VALUATION OF SECURITIES (E) TASK FORCE

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- RMBS Proposal Letter to American Council of Life Insurers, dated Sep. 10, 2009 (Attachment Six)
- Revised Prototype Draft of the Purposes and Procedures Manual of the NAIC SVO, dated Aug. 25, 2009 (Attachment Seven)

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Valuation of Securities (E) Task Force
Washington, DC
September 22, 2009

The Valuation of Securities (E) Task Force met in Washington, DC, Sept. 23, 2009. The following Task Force members participated: James J. Wrynn, Chair, represented by Matti Peltonen (NY); Thomas R. Sullivan, Vice Chair, represented by Kathy Belfi (CT); Steve Poizner represented by Kim Hudson (CA); Karen Weldin Stewart represented by David Lonchar (DE); Susan E. Voss represented by Jim Armstrong (IA); Michael T. McRaith represented by Jim Hanson (IL); Sandy Praeger represented by Ken Abitz (KS); James J. Donelon represented by Stewart Guerin (LA); Ralph S. Tyler, III represented by Alex Hart (MD); Glenn Wilson represented by Blaine Shepherd (MN); Ann Frohman represented by Jim Nixon (NE); Roger A. Sevigny represented by Paul Kropp (NH); Kim Holland represented by Chris Van Ess (OK); Joel Ario represented by Steve Johnson (PA); Alfred W. Gross represented by Van Tompkins (VA); Mike Kreidler represented by Pat McNaughton (WA); and Sean Dilweg represented by Kim Shaul (WI).

1. Adopt the minutes of interim meetings of the Valuation of Securities Task Force

Mr. Peltonen described the issues and activities discussed at the Task Force's interim meetings on Aug. 27, July 30, and July 7. Mr. Hudson made a motion to adopt the minutes of each meeting (Attachments One, Two and Three), and Mr. Abitz seconded. The motion passed.

2. Adopt Invested Asset Working Group's plan for regulation risks other than credit

Mr. Peltonen said that on July 30, the Task Force received and released for a 30-day comment period a document developed by the Invested Asset Working Group outlining a plan and approach to regulate risks other than credit. The Working Group concluded that it should pursue improvements in systems and development of analytical tools before deciding on any of the specific regulatory options for the various risks. The plan has three components. A disclosure component would require companies to provide qualitative information about risks other than credit in the Supplemental Investment Risk Interrogatory. A tools component would formally direct the SVO to build additional analytical tools for regulators to make the identified risks transparent. A monitoring component would enlarge the charge of the Working Group to include periodic meetings with the SVO to consult on market and investment trends and to permit ongoing regulatory input into development of analytical tools, processes and technology platform of the SVO. Andrew Melnyk (American Council of Life Insurers—ACLI) said the members of the ACLI supported the plan and looked forward to working with the Working Group in implementing it. Mr. Shepherd made a motion to adopt the plan. Mr. Armstrong seconded, and the motion passed.

3. Hear the report and adopt the July 23 minutes of the interim meeting of the Invested Asset Working Group

Mr. Peltonen said the Working Group's next focus would be on developing the Supplemental Investment Risk Interrogatory, assisting in development and implementation of SVO systems and analytical tools, and focusing on the issues in the Hybrid Risk-Based Capital Working Group report referred to the Working Group by the Task Force. Mr. Hudson made a motion to adopt the minutes (Attachment Four) of the Working Group. Mr. Armstrong seconded, and the motion passed.

4. Discuss and receive the proposed charge for the Invested Asset Working Group

Mr. Peltonen said the Invested Asset (E) Working Group was re-created in 2006 to serve as a contact point into the regulatory process for insurance companies and members of the investment advisory community. However, it was created to be an ad hoc group, operating only when convened by the Task Force to respond to specific assignments, and thereafter disbanded. The Working Group is concerned that if the NAIC is to achieve its transparency objectives, the members of the Working Group, supported by the SVO, must develop the background, knowledge, expertise, legitimacy and infrastructure necessary to quickly and efficiently represent the NAIC regulatory community in discussions on investment risk issues, with investment professionals representing the insurance industry and other capital market participants. Disbanding the Working Group after it completes its current charge risks an erosion of the procedures and infrastructure the Working Group has developed to support the transparency initiative. Accordingly, the Working Group proposes a revised charge that would emphasize that the Working Group's role is to proactively manage the NAIC transparency objective and infrastructure. Ms. Tompkins made a motion to receive and release the proposed Working Group charge for 2010 (Attachment Five) for a 30-day comment period. Mr. Hudson seconded, and the motion passed.

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5. Discuss the ACLI residential mortgage-backed securities proposal for risk-based capital relief

Mr. Peltonen said the ACLI has expressed concern with the effect that downgrades of residential mortgage-backed securities (RMBS) have had on insurers' risk-based capital (RBC). With almost half a trillion dollars in RMBS, downgrades are driving increases in RBC to an additional $9 billion for year-end 2009. Mr. Peltonen described the evolution of ACLI proposals to address this concern. The latest iteration of the ACLI's proposal (Attachment Six) is that the NAIC should hire a vendor to develop a process the SVO can implement to analyze RMBS for regulatory purposes. The concept is to develop an expected loss model with assumptions and parameters set by regulators, and to use this model to assess the approximately 18,000 insurer-owned RMBS. Potential vendors have indicated that such a process could be developed in 4-6 weeks. In addition, the vendor would map back the expected loss on the securities to the appropriate NAIC designation. This would replace the use of approved rating organization (ARO) ratings under the filing exempt (FE) rule for these securities.

Mr. Peltonen said there is a need to have such a process in place for year-end 2009 reporting. This means that for the short term, the process would stay within the current regulatory framework. He said the analytical output must be interpreted in context of the price at which each insurer carries the asset on their balance sheet. Mr. Peltonen gave a number of examples. Joseph Celantano (Pacific Life representing ACLI) explained the ACLI's proposal. He said the flaw in relying on rating agency default rating methodologies for risk-based capital is that default ratings predict the likelihood of a default but not the impact an actual default would have on the trances of securitizations insurance companies own. The modeling proposal would look at the RMBS securities on a CUSIP-by-CUSIP basis to determine the actual projected loss, thereby taking into account both probability of default and severity of loss. In addition, each individual company's holding level would take into account whether the company held the security at par or at 75, leading to vastly different expected losses and more appropriate RBC for those different levels. Mr. Celantano emphasized that the industry as a whole would, even under this proposal, be holding more capital currently then they did at Dec. 31, 2008, for these securities.

A discussion ensued between Birny Birnbaum (Center for Economic Justice—CEJ), Mr. Celantano and Mr. Peltonen about the ACLI proposal. Mr. Birnbaum characterized the ACLI proposal as another in a long series of capital and surplus relief for the industry provided by the NAIC. He questioned whether the industry is as strong as the NAIC claims or so weak that it requires constant changes in accounting, reserving and RBC rules. He questioned why the industry is happy with the FE rule for all other classes of securities except RMBS. Mr. Birnbaum challenged the logic of saying that the credit rating agencies got it wrong, but that nevertheless these securities are of greater quality than currently rated. Mr. Birnbaum said that if rating downgrades are driving RBC, the answer is for regulators to create an independent rating agency or to be sure that the rating agencies provide sound ratings, and the regulators will use them. Mr. Celantano explained that the specific rating agency methodology of concern to the industry is not used to rate other types of securities, and he emphasized that the industry will be holding more capital for non-agency RMBS on Dec. 31, 2009 than they held at Dec. 31, 2008, but less than if the capital was set by reference to the flawed methodology. Mr. Peltonen agreed, saying regulators see this as a search for a better method to setting capital for invested asset. He noted that structured security ratings have been far more volatile then corporate credits which is why regulators are focusing on this asset class. Mr. Peltonen said that he was not looking for any action on this issue at this time, and that it would be discussed during another meeting. The NAIC would also discuss these topics during the rating agency hearing later in the week.

6. Discuss whether to add RealPoint LLC to the NAIC Acceptable Rating Organization List for commercial mortgage-backed securities

Mr. Peltonen said the question before the Task Force is whether it wants to exercise its discretion and recommend that the NAIC purchase commercial mortgage-backed securities (CMBS) credit ratings from RealPoint. Mr. Armstrong made a motion to add RealPoint LLC as an acceptable rating organization (ARO). Mr. Shepherd seconded, and the motion passed.

7. Discuss Executive (EX) Committee recommendation to strengthen financial regulation

Mr. Peltonen provided background regarding the development of the two items to be discussed next. He said the first item asked the Task Force to consider whether additional disclosure of mortgage loan concentration and exposure is needed. Because the Invested Asset Working Group has and will continue to discuss mortgage loan exposures through a project to revise the reporting schedules for structured securities, Mr. Peltonen suggested this issue be referred to the group for study and a recommendation. The Working Group should consider whether the blanks proposal it completed provides the needed level of transparency for structured securities, and whether something more is needed for individual commercial mortgages on Schedule B. The Working Group should also consider whether regulators should request basic information on mortgages such as the type of business, loan-to-value, occupancy rate, and other similar factors—in essence, the same kind of information provided for residential mortgages. Any information the Working Group feels should be provided to regulators should enable them to evaluate the mortgage asset. The Working Group should also consider whether public data exists or

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whether the NAIC needs to obtain the information from filings—and if so, whether adding an information column is the appropriate way to proceed. Mr. Hudson made a motion to refer the issue to the Invested Asset Working Group for further consideration. Mr. Armstrong seconded, and the motion passed.

Mr. Peltonen said the next issue—increasing disclosure on the expected duration of life insurance liabilities under different scenarios—originated with a Task Force proposal for increased disclosure to the supplemental risk interrogatory to assess liquidity in context of asset liability matching. The same issue went before the Life and Health Actuarial Task Force and the Statutory Accounting Principles Working Group. Given the expression of concern by the Credit Default Swap (E) Working Group, it seems appropriate for the Task Force to communicate its interest and willingness to assist in this project to the Statutory Accounting Principles (E) Working Group, the Life and Health Actuarial Task Force and the Financial Analysis (E) Working Group—the three groups identified by the Credit Default Swap (E) Working Group. Mr. Hudson a motion to direct staff to draft a memorandum to the chairs of the groups mentioned and to summarize this decision in the next status report to the Financial Condition Committee. Mr. Hanson seconded, and the motion passed.

8. Adopt the reorganized Purposes and Procedures Manual for Dec. 31, 2009 release

Robert Carcano (NAIC) said staff reorganized the text of the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* from 36 different sets of guidance and instructions into six. The Task Force received the proposed prototype and released it for a 60-day comment period at the Summer National Meeting. Staff incorporated the comments it received into a revised draft, which was again released for comment. No further comments were received on this draft. Staff recommend that the Task Force adopt the revised format for publication on Dec. 31. It is anticipated that the existing format of the Manual will also be published, so the industry will not have to relearn the organization of the Manual during the critical year-end reporting process. Mr. Shepherd made a motion to adopt the newly formatted Manual as discussed in the staff memorandum (Attachment Seven). Mr. Hudson seconded, and the motion passed.

9. Status report on the use of the FE Database as a source for NAIC designation equivalents of NAIC ARO ratings

Mr. Peltonen said he wished to explore the feasibility of having the SVO perform the conversion of ARO ratings into NAIC Designations required by the filing exempt rule and permit insurers to obtain the result from the SVO instead of having to purchase rating services from all AROs. The discussion is prompted by industry concern that the FE rule requires the lowest of all ARO ratings assigned to a security. The number of AROs has increased, prompting a concern as to the growing cost of administering the FE rule. Chris Evangel (NAIC) said that currently, companies can purchase the Automated Valuation Service (AVS) to access the SVO database and see what security is FE and the appropriate NAIC Designation. The AVS is populated off the annual statement blanks from the prior year, so any securities purchased during the current year—or a security an insurer is considering purchasing—may not be in the FE database at the time they might look for it. So there is a gap in the data available. Mr. Evangel said the solution would be for the NAIC to find the entire universe of potential FE securities. He said he has spoken to the IS staff about this issue, and expects to roll out the service in 2010.

10. Other Matters

Mr. Peltonen said the buckets for "defined mortgage-backed securities and other mortgage-backed securities" and for "commercial mortgage-backed securities and other residential mortgage-backed securities" for Annual Statement Filing Guidance in 2009 requires an adjustment. The guidance defines first lien securities, but not the possibility that there are securities that may be 95% first lien and 5% second lien. Mr. Peltonen asked staff to study where the definitional line should be drawn so the Task Force can determine whether to permit the first lien category to include securities that have mixed collateral where the second lien component is not material.

Mr. Evangel said rating agency downgrades of the monolines has led to a large pool of municipal securities no longer wrapped by monoline insurance. These securities have not been re-rated by the agencies, or the agencies have not assigned underlying ratings. That capital charge is equal to if not greater than the RMBS charge the ACLI is concerned with, yet companies have not filed these securities with the SVO to the degree he would have anticipated, though there has been some pick-up in activity since the downgrade of Ambac. Mr. Evangel characterized the situation as a potential tidal wave and wanted regulators to be aware of this concern.

Having no further business, the Valuation of Securities (E) Task Force adjourned.

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Valuation of Securities (E) Task Force
Conference Call
July 7, 2009

The Valuation of Securities (E) Task Force met via conference call July 7, 2009. The following Task Force members participated: Kermitt J. Brooks, Chair, represented by Matti Peltonen (NY); Steve Poizner represented by Tomoko Stock (CA); Kevin McCarty represented by Ray Spudeck (FL); Sandy Praeger represented by Ken Abitz (KS); Glenn Wilson represented by Blaine Shepherd (MN); Ann Frohman represented by Jim Nixon (NE); Kim Holland represented by Chris Van Ess (OK); Joel Ario represented by Steve Johnson (PA); Alfred Gross represented by Van Tompkins (VA); Mike Kreidler represented by Tim Hays (WA); and Sean Dilweg represented by Kim Shaul (WI).

1. Adopt 2010 Charges for the Task Force and the Invested Asset (E) Working Group

Robert Carcano (NAIC) referred to the Feb. 11 memorandum on organizational matters presented at the Spring National Meeting, which contains the charges for the Task Force and the Invested Asset Working Group. Mr. Carcano explained that adoption of 2010 charges was not placed on the Task Force agenda for the Summer National Meeting and that the SVO staff is requesting that the Task Force adopt the charges at this interim meeting. No change is contemplated in the text of the current charges, which are accurately set forth in the memorandum. Mr. Peltonen asked if there were any questions from the members of the Task Force. Mr. Shepherd asked for a clarification of the dates in the memorandum. Mr. Carcano explained that the Task Force is being asked to adopt the text of the charges as set forth in the memorandum. Mr. Peltonen asked for a motion to adopt the charges for the Task Force and the Working Group for 2010 (Attachment One). Ms. Tompkins moved and Mr. Shepherd seconded the motion. The motion passed.

2. Addition of RealPoint as an Approved Rating Organization (ARO)

Mr. Peltonen said several insurers have requested that the NAIC purchase RealPoint ratings. Mr. Peltonen said that a nationally recognized statistical rating organization (NRSRO) can apply to sell rating services to the NAIC if it demonstrates that it assigns ratings to at least 10% of the aggregate dollar volume of Schedule D bonds actually owned by insurers. Alternatively, the NAIC may purchase such services at its discretion and without reference to the threshold requirement if it determines they are necessary to the proper administration of financial solvency monitoring efforts. The issue before the Task Force is whether there is a regulatory need for an additional ARO that only rates commercial mortgage-backed securities (CMBS). Steve Kraljic (TIAA-CREF) urged the NAIC to consider using RealPoint ratings because they are more accurate and provide greater transparency of risks in individual transactions. He added that RealPoint provides loan-level research and their subscriber model creates a surveillance incentive that traditional NRSROs don't have. Mr. Kraljic emphasized that the CMBS sector faces substantial challenges and that investors anticipate huge volatility, so having a rating organization with a specialty in a CMBS is important. Mr. Kraljic also discussed the impact that RealPoint ratings would have on insurer portfolios. Mr. Johnson also urged the Task Force to consider using RealPoint rating services, emphasizing the value of RealPoint's expertise for regulators. In separate statements, Ms. Shaul and Mr. Shepherd expressed concern that this issue had not been properly placed on the agenda. Mr. Peltonen explained that no action is contemplated during this call. but he is asking the Task Force to consider whether it should exercise its discretion and add RealPoint to the NAIC ARO List. Chris Evangel (NAIC) said that, given the sense of the industry (as expressed by Mr. Kraljic) that ARO ratings are inaccurate, the Task Force should consider whether to drop certain asset classes from the filing exempt rule. Mr. Peltonen said the Rating Agency Working Group is considering shortcomings in NRSRO ratings. Mr. Peltonen asked that the SVO conduct an analysis on the comparability of RealPoint ratings to those of other AROs. Mr. Johnson moved that the SVO do an evaluation of RealPoint for the Task Force, so that it could make a decision on RealPoint. Mr. Shepherd seconded the motion. The motion passed.

Having no further business, the Valuation of Securities (E) Task Force adjourned.

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Valuation of Securities (E) Task Force
Charges 2010

The mission of the Valuation of Securities (E) Task Force is to provide regulatory leadership and expertise on investment risk. The Task Force formulates policy recommendations and administrative instructions to regulate investments and investment risk. The Task Force also formulates NAIC policy that governs how analytical tools, for example, credit assessment, valuation and classification of insurer owned securities, is employed and how analytical insight into investment risk is applied for regulation. The Task Force is supported by the NAIC Securities Valuation Office which functions in accordance with instructions adopted by the Task Force and contained in the *Purposes & Procedures Manual of the NAIC Securities Valuation Office* (the "*Purposes &Procedures Manual*").

Ongoing Support of NAIC Programs, Products, or Services:

The Valuation of Securities Task Force will:

1) Consider and determine proposals to amend the Purposes and Procedures Manual - *Essential*

2) Provide interpretations of the instructions contained in the Purposes & Procedures Manual as it shall deem necessary and appropriate – *Essential*

3) Provide assistance to state regulators on issues involving investments made by the insurance industry - *Essential*

4) Review insurer's existing or anticipated investments and determine the appropriate credit assessment, valuation or other procedures that should be applied in their analysis. Coordinate the process by which statutory accounting, annual statement instructions, blanks reporting, asset and interest maintenance reserving, risk-based capital and other applicable guidance is formulated – *Essential*

5) As necessary, consider improvements to the process by which risks in invested assets are evaluated, communicated and monitored, and how the annual statement investment schedules could be made to better reflect risks embedded in securities - *Essential*

6) Monitor changes in accounting and reporting requirements resulting from continuing maintenance of the revised *Accounting Practices and Procedures Manual* to ensure that the *Purposes & Procedures Manual* continues to reflect regulatory objectives - *Essential*

7) Review and monitor ongoing operations of the SVO. From time to time, the Task Force may review any instruction, procedure or methodology in the *Purposes & Procedures Manual* to ensure it continues to reflect regulatory objectives. In this review and monitoring function, the Task Force shall coordinate administrative issues with the Internal Administration (EX1) Subcommittee and other issues with the appropriate NAIC Committee - *Essential*

8) Develop, adopt, monitor and revise as necessary, an annual agenda for the SVO Research Unit - *Essential*

9) Conclude the study begun in 2006 of the derivatives marketplace, to determine whether any changes to the current regulatory regime is appropriate, including whether the NAIC Derivatives Instruments Model Regulation No. 282 should be deleted, retained or modified - *Essential*

Staff Support: Chris Evangel/Robert Carcano/Richard P. Newman

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Invested Asset (E) Working Group

1. From time to time, the Valuation of Securities (E) Task Force may determine that the technical nature of some matter before it would be best advanced by convening the Invested Asset Working Group and transferring to it a specific regulatory assignment or assignments. The assignment or assignments thus transferred to the Invested Asset Working Group by the Valuation of Securities Task Force shall be within that charge of the Task Force related to development of a regulatory framework for new or evolving investments or the consideration of refinements for an existing regulatory framework applicable to an existing class of securities. The phrase regulatory framework refers collectively to and means the following regulatory mechanisms or processes: statutory accounting guidance, annual statement instructions, blanks reporting instructions, asset valuation reserves, interest maintenance reserves, risk based capital charges, valuation procedures for invested assets, credit assessment procedures for invested assets or any other aspect of the NAIC financial solvency framework within the scope of the charge of the Task Force. The Invested Asset Working Group is charged with the review of matters in the priority established by the Task Force.

2. The Invested Asset Working Group is charged with considering improvements to the process by which risks in new invested assets are evaluated, communicated and monitored, and how the annual statement investment schedules could be made more transparent to better reflect non-credit risks, such as various structural risks embedded in new and existing securities.

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Valuation of Securities (E) Task Force
Conference Call
July 30, 2009

The Valuation of Securities (E) Task Force met via conference call July 30, 2009. The following Task Force members participated: Kermitt Brooks, Chair, represented by Mike Moriarty (NY); Thomas R. Sullivan, Vice Chair, represented by Kathy Belfi (CT); Steve Poizner represented by Tomoko Stock (CA); Susan E. Voss represented by Jim Armstrong (IA); Michael McRaith represented by Kevin Fry; Sandy Praeger represented by Ken Abitz (KS); James J. Donelon represented by Stewart Guerin (LA); Glenn Wilson represented by Blaine Shepherd (MN); Ann Frohman represented by Tom James (NE); Kim Holland represented by Chris Van Ess (OK); Joel Ario represented by Steve Johnson (PA); Alfred W. Gross represented by Van Tompkins (VA); Mike Kreidler represented by Pat McNaughton (WA); and Sean Dilweg represented by Kim Shaul (WI). Also participating was: Jim Everett and Matti Peltonen (NY).

1. Report of Invested Asset (E) Working Group on Proposed "Plan for Enhancing Regulatory Structure for Other Than Credit Investment Risks"

Mr. Fry said that in response to its charge of improving the transparency of investment risk within the investment schedules, the Invested Asset (E) Working Group formed a technical advisory subgroup to identify investment risks (other than credit risk) in fixed-income securities. Since the conclusion of that effort, the Working Group has been engaged in an assessment of how these risks are regulated and whether there are ways to improve regulation. The Working Group has identified a number of options for improving regulation of most of the identified risks — but concluded that it was not desirable to select options for specific risks at this time, because improvements in systems and the development of analytical tools for regulators could dramatically impact the choices available to the Working Group. Instead, the Working Group developed an overall framework set forth in the July 13 memorandum (Attachment Two-A). The plan has three components: 1) insurer disclosure; 2) development of analytical tool for regulators; and 3) increased involvement in the monitoring of investment issues by regulators. The disclosure component would require companies to provide qualitative information about risks other than credit in the Supplemental Investment Risk Interrogatory. The tools component would formally direct the SVO to build additional analytical tools for regulators to make the identified risks transparent. The monitoring component would enlarge the charge of the Working Group to include periodic meetings with the SVO to consult on market and investment trends and to permit ongoing regulatory input into development of the technology platform of the SVO and development of analytical tools and processes. Mr. Fry emphasized that the adoption of the plan by the Working Group reflects the need to begin discussion on internal resource issues related to SVO operations. The plan does not actually contemplate the adoption of any changes to the regulatory process at this time. Mr. Moriarty said he supported the idea of outlining the direction that the Working Group intends to take. A conversation ensued about aspects of the proposed tools, which concluded with the observation that no decisions have been made with respect to how the tools should be developed, beyond identification of the risks for which tools could be developed. Mr. Moriarty asked for a motion to receive and release the plan for a 30-day comment period, to ensure the plan can be discussed and adopted not later than the Fall National Meeting. Ms. Belfi moved and Mr. Fry seconded the motion. The motion to receive and release the plan for a 30-day comment period passed.

2. Discuss ACLI Plan for Residential Mortgage-Backed Securities (RMBS)

Mr. Moriarty said the ACLI has requested a year-end 2009 adjustment to risk-based capital (RBC) for residential mortgage-backed securities (RMBS) (Attachment Two-A1). Joseph Celentano (Pacific Life, representing the ACLI) said the ACLI is concerned that nationally recognized statistical rating organization (NRSRO) methodologies are driving RBC levels higher than warranted by the risk in insurer-owned tranches because they do not consider loss severity. If a coverage ratio is less than one, an NRSRO will downgrade the security to NAIC 4 or below, not taking into consideration that a $1 loss on the entire structure still permits the tranche held by the insurer to perform in accordance with the original promise. Mr. Celentano said the impact on insurers was significant. About 50% of RMBS designated NAIC 1 (about 4,500 securities in the Fitch universe) at Dec. 31, 2008, are below NAIC 1 as of June 30, 2009. Therefore, downgrades of non-agency RMBS could generate a $7 billion RBC impact. An SVO study showed that downgrades of subprime collateral-backed RMBS could generate $4.5 billion in RBC impact. A recent study found that RBC ratios of the top 20 life and health companies was 396% as of Dec. 31, 2008, and would drop to 320% if 20% of RMBS was downgraded to NAIC 5. The ACLI proposes an interim process limited to senior and super-senior tranches downgraded from original issue that notches current rating levels based on an approved rating organization's (ARO) ratings and loss severity of the individual security. Mr. Celentano said the ACLI intends to submit a revised proposal in one or two weeks.

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Mr. Moriarty asked the SVO to review its July 27 memorandum (Attachment Two-A3). Mr. Carcano said the memorandum presents an analysis of both ACLI proposals to date. The SVO focused on evaluating the combined ACLI proposition that downgrades of RMBS were driving large increases in RBC and that the RBC increase was unwarranted by the actual risk in insurer-owned RMBS. SVO staff can verify that RMBS downgrades have impacted RBC charges, but not that the RBC increases are unwarranted by conditions in the RMBS market or whether the RBC increases are solely the result of overly conservative NRSRO assumptions. SVO staff believes the RMBS market has been severely impacted by a number of issues; that credit defaults will likely be much higher than both historical experience and the default rate previously anticipated; and that NRSRO downgrades are not driven by arbitrary or ultra-conservative NRSRO assumptions or any inherent deficiency of the rating model.

Mr. Peltonen asked the ACLI a series of questions aimed at ascertaining the number of securities affected by NRSRO downgrades, given that the target of the ACLI's concern was senior and super-senior tranches. Mr. Celentano replied it could be one or two tranches of each securitization depending on the "thinness" or "thickness" of individual tranches. Mr. Peltonen asked that the revised proposal estimate the number of securities affected, so that regulators have a better sense of the total number involved.

Mr. Moriarty said New York could support an alternative to the current ARO-driven rating approach if it involves a consultant working under the direction of the SVO to review transactions from individual securitization, as long as the approach encompassed the entire universe of RMBS and not simply those that have been downgraded. A discussion ensued over federal banking regulatory efforts to consider the issues being raised by the ACLI. Mr. Celentano said the ACLI would provide information on federal regulatory efforts to the Task Force when it became available.

Mr. Moriarty said he wanted to understand the potential magnitude of RBC impact of RMBS downgrades. He said company action level RBC as of 2008 was approximately $112 billion dollars. If this number is treated as the denominator, the RMBS impact would be the numerator and what he understood of RBC impact to date would not account for the change in the RBC ratio Mr. Celentano reported. Mr. Moriarty asked if the ACLI could assess the impact on action levels of individual companies. Mr. Celentano said the ACLI is considering a survey of member companies on the RBC impact issue from Dec. 31, 2008, to June 30, 2009. Mr. Moriarty said that NAIC staff would also consider this issue.

John Costas (Promontory Financial Group) said the methodology employed by his firm would enable the NAIC to calculate unexpected loss at the tranche level and proceed to calculate the capital requirements for RMBS at a participant or an aggregate level. Most of the banking industry relies on the model his firm uses to calculate unexpected loss. He said hoped to have a proposal ready for distribution to the Task Force shortly. Mr. Moriarty said he is aware that Promontory has been in contact with the SVO and that any information or proposal should be sent to the SVO staff for review by the appropriate staff members. Mr. Moriarty cautioned that these discussions assumed that the Task Force would agree to review whether an adjustment to RBC was warranted and that the NAIC should consider developing an internal SVO capability to assess the risk in structured securities, either for a short-term and or a long-term solution. He noted that the Task Force was willing to try to address this issue before the Winter National Meeting, but that the ACLI has not presented (and the Task Force did not have before it) either a detailed outline of the problem or a proposal to address it at this time.

Mr. Moriarty asked for a motion that the Task Force receive and release the ACLI memoranda and documentation and the SVO memorandum for a 30-day comment period to begin from the date the Task Force receives the revised ACLI proposal. Mr. Fry moved and Ms. Belfi seconded the motion. The motion to expose the ACLI proposal (Attachment Two-A2) and other documents passed.

3. Staff Report: Should the NAIC Purchase RealPoint Credit Ratings?

Harry Olsen (NAIC) said his evaluation of RealPoint included conversations with the RealPoint CEO and several of their research analysts, a review of SEC filings, confidential financial statements, and the reports and alerts available to RealPoint clients on the RealPoint Web site. Mr. Olsen then summarized his findings, which included the following observations: RealPoint has been engaged in analysis of commercial mortgage-back securities (CMBS) since 2001; it employs a staff of 45, 22 of whom are analysts. RealPoint has assigned ratings to approximately 700 CMBS transactions. RealPoint operates on a subscriber model; it has about 200 clients, most of whom are institutional investors. RealPoint methodology is similar to that used by Moody's; however, RealPoint evaluates transactions after information about them becomes public. RealPoint reviews all outstanding ratings on a monthly basis and adjusts them as necessary. RealPoint studies suggest that their rating changes occur as much as eight or 10 months before those of the major rating organizations. Mapping RealPoint rating symbols and definitions to those of other AROs would not be a problem. Mr. Moriarty asked for a motion to receive the staff

report (Attachment Two-A4) and release it for comment, with the intent of voting on this issue at the Fall National Meeting. Mr. Johnson moved and Mr. Shepherd seconded the motion. The motion passed.

4. Discuss the Use of VOS Database as Source of Filing Exempt Information

Mr. Peltonen said that, in response to industry concerns about the cost associated with having to purchase the rating services of a growing number of AROs, the Task Force is considering having the SVO perform the conversion of ARO ratings into NAIC Designations and having companies obtain that information from the SVO. Chris Evangel (NAIC) said that discussions are exploratory and that the proposal springs from industry concerns with the growing costs of rating services. Mr. Moriarty said that the intent here was just to inform the Task Force and that no action was contemplated on this item at this time.

Having no further business, the Valuation of Securities (E) Task Force adjourned.

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To: Members of the Invested Asset (E) Working Group
From: Kevin Fry, Chair of the Invested Asset (E) Working Group
Re: Outline of Plan for enhancing the regulatory structure for “other than credit” investment risks
Date: July 13, 2009

1. Introduction - The objective of the IAWG call on 7/23/09 at 11am Eastern is to present a Plan for enhancing the regulatory structure for handling “other than credit (OTC)” risks that exist in fixed income investments of insurers. This Plan was developed after consultations with IAWG members and SVO staff and after taking into consideration the alternatives that were discussed on the three previous IAWG calls held on 3/24/09, 4/7/09 and 4/15/09.

As a reminder, the technical advisory group known as the Risk Subgroup identified the following risks in addition to credit as individual security risks for fixed income investments:

- Liquidity
- Deferral
- Call
- Extension
- Currency
- Leverage
- Event

These risks are more fully explained in a Risk Subgroup Report dated August 26, 2008. This report can be accessed under the IAWG area of the NAIC website.

2. Outline - The Plan to enhance the regulatory structure for better transparency of “other than credit” investment risks has three components: Disclosure, Tools, and Monitoring.

a. **Disclosure -** The first component of the plan is better disclosure through a requirement for a narrative that contains quantitative and qualitative information about exposure to “other than credit” risks. The disclosure requirement could be located in the Supplemental Investment Risk Interrogatories which is required to be filed yearly on or before 4/1. Instructions for this disclosure would have to be carefully developed.

b. **Tools -** The second component of the plan is the development of tools by the SVO to monitor “other than credit” risks that are quantifiable. The SVO would be able to leverage off the database project in the development of the tools. The following are examples of tools:

- Liquidity – Develop a tool that provides a liquidity score for an insurer portfolio. This would be accomplished by the SVO assigning a score to specific asset types ranging from most liquid to least liquid. A weighted average approach would be used to score an insurer portfolio.
- Deferral – Develop a tool that quantifies portfolio concentration to deferral risk
- Call – Develop a tool that quantifies portfolio concentration to call risk.
- Pricing – Develop a tool that highlights individual securities or groups of securities that experience changes in market value.

c. **Monitoring -** The third and most important component of the plan would be a monitoring process where the SVO Research Unit would report periodically to the IAWG. During this process, the SVO Research Unit would inform regulators of risks that are likely to manifest in current market environments. This process would also provide a forum for regulators to guide the SVO Research Unit in the development of tools and other analytical capabilities that are relevant to changing market environments.

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OPTIONS TO CONSIDER FOR 7 RISKS OTHER THAN CREDIT			
Risks	Follow-up Options	Decision	Remarks
Liquidity	a) FAS 157 Level 1-2 as a proxy b) NYID Weighted Index from annual statement c) Changes to FAH & FEH* d) Create new bond characteristic column for FAS Level 1-3 e) Changes to SIRI* f) Best practices		NY and CT Insurance Department Liquidity Reports could be combined into a standardized form.
Event	a) Develop VAR/EVT static for highly diverse CDOs b) Changes to FAH & FEH c) Create new bond characteristic column d) Changes to SIRI		Unable to integrate VAR/EVT concept into current RBC methodology for all individual fixed income securities.
Call	a) Add call price and dates from S&P/IDC to VOS database b) Changes to FAH & FEH c) Changes to SIRI		Captured through Statutory Cash Flow Testing, asset adequacy analysis, and RBC formula C-3 Phase I. Insurer already required to list call option of a bond on Schedule D Part 1.
Extension	a) Changes to FEH		Captured through Statutory Cash Flow Testing, asset adequacy analysis, and RBC formula C-3 Phase I. The bond characteristic column may be inappropriate because extension is a universal risk in some bonds. FAH has section.
Deferral	a) Disclose terms of deferral and number of deferrals in annual statement b) Capture deferral as part of database symmetry project c) Changes to FAH and FEH d) Add bond characteristic column for hybrids		Captured through Statutory Cash Flow Testing, asset adequacy analysis, and RBC formula C-3 Phase I. The bond characteristic column requires disclosure of variable coupon securities and other types of options controlled by the issuer.
Currency	a) Disclose high versus low risk currencies (baskets) and any foreign exchange hedges in annual statement b) Changes to FEH		Addressed in the foreign column on the annual statement blank. Insurers are required to mark securities with one of seven symbols. Insurer already required to list foreign securities on Schedule D Part 1. May need to develop criteria for sovereign versus currency risk (Euro). FAH has section.
Leverage	a) Increase SVO surveillance of ratings agencies b) Changes to FEH c) Modify bond characteristic column to include structured securities (agency & non-agency)		Captured through RBC formula C-3 Phase I. The bond characteristic column requires disclosure of securities where the issuer has the right to vary timing of principal and coupon payments, for example mortgage backed securities. FAH has section.

*

- FAH: Financial Analysis Handbook
- FEH: Financial Examiners Handbook
- SIRI: Supplemental Investment Risk Interrogatory

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Proposal to modify current NAIC ratings for RMBS – 7/7/09 Draft

Background
The current economic climate has created numerous issues throughout the financial markets. One area of concern for the insurance industry relates to ratings migration and downgrades of residential mortgage backed securities (RMBS).

The RMBS market has been especially hard hit by rating actions taken by the various rating agencies. The insurance industry has heavily invested in RMBS. The life industry's invested assets were $3.1 trillion based on Moody's data as of December 2007; RMBS comprised 15.1% or $460 billion of invested assets. Moody's downgraded $260 billion of RMBS securities in February 2009, of which $100 billion were rated below investment grade by S&P or Fitch. On March 18, 2009, Moody's announced it was putting an additional $173 billion of RMBS securities on review for possible downgrade. The downgrades continued in April, with Fitch lowering the rating on a significant number of RMBS.

The downgrades are driven in large part because of the models used by the rating agencies. The models require an automatic downgrade, often to below investment grade, if a loss is projected to occur at any time during the life of the security, regardless of the severity of the loss. The consequence of the downgrades for the insurance industry is an automatic increase in the risk based capital (RBC) C-1 factor. The reason for the increase in RBC is due to the fact that the Securities Valuation Office (SVO) relies solely on the ratings from the nationally recognized statistical rating organizations (NRSROs), or rating agencies. The recent RMBS downgrade actions by the rating agencies have significantly increased the RBC that must be carried for RMBS, and insurers have no option available to appeal to the SVO for a rating review.

The estimated cumulative effect of the January and February 2009 RMBS downgrades results in an increase of $2.6 billion in additional C-1 capital at the company action level for life, accident and health companies. Industry C-1 capital was further increased by subsequent downgrades.

With this background, the industry is recommending a proposed change to the risk based capital held for RMBS that will better reflect the risk of holding the securities.

Details
The downgrade approaches taken by the rating agencies vary slightly. But in essence, each agency projects cash flows of the underlying collateral pool based on its own assumptions on prepayments, defaults, loss severity, and other assumptions. Then a coverage ratio is calculated as follows:

Coverage Ratio = Current credit support of the tranche / Projected cumulative loss of the collateral pool

New ratings are determined based on this ratio and the type of collateral in the pool (Prime/Alt-A/Subprime). For example, if the ratio is < 1, the new rating assigned will be CCC (NAIC 5), regardless of whether the tranche has actually suffered a loss, and regardless of the severity of expected loss.

The rating agencies take a similar approach to corporate bonds. They try to determine the level or probability of the first of dollar of loss. Under a usual corporate bond, a dollar of loss leads to an event of default, which would cascade into a series of events outline in the bond indenture. This is in stark contrast to an RMBS security where the first dollar of loss may mean only that. The security structure allows the security to continue without an acceleration event that would terminate the security.

Under the current rating agency approach, ratings do not distinguish between securities that have a total loss and securities that have minor losses. To quote Fitch Ratings in an April, 2009 release, "Two (RMBS) bonds rated 'B' have the same likelihood of a first dollar of loss, but they may have vastly different total losses and recoveries." Thus the rating is determined by the likelihood of the first dollar of principal loss, whereas required capital should reflect both the likelihood of loss and the expected severity of loss.

A more logical approach, and an approach more consistent with the goals of the RBC calculations, would be to determine required capital based on both the security's rating (a reflection of likelihood of first dollar of loss) and the security's current metrics which can be used to determine severity of future losses, if any.

One justification for this approach is the significant difference in the current C-1 factor applied to residential whole loans versus the C-1 factor for a CCC RMBS security. A CCC (NAIC 5) RMBS security carries an RBC C-1 factor of 17% (after-

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tax). A residential mortgage whole loan that is in foreclosure carries an RBC C-1 factor of 1.5% (after-tax). In other words, if the company owned the individual loans in the underlying collateral pool of an RMBS, and all of them were in foreclosure, it would only require a 1.5% RBC factor, instead of 17% RBC factor for a CCC RMBS security.

Proposed Solutions
Based on the fact that ratings for RMBS do not properly reflect the expected loss from the securities, we propose a "notching" approach for determining the RBC C-1 factor for RMBS. This proposed interim approach is to modify the current NAIC rating system for RMBS securities by taking into account existing delinquencies on a per security basis, estimated loss severities and coverage ratios. The notching determination is based on 4 step approach; the following steps are used for purposes of determining RBC C-1 risk factor:

1. Determine the level of delinquencies on per tranche basis. Delinquencies include any loan 60+ days delinquent, foreclosures, bankruptcy, and REO.

2. Multiply the level of delinquencies by the appropriate factor within the following severity matrix to determine an estimated level of loss.

Vintage	Prime	Alt A	Subprime
2008	45%	50%	55%
2007	45%	55%	60%
2006	50%	50%	60%
2005	45%	45%	55%
2004	30%	45%	50%
2003 and earlier	25%	40%	45%

3. Divide the current credit support for each tranche by the estimated loss level determined in step 2 to determine the coverage ratio.

4. Apply the coverage ratio determine in step 3 to the following matrix to determine the appropriate NAIC rating level for the determination of C-1 capital.

Coverage Ratios	NAIC Rating Level Improvement	
	1 Grade Higher	2 Grades Higher
Prime	>1.0%	>1.5%
Alt A	>1.0%	>1.5%
Subprime	>1.0%	>1.5%

RMBS securities that have not been downgraded since issuance would continue to carry the current RBC C-1 factor.

The proposal would accomplish a balance between:

- Recognition that these bonds are less creditworthy than when originally rated given the deterioration of the housing market and the weakening economy; and
- The difference on a per security basis of the level of delinquencies, severity of loss, and credit support.

It also has the benefit of being simple, straightforward and easy to implement. Data for each security is readily available and the steps provided can be easily implemented and verified.

This notching approach is modeled after what can be accomplished currently in the capital markets. Via a Re-REMIC structure, a downgraded RMBS security can be re-tranched into subordinated and senior securities. The total RBC required as a result of the Re-REMIC approach approximates the notching proposal.

Conclusion
For structured securities like RMBS, the current NAIC rating is entirely based on the rating agencies' ratings, which indicate the likelihood of the first dollar loss of principal. The resulting RBC C-1 factor does not reflect the potential severity of the loss.

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To overcome this deficiency, we have put forward an interim proposal that recognizes both the likelihood of loss and the severity of loss while a longer term approach is developed. The goals of the interim and longer-term approach are the same – that capital requirements are more closely aligned with the risk embedded in the securities. In the end, life companies will appropriately hold more RBC than before the recent downgrades, but will not be subjected to excessively inflated RBC requirements based on the first dollar of loss ratings methodology.

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John Bruins
Senior Actuary

Andrew Melnyk
Managing Director, Research

August 10, 2009

Mr. Michael Moriarty
Chair – Valuation of Securities Task Force
National Association of Insurance Commissioners
c/o State of New York Insurance Department
25 Beaver Street
New York, New York 10004

Mr. Lou Felice
Chair – Capital Adequacy Task Force
National Association of Insurance Commissioners
c/o State of New York Insurance Department
25 Beaver Street
New York, New York 10004

Re: Risk Based Capital for Residential Mortgage Backed Securities

Dear Messrs. Moriarty and Felice:

As you know, life and health insurers hold substantial amounts of residential mortgage backed securities (RMBS). As of year-end 2008, non-agency RMBS holdings were over $145 billion, with associated C-1 capital of approximately $2.0 billion. In the past few months over 64 percent of all AAA rated non-agency RMBS securities have been downgraded to below investment grade by at least one rating agency. These downgrades have had a significant impact on risk based capital (RBC) C-1 factor. Specifically, during the first half of 2009, C-1 capital attributable to RMBS increased by 440 percent to $11.0 billion. Clearly, this is of great concern to our member companies.

Given this dramatic increase, and given that rating agency analysis does not focus specifically on RBC, the American Council of Life Insurers (ACLI) would like to request that the NAIC consider the attached proposal to modify current NAIC ratings for RMBS (see below).[1] Please note that this most recent version of the proposal incorporates suggestions and comments from both industry and regulators. We also ask that you consider enacting these changes for 2009 RBC calculations. This would greatly relieve the severe impact on RBC being experienced by the industry, which we believe is unwarranted relative to the severity of the underlying loss potential.

Thank you for considering our proposal and for working with us on this issue.

---

[1] The ACLI represents three hundred forty (340) member companies operating in the United States, of which three hundred thirty two (332) are legal reserve life insurance companies, and eight (8) are fraternal benefit societies. These 340 member companies account for 93 percent of total assets, 93 percent of the life insurance premiums, and 94 percent of annuity considerations in the United States.

American Council of Life Insurers

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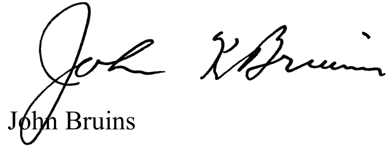
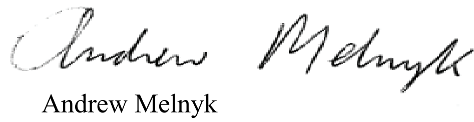
Sincerely,

John Bruins Andrew Melnyk

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Mr. Dan Swanson
Mr. Richard Newman
Mr. Chris Evangel

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Proposal to modify current NAIC ratings for RMBS

Background

The current economic climate has created numerous issues for investors. A major issue for the insurance industry is the potential for multi-billion dollar RBC impact created by rating agency downgrades of residential mortgage backed securities (RMBS). The problem is that the ratings do not distinguish between securities that are projected to experience a total loss and securities that are projected to experience minor losses. The industry recommends a change to the C-1 RBC determination process for RMBS to better reflect the risk to insurers of holding the securities.

The RMBS market has been especially hard hit by rating actions taken by the various nationally recognized statistical rating organizations (NRSROs) or “rating agencies”. The downgrades are driven by current stress in the US housing market and the rising probability of an expected loss. The rating agency models require a downgrade to single B or below if any loss is projected to occur at any time during the life of the security, regardless of the severity of the loss. The consequence of the downgrades for the insurance industry has been a significant increase in the risk based capital (RBC) C-1 factor applicable to the downgraded RMBS.

Based on a Bank of America Merrill Lynch June 2009 report[1], in excess of 64% of all AAA rated non-agency RMBS securities have been downgraded to below investment grade by at least one rating agency. The following chart is the percent of downgrades that have occurred in RMBS based on collateral type and vintage year. All the downgrades listed were from once AAA rated securities to below investment grade. All percents are based on current balances.

	Prime Fixed	Prime ARM	Alt-A Fixed	Alt-A ARM	Subprime
2000	0.0%	0.0%	0.0%	0.0%	44.8%
2001	0.0%	2.2%	0.0%	0.0%	58.0%
2002	0.0%	1.0%	0.0%	0.0%	24.6%
2003	0.0%	0.0%	0.5%	0.4%	8.4%
2004	0.0%	0.3%	0.8%	6.1%	7.1%
2005	24.6%	22.8%	55.1%	62.7%	31.0%
2006	66.8%	63.2%	92.5%	92.2%	81.1%
2007	76.9%	83.6%	91.8%	92.1%	87.4%
Total	41.8%	40.6%	68.2%	76.4%	70.8%

[1] *The Mortgage Credit Round-Up, June Update, July 21, 2009, Bank of America Merrill Lynch*

The life insurance industry has heavily invested in RMBS. The non-agency RMBS holdings of the life and health industry based on a study of statutory filings as of December 31, 2008 were over $145 billion with associated C-1 capital of approximately $2.0 billion.

The statutory filing data was augmented with information from Bloomberg to include current ratings, collateral and tranche type. The change in C-1 capital from December 31, 2008 to June 30, 2009 due to the downgrades was an estimated increase of 440% to $11.0 billion. The largest (measured by admitted assets) 20 life and health companies represent approximately 53% of the total admitted assets in the life and health industry. That group saw their C-1 capital for RMBS increase by 482%, from $.9 to $5.6 billion. The top twenty companies would hold 51% of the estimated June 30, 2009 total C-1 capital attributable to RMBS, the remaining 49% or $5.4 billion is widespread throughout the industry. Senior and super senior securities represent 68% of the number and 85% of the dollars of total non-agency RMBS assets held by the life and health industry.

The recent RMBS downgrade actions by the rating agencies has significantly increased the RBC that must be carried for RMBS, and insurers currently have no option available to appeal to the SVO for a rating review. Industry C-1 capital will be increased by subsequent downgrades.

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With this background, the industry recommends a change to the amount of risk based capital held for certain RMBS to better reflect the risk to insurers of holding the securities. RMBS securities that have not been downgraded since their issuance would continue to carry the current RBC C-1 factor.

Details

The approaches taken by the rating agencies vary slightly, but in essence, each agency projects cash flows of the security's underlying collateral pool based on their assumptions of prepayments, defaults, loss severity on liquidated loans, and others. Then a coverage ratio is calculated as follows:

Coverage Ratio = Current credit support of the tranche ÷ Estimated cumulative loss of the collateral pool

New RMBS ratings are determined based on this ratio and on the type of collateral in the pool (Prime/Alt-A/Subprime). For example, if the ratio is < 1, the new rating assigned most likely would be B (NAIC 4), or below, regardless of the severity of the expected losses to the tranche.

In rating RMBS, rating agencies take a similar approach to that utilized in rating corporate bonds and try to determine the level or probability of the first dollar of loss. With a typical corporate bond, a single dollar of loss leads to an event of default, which could then cascade into a series of negative events outlined in the bond indenture, usually including cessation of coupon payments and eventual recovery of some amount of principal through the bankruptcy process. This default event for corporate bonds is in stark contrast to RMBS, where the security structure allows the security to continue receiving remaining principal and interest without an acceleration event that would terminate the security. In the case of senior RMBS tranches, the ability to receive several years of coupon payments alone dramatically improves expected economic recoveries relative to a typical corporate bond.

Current ratings do not distinguish between securities that are projected to experience a total loss and tranches that are projected to experience minor losses. To quote Fitch Ratings in an April, 2009 release, "Two (RMBS) bonds rated 'B' have the same likelihood of a first dollar of loss, but they may have vastly different total losses and recoveries." Thus the current RMBS rating is determined by an evaluation of the likelihood of the first dollar of principal loss, whereas required insurer capital should reflect both the likelihood of loss and the expected severity of loss.

A more logical approach for RBC purposes, and an approach more consistent with the goals of the RBC calculations, would be to augment the current rating agency methodology of determining the probability of first dollar of loss with the security's current metrics which can be used to determine the estimated severity of potential future losses at the tranche level. It is important to note this approach is not designed to dispute the rating agencies' opinion of which tranches are at risk of incurring a loss. It is only designed to be a simple and straightforward way to move beyond the inherent flaw of only considering the first dollar of loss in determining ratings and in turn capital for senior RMBS.

Proposed Solution

Based on the fact that ratings for RMBS do not properly reflect the expected total loss from the securities, we propose an interim "notching" approach to determine the RBC C-1 factor limited to downgraded super senior and senior RMBS. Super senior and senior tranches are defined as those that are not subordinated to any other tranche. This interim approach will modify the current NAIC rating system for RMBS securities and take into account existing delinquencies on a pool by pool basis, estimated severities and losses. The notching determination is based on a 4 step approach; the following steps are used for purposes of determining RBC C-1 risk factor:

1. Determine the level of delinquencies on a per pool basis. Delinquencies will include any loan 60+ days delinquent, foreclosures, bankruptcy, and REO.

2. Multiply the level of delinquencies by the appropriate factor within the following severity matrix to determine an estimated level of loss. The severity matrix was derived from *U.S. RMBS Surveillance Methodology, April 2009* by DBRS and verified by comparison to Andrew Davidson & Co. In three instances where the severities differed by more than 10%, an average rounded to the nearest 5% was used.

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Vintage	Prime	Alt A	Subprime
2008	45%	50%	55%
2007	45%	55%	60%
2006	50%	50%	60%
2005	45%	45%	55%
2004	30%	45%	50%
2003 and earlier	25%	40%	45%

3. Subtract the current credit support for each tranche from the estimated loss level in step 2 above to determine the estimated tranche loss.

4. Apply the estimated tranche loss determined in step 3 to the following matrix to arrive at the appropriate NAIC rating level for C-1 capital.

Estimated Losses	NAIC Rating Level Improvement	
	1 Grade Higher	2 Grades Higher
Senior and Super Senior	<15%	<6%

The estimated losses were derived from *Corporate Default and Recovery Rates, 1920-2008, February 2009* by Moody's Investors Service. Assuming an initial NAIC C-1 factor of 5, a one or two notch adjustment would correspond to the long term Moody's credit loss assumption of 14.53% and 6.27% for senior unsecured bonds with an NAIC factor of 4 and 3, respectively.

If an RMBS security has not been downgraded since issuance, it will continue to carry the current RBC C-1 factor. The notching is limited to senior and super-senior tranches. These tranches, due to their "thickness", experience significantly lower probability of loss severities. The SVO commented recently that, "One can argue that assuming relatively better loss tolerance of senior and super senior tranches, the notching can be considered reasonable for such senior tranches".

This proposal's methodology is dynamic and will immediately disallow any notching upgrade if expected losses increase beyond the stated thresholds. Over time, this will ensure the notching of a given security remains appropriate, based on the actual losses, remaining subordination, and delinquencies experienced by the trust. It is also worth noting that capital will be assessed every quarter while the expected loss determined for each security by the rating agency methodology is for the life of the security.

This proposal applies a consistent approach. Rating agencies have divergent opinions in regards to future outcomes. By looking to current delinquencies, the proposal is directly observing trust performance as the basis for notching, diffusing the impact of any subjectivity of assumptions.

The proposal accomplishes a balance between:

- Recognition that certain RMBS securities are less creditworthy now than when they were originally rated, given the deterioration of the housing market and the weakening economy; and
- The difference on a per pool basis of the level of delinquencies, severity of loss, and credit support.

It also has the benefit of being simple, straightforward and easy to implement. Data for each pool is readily available and the steps in the approach can be easily implemented and verified.

This notching approach is more conservative than what can be accomplished currently in the capital markets. Via a Re-REMIC structure, a downgraded RMBS security can be re-tranched into subordinated and senior securities. A Re-REMIC approach would usually result in less C-1 capital then would be prescribed under this notching proposal.

The long term solution to this issue should be developed in concert with the NAIC, NRSRO's, the SVO and possibly any banking regulatory initiative. The long term solution can refine the simple severity measures used in this interim proposal to explore ways to develop a probability of loss along with an estimate of loss.

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Conclusion
For structured securities like RMBS, current NAIC ratings are based on the NRSROs' ratings, which are in turn focused primarily on the likelihood of the first dollar of loss. The resulting NAIC RBC C-1 factor does not completely reflect the potential severity of the loss.

To overcome this rating deficiency while a long term proposal is developed, we recommend an interim rating proposal that recognizes both the likelihood of loss and the severity of loss. Life companies will appropriately hold more RBC than before the recent RMBS downgrades, but will not be subjected to volatile RBC requirements primarily based on the first dollar of loss ratings methodology.

Statutory Filing Study Methodology

Information supplied in this proposal used data collected from the ACLI and Bloomberg. The ACLI provided life and health insurance industry holdings of RMBS as of 12/31/08. They used the 12/31/08 statutory filings and extracted from Schedule D Part 1, every bond classified in lines:

4000001-4099998- Industrial & Misc. - Single Class Mortgage Backed/Asset Backed
4100001-4199998- Industrial & Misc. - Defined Multi-Class Residential Mortgage Backed
4200001-4299998- Industrial & Misc. - Other Multi-Class Residential Mortgage Backed
4300001-4399998- Industrial & Misc. - Defined Multi-Class Commercial Mortgage Backed
4400001-4499998- Industrial & Misc. - Other Multi-Class Commercial Mortgage Backed

Other information pulled for each security was CUSIP, company code, company name, group name, description, NAIC designation, and carrying value. That data was run against Bloomberg and tranche type, collateral type and current ratings from S&P, Moody's and Fitch were added. Using the collateral type all non-residential securities were eliminated from the study. From the ratings the current NAIC designation was determined. If Bloomberg did not contain any rating from S&P, Moody's and Fitch, the 12/31/08 NAIC designation was selected for the current NAIC designation. The tranche type was used to determine if the tranche was in a senior position.

From the collected information, the RBC as of 12/31/08 and 8/7/09 were calculated. The carrying value from 12/31/08 was used to calculate the RBC as of 12/31/08 and 8/7/09, as 6/30/09 holdings and carrying values are not available.

The RBC as a result of the ratings downgrades increased from $2.0 billion to $11.0 billion, a 440% increase. Top twenty company information was collected as a sub-set of both the $2.0 billion and the $11.0 billion C-1 capital.

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To: Michael Moriarty, Chair of the Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force
From: SVO Staff[1]
Re: Review of ACLI Proposals Relative to Risk-Based Capital Implications of NRSRO Downgrades of Residential Mortgage-Backed Securities.
Date: July 27, 2009

1. Introduction

In a letter dated May 22, the American Council of Life Insurers (ACLI) expressed concerns with the impact on insurer risk-based capital (RBC) of NAIC acceptable rating organization (ARO) downgrades of residential mortgage-backed securities (RMBS), and requested regulatory relief. The staff was asked to evaluate the initial and subsequent ACLI proposals for effecting the requested RBC relief.

2. Summary Conclusion

The key focus of the staff has been on evaluating the accuracy of the concerns expressed by the ACLI and its proposed solutions to modify current RBC processes for RMBS. In particular, we have attempted to verify the combined proposition that the increased RBC exposure for RMBS is driven by the recent ratings downgrades under the current rating-based RBC formula and is unwarranted by the actual risk in the securities held by insurers. We also assessed the viability of ACLI's two proposed "notching" solutions for the RBC process modification. We confirmed that the RMBS ratings differ from the corporate debt ratings primarily due to the characteristics of such structured products secured by the static portfolio, and that the RMBS downgrades have impacted life insurers by driving up the RBC C-1 charges. The ACLI proposals would cut the increased RBC exposure substantially; however, we were unable to justify the rationale behind its "upward notching only" solutions, which imply that current RMBS ratings are overly conservative, especially considering the currently unfavorable loss rates trend of the RMBS ratings.

While we recognize the important social and political implications of the requested relief, our analysis does not support the view that the nature of the ARO methodology is *unfairly* driving the RBC increases. Although our analysis acknowledges that the RMBS ratings and corporate debt ratings are not directly comparable—primarily due to the different rating process implemented, and continuously evolving to reflect the rather unique attributes of the RMBS—the recent rating downgrades that resulted in the increases in the RBC C-1 are, in our view, fundamentally driven by an attempt to keep abreast of an unprecedented collapse of many of the components of the RMBS securitization process and the RMBS market. The nature of securitizations implies that as losses eat through lower-level tranches, the risk of non-payment on higher-level tranches increases because the tranches are interconnected at the level of cash flow. Although there are uncertainties, the current conditions fairly suggest that the credit worthiness of RMBS has deteriorated, and that the losses will likely exceed the previously anticipated level during the "pre-bubble" period. Analysis of individual securities for severity of loss indicates that losses would eat though thinner, lower-level tranches much faster—indicating a need to understand the individual structure of securitizations, since those with thinner, lower tranches could see more immediate impact on higher tranches.

We did not find anything that would suggest that ARO assumptions are patently unreasonable or self-serving, given that the nature of RMBS issues driving the downgrades are unprecedented and evolving. We think it is entirely possible that RBC implications for RMBS could be worse than predicted and that other asset classes may come under similar pressure for similar reasons in the very near term. We therefore believe that regulatory flexibility is essential, and that RBC dollars surrendered today could well be needed in the near term. We also feel that while other analytical approaches may provide additional insight, they are unlikely to undermine the basic message implicit in the ARO models. We would also caution that the focus of regulatory concerns should logically and properly shift to severity of loss, since the RMBS are exposed to plenty of uncertainties in the economy. In other words, knowing that previous assumptions have been proven incorrect and that we are experiencing an unprecedented environment with uncertain timing and rate of recovery, the real question is whether the current RBC C-1 factors adequately capture the potentially volatile performance of RMBS.

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3. Background and Analysis

a. ACLI Claim and Proposals – In separate proposals dated May 22 and July 7, the ACLI has requested that the NAIC review the proposed solutions to modify the process of the 2009 RBC C-1 calculations in a manner that better reflects its view of the true inherent credit risk of holding the RMBS securities. The ACLI claims that the current RBC formula, which relies on the C-1 factors set with the NRSROs' corporate ratings in mind, is responsible for an excessive increase in the RBC charges because the implications of the RMBS ratings differ from those of the corporate ratings. According to the ACLI, the heavily model-dependent RMBS ratings are excessively dependent on the base-case loss coverage ratio while neglecting the loss severity and the behavioral difference between the RMBS and corporate bonds. The ACLI counts RMBS exposure of life companies at $460 billion or 15.1% of the life industry's $3.1 trillion invested assets (as of December 2007, based on Moody's data). The ACLI estimates the cumulative effect of the January and February 2009 RMBS downgrades at an increase of $2.6 billion in additional C-1 capital for life, accident, and health companies.

ACLI's Original Proposal to NAIC for RBC
All mezzanine (including senior mezzanine) and subordinated securities – Maintain current NAIC rating Subprime senior, Alt-A senior RMBS and Option ARM senior securities – Assign an NAIC rating one grade higher than current NAIC rating – E.g., B would be equivalent to NAIC 3, rather than NAIC 4 Prime senior/super senior and Alt-A super senior RMBS securities – Assign an NAIC rating two grades higher than current NAIC rating – E.g., B would be modified to NAIC 2, rather than NAIC 4 RMBS that have not been downgraded since issuance would continue to carry the current RBC C-1 factor

Source: ACLI Letter dated May 22, 2009

CLI's Revised Proposal (Draft) to NAIC for RBC
Step 1: Determine the level of delinquencies on per tranche basis. Delinquencies include any loan 60+ days delinquent, foreclosures, bankruptcy, and REO.
Step 2: Multiply the level of delinquencies by the appropriate factor within the following severity matrix to determine an estimated level of loss.

Vintage	Prime	Alt A	Subprime
2008	45%	50%	55%
2007	45%	55%	60%
2006	50%	50%	60%
2005	45%	45%	55%
2004	30%	45%	50%
2003 and earlier	25%	40%	45%

Step 3: Divide the current credit support for each tranche by the estimated loss level determined in step 2 to determine the coverage ratio.

Step 4: Apply the coverage ratio determine in step 3 to the following matrix to determine the appropriate NAIC rating level for the determination of C-1 capital.

Coverage Ratios	NAIC Rating Level Improvement	
	1 Grade Higher	2 Grades Higher
Prime	>1.0	>1.5
Alt A	>1.0	>1.5
Subprime	>1.0	>1.5

RMBS that have not been downgraded since issuance would continue to carry the current RBC C-1 factor.

Source: ACLI Letter dated July 7, 2009

b. Limitations of SVO Review – In conducting our review, we relied on the accuracy of information submitted to us by the ACLI, Moody's and Fitch. We could not and did not audit or cross-check the accuracy of this information because doing so would involve significant issues with regard to the reconciliation and comparability of data between different organizations to which we lack access. In addition, our review relied on the accuracy of annual statement data filed by insurers with the NAIC. We assume for our purposes that all such information is reliable.

c. Methodology – In the conduct of our due diligence, the SVO reviewed the rating methodologies and the implications of rating categories employed by two major rating agencies—Moody's and Fitch Ratings—on RMBS and the developing issues in the marketplace in order to assess the claims made by ACLI. The SVO also assessed the impact of the ALCI's proposals on RBC charges and reviewed an alternative analytical methodology to assess whether it could provide additional and different insight into RMBS default and severity risk.

d. Assessment of RMBS Rating Process and Rating Comparability

i. Our review of the credit risk of RMBS and the rating processes of Moody's and Fitch for RMBS did not reveal any concrete evidence of overly cautious ratings, while confirming that the RMBS ratings are not directly comparable to the traditional corporate debt ratings. RMBS differ from corporate debts in that 1) systematic risk factors overwhelm diversifiable idiosyncratic risks, and 2) the RMBS is typically static. Both of these are attributable to the fact that RMBS are secured by a fixed pool of many individual mortgages. To provide ratings on the RMBS that display these distinguishable attributes, the rating agencies have implemented RMBS rating processes that use default probability and loss severity models that incorporate macroeconomic variables as well as loan and borrower characteristics as the core components. The result of the loss analysis is to determine how much

credit enhancement a given tranche security would need for a particular category of credit rating through stress tests. The loss coverage ratio determined by the credit support level and expected loss provides the basis for RMBS rating actions. It is understood that the rating agencies have continued their efforts to refine rating processes, as evidenced by the constant updates to their analytic models amid changing economic conditions.

Moody's: Moody's analytic tool for RMBS takes various loan-level inputs and simulates them through many economic scenarios to generate an estimated loss distribution for a mortgage pool. A set of broad macroeconomic variables—interest rate, home price changes, and unemployment rates—are used to simulate scenarios. For each path simulated, the tool relates loan-specific factors and economic variables to the likelihood of prepayment, default, and loss severity upon default for each loan and adds the losses for all loans in the pool. The aggregation of the outcomes under all the econometric paths results in the loss distribution for the pool, which is then used to estimate hypothetical credit support levels for the underlying pool corresponding to each rating category.

Moody's recently updated its loss projection implementing the Default Burnout Factor (DBF) approach, which incorporates the perspective that following the home price trough, the current portion of a pool will perform better than the portion of the pool that has already defaulted or been seriously delinquent at that point in time. The DBF approach reflects the results of both the performance-based (historical) and collateral-based (loan attributes) projection methods and differentiates the current pool statistics and delinquency status, projected serious delinquencies and loss severity throughout the anticipated home-price trough, and the projected performance of the portion of a pool that is current when home prices bottom out.

Fitch: Fitch Ratings relies on its default and loss model, which computes the base frequency of foreclosure (FOF) and loss severity (LS) at a loan level primarily based on risk dimensions broken down into three categories: seasoned loan risk, economic risk, and collateral risk. Recognizing the historical default and loss experience of each loan attribute relative to the baseline, either credit or penalty is typically assigned. In addition, the economic risk is addressed by using the National Risk Index (NRI) and regional risk multipliers provided by University Financial Associates, LLC (UFA) on a quarterly basis. Expected loss coverage ratio (LCR) determined by a bond's break-loss (BL) divided by the mortgage pool's base case expected loss provides the basis for initial rating assignments and migration of ratings in surveillance. Rating category thresholds for each transaction are based on model-generated target loss coverage multiples, which are not static and vary based on pool characteristics as they are computed by simulating changes in economic conditions for each loan. Fitch provides loss severity ratings (LSRs) for non-impairment rating categories and recovery rating (RR) for impairment rating categories to assist in the evaluation of expected loss severity.

Fitch has made a few enhancements to its analytic model. It recently introduced a three-quarter average regional risk multiplier to reduce the level of fluctuation while using a stressed NRI value across all rating categories to reflect further economic deterioration. It also reduced (or eliminated) a seasoning benefit and created an additional FOF penalty factor for loans underwritten to the "Reduced" documentation category. Fitch also reclassified the credit sector of negative amortization and option adjustable-rate mortgages from Alt-A to subprime.

ii. Distressed/Impairment Ratings – The distressed/impairment ratings for RMBS in general provide a blurred view of loss severity and say very little about the impact of tail events. Rather, they signal the likelihood of the expected loss. The first dollar loss serves a major role in impairment rating actions for both agencies, regardless of the severity. A security taking a loss under an expected scenario will typically be considered distressed. An RMBS with a base case LCR at 1 is generally mapped into a B rating scale, while that with a base case LCR less than 1 is typically considered stressed and rated B3/B- or below. Despite the many similarities in the rating processes and ratings for RMBS of these two rating agencies, there is a major distinction between the distressed/impairment ratings (Caa1/CCC+ and lower) of Moody's and Fitch Ratings. Moody's reflects the expected loss severity in its ratings using a predetermined grid, whereas Fitch utilizes recovery rates (RR) to communicate that particular information.

Moody's: The impairment ratings of Moody's are based on a grid of specific recovery assumptions. The Caa range indicates the expected recovery of 75% to 95% while the Ca and C ranges implies the expected recovery range of 25% to 75% and below 25%, respectively.

Fitch: While recognizing the first dollar loss under an expected scenario, Fitch's distressed ratings are not meant to provide predetermined expected loss severity, unlike those of Moody's. Rather, recovery ratings ranging from RR1

(90%–100% expected recovery) to RR6 (0%–10% expected recovery) are provided as supplemental information to assist in the evaluation of expected losses.

Despite the absence of explicit loss severity in the ratings of distressed RMBS, Fitch's average projected RMBS principal loss figures grouped by credit sector, priority, and long-term credit rating display two noticeable trends: 1) the projected average loss on higher priority tranches, including super senior and senior tranches, is distinctively lower than that of equally rated supporting tranches, such as senior support and mezzanine of the same loan-pool type; and 2) the average loss severity increases as ratings deteriorate, albeit the ranges of projected loss vary greatly across credit sectors (Prime, Alt-A, and Subprime).

Fitch Average Projected RMBS Principal Loss by Priority and Long-Term Credit Rating[1]

Priority	Long-Term Rating	Prime	Alt-A	Subprime
Super Senior	B	0%	0%	0%
Super Senior	CCC	0.7%	7%	19%
Super Senior	CC	2.6%	15%	53%
Super Senior	C	7.5%	25%	NA
Senior	B	0%	0%	0%
Senior	CCC	1.3%	8%	22%
Senior	CC	3.0%	19%	53%
Senior	C	8.3%	26%	66%
Senior Support	B	0%	0%	0%
Senior Support	CCC	13%	58%	46%
Senior Support	CC	34%	78%	90%
Senior Support	C	73%	85%	92%
Mezzanine	B	0%	0%	0%
Mezzanine	CCC	15%	77%	61%
Mezzanine	CC	30%	92%	93%
Mezzanine	C	93%	100%	99%

[1] Prime and Alt-A figures are pending Fitch's committee review.
Source: Presentation by Fitch to the SVO on July 8, 2009

e. Recent Rating Trends and Implications – In response to the unprecedented occurrence of the "tail" event in the relatively new RMBS market, the rating agencies have updated their analytical process and inputs and have reflected the updated expectations in ratings, resulting in significant downward ratings migrations across the capital structure, especially for the "bubble-time" (year 2005 to 2007) vintage transactions. The tail event and the consequential, massive downgrades have proved the complexity of such structured products and the need for rating process and input refinement. A single rating alone does not fully describe the credit risk of a rated tranche. Two securitized tranches with the same credit rating may be susceptible to credit risks such as downward migration and loss tolerance at different degrees. The loss probability density function for supporting tranches generally displays relatively thick-tails and is more sensitive to the migration risk than the one for super senior and senior tranches. For example, a "thick" senior tranche rated Caa/CCC and a "thin" mezzanine tranche may experience different loss rates and behave very differently when a loss more severe than expected occurs. By "thick" and "thin" we mean the proportion of the tranche in the overall capital structure of the transaction.

A tail risk analysis can provide valuable risk information as the tail of a loss distribution provides another aspect of credit risk that RMBS are exposed to and that current ratings fail to adequately capture. As discussed above, two different securitization positions may have only slight differing expected loss rates, but may have widely diverging tail risks. However, the incorporation of the loss at confidence interval and the economic capital concepts into the RBC process for RMBS may require a major revision to the current process. Recognizing the shortcoming of the current RMBS ratings, Fitch has introduced Principal Recovery Analysis, which provides view on the expected amount of principal recovery in a range of stressful mortgage pool loss scenarios. There are companies providing tail risk analysis, including Promontory Financial Group, LLC.

f. Analysis of ACLI Proposals – Since the greatest impact of the ACLI proposals would be on subprime RMBS, we reviewed the credit migrations on this asset class for the period from 12/31/08 to the first half of 2009.

Migration Matrix of NAIC Designations from 12/31/08 to 6/30/09 for Subprime and Subprime-Like RMBS

NAIC Designation As of December 2008	% of BACV as of June 2009						
	NAIC-1	NAIC-2	NAIC-3	NAIC-4	NAIC-5	NAIC-6	Total
NAIC-1	55%	13%	12%	11%	9%	1%	100%
NAIC-2		22%	28%	28%	16%	5%	100%
NAIC-3			24%	19%	46%	11%	100%
NAIC-4				26%	55%	19%	100%
NAIC-5					60%	40%	100%
NAIC-6						100%	100%
Total	40%	12%	13%	14%	16%	5%	100%

Source: Computed by the SVO from Annual Statement data and NRSRO electronic data

As shown in the table above, 11% of NAIC-1 designated RMBS as of YE08 and 9% in subprime securities were downgraded from NAIC-1 at 12/31/08 to NAIC-4 and NAIC-5 at 6/30/09, respectively.

The investment quality (NAIC-2 and above) securities dropped from 84.7% of the estimated total 2008 year-end exposure to 52.1%, while the distressed (NAIC-5 and below) securities increased from 3.8% to 20.6% over the six-month period. Considerable migrations into NAIC-3 (13.4% in June 09 vs. 6.2% in YE08) and NAIC-4 (13.9% in June 09 vs. 5.4% in YE08) have also been observed. The changes in the number of CUSIPs by designation scale over the same period also display a trend comparable to that of the exposure when measured in dollars.

Distribution of NAIC Designations for Subprime and Subprime-Like RMBS

	BACV December 2008 (%)	BACV June 2009 (%)
NAIC-1	73.6%	40.2%
NAIC-2	11.1%	11.9%
NAIC-3	6.2%	13.4%
NAIC-4	5.4%	13.9%
NAIC-5	3.2%	15.9%
NAIC-6	0.6%	4.7%
Total	100.0%	100.0%

	# of CUSIPs December 2008 (%)	# of CUSIPs June 2009 (%)
NAIC-1	65.6%	40.7%
NAIC-2	10.5%	11.4%
NAIC-3	5.4%	9.7%
NAIC-4	5.7%	9.7%
NAIC-5	5.1%	12.0%
NAIC-6	7.7%	16.4%
Total	100.0%	100.0%

Source: Computed by the SVO from Annual Statement data and NRSRO electronic data

According to our estimates, the downgrade trend has had a material, adverse impact on the RBC requirements for the subprime (-like) RMBS, **resulting in an estimated RBC charges increase of $4.5 billion for the subject securities from $1.5 to $6.0 billion**. The inclusion of the downgrades of prime RMBS would have further increased the impact on the RBC charges.

The Initial Proposal: ACLI initially proposed a "notching" approach, segregating securities that once had favorable attributes collectively implied by the credit sector and priority at issuance from the others. The proposed solution would benefit super senior and senior securities of prime and super senior of Alt-A by two full notches, while benefitting senior of Alt-A and subprime by one full notch. It is difficult to conclude whether the adjusted RBC C-1 factors (implied by notching) in relation to the loss expectations of rating agencies on the RMBS with impairment ratings is adequate, primarily due to the application of the RBC factors to the reported values of such securities, some of which can vary and be significantly lower than the original balance. Among 839 subprime(-like) RMBS held by the life industry and downgraded from NAIC-1 to NAIC-4 in the first half of 2009, only 87 securities were written-down for other than temporary impairments (OTTI) as of year-end 2008. The OTTI represented 1.5% of the total par value of such securities. At year-end 2008, 13.3% of the par value of NAIC-4 designated subprime(-like) RMBS and 26.77% of the par value of NAIC-5 designated RMBS were written-down by the life industry as OTTI.

Life Industry OTTI as % of Par for Subprime and Subprime-Like RMBS by Self-Reported NAIC Designation (YE08)

Self Reported NAIC Designation	OTTI as % of PAR
1	2.40%
2	7.88%
3	7.76%
4	13.30%
5	26.77%
6	47.76%
Total	7.06%

Source: Computed by the SVO from Annual Statement data and NRSRO electronic data

Although we can speculate that the priority has a high negative correlation with expected loss and that the revised RBC factors are in line with the loss expectations of rating agencies—assuming that the RMBS holders have reasonably written-down the values of such securities with impairment ratings—this overly simplified approach, which attempts to make upward changes to ratings to all senior tranches without a firm statistical basis, would raise an issue with regard to reliability of the outcomes.

Comparison of Loss Expectations by Rating and RBC Factors

NAIC Desig-nation	RBC Factor (before tax)[1]	Rating Level	Initially Proposed RBC Factor			
			ACLI Proposal			
			All (Sr.-)Mezzanine and Subordinated Securities	Senior Securities of Subprime, Alt-A & Option ARM	Super Senior and Senior of Prime and Super Senior of Alt-A	
4	10.0%	B1 ~ B3 or B	10.0%	4.6%	1.3%	
5	23.0%	Caa1 ~ Caa3 or CCC	23.0%	10.0%	4.6%	
6	30.0%	Ca or CC	30.0%	23.0%	10.0%	
6	30.0%	C	30.0%	23.0%	10.0%	

NAIC Designation	RBC Factor (before tax)[1]	Rating Level	Loss Expectation			
			Fitch[2][3]			Moody's
			All Sr. Support and Mezzanine Securities[4]	Senior Securities of Subprime & Alt-A	Super Senior and Senior of Prime and Super Senior of Alt-A	
4	10.0%	B1 ~ B3 or B	0%	0%	0%	0% - 5%
5	23.0%	Caa1 ~ Caa3 or CCC	13% - 77%	8% - 22%	0.7% - 7%	5% - 25%
6	30.0%	Ca or CC	34% - 93%	19% - 53%	2.6% - 15%	25% - 75%
6	30.0%	C	73% - 100%	26% - 66%	7.5% - 25%	75% - 100%

[1] RBC factors are applied to the reported security value
[2] Fitch's average projected RMBS principal loss
[3] Prime and AltA figures are pending Fitch's committee review
[4] Including Senior Support
Source: Loss expectation was presented by Moody's and Fitch to the SVO on July 8, 2009

The adoption of this overly simplified solution would result in an estimated RBC C-1 capital relief of $3.6 billion at June 2009.

Impact of NAIC Designations Migration on RBC C-1 for Subprime(-Like) RMBS[1] and Estimated RBC Relief sought by ACLI's First Solution

RBC	2008YE	6/30/2009	Difference
Current	1.5	6.0	$4.4
Proposed	0.8	2.4	$1.7

RBC Hit

RBC Relief		($3.6)

Capital Relief Sought (Protection Lost)

[1] All subprime RMBS are categorized as senior tranches; whereas all Alt-A RMBS are categorized as super-senior tranches
[2] Rounding error may exist causing slight total balance discrepancy.
Source: Computed by the SVO from Annual Statement data and NRSRO electronic data

The Revised Proposal: Subsequent to the submission of the original proposal, ACLI reformulated its "notching" approach to recognize the level of delinquencies, severity of loss, and credit support. The revised solution maps the coverage ratio to a pre-specified notching level (up to two full notches) for all downgraded RMBS, regardless of the credit sector. The coverage ratio is determined by dividing the current credit support for a tranche under review by the calculated loss, a product of the actual delinquency and the loss severity implied by the ACLI-proposed loss severity matrix (credit sector/vintage). While this revised approach has the benefit of being simple, straightforward, and easy-to-implement, one can still argue that a slight improvement in loss coverage based on actual delinquency does not necessarily warrant a higher NAIC designation for the RBC purpose. It also fails to provide the rationale behind the specified notching matrix and the use of actual delinquency rather than expected probability of default. Applying the revised notching approach to a simplified sample portfolio consisting of five randomly selected RBMS **resulted in a substantial, estimated C-1 capital relief of $8.24 million from $13.77 million under the current RBC process to $5.54 million under the proposed RBC process**.

Impact of Revised ALCI's Proposed RBC Process on NAIC C-1 Capital

Cusip	Description	STAT BV ($ in MM)	Moody's	S&P	Fitch
02152LAA3	COUNTRYWIDE ALT LN 2008-1R CL 1A1	61.06		AAA	B
02150EAD5	COUNTRYWIDE ALT LOAN TR 2007-5CB 1A4	48.18	Caa1	B	B
949837AR9	WELLS FARGO SE 2007-10 CL 1A16	10.41	B3		BB-
57643LLF1	MASTER ASSET BACKED SEC TR 2005-AB1 CLA6	24.51	Ba2	AAA	
881561WS9	TERWIN MORTGAGE TR 2005-9HGS CL M1 144A	14.81	Ba3	AA-	

Cusip	Description	NAIC Rating	Delinquency	Collteral Type	Vintage
02152LAA3	COUNTRYWIDE ALT LN 2008-1R CL 1A1	4	11.88	Alt A	2008
02150EAD5	COUNTRYWIDE ALT LOAN TR 2007-5CB 1A4	4	17.76	Alt A	2007
949837AR9	WELLS FARGO SE 2007-10 CL 1A16	4	5.09	Prime	2007
57643LLF1	MASTER ASSET BACKED SEC TR 2005-AB1 CLA6	3	21.56	Subprime	2005
881561WS9	TERWIN MORTGAGE TR 2005-9HGS CL M1 144A	3	7.724	Subprime	2005

Cusip	Description	Severity	Estimated Loss	Credit Support	Coverage Ratio
02152LAA3	COUNTRYWIDE ALT LN 2008-1R CL 1A1	50%	5.94	6.44	1.08
02150EAD5	COUNTRYWIDE ALT LOAN TR 2007-5CB 1A4	55%	9.77	10.37	1.06
949837AR9	WELLS FARGO SE 2007-10 CL 1A16	50%	2.55	3.97	1.56
57643LLF1	MASTER ASSET BACKED SEC TR 2005-AB1 CLA6	45%	9.70	12.90	1.33
881561WS9	TERWIN MORTGAGE TR 2005-9HGS CL M1 144A	45%	3.48	33.23	9.56

Cusip	Description	Proposed Notching	Proposed C-1 ($ in MM)	Current C-1 ($ in MM)
02152LAA3	COUNTRYWIDE ALT LN 2008-1R CL 1A1	3	2.81	6.11
02150EAD5	COUNTRYWIDE ALT LOAN TR 2007-5CB 1A4	3	2.22	4.82
949837AR9	WELLS FARGO SE 2007-10 CL 1A16	2	0.14	1.04
57643LLF1	MASTER ASSET BACKED SEC TR 2005-AB1 CLA6	2	0.32	1.13
881561WS9	TERWIN MORTGAGE TR 2005-9HGS CL M1 144A	1	0.06	0.68
		Total	**5.54**	**13.77**

Source: CUSIPs provided by ACLI

g. Cumulative Average Credit Loss Rates (RMBS Rating vs. Corporate Rating) – Reviewing the cumulative average credit loss rates for corporate and RMBS (prepared and reported by Moody's for Moody's-rated securities, 1993-2007), the SVO found that the one-year loss rate trend is contradictory to the loss rate trends covering longer time frames. It is attributable, in our view, to the recently observed deterioration in the credit worthiness and the severe loss given default in certain of the RMBS and raises a concern on the practicality of the historical data through the sanguine market conditions that existed until the last year of the data range. The Caa-rated RMBS experienced a one-year average cumulative loss rate much greater than that of equivalent and lower-rated corporate securities, despite the general trend of relatively lower average loss rates on RMBS compared with those on corporate securities.

Until 2007, the corporate securities had generally suffered greater average loss rates than the RMBS at equivalent rating categories, even though a full notching cannot be warranted at first glance, except for the B-rated RMBS based on the five-year loss data; the 6.27% average loss rate for the Ba corporate rating is greater than the 5.27% for the B-rated RMBS. One can argue that assuming relatively better loss tolerance of senior and super senior tranches, the notching can be considered reasonable for such senior tranches. However, considering the relatively short data history and the contradicting one-year trend, the inclusion of the 2008 cohort (to be reported in August of 2009) would facilitate a better comparison, as the additional loss resulted from the continuously weak economic conditions will be added, and as the downgrades actions taken prior to the formation of the 2008 cohort will be counted.

Moody's Avg. Cumulative Credit Loss Rates by Letter Rating

Rating	NAIC RBC C-1 Factors	Avg. Cumulative Credit Loss			
		Corporate[1]		RMBS[2]	
		1 Year	5 Year	1 Year	5 Year
Aaa		0.00%	0.02%	0.00%	0.00%
Aa		0.01%	0.14%	0.00%	0.02%
A	0.4% (NAIC 1)	0.02%	0.40%	0.04%	0.25%
Baa	1.3% (NAIC 2)	0.11%	1.10%	0.08%	0.49%
Ba	4.6% (NAIC 3)	0.60%	6.27%	0.37%	2.03%
B	10% (NAIC 4)	2.73%	14.53%	1.31%	5.27%
Caa-C[3]	23% (NAIC 5) 30% (NAIC 6)	10.50%	26.70%	21.93%	21.93%
Investment Grade		0.04%	0.52%	0.01%	0.05%
Speculative Grade		2.77%	12.24%	0.70%	3.15%
All Rated		0.99%	4.15%	0.03%	0.19%

[1] Moody's data based on average default rates and senior unsecured bond recoveries measured on issuer-weighted basis over 1982-2008 period.
[2] Moody's data based on expanded data set, stopping to collapse pari passu tranches and including wrapped securities, 1993-2007.
[3] RMBS Avg. Cumulative Credit Loss is for Caa credit category.
Source: Moody's Special Comment: Corporate Default and Recovery Rates, 1920-2008; Default & Loss Rates of Structured Finance Securities, 1993-2007

h. Re-REMICs – An increasing number of RMBS Re-REMICs, which aim to create a AAA-rated new senior tranche with credit support from a new unrated sub-tranche, are being issued in 2009 for regulatory capital and liquidity purposes, and the trend will likely continue for the near future.

i. Conclusions/Summary – After reviewing many aspects of the RBC issue raised by ACLI, the SVO recommends that the NAIC reject these "upward notching only" solutions, as they lack a clear and verifiable analytical justification. The SVO suggest a continued search for a better-aligned RBC process for RMBS by further examining the supplemental credit risk information provided by rating agencies and other alternative credit risk analytic product and service offerings.

While concluding that the current downward rating migration trend in RMBS is more a result of the continuously evolving rating process and updated inputs amid unprecedented economic conditions, rather than overtly cautious rating

agencies or patently exaggerated assumptions, the SVO acknowledges that the recent rating migrations have resulted in a significant increase in the RBC C-1 for RMBS for some insurers and that the RMBS ratings differ from the corporate debt ratings and may imply relatively lower loss rates for RMBS than those for corporate securities. Although RMBS rating decisions are not made for the risk analysis of RBC, and disparities exist among rating agencies, the upward notching only solutions that imply overly cautious ratings need to be further refined to be applied to the RBC process. In our view, the gap between ratings and the risk analysis for RBC can be narrowed by incorporating supplemental information either embedded into the letter ratings or provided or available in separate formats. A tail risk analysis can also provide valuable risk information, as the tail of a loss distribution provides another aspect of credit risk that ratings fail to adequately capture.

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To: Michael Moriarty, Chair of the Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force
From: Bob Carcano, Senior Counsel, SVO
Harry Olsen, Manager, Regulatory and Credit Analysis Team
Re: Staff Report – Assessment of RealPoint for Listing on NAIC ARO List
Date: July 14, 2009

1. **Introduction** – This report responds to your request that we review RealPoint for possible inclusion on the NAIC ARO List. We previously communicated to you that RealPoint does not meet the 10% threshold test articulated in the Purposes and Procedures Manual of the NAIC Securities Valuation Office (the "P&P Manual"). However, it is our understanding that the Task Force is considering adding RealPoint to the NAIC ARO List under its discretionary authority. The P&P Manual provides that the Task Force may determine that the credit ratings of a rating agency are necessary for the administration of a component of state based financial solvency monitoring.

2. **Summary Conclusion** - To be useful to the NAIC, organizations on the NAIC ARO List should have comparable analytical work products and demonstrate an equal degree of reliability. We have collected information from RealPoint representatives in order to evaluate comparability and to provide an opinion of how RealPoint credit ratings might contribute to NAIC financial solvency monitoring efforts under the filing exempt rule. RealPoint only assigns ratings to CMBS transactions. On the basis of the information we obtained either directly from RealPoint representatives, from its web-site or from other reliable public sources, it is our opinion that RealPoint credit ratings would be useful to NAIC processes associated with the filing exempt rule. RealPoint is a specialist in the CMBS market. It has been in business for over nine years, and has a group of sophisticated institutional clients that rely on and pay for its expertise. It has an experienced staff of analysts who use a proprietary CMBS program to review transactions on a monthly basis to keep clients abreast of the rapidly changing market. Realpoint's rating methodology is in line with that of Moody's. Over time, the ratings are generally similar to the other agencies, but often the rating actions are well ahead of the other agencies, frequently by six months or more for both upgrades and downgrades. Overall, it is our opinion than Realpoint is well qualified in rating CMBS securities.

3. **Staff Report**

a. **History and Organization -** RealPoint was founded in 2001 as part of the GMAC Commercial Mortgage Corporation to provide the market with an effective surveillance tool for investors in commercial real estate. It became an independent organization in August 2007 and is still operated by the same management that started the company. Today, RealPoint provides its services primarily to investors in the CMBS market, with approximately 200 institutional investor clients, and only a small part of its revenues coming from new issues. Employees total approximately 45, 22 of whom are involved in analytical activities. Generally, an analyst follows about 40 transactions with a current total of about 700 transactions monitored monthly. The monitoring function is automated. Information is received from servicers, trustees and other sources, and the system monitors the status of CMBS transactions.

b. **Rating Methodology -** The company's rating model subjects each loan in a portfolio to a series of stresses to gauge the likelihood of default. These stresses are based on historical empirical data from RealPoint's database as well as from market data providers. All stresses are designed to shock the cash flows which have been previously determined by RealPoint analysts' underwriting of the transaction, in order to determine at what level of stress a default would occur. Stresses are based on the worst observed property performance conditions in the past 30 years, as defined by specific property types. Stresses at the higher rating levels are of course more onerous than at lower levels. As an example, AAA stresses for office properties require the transaction to withstand a 36% decline in cash flows, while a BBB level would have to withstand a 22% decline. Attached are the company's stress levels by property type. RealPoint's methodology is comparable with the methodology used by Moody's in its RMBS analyses. Moody's analyzes default risk by comparing its projected cash flow to the required debt service and than subjects this cash flow to stress testing. Both firms do this on a property by property basis taking into account historical performance by specific property types. They both incorporate loan to values, cap rates and geographical differentiation into their analyses.

One of the major differences of RealPoint compared to other rating agencies is that they are not involved in the initial rating of the transaction. They obtain relevant information about a transaction another NRSRO has rated approximately 30 days after the transaction is public (at which point the information becomes public), analyze this information and provide an opinion. Another major difference of RealPoint compared to other rating agencies is the frequency and detail provided for each security analyzed. Historically, the major rating agencies focus on rating new issues for issuers with little or no subsequent surveillance or reporting. RealPoint evaluates each security on a monthly basis and uses its proprietary technology to adjust its ratings on a much timelier basis than the other agencies. Furthermore, RealPoint

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tracks and reports on Delinquency Status, Debt service coverage, LTV, seasoning and geographic concentration for every security (sample attached) on a monthly basis. RealPoint also comments on outlook changes under a perform, underperform, and outperform basis.

A good way to evaluate the rating actions of RealPoint is to look at the historical performance compared to the other agencies. Generally, RealPoint's ratings are much more stable and timelier than others. For example, in the past six months, RealPoint has downgraded 537 CMBS transactions. These same transactions were subsequently downgraded by one or more of the agencies but with an average lag of three months. Additionally, RealPoint has put together a study for the period January 2004 till October 2007 focusing on changes in ratings. This study shows that while RealPoint's downgrades and upgrades were eventually matched by the other agencies 80-90% of the time, these actions took place, on average, 8-10 months later. This volatility of the other agencies ratings is indicated by a Moody's 2009 report discussing potential downgrades, which expects its current review to result in "senior investment CMBS bonds, including junior AAA classes, to be downgraded 4 to 5 notches, and low investment grade to be downgraded 5 to 6 notches on average". Since Moody's does not monitor CMBS deals as frequently as Realpoint, its actions are much more volatile and less timely.

c. Mapping – Rating Differentials - RealPoint rating symbols are consistent with the other rating agencies, which use the AAA thru D rating symbols. Rating definitions also map well to the NAIC definitions and would follow the same mapping that the NAIC uses for the current AROs. We reviewed data showing the potential impact of using RealPoint credit ratings on the portfolio of insurers. That data indicates that if only RealPoint credit ratings were used, about 12% of CMBS transactions would be rated higher, 2% would be rated lower and 86% would be rated the same; viewed on an aggregate dollar basis only 3% of the portfolio would be rated differently. RealPoint explained that the agencies, as a result of current rating shortcomings for CMBS, have now taken a much more conservative position, and have increased their frequency of review, and tend to downgrade in a more general way, which accounts for the rating discrepancy.

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Draft: 9/11/09

Valuation of Securities (E) Task Force
Conference Call
August 27, 2009

The Valuation of Securities (E) Task Force met via conference call Aug. 27, 2009. The following Task Force members participated: James J. Wrynn, Chair, represented by Matti Peltonen (NY); Thomas R. Sullivan represented by Elaine Wieche (CT); Steve Poizner represented by Tomoko Stock (CA); Kevin McCarty represented by Ray Spudeck (FL); Michael T. McRaith represented by Jim Hanson (IL); James J. Donelon represented by Stewart Guerin (LA); Ralph S. Tyler, III, represented by Alex Hart (MD); Ann Frohman represented by Jim Nixon (NE); Kim Holland represented by Chris Van Ess (OK); Joel Ario represented by Steve Johnson (PA); Mike Kreidler represented by Tim Hays (WA); and Sean Dilweg represented by Kim Shaul (WI).

1. <u>*Purposes and Procedures Manual*</u>

Mr. Peltonen noted that a reformatted version of the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* was received by the Task Force during the Summer National Meeting and released for a 60-day comment period. The comment period has expired; comments received from the North American Securities Valuation Association (NASVA) have been incorporated into a revised draft, which has been posted to the SVO page on the NAIC Web site. Mr. Peltonen said that, on this call, he would like to receive the revised draft of the *Purposes and Procedures Manual* and vote to expose it for a short comment period.

Robert Carcano (NAIC) summarized the purpose and history of the project and the nature of the comments that were received. Mr. Carcano asked that the Task Force receive the revised version for a comment period ending Sept. 18, so that the Task Force can vote to adopt the reformatted document at the Fall National Meeting. Ms. Stock asked that a notice be sent to all chief examiners advising them of the project. Ms. Stock also asked that the pages be numbered sequentially, instead of sequentially within each part. Kathy Cohoon (Babson Capital, representing NASVA) said that NASVA had reviewed the changes, had worked with the SVO staff on the changes and supports the revised draft that is before the Task Force at this time.

Mr. Peltonen asked for a motion to receive the revised *Purposes and Procedures Manual* and expose it for comment until Sept. 18. Mr. Spudeck moved and Mr. Johnson seconded the motion. The motion passed.

Having no further business, the Valuation of Securities (E) Task Force adjourned.

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Draft: 8/5/09

Invested Asset (E) Working Group
Conference Call
July 23, 2009

The Invested Asset (E) Working Group of the Valuation of Securities (E) Task Force met via conference call July 23, 2009. The following Working Group members participated: Kevin Fry, Chair (IL); Tomoko Stock (CA); Mark Brandhorst (IA); Alex Hart (MD); Blaine Shepherd (MN); Matti Peltonen (NY); and Van Tompkins (VA).

1. Discuss Plan for Enhancing the Regulatory Structure for “Other than Credit” Risks

Mr. Fry said that the Working Group has developed a plan to address how to approach regulation of investment risks in fixed-income securities. The plan builds on the work of the Technical Resources Subgroup and is a direct result of public discussions, including three public conference calls held to discuss regulatory options, discussions between the chair and staff, other regulators and interested parties. The plan has three components, the first of which is disclosure. The plan recommends amendment of the Supplemental Investment Risk Interrogatory to include quantitative information and a company discussion of investment risks, similar to the Management Discussion and Analysis. The second component is focused on providing the SVO with analytical tools and resources to make investment risks more transparent to the regulatory community. The third component is monitoring. A number of the projects initiated by the Working Group involve the development of system capabilities and creation of analytical processes that require regulatory input into design and administrative areas. In addition, the Working Group is of the opinion that the larger objective of the NAIC transparency initiative requires it to periodically meet with SVO staff to discuss current investment issues and trends, and provide guidance on regulatory concerns and sensitivities. Mr. Fry said that the plan identifies broad objectives and approaches — and that the specifics will have to be developed by the Working Group once the plan, and the funding and system issues it presents, are adopted by the NAIC.

In response to a question from Mr. Shepherd, Mr. Fry clarified that the plan envisions an interactive process in which the development of systems, for example, could eliminate the need or desirability of some of the identified options. Therefore, the various regulatory options identified could well be considered for implementation as the Working Group continues its work. Ms. Stock noted that the plan recognizes that the Working Group must first identify the order in which it should move. For example, recommending changes to the *Financial Analysis Handbook* depends on first knowing what annual statement blank and disclosure changes are needed. Ms. Stock said the first priority for the Working Group is to ensure that regulators have the information they need and that the staff can begin to develop the identified tools. Mr. Shepherd and Mr. Fry agreed. Robert Carcano (NAIC) said the staff supported the plan and believed it provided much greater flexibility than simply adopting specific options for each risk at this time. Andrew Melnyk (American Council of Life Insurers—ACLI) said the ideas in the plan are significant and require much industry time to assess. He asked the Working Group to provide a sufficient time period for review and comment. Mr. Carcano said that the adoption of the plan would not have an immediate effect on insurers, because all proposals that flow from it — with the possible exception of some system or tool processes — would be publicly presented and would be subject to the usual comment process. The plan is chiefly concerned with addressing internal NAIC timelines, funding and related administrative approvals. Mr. Carcano also noted that the material that informed the plan has been available for review by interested persons since January 2009; therefore, whatever additional exposure might be needed should be short and focused. Mr. Fry agreed. A discussion ensued, during which it was decided that the Working Group would adopt the plan and refer it to the Task Force where it could be exposed for a 30-day comment period. Mr. Peltonen moved to adopt the plan and refer it to the Task Force and Mr. Shepherd seconded the motion. The motion passed.

2. Other Matters and Next Steps

Mr. Fry said that he would schedule a call in the next 30 days to begin work on remaining issues.

Having no further business, the Invested Asset (E) Working Group adjourned.

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To: Michael Moriarty, Chair of the Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force
From: Kevin Fry, Chair of the Invested Asset Working Group
Matti Peltonen, Vice Chair of the Invested Asset (E) Working Group
Bob Carcano, Senior Counsel, SVO
Re: Proposal to Redefine the Mission and Role of the Invested Asset (E) Working Group
Date: September 1, 2009

1. **Introduction -** The Invested Asset (E) Working Group ("IAWG" or "Working Group") was re-created in 2006[1] to serve as a forum for regulators to address new investment structures and to propose regulatory rules to address them. The IAWG functions as a contact point into the regulatory process for insurance companies and members of the investment advisory community. As we approach the completion of our current charge we are concerned that the operating pattern of the IAWG is inappropriate to its role and function. The IAWG was conceived as an ad hoc group, operating only when convened by the Task Force to respond to a specific assignment and disbanding immediately thereafter.[2] This memorandum proposes an alternative organizational pattern and charge for the IAWG and explains our reasoning.

2. **Background** – Immediately after its formation, the IAWG was assigned to review Constant Proportion Debt Obligations. This assignment convinced the Working Group that if the NAIC was to attain its transparency objective, the IAWG would have to be able to provide comprehensive, one-stop regulatory guidance in as timely a manner as the complexity of the new instrument permitted. As a result, we requested an expanded charge to consider improvements to the process by which risks in investments are evaluated, regulatory rules are made and guidance is communicated to insurance companies, market participants and the regulatory community.[3] We recognized and articulated that:

- Improving transparency would require insurance companies, their trade representatives, investment advisors and market participants to identify new securities and to work with regulators to highlight actual and potential risks and translate analytical insights into appropriate regulatory rules. Our first priority therefore was to facilitate this interaction by developing the specific procedures that would apply in a technical review of a new security.[4]

- The expression of regulatory concerns about risks in securities that have already been purchased by insurance companies runs a great risk of creating market turmoil. Accordingly, we have focused considerable attention on identifying the kinds of investment risks (other than credit) that are associated with fixed-income securities in order to create a more comprehensive regulatory framework. We are now evaluating the best ways to regulate those risks. The investment risk framework we are developing provides the primary background against which regulators will develop rules for investments.

- A risk focused approach to regulation requires regulators to understand investment risks and that they and the SVO as their primary advisor have the tools and systems necessary to conduct thorough financial solvency monitoring. Accordingly, we have worked with NAIC staff to identify where changes are necessary to investment schedules and reporting instructions, create a dynamic electronic system to identify risk attributes of securities owned by insurers,

[1] The Invested Asset (E) Working Group was re-formed as part of NAIC transparency initiative, whose components are identified below:
- The SVO should report all of its determinations involving publicly traded securities on the SVO Web site;
- Broker-dealers could have direct access to the SVO to obtain SVO opinions before bringing new securities to the market;
- The SVO would explain its determinations as required through research articles;
- Clarifying amendments could be made to portions of the *Purposes and Procedures Manual;* and
- The Invested Asset Working Group should be reestablished and tasked with reviewing new investment vehicles as and when so directed by the Valuation of Securities (E) Task Force.

[2] Invested Asset (E) Working Group – Charge adopted December 10, 2006. From time to time, the Valuation of Securities (E) Task Force may determine that the technical nature of some matter before it would be best advanced by convening the Invested Asset Working Group and transferring to it a specific regulatory assignment or assignments. The assignment or assignments thus transferred to the Invested Asset Working Group by the Valuation of Securities Task Force shall be within that charge of the Task Force related to development of a regulatory framework for new or evolving investments or the consideration of refinements for an existing regulatory framework applicable to an existing class of securities. The phrase regulatory framework refers collectively to and means the following regulatory mechanisms or processes: statutory accounting guidance, annual statement instructions, blanks reporting instructions, asset valuation reserves, interest maintenance reserves, risk based capital charges, valuation procedures for invested assets, credit assessment procedures for invested assets or any other aspect of the NAIC financial solvency framework within the scope of the charge of the Task Force. The Invested Asset Working Group is charged with the review of matters in the priority established by the Task Force.

[3] The Invested Asset Working Group is charged with considering improvements to the process by which risks in new invested assets are evaluated, communicated and monitored, and how the annual statement investment schedules could be made more transparent to better reflect non-credit risks, such as various structural risks embedded in new and existing securities. (Charge adopted June 3, 2007.)

[4] The role of the IAWG and the process for reviewing securities is explained at http://www.naic.org/committees_e_vos_iawg.htm

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- identify analytical tools and concepts for development that will assist regulators understand investment issues and expand SVO capabilities.

If the IAWG is disbanded after completing its current charge, the infrastructure we have just described would quickly erode. Our opinion is that the function of the IAWG should be to proactively manage the NAIC transparency objective and the infrastructure described above. The members of the IAWG, supported by the SVO, must develop the background, knowledge, expertise, legitimacy and infrastructure necessary to quickly and efficiently represent the NAIC regulatory community in discussions on investment risk issues with investment professionals representing the insurance industry and other capital market participants. This can only happen if the IAWG evolves into the regulatory partner of the SVO. The IAWG should:

- Ensure that its members develop and maintain expertise about investment risks in general and SVO operations in particular;
- Serve the SVO as a base of knowledge about regulatory practices and procedures;
- Provide the SVO with direction and guidance to assist the SVO identify those market signals and information that have immediate regulatory significance;
- Be the chief representative of the regulatory community to the SVO analytical staff;
- Assist the SVO to identify regulatory needs;
- Ensure proper dissemination of investment know-how to the regulatory community;
- Provide guidance in the completion and implementation of system projects commenced during its current charge; [5] and
- Have a role in identifying technology platform characteristics that would most effectively assist the regulatory mission and assist the management and evolution of these systems.

We believe the recommended charge (Attachment One) would accomplish the objectives identified.

Attachment One
Proposed 2010 Charge for the Invested Asset (E) Working Group

The Invested Asset (E) Working Group (IAWG) is established as a standing NAIC Working Group. The mission of the IAWG is to provide continuity in and manage NAIC processes related to the development of regulatory rules to address new investment structures. The IAWG shall fulfill this charge by:

[5] A summary of these projects and the issues they present for regulators and the staff is set forth below:
A) Database Symmetry
  i. Development of risk attribute granularity and implication for the Investment Schedule project
  ii. Other than credit risks that can be monitored by this process
B) Enhanced SVO Monitoring Process and Role
  i. Priority Coding
  ii. Pricing Information
  iii. Greater Reporting on Exposures
3) Implementation of Phases 1, 2 and 3 of the Investment Schedule Project.

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- Serving as the primary NAIC contact point into the regulatory process for insurance companies, their investment advisors and other market participants;

- Creating and maintaining a framework and the necessary procedures and processes to conduct technical assessments of investment risks in investment products eligible for purchase by insurance companies;

- Developing and maintaining knowledge and expertise about investment risks and issues as well as SVO operations and capabilities;

- Guiding the development of the technology platform of the SVO to ensure the development, implementation and evolution of systems and tools that adequately support NAIC financial solvency objectives;

- Serving as the primary NAIC regulatory resource to alert the NAIC regulatory community of the identification of regulatory issues and concerns in specific investments or in investments generally;

- Ensuring that the process by which risks in invested assets are evaluated, communicated and monitored is updated as necessary to permit a timely and comprehensive response to requests for regulatory guidance;

- Ensuring that the NAIC framework for investment risks in all annual statement investment schedules and reporting instructions capture relevant information of investment risks in insurer owned securities; and

- Performing or conducting such other ancillary or related activity that are consistent with its mission and charge.

In its fulfillment of this charge, the IAWG shall meet with the SVO on a regular basis. in sessions which are either open or closed to the public, in accordance with, and within the parameters of, the requirements of the NAIC Open Meetings Policy. During these sessions the IAWG shall consult on:

- SVO operations;

- Risks in investment or investment trends identified by the SVO;

- Regulatory practices and regulatory sensitivities that should serve as inputs in the conduct of SVO analytical responsibilities; and

- Market signals and information that warrant scrutiny for possible regulatory relevance.

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John Bruins
Senior Actuary

Andrew Melnyk
Managing Director, Research

September 10, 2009

Mr. Michael Moriarty
Chair – Valuation of Securities Task Force
National Association of Insurance Commissioners
c/o State of New York Insurance Department
25 Beaver Street
New York, New York 10004

Mr. Lou Felice
Chair – Capital Adequacy Task Force
National Association of Insurance Commissioners
c/o State of New York Insurance Department
25 Beaver Street
New York, New York 10004

Re: Revised ACLI Proposal - RBC for Residential Mortgage Backed Securities (RMBS)

Dear Messrs. Moriarty and Felice:

Thank you for considering the previous version of our proposal to modify current NAIC ratings for RMBS (submitted on August 10, 2009), and for considering the revised and expanded proposal (see attached).[1]

For structured securities like RMBS, current NAIC ratings are based on nationally recognized statistical rating organization (NRSRO) ratings, which are in turn focused primarily on the likelihood of the first dollar of loss. The resulting NAIC RBC C-1 factor does not completely reflect the potential severity of the loss.

To overcome this rating deficiency we recommend a rating proposal that recognizes both the likelihood of loss and the severity of loss. Life companies will appropriately hold more RBC than before the recent RMBS downgrades, but will not be subjected to volatile RBC requirements primarily based on the first dollar of loss ratings methodology.

The American Council of Life Insurers (ACLI) would like to request that the NAIC consider the attached revised proposal to modify current NAIC ratings for RMBS. As stated previously, we ask that you consider enacting these changes for 2009 RBC calculations. This would greatly relieve the unwarranted impact on RBC being experienced by the industry.

Thank you for considering our proposal and for working with us on this issue.

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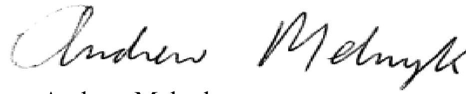
[1] The ACLI represents three hundred forty (340) member companies operating in the United States, of which three hundred thirty two (332) are legal reserve life insurance companies, and eight (8) are fraternal benefit societies. These 340 member companies account for 93 percent of total assets, 93 percent of the life insurance premiums, and 94 percent of annuity considerations in the United States.

Sincerely,



John Bruins
Senior Actuary

Andrew Melnyk
Managing Director, Research

CC: Mr. Matti Peltonen
Mr. Dan Swanson
Mr. Richard Newman
Mr. Chris Evangel

September 9, 2009

Proposal to modify current NAIC ratings for RMBS

Background

The current economic climate has created numerous issues for investors. A major issue for the insurance industry is the potential for multi-billion dollar RBC impact created by rating agency downgrades of residential mortgage backed securities (RMBS). The problem is that the ratings do not distinguish between securities that are projected to experience a total loss and securities that are projected to experience minor losses. The industry recommends a change to the C-1 RBC determination process for RMBS to better reflect the risk to insurers of holding the securities.

The RMBS market has been especially hard hit by rating actions taken by the various nationally recognized statistical rating organizations (NRSROs) or "rating agencies". The downgrades are driven by current stress in the US housing market and the rising probability of an expected loss. The rating agency models require a downgrade to single B or below if any loss is projected to occur at any time during the life of the security, regardless of the severity of the loss. The consequence of the downgrades for the insurance industry has been a significant increase in the risk based capital (RBC) C-1 factor applicable to the downgraded RMBS.

Based on a Bank of America Merrill Lynch June 2009 report[1], in excess of 64% of all AAA rated non-agency RMBS securities have been downgraded to below investment grade by at least one rating agency. The following chart is the percent of downgrades that have occurred in RMBS based on collateral type and vintage year. All the downgrades listed were from once AAA rated securities to below investment grade. All percents are based on June 30, 2009 balances.

	Prime Fixed	Prime ARM	Alt-A Fixed	Alt-A ARM	Subprime
2000	0.0%	0.0%	0.0%	0.0%	44.8%
2001	0.0%	2.2%	0.0%	0.0%	58.0%
2002	0.0%	1.0%	0.0%	0.0%	24.6%
2003	0.0%	0.0%	0.5%	0.4%	8.4%
2004	0.0%	0.3%	0.8%	6.1%	7.1%
2005	24.6%	22.8%	55.1%	62.7%	31.0%
2006	66.8%	63.2%	92.5%	92.2%	81.1%
2007	76.9%	83.6%	91.8%	92.1%	87.4%
Total	41.8%	40.6%	68.2%	76.4%	70.8%

[1] *The Mortgage Credit Round-Up, June Update, July 21, 2009, Bank of America Merrill Lynch*

The life insurance industry has heavily invested in RMBS. The non-agency RMBS holdings of the life and health industry based on a study of statutory filings as of December 31, 2008 were over $145 billion with associated C-1 capital of approximately $2.0 billion.

The statutory filing data was augmented with information from Bloomberg to include current ratings, collateral and tranche type. The change in C-1 capital from December 31, 2008 to June 30, 2009 due to the downgrades was an estimated increase of 440% to $11.0 billion. The largest (measured by admitted assets) 20 life and health companies represent approximately 53% of the total admitted assets in the life and health industry. That group saw their C-1 capital for RMBS increase by 482%, from $0.9 to $5.6 billion. The top twenty companies would hold 51% of the estimated June 30, 2009 total C-1 capital attributable to RMBS, the remaining 49% or $5.4 billion is widespread throughout the industry.

The recent RMBS downgrade actions by the rating agencies has significantly increased the RBC that must be carried for RMBS, and insurers currently have no option available to appeal to the SVO for a rating review. Industry C-1 capital will be increased by subsequent downgrades.

With this background, the industry recommends a change to the amount of risk based capital held for RMBS to better reflect the risk to insurers of holding the securities.

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Details

The approaches taken by the rating agencies vary slightly, but in essence, each agency projects cash flows of the security's underlying collateral pool based on their assumptions of prepayments, defaults, loss severity on liquidated loans, and others. Then a coverage ratio is calculated as follows:

Coverage Ratio = Current credit support of the tranche ÷ Estimated cumulative loss of the collateral pool

New RMBS ratings are determined based on this ratio and on the type of collateral in the pool (Prime/Alt-A/Subprime). For example, if the ratio is < 1, the new rating assigned most likely would be B (NAIC 4), or below, regardless of the severity of the expected losses to the tranche.

In rating RMBS, rating agencies take a similar approach to that utilized in rating corporate bonds and try to determine the level or probability of the first dollar of loss. With a typical corporate bond, a single dollar of loss leads to an event of default, which could then cascade into a series of negative events outlined in the bond indenture, usually including cessation of coupon payments and eventual recovery of some amount of principal through the bankruptcy process. This default event for corporate bonds is in stark contrast to RMBS, where the security structure allows the security to continue receiving remaining principal and interest without an acceleration event that would terminate the security. In the case of senior RMBS tranches, the ability to receive several years of coupon payments alone dramatically improves expected economic recoveries relative to a typical corporate bond.

Current ratings do not distinguish between securities that are projected to experience a total loss and tranches that are projected to experience minor losses. To quote Fitch Ratings in an April, 2009 release, "Two (RMBS) bonds rated 'B' have the same likelihood of a first dollar of loss, but they may have vastly different total losses and recoveries." Thus the current RMBS rating is determined by an evaluation of the likelihood of the first dollar of principal loss, whereas required insurer capital should reflect both the likelihood of loss and the expected severity of loss.

A more logical approach for RBC purposes, and an approach more consistent with the goals of the RBC calculations, would be to determine an estimated or modeled loss from a base set of consistent assumptions applied to the individual characteristics of each security. The estimated loss relative to par can be translated into expected loss for each holder of the security given their purchase price, write-downs and any other individual factors impacting their holdings.

Proposed Solution

Based on the fact that ratings for RMBS do not properly reflect the expected total loss from the securities, in discussion with regulators we propose the Securities Valuation Office (SVO) engage an independent third party firm to model losses of RMBS securities held by the insurance industry.

The modeling should be conducted on a security level basis and should use assumptions generally accepted by market participants for prepayments, home price levels, expected defaults, severities of loss, and performance of loans in good standing, along with other assumptions including interest rates. The result of the modeling should be a modeled loss value. The modeled loss is the probability weighted difference in current par value less the present value of principal and interest cash flows generated under multiple interest rate and credit scenarios discounted at the weighted average coupon rate of the underlying pool and represented as a percent of par value.

The modeled loss figure will be communicated in a manner to be determined later. Each insurance company will then calculate an Expected Loss from the following formula:

Expected Loss = Maximum (cv / par – (1 – ml), 0) / (cv / par)

where:

cv = Book/Adjusted Carrying Value (as reported on Schedule D – Part 1, column 11)
par = Par Value (as reported on Schedule D – Part 1, column 10)
ml = Present value of modeled loss as % of current par derived from independent modeler

The Expected Loss is then applied to the following matrix to arrive at the appropriate NAIC rating level for C-1 capital.

C-1 Rating Category	**Expected Loss**
NAIC 1	<=.50%
NAIC 2	.51% to 1.00%
NAIC 3	1.01% to 6.00%
NAIC 4	6.01% to 15.00%
NAIC 5	15.01% to 27.00%
NAIC 6	>27%

The estimated loss levels were derived from *Corporate Default and Recovery Rates, 1920-2008, February 2009* by Moody's Investors Service. The loss levels are the average cumulative loss rates for each NAIC rating category based on average default rates and recoveries for senior unsecured bonds.

For any security that cannot or has not been modeled by the independent modeler and assigned a C-1 rating based on the above matrix, one of two alternative approaches may be used to develop the expected loss.

The first alternative is the use of an internal or outsourced model at the direction of the individual insurance company. Such model's output should be the same as described above utilized by the SVO for modeled loss. Such internal or outsourced model should have an attestation from an officer responsible for modeling as to the validity of the results and methodology used to determine the modeled loss.

The second alternative is to use an expected loss metrics methodology that takes into account existing delinquencies on a pool by pool basis, estimated severities and losses. The metrics methodology is based on a 4 step approach; the following steps are used for purposes of determining RBC C-1 risk factor:

1. Determine the level of delinquencies on a per pool basis. Delinquencies will include any loan 60+ days delinquent, foreclosures, bankruptcy, and REO.

2. Multiply the level of delinquencies by the appropriate factor within the following severity matrix to determine an estimated level of loss. The severity matrix was derived from *U.S. RMBS Surveillance Methodology, April 2009* by DBRS and verified by comparison to Andrew Davidson & Co. In three instances where the severities differed by more than 10%, an average rounded to the nearest 5% was used. This matrix should be updated annually.

Vintage	Prime	Alt A	Subprime
2008	45%	50%	55%
2007	45%	55%	60%
2006	50%	50%	60%
2005	45%	45%	55%
2004	30%	45%	50%
2003 and earlier	25%	40%	45%

3. Subtract the current credit support for each tranche from the estimated loss level in step 2 above to determine the estimated tranche loss.

4. Apply the estimated loss determined in step 3 to the Expected Loss formula above to determine the Expected Loss. Apply the Expected Loss to the C-1 NAIC matrix above to determine the appropriate level of capital.

If the SVO cannot or has not modeled the RMBS security, it is at the discretion of the insurance company as to which alternative they use to develop the appropriate RBC C-1 factor.

Methodologies in this proposal are dynamic and will immediately reflect the securities expected future performance. Over time, this will ensure the capital applied to a given security remains appropriate, based current modeling assumptions or the actual losses, remaining subordination, and delinquencies experienced by the trust. It is also worth noting that capital will be

assessed every quarter while the expected loss determined for each security by the rating agency methodology is for the life of the security.

This proposal applies a consistent approach. Rating agencies have divergent opinions in regards to future outcomes. By looking to a consistent modeling approach, the proposal is directly observing the securities actual and expected future performance as the basis for capital.

The proposal accomplishes a balance between:

- Recognition that certain RMBS securities are less creditworthy now than when they were originally rated, given the deterioration of the housing market and the weakening economy; and
- The difference of the securities loss expectations for each insurance company given different purchase prices, write-downs and other individual factors impacting the statutory carrying value.

This approach is more conservative than what can be accomplished currently in the capital markets. Via a Re-REMIC structure, a downgraded RMBS security can be re-tranched into subordinated and senior securities. A Re-REMIC approach would usually result in less C-1 capital then would be prescribed under this notching proposal.

This proposed solution should be developed in concert with the NAIC and the SVO. The solution can be refined over time as the SVO can be continually improve and update the modeling capabilities of the independent outside consultant.

Conclusion

We recommend the proposal set forth above. For structured securities like RMBS, current NAIC ratings are based on the NRSROs' ratings, which are in turn focused primarily on the likelihood of the first dollar of loss. The resulting NAIC RBC C-1 factor does not completely reflect the potential severity of the loss.

To overcome this rating deficiency we recommend a rating proposal that recognizes <u>both</u> the likelihood of loss and the severity of loss. Life companies will appropriately hold more RBC than before the recent RMBS downgrades, but will not be subjected to volatile RBC requirements primarily based on the first dollar of loss ratings methodology.

Statutory Filing Study Methodology

Information supplied in this proposal used data collected from the ACLI and Bloomberg. The ACLI provided life and health insurance industry holdings of RMBS as of 12/31/08. They used the 12/31/08 statutory filings and extracted from Schedule D Part 1, every bond classified in lines:

4000001-4099998- Industrial & Misc. - Single Class Mortgage Backed/Asset Backed
4100001-4199998- Industrial & Misc. - Defined Multi-Class Residential Mortgage Backed
4200001-4299998- Industrial & Misc. - Other Multi-Class Residential Mortgage Backed
4300001-4399998- Industrial & Misc. - Defined Multi-Class Commercial Mortgage Backed
4400001-4499998- Industrial & Misc. - Other Multi-Class Commercial Mortgage Backed

Other information pulled for each security was CUSIP, company code, company name, group name, description, NAIC designation, and carrying value. That data was run against Bloomberg and tranche type, collateral type and current ratings from S&P, Moody's and Fitch were added. Using the collateral type all non-residential securities were eliminated from the study. From the ratings the current NAIC designation was determined. If Bloomberg did not contain any rating from S&P, Moody's and Fitch, the 12/31/08 NAIC designation was selected for the current NAIC designation. The tranche type was used to determine if the tranche was in a senior position.

From the collected information, the RBC as of 12/31/08 and 8/7/09 were calculated. The carrying value from 12/31/08 was used to calculate the RBC as of 12/31/08 and 8/7/09, as 6/30/09 holdings and carrying values are not available. The RBC as a result of the ratings downgrades increased from $2.0 billion to $11.0 billion, a 440% increase. Top twenty company information was collected as a sub-set of both the $2.0 billion and the $11.0 billion C-1 capital.

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To: Michael Moriarty, Chair of the Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force
Persons Interested in the Work of the Valuation of Securities (E) Task Force
From: Bob Carcano, Senior Counsel, SVO
Re: Revised Prototype Draft of the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*
Date: August 25, 2009

1. During the Summer National Meeting held July 14, 2009, the Valuation of Securities (E) Task Force received a prototype draft of the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* developed by the staff and released it for a 60-day comment period. The comment period has ended and the SVO has incorporated comments received from NASVA to create a revised draft.

2. We request an interim meeting of the Task Force for the purpose of receiving and releasing the revised draft for a short comment period beginning the day of the interim meeting and ending prior to the Fall National meeting of the Valuation of Securities (E) Task Force. This request is calculated to permit the Task Force to vote at the Fall National Meeting to adopt the revised prototype of the Manual for publication beginning with December 12. 2009. An early adoption would permit us to work with the NAIC Publications Department to explore possible formatting and other useful related considerations and also permit the industry to become familiar with the new layout and format of the Manual.

3. The staff also recommends that the NAIC publish the December 31, 2009 Manual in both the existing format and the new format. This will prevent any confusion among the industry in the application of instructions for the year-end process but at the same time prepare us to transition to the new format.

4. As previously discussed, the revised Manual no longer includes former Section 13 of the Appendix, whose subject is Asset Valuation Reserve and Interest Valuation Reserve. This text does not relate to SVO duties or functions and therefore does not correspond to any existing text in the Manual itself. We have discussed this with NAIC Financial Reporting Services staff and they propose that the text of this Section be placed on the NAIC webpage so it is available to users.

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