures had already stopped performing and were in crisis, which the court held to be "no small consideration" with regard to the future rights of creditors (Hopewell, 238 B.R. at 35). In addition, the court, citing Petition of Tam, 170 B.R. 838, 25 Bankr. Ct. Dec. (CRR) 1635 (Bankr. S.D. N.Y. 1994), and Petition of Ward, 201 B.R. 35, 3617 (Bankr. S.D. N.Y. 1996), corrected, (Oct. 10, 1996), took a searching look at "the amount of judicial involvement and supervision, or, conversely, the degree of access to the court available at various stages to creditors so that they may voice any objections they may have" (Hopewell, 238 B.R. at 50), and based its determination to recognize the Bermuda scheme on the availability of many important procedural protections that are notably absent from the BAIC scheme. The Hopewell scheme included multiple opportunities for pre- and postsanction redress in the courts regarding such matters as replacement of the liquidators, determination of claims, valuation and compensation, preferential treatment of insiders, and the ability of creditors to terminate the proceedings. These factors distinguish Hopewell from the section 425 solvent schemes, in which there is no court involvement or supervision of the company, nor any right of access to the courts for aggrieved creditors.

37. 11 U.S.C.A. § 1501(a).

38. H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 118 (2005).

39. See S. Rep. No. 989, 95th Cong., 2d Sess. 35, reprinted in 1978 U.S.C.C.A.N. 5787, 5821, explaining section 304 and discussed in In re Maxwell Communication Corp. plc by Homan, 93 F.3d 1036, 1048, 29 Bankr. Ct. Dec. (CRR) 788 (2d Cir. 1996). See also H.R. Rep. No. 95-595 to accompany H.R. 8200, 95th Cong., 1st Sess. (1977) p. 324 ("this section governs cases filed in the bankruptcy courts that are ancillary to foreign proceedings. That is, where a foreign bankruptcy case is pending concerning a particular debtor and that debtor has assets in this country, the foreign representative may file a petition under this section"). See also In re Treco, 240 F.3d 148, 156, 37 Bankr. Ct. Dec. (CRR) 125 (2d Cir. 2001) ("§ 304 addresses situations in which a bankruptcy proceeding has been instituted in a foreign country and the debtor has assets in the United States.").

40. United Nations Commission on International Trade Law (UNCITRAL), Guide to Enactment of the Model Law on Cross-Border Insolvency (Model Law), ¶ 51.

41. Guide to Enactment of Model Law, ¶ 24.

42. Even if true, that would not suffice because, as discussed above, solvent schemes are not judicial proceedings and the scheme companies' assets are not subject to judicial control.

43. In re Rose, 318 B.R. 771, 774-76, 44 Bankr. Ct. Dec. (CRR) 19, 53 Collier Bankr. Cas. 2d (MB) 900 (Bankr. S.D. N.Y. 2004).

44. In re Rose, 318 B.R. 771, 775, 44 Bankr. Ct. Dec. (CRR) 19, 53 Collier Bankr. Cas. 2d (MB) 900 (Bankr. S.D. N.Y. 2004).

45. In re Rose, 318 B.R. 771, 776, 44 Bankr. Ct. Dec. (CRR) 19, 53 Collier Bankr. Cas. 2d (MB) 900 (Bankr. S.D. N.Y. 2004).

46. In re Rose, 318 B.R. 771, 774-76, 44 Bankr. Ct. Dec. (CRR) 19, 53 Collier Bankr. Cas. 2d (MB) 900 (Bankr. S.D. N.Y. 2004). One other U.S. court has been asked to pass on a Part VII scheme, in which, like Rose, the assets of several solvent U.K. insurers were to be transferred to another U.K. insurer. In re petition of Catherine Geraldine Regan, as Foreign Representative of Riverstone Insurance (UK) Limited, Case. No 05-12678 (RDD). Objections to the recognition of the scheme were resolved before the final hearing. Because the parties had reached agreement, the court agreed to sign the order granting the section 304 petition. Recognizing the serious legal grounds for dispute about the validity of this outcome, however, the court expressly required that the order provide that it "shall have no precedential value in any other case or controversy either in this Court or in any other Court."

47. If a solvent scheme is not a "foreign proceeding," the scheme proponents by definition cannot be "foreign representatives" under section 101(24) of the Bankruptcy Code.

48. Before the amendment, section 101(23) provided that a foreign proceeding "means proceeding, whether judicial or administrative and whether or not under bankruptcy law, in a foreign country in which the debtor's domicile, residence, principal place of business, or principal assets were located at the commencement of such proceeding, for the purpose of liquidating an estate, adjusting debts by composition, or discharge, or effecting a reorganization."

49. Petition of Tam, 170 B.R. 838, 25 Bankr. Ct. Dec. (CRR) 1635 (Bankr. S.D. N.Y. 1994), cited with approval in In re SPhinX, Ltd., 351 B.R. 103, 116, 47 Bankr. Ct. Dec. (CRR) 17, 56 Collier Bankr. Cas. 2d (MB) 1176 (Bankr. S.D. N.Y. 2006), aff'd, 371 B.R. 10 (S.D. N.Y. 2007).

50. Petition of Tam, 170 B.R. 838, 25 Bankr. Ct. Dec. (CRR) 1635 (Bankr. S.D. N.Y. 1994) (footnote omitted.). See also In re Master Home Furniture Co. Ltd., 261 B.R. 671, 37 Bankr. Ct. Dec. (CRR) 216 (Bankr. C.D. Cal. 2001) (Taiwanese proceeding was not a "foreign proceeding" because after petition is filed under Taiwanese law and until governmental agencies report to the court on the debtor's business and proposed reorganization, the debtor operates free of judicial or administrative oversight).

Cf. In re Netia Holdings S.A., 277 B.R. 571 (Bankr. S.D. N.Y. 2002), which declined to extend the Master Home Furniture decision to a Polish proceeding, holding that there was sufficient judicial oversight by the Polish court prior to the court's determination of whether an Arrangement Proceeding should be opened to constitute a "foreign proceeding." In re Netia Holdings S.A., 277 B.R. at 585 ("This Court agrees with Netia that given creditors' ability to be heard and the Polish Court's substantial involvement—including conducting hearings and examining witnesses—in the Arrangement Proceeding currently underway in Poland, the Arrangement Proceeding allows for, and has already involved, considerably more involvement on the part of the court and creditors than the Taiwanese proceeding in Master Home.").

Netia does not, however, mean that solvent schemes must be recognized. It was decided before the 2005 revisions to the Bankruptcy Code, when section 304 did not require control or supervision of the debtor's assets by the foreign court. Now, in contrast, Chapter 15 explicitly requires such court supervision in the definition of a "foreign proceeding." 11 U.S.C.A. § 101(23). In addition, the concern expressed in Netia about a "run at a debtor's assets" or the "piecemeal distribution of a debtor's estate" do not apply when the scheme company is highly solvent and well able to satisfy its obligations as they come due.

51. In re SPhinX, Ltd., 351 B.R. 103, 116, 47 Bankr. Ct. Dec. (CRR) 17, 56 Collier Bankr. Cas. 2d (MB) 1176 (Bankr. S.D. N.Y. 2006), aff'd, 371 B.R. 10 (S.D. N.Y. 2007).

52. Matter of Chicago, Milwaukee, St. Paul and Pacific R. Co., 791 F.2d 524, 527 (7th Cir. 1986). See also Ruskin v. Griffiths, 269 F.2d 827, 832 (2d Cir. 1959) (holding that it would be "the opposite of equity" to allow a solvent debtor to escape its contractual obligations); Esopus Creek Value LP v. Hauf, 913 A.2d 593, 603 (Del. Ch. 2006), judgment entered, 2006 WL 4782263 (Del. Ch. 2006) ("It therefore seems an abuse of the bankruptcy process for a robust and healthy company, encumbered by virtually no debt, to seek out the vast and extraordinary relief a bankruptcy court is capable of providing.... Truly, '[c]hapter 11 was designed to give those teetering on the verge of a fatal financial plummet an opportunity to reorganize on solid ground and try again, not to give profitable enterprises an opportunity to evade' other contractual

and state law obligations."); In re 139-141 Owners Corp., 313 B.R. 364, 369, 43 Bankr. Ct. Dec. (CRR) 146 (S.D. N.Y. 2004).

53. In re Dow Corning Corp., 456 F.3d 668, 679, 46 Bankr. Ct. Dec. (CRR) 222, Bankr. L. Rep. (CCH) P 80664, 2006 FED App. 0260P (6th Cir. 2006), cert. denied, 127 S. Ct. 1874, 167 L. Ed. 2d 385 (U.S. 2007).

54. In re Dow Corning Corp., 456 F.3d 668, 679, 46 Bankr. Ct. Dec. (CRR) 222, Bankr. L. Rep. (CCH) P 80664, 2006 FED App. 0260P (6th Cir. 2006), cert. denied, 127 S. Ct. 1874, 167 L. Ed. 2d 385 (U.S. 2007).

55. In re Integrated Telecom Express, Inc., 384 F.3d 108, 112, 43 Bankr. Ct. Dec. (CRR) 175, Bankr. L. Rep. (CCH) P 80168 (3d Cir. 2004), cert. denied, 545 U.S. 1110, 125 S. Ct. 2542, 162 L. Ed. 2d 286 (2005) ("[A] Chapter 11 petition filed by a financially healthy debtor, with no intention of reorganizing or liquidating as a going concern, with no reasonable expectation that Chapter 11 proceedings will maximize the value of the debtor's estate for creditors, and solely to take advantage of a provision in the Bankruptcy Code that limits claims on long-term leases," was filed in bad faith"; good faith necessarily requires some degree of financial distress on the part of the debtor).

56. In re SGL Carbon Corp., 200 F.3d 154, 166, 35 Bankr. Ct. Dec. (CRR) 116, 43 Collier Bankr. Cas. 2d (MB) 668, Bankr. L. Rep. (CCH) P 78084, 1999-2 Trade Cas. (CCH) ¶ 72739 (3d Cir. 1999). Compare In re Schur Management Co., Ltd., 323 B.R. 123, 126-27, 44 Bankr. Ct. Dec. (CRR) 151 (Bankr. S.D. N.Y. 2005) (finding that where debtors have only a "mere possibility of a future need to file" and are in no current financial distress, they do not meet the good-faith filing requirement) with In re Century/ML Cable Venture, 294 B.R. 9, 36 (Bankr. S.D. N.Y. 2003) (finding good faith filing where petitioner "does not have cash on hand sufficient to pay [the creditor], and would face liquidation or dismemberment in the event of a judgment").

57. In re Integrated Telecom Express, Inc., 384 F.3d 108, 129, 43 Bankr. Ct. Dec. (CRR) 175, Bankr. L. Rep. (CCH) P 80168 (3d Cir. 2004), cert. denied, 545 U.S. 1110, 125 S. Ct. 2542, 162 L. Ed. 2d 286 (2005).

58. In re Dixie Broadcasting, Inc., 871 F.2d 1023, 1028, 20 Collier Bankr. Cas. 2d (MB) 1521, Bankr. L. Rep. (CCH) P 72874 (11th Cir. 1989) (Bankruptcy Code "is not intended to insulate financially secure sellers or buyers from the bargains they strike"); Dunes Hotel Associates v. Hyatt Corp., 245 B.R. 492 (D.S.C. 2000). (solvent debtor could not use bankruptcy to strike down a bilateral contracts to the detriment of its noninsider creditors); Furness v. Lilienfield, 35 B.R. 1006, 1009, 11 Bankr. Ct. Dec. (CRR) 1342, 10 Collier Bankr. Cas. 2d (MB) 930 (D. Md. 1983) (bankruptcy laws were "designed to give those teetering on the verge of a fatal financial plummet an opportunity to reorganize on solid ground and try again, not to give profitable enterprises an opportunity to evade contractual or other liability"), In re Chi-Feng Huang, 23 B.R. 798, 803, 9 Bankr. Ct. Dec. (CRR) 972, 7 Collier Bankr. Cas. 2d (MB) 639 (B.A.P. 9th Cir. 1982) ("[I]t is not true that solvent debtors may petition for bankruptcy and then obtain a windfall by rejecting their executory contracts"); In re Liberate Technologies, 314 B.R. 206, 214-15 43 Bankr. Ct. Dec. (CRR) 170, 52 Collier Bankr. Cas. 2d (MB) 1451 (Bankr. N.D. Cal. 2004) (petition filed solely to take advantage of section 506(b)(6)); In re Albrechts Ohio Inns, Inc., 152 B.R. 496, 501 (Bankr. S.D. Ohio 1993) (it "perverts the wholesome economic objective" of the bankruptcy laws to "nakedly... allow the remaking of a bilateral contract by one of the parties thereto"); In re Southern California Sound Systems, Inc., 69 B.R. 893, 900, 15 Bankr. Ct. Dec. (CRR) 579, Bankr. L. Rep. (CCH) P 71674 (Bankr. S.D. Cal. 1987) (Chapter 11 petition filed to reject executory contract pursuant to 11 U.S.C.A. § 365(a)).

59. In re Integrated Telecom Express, Inc., 384 F.3d 108, 129, 43 Bankr. Ct. Dec. (CRR) 175, Bankr. L. Rep. (CCH) P 80168 (3d Cir. 2004), cert. denied, 545 U.S. 1110, 125 S. Ct. 2542, 162 L. Ed. 2d 286 (2005).

60. In re Integrated Telecom Express, Inc., 384 F.3d 108, 126, n. 8, 129, 43 Bankr. Ct. Dec. (CRR) 175, Bankr. L. Rep. (CCH) P 80168 (3d Cir. 2004), cert. denied, 545 U.S. 1110, 125 S. Ct. 2542, 162 L. Ed. 2d 286 (2005).

61. In re SPhinX, Ltd., 351 B.R. 103, 121, 47 Bankr. Ct. Dec. (CRR) 17, 56 Collier Bankr. Cas. 2d (MB) 1176 (Bankr. S.D. N.Y. 2006), aff'd, 371 B.R. 10 (S.D. N.Y. 2007). Judge Lifland acknowledged this factor without objection in his recent decision in In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., 374 B.R. 122, 48 Bankr. Ct. Dec. (CRR) 216 (Bankr. S.D. N.Y. 2007).

62. This good faith standard is a "threshold inquiry [that] is particularly sensitive where, as here, the petition seeks to distribute value directly from a creditor to a company's shareholders." In re Integrated Telecom Express, Inc., 384 F.3d 108, 127, n. 8, 129, 43 Bankr. Ct. Dec. (CRR) 175, Bankr. L. Rep. (CCH) P80168 (3d Cir. 2004), cert. denied, 545 U.S. 1110, 125 S. Ct. 2542, 162 L. Ed. 2d 286 (2005), citing Bank of America Nat. Trust and Sav. Ass'n v. 203 North LaSalle Street Partnership, 526 U.S. 434, 453, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 34 Bankr. Ct. Dec. (CRR) 329, 41 Collier Bankr. Cas. 2d (MB) 526, Bankr. L. Rep. (CCH) P 77924 (1999).

63. JP Morgan Chase Bank v. Altos Hornos de Mexico, S.A. de C.V., 412 F.3d 418, 423, 44 Bankr. Ct. Dec. (CRR) 254, Bankr. L. Rep. (CCH) P 80309 (2d Cir. 2005). See also In re Treco, 240 F.3d 148, 157, 37 Bankr. Ct. Dec. (CRR) 125 (2d Cir. 2001). ("The principle of comity has never meant categorical deference to foreign proceedings. It is implicit in the concept that deference should be withheld where appropriate to avoid the violation of the laws, public policies, or rights of the citizens of the United States."); Pravin Banker Associates, Ltd. v. Banco Popular Del Peru, 109 F.3d 850 , 854 (2d Cir. 1997) (comity should not be extended "when doing so would be contrary to the policies or prejudicial to the interests of the United States").

The U.K., which is also a UNCITRAL signatory, applies similar principles in considering whether to give effect to U.S. bankruptcy orders. See e.g. Re T&N Ltd and other companies, [2004] EWHC 2361 (ch): "Comity, as a means of achieving cooperation between different jurisdictions in cross-border insolvency cases, is of great importance. It is a highly relevant factor in the exercise by the court of discretionary powers. It does not, however, enable the court to alter or dispense with mandatory provisions of the law which it administers. This is the case even in an ancillary winding up in England of a foreign-registered company. Further, if the position were reached that the English Court considered that CVAs or schemes of arrangement designed to implement the Plan were unfair and would thus not be sanctioned or allowed to stand, it is very difficult to see that the Court would nonetheless give effect to it as a matter of comity, always assuming that it had the jurisdiction to do so."

64. Morta v. Korea Ins. Corp., 840 F.2d 1452, 1460 (9th Cir. 1988) (citing Charles Fried, Contract as Promise 1, 132 (1981).

65. University of Dist. of Columbia Faculty Ass'n/NEA v. Board of Trustees of University of Dist. of Columbia, 994 F. Supp. 1, 9, 125 Ed. Law Rep. 463, 157 L.R.R.M. (BNA) 2338 (D.D.C. 1998), aff'd and remanded, 163 F.3d 616, 131 Ed. Law Rep. 583, 160 L.R.R.M. (BNA) 2091 (D.C. Cir. 1998).

66. Morta v. Korea Ins. Corp., 840 F.2d 1452 (9th Cir. 1988) (internal quotations and citations omitted); see also In re Schenck Tours, Inc., 69 B.R. 906, 913 (Bankr. E.D. N.Y. 1987), order aff'd, 75 B.R. 249 (E.D. N.Y. 1987) (stating that "a party should not be excused from what may have become a hard bargain.... Equity does not relieve from hard bargains merely because they are such.... A party may not abrogate a contract just because it might be commercially disadvantageous to perform it. If such abrogation would be permitted, all commercial contracts would be placed in dire jeopardy.") See also In re Treco, 240 F.3d 148, 160, 37 Bankr. Ct. Dec. (CRR) 125 (2d Cir. 2001), in which the Court of Appeals for the Second Circuit held that because security interests are recognized as property rights under the Fifth Amendment, the failure of Bahamian law to protect the security interests of U.S. citizens in a Bahamian procedure required the U.S. court to deny recognition to the Bahamian procedure. Contract rights are of course included in the kind of property rights to which courts afford constitutional protection against governmental taking. Lynch v. U.S., 292 U.S. 571, 54 S. Ct. 840, 78 L. Ed. 1434 (1934); Ganci v. New York City Transit Authority, 420 F. Supp. 2d 190 (S.D. N.Y. 2005), judgment aff'd, 163 Fed. Appx. 7 (2d Cir. 2005).

The Supreme Court's recent decision in Travelers Cas. and Sur. Co. of America v. Pacific Gas and Elec. Co., 127 S. Ct. 1199, 167 L. Ed. 2d 178, 47 Bankr. Ct. Dec. (CRR) 265, 57 Collier Bankr. Cas. 2d (MB) 314, Bankr. L. Rep. (CCH) P 80880 (U.S. 2007), supports this point, in its holding that creditors' rights in bankruptcy are generally governed by their contracts with the debtors as interpreted by applicable state law.

67. While it is certainly true that debtors are able to reject executory contracts under section 365 of the Bankruptcy Code (11 U.S.C.A. § 365), if they are solvent they must pay rejection damage claims in full before delivering value to their equity holders.

68. In re Schenck Tours, Inc., 69 B.R. 906, 910-11 (Bankr. E.D. N.Y. 1987), order aff'd, 75 B.R. 249 (E.D. N.Y. 1987)).

69. In re Schenck Tours, Inc., 69 B.R. 906, 911 (Bankr. E.D. N.Y. 1987), order aff'd, 75 B.R. 249 (E.D. N.Y. 1987).

70. See, e.g., Joint Anti-Fascist Refugee Committee v. McGrath, 341 U.S. 123, 171-172, 71 S. Ct. 624, 95 L. Ed. 817 (1951) (Frankfurter, J., concurring).

71. Drexel Burnham Lambert Group Inc. v. Galadari, 777 F.2d 877 (2d Cir. 1985).

72. Interpool Ltd. v. Certain Freights of the M/V Venture Star, 102 B.R. 373, 378 (D.N.J. 1988).

73. Interpool Ltd. v. Certain Freights of the M/V Venture Star, 102 B.R. 373, 375-76, 380 (D. N.J. 1988).

74. Drexel Burnham Lambert Group, Inc. v. Galardi, 127 B.R. 87, 100 (S.D. N.Y. 1991) (refusing to grant comity to a foreign bankruptcy proceeding because the proceeding did not comply with fundamental fairness and due process under U.S. law when the foreign entity ruling on creditors' claims was not impartial).

See also Hooters of America, Inc. v. Phillips, 173 F.3d 933, 938-40, 79 Fair Empl. Prac. Cas. (BNA) 629, 75 Empl. Prac. Dec. (CCH) P 45822 (4th Cir. 1999)) (court refused to compel arbitration when the employer's arbitration rules—which among other things allowed the employer to control selection of the arbitration panel—were biased and one-sided); Hudson v. Chicago Teachers Union Local No. 1, 743 F.2d 1187, 1195, 20 Ed. Law Rep. 56, 117 L.R.R.M. (BNA) 2314 (7th Cir. 1984), judgment aff'd, 475 U.S. 292, 106 S. Ct. 1066, 89 L. Ed. 2d 232, 30 Ed. Law Rep. 649, 121 L.R.R.M. (BNA) 2793 (1986) (finding that the union's grievance procedure was constitutionally inadequate when there was no independent arbitrator because the arbitrator was paid by the union and had a financial incentive to decide cases favorably to the union).

75. The Canadian courts agree with the premises that there should be a right to judicial review and the right to application of the law of the contract, as indicated in Re Cavell Insurance Co. ,2005 A.C.W.S.J. LEXIS 1149, 2005 A.C.W.S.J. 2939, 137 A.C.W.S. (3d) 419, at ¶ 17; Re Cavell Insurance Co., [2005] O.J. No. 1725, 2005 On.C. LEXIS 1954, ¶¶ 9-10.

76. Interpool Ltd. v. Certain Freights of the M/V Venture Star, 102 B.R. 373 (D.N.J. 1988).

77. See Drexel Burnham Lambert Group, Inc. v. Galardi, 127 B.R. 87, 100 (S.D. N.Y. 1991) (denying comity under section 304 to foreign proceeding because, among other things, the foreign proceeding failed to afford a U.S. creditor procedural due process when the committee overseeing the proceeding acted as both trustee and judge with respect to the determination of claims); cf. Pravin Banker Associates, Ltd. v. Banco Popular del Peru, 165 B.R. 379, 386 (S.D. N.Y. 1994) (holding that Peruvian bank liquidation procedures comported with U.S. notions of due process when, among other things, the liquidation procedures included the right to appeal claims determinations to Peruvian courts and the trustees overseeing the case were "suitably independent").

78. In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., 374 B.R. 122, 48 Bankr. Ct. Dec. (CRR) 216 (Bankr. S.D. N.Y. 2007).

79. 11 U.S.C.A. § 1522(a).

80. 11 U.S.C.A. § 1522(b)

81. 11 U.S.C.A. § 1522(c).

82. Re Cavell Insurance Co., 2005 A.C.W.S.J. LEXIS 1149, 2005 A.C.W.S.J. 2939, 137 A.C.W.S. (3d) 419, at ¶ 17; Re Cavell Insurance Co., [2005] O.J. No. 1725, 2005 On.C. LEXIS 1954, ¶¶ 9-10.

83. The case and its implications are discussed by Goodmans LLP at http://www.goodmans.ca/pdfs/cross%20border%20jurisdiction.pdf.

Solvent Insurance Schemes Should Not Be Recognized [*Reprised*]

SUSAN POWER JOHNSTON AND MARTIN BEELER

In December 2007 this journal published an article titled "Why U.S. Courts Should Deny or Severely Condition Recognition to Schemes of Arrangement for Solvent Insurance Companies,"[1] which discussed the tsunami wave of solvent insurance schemes coming from the UK and seeking enforcement under Chapter 15. The article pointed out how grossly inequitable these solvent schemes are to U.S. holders of "occurrence" insurance policies who face "incurred but not reported" (IBNR) long-tail tort liability in potentially enormous amounts. It argued that the schemes did not qualify for protection under Chapter 15 because (a) the UK proceedings involving solvent insurance companies do not fall within the definition of a "foreign proceeding" in 11 U.S.C.A. § 101(23), and (b) the schemes violate fundamental U.S. policies, including the bedrock policy that commercial contracts ordinarily should be enforced according to their terms, and the equally important policy of not allowing solvent companies to misuse the bankruptcy process to shed wholesale their executory contracts. In the alternative, if U.S. courts are inclined to continue to recognize these schemes despite their incompatibility with Chapter 15 and fundamental U.S. law, the article contended that U.S. courts should provide important procedural protections to U.S. policyholders.

In August 2008 this journal published a reply by proponents of solvent insurance schemes that attempted to justify the extension of Chapter 15 protection to those arrangements (the "Scheme Proponents' Reply").[2] We disagree with the positions taken by the Scheme Proponents in their Reply, which we believe do not respond to the material points made in the original article.

Ms. Johnston is of counsel to and Martin Beeler is an associate of Covington & Burling LLP where they practice in the area of bankruptcy and creditors' rights.

When Statutory Language Is Clear and Unambiguous on Its Face, Resort to Legislative History and Other Extraneous Material Is Inappropriate

The Scheme Proponents open their discussion with a reference to certain private communications that the authors apparently had with Daniel Glosband, one of the drafters of Chapter 15, in which they seemingly agreed between them, without notice to any other interested party, that Chapter 15 would cover solvent UK insurance schemes. According to the Scheme Proponents, Mr. Glosband's view may also have been communicated to various members of the Congressional subcommittees responsible for the drafting of Chapter 15. These communications are not part of the public record or the legislative history and, in any event, can have no bearing on how courts interpret the statute. As the Supreme Court has consistently held in the context of interpreting the Bankruptcy Code, if the statutory language is clear and unambiguous and does not lead to an absurd result, reference to materials outside the text of the statutory provisions is wholly inappropriate.[3] Even in the rare case in which a court would have recourse to extrinsic materials as an aid to interpretation, Mr. Glosband's letters would not be considered. Courts do not accept the views of an individual drafter (let alone someone who was not a member of Congress) as an expression of the intent of the legislative body that enacted the law.[4] Certainly nonpublic, pre-enactment correspondence between one of the persons who worked on the statute and private lawyers seeking to position their clients for future litigation can have no bearing on how courts read and interpret the resulting statutory provisions.[5]

The Definition of Foreign Proceeding Does Not Include Solvent Insurance Schemes

As the Solvent Schemes Article demonstrated, the definition of "foreign proceeding" does not encompass solvent schemes under UK law.[6] UK solvent insurance schemes do not invoke a foreign law related to insolvency or adjustment of debt,[7] the assets and affairs of the scheme company are not subject to control or supervision by the foreign court,[8] and the solvent scheme companies are not engaging in the kind of reorganization or liquidation contemplated by the U.S. Bankruptcy Code.

Bankruptcy Code sections 109(b) and 1501(c)(1) are irrelevant to the question of whether foreign solvent insurance schemes are "foreign proceedings" within the meaning of section 101(23). There is no dispute that under section 109(b) and 1501(c)(1), foreign insurance companies are entitled to file for Chapter 15 protection provided that they otherwise comply with the relevant and applicable provisions of the Bankruptcy

Code. However, those sections do not override the definition of foreign proceeding in section 101(23). When, as discussed above, a particular foreign restructuring involving a foreign insurance company does not fit within the definition, as the solvent insurance schemes do not, section 1501(c)(1)'s inclusion of foreign insurance companies within the intended ambit of Chapter 15 does not change that result.

Hopewell Does Not Mandate Recognition of UK Solvent Insurance Schemes

The Scheme Proponents place great emphasis on the *Hopewell* case.[9] *Hopewell* was the first, and one of the few proceedings brought under Code section 304, to involve a foreign solvent insurance scheme. The differences between the *Hopewell* scheme and the UK solvent insurance schemes, however, are numerous.

First, and fundamentally, the *Hopewell* scheme was a "cut-off" scheme of arrangement under Bermuda law and did not involve the UK Companies Act. Moreover, the *Hopewell* court took a searching look at "the amount of judicial involvement and supervision, or, conversely, the degree of access to the court available at various stages to creditors so that they may voice any objections they may have."[10] Its recognition of the Bermuda scheme was premised in large part on the availability of many important procedural protections that are notably absent from the UK solvent insurance schemes. For example, the *Hopewell* scheme included multiple opportunities for presanction and postsanction redress in the courts regarding such matters as replacement of the liquidators, determination of claims, valuation and compensation, preferential treatment of insiders, and the ability of creditors to terminate the proceedings.[11] In stark contrast, the solvent insurance schemes provide for no ongoing court supervision of the schemed company, nor any right of access to the courts for creditors aggrieved by the nontransparent claims adjudication process, nor any scrutiny of preferential transfers, nor any ability of creditors to terminate the proceedings. Unlike the *Hopewell* scheme, the solvent insurance schemes leave the policyholders completely at the mercy of the scheme proponents and their hand-picked nonlawyer "adjudicators"[12] following sanction.

Of particular importance in this regard is the means by which disputed claims were resolved under the *Hopewell* scheme: claimants with unliquidated or disputed claims, like the IBNR claims discussed in the Solvent Scheme article, were sent to binding arbitration under Bermuda law, pursuant to which the arbitrators were party-appointed.[13] The solvent schemes do not provide for arbitration of claims disputes, much less arbitration by party-selected arbitrators. Instead, the scheme proponents usually select the people who will adjudicate claims disputes, and in most schemes, the policyholders generally have no say in who the adjudicator will be.[14]

The *Hopewell* court found that the vote on the scheme was unanimous and that the objectors to the section 304 proceeding, after voting in favor of the scheme in Bermuda, had changed their minds and filed their objections to the section 304 proceeding only after the law changed adversely to their interests.[15] Even with the massive vote-rigging adjustments that were made by the scheme proponents in *BAIC* and *WFUM*, those schemes were not supported unanimously by the policyholders.[16]

The *Hopewell* scheme provided for two classes of creditors, those with liquidated matured claims and those with contingent, unliquidated and/or disputed claims. The creditors with liquidated claims, Class A, were to be paid immediately in full; and the creditors with claims that had not yet matured, Class B, were to be paid only upon maturation of their claims. In contrast, the UK solvent insurance schemes have until recently provided for only one class.[17] Moreover, none of them have permitted the IBNR claims to be paid upon maturation. Instead, they have all required the IBNR claimants to rapidly accelerate the valuation of their claims pursuant to estimation procedures rigidly controlled by the scheme managers.

The *Hopewell* scheme also provided a four year period of time between notice to creditors and the bar date to enable creditors with unliquidated claims to value and perfect them. In contrast, even though the long tail IBNR claims of U.S. policyholders are far more difficult to calculate than the unmatured claims typical in the *Hopewell* case, the UK solvent insurance schemes provide very truncated bar dates. BAIC's proposed bar date was only 120 days after sanction of the scheme. WFUM's was 180 days.[18] Even if it were theoretically possible to accelerate the valuation of IBNR claims that by definition represent unknown exposures covered by the schemed policies, these truncated bar-date periods are grossly insufficient to enable policyholders to retain actuaries, gather and assimilate data, and perform the sophisticated quantitative modeling that would be necessary to value such contingent exposures properly.

As noted in the Solvent Schemes Article,[19] although the court regarded Hopewell as technically solvent, some evidence rendered questionable its continuing solvency, and many of the retrocessionaires which insured a significant percentage of its exposures had already stopped performing and were in crisis, which the court held to be "no small consideration" with regard to the future rights of creditors.[20] These facts are in sharp contrast to the admitted and comfortable solvency of most of the UK solvent insurance schemes.

For all of these reasons, *Hopewell* provides no support for approval of UK solvent insurance schemes.

Sanction of the Solvent Schemes in the UK Does Not Preclude U.S. Bankruptcy Court Consideration of Appropriate Objections

Contrary to the Scheme Proponents' contention, the U.S. bankruptcy courts should not rubber stamp UK solvent insurance schemes merely because they were sanctioned in the UK. The issues raised by the potential objections outlined in the Solvent Scheme article are substantially different from the kind of issues determined by the sanction of a scheme in the UK, and UK sanction of a scheme does not preclude a successful challenge under the different legal standards of Chapter 15. A scheme may arguably merit sanction under the very modest requirements of UK law[21] yet fail to satisfy the separate and independent requirements of sections 101(23) and 1506. The UK courts' factual determinations and legal holdings do not address these considerations or the different statutory standards that underlie them. Sanction of a UK solvent insurance scheme thus cannot have collateral estoppel effect on challenges to recognition of such a scheme under Chapter 15.[22] Moreover, the unopposed orders approving solvent schemes under section 304 and Chapter 15 are not binding precedent in subsequent contested Chapter 15 cases.[23]

The Scheme Proponents note that on the two occasions when policyholders have had a chance to litigate their objections to solvent schemes in the UK, the High Court has responded responsibly and fairly, given the statute and precedent that it had to work with. However, there are literally dozens of solvent insurance schemes in which no policyholder has participated in the expensive process of pursuing objections in the English court. Some of these schemes, despite their claim to be solvent, are actually close to insolvency but are reluctant to label themselves that way. Some, like *La Mutuelle Mans d'Assurances*,[24] and *NRG*[25] primarily involved reinsurance and thus had few, if any, American IBNR policyholders. In still other cases, it is possible that the policyholders either did not receive adequate notice of the scheme or did not fully understand the consequences of the scheme. The extraordinary low number of votes in both *BAIC* and *WFUM* suggest, as noted in the Solvent Scheme article, that the scheme proponents do not succeed in giving what would be considered adequate notice to the policyholders about the schemes under U.S. constitutional standards.[26]

It is, moreover, expensive for creditors to object to solvent schemes. Experiences in the *BAIC* and *WFUM* schemes demonstrate that: (a) any effort to oppose a scheme will be met with fierce resistance by the scheme proponents, represented by sophisticated UK law firms; (b) the resulting litigation will be intensive, lengthy, and quite expensive; and (c) scheme opponents face the risk of English "fee shifting" at many stages in the proceeding should they fail to prevail on particular contested issues. Given these costs and risks, in many cases individual policyholders conclude that they do not have sufficient amounts of coverage at stake to justify a formal opposition in the UK courts. While the aggregate amount of coverage placed at risk by all the solvent schemes is immense, the amount of coverage at stake for a single policyholder in a single scheme may be quite modest. It is likely the result of the above factors that so few objections are filed to the schemes, and it is hard to believe that U.S. courts would be comfortable that the process is fair when policyholder participation is so low.

Finally, U.S. courts should not relax their obligation to ensure that any solvent insurance scheme meets U.S. legal requirements; careful scrutiny of a scheme to this end is entirely consistent with comity, as the UK courts have themselves demonstrated. For example, in In *Re T&N Ltd. and other companies*,[27] the UK administrators of Turner & Newall, a UK subsidiary of Federal Mogul, asked the UK High Court for direction in connection with a Chapter 11 plan proposed by Federal Mogul that would have required the T&N administrators to file a scheme of arrangement in the UK court that in their view would violate UK law in material and substantial ways. The UK court observed:

> Comity, as a means of achieving cooperation between different jurisdictions in cross-border insolvency cases, is of great importance. It is a highly relevant factor in the exercise by the court of discretionary powers. It does not, however, enable the court to alter or dispense with mandatory provisions of the law which it administers. This is the case even in an ancillary winding-up in England of a foreign -registered company: see In re Bank of Credit and Commerce International (no 10) [1977] Ch 213, [1996] 4 All. ER 796. Further, if the position were reached that the English Court considered that CVAs or schemes of arrangement designed to implement the Plan were unfair and would thus not be sanctioned or allowed to stand, it is very difficult to see that the Court would nonetheless give effect to it as a matter of comity, always assuming that it had the jurisdiction to do so.

Nothing in Chapter 15 requires a U.S. court to ignore fundamental principals of U.S. law in considering recognition of a foreign scheme or in considering whether the rights of U.S. citizens are protected in such schemes—indeed, Chapter 15 requires the opposite. Moreover, as the UK court observed in *T&N*, comity does not require a court to ignore its own laws in considering whether to give effect to an order of another country, and Chapter 15 does not change this fundamental concept. Thus sanction of solvent insurance schemes under UK law does not mean that U.S. courts should recognize those schemes without regard to U.S. law.

U.S. Bankruptcy Courts Have an Obligation to Ensure that Schemes Comply with Fundamental Issues of Public Policy

There is no dispute that the purpose of Chapter 15 is to facilitate the U.S. courts' ability to provide appropriate assistance to foreign courts and foreign representatives. This general intent, however, does not override the U.S. bankruptcy court's obligation to ensure that the foreign proceeding does not violate fundamental issues of public policy and to ensure that U.S. creditors' rights are protected.

Treatment of Executory Contracts in Chapter 11 Is Wholly Unlike Treatment of Policies in Solvent Schemes

The Scheme Proponents do not argue that protection of commercial contract rights are not of fundamental concern in U.S. law. They merely contend that because contractual rights may be modified in U.S. bankruptcy cases, U.S. bankruptcy courts should be comfortable with the havoc that solvent schemes wreak on policyholders' rights under "occurrence" policies, which were specifically marketed by London Market insurers for decades as providing unlimited, "evergreen" protection to U.S. policyholders for all manner of liabilities resulting from injurious events happening during the policy periods. Apart, however, from limited statutory restrictions on certain contract damages,[28] and the bankruptcy courts' limited discretion in appropriate cases to require parties to resolve disputes in the bankruptcy forum rather than pursuant to contractual arbitration provisions,[29] bankruptcy courts lack jurisdiction or authority to modify contract terms absent consent of the nondebtor party. U.S. bankruptcy courts certainly do not have the authority to abrogate acknowledged contract rights of individual insureds in the manner contemplated by the UK solvent insurance schemes.

There are only four options with regard to contacts under U.S. bankruptcy law:

1. if the contract is executory,[30] the debtor may assume it, but in that case the bankruptcy court has no jurisdiction to modify the contractual terms over the objection of the nondebtor party, and the nondebtor party is entitled to demand complete performance thereafter by the debtor under the contractual terms;[31]

2. the debtor may reject the executory contract, in which case the contract is deemed breached as of the petition date, and while the nondebtor party cannot demand literal performance of the contract from the debtor, it has a claim for money damages for the breach (which in the case of an insurance policy would presumably be the present value of the future insurance proceeds that would have been required to be paid once the claims matured);
3. the contract may be assumed with modifications agreed to by the nondebtor party; or
4. If the contract is nonexecutory, the debtor may refuse to perform, and the nondebtor party may then assert a claim for damages, which, in the case of insurance policies, would be measured by the present value of the future performance.

When the debtor is insolvent, the claim of a creditor for damages for breach of contract is paid on a pro rata basis with the claims of other unsecured creditors. However, when the debtor is solvent (like the solvent scheme insurers), the creditor is entitled to full payment. Regardless of whether occurrence policies for which premiums have been paid are characterized as executory or nonexecutory, we are aware of no U.S. authority that permits a solvent U.S. debtor to evade its contractual obligations to an insured under existing occurrence policies in the manner proposed by the solvent schemes.

Similarly, although solvent entities are not precluded from seeking relief under the U.S. Bankruptcy Code, a solvent entity is not entitled to seek bankruptcy relief for the sole purpose of rejecting its executory contracts and thus harming its unsecured creditors for the benefit of its shareholders (which is precisely what the solvent schemes are doing). In *In re Integrated Telecom Express, Inc.*,[32] a solvent debtor filed for bankruptcy for the purpose of increasing distributions to shareholders by taking advantage of the cap on liability to landlords with respect to lease rejection damages under Bankruptcy Code section 502(b)(6). The U.S. Court of Appeals for the Third Circuit held that the case was filed in bad faith and should have been dismissed, stating:

> To be filed in good faith, a petition must do more than merely invoke some distributional mechanism in the Bankruptcy Code. It must seek to create or preserve some value that would otherwise be lost—not merely distributed to a different stakeholder—outside of bankruptcy. This threshold inquiry is particularly sensitive where, as here, the petition seeks to distribute value from a creditor to a company's shareholders.[33]

The court noted that liquidation plans were permissible but that such plans must also serve a valid bankruptcy purpose, either by preserving some value as a going concern, by liquidating a company as a whole or in such a way as to preserve some goodwill, or by maximizing the value of the debtor's estate (as opposed to simply redistributing that value to other interests).[34] The court concluded that a solvent debtor's misuse of Chapter 11 to increase the amount distributed to shareholders at the expense of any creditor by resorting to provisions of the Code that limited the creditor's claim was not a "valid bankruptcy purpose" and therefore not a good-faith filing.[35]

Thus the ability of insolvent U.S. debtors to reject executory contracts under Chapter 11 does not justify recognition of solvent insurance schemes that violate U.S. policyholders' contractual rights to payment of covered claims as they become due.

Among the contractual rights that are violated by the schemes is the right to have claims determined under the state law governing the contract. The scheme adjudicators usually are not legally trained, and few if any are trained in U.S. law. Moreover, the schemes, while claiming that they will determine claims according to applicable law, in fact apply distorted and incorrect versions of U.S. law. For example, under most occurrence policies, like the policies at issue in *BAIC* and *WFUM*, an occurrence activates all successive policies on the risk during the extended period in which progressive injury or damage developed in a third-party claimant. Under the laws of many states, policyholders are entitled to invoke the "All Sums" methodology of determining what policies must respond to a triggering event, which enables the policyholder to recover all of its damages from any triggered insurer on the risk. It also permits the insurer(s) who are selected to pay the claim to seek contribution from the other responsible insurers.[36] Critically, however, the insurer's right to seek that contribution vests only after it has paid the policyholder its full obligation.

Despite the clear policy language and applicable state law requiring application of the All Sums approach, the schemes instead often apply what the *WFUM* scheme called the "All Sums Net of Contribution" allocation,[37] thus shifting to the policyholders the insurers' contractual obligation to indemnify the insured fully and only then to recover any contribution amounts from other insurers. This shift: (a) fundamentally abrogates the core purpose and principles of the "All Sums" rule; (b) severely prejudices policyholders by foisting onto them the burden of running down scores of other insurance companies in court and recovering their respective "pro rata" shares; (c) is contrary to the substantive state law applicable to the policies; and (d) has been rejected by U.S. courts.[38]

Solvent Schemes Violate Policyholders' Due Process Rights

The Scheme Proponents do not argue that due process is not a fundamental public policy of the U.S. Instead, they assert that "by virtue of the U.K. High Court's involvement, the insurance company's assets and affairs are subject to judicial supervision,"[39] which they contend ensures that policyholders' due process rights under U.S. law are protected. This claim is unsupported, and we believe it to be inaccurate. The High Court's role is extremely limited: it merely decides if the classification of policyholders is correct, if the vote was for the scheme, and if the scheme is fair according to the rather malleable UK standards. Not surprisingly, we are not aware of any UK solvent insurance scheme cases in which the High Court has engaged in a penetrating analysis of fairness in the absence of litigated objections from policyholders. Instead, the High Court appears to rely on the anemic voting that inherently mars these proceedings and to defer to the scheme proponents' paternalistic and unopposed assertions that the schemes are in everyone's best interests.

It cannot be disputed that neither former section 425, Part 26, nor the schemes themselves provide for the High Court to take any action with respect to or exercise any supervision over the schemed companies' assets or the conduct of their businesses, and the High Court plays no role in adjudicating policyholder claims or in reviewing the adjudication of the claims conducted by the nonlawyer scheme actuaries or scheme adjudicators. There is no case decided under section 304 or Chapter 15 in which a U.S. court approved, over meaningful policyholder objection, a foreign scheme in which the court's role was so limited and the adjudicatory process so one-sided and lacking in basic procedural safeguards.[40]

The Scheme Proponents rely on *Hopewell* in support of this proposition, but as discussed above, there was significant court participation in the every major facet of the scheme at issue in *Hopewell*, which is absent in the UK solvent insurance schemes.

Solvent Insurance Schemes Are Not Like Chapter 11 Cases

The Scheme Proponents suggest that solvent insurance schemes proposed under UK law are similar to Chapter 11 cases and so should not alarm U.S. bankruptcy judges.[41] On the contrary, the differences between Chapter 11 and former section 425 and Part 26 are greater and more material than their similarities. While both statutes permit companies to enter into arrangements with their constituents to restructure their financial relationships, that is fundamentally where the resemblance ends. Just a few of the more salient differences are outlined below.

Title 11 and Chapter 11 are detailed statutory schemes encompassing many sections and covering all aspects of the reorganization or liquidation of a company in financial distress, whether solvent or not. In contrast, former section 425 was a single section with three short subparagraphs that addressed merely the agreement between the company and its constituents and the percentages of support necessary for sanction.[42] Part 26 is not materially more detailed.

Chapter 11 provides that the bankruptcy court will hear and determine all issues relating to claims objections and estimation proceedings, with a right of appeal from adverse decisions to the district court and the court of appeals. No similar provision exists in either section 425 or Part 26, and in fact, the policyholders have no right to judicial review of adverse decisions made about their claims by the scheme managers, scheme actuaries, or the scheme proponents' hand-picked "independent" adjudicator, unless they can prove actual fraud.

Chapter 11 ensures that creditors have appropriate negotiating leverage by requiring that the U.S. Trustee to appoint a creditors' committee to act in a representative capacity for all creditors, with their costs paid for by the debtor, and in the discharge of their fiduciary duties they aggressively assert concerns common to all creditors, comparable to the kinds of objections to schemes that are discussed in the Solvent Scheme article. No similar provision exists in section 425 or Part 26—the solvent schemes make no provision for collective policyholder representation and indeed are structured to minimize consultation and concerted action by policyholder creditors.[43] Thus while the experience of a policyholder facing a scheme may bear a facial resemblance to that of an unsecured creditor with a small claim in a Chapter 11 case, that resemblance is misleading; the protections for small unsecured creditors under Chapter 11 are significantly greater than those for policyholders under section 425 and Part 26.[44]

Although like former section 425 and Part 26, Chapter 11 leaves the debtor in possession and management of its assets, the U.S. bankruptcy court has continuing jurisdiction to supervise the debtor's activities. Chapter 11 requires that the debtor bring all transactions outside the ordinary course of business and all motions to assume or reject executory contracts to the bankruptcy court for approval, after notice and hearing to all creditors. No similar provision exists in former section 425 or Part 26, under which the scheme proponent continues to manage its business entirely without court supervision, often with no transparency at all.

A fundamental goal of Title 11 is to ensure that similarly situated creditors are treated the same. To this end, settlement agreements must be noticed to all creditors and are subject to court approval, and plans must provide that creditors are properly classified and that members of a class receive the same identical payment. No similar provisions exist in section 425 or Part 26. Scheme Proponents routinely enter into settlement agreements with their constituents for highly dissimilar values but have no obligation to publish information about the settlements or to obtain court approval of them. Moreover, the concept of classification in the UK is completely different from the U.S. concept and is much less formal and stratified than is the case under Chapter 11. Solvent schemes routinely place policyholders creditors who have no common interests in the same classes—policyholders with IBNR claims have been joined with policyholders with mature claims, reinsurers, and affiliates of the scheme company.

Title 11 does not permit preferential or fraudulent transfers to be made either before or after the petition date. In contrast, former section 425 and Part 26 impose no limits on the scheme proponent's ability to transfer its assets to anyone in any amount, either before, during, or after the scheme.

Chapter 11 and relevant case law require a solvent debtor to abide by its contractual obligations and do not permit a debtor to modify the terms of its prepetition contracts to the detriment of the contract party for the benefit of its equity holders. No similar requirement exists under former section 425 or Part 26, and indeed, this is presumably the principal purpose of the solvent insurance schemes of arrangement—to terminate policyholders' long-tail coverage rights prematurely and to transfer over to the shareholders the value that would otherwise go to the policyholders upon maturity of their claims.

Chapter 11 is premised on an assumption that the debtor's activities while in bankruptcy will be completely open and transparent to the court and to the creditors. It requires that creditor votes be solicited on the basis of a disclosure statement that the creditors' committee, all parties in interest, and the court see and thoroughly ventilate before it is disseminated for a vote. In contrast, the UK solvent scheme solicitation materials are prepared by the scheme proponents and are not at any stage subject to testing or review by parties in interest (including the policyholders) or the court.

The Rhode Island State Statute Does Not Relieve Federal Bankruptcy Judges From Their Obligation to Ensure that Solvent Insurance Schemes Comply with Chapter 15

The Scheme Proponents argue that a solitary and largely unused Rhode Island statute authorizing domestic Rhode Island insurance companies to enter into schemes with their policyholders, and which has some similarities with former section 425 and Part 26, should give

U.S. bankruptcy courts comfort that UK solvent insurance schemes do not violate the fundamental policies of the U.S. This is a red herring for several reasons.

First, while Rhode Island has chosen to adopt this statutory scheme, 49 other states have not. A single state's adoption of a remedy comparable to UK scheme provisions does not support the assertion that solvent insurance schemes are compatible with U.S. public policy. In any event, we are not aware that any insurer has taken advantage of the Rhode Island's scheme, and so it is untested.

Second, in applying Chapter 15 to foreign insurance schemes, the U.S. bankruptcy courts must be guided by federal standards, including those articulated in the Bankruptcy Code. Whatever law a state legislature may conclude is appropriate to enact in its own state should have no weight with a federal court interpreting a federal statute faced with these fundamental issues of public policy.

Finally, the Rhode Island statutory scheme raises the same fundamental questions about violation of established contract rights and due process rights that the solvent schemes do. For those reasons we believe that it is fatally flawed, and any attempt by an insurer to utilize that statute over policyholder objections would be rejected by U.S. courts applying U.S. law.

Conclusion

Solvent insurance schemes erode and vitiate occurrence coverage for U.S. policyholders with IBNR claims. Without collective representation of policyholders in the UK, individual policyholders must either incur large legal fees to oppose the schemes, which may be unjustified in a given scheme, or trust in the scheme proponents to treat their claims fairly. U.S. courts should be aware of the ways in which solvent schemes infringe fundamental U.S. policies and should, at a minimum, assure that the interests and due process rights of U.S. policyholders are adequately protected against this form of encroachment. Courts in other countries have not hesitated to protect their own citizens and enforce their own laws when schemes or plans brought from abroad for enforcement against local creditors violate such local laws.[45] U.S. courts should be no less willing to ensure that U.S. policyholders' fundamental contract and due process rights are secure.

NOTES

1. Susan Power Johnston, Why U.S. Courts Should Deny or Severely Condition Recognition to Schemes of Arrangement for Solvent Insurance Companies, 16 J. Bankr. L. & Prac. 953 (Dec. 2007), hereafter "Solvent Schemes article."

2. Howard Seife & Francisco Vasquez, U.S. Courts Should Continue to Grant Recognition to Schemes of Arrangement of Solvent Insurance Companies, 17 J. Bankr. L. & Prac. 571 (July 2008).

3. See, e.g., Lamie v. U.S. Trustee, 540 U.S. 526, 534, 124 S. Ct. 1023, 157 L. Ed. 2d 1024, 42 Bankr. Ct. Dec. (CRR) 122, 50 Collier Bankr. Cas. 2d (MB) 1299, Bankr. L. Rep. (CCH) P 80038 (2004) ("It is well established that 'when the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms") (quoting Hartford Underwriters, 530 U.S. at 6); Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 6, 120 S. Ct. 1942, 147 L. Ed. 2d 1, 36 Bankr. Ct. Dec. (CRR) 38, 43 Collier Bankr. Cas. 2d (MB) 861, Bankr. L. Rep. (CCH) P 78183 (2000); U.S. v. Ron Pair Enterprises, Inc., 489 U.S. 235, 242, 109 S. Ct. 1026, 103 L. Ed. 2d 290, 18 Bankr. Ct. Dec. (CRR) 1150, Bankr. L. Rep. (CCH) P 72575, 89-1 U.S. Tax Cas. (CCH) P 9179, 63 A.F.T.R.2d 89-652 (1989) ("The plain meaning of legislation should be conclusive, except in 'the rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.'") (quoting Griffin v. Oceanic Contractors, Inc., 458 U.S. 564, 571, 102 S. Ct. 3245, 73 L. Ed. 2d 973, 1982 A.M.C. 2377 (1982)). In this case, the plain meaning of the statute, as discussed in the Solvent Scheme article and hereafter, is quite clear, is not absurd, and, literally applied, will protect the rights of U.S. policyholders consistent with the purposes and intent of the drafters of Chapter 15.

4. In re Eastport Associates, 935 F.2d 1071, 1081, Bankr. L. Rep. (CCH) P 74021 (9th Cir. 1991) (declaration of attorney regarding effect of legislation that he drafted on behalf of client did not reflect intent of legislature regarding scope of legislation). "[C]ourts do not even rely on statements of individual lawmakers, so they should similarly not rely on statements by outside individuals who were involved in drafting the legislation." Eastport Assoc., 935 F.2d at 1081 (citing Carmona v. Division of Industrial Safety, 13 Cal. 3d 303, 311 n.8, 118 Cal. Rptr. 473, 530 P.2d 161, 1974-1975 O.S.H. Dec. (CCH) P 19212 (1975)).

5. The leading treatise on statutory interpretation notes that the draftsman's view of the meaning or intent of legislation may be relevant in limited circumstances:

> if the draftsman's views were clearly and prominently communicated to the legislature when the bill was being considered for enactment, so as to give reason to believe that the legislators' understanding of the bill would have been influenced by the draftsman's communicated views and so long as to be visible to others who are concerned to understand the meaning of the act, there is reason to invoke an exception to the general rule and attach weight to the draftsman's views.

2A Norman J. Singer & J.D. Shambie Singer, Statutes & Statutory Construction § 48:12 (7th Ed. 2007). The Glosband letters do not meet this exacting standard.

6. Solvent Schemes Article, 16 J. Bankr. L. & Prac. at 963-967.

7. Section 425 was repealed and replaced as of April 1, 2008 by Part 26 (Arrangements and Reconstructions) of the Companies Act of 2006. Part 26 does not materially alter the text of section 425 or the law applicable to solvent schemes under former section 425. See Companies Act 2006, Explanatory Notes at 176 ("The provisions of this Part... restate sections 425 to 427 of the 1985 Act"). References in the text to "Section 425" or "Section 425" schemes should be understood to apply equally to solvent insurance schemes implemented under Part 26. While former section 425 and its successor Part 26 may be used to restructure debt, they do not encompass insolvency proceedings, which are addressed in different UK statutory regimes, and their apparent intended use reaches to any conceivable arrangement that a solvent company might want to make with its creditors or its equity holders. See Solvent Scheme article, 16 J. Bankr. L. & Prac. 953, n. 1 and Companies Act 2006, Part 26.

The Scheme Proponents attempt to distinguish In re Rose, 318 B.R. 771, 774-76, 44 Bankr. Ct. Dec. (CRR) 19, 53 Collier Bankr. Cas. 2d (MB) 900 (Bankr. S.D. N.Y. 2004),on the ground that it involved a different UK statute, but the court's judgment—that what matters is the nature of the foreign statute and that a foreign statute that is not the kind of insolvency statute contemplated by the Bankruptcy Code cannot pass muster under the precursor to Chapter 15—is equally applicable to section 425.

8. As noted in the Solvent Scheme Article (16 J. Bankr. L. & Prac. at 957), the Scheme Proponents' co-counsel in the *WFUM* case admitted as much during the UK hearings: "the sanction of a scheme is not an intervention in the companies' affairs by the court. It is simply a necessary step in giving statutory force to a creditor's composition or agreement or re-arrangement, whatever the particular scheme happens to be about." 4th May 2006 Transcript, at p. 664, In the Matters of Sovereign Marine & General Insurance Company Limited and Others, High Court of Justice, Chancery Division, Companies Court (Warren, J). (G. Moss, QC speaking).

9. In re Board of Directors of Hopewell Intern. Ins. Ltd., 238 B.R. 25, 34 Bankr. Ct. Dec. (CRR) 1273 (Bankr. S.D. N.Y. 1999), order aff'd, 275 B.R. 699, 48 Collier Bankr. Cas. 2d (MB) 362 (S.D. N.Y. 2002).

10. Hopewell, 238 B.R. at 50, citing Petition of Tam, 170 B.R. 838, 25 Bankr. Ct. Dec. (CRR) 1635 (Bankr. S.D. N.Y. 1994); and Petition of Ward, 201 B.R. 357, 361 (Bankr. S.D. N.Y. 1996), corrected, (Oct. 10, 1996).

11. Hopewell, 238 B.R. at 50-53.

12. The adjudicators tend to be accountants with no legal or dispute resolution background who have deep ties to the London financial services market.

13. Hopewell, 238 B.R. at 50-53.

14. The WFUM scheme did provide that certain disputes about law or fact may be determined by an independent arbitrator in whose selection the policyholders could participate. If the parties are not able to agree, the WFUM scheme administrators have sole discretion to pick the arbitrator, and the WFUM scheme administrators assert that they also have absolute discretion to determine what disputes will be referred to the independent arbitrator. WFUM Pools Scheme: A Proposal in Relation to Scheme of Arrangement Pursuant to Section 425 of the Companies Act of 1985 Concerning Business Underwritten and/or Administered by Willis Faber (Underwriting Management) Limited ("Wfum"), Devonport Underwriting Agency Limited ("Dual") and Willis Faber & Dumas Limited ("WF&D") on Behalf of the Scheme Companies Referred to Below, Together with Other Liabilities of Sovereign Marine & General Insurance Company Limited and Its Subsidiaries as Defined in Appendix A to the Scheme at Pages 275 to 279 and Described in the Explanatory Statement at Pages 62 to 69 Between Sovereign Marine & General Insurance Company Limited (by Way of Amendment to an Existing Scheme of Arrangement Dated 15 October 1999) Allianz Cornhill Insurance Plc Oslo Reinsurance Company (U.K) Limited Allianz Global Corporate & Specialty (France) Sovereign Insurance (U.K) Limited Atlantic Mutual Insurance Company Sphere Drake Insurance Limited Continental Reinsurance Corporation International Limited the Ocean Marine Insurance Company Limited Greyfriars Insurance Company Limited the Sea Insurance Company Limited Heddington Insurance (U.K.) Limited Tokio Marine Europe Insurance Limited Hibernian General Insurance Limited Wausau Insurance Company (U.K.) Limited Mitsui Sumitomo Insurance Company (Europe), Limited and Their Respective Scheme Creditors (as Defined in the Scheme), dated 31st July 2006 (the "WFUM Scheme"), available online at: https://www.wfumpools.com/wfumdc/WFUM%20Pools%20Scheme%20Document.pdf, at 2.2.4.

15. Hopewell, 238 B.R. at 41, 65-66.

16. In the Matter of the British Aviation Insurance Company, Limited, [2006] 1 BCLC 665, [2005] EWHC, ¶ 83 (available online at: http://www.bailii.org/ew/cases/EWHC/Ch/2005/1621.html); In the Matters of Sovereign Marine & General Insurance Company Limited and Others, [2006] EWHC 1335 and [2007] 1 BCLC 228.

17. BAIC's failure to propose a separate class for IBNR policyholders contributed to the High Court's refusal to sanction the scheme. In the Matter of the British Aviation Insurance Company, Limited, [2006] 1 BCLC 665, [2005] EWHC, ¶ 92. WFUM originally proposed a single class, but the High Court required two classes, one for IBNR claims and a separate class for policyholders with claims not requiring estimation. In the Matters of Sovereign Marine & General Insurance Company Limited and Others,. High Court of Justice, Chancery Division, Companies Court, [2006] EWHC 1335 and [2007] 1 BCLC 228, ¶ 180.

18. The High Court noted that if it had sanctioned the BAIC scheme it would have required a bar date one year after the Effective Date. In the Matter of the British Aviation Insurance Company, Limited, [2006] 1 BCLC 665, [2005] EWHC, ¶ 127.

19. Solvent Scheme Article, 16 J. Bankr. L. & Prac. 593, n. 36.

20. Hopewell, 238 B.R. at 35.

21. Many solvent schemes, like the BAIC scheme, suffer from substantive or procedural problems that would cause them to fail even under UK law.

22. See Peterson v. Clark Leasing Corp., 451 F.2d 1291, 1292 (9th Cir. 1971) (state court's finding that corporate veil could be pierced did not estop debtor from contesting objection to discharge for failure to keep books and records because California corporate law did not precisely trace bankruptcy law on the point); In re Chi-Chi's, Inc., 338 B.R. 618, 626, 64 Fed. R. Serv. 3d 100 (Bankr. D. Del. 2006) (no preclusive effect when legal standards governing the actions are significantly different); James W. Moore, 18 Moore's Federal Practice § 132.02[2][h]. Notably, the *Hopewell* court did not hold that the Bermudan approval of the scheme estopped consideration of the objections raised to the 304 petition on their merits. See In re Board of Directors of Hopewell Intern. Ins. Ltd., 238 B.R. 25, 68, 34 Bankr. Ct. Dec. (CRR) 1273 (Bankr. S.D. N.Y. 1999), order aff'd, 275 B.R. 699, 48 Collier Bankr. Cas. 2d (MB) 362 (S.D. N.Y. 2002).

23. See, e.g., In re J.A. Jones, Inc., 361 B.R. 94, 105 (Bankr. W.D. N.C. 2007); In re Holloway, 337 B.R. 6, 10 (Bankr. D. Mass. 2006); and see In re petition of Catherine Geraldine Regan, as Foreign Representative of Riverstone Insurance (UK) Limited, Case. No 05-12678 (RDD), in which objections to the recognition of the scheme were resolved before the final hearing. Because the parties had reached agreement, the court agreed to sign the order granting the section 304 petition. Recognizing the serious legal grounds for dispute about the validity of this outcome, however, the court expressly required that the order provide that it "shall have no precedential value in any other case or controversy either in this Court or in any other Court."

24. Petition of Jeffrey John Lloyd, as Foreign Representative of La Mutuelle du Mans Assurances IARD, U.K. Branch, No. 05-60100 (Bankr. S.D.N.Y., May 17, 2005).

25. Petition of Alan Boyce, as Foreign Representative of NRG Victory Reinsurance Ltd., No. 06-11052 (Bankr. S.D.N.Y., March 31, 2006).

26. Mr. Justice Lewison noted in *BAIC* that if he had sanctioned the scheme, he would have directed more extensive advertising than the scheme proponents had intended. In the Matter of the British Aviation Insurance Company, Limited, [2006] 1 BCLC 665, [2005] EWHC, ¶ 127.

27. Re T&N Ltd. and other companies, [2004] EWHC 2361, ¶ 134 [21 Oct. 2004].

28. 11 U.S.C.A. § 502(b)(6) and (7).

29. In re U.S. Lines, Inc., 197 F.3d 631, 640, 35 Bankr. Ct. Dec. (CRR) 187, 2000 A.M.C. 784 (2d Cir. 1999).

30. An "executory contract" is generally understood to be one in which material performance obligations remain due on both sides as of the date on which a bankruptcy petition is filed. In re Ionosphere Clubs, Inc., 85 F.3d 992, 998-99, 29 Bankr. Ct. Dec. (CRR) 203 (2d Cir. 1996); Wechsler v. Hunt Health Systems, Ltd., 330 F. Supp. 2d 383, 429 (S.D. N.Y. 2004). Insurance policies are often held to be executory contracts. If a policy is held not to be executory, it is because material performance remains due only on one side—in the event of such a holding in the solvent insurance scheme context, the material performance remaining due is by the insurers.

31. N.L.R.B. v. Bildisco and Bildisco, 465 U.S. 513, 531–32, 104 S. Ct. 1188, 79 L. Ed. 2d 482, 11 Bankr. Ct. Dec. (CRR) 564, 9 Collier Bankr. Cas. 2d (MB) 1219, 5 Employee Benefits Cas. (BNA) 1015, 115 L.R.R.M. (BNA) 2805, Bankr. L. Rep. (CCH) P 69580, 100 Lab. Cas. (CCH) P 10771 (1984); U.S., Dept. of Air Force v. Carolina Parachute Corp., 907 F.2d 1469, 1472, 23 Collier Bankr. Cas. 2d (MB) 620, 36 Cont. Cas. Fed. (CCH) P 75903, 17 Fed. R. Serv. 3d 102 (4th Cir. 1990).

32. In re Integrated Telecom Express, Inc., 384 F.3d 108, 43 Bankr. Ct. Dec. (CRR) 175, Bankr. L. Rep. (CCH) P 80168 (3d Cir. 2004).

33. Integrated Telecom, 384 F.3d at 129 (quoting Bank of America Nat. Trust and Sav. Ass'n v. 203 North LaSalle Street Partnership, 526 U.S. 434, 453, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 34 Bankr. Ct. Dec. (CRR) 329, 41 Collier Bankr. Cas. 2d (MB) 526, Bankr. L. Rep. (CCH) P 77924 (1999)).

34. Integrated Telecom, 384 F.3d at 126.

35. As discussed in the Solvent Scheme article, 16 J. Bankr. L. & Prac. at 967-68, a number of bankruptcy court decisions have also held that filing for bankruptcy with the sole purpose of trying to reject an executory contract or lease is bad faith and/or that rejection would be denied in such instances. See In re Chi-Feng Huang, 23 B.R. 798, 802, 9 Bankr. Ct. Dec. (CRR) 972, 7 Collier Bankr. Cas. 2d (MB) 639 (B.A.P. 9th Cir. 1982); In re Silberkraus, 253 B.R. 890, 906, 36 Bankr. Ct. Dec. (CRR) 995, 47 Fed. R. Serv. 3d 1368 (Bankr. C.D. Cal. 2000), subsequently aff'd, 336 F.3d 864, 41 Bankr. Ct. Dec. (CRR) 144, 50 Collier Bankr. Cas. 2d (MB) 810, Bankr. L. Rep. (CCH) P 78876, 55 Fed. R. Serv. 3d 1291 (9th Cir. 2003); In re Dolphin Titan Intern., Inc., 93 B.R. 508, 512 (Bankr. S.D. Tex. 1988); In re Southern California Sound Systems, Inc., 69 B.R. 893, 900, 15 Bankr. Ct. Dec. (CRR) 579, Bankr. L. Rep. (CCH) P 71674 (Bankr. S.D. Cal. 1987) ("Where the court becomes convinced that the true purpose of filing a petition is other than to reorganize a financially distressed business, but to merely take advantage of one of the remedies available under the Code, dismissal is appropriate in order to protect the jurisdictional integrity of the court."); see also Dunes Hotel Associates v. Hyatt Corp., 245 B.R. 492, 506 (D.S.C. 2000) (denying lease avoidance where debtor and debtor's equity holder were only entities that would benefit from avoidance); In re Carrere, 64 B.R. 156, 14 Bankr. Ct. Dec. (CRR) 977, 15 Collier Bankr. Cas. 2d (MB) 407, Bankr. L. Rep. (CCH) P 71279 (Bankr. C.D. Cal. 1986) (finding no "cause" to reject contract if the major motivation of debtor in filing the case is to be able to perform under a more lucrative contract). The Ninth Circuit BAP stated in *Chi-Feng Huang* that "it is not true that solvent debtors may petition for bankruptcy and then obtain a windfall by rejecting their executory contracts." Chi-Feng Huang, 23 B.R. at 803. The court also held that in the case of the rejection of a contract by a solvent debtor the party whose contract is rejected must have its claim satisfied in full before the debtor may obtain recovery. Chi-Feng Huang, 23 B.R. at 803.

36. See, e.g., Zurich Ins. Co. v. Raymark Industries, Inc., 118 Ill. 2d 23, 112 Ill. Dec. 684, 514 N.E.2d 150 (1987); Keene Corp. v. Insurance Co. of North America, 667 F.2d 1034, 1047-1050, 12 Envtl. L. Rep. 20105 (D.C. Cir. 1981) (rejected by, Hancock Laboratories, Inc. v. Admiral Ins. Co., 777 F.2d 520 (9th Cir. 1985)); Goodyear Tire & Rubber Co. v. Aetna Cas. & Sur. Co., 95 Ohio St. 3d 512, 2002-Ohio-2842, 769 N.E.2d 835, 840-41 (2002); Allstate Ins. Co. v. Dana Corp., 759 N.E.2d 1049, 1057-58 (Ind. 2001); Hercules, Inc. v. AIU Ins. Co., 784 A.2d 481, 491 (Del. 2001); American Nat. Fire Ins. Co. v. B & L Trucking and Const. Co., Inc., 134 Wash. 2d 413, 951 P.2d 250, 256-57, 46 Env't. Rep. Cas. (BNA) 1652 (1998) (en banc); Aerojet-General Corp. v. Transport Indem. Co., 17 Cal. 4th 38, 70 Cal. Rptr. 2d 118, 948 P.2d 909, 929-30, 46 Env't. Rep. Cas. (BNA) 1025, 28 Envtl. L. Rep. 20590 (1997), as modified on denial of reh'g, (Mar. 11, 1998); Armstrong World Industries, Inc. v. Aetna Casualty & Surety Co., 45 Cal. App. 4th 1, 52 Cal. Rptr. 2d 690, 710 (1st Dist. 1996); American Physicians Ins. Exchange v. Garcia, 876 S.W.2d 842, 855, 51 A.L.R.5th 899 (Tex. 1994); J.H. France Refractories Co. v. Allstate Ins. Co., 534 Pa. 29, 626 A.2d 502, 507-8 (1993).

37. WFUM Scheme, p. 318.

38. Viacom, Inc. v. Transit Cas. Co., 138 S.W.3d 723, 726 (Mo. 2004), as modified on denial of reh'g, (Aug. 3, 2004) (en banc).

39. Scheme Proponents' Reply, 17 J. Bankr. L. & Prac. 571.

40. The Scheme Proponents point out that dozens of solvent schemes have been approved in the U.S. under section 304 and Chapter 15, as if those unopposed cases compel the courts to continue to rubber stamp all future solvent insurance schemes. What courts are willing to do when a scheme is not opposed, however, should have no weight if a scheme is opposed and its legitimacy actively contested. In any event, unopposed orders have no precedential effect. See, e.g., Jones, 361 B.R. at 105. Also, to date, no meaningful opposition has ever been mounted to recognition of a solvent insurance scheme under Chapter 15, largely because scheme

administrators have succeeded in buying off the opposition to avoid a meaningful challenge in the U.S.

The Scheme Proponents note that in the *WFUM* case several policyholders who filed no objections to sanction of the scheme in the UK filed a three-page objection to recognition of the scheme under Chapter 15. See In re PRO Insurance Solutions Limited, 07 B 12934 (JMP), Objections to Petitions (Docket No. 13). The objectors put their entire argument in three paragraphs, cited only the UK *BAIC* decision in support of their objection, and defaulted at the hearing. The order granting recognition to the scheme did not allude to the objection. See Order Signed on 10/23/2007 Granting Recognition of Foreign Proceedings, Permanent Injunction and Related Relief (Docket No. 23). This order does not, therefore, stand for the proposition that U.S. bankruptcy courts should defer to UK courts which have sanctioned solvent insurance schemes without consideration of the kinds of concerns discussed in detail in the Solvent Scheme article.

41. Scheme Proponents' Reply, 17 J. Bankr. L. & Prac. 571.

42. Solvent Scheme Article,16 J. Bankr. L. & Prac. 953, n. 2.

43. Witness the WFUM scheme, where the proponents repeatedly went to great lengths to prevent objecting creditors from learning the identity of other creditors both before and after the vote.

44. Former section 425 and Part 26 contemplate that creditors will confer to determine their mutual advantage with respect to a scheme. This would appear to require that the creditors have access to contact information about other creditors so as to make that conference feasible. Several scheme proponents have, however, refused to make a policyholder list available, alleging that the identity of the policyholder is confidential. They have instead required policyholders who wish to confer to provide their contact information on a confidential website and wait to hear from other similarly situated entities. Of course, when they file Chapter 15 petitions they are required to file a list of the names and addresses, inter alia, of all parties whom they wish to be bound by the injunctions that they seek from the U.S. courts, who include all of the U.S. policyholders affected by the scheme. Fed. R. Bankr. P. 1007(a)(4)[Interim] and 2002(q)(1) [Interim] (scehduled to take effect as of 12/1/2008). Thus the identity of the policyholders is not, and cannot be, confidential once a Chapter 15 petition is filed.

45. See, e.g., Re Cavell Insurance Co., 2005 A.C.W.S.J. LEXIS 1149, 2005 A.C.W.S.J. 2939, 137 A.C.W.S. (3d) 419, at ¶ 17; Re Cavell Insurance Co., [2005] O.J. No. 1725, 2005 On.C. LEXIS 1954, ¶¶ 9-10 (UK scheme that did not provide a right of judicial review of adverse claims determinations and which did not apply Canadian law when required by contracts not approved); and see Re T&N Ltd. and other companies, [2004] EWHC 2361 [21 Oct. 2004].

No. 165 of 2005

IN THE HIGH COURT OF JUSTICE

CHANCERY DIVISION

COMPANIES COURT

IN THE MATTER OF THE BRITISH AVIATION INSURANCE COMPANY LIMITED

AND

IN THE MATTER OF THE COMPANIES ACT 1985

WITNESS STATEMENT OF
SUSAN POWER JOHNSTON

I, Susan Power Johnston, of 60 Pineapple Street, 6J, Brooklyn New York, 11201 USA, will say as follows.

1. I submit this statement in connection with the opposition of Textron Inc., Goodrich Corporation and the Goodyear Tire and Rubber Company to the request by The British Aviation Insurance Company ("BAIC") that the High Court sanction a Solvent Scheme of Arrangement involving insurance policies issued or subscribed by BAIC for the benefit of United States policyholders.

2. I am Of Counsel to the firm of Covington & Burling, the United States counsel and London solicitors for Goodrich Corporation ("Goodrich"), The Goodyear Tire & Rubber Company ("Goodyear") and Textron, Inc. ("Textron"). I have a B.A. degree from Emory University, where I was Phi Beta Kappa and received Highest Honors in my major, and a J.D. degree from Harvard Law School, from which I graduated *cum laude*. I have practiced law for nearly 26 years and for 18 years have specialized in the area of bankruptcy and creditors rights. I make this statement in support of the objections of Goodrich, Goodyear and Textron to the Solvent Scheme of Arrangement (the "Scheme") and to respond to certain statements made in the Witness Statement of Howard Seife, dated June 4, 2005 (the "Seife Statement").

NY: 479913-7

The False Analogy to Section 524(g) of the Bankruptcy Code

3. Mr. Seife explains in paragraphs 5-12 of his statement that the truncated procedures by which BAIC proposes to determine obligations to its insureds if the proposed Scheme is sanctioned are "most closely analogous" to the procedures that often govern adjudication of individual personal injury claims following confirmation of plans of reorganization pursuant to section 524(g) of the United States Bankruptcy Code, 11 U.S.C. §§ 101 et seq.[1] I do not disagree with the facts set out by Mr. Seife, but I disagree that those facts are relevant to this matter. The fact that the proposed Scheme procedures bear some resemblance to procedures commonly agreed by creditors and debtors under the unique circumstances presented by section 524(g) plans does not mean that the proposed Scheme procedures should be approved on that basis, and the Court should take note of several important differences between section 524(g) plans and the Scheme.

4. First, plans confirmed under section 524(g) require consent of 75% of the current asbestos personal injury plaintiffs voting on the plan. This is a higher threshold for consent than that proposed in the Scheme, which requires approval (in addition to 75% in value of claims voting) only by a majority in number of the voting creditors in each assigned class -- a lower threshold which the BAIC Solvent Scheme achieved only by combining numerous creditors with different interests (including direct insureds, reinsureds and reinsurers) into a single omnibus class and disqualifying certain votes. While Mr. Seife correctly states in paragraph 16 of his Statement that the post-confirmation procedures used to determine the claims of individual personal injury claimants under Section 524(g) plans generally limit access to courts until non-judicial means of resolution have failed, the debtor is required in such plans to obtain the consent of the asbestos personal injury claimants' class to the use of such non-judicial procedures before confirming a plan of reorganization, and that the class of personal injury claimants cannot be forced to accept such truncated procedures. They consent to the imposition of such procedures in exchange for other benefits offered under the confirmed plans.

5. The negotiation of section 524(g) plans typically is vigorous, protracted, and characterized by considerable bargaining leverage on the part of the thousands of asbestos personal injury claimants who are the debtor's principal creditors. In fact, it is typically the case that a plan will not be confirmed under section 524(g) unless the representatives of asbestos personal injury claimants participate in structuring and approve all of the material elements of the plan, both procedural and substantive. In contrast, BAIC created the Scheme under review unilaterally, and Scheme creditors had no opportunity to negotiate with BAIC concerning any aspect of the procedures that BAIC has stated will govern allowance of their claims.

---

[1] Section 524(g) was enacted by the U.S. Congress to address the problems caused by proliferating bankruptcy filings by companies named as defendants in thousands of underlying asbestos personal injury cases. The provision is designed to deal with the unique features of mass tort asbestos bankruptcies, and is not applicable to other debtors. A copy of section 524(g) is attached at SPT1 Exhibit pages ___.

6. Furthermore, unlike the typical Section 524(g) claims resolution mechanism, the BAIC Scheme offers no opportunity for insureds who are dissatisfied with the decisions on their claims by the Scheme Manager and the Scheme Adjudicator to resort to a court for relief. Indeed, Mr. Seife in paragraph 22 of his Statement touts the Scheme's denial of access to the courts as one of the Scheme's most attractive attributes.

7. Unlike the BAIC Scheme, Section 524(g) also requires the appointment of a representative to ensure that the plan treats fairly the interests of the future asbestos claimants (i.e., those who were exposed to asbestos fibers but have not yet developed compensable illnesses), and provides that representative with considerable negotiating leverage over the final content of the plan. The United States Congress, by including such a requirement, explicitly acknowledged the inability of personal injury plaintiffs with current claims to represent fairly the interests of individuals who have been exposed to asbestos but do not yet have a manifest disease. Future personal injury plaintiffs under a section 524(g) plan are most closely analogous to BAIC's insureds with long tail IBNR claims, with the significant differences that under the Scheme, the interests of creditors with predominantly IBNR claims are not separately classified and, as noted above, they have not been afforded any opportunity to negotiate the terms of the Scheme.

8. Mr. Seife seems to say that because the Scheme will determine BAIC's liability to individual creditor companies, it is appropriate and fair that procedures for such claim determinations under the Scheme be comparable to (although -- as noted above -- significantly less robust than) the post-confirmation procedures employed by Section 524(g) trusts to determine the claims of individual personal injury claimants. He suggests that the claims by individual creditor insureds for future insurance coverage should be determined in the same manner as claims of individual persons with current illnesses are determined, because they are both individual claimants. This analogy disregards the nature of the IBNR claims of BAIC's insureds under the Scheme. There is no valid comparison between IBNR insurance claims and the claims of individual personal injury claimants who already have manifest illnesses. Such individual personal injury claims are determined based on objective evidence of each individual claimant's history of occupational exposure, history of disease, earnings capacity, and other objective facts such as existence of dependents, which are easily ascertainable at the time of the determination. As all of BAIC's witnesses agree, the claims -- particularly IBNR claims -- of BAIC's insureds will have to be determined actuarially, using methods that are exactly like the methods used to estimate the global asbestos or other tort liabilities of a Chapter 11 debtor, as set out in paragraph 12 of the Seife Statement (and as set out in the witness statement of Dr. Rabinovitz filed with the Court). Thus, Dr. Rabinovitz is correct in analogizing the estimation of each insured creditor's IBNR liability (and BAIC's ultimate exposure for that liability) to the estimation of a section 524(g) debtor's aggregate asbestos liability.

9. Mr. Seife cites no United States legal authority for the proposition that a solvent insurer would be entitled to the protections offered to insolvent asbestos defendants under Section 524(g). To the contrary, domestic insurance companies are not entitled to be debtors under the Bankruptcy Code, *see* 11 U.S.C. 109(b)(2), and Section 524(g) is by its express terms limited to companies facing asbestos tort claims. *See* 11 U.S.C.§ 524(g)(2)(B)(i)(I). Thus,

the suggestion that the Scheme should be considered as if it were a Section 524(g) claims resolution facility, and approved because of its similarities to such facilities, is unfounded.

Impermissible Abrogation of Contract Rights

10. Mr. Seife's statement in paragraph 25 that "it is well recognized that bankruptcy, reorganizations and similar types of proceedings can change bargained for contractual rights" is also misleading. Apart from limited statutory restrictions on certain contract damages,[2] and the bankruptcy courts' limited discretion in appropriate cases to require parties to resolve disputes in the bankruptcy forum rather than pursuant to contractual arbitration provisions,[3] bankruptcy courts do not have power to change contract terms absent consent of the non-debtor party. The cases cited in footnote 36 of the Seife Statement certainly do not support the proposition that the United States bankruptcy courts have authority to abrogate acknowledged contract rights of individual insureds, as proposed by the BAIC Scheme.

11. In general, the options with regard to contacts under U.S. bankruptcy law are threefold: (a) if the contract is executory,[4] the debtor can assume it, but in that case the bankruptcy court has no jurisdiction to modify the contractual terms over the objection of the non-debtor party, and the non-debtor party is entitled to demand complete performance thereafter by the debtor under the contractual terms;[5] (b) the debtor can reject the executory contract, in which case the contract is deemed breached as of the petition date, and while the non-debtor party cannot demand performance of the contract from the debtor, it has a claim for money damages for the breach (which in the case of an insurance policy would presumably be the present value of the future insurance proceeds that would have been required to be paid); or (c) the contract may be assumed with modifications agreed to by the non-debtor party. If the contract is non-executory, the debtor may refuse to perform, and the non-debtor party may then assert a claim for damages, which would, in the case of insurance policies, be measured by the present value of the future performance. When the debtor is insolvent, the claim of a creditor for damages for breach of contract is paid on a *pro rata* basis. However, when the debtor is solvent (like BAIC), the creditor is entitled to full payment. I am aware of no U.S. authority, and Mr. Seife has not cited any such authority to the Court, permitting a solvent debtor to evade its contractual obligations to an insured under existing policies in the manner proposed by BAIC.

---

[2] 11 U.S.C. § 502(b)(6) & (7).

[3] *In re United States Lines*, 197 F.3d 631, 640 (2d Cir. 1999).

[4] An "executory contract" is generally understood to be one in which material performance obligations remain due on both sides as of the date on which a bankruptcy petition is filed. *In re Ionosphere Clubs, Inc.*, 85 F.3d 992, 998-99 (2d Cir. 1996); *Wechsler v. Hunt Health Systems, Ltd.*, 330 F. Supp.2d 383, 429 (S.D.N.Y. 2004). Insurance policies are often held to be executory contracts. If a policy is held not to be executory, it is because material performance remains due only on one side - in this case on BAIC's side.

[5] *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 531–32 (1984); *U.S. Dep't of Air Force v. Carolina Parachute Corp.*, 907 F.2d 1469, 1472 (4th Cir. 1990).

12. Although solvent entities like BAIC are not precluded from seeking relief under the U.S. Bankruptcy Code, substantial authority exists for the proposition that a solvent entity is not entitled to seek bankruptcy relief for the purpose of rejecting its executory contracts, and thus disadvantaging its unsecured creditors for the benefit of its shareholders. For example, in *In re Integrated Telecom Express, Inc.*, 384 F.3d 108 (3d Cir. 2005), a solvent debtor filed for bankruptcy for the purpose of increasing distributions to shareholders by taking advantage of the cap on liability to landlords with respect to lease rejection damages under section 502(b)(6) of the Bankruptcy Code: The United States Court of Appeals for the Third Circuit held that the case was filed in bad faith and should have been dismissed, stating:

> To be filed in good faith, a petition must do more than merely invoke some distributional mechanism in the Bankruptcy Code. It must seek to create or preserve some value that would otherwise be lost--not merely distributed to a different stakeholder--outside of bankruptcy. This threshold inquiry is particularly sensitive where, as here, the petition seeks to distribute value from a creditor to a company's shareholders.

Id. at 129. (quoting *Bank of Am. Nat'l. Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 453 (U.S. 1999)). The Court noted that liquidation plans were permissible, but that such plans must also serve a valid bankruptcy purpose, either by preserving some value as a going-concern, by liquidating a company as a whole or in such a way as to preserve some goodwill, or by maximizing the value of the debtor's estate (as opposed to simply redistributing that value to other interests). *Id.* at 126. Thus, the Court concluded that a solvent debtor's misuse of Chapter 11 to increase the amount distributed to shareholders at the expense of any creditor, by resorting to provisions of the Code that limited such creditor's claim, was not a "valid bankruptcy purpose" and therefore not a good-faith filing.

13. A number of bankruptcy court decisions have also held that filing for bankruptcy with the sole purpose of trying to reject an executory contract or lease is bad faith, and/or that rejection would be denied in such instances. *See In re Chi-Feng Huang*, 23 B.R. 798, 802 (9th Cir. BAP 1982); *In re Silberkraus*, 253 B.R. 890, 906 (Bankr. C.D. Cal. 2000); *In re Dolphin Titan Intern. Inc.*, 93 B.R. 508, 512 (Bankr. S.D. Tex. 1988); *In re Southern California Sound Systems, Inc.*, 69 B.R. 893, 900 (Bankr. S.D. Cal. 1987) ("Where the court becomes convinced that the true purpose of filing a petition is other than to reorganize a financially distressed business, but to merely take advantage of one of the remedies available under the Code, dismissal is appropriate in order to protect the jurisdictional integrity of the court."); *see also In re Dunes Hotel Associates*, 245 B.R. 492, 506 (D. S.C. 2000)(denying lease avoidance where debtor and debtor's equity holder were only entities that would benefit from avoidance); *In re Carrere*, 64 B.R. 156 (Bankr. C.D. Cal. 1986) (finding no "cause" to reject contract if the major motivation of debtor in filing the case is to be able to perform under a more lucrative contract). The Ninth Circuit BAP stated in *Chi-Feng Huang* that "it is not true that solvent debtors may petition for bankruptcy and then obtain a windfall by rejecting their executory contracts." 23 B.R. at 803. The court also held that in the case of the rejection of a contract by a solvent debtor the party whose contract is rejected must have its claim satisfied in full before the debtor may obtain recovery. *Id.*

Hopewell Is Inapposite

14. Mr. Seife's reliance on the *Hopewell* case is also misplaced. While *Hopewell* involved a solvent scheme, the differences between the *Hopewell* scheme and BAIC's proposed scheme are numerous and include the following:

a). Hopewell's scheme remitted claimants with unliquidated or disputed claims to binding arbitration under Bermuda law, pursuant to which the arbitrators were party appointed. In stark contrast, BAIC has refused to permit disputes to go to arbitration, and has hand - picked the Scheme Adjudicator, who cannot be said to be an independent neutral arbiter. Indeed, the BAIC Scheme Managers rejected requests that a neutral Scheme Adjudicator be appointed.

b). The *Hopewell* court found that the vote on the scheme was unanimous, and that the objectors to the Section 304 proceeding, after voting in favor of the scheme, had changed their minds when the law changed adversely to their interests. In stark contrast, objecting creditors Goodrich, Textron and Goodyear, as well as the many other direct insureds who have voted against this proposed scheme, have never voted in favor of the BAIC Solvent Scheme, and have instead consistently made their opposition clear.

c). As the Court noted, the Hopewell scheme provided for two classes of creditors, those with liquidated matured claims and those with contingent, unliquidated and/or disputed claims. The creditors with liquidated claims in Class A were to be paid immediately in full, and the creditors with claims that had not yet matured, in Class B, were to be paid upon maturation of their claims. In contrast, the BAIC scheme provides only one class, even though BAIC's insureds are even more divided in nature and interest than were the Hopewell creditors.

d). The Hopewell scheme provided a four year period of time between notice to creditors and the bar date to enable creditors with unliquidated claims to value and perfect them. In contrast, the BAIC scheme provides for only 120 days, even though the long tail IBNR claims of U.S. policyholders are far more difficult to calculate than the unmatured claims typical in the Hopewell case.

The Third Circuit's *Combustion Engineering* Decision
Exemplifies the United States' Concern for Equality of Treatment

15. Mr. Seife is unduly dismissive of the *published* decision of the U.S. Court of Appeals in *Combustion Engineering* and its relevance to this matter.[6] Mr. Seife even contends in paragraphs 26-29 of his Statement that the decision -- which fills 56 pages in the official federal reporter -- is without precedential value because it ultimately remanded the case to the bankruptcy court for additional fact finding. To the contrary, *Combustion Engineering* is the first federal appellate decision analyzing and applying section 524(g) of the U.S. Bankruptcy Code. Moreover, the Court in that case directly addressed one of the fundamental principles of the United States Bankruptcy Code, equal treatment for similarly situated creditors, which is of primary importance here as it is in asbestos bankruptcy proceedings. The Court stated:

> The pre-petition transfer in this case also implicates the fundamental bankruptcy policy of "equality of distribution among creditors." In this regard, we consider the bankruptcy scheme as an integrated whole in order to evaluate whether Plan confirmation is warranted. Viewing the Combustion Engineering pre-pack bankruptcy as a whole, the record reveals that it may lack the requisite equality of distribution among creditors. The Plan, as it relates to asbestos claimants, consists of two elements: the pre-petition CE Settlement Trust and the post-petition Asbestos PI Trust. Under this interdependent, two-trust framework, the Certain Cancer Claimants, the future asbestos claimants and other non-parties to the pre-petition settlement appear to receive a demonstrably unequal share of the limited Combustion Engineering fund. 391 F.3d at 241-42.

The Court of Appeals concluded that the record below did not contain sufficient facts to enable it to resolve the issue, but as the language quoted above confirms, the Court of Appeals would have overruled the plan's confirmation without further fact finding had the record on appeal supported the proposition that the current asbestos claimants who were parties to the pre-petition settlement would receive more than the future asbestos claimants. *Combustion Engineering* confirms that United States courts would not consider acceptable a distribution proposal like that in the BAIC Scheme, which virtually ensures disparate treatment of similarly situated creditors, and provides no significant procedural protections against such disparate treatment.

---

[6] In re Combustion Engineering, Inc., 391 F. 3d. 190 (3d Cir. 2005).

Submitted 11/10/09 by James Veach -
Mound, Cotton, Wollan & Greengrass

B. New York Regulation 141

1. Description/Background

In 1989, and at the Superintendent of Insurance's request, the New York Legislature enacted New York Insurance Law § 1321. Section 1321 authorized the Superintendent to permit an impaired or insolvent New York domestic insurer (or an impaired or insolvent United States Branch of an alien insurer entered through New York) to commute reinsurance agreements to eliminate the company's impairment or insolvency.

Until the Legislature enacted NYIL § 1321, commutation agreements with troubled New York domestic insurers were subject to challenge as potential preferences pursuant to the Insurance Law's voidable transfer provisions. NYIL § 7425. When the Legislature enacted Section 1321, the Legislature extended the voidable transfer period from four to twelve months. NYIL § 7425(a). The legislature also amended the Insurance Law to provide that commutation agreements executed pursuant to NYIL § 1321 "shall not be voidable as a preference." NYIL §7 425(d).

Section 1321 required that any commutation proposed under the new statute be approved by the Superintendent "in accordance with standards prescribed by regulation." In 1990, acting Superintendent Wendy Cooper promulgated Regulation 141. Regulation No. 141, Commutation of Reinsurance Agreements, N.Y. Comp. Codes R. & Regs. tit. 11, Section 128 (1989) (11 NYCRR Section 128) (Regulation 141). Regulation 141 sets out the "applicable standards that the superintendent will use in determining whether such commutations entered . . . will be approved."

Procedures

Regulation 141 applies to all New York-domiciled insurers (and U.S.Branches) "other than a life insurance company" as defined in NYIL § 107(a)(2). The Regulation sets out how a troubled insurer may propose and implement a Regulation 141 Plan. Among other things, the Regulation's procedures add the requirement that any company seeking the benefits of Regulation 141 must stipulate that the troubled insurer will consent to an order of rehabilitation or liquidation if its proposed commutation plan does not restore policyholder surplus to the required minimum amounts (or such surplus as the Superintendent deems adequate).

The troubled insurer must provide the Department with a draft commutation agreement and a proposed commutation offer that will be extended to "each and every ceding insurer to which the impaired or insolvent insurer has obligations." The reinsurer must also provide a balance sheet showing both the insurer's impairment or insolvency as determined by the Superintendent and a pro forma balance sheet reflecting the troubled company's financial condition subsequent to the plan's implementations.

The proposed commutation offer must include an offer to pay a percentage of the cedent's losses. The impaired insurer must advise its cedents that the commutation offer remains subject to the Superintendent's determination that the total of all accepted commutation offers has restored policyholder surplus either to a statutory minimum or an amount that the Superintendent deems adequate.

The Regulation 141 requires that offers to commute assumed reinsurance obligations be made to "each and every ceding insurer to which the impaired insurer or insolvent insurer has obligations." The Regulation broadly defines the term "obligations" to include paid losses, loss reserves, IBNR, all loss adjusting expenses (paid, case, and IBNR), reserves for unearned premiums, and "any other balances due under the reinsurance agreements." The terms of all proposed commutation agreements must be the same.

For example, the same discount must be offered to each cedent, *e.g.,* 90% of paid losses, 60% of case reserves, and 30% of IBNR. No cedent may be favored with different discounts. Discounts for different lines of business may be proposed, but these discounts must be "reasonable, actuarially sound, and supported by documents justifying such a variance." To date, none of the Regulation 141 Plans approved by New York Superintendents of Insurance has incorporated different discounts by line of business.

Any proposed Regulation 141 Plan submitted to the Superintendent must include an exhibit setting forth the obligations due each cedent to which the troubled company has obligations and the consideration (commutation offer) to be paid each cedent. Within ten days of the Plan's approval, the troubled company must deliver its proposed commutation agreements to its cedents.

No cedent may be compelled to commute its "obligations." The terms of the proposed commutations and the amount offered "shall not be subject to negotiation." Each cedent makes its own determination with respect to whether the cedent wishes to accept the proposed commutation or refuse to commute and run the risk that the Regulation 141 Plan will not succeed.

The results of an approved plan must be returned to the Superintendent within a period specified by the Superintendent. The plan results must include:

- copies of all executed commutation agreements;
- copies of all rejected commutation agreements;
- "correspondence pertaining to all . . . offers made to the ceding insurers";
- a pro forma balance sheet showing the effect of the accepted/rejected offers;
- any other components of the Plan to restore surplus to policyholders; and
- copies of any agreements that modify, commute, or assign any retrocession agreements.

If the Superintendent determines that the proposed commutation agreements and any other plan components sufficiently restore policyholder surplus, the commutation agreements take effect. The Superintendent may specify when he or she approves the Regulation 141 plan that cedents that agree to commute be paid within so many business days.

If the Superintendent determines that surplus has not been restored, the Superintendent may proceed against the troubled company armed with the company's stipulation consenting to entry of any order of rehabilitation or liquidation. This eliminates any delay in obtaining an order of rehabilitation or liquidation.

Safeguards

The primary procedural safeguards for an approved Regulation 141 mass-commutation plan include:

- the state regulator's full discretion to accept, reject, or modify any proposed plan;
- explicit requirements that the same commutation terms be offered to every ceding company whose obligations appear on the troubled company's books and records;
- the absence of any "cram down" provisions that would allow the Superintendent to approve the commutation of a cedent's contracts over a cedent's objections;
- time-frames for the submission of a plan and payment of agreed commutation amounts within days after the plan's results have been approved; and
- provisions calling for the preservation and production of all communications between the troubled company and its cedents.

In addition, and as previously noted, the commutation agreements executed pursuant to an approved Regulation 141 plan will not take effect "unless . . . the plan shall eliminate the insurer's impairment or insolvency" and restore surplus to policyholders to levels required under the Insurance Law or an amount that the Superintendent deems "is adequate in relation to the insurer's outstanding liabilities or financial needs."

Although the troubled company's directors must consent to an order of rehabilitation or liquidation if the company's surplus has not been restored to the required minimum, the Superintendent need not consider any plan proposed pursuant to Regulation 141 "in lieu of taking any other action" against the company. This gives the Superintendent full discretion to decide whether to allow the troubled company to propose a plan or to take other action against the company, including supervision, rehabilitation, or liquidation.

See *VII. Appendix – D. Reference List of NAIC Model Laws and State Selected Related Statutes* for review of the Regulation.

2. **ADVANTAGES/DISADVANTAGES**

ADVANTAGES

- No cedent can be outvoted and compelled to accept a commutation offer;

- All communications to and from the ceding insurer must be preserved and provided to the regulator;

- Although the regulation was designed for professional reinsurers, the plan also works if troubled insurers assumed reinsurance and also wrote direct business;

- No court approval is required;

- The plan must show how the proposed commutations will affect its retrocessional program, thus reducing the risk that the commutation plan will bind or negatively affect retrocessionaires;

- The Superintendent has ultimate oversight, flexibility, and control, to the extent that the Superintendent may approve, disapprove, or modify a plan, but the Superintendent may also review all communications exchanged relating to the offer to ensure that no unfair offsets were arranged or that offers to commute did not otherwise favor or disfavor particular cedents; and

- Regulation 141 also allows for other components to be added to the plan to restore policyholder surplus, including surplus notes and capital contributions.

DISADVANTAGES

- Inasmuch as an offer under this regulation is based on the assuming reinsurer's books at a given date, discrepancies between the ceding and assuming insurers' books are likely to occur;

- Timing could become problematic if the regulator does not enforce strict deadlines regarding the consideration and execution of offers;

- Regulation 141 does not require an audited balanced sheet to confirm the extent of the troubled insurer's financial condition; and

- Many subjective considerations must be used by the troubled insurer to determine what percentage of approval will be required for the plan to work; if the plan fails to garner enough support to restore policyholder surplus, the troubled insured has stipulated not to oppose the Superintendent's petition to an appropriate court for an order of rehabilitation or liquidation.

Plans Undertaken

Thus far three professional reinsurers have successfully implemented New York Superintendent-approved commutation plans pursuant to Regulation 141: (1) Rochdale Insurance Company; (2) Paladin Reinsurance Company; and (3) Constellation Reinsurance Company.

In addition, the Insurance Company of the State of New York (INSCORP) obtained the Superintendent's approval for a Regulation 141 Plan. INSCORP submitted its commutation plan results to the Superintendent. As a result, however, of the continued adverse development of INSCORP's construction defect line of business, INSCORP's policyholder surplus could not be improved to an acceptable level and INSCORP was recently placed in rehabilitation.

C. Benefits, Risks and C~~c~~ontrols: For US Claimants/Policyholders When A Non-US Insurer or Reinsurer Restructures

1. Introduction

This section considers the impact upon U.S. policyholders and creditors of the restructuring of non-U.S. insurers and reinsurers. It will not consider the impact upon U.S. policyholders and creditors of the restructuring of the U.S. branch of a non-U.S. insurer because that will be governed largely by familiar U.S. laws and procedures. However, it should be noted that the extent to which the U.S. branch may realize economic support from its non-U.S. parent and/or affiliates is likely to be governed primarily by the laws of the jurisdiction(s) in which the latter are domiciled.

Of greater concern in this section is the impact on U.S. policyholders and creditors of the restructuring of a non-U.S. insurer~~-~~ or reinsurer outside the U.S. The restructuring of a non-US insurer or reinsurer may be governed simultaneously by the laws of several jurisdictions. For example, as Solvency II becomes the norm in the European Union (EU), an insurer or reinsurer doing business in many member jurisdictions may be subject to their various laws to varying degrees. However, the jurisdiction in which the parent is domiciled (or the Group Supervisor, if different) may be particularly influential even over the fate of subsidiaries in other jurisdictions. The continued evolution of group supervision as an integral part of Solvency II is likely to enhance the influence of the parent's domicile. Less predictable will be the management of restructuring of insurers doing business simultaneously in EU and non-EU jurisdictions. There remains a wide disparity in the core principles underlying insurance regulatory systems throughout the globe, some attributable to the pace of economic development, others to fundamental cultural differences, and still others to specific national public policies.

This section endeavors to identify the key considerations that should be evaluated from the perspective of U.S. policyholders and creditors when their non-U.S. insurer or reinsurer is restructured. It seeks also to provide a sampling of illustrations of how those considerations might evolve in specific circumstances. Pre-purchase evaluation of how these considerations are addressed in a particular jurisdiction may enable the astute policyholder to avoid purchasing coverage that is apparently reliable but for which there is little effective protection upon restructuring.

2. Potential Advantages And Risks Of Restructuring Mechanisms

In many non-U.S. jurisdictions mechanisms are available for the restructuring of insurers and reinsurers~~ruers~~ short of formal rehabilitation or liquidation proceedings. A distinction should be drawn between restructuring in the face of potential insolvency (the focus of this paper) and restructuring as a business strategy not in response to immediate solvency concerns. In the latter case, there is little justification for compromising policyholder interests and regulatory schemes typically do not permit that result. It is in the face of a potential insolvency that restructuring can present a meaningful dilemma.

On the one hand, restructuring mechanisms can be advantageous when compared to rehabilitation or liquidation proceedings in three key respects.

a. Such mechanisms typically offer at least a realistic prospect of a faster resolution of the underlying financial challenge;

b. Often, these mechanisms are cheaper and therefore consume fewer scarce resources in the implementation of the process itself; and

c. Often these mechanisms serve to preserve coverage that might otherwise have to be terminated in the context of formal proceedings.

On the other hand, there can be some serious draw-backs in these alternative schemes. The next subsection considers key factors in more detail. However, the principal concerns that may arise in the context of these alternatives include:

d. Reduced regulatory and judicial oversight resulting in diminished policyholder protection;

e. Greater likelihood that policyholder interests will be compromised for the sake of other constituencies such as owners, managers and other creditors; and

f. The probability that policyholders will have less influence in the process and a diminished ability to protect themselves from potentially adverse outcomes.

3. KEY CONSIDERATIONS

In the U.S., state insurance regulators are accustomed to the fundamental principle that the interests of policyholders (used here as including insureds), especially consumers, should take precedence over those of unsecured non-policyholder creditors. This principle is not mandated in non-insurer bankruptcies in the U.S. and may not have the same importance in non-U.S. jurisdictions. It is helpful to identify the likely principal interests of policyholders (including insureds) as they may be affected in insurer restructuring.

In addition, this subsection will identify key considerations for reinsureds and creditors when a non-U.S. reinsurer restructures. The treatment of reinsureds ~~in the reinsurance context~~ is the primary consideration, however a proper restructuring plan will keep tax authorities and other creditors informed as well. While the nature of the reinsured/reinsurer (sometimes referred to as cedant and assuming company) relationship ~~makes~~invokes many of the same key considerations ~~the same~~, because typically reinsureds are sophisticated business entities rather than individual consumers, slight differences may arise.

a. RIGHT OF PAYMENT

Not surprisingly, the principal interest of policyholders is likely to be assurance that claims (perhaps including those for return of unearned premium) will be paid promptly and in full. With the arguable exception of continuation of coverage, it is likely that policyholders' other interests (discussed below) are derivative of and ancillary to payment concerns.

The ability to obtain full payment of claims may turn on many factors, only some of which may be attributable to the nature of the proceeding. For example, the debtor's financial condition will always be a key consideration, regardless of the nature of the proceeding. The nature of the claim will also be an important consideration. For example, p~~P~~olicyholders making claims based on incurred but not reported losses (IBNR) must rely on actuarial estimates which can vary widely. Such policyholders face a risk that any payment under a restructuring plan would be insufficient to meet future liabilities. This section does not address such considerations which, however important, are unrelated to the nature of the proceeding or the regulatory or supervisory scheme under which it operates.

~~The full and prompt payment of claims is also the principal interest of a reinsured. However, in the reinsurance context, the issue of set-off also comes into play. If only part of a company's business is subject to the restructuring plan, reinsurers may be concerned that they will lose existing set-off rights. This concern by reinsurers may affect the ability of reinsureds to receive full payment. There may also be political or corporate reasons for particular reinsureds to object to a restructuring plan – especially in the case where the reinsured is also a reinsurer and may be unwilling to help one of its potential competitors with a restructuring. The presence of existing disputes or investigations may also affect how a reinsured views a restructuring plan.~~

~~Reinsurers have repeatedly expressed opposition to any system that could result in the accelerated and involuntary payment of their obligations based on any estimation of policyholder claims. Reinsurers oppose compelled payment of reinsurance recoverables based on IBNR on the basis that they are theoretical losses with theoretical values allocated in a theoretical fashion. Because reinsurance is a contract of indemnity, reinsurers cannot be required to pay losses, such as incurred by not reported losses, which are unidentified or unknown.~~

b. CONTINUATION OF COVERAGE

Under a variety of circumstances, it may be difficult for a policyholder to find acceptable coverage to replace that provided by the restructuring insurer. In the U.S. this interest is typically given more weight in the insurance rather than reinsurance context and in the case of life accident and health insurance more than it is in the context of property and casualty insurance.

c. CLAIM PRIORITIES

As noted, we are accustomed in this country to the supremacy of policyholders over other unsecured creditors. This priority is critically important when available assets may not suffice to discharge fully all liabilities of the insurer. Of course, in insurer insolvencies, typically the category of general creditors includes most notably reinsureds. Thus, the interests of reinsureds and policyholders, treated as congruent in much of this section, may be very divergent in particular circumstances. Policyholder priority may not be observed as strictly, or at all, in other jurisdictions.

d. GUARANTY ASSOCIATION COVERAGE

Over the last four decades the U.S. insurance sector has implemented nearly universal guaranty fund mechanisms providing at least basic protection for the insureds of most failed insurers. There are of course notable exceptions like health maintenance organizations, risk retention groups, surplus lines carriers and certain lines (separate account annuities, fiduciary bonds, etc.). in the main, however, this "safety net" serves to soften the impact of insurer failure and effectively provides a standard against which are measured the anticipated results of restructuring. Most non-U.S. jurisdictions have not implemented nearly as comprehensive an insolvency protection scheme. The guranty association mechanism is typically not available to reinsureds in the U.S. or elsewhere.

e. RIGHT TO VOTE

Although largely foreign to U.S. insurer restructuring and insolvency proceedings, in other jurisdictions, policyholders may have a right to vote on the restructuring plan. Most often, however, that right exists when the plan does not require that policyholder contracts be fulfilled in their entirety. In such plans, policyholders whose claims consist of incurred but not reported losses may have different rights from policyholders who have unsettled paid claims or outstanding losses.

f. CRAM DOWN

In certain jurisdictions, it is possible for policyholders or reinsureds to be compelled to accept a restructuring plan that requires that they make economic concessions. The plan may require approval upon the votes of creditors or it may simply require regulatory or court approval. This should be contrasted with U.S. laws, which typically do not permit restructuring plans in which policyholders' interests are compromised for the benefit of non-policyholder creditors.

g. VOICE IN REPLACEMENT

The restructuring plan may entail coverages being transferred to other insurers or reinsurers with whom policyholders or reinsureds had no relationship. In some cases (including instances in the U.S.), policyholders or reinsureds may have little discretion in the transaction (except potentially non-payment of premium and forfeiture of coverage).

h. TRANSPARENCY

The ability of creditors, including policyholders or reinsureds, to obtain information about the proceeding, and the financial factors upon which key decisions will be based, varies considerably from jurisdiction to jurisdiction. Access to relevant information, however, is often the essential first step in a policyholder's ability to protect his, her or its interest in a restructuring.

i. ACCOUNTABILITY

The individual or entity responsible for managing the restructuring may be a private practitioner engaged by the restructuring entity's management, a group of creditors or a regulatory authority. Alternatively, the process may be placed in the hands of a public official. The degree to which the individual or entity in charge of the process is accountable to a superior or independent authority can be critically important in assuring the fairness and efficacy of the process. In those instances in which oversight consists principally of court supervision, the independence of the tribunal is important and so is the degree to which interested parties have access to that tribunal.

j. REGULATORY PROTECTION

In some jurisdictions (including the U.S.) statutory or common law (judicial decision) standards govern the manner in which an insurer or reinsurer may be restructured. They range from fundamental constitutional protections against the taking of property without due process to specific thresholds that must be satisfied before a Rehabilitation Plan can be approved. The availability of such protections and of a viable enforcement mechanism (such as an empowered administrative agency) are generally key to the prospect of a meaningful recovery or protection for policyholders and reinsureds.

k. Enforcement in the United States

Non-U.S. restructuring plans have been enforced by the U.S. courts under Chapter 15 of the United States Bankruptcy Code. Chapter 15 governs cross-border insolvencies and is a framework whereby representatives in corporate restructuring procedures outside the U.S. can obtain access to U.S. courts. Chapter 15 permits a U.S. bankruptcy court to cooperate with a foreign procedure in which assets and affairs of the debtors are "subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation." Recent Bankruptcy Act amendments resulting in the current form of this provision were intended in part to bring U.S. law into greater harmony with the provisions adopted by the United Nations Commission on International Trade Law ("UNCITRAL") and observed throughout much of the globe. Applicability of these rules can be complex and often commences with a determination of which jurisdiction's proceeding will control. The emerging trend is to defer to the jurisdiction in which lies the Center of Main Interest ("COMI"). However, it is important to note that the COMI may not necessarily be the domiciliary jurisdiction of the insolvent and that cases applying this principle sometimes reach puzzling results. While further discussion of these issues is beyond the scope of this section, the subject merits careful attention when applicable.

l. Standing To ~~Paper~~Appear

The ability to appear before the tribunal or agency conducting or overseeing the proceeding may be an important component of ~~policyholders~~ creditor protection. Of course, the fairness and impartiality of such tribunal or agency are of critical importance. Moreover, the right to appear may be far less important when the individual managing or overseeing the process is charged principally or in material part with protection of policyholders and reinsureds and takes that responsibility seriously.

m. Set-offs, Claims Acceleration and Estimation, Preferences, and Voidable Transfers

Insolvency proceedings can trigger a number of unique technical rules that are common in U.S. jurisdictions but may not receive the same treatment in other regimes. Among these are provisions that govern set-offs of claims and credits, acceleration and estimation of claims, when payments before commencement of a proceeding may be deemed to be reversible preferences, when such payments may constitute fraudulent or voidable transfers, and other such rules.

Illustrative is the issue of claims acceleration and estimation. Reinsurers have repeatedly expressed opposition to any system that could result in the accelerated and involuntary payment of their obligations based on any estimation of policyholder claims. Reinsurers oppose compelled payment of reinsurance recoverables based on IBNR on the basis that they are theoretical losses with theoretical values allocated in a theoretical fashion. Because reinsurance is a contract of indemnity, reinsurers assert that they cannot be required to pay losses, such as incurred by not reported losses, which are unidentified or unknown.

While it is beyond the scope of this section to consider the details of each of these “technical” issues, it is important for the affected party to identify those that may be important in the particular case and determine how they are addressed in the specific proceeding. It should be noted that the application of these rules may not always be immediately evident. For example, if only part of a company’s business is subject to the restructuring plan, reinsurers may be concerned that they will lose existing set-off rights. This concern by reinsurers may affect the ability of reinsureds to receive full payment.

n. Politics

Finally, it should never be forgotten that “all politics are local.” In the U.S. the degree to which political considerations control an outcome is somewhat mitigated by cultural and legal constraints. These constraints, however, may not be as applicable in non-U.S. jurisdictions. Familiarity with the local environment is essential in order to avoid unpleasant surprises. And political considerations may not relate just to governmental entities – they may relate to the industry as well. Thus, for example where the reinsured is also a reinsurer it may be unwilling to help one of its potential competitors with a restructuring. The presence of existing disputes or investigations may also affect how a reinsured views a restructuring plan.

~~D. Benefits, Risks and controls: For US Claimants/Policyholder When A Non-US Reinsurer Restructures~~

W:\Dec09\Cmte\E\SG\Restructuring Mech\Att1C Revisions to VC.doc

Wayne Mehlman
Counsel, Insurance Regulation
(202) 624-2135 t (202) 572-4804 f
waynemehlman@acli.com

November 30, 2009

Financial Condition (E) Committee
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108-2604

RE: Guaranty Association Disclosure Notice Template

Members of the E Committee:

The American Council of Life Insurers (ACLI) appreciates this opportunity to comment on the guaranty association disclosure notice template that was recently approved by the Receivership & Insolvency Task Force (RITF) and referred to your Committee for consideration. The ACLI is the primary trade association of the life insurance industry, representing 340 member companies that account for 93% of the industry's total assets in the United States, 94% of life insurance premiums and 94% of annuity considerations.

The ACLI and the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) have worked with the RITF, the Life Insurance and Annuities (A) Committee and its Annuity Disclosure Working Group during the past few months to develop a notice template that could be presented to the states for adoption.

We believe that the template that was approved by the RITF during its November 18 conference call (Version A in its agenda materials) is concise, consumer-friendly and consistent with Section 19.C of the *Life and Health Insurance Guaranty Association Model Act* (the Model). In addition, it will help achieve greater uniformity among the states if it is widely adopted. Currently, state disclosure notices vary significantly by length, format and provisions addressed therein.

We, therefore, urge you to approve the template that has been referred to your Committee for consideration without modification.

Once the template is finalized, we strongly prefer that it take the form of a guideline, either free-standing or as one relating to the Model. The Model itself should not be reopened in order to incorporate the template.

Thanks again for this opportunity to comment, and please contact me at waynemehlman@acli.com or (202) 624-2135 if you have any questions.

American Council of Life Insurers
101 Constitution Avenue, NW, Washington, DC 20001-2133
www.acli.com

Sincerely,

Wayne A. Mehlman

Wayne A. Mehlman
Counsel, Insurance Regulation

cc: Roger Sevigny, NAIC President
Therese M. Vaughn, NAIC Chief Executive Officer
Todd Sells, Director, Financial Regulatory Services Division
Jim Mumford, Chair, Receivership & Insolvency Task Force
David Vacca, Assistant Director, Insurance Analysis and Information Services Department

W:\Dec09\Cmte\E\ACLI letter to E Committe.pdf

Guideline for Notice of Protection Provided by [State] Life and Health Insurance Guaranty Association

Background: During November 2009, the Receivership & Insolvency (E) Task Force adopted a clear and conspicuous disclaimer template (below) regarding the protection provided by Life and Health Insurance Guaranty Associations as described in Section 19: Prohibited Advertisement of Insurance Guaranty Association Act in Insurance Sales; Notice to Policy Owners within the NAIC *Life & Health Insurance Guaranty Association Model Act* (#520). The Task Force strongly encouraged each state to incorporate this template "as written" via regulation to ensure consistency and uniformity. Additionally, the Task Force directed NAIC that this Guideline was to always accompany the NAIC *Life & Health Insurance Guaranty Association Model Act* (#520) as a companion product when provided to interested parties or interested regulators.

– Suggested Disclaimer –

NOTICE OF PROTECTION PROVIDED BY [STATE] LIFE AND HEALTH INSURANCE GUARANTY ASSOCIATION

This notice provides a **brief summary** of the [STATE] Life and Health Insurance Guaranty Association ("the Association") and the protection it provides for policyholders. This safety net was created under [STATE] law, which determines who and what is covered and the amounts of coverage.

The Association was established to provide protection in the unlikely event that your life, annuity or health insurance company becomes financially unable to meet its obligations and is taken over by its Insurance Department. If this should happen, the Association will typically arrange to continue coverage and pay claims, in accordance with [STATE] law, with funding from assessments paid by other insurance companies.

The basic protections provided by the Association are:

- Life Insurance
    - [$___,000] in death benefits
    - [$___,000] in cash surrender or withdrawal values
- Health Insurance
    - [$___,000] in hospital, medical and surgical insurance benefits
    - [$___,000] in disability [income] insurance benefits
    - [$___,000] in long-term care insurance benefits
    - [$___,000] in other types of health insurance benefits
- Annuities
    - [$___,000] in withdrawal and cash values

The maximum amount of protection for each individual, regardless of the number of policies or contracts, is [$___,000]. Special rules may apply with regard to hospital, medical and surgical insurance benefits.

Note: Certain policies and contracts may not be covered or fully covered. For example, coverage does not extend to any portion(s) of a policy or contract that the insurer does not guarantee, such as certain investment additions to the account value of a variable life insurance policy or a variable annuity contract. There are also various residency requirements and other limitations under [STATE] law.

To learn more about the above protections, [as well as protections relating to group contracts or retirement plans,] please visit the Association's website at [www.______________], or contact:

[STATE] Life and Health Insurance Guaranty Association
[ADDRESS]
[PHONE NUMBER]

[STATE] Department of Insurance
[ADDRESS]
[PHONE NUMBER]

Insurance companies and agents are not allowed by [STATE] law to use the existence of the Association or its coverage to encourage you to purchase any form of insurance. When selecting an insurance company, you should not rely on Association coverage. If there is any inconsistency between this notice and [STATE] law, then [STATE] law will control.

W:\Dec09\Cmte\E\Guideline for Notice of Protection.doc

National Association of Insurance Commissioners

Alternative Mechanisms for Troubled Companies

An NAIC White Paper

December 2009

Created by the
NAIC Restructuring Mechanisms for Troubled Companies Subgroup
of the
Financial Condition (E) Committee

Drafting Note: This White Paper is limited to situations where the legal entity is in a financially troubled condition which could potentially lead to an insolvency in the foreseeable future. It will not consider situations where the insurer is merely inconvenienced by a particular book of business.

TABLE OF CONTENTS

I. INTRODUCTION

A. BACKGROUND/PURPOSE

State insurance regulators have well-developed receivership statutes, practices, and procedures to handle impaired and insolvent insurers. These statutes, practices, and procedures serve, first and foremost, the goal of consumer protection. They are a critical and essential part of the Regulatory Solvency Framework. However, given improvements with regard to the early detection of financially troubled insurers and insured's requirements for A-rated coverage, a new landscape has emerged with a growing number of troubled insurers seeking to engage in mechanisms of run-off or restructuring as an alternative to being placed in traditional receivership proceedings. For example, as of mid-year 2008 alone, there were approximately 129 active insurers in voluntary run-off domiciled in the United States with over $36 billion in claims in progress. As a result of a changing landscape and the fact that the NAIC has little formal documentation available to regulators dealing with alternative mechanisms for winding-down troubled companies, the Receivership & Insolvency (E) Task Force during 2007 began drafting charges to undertake a study of alternative mechanisms and relative best practices. These charges were presented to the Financial Condition (E) Committee ("Committee") during the 2007 NAIC Winter National Meeting. The Committee members supported the charges, but felt the topic of active troubled insurers required the expertise and perspective of regulators involved in the active solvency monitoring process, as well as receivership process. Thus, a Restructuring Mechanisms for Troubled Insurers Subgroup ("Subgroup") was formed directly under the Committee with regulators representing both perspectives. The Subgroup's 2008 adopted charges were as follows:

> Undertake a study of alternative mechanisms, such as solvent schemes of arrangement, solvent run-offs, and Part VII portfolio transfers (a transfer leaving no recourse to original contractual obligor/insurer) and any other similar mechanisms to gain an understanding of:
>
> (i) how these mechanisms are utilized and implemented;
> (ii) the potential affect on claims of domestic companies, including the consideration of preferential treatment within current laws;
> (iii) how alien insurers (including off-shore reinsurers) who have utilized these mechanisms might affect the solvency of domestic companies; and
> (iv) best practices for state insurance departments to consider if utilizing similar mechanisms in the United States and/or interacting with aliens who have implemented these mechanisms.

The study is documented in the form of an NAIC White Paper. Additionally, the study will be limited to situations where the legal entity is in a financially troubled condition which could potentially lead to an insolvency in the foreseeable future. The Subgroup will not consider situations where the insurer is merely inconvenienced by a particular book of business or wishes to exit the insurance business for reasons unrelated to solvency.

B. AUTHORITY & APPLICABILITY

The information in this White Paper is meant to provide guidance to state insurance regulators and be an advisory resource. It discusses approaches and concepts that are available within and outside the United States in order to assist regulators with assessing possible alternatives for handling troubled insurers. Mechanisms discussed in this White Paper may not be available or applicable in all jurisdictions due to differences in statutes, regulations, and implementing tools and resources, as well as changing market conditions. In fact, statutes and regulations that define the authority and duties of regulators may require, or provide for, specific procedures to be implemented in certain circumstances. In addition, although this White Paper was intended to generally apply to all risk-assuming entities that are subject to the authority of the insurance department, the majority of the Subgroup's discussion was focused on property/casualty insurance companies. Due to their unique characteristics, the mechanisms mentioned in this White Paper, may not be appropriate in the context of life, health, or other personal lines of insurance for which guaranty association protections are available, or for certain types of specialized risk-assuming entities (*e.g.*, health maintenance organizations, syndicates, risk retention groups, chartered purchasing groups, chartered self-insured groups or pools, captives, insurance exchanges, etc.). Lastly, an appropriate mechanism for a particular troubled insurer will also depend on the specific circumstances of the situation.

C. OTHER CONSIDERATIONS

As state insurance regulators consider the relative advantages and disadvantages of these alternative mechanisms, they should do so in the context of the overall policy objectives behind each alternative. Different policy objectives will inevitably lead to very different results. The current system that utilizes liquidation and provides for guaranty fund protection for certain policyholder claims reflects a legislative policy that places the rights of policyholders and claimants above the interests of other creditors of the insolvent company. While these laws may vary somewhat from state to state, they share several key features. The interests of policyholders and claimants are granted priority over claims brought by other insurers, the government, and general creditors. The laws seek to preserve, to the greatest possible extent, the insurance protection that the policyholder believed he/she was getting when he/she purchased his/her policy from the now insolvent insurer. The law treats all similarly situated claimants in the same manner thereby prohibiting preferential treatment for certain favored individuals or entities. Finally, they preserve, in some meaningful form, the right of judicial review. These elements form the foundation of the existing system that exhibits a clear legislative choice to place the interests of consumers above the interests of investors and large institutions that are better equipped to withstand the losses resulting from insurer insolvency.

II. General Advantages and Disadvantages for Utilizing Alternative Mechanisms for Troubled Companies

A. Advantages

- Alternative mechanisms can be useful tools for a troubled insurer's management and regulators, potentially leading to a quicker resolution than a traditional receivership.
- Alternative mechanisms typically allow for continuous claims payments, or at least orderly claims processing and partial claims payments without interruption.
- Alternative mechanisms can cost less than receiverships, thus resulting with maximum dollars paid out to policyholders/claimants.
- Alternative mechanisms may allow greater flexibility to achieve commercially acceptable results, such as freeing up capital.

B. Disadvantages

- The inherent risk for consumer and claimant issues increases requiring stronger regulatory monitoring and controls for protection. For some alternative mechanisms, there is no guarantee appropriate fairness will take place.
- Alternative mechanisms for troubled insurers might become a tool for solvent carriers to transfer value away from policyholders.
- As to reinsurance, restructuring might affect the value of the future reinsurance claim, offset rights, arbitration rights, and reinsurance collateral.
- The cost of efficiency or company enticements may come at the expense of policyholders or insureds.
- Difficult decisions arise with a troubled insurer that is not clearly solvent or insolvent and significant ramifications could follow with certain choices.
- Companies may seek to continue run-off or restructuring activities even after it becomes clear that the company is hopelessly insolvent, resulting in preferential payments made at the expense of outstanding claims.
- Compensation incentives may restrict future claims paying ability.
- Voluntary restructuring schemes may deny policyholders and consumers the substantive and procedural safeguards otherwise available for their protection in court supervised receivership proceedings.
- Run-off and restructuring schemes may be used to circumvent state priority and preference rules in order to discount claims at the expense of policyholders and other claimants. They may also be used to circumvent other consumer protection laws, including state receivership and guaranty association laws as well as commutation and assumption transfer laws.
- May allow the company to terminate coverage and extinguish liabilities over the objections of policyholders and other creditors by majority cram-down vote.
- Run-offs and restructuring schemes may result in substantially reduced payments to policyholders. State receivership laws typically require a showing that a rehabilitation plan is fair and equitable, complies with priority rules, and provides no less favorable treatment of claims than would occur in liquidation. Run-offs and alternative mechanisms, such as those addressed herein, may have the ability to sidestep these equitable standards and permit broad

discretion in discounting claim values. In fact, the success of a plan may be dependent on the ability to impose deep discounts on claims, and there may be no rules or mandatory standards in place to protect policyholders or claimants.

- There is a risk that similarly situated creditors will be treated differently or that they will receive payments that are less than they would receive in an insolvency proceeding.
- Alternative mechanisms adopted in any given state may not be enforceable across state lines leaving the company at risk of further exposure, litigation, and ongoing collection activity which may disrupt efforts to implement a restructuring plan.
- Alternative mechanisms are not appropriate for compromising the claims of consumer policyholders due to lack of sophistication and the existence of extensive consumer protections built into insolvency laws.
- In the absence of strong regulatory involvement, there is a risk that policyholders and creditors will not receive adequate or accurate information on which to base their decisions.
- The interests of management may not be the same as the interests of policyholders and creditors.

III. TYPES OF ALTERNATIVE MECHANISMS FOR TROUBLED COMPANIES

MECHANISMS AVAILABLE TO INSURERS WITHIN THE UNITED STATES AND RELATED TERRITORIES

A. RUN-OFF OF TROUBLED INSURER

1. DESCRIPTION

A troubled company run-off is usually a voluntary course of action where the insurer ceases writing new business on all lines-of-business, but continues collecting premiums and paying claims as they come due on existing business. Due to state cancellation laws, the insurer may be required to renew business, which can be particularly challenging for insurers running off personal lines risks. The insurer may seek to run-off business in the traditional sense, paying claims in full in the ordinary course of business, or management of the insurers might seek to end or limit their exposure on insurance business before policy terms expire, by utilizing reinsurance, assumption transfers, negotiated settlements and/or voluntary policy commutations. These transactions should not have a negative impact on policyholders as close regulatory monitoring is normally maintained throughout the process. The goal is to completely close operations while remaining solvent.

In order to succeed in run-off, assets and income must be maintained at sufficient levels to cover the remaining claims and administrative costs of handling those claims. However, solvent run-offs may have little revenue other than investment income, and run-offs may develop into insolvencies that could require receivership proceedings, for example, if the insurer is unable to collect reinsurance, errors in estimating recoverable assets, decline in asset values and investment income, and/or encounters other cash flow issues at any point in the process.

Although run-off mechanisms can generally be applied to property/casualty, life, health, title, or fraternal insurers, it is of general consensus personal lines should not be included in any commutation plan incorporated as a component of any run-off plan.

a. STATUTORY BASIS FOR SUPERVISED RUN-OFF PLANS

Run-off of a troubled company may be subject to regulatory supervision under applicable state law. (*See e.g.*, NAIC Risk-Based Capital (RBC) For Insurers Model Act, Section 6.B.(2).) Regulatory supervision of a troubled company run-off may be triggered in order to enhance the regulatory oversight and monitoring of the financial performance, consumer protections, and market conduct related to implementation of the run-off plan. Enhanced regulatory oversight may include increased financial and regulatory reporting requirements, regulatory approval of transactions and claim settlement practices, and on-site regulatory supervision. Supervision of the run-off plan is conducted in order to ensure that policyholders, consumers, and other creditors fare no worse under the run-off plan than in receivership.

For example, the Illinois Insurance Code, based on the NAIC Model Act, provides the Illinois Director of Insurance with a discretionary alternative mechanism for handling troubled property and casualty companies and health organizations whose RBC Report indicates a mandatory control level event. Section 35A-30(c) of the Illinois Insurance Code, 215 ILCS 5/35A-30(c), provides:

> In the case of a mandatory control level event with respect to a property and casualty insurer, the Director shall take the actions necessary to place the insurer in receivership under Article XIII or, **in the case of an insurer that is writing no business and that is running-off its existing business, may allow the insurer to continue its run-off under the supervision of the Director.** (Emphasis supplied)

A mandatory control level event is defined under the statute as an RBC Report that indicates that the insurer's total adjusted capital is less than its mandatory control level RBC. Under this statutory mechanism, if there is a mandatory control level event at a company that has ceased writing new business and the company is engaged in a voluntary run-off, the Director has the discretion to either seek a receivership order or to allow the company to continue its run-off under the Director's supervision.[1] In order to persuade the Director to exercise the supervised run-off option, the company must prepare and present a comprehensive run-off plan, including financial projections, that establishes that the plan is viable, that there is a high probability that the run-off can be conducted without putting policyholders at greater risk and that all claim obligations will be satisfied.

The specific content of the run-off plan may vary depending upon the nature of the business being run-off and the financial circumstances of the troubled company. (See a sample outline for a run-off plan at *VII. Appendix. C.*) However, the primary goals of the plan should include and achieve consumer protection, satisfaction of all policyholder obligations, and the maintenance of positive surplus and sufficient liquidity. Typically, the components of such a plan would include substantial cost-cutting measures, commutations of reinsurance agreements, collection of outstanding premium, recovery of statutory deposits, policy buy-backs, novations and claim settlements.[2] A key element of such a plan would be a discussion of the benefits to the policyholders of a run-off rather than a receivership, including the impact of any state guaranty fund or guaranty association coverage.

The nature and scope of the Director's supervision may be delineated in a comprehensive corrective order, which would include and reference such things as the run-off plan, periodic reporting requirements, on site monitoring, procedures relating to the approval of transactions, claim settlement practices, and other related matters. The corrective order, which may be amended from time to time, would likely be confidential under state law. Because the company is involved in a supervised run-off, it may be appropriate to negotiate certain adjustments (e.g., discount reserves, allow prepaid expenses, remove schedule F penalty) to its statutory financial statements, but, as adjusted, the financial statements should still comply with Generally Accepted Accounting Principles. Any such adjustments should be based upon credible forecasts and other available information.

---

[1] Section 35A-30(d), 215 ILCS 5/35A-30(d), of the Illinois Insurance Code provides the Director with a similar supervised run-off option with respect to troubled health organizations.

[2] In 2005, the Illinois voidable preference statute was amended to provide that in the case of a company involved in a supervised run-off, a transaction involving transfer of cash or other assets by the company (buy-back, settlements, etc.) which was approved by the Director in writing cannot later be found to constitute a voidable transfer, 215 ILCS 5/204 (m)(C). This provision provides policyholders and other parties to buyback, novation, commutation and other approved transactions with protection from the voidable preference statute in the event that the company ultimately goes into liquidation. In the absence of this protection, policyholders and others may be reluctant to enter into such transactions.

2. ADVANTAGES/DISADVANTAGES

ADVANTAGES

- Voluntary run-offs may enable commercial parties to achieve commercially acceptable results in arm's length transactions which reflect customary market practice.
- Timely defense and payment of policyholder claims in full not otherwise always covered by guaranty funds or associations.
- Potentially more favorable environment for the negotiation of disengagement transactions and commutations with reinsurers.
- Continuity of management information systems.
- Some business entities may be willing to acquire insurance companies in run-off and inject additional capital or reduce overhead expense. This consolidation and management expertise could provide some efficiency for regulators with regard to their monitoring processes.
- Typically involve commutations and other solutions reflective of the consent of the contracting parties.
- There is evidence that it appears to be a robust method given there are accumulators of seasoned run-off companies.
- Strategic decisions can be made quickly and efficiently working with appropriate state regulators.

DISADVANTAGES

- Preferential treatment issues might arise when dealing with business-to-business structures, if both large and small policyholders exist, as deals tend to focus on settling with large carriers first. In addition more complicated commutations may be structured in the run-off plan to be handled last.
- Preferential payments may arise with respect to creditors whose priority of payment in the event of liquidation would be classified below that of policyholder and consumer claims.
- Policyholders and consumers may be compelled to accept less than the fair value of their claims.
- Potential negative impact of adverse claim development.
- Attempts to commute or settle with policyholders (complete policy buy-backs) can result in reinsurers resisting payment.
- To the extent the estate assets are reduced by paying claims earlier, the estate assets remaining to pay remaining policyholder and guaranty association claims will be reduced, costing the industry more.
- Larger insureds may have better leverage to negotiate better settlements.
- Absent regulatory oversight, there is no guarantee that settlements will be at consistent or even fair levels.
- The absence of court oversight and mandatory rules and standards (such as priority rules and rehabilitation plan standards) increases the likelihood that policyholder claims will be sharply discounted and that bargained for benefits and protections will be lost.
- Guaranty funds may be disadvantaged in a subsequent receivership if non-guaranteed creditors were paid more than the ultimate distribution from the receivership.

B. New York Regulation 141

1. Description

In 1989, at the New York Superintendent of Insurance’s request, the New York Legislature enacted New York Insurance Law § 1321. Section 1321 authorized the Superintendent to permit an impaired or insolvent New York domestic insurer (or an impaired or insolvent United States Branch of an alien insurer entered through New York) to commute reinsurance agreements to eliminate the company's impairment or insolvency.

Until the Legislature enacted NYIL § 1321, commutation agreements with troubled New York domestic insurers were subject to challenge as potential preferences pursuant to the Insurance Law's voidable transfer provisions. When the Legislature enacted Section 1321, the Legislature extended the voidable transfer period from four to twelve months (NYIL § 7425(a)). The legislature also amended the Insurance Law to provide that commutation agreements executed pursuant to NYIL § 1321 "shall not be voidable as a preference" (NYIL §7425(d)).

Section 1321 required that any commutation proposed under the new statute be approved by the Superintendent "in accordance with standards prescribed by regulation." In 1990, the acting New York Superintendent promulgated Regulation 141 (Regulation No. 141, Commutation of Reinsurance Agreements, N.Y. Compo Codes R. & Regs. tit. 11, Section 128 (1989) (11 NYCRR Section 128)). Regulation 141 sets out the "applicable standards that the superintendent will use in determining whether such commutations entered . . . will be approved."

Regulation 141 applies to all New York-domiciled insurers (and US Branches) "other than a life insurance company" as defined in NYIL § 107(a)(2). However, the regulation excludes impaired or insolvent life insurers and solvent insurers. The Regulation sets out how a troubled insurer may propose and implement a Regulation 141 Plan. Among other things, the Regulation's procedures add the requirement that any company seeking the benefits of Regulation 141 must stipulate that the troubled insurer will consent to an order of rehabilitation or liquidation if its proposed commutation plan does not restore policyholder surplus to the required minimum amounts (or such surplus as the Superintendent deems adequate).

The troubled insurer must provide the New York Department with a draft commutation agreement and a proposed commutation offer that will be extended to "each and every ceding insurer to which the impaired or insolvent insurer has obligations." The reinsurer must also provide a balance sheet showing both the insurer's impairment or insolvency as determined by the Superintendent and a pro forma balance sheet reflecting the troubled company's financial condition subsequent to the plan's implementations.

The proposed commutation offer must include an offer to pay a percentage of the cedent's losses. The impaired insurer must advise its cedents that the commutation offer remains subject to the Superintendent's determination that the total of all accepted commutation offers has restored policyholder surplus either to a statutory minimum or an amount that the Superintendent deems adequate.

The Regulation 141 requires that offers to commute assumed reinsurance obligations be made to "each and every ceding insurer to which the impaired insurer or insolvent insurer has obligations." The Regulation broadly defines the term "obligations" to include paid losses, loss reserves, IBNR, all loss adjusting expenses (paid, case, and IBNR), reserves for unearned premiums, and "any other balances due under the reinsurance agreements." The terms of all proposed commutation agreements must be the same.

For example, the same discount must be offered to each cedent, e.g., 90% of paid losses, 60% of case reserves, and 30% of IBNR. No cedent may be favored with different discounts. Discounts for different lines of business may be proposed, but these discounts must be "reasonable, actuarially sound, and supported by documents justifying such a variance." To date, none of the Regulation 141 Plans approved by New York Superintendents of Insurance has incorporated different discounts by line of business.

Any proposed Regulation 141 Plan submitted to the Superintendent must include an exhibit setting forth the obligations due each cedent to which the troubled company has obligations and the consideration (commutation offer) to be paid each cedent. Within ten days of the Plan's approval, the troubled company must deliver its proposed commutation agreements to its cedents. No cedent may be compelled to commute its "obligations." The terms of the proposed commutations and the amount offered "shall not be subject to negotiation." Each cedent makes its own determination with respect to whether the cedent wishes to accept the proposed commutation or refuse to commute and run the risk that the Regulation 141 Plan will not succeed.

The results of an approved plan must be retuned to the Superintendent within a period specified by the Superintendent. The plan results must include: copies of all executed commutation agreements; copies of all rejected commutation agreements; “correspondence pertaining to all …offers made to the ceding insurers”; a pro forma balance sheet showing the effect of the accepted/rejected offers; any other components of the Plan to restore surplus to policyholders; and copies of any agreements that modify, commute, or assign any retrocession agreements.

If the Superintendent determines that the proposed that the proposed commutation agreements and any other plan components sufficiently restore policyholder surplus, the commutation agreements take effect. The Superintendent may specify when he or she approves the Regulation 141 plan that cedents that agree to commute be paid within so many business days.

If the Superintendent determines that surplus has been restored, the Superintendent may proceed against the troubled company armed with the company’s stipulation consenting to entry of any order of rehabilitation or liquidation.

The primary procedural safeguards for an approved Regulation 141 plan include: the state regulator’s full discretion to accept, reject, or modify any proposed plan; explicit requirements that the same commutation terms be offered to every ceding company whose obligations appear on the troubled company’s books and records; the absence of any “cram down” provisions that would allow the Superintendent to approve the commutation of a cedent’s contracts over a cedent’s objections; time-frames for the submission of a plan and payment of agreed commutation amounts within days after the plan’s results have been approved; and provisions calling for the preservation and production of all communications between the troubled company and its cedents.

In addition, and as previously noted, the commutation agreements executed pursuant to an approved Regulation 141 plan will not take effect "unless. . . the plan shall eliminate the insurer's impairment or insolvency" and restore surplus to policyholders to levels required under the Insurance Law or an amount that the Superintendent deems "is adequate in relation to the insurer's outstanding liabilities or financial needs. "

Although the troubled company's directors must consent to an order of rehabilitation or liquidation if the company's surplus has not been restored to the required minimum, the Superintendent need not consider any plan proposed pursuant to Regulation 141 "in lieu of taking any other action" against the company. This gives the Superintendent full discretion to decide whether to allow the troubled company to propose a plan or to take other action against the company, including supervision, rehabilitation, or liquidation.

Thus far three professional reinsurers have successfully implemented New York Superintendent-approved commutation plans pursuant to Regulation 141: (1) Rochdale Insurance Company; (2) Paladin Reinsurance Company; and (3) Constellation Reinsurance Company. In addition, the Insurance Company of the State of New York (INSCORP) obtained the Superintendent's approval for a Regulation 141 Plan and submitted its commutation plan results to the Superintendent. However, as a result of the continued adverse development, INSCORP's policyholder surplus could not be improved to an acceptable level and INSCORP was placed in rehabilitation.
.

See *VII. Appendix – D. Reference List of NAIC Model Laws and State Selected Related Statutes* for review of the Regulation.

2. ADVANTAGES/DISADVANTAGES

ADVANTAGES

- No cedent can be outvoted and compelled to accept a commutation offer.
- All communications to and from the ceding insurer must be preserved and provided to the regulator.
- Although the regulation was designed for professional reinsurers, the plan also works if the troubled insurer is assumed reinsurance and also wrote direct business.
- No court approval is required.
- The plan must show how the proposed commutations will affect its retrocessional program, thus reducing the risk of the commutation plan will bind or negatively affect retrocessionaires.
- The Superintendent has ultimate oversight, flexibility, and control, to the extent that the Superintendent may approve, disapprove, modify a plan, and the Superintendent may also review all the communications exchanged relating to the offer to ensure that no unfair offsets were arranged or that offers to commute did not otherwise favor or disfavor particular cedents.
- Regulation 141 also allows for other components to be added to the plan to restore policyholder surplus, including surplus notes and capital contributions.

DISADVANTAGES

- As an offer under this regulation is based on the assuming reinsurer's books at a given date, discrepancies between the ceding and assuming insurers' books are likely to occur.

- Timing could become problematic if the regulator does not enforce strict deadlines regarding the consideration and execution of offers.
- Regulation 141 does not require an audited balanced sheet to confirm the extent of the troubled insurer's financial condition.
- Many subjective considerations must be used by the troubled insurer to determine in advance what percentage of approval is needed for the plan to work.

C. Rhode Island Statute and Regulation for Voluntary Restructuring of Solvent Insurers

1. Description

Rhode Island's Title 27, Chapter 14.5[3] provides for voluntary restructuring of solvent insurers. The statute was intended to provide an alternative to a traditional run-off by bringing "solvent schemes of arrangement" (which are discussed further in the next section) to the United States. It allows solvent companies that are in run-off to reach a court ordered (and Department of Insurance supervised) agreement with all of its creditors in order to accelerate completion of the run-off bringing certainty of payment to creditors and reducing administrative costs often associated with lengthy run-offs.

The statute sets forth a structure for court ordered review, approval and implementation of what the statute refers to as a "commutation plan." The process may only be utilized by reinsurers and commercial property and casualty insurers domiciled in Rhode Island and in run-off. R.I. Gen. Laws § 27-14.5-1(6) In addition, the insurer must be solvent and adequately reserved in accordance with all applicable Rhode Island statutes and regulations as well as in compliance with all other Department solvency standards.

A company considering the process must first prepare and submit their proposed commutation plan to the insurance department for review.[4] Insurance Regulation 68(4)(a)(i). A commutation plan is very broadly defined as a plan for extinguishing the outstanding liabilities of a commercial run-off insurer. After the plan is reviewed by the Department and all issues are resolved, the company may apply to the Court for an Order agreeing to classes of creditors and calling for a meeting of creditors. Insurance Regulation 68(4)(a)(iii). At this point the Company is required to give notice of the application and proposed commutation plan to all parties pursuant to fairly broad requirements set forth in the statute. R.I. Gen. Laws §§ 27-14.5-3 and 27-14.5-4(b)(1).

All creditors and interested parties (such as Guaranty Funds) are granted full access to the plan and all information related to the plan. Both creditors and interested parties are given an opportunity to file comments or objections to the plan with the court. R.I. Gen. Laws § 27-14.5-4(b)(3). Ultimately, all creditors must be given an opportunity to vote on the commutation plan, and approval of the plan requires consent of at least (i) 50% of each class of creditors and (ii) the holders of 75% in value of the liabilities owed to each class of creditors. R.I. Gen. Laws § 27-14.5-4(b)(4). However, it is important to

[3] The Rhode Island statute was adopted in 2002 and amended in 2007. See R.I. Gen. Laws § 27-14.5-1 *et seq*., "Voluntary Restructuring of Solvent Insurers," and R.I. Insurance Regulation 68 (Commutation Plan regulations).

[4] Plan approval is done by the court; however, the Department has the statutory authority to intervene in any proceeding brought under this statute. According to the RI Department, it is highly unlikely that the court would approve a plan over the Department's objection.

note that only the claims of creditors present or voting through proxy at the meeting of the creditors are counted towards determining whether the requisite majorities have been achieved. *See* Insurance Regulation 684(e)(i).

Upon approval of the commutation plan by the creditors, the Company must petition the Court to enter an order confirming the approval and allowing implementation of the plan. R.I. Gen. Laws § 27-14.5-4(c)(1). The implementation order must enjoin all litigation in all jurisdictions between the applicant and creditors as well as release the applicant of all obligations to its creditors upon payment of the amounts specified in the plan. R.I. Gen. Laws § 27-14.5-4(c)(2). The court may only issue an implementation order if it determines that implementation of the commutation plan would not materially adversely affect either the interests of objecting creditors or the interests of assumption policyholders. R.I. Gen. Laws § 27-14.5-(c)(1)(ii). The court does have a responsibility to ensure that all policyholders and creditors have been treated fairly. Once the implementation order is entered distribution to creditors may begin.

After implementation and upon completion of the commutation plan the court can issue an order of discharge or dissolution. As a result of this order, the Company is either (i) dissolved or (ii) discharged from the proceeding without any liabilities. At this point any residual assets are distributed to the company owners. R.I. Gen. Laws § 27-14.5-4(d).

One of the key aspects of the process is that the court's implementation order releases the insurer from all obligations to its creditors upon payment of the amounts specified in the commutation plan. This brings about a court ordered finality to the run-off that would not be possible utilizing traditional run-off options. To this end, the order actually binds the insurer and all of its creditors and owners whether or not a particular creditor or owner is affected by the plan or has accepted the plan or whether or not the creditor or owner ultimately receives money under the plan. The order is also binding whether or not creditors had actual notice. R.I. Gen. Laws § 27-14.5-3(b).

It is also important to note that because the restructuring mechanism provided for by the statute would not be appropriate or practical for companies with a large number of small creditors with very diverse interests, the statute is restricted to use by reinsurers and <u>commercial</u> property and casualty insurers. It includes express limitations on the lines of business that can be included in a commutation plan, and specifically excludes all life insurance, workers' compensation and personal lines. ("excluded lines"). (*See* R.I. Gen. Laws § 27-14.5-1(21)). However, in cases where a company does have excluded lines, the statute provides for a bifurcated process for disposing of all lines of business within the context of the run-off scheme. Commercial lines would be included in the commutation plan, and if possible excluded lines would be transferred to an eligible insurer, through court ordered and Department sanctioned assumption reinsurance. *See* R.I. Gen. Laws § 27-14.5-1(6) and R.I. Gen. Laws § 27-14.5-4(d)(2)(ii). Again, the process is available only to solvent companies - the theory being that the restructuring would permit all liabilities to be paid in full.

The definition of "Commercial Run-off Insurer" under the statute was expanded by amendment in 2007 to include companies newly formed or re-activated under Rhode Island law solely for the purpose of accepting transferred business for restructuring pursuant to the statute. See R.I. Gen. Laws § 27-14.5-1(6). The purpose of this amendment was to expand the population of insurers that might qualify for the process. The amendment permits an insurer to transfer some or all of its commercial liabilities (a very controversial process) to a newly formed run-off entity for the sole purpose of implementing a commutation plan pursuant to the statute. The original insurer would be allowed to continue writing business with no further obligations under the transferred policies. Any such transfer would require prior approval of the Department.

Since the statute's enactment in 2002, no insurer has availed itself of the statute and no other US state has adopted a similar law.

2. ADVANTAGES

- Provides an alternative that might provide a better solution for policyholders and investors than traditional run-off options (creditor democracy).
- Provides certainty of payment to creditors of present and future claims.
- Avoidance of a lengthy run-off with the associated on-going administrative costs, adverse claim development and deteriorating reinsurance collections.
- Provides certainty of payment by reinsurers.
- Accelerated release of capital to shareholders at the conclusion of the process allowing for more efficient deployment of capital to non-runoff operations.
- Such mechanisms might attract capital to the industry since the availability of a reasonable exit mechanism for these companies will create an active market for investment in runoff companies.

DISADVANTAGES

- This statute permits an insurer to terminate coverage and extinguish liabilities, over the objections of policyholders and creditors who are in the minority.
- Creditors are bound by the plan, whether they had notice or not and only those present or voting through proxy are counted towards establishing the requisite majority, which may create incentives to manipulate notice (though the Department and Court could take steps to prevent such manipulation).
- Although the process is limited to solvent insurers and the intent therefore is that full value will be paid to all creditors, there are no guarantees that all policyholders will receive full value, or even present value for their claims (especially those with IBNR claims).
- There is no reference to segregating and preserving reserve assets for excluded lines, or any explanation as to how policies and claims would be administered and paid during the interim period prior to completion of the plan.
- Questions concerning the enforceability of any such plan across state lines may leave companies exposed to further risk, litigation and disruption or termination of a plan, i.e. even if the Rhode Island Court did approve the plan its is possible that policyholder or claimant actions could arise in other state's court, (or perhaps federal courts) resulting in enforcement and implementation issues for the company attempting the restructuring.[5]
- Although, the Rhode Island Plan is available only to commercial insurers and reinsurers in run-off, the plan is not exclusively limited to "troubled" companies; thus, any commercial run-off insurer could conceivably use this mechanism to cease operations and eliminate ongoing claims payment liability.

[5] For a detailed discussion on the issue of enforceability, see David Wright, "A Question of Enforceability," Run Off Business, Issue 12, Spring 2005, pp. 20-22.

- Despite the fact that there is significant statutorily delineated regulatory guidance included in the Rhode Island framework (unlike UK Solvent Schemes), parties may view Rhode Island's "commutation plan" statute as simply a domestic versions of the UK's solvent schemes and attribute all of the "Disadvantages" associated with III. D. 2. UK-Like Solvent Schemes of Arrangements below to the Rhode Island system.
- Because the Rhode Island statute allows for the formation or reactivation of a domestic company and the transfer of assets and liabilities to that company, certain parties view this as allowing a "ring-fence" of assets, unfairly shielding assets from creditors.

MECHANISMS AVAILABLE TO INSURERS OUTSIDE THE UNITED STATES AND RELATED TERRITORIES

D. UK-LIKE SOLVENT SCHEMES OF ARRANGEMENTS

1. DESCRIPTION

A scheme of arrangement is essentially a statutory compromise or arrangement between a company and its creditors. The process is allowed under Part 26 of the United Kingdom ("UK") Companies Act 2006 that requires: majority creditor approval representing at least 75% in value of obligations; confirmation by the UK Financial Service Authority ("FSA") of no objections; and court sanction. If approved, the process will bind all creditors, but does not necessarily bind reinsurers. The process has evolved over the years and includes a process for insolvent and solvent insurers.

The FSA maintains a very active role in reviewing the schemes with a review document containing approximately 30 questions. In July 2007, the FSA issued a process guide related to decisions made with schemes that included the following:

- Stresses scheme must comply with principles for businesses (*e.g.*, treating policyholders fairly and communicating in clear terms);
- Established an FSA schemes review committee;
- Stated that the run-off should be at least five years old;
- Distinguishes between individual retail and small commercial policyholders, large commercial policyholders and other risk carriers;
- Distinguishes between insolvent risk carrier, marginally solvent risk carrier and substantially solvent risk carrier;
- In case of substantially solvent risk carrier, the FSA is likely to object to a scheme unless the risk carrier offers benefits designed to ensure that policyholders are not in a worse position than in a solvent run-off;
- Provides for a role of policyholder advocate; and
- FSA may not object to a scheme, even if it fails to satisfy the criteria stipulated, if the risk carrier can demonstrate that the scheme treats policyholders fairly (*e.g.*, through suitable additional benefits for policyholders and/or safeguards for dissenting procedures).

As of September 2008, there have been approximately 174 solvent schemes of UK non-life business. However, in every instance when policyholders have mounted serious opposition, the UK courts have ruled in the policyholders' favor. In particular, objecting policyholders have successfully challenged the BAIC, WFUM and Scottish Lion solvent schemes in the UK courts. These are the only solvent schemes involving direct policyholder coverage that have been challenged to date, and all three have resulted in the court rulings favorable to the policyholders. To date, no UK court has agreed to sanction a solvent scheme involving direct coverage (as opposed to reinsurance) in the face of a policyholder legal challenge to the scheme.

Claims being paid can include incurred but not reported ("IBNR") and most schemes have the ability to pay for IBNR based on estimation methodology. Additionally, schemes will allow a creditor's methodology to be used, if reasonable.

Chapter 15 of the US Bankruptcy Code may be used to assist with a scheme of arrangement in the United States. The effect is to grant a bankruptcy court in the U.S. authority to enforce the scheme and protect the company's assets from creditors. However, although no UK solvent scheme has yet been challenged under Chapter 15 of the US Bankruptcy Code, there is a possibility that such challenges may arise and the US bankruptcy courts could reject solvent schemes.

2. ADVANTAGES/DISADVANTAGES

ADVANTAGES

- Some advocates state that solvent scheme mechanisms, in particular, has proven to be very effective in the UK and other jurisdictions to permit closure of companies that have reduced their liabilities to fairly minimal levels and that can reasonably estimate their future liabilities.
- Such mechanisms might attract capital to the industry since the availability of a reasonable exit mechanism form these companies will create an active market for investment in run-off companies.
- Companies using UK schemes of arrangements have statistically improved their net asset position by approximately 5%.
- Some insurers have made payments to creditors at or near 100%.
- Schemes may allow a creditor's claim estimation methodology to be used, if reasonable.

DISADVANTAGES

- Schemes may undermine the value of insurance contracts by not honoring contractual obligations.
- Lost coverage may hurt policyholders at the expense of American citizens and the economy.
- Schemes could pose a formidable collective action problem.
- Schemes could undermine the reliability of insurance institutions.
- Schemes may allow for the reduction or cancellation of contractual obligations outside the scope of the current receivership system by not adhering to the statutory priority of distribution rules. Under such a scheme, a troubled company could force certain policyholders to commute (or buy-back) mutually agreed-upon insurance coverage despite their objections.
- The use of terms "debtor" and "creditor" used in the restructuring arena may tactically create a new environment for insurance where risk transfer is not necessarily part of the product purchased.
- Enforceability across state lines.
- Schemes could be used by companies to simply reorganize their corporate structure to move reinsurance operations unencumbered by old claims under a different name.
- Reinsurance (E) Task Force in their latest proposal had a provision where an insurer engaging in solvent schemes would not be allowed to take a reduction of collateral.
- Chapter 15 is a relatively new provision of the Bankruptcy Code with relatively little case law to support it; thus, leaving the ability for judges' discretion and leeway in its application.
- Schemes can involve reinsurers, where the reinsurance contract with an insurance company is negatively affected.
- Schemes could provide an opportunity for solvent insurers to avoid insurance and reinsurance obligations and return the risk to insureds of ceding companies who purchased the coverage in good faith.

- Schemes force creditors to trade insurance coverage for payments based on estimations of future claims which are inexact and possibly unfair.
- The individuals chosen to adjudicate claims under a scheme may lack expertise in the necessary legal issues.
- There is no oversight of solicitation by the company of scheme acceptances. Thus, some accepting creditors may have already achieved favorable settlements while dissenting creditors are left to litigate their claims in an unfavorable forum.
- Schemes do not allow dissenting policyholders to opt out of the scheme.
- Schemes do not ensure continuation of coverage.
- Schemes do not include a safety net of guaranty association protection.
- Schemes do not allow a policyholder to seek judicial review of its claims against the insurer.

E. PART VII PORTFOLIO TRANSFERS

1. DESCRIPTION

Part VII of the Financial Services and Markets Act 2000 ("FSMA") allows for a transfer of insurance business under a statutory and court process. The transfer allows a reinsurer to move all or certain of its reinsurance business (assets and liabilities) to another reinsurer without the consent of each and every policyholder but with the sanction of the UK High Court. The main statutory requirements are: 1) policyholder notification; 2) a report by an independent expert; 3) UK High Court approval; and, 4) no objection by the FSA or other regulators and interested parties, including policyholders.

The court is involved in the process with the directions hearing, which is when court will grant leave to proceed. The court is also involved in the hearing to sanction the transfer (or final hearing). The relevant legislation and requirements can be found in VII. Appendix D.4.

The transferee must be an insurance company established in an European Economic Area (EEA) state. However, the transferor can be authorized in the UK, a EEA branch of UK firm, a UK branch of EEA firm, a EEA firm no UK branch, or a non-EEA, but permitted to carry on business in the UK.

Per an FSA website, the following are reasons why reinsurance firms undertake Part VII transfers:

- Rationalization – combine similar business from two or more subsidiaries, putting all into a single regulated entity;
- Efficiency – transfer business between third parties, separating old liabilities in run-off from new business, putting each into separate firms;
- Capital reduction – transfer business to a new firm and extract any surplus shareholders' funds; and
- Exit – transfer business such as employers' liability that cannot be schemed.

The legal effect of a Part VII transfer is a statutory unilateral novation of the affected contracts of insurance or reinsurance, including any rights attaching to those contracts.

The two primary aspects for the protection of affected parties are as follows: 1) the independent expert's report, which needs only to consider the effect on policyholders; and 2) the court is required to be satisfied that the transfer as a whole is fair as between the interests of different classes of persons affected by the transfer.

Per the FSA website, the FSA and the court are concerned whether a policyholder, employee, or other interested person or any group of them will be adversely affected by the scheme. This is primarily a matter of actuarial and regulatory judgment involving a comparison of the security and reasonable expectations of policyholders without the scheme with what would be the result if the scheme were implemented. The court will pay close attention to any views expressed by the FSA, regarding whether individual policyholders or groups of policyholders may be adversely affected does not necessarily mean, however, that the transfer is to be rejected by the court.

The key question is whether the transfer as a whole is fair as between the interests of the different classes of persons affected. However, it is not the function of the court to produce what, in its view, is the best possible scheme. With regard to different transfers, the court may deem all fair, but it is the company's directors' choice to select the transfer to pursue. Under the same principle, the details of the scheme are not a matter for the court provided that the scheme as a whole is found to be fair. Thus, the court will not amend the scheme, because individual provisions could be improved upon.

Overall, a loss portfolio transfer is a means of transferring outstanding net or gross legal liability from one insurer to another insurer. It has been viewed as a form of retrospective reinsurance. The transfers must be sanctioned by the court, and are subject to review and opinion by an independent expert that is approved by the FSA. Notice of the proposed transfer is usually required to be sent to all policyholders of the parties unless the court decides otherwise. A detailed report must also be provided setting out all the details and the independent expert's opinion. The FSA and any party who feels adversely affected by the transfer can make representation to the court for consideration.

The FSA is also required to assess a number of aspects (*e.g.*, whether policyholders will be worse off moving from one place to another, or if there is any potential risk posed by the transfer). Rating agency ratings or the effect on ratings could be a component as part of the FSA's considerations, as well as other regulatory bodies.

There have been over 100 Part 7 transfers, and the majority dealt with internal reorganization within holding groups. Over 50% were performed in the life industry. Very few Part 7 transfers have seen business go from a company to a third party; however, they are becoming increasingly popular. The receiving company's motives for entering into these arrangements may stem from tax advantages to potential profits based on one's claims handling experience.

COMPARISON OF PART 7 TRANSFERS WITH U.S. ALTERNATIVES (*BINGHAM TABLES*)

	Part 7 Transfers	Assumption Reinsurance Solvent	Assumption Reinsurance Insolvent	Rehabilitation Proceedings
Creditor Voting	No	Yes	No	No
Regulatory Review	Yes	Yes	Yes	Yes
Creditor Input	Low	High	Low	Medium
Transparency	Low	High	Low	Medium
Court Review	Yes	No	No	Yes
Hold-ups & Hold-outs	No	Yes	No	No

	Schemes of Arrangement	Run-off with Commutations	Rehabilitation Proceedings
Who Runs the Case	Management	Management	Regulator
Stay of Proceedings	Yes	No	Yes
Hold-ups and Hold-outs	Yes	Yes	No
Creditor Votes	Yes	Yes	No
Regulatory Involvement	Review	Ongoing Monitoring	Control
Claims Adjudication	Management Appointee	Variety of Courts	Receivership Court

The foregoing tables compare schemes of arrangement and Part 7 transfers with analogous mechanisms available under U.S. law. While it appears that the mechanisms are similar in many respects, in practice they have proven to be quite different. Under UK schemes of arrangement, policyholders have been forced to accept payouts based on estimations of their claims so that equity holders can recapture the capital of the company. Under UK Part 7 transfers, policyholders have been forced to accept the credit of another insurer in order to permit the insurer from whom they bought the policy to exit business and recapture its capital. Current U.S. practice, with the possible exception of the Rhode Island statute, would not enable these results. Policyholders are only required to accept payment based on estimation in the U.S. where the company is insolvent and shareholders will not receive a return of their capital. Also, under current U.S. practice, policy transfers to a new insurer are not made involuntarily except where there is an insolvency of the transferor. While UK regimes certainly have safeguards in the form of voting (in the case of schemes) and court review (in the case of schemes and Part 7 transfers) the ultimate risk is left on the policyholder.

2. ADVANTAGES/DISADVANTAGES

ADVANTAGES

- Permit more efficient management of transferred books of business, allows dedicated capital and focused solutions to be applied to run-off liabilities, and promotes efficient use of capital for ongoing business.
- Options can be explored to strengthen policyholder protections and reach regulator approval, such as altering deductibles, strengthening reserves, reinsurance obtained, and other arrangements to share the risk.

- Might attract new capital to insurance businesses insofar as it can be invested directly in run-off liabilities, and strengthens ongoing companies by permitting the separation of those liabilities.
- Can reduce risk of exposure.
- A recent amended UK rule introduces a simpler alternative where no court sanction is required for pure reinsurance business transfers if all the policyholders affected by the transfer consent to the proposal.
- Substantial regulatory oversight is required.

DISADVANTAGES

- Could transfer obligations from the entity the creditor dealt to: one which is completely unknown; one with whom the creditor would have never willingly chosen to deal; from a differing country subject to different regulation; and a less secure debtor.
- A Part VII-like transfer to an alien reinsurer from a U.S. domestic reinsurer may cause the primary insurer to lose its credit for reinsurance.
- Very difficult to quantify trapped capital in these scenarios.
- Problems could arise for a ceding company, if the Part VII transfer goes to a reinsurer with a lower rating, because the rating agency could lower the ceding company's rating.
- Could present unique accounting and reporting anomalies on both a statutory and GAAP basis.
- The regulator is not required to publicly explain its decision-making process.

IV. OBSERVATIONS AND CONSIDERATIONS BEFORE USING ALTERNATIVE MECHANISMS

A. EXISTING STATUTORY AUTHORITY AND REQUIREMENTS

1. STATE RECEIVERSHIP/GUARANTY FUND LAWS

Delinquency proceedings (receiverships) are instituted against an insurance company by an insurance department for the purpose of conserving, rehabilitating, or liquidating an insurance company. All require a court order, and the domiciliary state court will take jurisdiction over matters involving the resulting receivership estate. The court's role is to ensure transparency and due process and to be an independent arbiter of any disputes that may arise. The nature and timing and extent of regulatory action in any given troubled insurer situation depends on the circumstances of the particular situation.

The U.S. Constitution in Article I, Section 10 states that "No state shall…pass any…law impairing the obligation of contracts." However, during certain delinquency proceedings, states may, on rare exceptions, impair contracts, but only where there is a legitimate public purpose behind the law.

It should be noted that the language in the rehabilitation statutes for most states is very broad and provides that anything that will restructure, revitalize, or reform the insurer can be proposed in a plan.

2. PRIORITY DISTRIBUTION STATUTES/PREFERENTIAL TREATMENT

One of the key consumer protections in the existing state delinquency proceedings are the priority distribution statutes that require payment of policyholder level claims before the payment of any other claimants including non-policy claims of the United States government, claims of other insurers and reinsurers, and general creditors. These same priority distribution statutes also require members of the same class or group of creditors to be treated similarly. The priority distribution statutes assure that the needs of consumers, who might not be sophisticated in insurance matters, are placed ahead of non-policyholder level claimants and that everyone with the same level or type of claim is treated the same.

If assets are not sufficient to cover the remaining claims and administrative costs of an insurer using one of the alternative mechanisms, then all claims paid prior to that point have been given a preference at the expense of the claims to be paid in the future. As a result, the receiver could be statutorily required to attempt to recover these preferential payments.

B. CONSUMER PROTECTIONS AND PUBLIC POLICY CONSIDERATIONS

In order to ensure some baseline of protections for policyholders and consumers, there are certain core principles that regulators should strive to maintain with any alternative mechanism for troubled insurers. The first among these, a requirement that the company honor its contractual obligations to policyholders, is considered the primary and overriding principle. This first principle translates into no impairment of policy benefits and claims without the express, informed, voluntary consent of the policyholder. The others are corollary principles, all supporting that primary goal of honoring contractual obligations to policyholders. Any alternative mechanism for run-off or restructuring of a troubled insurance company's obligations should strive to establish parameters consistent with these principles.

Core Principles:

1. Honor Contractual Obligations to Policyholders. Alternative mechanisms should not be a way for an insurance company to sidestep its contractual obligations to policyholders. There should be no involuntary restructuring of policies or impairment of policy benefits or claims permitted outside of receivership. This would preclude any changes to policies, or reductions to policy claims or benefits, without the express, informed, voluntary consent of individual policyholders. Accordingly, there should be no cram-down approval of a mechanism by majority vote over the objection of policyholders, no involuntary transfer of risk back to policyholders through forced commutation of claims or otherwise, and no cancellation, termination, or non-renewal of coverage, except as permitted under the express terms of the policy. In short, every policyholder should be entitled to continue coverage and to receive all policy benefits, for the full term of their policy.

2. Meaningful Notice and Information Sharing. This contemplates accurate, consistent, and timely notice and disclosures to all policyholders, creditors, and guaranty associations of meaningful information (including financial information, status plans, and any proposed assumption reinsurance or other significant transactions) at inception and on an established schedule thereafter. Disclosures should also identify creditors (at least below the policy level) in order to permit some meaningful, organized discussion among creditors.

3. Adherence to Priority Scheme. Alternative mechanisms should require adherence to statutory liquidation priority schemes. They should not provide a mechanism for circumventing the distribution priority to benefit the company, its shareholders, employees, other stakeholders, or specific groups of policyholders at the expense of other classes of policyholders. Controls on preferences and the outflow of assets are needed, and will require regular ongoing review. The company and/or equity shareholders should not be permitted to retain assets unless all claims having priority, as measured under state liquidation laws, have been satisfied in full.

4. Coherent, Comprehensive Financial Planning. Any alternative mechanism should be based on a fully developed and comprehensive financial plan which includes complete and meaningful financial data, and projections based on reasonable and realistic financial assumptions. There should be full disclosure and transparency in financial planning, monitoring, and reporting as a condition to approval of any such plan and throughout implementation. In addition, any such mechanism should provide a global solution addressing all in-force policies and pending policy claims. There should be no ring fencing or piecemeal disposition of assets and liabilities which may result in unequal treatment of policyholder claims, and give rise to preference and priority concerns. Moreover, the fairness and reasonableness of any mechanism cannot be reasonably assessed on a transaction by transaction basis without consideration of the overall impact on other policyholders and creditors.

5. Procedural Safeguards. Any alternative mechanism should provide substantive procedural safeguards, including clear standards for disclosure, reporting, and external review, appropriate and timely notice, access to information, and the opportunity for informed participation for all stakeholders, court, and/or regulatory approval for all significant actions to be taken, and meaningful compliance monitoring and reporting.

V. OBSERVATIONS AND CONSIDERATIONS WHEN USING ALTERNATIVE MECHANISMS

A. EXISTING STATUTORY AUTHORITY AND REQUIREMENTS

1. USE OF PERMITTED PRACTICES

There have been situations where an insurer would be able to maintain operations for 20 years, but to date, since liabilities barely exceed assets based on NAIC Accounting Practices and Procedures, the insurer is nearly or technically insolvent. A carefully thought-out permitted practice could allow a troubled insurer time to dramatically restructure in order to provide better results for consumers in terms of timely claims payments.

2. MODIFICATIONS TO EXISTING STATUTORY AUTHORITY

In some circumstances, state insurance regulators may want to consider modifying laws and regulations to provide for a more favorable environment for certain alternative mechanisms. For example, the Illinois Division of Insurance ("Division") strongly supported the General Assembly's adoption of 215 ILCS 5/204 in the Illinois Insurance Code's provision on Prohibited and Voidable Transfers and Liens to protect transfers made during the Division's supervision of a solvent run-off. The language reads as follows:

> "m) The Director as rehabilitator, liquidator, or conservator may not avoid a transfer under this Section to the extent that the transfer was: ***
>
> (C) In the case of a transfer by a company where the Director has determined that an event described in Section 35A-25 [215 ILCS 5/35A-25] or 35A-30 [215 ILCS 5/35A-30] has occurred, specifically approved by the Director in writing pursuant to this subsection, whether or not the company is in receivership under this Article. Upon approval by the Director, such a transfer cannot later be found to constitute a prohibited or voidable transfer based solely upon a deviation from the statutory payment priorities established by law for any subsequent receivership."

B. SURVEILLANCE MONITORING BY STATE INSURANCE REGULATOR

State insurance regulators need to consider whether the state has appropriate expertise on staff or whether the state needs to hire outside consultants of particular functions, such as claims assessment, reserves, reinsurance, etc. Please refer to the *NAIC Troubled Insurance Company Handbook* for a description of competency and skills of personnel assigned to conduct surveillance on troubled insurers.

1. SUPERVISION ORDERS/CONSENT AGREEMENTS/LETTER OF UNDERSTANDING

Regulators may want to consider various methods to articulate the regulator's expectations with an alternative mechanism, as well as the possible recourse that may occur with the insurer as a result of certain actions or behaviors. Such communication methods can be informal, such as a letter of understanding with the insurer, or formal, such as voluntary consent agreement or a confidential supervision order.

If a supervision order is taken under the Commissioner's administrative provisions, the insurer's management will generally remain in place subject to restrictions in the supervision order and the direction of the supervisor. The supervision can be voluntary or involuntary and confidential or public. Confidential supervisions are becoming more infrequent as disclosures of such regulatory actions have become more necessary under federal law for insurers within publicly traded groups. Additionally, some states may require court approval, as well.

2. FINANCIAL REPORTING/ANALYSIS/EXAMINATION

All active insurers that are not in liquidation proceedings should be filing quarterly financial statements to the NAIC Financial Data Repository to provide regulators, policyholders, creditors, and claimants meaningful information. Enhanced monitoring, such as monthly financial statements and claims/exposure reports, should also be considered.

All states should conduct analysis and examination practices in compliance with Part B of the Financial Regulation Standards and Accreditation Program.

3. COMMUNICATIONS

As a result of utilizing various alternative mechanisms, regulators should attempt to coordinate the situation and supervisory plan with other affected insurance departments/jurisdictions, other regulatory agencies, and guaranty associations. Coordination may be useful to avoid actions that may be counterproductive. Interdepartmental and intradepartmental communication is also important to ensure key departmental officials possess all relevant information to permit decisions to be made on a timely basis.

C. BENEFITS, RISKS AND CONTROLS: FOR US CLAIMANTS/POLICYHOLDERS WHEN A NON-US INSURER OR REINSURER RESTRUCTURES

1. INTRODUCTION

This section considers the impact upon U.S. policyholders and creditors of the restructuring of non-U.S. insurers and reinsurers. It will not consider the impact upon U.S. policyholders and creditors of the restructuring of the U.S. branch of a non-U.S. insurer because that will be governed largely by familiar U.S. laws and procedures. However, it should be noted that the extent to which the U.S. branch may realize economic support from its non-U.S. parent and/or affiliates is likely to be governed primarily by the laws of the jurisdiction(s) in which the latter are domiciled.

What this section examines is the possible impact on U.S. policyholders and creditors of the restructuring of a non-U.S. insurer or reinsurer outside the U.S. The restructuring of a non-US insurer or reinsurer may be governed simultaneously by the laws of several jurisdictions. For example, as Solvency II becomes the norm in the European Union (EU), an insurer or reinsurer doing business in many member jurisdictions may be subject to their various laws to varying degrees. However, the jurisdiction in which the parent is domiciled (or the Group Supervisor, if different) may be particularly influential even over the fate of subsidiaries in other jurisdictions. The continued evolution of group supervision as an integral part of Solvency II is likely to enhance the influence of the parent's domicile. Less predictable will be the management of restructuring of insurers doing business simultaneously in EU and non-EU jurisdictions. There remains a wide disparity in the core principles underlying insurance regulatory systems throughout the globe, some attributable to the pace of economic development, others to fundamental cultural differences, and still others to specific national public policies.

This section endeavors to identify the key considerations that should be evaluated from the perspective of U.S. policyholders and creditors when their non-U.S. insurer or reinsurer is restructured. It seeks also to provide a sampling of illustrations of how those considerations might evolve in specific circumstances. Pre-purchase evaluation of how these considerations are addressed in a particular jurisdiction may enable the astute policyholder to avoid purchasing coverage that is apparently reliable but for which there is little effective protection upon restructuring.

2. Potential Advantages And Risks Of Restructuring Mechanisms

In many non-U.S. jurisdictions mechanisms are available for the restructuring of insurers and reinsurers short of formal rehabilitation or liquidation proceedings. A distinction should be drawn between restructuring in the face of potential insolvency (the focus of this paper) and restructuring as a business strategy not in response to immediate solvency concerns. In the latter case, there is little justification for compromising policyholder interests and regulatory schemes typically do not permit that result. It is in the face of a potential insolvency that restructuring can present a meaningful dilemma.

On the one hand, restructuring mechanisms can be advantageous when compared to rehabilitation or liquidation proceedings in three key respects.

a. Such mechanisms typically offer at least a realistic prospect of a faster resolution of the underlying financial challenge;

b. Often, these mechanisms are cheaper and therefore consume fewer scarce resources in the implementation of the process itself; and

c. Often these mechanisms serve to preserve coverage that might otherwise have to be terminated in the context of formal proceedings.

On the other hand, there can be some serious draw-backs in these alternative schemes. The next subsection considers key factors in more detail. However, the principal concerns that may arise in the context of these alternatives include:

d. Reduced regulatory and judicial oversight resulting in diminished policyholder protection;

e. Greater likelihood that policyholder interests will be compromised for the sake of other constituencies such as owners, managers and other creditors; and

f. The probability that policyholders will have less influence in the process and a diminished ability to protect themselves from potentially adverse outcomes.

3. KEY CONSIDERATIONS

In the U.S., state insurance regulators are accustomed to the fundamental principle that the interests of policyholders (used here as including insureds), especially consumers, should take precedence over those of unsecured non-policyholder creditors. This principle is not mandated in non-insurer bankruptcies in the U.S. and may not have the same importance in non-U.S. jurisdictions. It is helpful to identify the likely principal interests of policyholders (including insureds) as they may be affected in insurer restructuring.

In addition, this subsection will identify key considerations for reinsureds and creditors when a non-U.S. reinsurer restructures. The treatment of reinsureds is the primary consideration, however a proper restructuring plan will keep tax authorities and other creditors informed as well. While the nature of the reinsured/reinsurer (sometimes referred to as cedent and assuming company) relationship invokes many of the same key considerations, because typically reinsureds are sophisticated business entities rather than individual consumers, slight differences may arise.

a. RIGHT OF PAYMENT

Not surprisingly, the principal interest of policyholders is likely to be assurance that claims (perhaps including those for return of unearned premium) will be paid promptly and in full. With the arguable exception of continuation of coverage, it is likely that policyholders’ other interests (discussed below) are derivative of and ancillary to payment concerns.

The ability to obtain full payment of claims may turn on many factors, only some of which may be attributable to the nature of the proceeding. For example, the debtor’s financial condition will always be a key consideration, regardless of the nature of the proceeding. The nature of the claim will also be an important consideration. For example, policyholders making claims based on incurred but not reported losses (IBNR) must rely on actuarial estimates which can vary widely. Such policyholders face a risk that any payment under a restructuring plan would be insufficient to meet future liabilities. This section does not address such considerations which, however important, are unrelated to the nature of the proceeding or the regulatory or supervisory scheme under which it operates.

b. CONTINUATION OF COVERAGE

Under a variety of circumstances, it may be difficult for a policyholder to find acceptable coverage to replace that provided by the restructuring insurer. In the U.S. this interest is typically given more weight in the insurance rather than reinsurance context and in the case of life accident and health insurance than it is in the context of property and casualty insurance.

c. CLAIM PRIORITIES

As noted, we are accustomed in this country to the supremacy of policyholders over other unsecured creditors. This priority is critically important when available assets may not suffice to discharge fully all liabilities of the insurer. Of course, in insurer insolvencies, typically the category of general creditors includes most notably reinsureds. Thus, the interests of reinsureds and policyholders, treated as congruent in much of this section, may be very divergent in particular circumstances. Policyholder priority may not be observed as strictly, or at all, in other jurisdictions.

d. Guaranty Association Coverage

Over the last four decades the U.S. insurance sector has implemented nearly universal guaranty fund mechanisms providing at least basic protection for the insureds of most failed insurers. There are of course notable exceptions like health maintenance organizations, risk retention groups, surplus lines carriers and certain lines (separate account annuities, fiduciary bonds, etc.). in the main, however, this "safety net" serves to soften the impact of insurer failure and effectively provides a standard against which are measured the anticipated results of restructuring. Most non-U.S. jurisdictions have not implemented nearly as comprehensive an insolvency protection scheme. The guaranty association mechanism is typically not available to reinsureds in the U.S. or elsewhere.

e. Right to Vote

Although largely foreign to U.S. insurer restructuring and insolvency proceedings, in other jurisdictions, policyholders may have a right to vote on the restructuring plan. Most often, however, that right exists when the plan does not require that policyholder contracts be fulfilled in their entirety. In such plans, policyholders whose claims consist of incurred but not reported losses may have different rights from policyholders who have unsettled paid claims or outstanding losses.

f. Cram Down

In certain jurisdictions, it is possible for policyholders and reinsureds to be compelled to accept a restructuring plan that requires that they make economic concessions. The plan may require approval upon the votes of creditors or it may simply require regulatory or court approval. This should be contrasted with U.S. laws, which typically do not permit restructuring plans in which policyholders' interests are compromised for the benefit of non-policyholder creditors.

g. Voice In Replacement

The restructuring plan may entail coverages being transferred to other insurers or reinsurers with whom policyholders and reinsureds had no relationship. In some cases (including instances in the U.S.), policyholders and reinsureds may have little discretion in the transaction (except potentially non-payment of premium and forfeiture of coverage).

h. Transparency

The ability of creditors, including policyholders or reinsureds, to obtain information about the proceeding, and the financial factors upon which key decisions will be based, varies considerably from jurisdiction to jurisdiction. Access to relevant information, however, is often the essential first step in a policyholder's ability to protect his, her or its interest in a restructuring.

i. Accountability

The individual or entity responsible for managing the restructuring may be a private practitioner engaged by the restructuring entity's management, a group of creditors or a regulatory authority. Alternatively, the process may be placed in the hands of a public official. The degree to which the individual or entity in charge of the process is accountable to a superior or independent authority can be critically important in assuring the fairness and efficacy of the process. In those instances in which oversight consists principally of court supervision, the independence of the tribunal is important and so is the degree to which interested parties have access to that tribunal.

j. Regulatory Protection

In some jurisdictions (including the U.S.) statutory or common law (judicial decision) standards govern the manner in which an insurer may be restructured. They range from fundamental constitutional protections against the taking of property without due process to specific thresholds that must be satisfied before a Rehabilitation Plan can be approved. The availability of such protections <u>and</u> of viable enforcement mechanisms (such as an empowered administrative agency) are generally key to the prospect of a meaningful recovery or protection for policyholders and reinsureds.

k. Enforcement in the United States

Non-U.S. restructuring plans have been enforced by the U.S. courts under Chapter 15 of the United States Bankruptcy Code. Chapter 15 governs cross-border insolvencies and is a framework whereby representatives in corporate restructuring procedures outside the U.S. can obtain access to U.S. courts. Chapter 15 permits a U.S. bankruptcy court to cooperate with a foreign procedure in which assets and affairs of the debtors are "subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation." Recent Bankruptcy Act amendments resulting in the current form of this provision were intended in part to bring U.S. law into greater harmony with the provisions adopted by the United Nations Commission on International Trade Law ("UNCITRAL") and observed throughout much of the globe. Applicability of these rules can be complex and often commences with a determination of which jurisdiction's proceeding will control. The emerging trend is to defer to the jurisdiction in which lies the Center of Main Interest ("COMI"). However, it is important to note that the COMI may not necessarily be the domiciliary jurisdiction of the insolvent and that cases applying this principle sometimes reach puzzling results. While further discussion of these issues is beyond the scope of this section, the subject merits careful attention when applicable.

l. Standing To Appear

The ability to appear before the tribunal or agency conducting or overseeing the proceeding may be an important component of creditor protection. Of course, the fairness and impartiality of such tribunal or agency are of critical importance. Moreover, the right to appear may be far less important when the individual managing or overseeing the process is charged principally or in material part with protection of policyholders and reinsureds and takes that responsibility seriously.

m. Set-offs, Claims Acceleration and Estimation, Preferences, and Voidable Transfers

Insolvency proceedings can trigger a number of unique technical rules that are common in U.S. jurisdictions but may not receive the same treatment in other regimes. Among these are provisions that govern set-offs of claims and credits, acceleration and estimation of claims, when payments before commencement of a proceeding may be deemed to be reversible preferences, when such payments may constitute fraudulent or voidable transfers, and other such rules.

Illustrative is the issue of claims acceleration and estimation. Reinsurers have repeatedly expressed opposition to any system that could result in the accelerated and involuntary payment of their obligations based on any estimation of policyholder claims. Reinsurers oppose compelled payment of reinsurance recoverables based on IBNR on the basis that they are theoretical losses with theoretical values allocated in a theoretical fashion. Because reinsurance is a contract of indemnity, reinsurers assert that they cannot be required to pay losses, such as incurred by not reported losses, which are unidentified or unknown.

While it is beyond the scope of this section to consider the details of each of these "technical" issues, it is important for the affected party to identify those that may be important in the particular case and determine how they are addressed in the specific proceeding. It should be noted that the application of these rules may not always be immediately evident. For example, if only part of a company's business is subject to the restructuring plan, reinsurers may be concerned that they will lose existing set-off rights. This concern by reinsurers may affect the ability of reinsureds to receive full payment.

n. POLITICS

Finally, it should never be forgotten that "all politics are local." In the U.S. the degree to which political considerations control an outcome is somewhat mitigated by cultural and legal constraints. These constraints, however, may not be as applicable in non-U.S. jurisdictions. Familiarity with the local environment is essential in order to avoid unpleasant surprises. And political considerations may not relate just to governmental entities – they may relate to the industry as well. Thus, for example where the reinsured is also a reinsurer it may be unwilling to help one of its potential competitors with a restructuring. The presence of existing disputes or investigations may also affect how a reinsured views a restructuring plan.

VI. CONCLUSION

Overall, although alternative mechanisms for troubled insurers can provide cost savings or greater efficiency over the current system, these mechanism can also pose unique risks for consumers and require specialized surveillance monitoring, practices, and procedures, particularly where the activities may occur outside of court supervised receivership proceedings. In this context, regulators are encouraged to consider implementing standards and best practices responsive to these risks in order to preserve important consumer protections, increase transparency, and provide appropriate procedural safeguards.

First and foremost, it is the responsibility of regulators to protect insurance consumers. Thus, proponents of alternative mechanisms for troubled insurers should be pressed to prove to the regulator's satisfaction that the claims of greater efficiency or flexibility will not be used to strip policyholders and claimants of their policy rights so that value can be returned to investors. And regulators should ensure all alternative mechanisms for troubled insurers place the interests of consumers ahead of other competing interests, coupled with a clear statement of goals and objectives and a meaningful oversight mechanism.

VII. APPENDIX

A. CASE STUDIES

This Chapter describes troubled insurance company situations to illustrate some of the alternative concepts and techniques discussed earlier in this paper. The names of the insurers have intentionally been omitted. These case studies are not intended to reveal all problems or situations that may arise during the restructuring of a troubled reinsurance company. Additionally, the proposed actions with respect to the subject company may not be appropriate in all jurisdictions in light of changing market conditions and the possible differences in statutes, regulations, and implementing tools and resources.

1. RESTRUCTURED TROUBLED REINSURANCE COMPANY

Company characteristics, circumstances, and concerns:
- A property-casualty reinsurance company (treaty and individual risk basis);
- Primary reinsured lines included allied lines, commercial multiple peril, accident & health; workers' compensation, liability, and non-proportional reinsurance;
- Immediate parent and primary reinsurer of a direct property-casualty insurer;
- Non-U.S. ultimate parent; and
- Parent refused to provide further financial support to its subsidiary.

BACKGROUND. Restructured Troubled Reinsurance Company ("RTRC") was an established property-casualty reinsurer that appeared to be reporting significantly improving financials since two years earlier, accomplished through active re-underwriting and non-renewal of underperforming business. RTRC was a large reinsurer licensed or accredited in 27 states. Growth was moderate over the years, and the company remained adequately capitalized until significant adverse development constrained resources. Almost all property-casualty lines of reinsurance were written by RTRC with primary focus on workers' compensation, accident & health, liability, and proportional reinsurance. The group restructured through a series of transactions and separated its third-party assumed reinsurance business into an independent corporate structure. RTRC received a surplus note contribution from its ultimate parent that provided for semi-annual interest payments.

CAUSES OF TROUBLE. The Insurance Department (the "Department") had no information immediately on hand that would have raised a question regarding the solvency of RTRC. The financial statements reported much improved underwriting results as well as ratios that were also continuing to show improvement. Approximately six months after the financial examination, but a few months prior to the restructuring, management met with the Department to discuss the rising amount of reinsurance recoverable related to its "Unicover" business. RTRC conducted a detailed internal review of its prior years' U.S. casualty business and found that significant reserve strengthening was necessary in its general liability and specialty liability lines causing a substantial surplus strain and the triggering of the Department's hazardous financial condition regulation.

PRELIMINARY ACTIONS. The Department had several telephone conferences with RTRC management whereby we were informed that a capital contribution from its ultimate parent would be forthcoming as a result of the significant adverse development discussed above. Management then contacted the

Department for a meeting on the premise that the Chairman was in town and wanted a face-to-face meeting to discuss what was going on at the group. During that meeting, the Department was informed RTRC and its direct subsidiary would be placed in run-off and neither would a capital infusion as originally discussed. A firm was hired by RTRC's parent to assist in the development of a strategic plan for a solvent run-off.

CORRECTIVE ACTIONS. The Department sought to institute more rigorous financial monitoring. RTRC entered into a confidential letter agreement ("Agreement") with the Department that required the Department's approval prior to, among other things, making any material changes to management; moving books and records; making any withdrawals from bank accounts outside the ordinary course of business; incurring any debt; writing or assuming any new business or making dividend payments or other distributions. It also provided that the Department would receive a monthly report of commutation activity (which as can be seen below was the bedrock of the run-off plan); a copy of the final reserve analysis report prepared by an outside firm; and any additional reports the Department reasonably determined was necessary to monitor the financial condition. Finally, the Agreement provided that senior management would meet with Department staff, in person or by conference call weekly.

RTRC hired outside actuaries to conduct an external audit. In addition to the reserve strengthening was a non-admission of its deferred tax asset.

A cash flow analysis was commissioned by the Department to conclude whether or not RTRC could, in fact, have a solvent run-off. RTRC developed a Business Plan/Run-off Plan (the "Plan") which combined commutations with expense cuts (staff and facilities reduction). Quarterly RBC filings were required. Employment levels were reduced commensurate with the Plan and a retention plan was implemented to help retain talented, necessary staff and management. Surplus note interest payments were disapproved. The Department requested NAIC staff to set up a conference call for regulators so we could inform states of the situation and provide them time to ask questions or air concerns.

Ultimately, a RBC Plan was approved by the Department. Subsequently, a revised Business Plan/Run-off Plan was filed and approved, and the Agreement was extended for an additional year.

As commutations continued and improvements began to take hold, the company and its subsidiary were eventually sold. A new plan was developed as under new ownership with substantial resources, emphasis was no longer on an aggressive commutation strategy but was now on an aggressive asset management strategy. Monthly calls with management were temporarily put into place to ensure the Department would be aware of any changing circumstance. A less restrictive Agreement was implemented as the Department was more comfortable with the possibility of a positive outcome. Ultimately, the subsidiary was again sold – another positive development for RTRC. The frequency of reserve reporting was reduced to an annual basis as long as there was no change in Chief Actuary and RTRC was released from the Agreement.

2. NEW YORK REGULATION 141 PLAN

Company characteristics, circumstances, and concerns:

- professional property and casualty reinsurers and insurers that write such business and also assume reinsurance of property and casualty business;
- all property and casualty lines, but not life business;

- member of a holding company group or stand-alone entity; and
- other members of the holding company would not or could not provide further financial help.

BACKGROUND. ABC Reinsurance Company ("ABC") was a professional reinsurer incorporated in New York in 1977. ABC became capital impaired and ceased underwriting in 1985. ABC's management sought approval to commute certain assumed contracts, but the New York Superintendent of Insurance maintained that these commutations would prefer certain creditors over others and that the Superintendent lacked statutory authority to approve such commutations under then-existing New York Insurance Laws.

CAUSES OF TROUBLE. The parent company refused to add capital. The Department, lacking the authority to authorize the commutations, moved to place ABC in rehabilitation pursuant to New York Insurance Law Article 74. In 1987, the Superintendent moved in Supreme Court, New York County ("Court"), for an order of liquidation. ABC remained in liquidation until 1992.

During those five years, ABC's liquidator approved some cedents' claims, but paid none. In 1990, however, the New York Insurance Department introduced, and the legislature adopted, an amendment of NYIL 1321 to permit an impaired or insolvent New York insurer to commute reinsurance agreements and, with the Superintendent's approval, eliminate the risk that those agreements could be avoidable as a preference.

In May 1992, the Superintendent, in his role as ABC's liquidator, petitioned the court to approve a plan of reorganization based on a 100% quota share of ABC's portfolio of outstanding losses on all business that ABC wrote before its liquidation. XYZ Reinsurance Company of New York ("XYZ") proposed the reorganization plan and provided the reinsurance cover.

After a July 1992 hearing, the court approved ABC's reorganization plan and entered a final order and judgment that terminated the liquidation proceeding. The XYZ quota share contained a $305 million limit and an expansion of the quota share's limit that expanded based on a formula that included, among other things, paid losses, reinsurance recoveries, and interest income. ABC resumed operations with new directors and officers, but the plan also provided for a manager to administer ABC's run-off.

When the Superintendent petitioned the court in 1992 to approve the reorganization plan, ABC's projected liabilities were, as of December 31, 1990, $295.3 million. By 1993, ABC and its quota share reinsurer had paid more than $302.8 million to its ceding insurers. In 2002, ABC substantially increased its asbestos-related IBNR reserves, as did much of the industry. As reported on its 2002 annual statement, ABC's capital became impaired by more than $12,700,000.

PRELIMINARY ACTIONS. As a result of its 2002 impairment and pursuant to New York Insurance Law § 1321 and Insurance Regulation 141 (11 NYCRR Part 128) ("Regulation 141"), ABC submitted to the New York Insurance Department a plan to eliminate capital impairment pursuant to Regulation 141 ("141 Plan"). As required under Regulation 141, ABC's board and the company's sole shareholder stipulated that if ABC's implementation of the Regulation 141 Plan failed to restore ABC's surplus to policyholders to the minimum required as determined in accordance with Regulation 141, ABC would not oppose a petition to again liquidate the company pursuant to New York Insurance Law Article 74.

Under Regulation 141, no commutation of ABC's assumed reinsurance could become effective, and no consideration for any such commutation agreement could be paid until the Superintendent determined that a sufficient number of fully-executed commutation agreements have been returned to restore ABC's surplus to the required minimum (11 NYCRR § 128.5). Regulation 141 also required that ABC provide the Superintendent with copies of all e-mail, correspondence, and other communications between ABC and its ceding insurers relating to the current Regulation 141 commutation offers, including any e-mail, correspondence, or other communications rejecting the offer.

The proposed 141 Plan and Regulation 141 also required that ABC offer the same, non-negotiable commutation terms to all of its ceding companies. The 141 Plan further required that an offer to commute reinsurance agreements be made to every ceding insurer for which ABC had paid losses and LAE ("Paid Losses") or known case losses and LAE ("Case Reserves") on its books as of June 30, 2003.

Under its Regulation 141 Plan, ABC offered to pay 100% of Paid Losses and 60% of Case Reserves to commute obligations under the reinsurance agreements. Cedents were required to respond to this offer within 90 days.

CORRECTIVE ACTIONS. In January 2004, the Superintendent approved the 141 Plan and allowed ABC to extend commutation offers to its cedents. Shortly thereafter, ABC mailed commutation offers pursuant to the Plan to about 580 cedents. In October, ABC delivered to the Superintendent more than 300 executed commutation agreements along with copies of all correspondence with cedents relating to the Plan. The Superintendent subsequently determined that these commutation agreements would, upon his approval, eliminate ABC's impairment.

With the Superintendent's approval, ABC paid $22,558,221 to those ceding insurers that accepted its Regulation 141 commutation offers. The post-Plan ABC balance sheet showed a positive surplus of $3,675,366 and the elimination of its 2002 impairment.

The completed Regulation 141 Plan left ABC with many cedents. No cedents were compelled to accept the 141 commutation offers, and the Superintendent's approval of the Plan was premised on ABC's sufficient surplus to policyholders to complete its run-off. At the same time, Regulation 141 gave the Superintendent the statutory authority to permit commutation with a troubled company – avoid a protracted receivership – while also respecting every cedent's right to reject the proposed commutation offers and run the risk that ABC would lack sufficient capital to complete its run-off.

3. COMMERCIAL INSURANCE COMPANY RUN-OFF

Company characteristics, circumstances, and concerns:

- A property-casualty insurance company, writing primarily commercial lines on a national basis;
- Primary lines included commercial multiple peril, accident & health, workers' compensation, general liability;
- Member of a large multinational property-casualty insurance and reinsurance group with a non-U.S. ultimate parent; and
- Parent sought to provide sufficient capital support to its subsidiary.

BACKGROUND. Restructured Troubled Insurance Company ("RTIC") was an established property-casualty insurer pursuing a business model outsourcing most of its underwriting and claims functions to

Managing General Agents and Third Party Administrators, respectively. RTIC was licensed and operated in 50 states and wrote directly and through six subsidiary companies. The company had been operating for over 50 years and independent for approximately six years prior to being purchased by its current parent. Following the acquisition, RTIC pursued a modified business strategy for three years before being placed into run-off. RTIC wrote most lines of commercial liability insurance with primary focus on workers' compensation, accident & health, and general liability insurance.

CAUSES OF TROUBLE. Although the parent company installed new management and sought to reverse the business decline at RTIC following the acquisition, continued underwriting losses and adverse development from past years resulted in a ratings downgrade at the company. In addition, the California Insurance Department (the "Department") had been monitoring RTIC for some time due to the poor underwriting results and concern over the company's capitalization. The parent determined that the business model for the company was not appropriate for the then-current market and was not likely to result in a return to profitable business for the company. The parent also determined that the profitable lines of business RTIC was writing could be pursued through restructured and separately capitalized subsidiary companies while the potential for continued adverse development in certain lines, particularly workers' compensation, written by RTIC would require substantial new capital for RTIC to regain its ratings. Accordingly, the parent determined to place RTIC into run-off.

PRELIMINARY ACTIONS. The parent developed a run-off plan that called for the capital and operational restructuring of RTIC. Representatives of the parent, RTIC, and the run-off manager met with the Department to present a detailed plan for RTIC in run-off. The plan included a restructured capital base intended to provide sufficient flexibility and liquidity for the run-off. A principal component of this restructuring was the merger of a subsidiary of the parent already in run-off into RTIC. This contributed company had been in solvent run-off for a number of years and held sufficient excess capital to support RTIC in run-off. The resulting merged entity was to be placed under the management team of the contributed company, a dedicated professional team with ten years of experience in the operation of run-off companies.

Over the course of a three-month period, the Department and the company representatives met frequently to refine the run-off plan. The Department was receptive to a solvent run-off under the control of the parent provided that the parent could demonstrate sufficient capitalization within RTIC, the establishment of certain financial standards for RTIC and enhanced financial and operational reporting by the company. Upon approval by the Department of the run-off plan and the merger, RTIC was formally placed in run-off.

CORRECTIVE ACTIONS. The Department, the parent, and RTIC entered into an agreement that required the RTIC to maintain a minimum RBC standard of 200%, a net-reserves-to-surplus ratio of no greater than 3 to 1, and a specified minimum surplus amount. The parent guaranteed that RTIC would meet these standards. RTIC also agreed to provide frequent and detailed reporting to the Department on the progress of the run-off.

Based upon the company's actuarial analysis and a separate review by the Department, RTIC strengthened reserves in certain lines. The run-off plan also included a restructuring of the capital of RTIC which, in addition to the merger included the contribution of a three-year term note from the parent ("Parent Note") to insure liquidity and sufficient capital, the transfer of the stock of certain affiliated companies from RTIC into a trust in favor of RTIC. Certain subsidiaries of RTIC were purchased by the parent to continue writing certain lines outside of the run-off. RTIC reduced staff, and certain operations were subsequently transferred directly to the run-off manager. A retention plan was created to help retain knowledgeable, talented staff and management for the run-off. RTIC met separately with the domestic regulators of its subsidiary insurance companies to inform them of the plan and obtain their approval where necessary. RTIC and the Department also coordinated with NAIC staff to inform all interested states of the situation at a regulator NAIC meeting and to provide regulators with the opportunity to ask questions or air concerns.

With the Department's agreement, RTIC began to terminate its MGA and most of its TPA agreements and assumed direct control of most of its claims. The company then began to aggressively settle claims, reduce its overall exposures, and to commute certain reinsurance contracts where protection was uncertain or disputed. The investment manager restructured RTIC's investment portfolio to better address the anticipated cash flow and capital requirements of the run-off.

PROGRESS OF THE RUN-OFF. The Department's cooperation with management and establishment of clear operating guidelines, the capital support at RTIC provided by the parent and singular focus of management on the satisfaction of RTIC's obligations and responsible management of the company's assets have resulted in a stable and successful run-off. Five years into the run-off, RTIC had reduced open claims by approximately 85%, reduced reserves by approximately 40%, and increased surplus by over 70%. The stabilization of RTIC, its successful execution of the run-off plan and gains in its investment portfolio have resulted in the Department's agreement to terminate the trust arrangements created for the affiliated company investments, deferral, and subsequent forgiveness of the third installment of the Parent Note and the return of excess capital from RTIC to the parent. RTIC continues to adhere to the established financial standards, maintaining a comfortable margin over the minimum requirements established by the Department. RTIC management and the Department continue to meet approximately quarterly to review the progress of the run-off.

4. RESTRUCTURED TROUBLED LONG-TERM CARE COMPANY

Company characteristics, circumstances, and concerns:

- A stock life, accident and health company;
- Part of a large national life and A&H group;
- Primary line of business is a closed block of predominately long-term care in force;
- Ceased writing new business five years prior to restructuring;
- Received large capital contributions from Parent for many years;
- Continuous premium rate increase requests;
- Adverse claim development and reserve strengthening; and
- Low RBC ratio.

BACKGROUND. Restructured Troubled Long-Term Care Company (the "Company") was a writer of predominately long-term care business, operating in most of the 46 states, D.C., and the U.S. Virgin Islands. It had held a firm niche position in the long-term care market with profitable operations and a conservative balance sheet. The long-term care block of business was written by the Company and its predecessor companies prior to being acquired by the Company in the 1990s.

CAUSES OF TROUBLE. Shortly after the acquisition of long-term care blocks in the 1990s, the Company reported a reserve deficiency. The Company phased in a new reserve valuation basis for long-term care policies, requested and implemented premium rate increases, and implemented tighter underwriting standards. The cause of trouble was underpricing and underreserving that became evident as the company experienced claim costs and utilization that exceeded expectations. The original pricing assumptions on long-term care assumed a 4% to 5% lapse rate while the actual lapse rate was only 1% to 2%. Additionally, the Company's investment return assumptions were much higher than actual returns.

Over the course of more than a dozen years, the Company received capital contributions to offset losses. The Company reported an increasingly larger reserve deficiency each year from 1998 to 2007, several years in excess of $100 million deficient. The Company reported net losses in each year from 1997 to 2007.

PRELIMINARY ACTIONS. In 2003, Company management decided to stop marketing insurance products and to place the Company in run-off. The insurance department began monitoring the Company monthly and meeting with Company management on a quarterly basis as a result of continued poor operating performance, reserve deficiencies, and multi-year rate increase requests. A study was conducted of the Company's incurred claims experience. As a result, the Company updated the claim cost assumptions underlying the contract reserves and unearned premium reserves for the long-term care policies. The change was made using the "pivot" method such that the change in claim costs would be accrued into the reserve balance over time. Multiple premium rate increases were sought. Over the course of 15 years the Company received over $900 million in capital contributions from the parent. The parent company indicated that no future capital contributions would be forthcoming.

The Company also came under scrutiny for market conduct issues including claims administration and complaint handling practices. The Company underwent a market conduct examination to get a further understanding of the market conduct problems within the Company and as a result, a settlement agreement was reached and recommendations for corrective measures were made and an improvement plan was developed. The settlement included a monetary penalty for violations; a contingent penalty for non-compliance with improvements including systems upgrades and improved claims administration; and restitution and remediation regarding the reevaluation of denied claims.

CORRECTIVE ACTIONS. With the approval of the insurance department, the Company's parent transferred the stock of the Company to a non-profit independent trust. In connection with the transfer, the parent contributed additional capital to the Company to fund future operating expenses. The capital was in the form of senior notes payable, invested assets, cash, and the forgiveness of unpaid dividends. The trust is intended to operate the Company for the exclusive benefit of the long-term care policyholders, without a profit motive. It is governed by a board of trustees under the oversight of the insurance department, as outlined in the Form A Acquisition Order.

5. LIABILITY OF INSURERS TRANSFERRED TO THIRD PARTY – EUROPE

BACKGROUND. The European market is a provider of insurance and reinsurance to insureds and cedents worldwide.

Events that took place in Europe during the 1990's provide an example of an extreme case of a market coming to the brink of collapse, only to be saved by a series of transactions which were simple in concept but, of necessity, very complex in their implementation. Those transactions amounted to what has become a famous event in the history of insurance. Most recently the final transaction took place which had the effect of removing the outstanding liabilities of the re/insurers in question.

CAUSES OF TROUBLE. In the early 1990s there was an unexpected, huge increase in long-tail liability claims (typically asbestos, pollution and health hazard) made against certain European market insurers. Many of these insurers faced collapse as the liabilities swamping the market and the difficulty in estimating the IBNR and calculating an appropriate reinsurance premium, were so great. The effect of was that several troubled European insurers were without protection and remained exposed to the incoming claims.

CORRECTIVE ACTIONS. The situation was so dire that immense efforts were made to bring about a solution. One solution, in particular, allowed certain troubled European insurers to pay a premium (which varied according to exposure) and have all the liabilities for the exposed years 1992 and earlier to be reinsured by a specially formed company, ABC Reinsurer. Claims handling and all other aspects of the run-off were transferred to XYZ insurer (a wholly owned subsidiary of ABC Reinsurer). XYZ also reinsured ABC Reinsurer under a retrocession agreement. Certain rights of the original troubled insurers as reinsureds of ABC Reinsurer were held on trust for policy holders: in this way, the benefit of all reinsurance recoveries were applied in paying the liabilities due to policyholders. The intervening ten years to 2006 found XYZ working to plan with a controlled programme of inwards and outwards commutations as a means of dealing with the run off of these liabilities. In all practicality the original troubled insurers had finality, i.e. they were no longer financially exposed personally so long as XYZ remained solvent. However, as a matter of law, they did remain personally liable to policyholders for any excess liability over and above that paid by XYZ.

By early 2006, the market in the purchase of portfolios in run off had taken off. XYZ was the world's largest business in run off, so large that the number of likely purchasers was very limited. However, fortunately by the end of 2006, the two stage deal with a large conglomerate, XOX, was announced, the stages being:

1) XYZ retroceded to XOX’s subsidiary, BOB, its liabilities to ABC Reinsurer arising under the agreement. Cover was limited to approximately US $6 billion over and above existing reserves as at March 2006 of approximately US $9 billion. The premium was all of XYZ's assets less approximately US $340 million plus a US $145 million contribution from some of the original troubled insurers. Staff and operations were transferred to another XOX subsidiary, RRR.
2) A "Part VII transfer" of all the liabilities of the original troubled European insurers (and the protection of the ABC Reinsurer-XYZ- BOB reinsurance chain) to a third party company. Provided the transfer were to take place before December 2009, XYZ would be entitled to purchase further reinsurance from BOB of up to US $1.3 billion if XYZ's net undiscounted reserves had not deteriorated by more than US $2 billion from their 31 March 2006 position.

Part VII of the UK Financial Services & Markets Act 2000 (FSMA) provides a statutory novation of business (i.e. reinsureds' obligations to their policyholders) by a transferor re/insurer to the transferee re/insurer provided that strict procedures are complied with. The novation is effected by court order. The court order has the effect of vesting the transferor's business in the transferee without the need for consent of the policy holders/reinsureds. The court can and usually does order assets attributable to the underlying business to be transferred i.e. including the outwards reinsurance contracts. There are strict definitions of business which are subjected to a Part VII transfer. Put broadly it applies to transfers of business carried on in the UK or elsewhere within the European Economic Area (EEA) with a UK connection as defined and where the transferred business is to be carried on from an establishment of a transferee in an EEA State. There are various conditions and exclusions.

The unusual position of these particular re/insurers, should they wish to avail themselves of Part VII, was recognised at the time Part VII first became law. However, additional changes to the legislation had to be made to facilitate this transaction and they became law in 2008. In particular the Part VII provisions in the FSMA were extended to a further cohort of these particular re/insurers .

Under the Part VII transfer procedure there are two court applications. The first gives directions as to notices to be served and other technical requirements allowing any opposing reinsureds or indeed outwards reinsurers to object to the transfer. In the case of the XYZ Part VII, certain requirements were dispensed with taking into account the high volume of notices which would have to be given to individual names and other relevant parties. An essential part of the procedure is the report provided by an independent expert whose identity is approved by the Financial Services Authority (FSA). Furthermore, the FSA itself provides a report indicating its views and it is made available to those interested in the transfer. Time is allowed for any objectors to produce their own case in the context of the independent expert report and the FSA's report. In the case of the XYZ transfer, the FSA indicated that it would not object to the transfer.

The second and final stage of the process is the application for sanction by the court. The court has discretion whether to sanction the transfer scheme but may not do so unless it considers that, in all the circumstances of the case, it is appropriate to do so. Under case law on the statutory provisions the court is concerned as to whether a policyholder, employee or other interested person or any of them will be adversely affected by the transfer scheme. The hearing took place in mid-year 2009 and the judge concluded that the Part VII transfer scheme should go ahead. .

During the hearing the judge was satisfied that other requirements protecting policy holders of the business being transferred had been fulfilled such as that certificates of solvency for the transferee company were obtained confirming the adequacy of the transferee's solvency for the purpose. Presentations had been carried out in the UK and in the jurisdiction of XOX to transferring policy holders, the original troubled insurers and their representatives explaining the import of the transfer. Help lines and a website had been set up. Numerous telephone calls, emails or letters had been sent in response by the Part VII advisers with less than 10 persons raising substantive issues.

ENFORCEMENT IN OTHER JURISDICTIONS. Part VII of the FMSA originates from EU Directives. The sanction order is thereby recognized throughout the EEA. A further step would be needed to ensure enforcement in the United States and other countries where policyholders were located. However, the shape of the scheme is such that enforcement in the United States and other jurisdictions is most probably unnecessary. Policy holders would be entitled to drawdown on trust funds located in the United States, Canada, Australia and South Africa providing them with security for amounts accruing due to them over time should there be any default payment.

PROGRESS. With the sanction of this transfer scheme granted during mid-year 2009, the two stage transaction provided by the XOX group was completed in time. Because the transfer has been affected prior to December 2009, it is believed the further amount of US $1.3 billion reinsurance cover will be available to secure payment in future of all policy holders claims.

B. SAMPLE DOCUMENTS

1. SAMPLE SUPERVISION CONSENT ORDER

--	§	
In the Matter of:	§	
	§	
The Administrative Supervision of	§	
RESTRUCTURED TROUBLED	§	
REINSURANCE CORPORATION, a	§	Docket No. EX xx-xx Connecticut domiciled
property and casualty insurance company.	§	
--	§	

CONSENT ORDER

This Consent Order is entered into by and between Restructured Troubled Reinsurance Corporation ("RTRC") and the Insurance Commissioner of the State of Connecticut (the "Commissioner") to provide supervision and regulatory oversight of RTRC in the run-off of its insurance and reinsurance obligations in force.

WHEREAS, the Commissioner hereby finds, and RTRC agrees, as follows:

1. The Commissioner has jurisdiction over the subject matter and of RTRC.

2. RTRC is a Connecticut-domiciled property and casualty insurer and reinsurance company having its principal office at XXX Street, Anywhere, XX 00000, and holds a certificate of authority to transact the business of insurance and reinsurance in Connecticut and is licensed or accredited in a number of other states.

3. RTRC is a wholly-owned direct subsidiary of Restructured Troubled Corporation ("RTC"), a Delaware corporation and an indirect subsidiary of Restructured Troubled (Barbados) Ltd., a Barbados corporation which is a wholly-owned direct subsidiary of Restructured Troubled Group Ltd. ("RTG"), a Bermuda corporation.

4. Due to the significant deterioration of RTG's financial condition in 20XX, on December 3, 20XX, RTRC entered into a "letter of understanding" with the Connecticut Insurance Department ("Department") as part of the Department's continuing financial monitoring of RTRC pursuant to which RTRC agreed that it would not take certain actions without the prior written approval of the Connecticut Insurance Commissioner or her designee, including, among others, disposing of any assets, settling any intercompany balances or paying any dividends.

5. RTRC has submitted to the Department a risk-based capital report, (the "RBC Report") pursuant to CONN. AGENCIES REGS. § 38a-72-2. The RBC Report indicates that RTRC was at the "Regulatory Action Level Event" as of December 31, 20XX. On July 30, 20XX, RTRC filed with the Department an updated RBC Report which estimates that RTRC was at the "Authorized Control Level Event" as of June 30, 20XX.

6. RTRC has ceased underwriting activities and has determined that it is in the best interests of its policyholders and creditors to run-off the existing operations of RTRC in such a manner as would maximize the availability of funds to satisfy the interests of policyholders, creditors, and other constituents.

7. RTRC has retained the services of a firm with expertise and experience in run-off management to review the operations of RTRC and its subsidiaries in run-off, to supplement its internal resources, and to accelerate the successful completion of the run-off, all pursuant to a comprehensive run-off plan (including therein, among other items, a plan to effectuate commutation of existing reinsurance obligations), the run-off management consultant will develop and submit, along with a more extensive run-off engagement agreement retaining their services to manage the run-off, to the RTRC Board of Directors for approval and, if such plan and agreement are approved, to the Commissioner, creditors of RTC, and other constituencies for approval.

8. On April 15, 20XX, the Department commenced a targeted examination of the financial condition of RTRC pursuant to CONN. GEN. STAT. § 38a-14. The examination was called based on RTRC's submission of a Cash Flow Projection Model to demonstrate that RTRC has sufficient assets and cash flow to pay both claims and operating expenses as those obligations become due.

9. On August 20, 20XX, RTG and RTC filed for protection under Chapter 11 of Title 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware.

10. RTRC is in such condition that regulatory control of the insurer is appropriate to help safeguard its financial security and is in the best interests of the policyholders and creditors of the insurer and of the public as RTRC administers the run-off of its existing business.

IT IS THEREFORE ORDERED AND AGREED THAT:

11. RTRC hereby consents to and shall be placed under the administrative supervision of the Commissioner pursuant to CONN. GEN. STAT. § 38a-962b and under the terms herein.

12. RTRC hereby knowingly and voluntarily waives receipt of written notice under CONN. GEN. STAT. § 38a-962b of grounds for the Commissioner to effectuate administrative supervision by the Commissioner.

13. The period of administrative supervision by the Commissioner shall commence upon execution of this Consent Order. The period of supervision pursuant to this Consent Order shall be coterminous with the run-off of RTRC's existing business, unless the Commissioner takes action pursuant to Paragraph 27 hereof.

14. The determination that RTRC shall be subject to administrative supervision by the Commissioner may be abated and thereby released from administrative supervision by the Commissioner if RTRC complies with the orders of supervision provided herein and, during the period of supervision, RTRC shall have attained sufficient liquidity, surplus, and reserves necessary to exceed and maintain Company Action Level RBC, as defined in CONN. AGENCIES REGS. § 38a-72-1, or the

Commissioner in her sole discretion determines the supervision of RTRC is no longer necessary for the protection of policyholders, claimants, creditors, or is no longer in the public interest.

15. During the period of supervision, RTRC shall not undertake, engage in, commit to accept, or renew any insurance obligations including without limitation, insurance or reinsurance policies or any similar arrangements or agreements of indemnity or, without the prior written approval of the Commissioner, make any material change in any insurance or reinsurance agreement which would increase the financial obligations of RTRC in any material respect. Moreover, RTRC shall not engage in activities beyond those that are routine in the day-to-day conduct of its business in run-off and are otherwise consistent with its comprehensive business run-off plan ("Run-off Plan") to be filed with, and found acceptable by, the Commissioner, without the prior approval of the Commissioner or her designee. The routine day-to-day conduct of RTRC's business in run-off includes but is not limited to: (a) paying claims and operating expenses as such obligations become due and in accordance with the applicable law and the settlement and commutation of claims and insurance and reinsurance obligations, unless otherwise provided in the following paragraph or otherwise directed or approved by the Commissioner or her designee; (b) defending RTRC and persons insured or claiming to be insured by RTRC against claims arising from or related to insurance policies and reinsurance agreements previously issued, assumed, or ceded by RTRC; (c) settling or otherwise resolving or attempting to adjust and resolve such claims; (d) engaging, directing, discharging, and compensating counsel (including reasonable costs incurred) with respect to such claims or other matters; (e) paying settlements or judgments with respect to such claims; and (f) investing the assets of RTRC and liquidating such assets in an appropriate manner as required to pay claims, operating expenses, settlements, commutations, and other charges in the ordinary course of business and subject to the provisions of this Consent Order.

The routine day-to-day conduct of RTRC's business in run-off also includes but is not limited to: (a) submitting information to reinsurers with respect to RTRC's reinsured losses and loss adjustment expenses; (b) advising reinsurers of all sums due to RTRC under their respective reinsurance contracts and treaties with RTRC (including settlement and commutation thereof, provided, however, that RTRC shall not enter into commutation of liabilities (either inward or outward including obligations of others to RTRC) or settlements of claims other than for amounts not in excess of $250,000 except as otherwise provided in the Run-off Plan or otherwise approved by the Commissioner or her designee); and (c) taking all actions necessary and appropriate to recover all sums due to RTRC from reinsurers and others.

The following activities, to the extent not necessary for the adjusting and payment of losses and expenses associated with claims adjusting and settlement or commutation of reinsurance agreements are understood to be outside the day-to-day conduct of RTRC's business in run-off, and in no event shall RTRC engage in or undertake the following activities without the prior approval of the Commissioner or her designee:

(a) Dispose of, convey, or encumber any of its assets or its business in force;
(b) Withdraw any of its bank accounts;
(c) Lend any of its funds;
(d) Invest any of its funds;
(e) Transfer any of its property;
(f) Incur any debt, obligation, or liability;

(g) Merge or consolidate with another company;
(h) Write new or renewal business,
(i) Enter into any new reinsurance contract or treaty;
(j) Terminate, surrender, forfeit, convert, or lapse any insurance policy, certificate, or contract, except for nonpayment of premiums due;
(k) Release, pay, or refund premium deposits, unearned premiums, or other reserves on any insurance policy, certificate, or contract.
(l) Make any material change in management; or
(m) Increase salaries and benefits of officers or directors or the preferential payment of bonuses, dividends or other payments deemed preferential.

RTRC shall make a recommendation with the reasons therefor in writing to obtain the prior approval of the Commissioner as to any of the foregoing actions.

16. The Commissioner shall have the final authority to approve or disapprove the initiation, settlement, or withdrawal by RTRC of any action, dispute, arbitration, litigation, or proceeding of any kind involving RTRC that is not in the ordinary course of business or would require payment in excess of $250,000. RTRC shall prepare a written report to the Commissioner with a recommendation for approval or disapproval with the reasons therefor.

17. Without the prior written approval of the Commissioner, RTRC shall not (i) add any individual who is not currently a senior executive officer of RTRC, or one of its affiliates, to the board of directors of RTRC or (ii) move the principal offices or records of RTRC to a location outside of Connecticut.

18. RTRC shall file with the Department a monthly financial statement consisting of a balance sheet and income statement on the 25th day of each month as of the end of the prior month.

19. At least annually, RTRC shall submit an actuarial analysis prepared by a qualified actuary as defined in CONN. AGENCIES REGS. § 38a-53-1 of the loss and loss adjustment expense reserves.

20. RTRC shall submit a report on a quarterly basis containing detailed information on all commutations of reinsurance treaties and related activities which have occurred year-to-date, including specific impact on RTRC's statutory financial statement.

21. RTRC shall submit to the Department any additional reports that the Department reasonably determines as necessary to ascertain the financial condition of RTRC.

22. RTRC shall submit any and all reports or items required by this Consent Order, and all requests for the Commissioner's action or approval to:

______________________ (name)
Connecticut Insurance Department
P.O. Box 816
Hartford, Connecticut 06142-0816
(860) 297-3823
(860) 566-7410 FAX

23. The Commissioner may retain, at RTRC's expense, such experts (including, but not limited to, attorneys, actuaries, accountants, and investment advisors) not otherwise a part of the Commissioner's staff, as the Commissioner reasonably believes is necessary to assist in the supervision of RTRC.

24. RTRC hereby knowingly and voluntarily waives all rights of any kind to challenge or to contest this Consent Order, in any forum now available to it, including the right to any administrative appeal pursuant to CONN. GEN. STAT. § 4-183.

25. This Consent Order of supervision, and proceedings, hearings, notices, correspondence, reports, records and other information in the possession of the Commissioner or the Department relating to the administrative supervision by the Commissioner of RTRC are subject to the confidentiality provisions of CONN. GEN. STAT. § 38a-962c and § 38a-8.

26. RTRC shall continue to comply with all obligations under law, including applicable financial, regulatory, and tax reporting requirements.

27. Nothing in this Consent Order shall preclude the Commissioner from taking further action as the Commissioner in her sole discretion deems appropriate and in the best interest of RTRC's policyholders and the public, including commencement of further legal proceedings if and as necessary under Chapter 704c of the Connecticut General Statutes.

28. This Consent Order shall supersede in all respects the "letter of understanding" between RTRC and the Department referenced to in Paragraph 4 of this Consent Order, which letter shall have no further force and effect.

29. The Board of Directors of RTRC, at a specially called meeting or by unanimous written consent, has simultaneously, with the entry of this Consent Order, approved and provided resolutions complying with the terms of this Consent Order, which is effective upon entry of this Consent Order.

The foregoing Consent Order for Restructured Troubled Reinsurance Corporation is entered and shall be effective at 3:00 p.m. on this ________ day of September 20XX.

____
(name)
Insurance Commissioner

Agreed and Consented to by RESTRUCTURED TROUBLED REINSURANCE CORPORATION on this _______ day of September 20XX.

By:____
(name)
President

(Corporate Seal)

On this _____________ day of September 20XX, before me, the subscriber, personally appeared ______________________________, the President of Restructured Troubled Reinsurance Corporation, who I am satisfied is the person who has signed the preceding Consent Order, and he did acknowledge that he signed, sealed with the corporate seal, and delivered the same as such officer aforesaid and that the Consent Order is the voluntary act and deed of such company made by virtue of the authority vested in him by its Board of Directors.

____

(name), (Title)

2. SAMPLE REINSURER LETTER AGREEMENT

November , 20XX

President
Restructured Troubled Reinsurance Company
XXX Street
Anywhere, XX 00000

Dear ________:

The Any State Insurance Department ("Department") continues its financial monitoring of Restructured Troubled Reinsurance Corporation ("RTRC" or "Company").

The Company's parent, Restructured Troubled Group Ltd. ("RTG") reported an operating loss of $245 million for the third quarter of 2002 and an operating loss of $252.6 million for the first nine months of 2002. The loss resulted principally from approximately $100.7 million of loss reserve increases recorded by the operating subsidiaries and a $64.5 million loss related to the establishment of a deferred tax valuation reserve. The operating results for the first nine months of 20XX included approximately $33 million of loss development related to the September 11th terrorist attacks recorded in the first quarter of 20XX. On October 18, 20XX, A.M. Best Company lowered the ratings of the operating subsidiaries of RTG from A- to B+. Subsidiary Insurance Company was lowered from A- to B. The downgrade constituted an event of default under RTG's bank credit facility, under which banks had issued $336 million in letters of credit to support RTG's underwriting at its Lloyd's operation. On November 1, 20XX, with the approval of the Department, the Company entered into an Underwriting and Reinsurance Arrangement with Facility Re, Inc., whereby new business is underwritten by Facility Insurance Company, a member of the Facility Group. On November 14, 2002, A.M. Best again lowered the ratings of the operating subsidiaries of RTG from B+ to B-. Subsidiary Insurance Company was lowered from B to C++.

In order to protect the existing quality and integrity of RTRC's assets, reserves, and management to protect policyholders/reinsureds and the public, it is requested that the Company agree to the following:

1. RTRC shall not take any of the following actions without the prior written approval of the Insurance Commissioner or her designee:

    a. Dispose of, convey, or encumber any of its assets or its business in force;
    b. Withdraw any of its bank accounts except in the ordinary course of business;
    c. Settle any intercompany balances;
    d. Lend any of its funds;
    e. Transfer any of its property;
    f. Make any investments other than cash equivalents;

g. Incur any debt, obligation, or liability, except liabilities in the ordinary course of business;
h. Make any material change in management;
i. Make any material change in the operations of the Company;
j. Move any books and records from its office in Stamford, Connecticut;
k. Pay any dividends, ordinary or extraordinary;
l. Enter into any affiliated reinsurance contracts, affiliated commutation agreements, or settlement agreements;
m. Enter into any unaffiliated insurance or reinsurance contracts that would constitute new or renewal business, or any unaffiliated commutation agreements or settlement agreements in excess of $1 million not in the ordinary course of business; or
n. Enter into affiliated transactions of any nature.

2. Senior management shall meet with the Department, in person or by conference call, with such frequency as may be deemed necessary by the Insurance Commissioner or her designee, to provide updates on the status of the parent and any changes in the status of the Company.

3. A monthly financial statement consisting of a balance sheet and income statement shall be filed with the Department on the 25th day of each month as of the prior month end.

4. The above-described terms shall continue in effect until such time as the Insurance Commissioner shall deem they are no longer necessary or issues an order that supersedes this agreement.

5. RTRC acknowledges that nothing contained herein shall in any way limit any power or authority given the Insurance Commissioner under the laws of the State of Connecticut, including the right to initiate any further actions as she deems in her discretion to be necessary for the protection of RTRC's policyholders/reinsureds and the public.

I have enclosed two originals of this letter to your attention. Please sign and date both originals, retain one for your file, and return one executed original to me.

Sincerely,

________________, Chief Examiner
Financial Analysis & Compliance

AGREED TO this __________ day of November, 20XX, by a duly authorized representative of RTRC.

C. Sample Outline for Run-Off Plans

The following is a sample outline for a run-off plan.

I. Introductory Overview
   A. Executive Summary: providing an executive level summary of the history, current business conditions, recent significant transactions, and proposed Run-Off solution.
      1. Status
      2. Mission
      3. Business (Guiding) Principles
   B. Plan Objectives: describing the ability of the plan to fully and timely settle all valid policyholder claims in compliance with the liquidation priorities of state distribution scheme.
   C. Advantages
   D. Benefits
II. Corporate History
   A. Summary
   B. Recent Happenings: description of business plans, significant transactions, prior restructuring plans, and financial performance related thereto.
      1. Mergers & Acquisitions
      2. Employment
      3. Internal Growth
      4. External Factors
      5. Current Position
   C. Business Description: including a comprehensive description of organizational and corporate structure, lines of insurance, nature of policyholder and other risks, and claim-handling function associated with the run-off.
      1. Lines
      2. Programs
      3. Markets
   D. Reserve Development
      1. Environmental Issues
      2. Underwriting Issues
      3. Adverse Development
      4. Reserves by Line - Summary
   E. Financial Condition: Summary of recent financials.
      1. Summary
      2. Statutory Surplus
      3. Consolidated Financial Statement(s)
      4. Operating Expenses
         a. Staffing
         b. Insurance
         c. Real Estate
         d. Fixed Costs
         e. Information Technology
      5. Taxes
   F. Operations: Description and historical comparison of staffing, real estate, expenses, insurance and information technology and other pertinent operations associated with Run-Off.

1. Claims Handling
2. Reinsurance
   a. Outstanding Balances
   b. Disputes
   c. Solvency Issues
   d. Uncollectibles
   e. Write-offs
   f. Collateral
   g. Lines of Business
   h. Programs
   i. Processes & Systems

III. Run-off Plan: Description of Initiatives and Priorities-including demonstration of Run-Off Plan serving the best interests of policyholders and other claimants.

A. Summary
B. Financial Projections: including description of surplus enhancing initiatives and transactions, loss development, liquidity and expense projections.
   1. Key Factors
   2. Assumptions
   3. Revenues
   4. Expenses
   5. Surplus Projection
   6. Liquidity Projection
C. Initiatives
   1. Surplus Enhancing
      a. Policy Buybacks
      b. Expense Reductions
         i. Operating Expenses
            a. Staffing
            b. Real Estate
            c. Fixed Costs
            d. Insurance/Benefits
            e. Information Technology
         ii. Allocated Loss Adjustment Expenses
      c. Reinsurance Commutations
   2. Liquidity
      a. Asset Portfolio Assessment
      b. Encumbered Assets
      c. Unencumbered Assets
      d. Statutory Deposits
D. Risk Factors: Description and projection of risks associated with Run-Off plan, including regulatory concerns, preferences, and risks associated with policyholders, guaranty funds/associations, including identification of critical elements for plan success.
   1. Define Uncertainties
      a. Business
      b. Economic
      c. Regulatory
   2. Additional Adverse Loss Reserve Development

3. Increased Reinsurance Disputes
4. Unexpected Liabilities
5. Drastic Asset Value Changes
6. Financial Market – Investments

E. Voluntary Run-off vs. Receivership: Analysis and comparison between the alternative mechanisms from best interests of policyholders, claimants, and guaranty funds/associations.
F. Regulatory Reporting: Description of proposed regulatory supervision and reporting requirements. E.g., monthly statutory basis financial statements (balance sheet, statement of income and statement of cash flow), including comparison of actual results to Plan projections; quarterly reports demonstrating reinsurance recoverables and premium receivables past due, in dispute, litigation or arbitration; report demonstrating material credit exposures, related collateral held, and identity of credit impaired transactions; unpaid losses on state-by-state basis; weekly cash flow report; periodic review of loss reserves and amortization of any permitted loss reserve discounting, including appropriate actuarial certification; copies of all internal and external audit reports within five business days of issue; approval of all transactions exceeding pre-determined thresholds; and identification of prohibited transactions.
G. Corporate Governance: Description of proposed governance and internal controls.

D. RELEVANT NAIC MODEL LAWS & REGULATIONS AND STATE STATUTES

This appendix section provides current and relevant NAIC Model Laws and Regulations, as well as specific state statutes that pertain to an insurance department's authority and responsibilities in dealing with troubled insurers. The sections are not intended to be all-inclusive, rather, a reference source.

1. NAIC MODEL LAWS & REGULATIONS

- Administrative Supervision Model Act
- Insurers Receivership Model Act
- Model Regulation to Define Standards and Commissioners' Authority for Companies Deemed to be in a Hazardous Financial Condition
- Criminal Sanctions for Failure to Report Impairment Model Bill

2. RULES AND REGULATIONS OF THE STATE OF NEW YORK - TITLE 11 INSURANCE DEPARTMENT - CHAPTER IV FINANCIAL CONDITION OF INSURER AND REPORTS TO SUPERINTENDENT - SUBCHAPTER D REINSURANCE - PART 128 COMMUTATION OF REINSURANCE AGREEMENTS (REGULATION 141)

(Text is current through February 15, 2008.)

Section 128.0. Purpose.
Section 1321 of the Insurance Law authorizes the Superintendent of Insurance to permit an impaired or insolvent domestic insurer or an impaired or insolvent United States branch of an alien insurer entered through this state to commute reinsurance agreements as a means of eliminating such an impairment or insolvency. This Part sets forth applicable standards that the superintendent will use in determining whether such commutations will be approved.

Section 128.1. Applicability.
This Part shall be applicable to any domestic insurer or United States branch of an alien insurer entered through this state, other than a life insurance company as defined in section 107(a)(28) of the Insurance Law.

Section 128.3. General provisions.
(a) Nothing in this Part shall require the superintendent to give prior consideration to a plan which contains the commutation of reinsurance agreements in lieu of taking any other action against an impaired or insolvent insurer in accordance with the Insurance Law, including proceeding against such insurer pursuant to article 74 of the Insurance Law.
(b) All the terms and conditions of any plan which contains the commutation of reinsurance agreements are subject to approval by the superintendent and no such plan will be approved by the superintendent unless the effect of the plan shall eliminate the insurer's impairment or insolvency and restore the insurer's surplus to policyholders to the greater of the minimum amount required to be maintained pursuant to the applicable provisions of the Insurance Law or to the amount the superintendent determines is adequate in relation to the insurer's outstanding liabilities or financial needs. The determination regarding the adequacy of the insurer's surplus to policyholders shall be made in accordance with the factors set forth in section 1104(c) of the Insurance Law.

Section 128.4. Requirements.
(a) Any plan submitted by an impaired or insolvent insurer which contains the commutation of reinsurance agreements shall provide that:

(1) the offer to commute reinsurance agreements is made to each and every ceding insurer to which the impaired or insolvent insurer has obligations;
(2) the terms of the commutation agreement to be offered to each and every ceding insurer are the same, except that the percentage by which the impaired or insolvent insurer proposes to discount obligations due to each ceding insurer may vary in regard to the type of business being commuted. Any variance by type of business shall be reasonable, actuarially sound and supported by documentation justifying such a variance; and
(3) the impaired or insolvent insurer agrees to enter into a stipulation with the superintendent consenting to an order of rehabilitation or liquidation in the event that the implementation of the plan by the insurer does not result in restoring the insurer's surplus to policyholders to the minimum required as determined in accordance with section 128.3(b) of this Part.

(b) Any plan submitted by an impaired or insolvent insurer which contains the commutation of reinsurance agreements shall include:
(1) a balance sheet that reflects the insurer's impairment or insolvency as determined by the superintendent, a pro forma balance sheet reflecting the financial condition of such insurer subsequent to the effective date of the plan, and a reconciliation between both balance sheets;
(2) an exhibit setting forth the obligations due to each and every ceding insurer as of the proposed effective date of such plan and the consideration to be offered each and every ceding insurer for the commutation of such obligations. The obligations shall be classified in accordance with the categories contained in the definition set forth in section 128.2(c) of this Part; and
(3) details regarding any retrocessionaire's participation in the plan.

Section 128.5. Procedures.

(a) Any plan which contains the commutation of reinsurance agreements shall be submitted to the superintendent by the impaired or insolvent insurer within a period designated by the superintendent, which shall not be more than 90 days from the determination of the insurer's impairment or insolvency.

(b) If the superintendent has no objection to any of the plan's terms and conditions and determines that the impaired or insolvent insurer's surplus to policyholders will be restored to the minimum required as determined in accordance with section 128.3(b) of this Part, the proposed plan shall be approved and the insurer shall offer the commutation proposals to its ceding insurers. No commutation agreement shall become effective and no consideration for any commutation agreement shall be paid by the impaired or insolvent insurer until the superintendent determines that, as a result of the commutation proposals agreed to and executed by the ceding insurers, along with the effect of any other components of the plan, the impaired or insolvent insurer's surplus to policyholders is restored to the minimum required.

(c) Within 10 days after the superintendent approves the plan, the impaired or insolvent insurer shall deliver the proposed commutation agreements to each ceding insurer. The terms of any commutation agreement shall not be subject to negotiation between the impaired or insolvent insurer and the ceding insurer.

(d) The impaired or insolvent insurer shall submit to the superintendent, within a designated period as determined by the superintendent, copies of the executed commutation agreements from those ceding insurers agreeing to the proposed terms, copies of rejections of the commutation agreements by those ceding insurers not agreeing to the proposed terms and copies of any other correspondence pertaining to all such offers made to the ceding insurers. This submission shall include a balance sheet that reflects the effect of the executed agreements, together with any other components of the plan, upon the insurer's impairment or insolvency as determined by the superintendent. The insurer shall also submit copies of executed agreements with any retrocessionaires which either modify, commute or assign any retrocession agreement.

(e) If the superintendent determines that, as a result of the executed commutation agreements submitted by the impaired or insolvent insurer, together with any other components of the plan, the insurer's surplus to policyholders is restored to the minimum required as determined in accordance with section 128.3(b) of this Part, the executed commutation agreements shall become effective.

(f) If the superintendent determines that, as a result of the executed commutation agreements submitted by the impaired or insolvent insurer, together with any other components of the plan, the insurer's surplus to policyholders is not restored to the minimum required as determined in accordance with section 128.3(b) of this Part, the superintendent may proceed against the insurer in accordance with the stipulation executed pursuant to section 128.4(a)(3) of this Part.

Section 128.6. Reporting requirements.
Any impaired or insolvent insurer which eliminates such impairment or insolvency using commutations approved by the superintendent in accordance with the provisions of this Part shall exclude all historical data pertaining to such commutations from the loss development schedules contained in future financial statements filed in accordance with applicable provisions of the Insurance Law. The historical data pertaining to the business commuted shall be reported on a supplemental loss development schedule in a form consistent with the schedule contained in statutory financial statements as filed with this department. The supplemental schedule shall show the aggregate experience of such business as of the effective date of commutation agreement.

3. RHODE ISLAND STATUTE AND REGULATION - VOLUNTARY RESTRUCTURING OF SOLVENT INSURERS TITLE 27 CHAPTER 14.5 AND REGULATION 68

§ 27-14.5-2 Jurisdiction, venue, and court orders.
(a) The court considering applications brought under this chapter shall have the same jurisdiction as a court under chapter 14.3 of this title.
(b) Venue for all court proceedings under this chapter shall lie in the superior court for the county of Providence.
(c) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this chapter. No provision of this chapter providing for the raising of an issue by a party in interest shall be construed to preclude the court from, on its own motion, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

§ 27-14.5-3 Notice.
(a) Wherever in this chapter notice is required, the applicant shall, within ten (10) days of the event triggering the requirement, cause transmittal of the notice:
- (1) By first class mail and facsimile to the insurance regulator in each jurisdiction in which the applicant is doing business;
- (2) By first class mail to all guarantee associations;
- (3) Pursuant to the notice provisions of reinsurance agreements or, where an agreement has no provision for notice, by first class mail to all reinsures of the applicant;
- (4) By first class mail to all insurance agents or insurance producers of the applicant;
- (5) By first class mail to all persons known or reasonably expected to have claims against the applicant including all policyholders, at their last known address as indicated by the records of the applicant;
- (6) By first class mail to federal, state, and local government agencies and instrumentalities as their interests may arise; and
- (7) By publication in a newspaper of general circulation in the state in which the applicant has its principal place of business and in any other locations that the court overseeing the proceeding deems appropriate.
  - (b) If notice is given in accordance with this section, any orders under this chapter shall be conclusive with respect to all claimants and policyholders, whether or not they received notice.
  - (c) Where this chapter requires that the applicant provide notice but the commissioner has been named receiver of the applicant, the commissioner shall provide the required notice.

§ 27-14.5-4 Commutation plans.
(a) Application. Any commercial run-off insurer may apply to the court for an order implementing a commutation plan.
- (1) The applicant shall give notice of the application and proposed commutation plan.
- (2) All creditors shall be given the opportunity to vote on the plan.

(3) All creditors, assumption policyholders, reinsurers, and guaranty associations shall be provided with access to the same information relating to the proposed plan and shall be given the opportunity to file comments or objections with the court.

(4) Approval of a commutation plan requires consent of: (i) fifty percent (50%) of each class of creditors; and (ii) the holders of seventy-five percent (75%) in value of the liabilities owed to each class of creditors.

(1) The court shall enter an implementation order if: (i) the plan is approved under subdivision (b)(4) of this section; and (ii) the court determines that implementation of the commutation plan would not materially adversely affect either the interests of objecting creditors or the interests of assumption policyholders.

(2) The implementation order shall:

(i) Order implementation of the commutation plan;

(ii) Subject to any limitations in the commutation plan, enjoin all litigation in all jurisdictions between the applicant and creditors other than with the leave of the court;

(iii) Require all creditors to submit information requested by the bar date specified in the plan;

(iv) Require that upon a noticed application, the applicant obtain court approval before making any payments to creditors other than, to the extent permitted under the commutation plan, payments in the ordinary course of business, this approval to be based upon a showing that the applicant's assets exceed the payments required under the terms of the commutation plan as determined based upon the information submitted by creditors under paragraph (iii) of this subdivision;

(v) Release the applicant of all obligations to its creditors upon payment of the amounts specified in the commutation plan;

(vi) Require quarterly reports from the applicant to the court and commissioner regarding progress in implementing the plan; and

(vii) Be binding upon the applicant and upon all creditors and owners of the applicant, whether or not a particular creditor or owner is affected by the commutation plan or has accepted it or has filed any information on or before the bar date, and whether or not a creditor or owner ultimately receives any payments under the plan.

(3) The applicant shall give notice of entry of the order.

(1) Upon completion of the commutation plan, the applicant shall advise the court.

(2) The court shall then enter an order that:

(i) Is effective upon filing with the court proof that the applicant has provided notice of entry of the order;

(ii) Transfers those liabilities subject to an assumption reinsurance agreement to the assumption reinsurer, thereby notating the original policy by substituting the assumption reinsurer for the applicant and releasing the applicant of any liability relating to the transferred liabilities;

(iii) Assigns each assumption reinsurer the benefit of reinsurance on transferred liabilities, except that the assignment shall only be effective upon the consent of the reinsurer if either:

(A) The reinsurance contract requires that consent; or

(B) The consent would otherwise be required under applicable law; and

(iv) Either:

(A) The applicant be discharged from the proceeding without any liabilities; or

(B) The applicant be dissolved.

(3) The applicant shall provide notice of entry of the order.

(e) Reinsurance. Nothing in this chapter shall be construed as authorizing the applicant, or any other entity, to compel payment from a reinsurer on the basis of estimated incurred but not reported losses or loss expenses, or case reserves for unpaid losses and loss expenses.

(f) Modifications to plan. After provision of notice and an opportunity to object, and upon a showing that some material factor in approving the plan has changed, the court may modify or change a commutation plan, except that upon entry of an order under subdivision (d)(2) of this section, there shall be no recourse against the applicant's owners absent a showing of fraud.

(1) The commissioner and guaranty funds shall have the right to intervene in any and all proceedings under this section; provided, that notwithstanding any provision of title 27, any action taken by a commercial run-off insurer to restructure pursuant to chapter 14.5, including the formation or re-activation of an

insurance company for the sole purpose of entering into a voluntary restructuring shall not affect the guaranty fund coverage existing on the business of such commercial run-off insurer prior to the taking of such action.

(2) If, at any time, the conditions for placing an insurer in rehabilitation or liquidation specified in chapter 14.3 of this title exist, the commissioner may request and, upon a proper showing, the court shall order that the commissioner be named statutory receiver of the applicant.

(3) If no implementation order has been entered, then upon being named receiver, the commissioner may request, and if requested, the court shall order, that the proceeding under this chapter be converted to a rehabilitation or liquidation pursuant to chapter 14.3 of this title. If an implementation order has already been entered, then the court may order a conversion upon a showing that some material factor in approving the original order has changed.

(4) The commissioner, any creditor, or the court on its own motion may move to have the commissioner named as receiver. The court may enter such an order only upon finding either that one or more grounds for rehabilitation or liquidation specified in chapter 14.3 of this title exist or that the applicant has materially failed to follow the commutation plan or any other court instructions.

(5) Unless and until the commissioner is named receiver, the board of directors or other controlling body of the applicant shall remain in control of the applicant.

RI Regulation 68 - **http://www.dbr.state.ri.us/documents/rules/insurance/InsuranceRegulation68.pdf**

Section 2 *Purpose*
The purpose of this Regulation is to outline the procedural requirements for insurance companies applying for the implementation of a Commutation Plan pursuant to R.I. Gen. Laws § 27-14.5-1, *et seq*. and related matters.

4. PART VII OF THE FINANCIAL SERVICES AND MARKETS ACT 2000 ("FSMA")

http://www.opsi.gov.uk/acts/acts2000/ukpga_20000008_en_1

http://fsahandbook.info/FSA/html/handbook/SUP/18

http://fsahandbook.info/FSA/html/handbook/PRIN

E. REFERENCES

- The KPMG Run-off Survey – Non-Life Insurance (October 2008)

- Connecticut Insurance Law Journal Association; William Goddard, 2003, *139 THE REVOLUTION OF THE TIMES:RECENT CHANGES IN U. K. INSURANCE INSOLVENCY LAWS AND THE IMPLICATIONS OF THOSE CHANGES VIEWED FROM A U. S. PERSPECTIVE*

- FSA Engagement with Insurance Business Scheme Transfers Under Part VII FSMA, 21 October 2008

- David Wright, "A Question of Enforceability," Run Off Business, Issue 12, Spring 2005, pp. 20-22.

- Susan Power Johnston, "Why U.S. Courts Should Deny or Severely Condition Recognition to Schemes of Arrangement For Solvent Insurance Companies," Norton Journal of Bankruptcy Law and Practice [Vol. 16]

- Susan Power Johnston and Martin Beeler, "Solvent Insurance Schemes Should Not Be Recognized," Norton Journal of Bankruptcy Law and Practice [Vol. 17]

- No. 165 of 2005, In the High Court of Justice Chancery Division Companies Court, In the Matter of the British Aviation Insurance Company Limited and In the Matter of the Companies Act 1985, Witness Statement of Susan Power Johnston, NY: 479913-7

W:\Dec09\Cmte\E\Alternative Mechanisms White Paper.DOC

The United States Insurance Financial Solvency Framework and Core Principles:

An Overview

Purpose of Framework and Core Principles

Briefly summarize the U.S. system of financial solvency regulation and core principles underlying it

Purpose:
- Evaluate our system for updating
- Inform others in different countries
- Inform US federal government departments and agencies

US Regulatory Mission

To protect the interests of the policyholder and those who rely on the insurance coverage provided to the policyholder first and foremost, while also facilitating an effective and efficient marketplace for insurance products.

Preconditions for Effective Regulation

The regulatory authority:

adequate powers
operationally independent
accountable
maintain sufficient, skilled staff
handle confidential information

Foundation of US Insurance Financial Solvency Framework

Unique, interconnected features:
1. Peer review leading to checks & balances
2. Diversity of perspectives leading to centrist solutions
3. A risk-focused approach to regulation

These interact together
Example: State Accreditation

US Insurance Financial Solvency Core Principles Formulation

1. Regulatory Reporting, Disclosure, and Transparency
2. Off-site Monitoring and Analysis
3. On-site Risk-focused Examinations
4. Reserves, Capital Adequacy & Solvency
5. Regulatory Control of Significant, Broad-based Risk-related Transactions

US Insurance Financial Solvency Core Principles Formulation (Cont'd)

6. Preventive and Corrective Measures, Including Enforcement
7. Exiting the Market and Receivership

Accreditation

Embodies core principles

Purpose of accreditation program is for state insurance departments to meet minimum baseline standards of solvency regulation, especially with respect to regulation of multi-state insurers

US Insurance Financial Solvency Standards and Monitoring

US Insurance Company Requirements

US Insurance Regulatory Monitoring Requirements

US Insurance Financial Solvency Standards and Monitoring

US Insurance Company Requirements

Examples:

1. File audited financial statements
2. Report RBC information
3. Submit to examinations

US Insurance Financial Solvency Standards and Monitoring

US Insurance Regulatory Monitoring Requirements

Examples:

1. Conduct Insurer Examinations
2. Ladder of intervention if RBC deficiencies
3. Approval of certain transactions

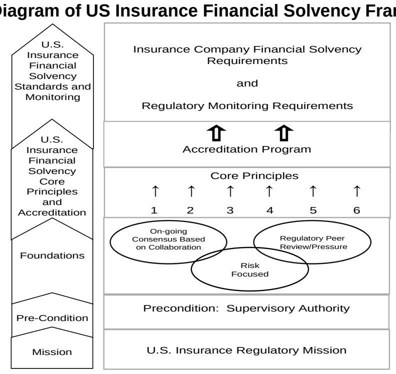
US Insurance Regulatory Monitoring Requirements

In addition, NAIC monitoring activities:

Examples:

1. Financial Analysis Solvency Tools (FAST)
2. Financial Analysis Working Group (FAWG)

Diagram of US Insurance Financial Solvency Framework



The United States Insurance Financial Solvency Core Principles:

Enter Title Here

An Overview

Core Principle 1

Regulatory Reporting, Disclosure, and Transparency

- Regular financial reports
- Standardized reporting
- Supplemental Data
- Updating as necessary

Core Principle 2

Off-site Monitoring and Analysis

- Assess current and prospective risks
- Follow-up to previous analysis
- Prioritization system
- Some tools provided by NAIC

Core Principle 3

On-Site Risk-Focused Examinations

Examine corporate governance, risk mgmt oversight, and financial strength
All significant risks assessed – mitigation
Complying with state laws and regulations
Reported financial conditions assessed

Feedback Loop among Core Principles 1-3

- Financial Reports feed into
  - Off-site analysis and on-site examinations
- Examinations feed into
  - Off site analysis and financial reporting
- Off-site analysis feed into
  - On-site examinations and financial reporting

Core Principle 4

Reserves, Capital Adequacy and Solvency

Accounting requirements
RBC requirements
Minimum statutory reserves
State-specific minimum capital requirements

Core Principle 5

Regulatory Control of Significant, Broad-based, Risk-related Transactions

Examples:

Licensing
Change in Control
Dividend Payments
Transactions with Affiliates

Core Principle 6

Preventive and Corrective Measures, Including Enforcement

timely and suitable
hazardous financial condition measures
RBC and capital deficiencies

Core Principle 7

Exiting the Market and Receivership

range of options
receivership scheme and policyholders
state guaranty associations

Conclusion

Thank You!

W:\Dec09\Cmte\E\FrameworkPresentationWinterMeeting.ppt