The Insurance Receiver

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To My Colleagues and Friends:

As we usher in a new decade, so too do we welcome cheerily a new regime. In December, IAIR elected as its new or re-enlisted directors Joe DeVito, DeVito Consulting, Inc.; Alan Gamse, Semmes, Bowen, Semmes, PC; Michelle Avery, Veris Consulting, Inc.; Lowell Miller, NC Life & Health Insurance Guaranty Association; and Vivien Tyrell, Reynolds Porter Chamberlain, LLP. Joe, Lowell and Vivien have previously served and accept these positions with open eyes. Please be VERY nice to Alan and Michelle who have not served as directors before and from whom we expect great things. Most of all, we expect them to run for re-election in 2012.

Patrick Cantilo

The newly constituted Board met in December and also elected new officers. While I can report on the Board's decisions, I cannot necessarily explain all of them. For example, I am now the President?? But you can feel better because Hank Sivley has been elected First Vice President, Doug Hartz is Second Vice President, Joe DeVito is Treasurer and Alan Gamse (taking advantage of his inopportune trip to the rest room) was elected Corporate Secretary.

We embrace the new year with eager anticipation as we plan for our first regular meeting in conjunction with the March NAIC meeting in Denver, followed shortly by the 2010 Insolvency Workshop being held at the Eden Rock, April 21st–23rd in Miami Beach. Details, as always, are provided on our website. In deference to religious holidays coinciding with the March meeting, sessions were scheduled as much as possible to avoid Palm Sunday (March 28) and Passover (beginning at Sunset, Monday, March 29). I apologize for other conflicts that will undoubtedly arise from the resulting compressed schedule.

A brief note about the new Prez for those of you with whom I have not yet spent much time. After semi-formative years in Buenos Aires, Argentina, I allowed my family to take me with them to Miami, realizing that my chances of living on my own on the streets of Buenos Aires in the style to which I wanted to become accustomed would not be easy at age 11. Years later I found myself in college

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IAIR's President's Message (Continued)

and then law School in Austin, Texas, and have been unable to find a good reason to leave the self-styled Live Music Capital of the World in the ensuing four decades. After a tour of duty in the then Texas State Board of Insurance's Liquidation Division, I set out to earn a living in the private sector, leading eventually to my current position at CANTILO & BENNETT, L.L.P. In 1991 I was one of the principal charter members of the Society of Insurance Receivers, which eventually became IAIR. This is already way too much about me but if you feel compelled to atone for some egregious crime against humanity by learning even more, feel free to peruse my firm's website, www.cb-firm.com.

"Never mind all that dribble..." you say, "... tell me about what 2010 will bring." Rightly so! Motivated by the same curiosity, upon being elected I rushed to consult one of the great sages of our time on that very subject. Hannah Montana had this to say: "Isn't it cool when your famous dad can get you a neat TV gig? Oh, oh, oh, for IAIR you mean? Here's the deal; it's not just about receiverships any more. Ever hear of the White Paper? Think Alternative Mechanisms! By the way, don't you just love how I dance?"

Hannah (regardless of her hair color at any given moment) is right, of course. We must acknowledge that political and other imperatives will foster with ever more vigor the development and utilization of non-receivership mechanisms in many cases in which earlier times would have seen receiverships. Your Association will not be left behind! We are devoting our vast intellectual powers to the development of opportunities for our members in this brave new world as well. Look for these developments in our programs as we invade this new year. But you will also see the Membership and other committees strive to bring you tangible initiatives to assist you in capitalizing on new opportunities.

We also will devote our attention to fine-tuning the mission our Association should pursue and seeing what, if any, improvements we can make to get us there. One area in which we began last year to apply renewed energy is in delivering meaningful benefits to the membership. One such initiative is just being launched. Look on our website for IAIR's JobTarget page (It is located in the upper right-hand corner of the home page and has its own tab!) that will enable our members to post their resumes at no charge and enable employers throughout the globe, at a very reasonable cost, to scrutinize the credentials of our job-seeking members.

Quit yawning! O.K. you want to know what you can do to help. First, if you are not already accredited, get with it! It ain't hard and it makes you feel really, really good about yourself. Among our longer term goals is to cause the world at large, and especially the insurance community, to recognize IAIR credentials as the definitive indicia of proficiency in our field. As we attain that goal, won't it be cool to have those credentials? Won't it be even cooler to be able to say you've had them for a while? Turn to the "Designations" link in our website for all you need to know to become a CIR or an AIR. If you have more questions, Maria Sclafani, our Mission Control Specialist (a/k/a Executive Director) can assist you with the application process. Second, take off your jacket and jump head-first into one of our committees. You don't have to bring your own paper, scissors or glue, but you will have the chance to add to the success of IAIR in a meaningful way. Moreover, our committees present spectacular networking and getting-famous opportunities. Details available on ... our website of course. Third, ...

You are on a long-awaited date with that very attractive young lady (or the dashing young man) in purchasing, three cubicles over. You finished talking about your TPS reports, wine has flowed freely, awe-struck laughter greeted your jokes and your eloquence has conquered all resistance. In a suggestive, raspy voice, Gertrumina (or Lancealittle) whispers "Take me home, I would very much like to see your etchings! How can I make you happy?" That's when you look deeply into her (his) eyes and, without skipping a breath, you intone romantically "Please, please ... join IAIR!" NEW MEMBERS. That's what else you can do for your loving Association.

Having shamelessly placed my hat in front of you in search of your contributions in the very first message I pen as President, I fear that I have now over-extended my meager welcome.
So I close by thanking you sincerely for this opportunity to do my bit for IAIR and look forward to seeing each and every one of you at our meetings.

Au revoir et à bientôt.

Patrick

Board Talk: Alan Gamse, Esq., Semmes, Bowen Semmes, PC

Michelle J. Avery, CPA, Veris Consulting, Inc.

The end of 2009 saw the election of a few new Directors to the IAIR Board. As a new board member myself, I took the opportunity to reach out to another new face, Alan Gamse, a newly elected IAIR Board member, for this interview.

Alan Gamse

Given that Alan's office is in Baltimore and I'm located just outside DC, we initially decided to meet in person for the interview – but, Mother Nature had another plan. As the inches and then feet of snow started piling up in February, we decided risking life and limb for the Board Talk article wasn't worth it and rather Alan and I changed our plans and opted for a phone interview.

Alan has been in Maryland for most of his life – there was a short stint in Massachusetts when he attended MIT, but if you ask him, he will tell you that was a mistake. He quickly learned that electrical engineering wasn't for him and instead, he graduated with a degree in Industrial Management and quickly found his way to law school at the University of Maryland. Alan clerked for the Maryland Court of Appeals and then found a home at Semmes, Bowen and Semmes where he has been for over 40 years.

Although new to the Board, Alan is by no means new to IAIR. Alan became a member of IAIR in the early 1990s and has been doing work in the insolvency arena since his first introduction to it with the Maryland Indemnity insolvency in 1978. Alan has spent much of his time working with various guaranty associations including Maryland and Washington, DC. His work at Semmes includes a range of services in the insurance corporate and regulatory arenas. See below for Alan's responses to the gauntlet of probative Board Talk questions:

1. **How long have you been a Board member? When does your term expire?**
   Alan was elected during the IAIR Annual meeting in December and his first term will last three years but like any good politician it's never too early to start thinking about re-election.
2. **Do you serve on any IAIR committees? Which ones?**
   Alan has been the Chair of the Website Committee for "longer than he can remember" and for the past several years has attended over half of the various other committee meetings in order to stay abreast of issues as they relate back to the website maintenance, management and functionality. He has been an integral part of the transition to the new website and continues to add new ideas.
3. **What is the most important issue you see facing IAIR during your term on the Board?**
   The insurance insolvency industry has evolved from the insolvencies of small single-state insurers to those of large multi-state carriers writing many esoteric types of coverage. Now the industry continues to evolve rapidly with run-offs and restructurings coming into vogue and, at least in the short run, replacing the traditional rehabilitations and liquidations. Alan believes IAIR, as an organization, needs to remain relevant to the needs of its members; and he warns that without undertaking evolutionary changes, one can easily wind up a buggy maker while everyone else drives cars. IAIR is working hard to evaluate its mission and to make sure that it continues to evolve and adapt to the needs of the marketplace.

Board Talk (Continued)

4. **If you'd like, please tell us about your personal life. Where were you born? Where do you live? Are you married? Do you have any children?**
   Alan has lived in downtown Baltimore for over 40 years. This has included 35 years in a rowhouse community about a mile and a half from the inner harbor. In 2001, he and his wife moved to a high-rise condominium on Baltimore's inner harbor where they overlook both the Aquarium and Fort McHenry. Alan has two children, a son living in Illinois and a daughter currently living in Paris, France. His children have been thoughtful enough to provide him with four grandchildren ranging in age from nine years to a year and a half.
5. **What is the last fictional book you read that you would recommend to others?**
   Although he isn't a frequent reader of fiction, Alan enjoyed and recommended Ayn Rand's last novel, published in 1957, *Atlas Shrugged*, which he has just read for about the 20th time. This novel is described as "an intellectual mystery story that integrates ethics, metaphysics, epistemology, politics, economics, and sex." According to Alan, the book is scarily relevant to our current economy.
6. **What is your favorite sport? Team?**
   Although he used to be a fan of the home teams – the Orioles and Colts - Alan became frustrated with the management, strikes and player turnover. His sports interests are limited to following Johns Hopkins' lacrosse. Alan anecdotally mentioned that in recent years he has been inside Camden Yards and Ravens Stadiums more times to finish 5K and 10K road races than for spectator sports events
7. **What is your favorite leisure activity?**
   Alan mentioned running in reference to the last question and indicates he enjoys the frequent run along the promenade in the Inner Harbor of Baltimore. However when asked about his favorite leisure activity, he indicated that he enjoys traveling with his family both nationally and internationally. Just last summer he went to Istanbul, Turkey and has a trip to Egypt and Jordan coming up. Less extravagant but wonderful still, he spent some time in Aspen, Colorado and Illinois over the holidays.
8. **What is your favorite NAIC/IAIR conference location?**
   Consistent with several of the previously interviewed Board members, Alan really enjoys the meetings that are held in San Francisco. He enjoys the downtown, energy and walk-ability of the beautiful city.
9. **Give us one piece of information that most people don't know about you?**
   Although during our conversation Alan was pensive at times, there was no hesitation when I asked him this question. Alan was "armed" with his answer. Alan shared with me that he was, by his own description, a "gun nerd." While that doesn't mean the Alan packs heat; Alan did shoot competitive rifle in high school. Impressively during his junior and senior years he was the Maryland Scholastic Association High Scorer. I'm sure for those of you that already know Alan, this probably comes as quite a surprise.

Thank you Alan, for your time.

Michelle Avery, CPA is an Executive Vice President and Managing Director at Veris Consulting, Inc. within the firm's forensic accounting practice. Michelle has extensive experience assisting counsel in causation and damage assessments related to filed property casualty and life and health insurance companies. Michelle is a member of the AICPA's NAIC/AICPA Working Group Task Force.

To submit an article, please contact Maria Sclafani at mcs@iair.org. The deadline for the Summer 2010 issue is July 1, 2010.

The Year In Review: An Interview with Commissioner Karen Weldin Stewart

By Paula Keyes, CPCU, ARe, AIR, CPIW, DAE, Paula Keyes and Associates LLC

Karen Weldin Stewart was elected to the office of Insurance Commissioner for the State of Delaware in 2008 and began her four-year term on January 6, 2009. She previously worked for the State of Delaware as their Deputy Receiver from 1989 to 1993. Commissioner Stewart is a founding member of IAIR (f/k/a "SIR") and served as its first President for a three-year term. She is currently serving on the IAIR Board of Directors. The following is an interview with Commissioner Stewart recapping her first year in the office of Insurance Commissioner.

Karen Weldin

Q: When your term began what were your goals as Insurance Commissioner?

A: I had six main goals at the beginning of my term. They are:

1. Making health insurance more affordable for Delaware consumers, which was started with the passage in 2009 of Delaware S.B. 35 giving the Commissioner the power to approve/disapprove health insurance rate filings;
2. Developing DE as an attractive domicile for captive insurance companies. In August 2009, we launched our new Bureau of Captive Financial Insurance Products. By the end of 2009, eight new captives had domiciled in DE;
3. Increasing investment opportunities for financially strong insurance companies in DE. In the summer of 2009, I issued an emergency order easing the reserve burdens on certain DE-domiciled insurers and during the current legislative session, we will be introducing legislation giving greater investment flexibility to the best-performing insurance companies domiciled here;
4. Improving the performance of the DOI's Consumer Services Division. Despite staff reductions, the Consumer Services Division handled nearly 10% more inquiries than in 2008, while trimming response time to an average of less than four hours;
5. Securing renewed accreditation from the NAIC. A new 5-year accreditation was secured in the spring of 2009; and
6. Increasing the coverage for consumers provided by the Delaware Life and Health Guaranty Association. The first bill we introduced extended coverage for consumers from $100,000 to $300,000 for included policies. We received unanimous bi-partisan support for the bill and last month, the Life and Health Guaranty Association Amendment was signed into law by Governor Jack Markell.

Q: Have those goals changed since you took office and if so, why?

A: As old goals are realized, new goals are established. In 2010, we are working on a legislative agenda that presently incorporates approximately 10 new initiatives. Some of these are consumer protection measures and others are designed to stimulate economic development.

Of course, changes in the economy will affect our goals. With our state facing a very large deficit, the legislature will not pass any bills that include a fiscal note. This impinges on our ability to introduce certain programs that I would otherwise support. However, things that are too cost prohibitive now may become more viable once the climate improves.

Tackling health insurance problems remains critical. While we cannot predict how the landscape will change if and when federal healthcare reform legislation is passed, one long-term goal of mine is the formation of a high risk pool which would greatly reduce the number of uninsureds in DE.

Another goal is to reduce the number of uninsured motorists in the state. We are presently working on

The Year In Review (Continued)

a multi-agency pilot program to develop technology and implement new procedures which we feel is very promising. Fewer uninsured motorists translates into lower premiums for all DE drivers.

Another area of concern is reducing the incidence of accidents among young drivers. The DOI sponsors C.A.T., a combination classroom and hands-on collision avoidance training program that targets drivers between the ages of 16 and 20. The accident rate among young drivers in our state is several percentage points greater than the rate for the universe of all drivers. I'm working to bring these numbers down.

I will continue to push measures designed to stimulate economic development in Delaware. The Captive Bureau will play a major role. Late last year, the first serial captive in the world was formed in Delaware. We see serial captives as being particularly beneficial with respect to insuring employee benefits. This is a timely development and we think this is an area where we can make strides.

My staff is also evaluating the idea of establishing a reinsurance exchange in Delaware. While I haven't yet come to any final conclusions in this regard, this concept is emblematic of my emphasis on looking closely at all potential options to build the Delaware economy and develop well-paying, sustainable jobs in our state.

I will also work to expand our Workplace Safety Program. Under DE law, a qualifying business that passes an authorized safety audit receives up to a 19% discount off their Workers' Compensation premiums. While over 1500 Delaware businesses currently participate in the program, we estimate that this number represents not more than 10-15% of the total universe of businesses that could participate in the program. During 2009, we initiated a program working with the various chambers of commerce in the state to promote the program to their membership. This is a program I will continue and expand during 2010.

In 2009, the department began auditing insurance companies doing business in DE to verify that they had paid the correct amount of premium tax. 24 audits are presently underway and more will be started in 2010. In addition to collecting all the outstanding premium tax that is owed (all of which goes to the state's general fund), the Department will also receive a surcharge on each of these exams. Our conservative estimate is that the surcharges on the current exams will exceed $100,000.

I will also work to increase the scope of ElderInfo (SHIP) operations. We've undertaken several steps to increase our contacts with Medicare recipients and citizens becoming eligible for Medicare. In 2010, the DOI will be using electronic media more extensively than ever before. For example, we have cultivated a list of over 100,000 Delaware email addresses to which we will email consumer alerts, news releases and other information including materials relating to Medicare. We will also continue to work diligently with senior centers throughout the state. We rely on volunteers to conduct much of our outreach and I'd like to see the number of volunteers grow this year. Our SHIP grant from CMS was significantly increased over 2009, and our goal is to maximize this grant to increase our total number of client contacts.

Q: What have been your biggest challenges in meeting these goals?

A: The challenges have been the difficult economic climate, which has posed one of the greatest challenges to my administration, the uncertainties surrounding federal health care legislation, and the prospect of federal regulation of insurance have also posed challenges.

Q: What has been your greatest reward as the Insurance Commissioner?

A: One of my greatest rewards was helping to facilitate Farmers Insurances' successful acquisition of 21st Century, a Delaware-based company. Successfully consummating this transaction preserved approximately 750 jobs in Delaware.

A second great reward was successfully concluding negotiations and litigation which resulted in a dramatic reduction in workers' compensation premiums for Delaware businesses. These reductions will be implemented over a four year period. In year 1, the reduction will be 22%. Thereafter the subsequent annual reductions will be 6%, 6% and 5%.

Q: Has the financial crisis impacted your role as Insurance Commissioner and if so, in what specific ways?

A: As I said earlier, one of the biggest impacts of the financial crisis is the uncertainty it has created. Many of the initiatives we have undertaken are subject to changes in the economy and/or federal action – or inaction – which ensues.

The Year In Review (Continued)

The financial crisis has impacted all Delawareans. Unemployment in our state is running at approximately 10%. As people lose their jobs, they lose their health insurance and make decisions to forego other types of insurance they view as too costly.

One thing I'm concerned about is the increasing presence of fraudulent discount healthcare programs which are being deceptively marketed as health insurance. In Delaware, as well as in other states across the country, we're seeing an increase in this problem as economic times worsen.

Q: What is the political climate in the state and has it changed with the election of a new party in Washington?

A: In 2008, the Democrats carried both houses of the General Assembly. Previously, the House of Representative had been controlled by the Democrats but the Republicans had held a majority in the Senate. Delaware also elected a Democratic governor in 2008, so I think expectations were high at that time that the various branches of the government would be able to work together and get a lot done. To a certain extent, that has happened. However, you see the same kind of divisions in opinion among Delawareans that you see in the nation as a whole and I think there is a level of anxiety among our citizens that is similar to what we're seeing going on around the country

Q: As you fill the remainder of your term, what do you hope to accomplish?

A: The primary mission of the DOI is to ensure reliable insurance coverage at reasonable rates for Delaware consumers. Doing so will always remain my first priority.

To meet this mandate, one thing I have to do is to make sure insurers doing business in Delaware remain financially healthy. Insolvent insurers can't pay claims. Our regulators do a great job and we haven't had a liquidation in 15 years.

I'll continue to emphasize consumer services. I'm proud of our track record to date, particularly in light of the fact that due to budgetary constraints, we're short-staffed. But, we will not rest on our laurels. I'm committed to making sure that every consumer who contacts our office receives prompt, professional, respectful and effective assistance. We may not always be able to get the consumer the result they seek, but we can continually strive to provide the level of service to which they are entitled.

Q: Do you have any parting thoughts you would like to share with IAIR?

A: IAIR remains a passion for me; as it has always been since I helped found it almost 20 years ago. As anyone who knows me will tell you, I have fond memories of my time as Delaware's Deputy Receiver and it's a topic I'm always ready to talk about. My prior experiences have helped form my present perspective and my goals for the future. My involvement with IAIR, and the relationships I have formed and nurtured through my participation in this organization, remain at the core of who I am both personally and professionally.

IAIR Welcomes New Members

The following members were approved at the Winter 2009 IAIR Board of Directors Meeting:

Rebecca Belanger-Walkins, CFE, MCM, is Managing Member with Examination Resources, LLC, located in Atlanta, Georgia.

Bryan Fuller, CPCU, ARe is Senior Reinsurance Consultant for Rector and Associates located in Kansas City, Missouri.

Cliff King is Director of Group Operations for Pro Group Management, an administrator of self insured group workers' compensation insurance, located in Carson City, Nevada.

Randolph D. Lamberjack, CPA, CFE is President of Noble Consulting Services, Inc., located in Indianapolis, Indiana.

Robert L. Margolis is a Partner with the law firm Robinson, Curley & Clayton, P.C. in Chicago, Illinois.

Michael Motil is a Principal with Motil Consulting, Inc., located in Columbus, Ohio.

Gregory Pierce, J.D. is a Partner with Scott, Douglas & McConnico, LLP located in Austin, Texas.

Jacqueline Rixen, J.D., owner and operator of Rixen Law located in Austin, Texas.

Lehman Brothers: Scheme of Arrangement Rejected by UK Court

By Elizabeth Wheal & Charlotte Lilley, Reynolds Porter Chamberlain LLP

This article first appeared in INSOL's online newsletter and is reprinted with their kind permission.

On 6 November 2009, the Court of Appeal upheld the judgment of Mr. Justice Blackburne that a scheme of arrangement under Part 26 of the Companies Act 2006 could not be used by the administrators (PricewaterhouseCoopers "PwC") of Lehman Brothers International (Europe) ("LBIE") to return assets to the LBIE's clients. The scheme was proposed to unravel the problems faced by LBIE in relation to property held on behalf of clients (mostly hedge funds). This article sets out the background to this case, the first instance and appeal decisions, and the future implications.

Background

It is well known that LBIE went into administration on 15 September 2008, and PwC were appointed as their administrators. At the time of its collapse, LBIE held more than $30 billion of client assets. LBIE held such assets as trustee on behalf of prime brokerage, custody and other clients. These assets were held through depositories, exchanges, sub-custodians and clearing systems under different contractual arrangements, such as the International Prime Brokerage Agreement, the Master Custody Agreement and the Margin Lending Agreement.

As the assets were held on trust for the clients, the assets need to be returned to the clients. PwC as administrator is responsible for identifying the trust clients, the trust property over which the clients have a proprietary claim and the net financial position between LBIE and each client at the time LBIE went into administration. This very complicated exercise is made worse by there being competing claims for the same asset.

In March 2009, the High Court granted PwC permission to explore the use a scheme of arrangement under Part 26 of the Companies Act 2006 ("CA 2006") to aid the process of returning the trust assets to LBIE's trust clients. However, the court made clear that there was an issue as to whether the court had jurisdiction to sanction such a scheme of arrangement. It was agreed that this question would be revisited after PwC had developed a scheme. The hearing to establish the answer to this question was heard in July 2009.

Proposed Scheme of Arrangement

Recognising the difficulties faced in proposing a scheme of arrangement, PwC set up a "sounding board" to formulate a scheme. This sounding board includes representatives from PwC, Linklaters (solicitors for PwC), a creditors' committee member (one including an unsecured creditor who would not be party to the scheme) and two industry bodies (the Alternative Investment Management Association and the Managed Funds Association).

The aim of the scheme was to simplify and speed up the return of assets to LBIE's clients, whilst at the same time providing certainty and finality. In basic terms, it was proposed that LBIE's clients (the "scheme creditors") should be split into three pools, so that their claims could be dealt with on a class rather than individual basis. The intention was that the scheme creditors would release their proprietary rights (claims) against LBIE, the administrators and other creditors in exchange for a new claim. This new claim would be of equal value to their original proprietary rights, and would be discharged by the scheme creditors receiving assets from the scheme creditor pool they were assigned to under the scheme. Effectively, the scheme replaced a scheme creditor's original proprietary rights with new rights which would be discharged with trust property.

The scheme set out a cut-off date for the trust clients to submit their claims; this was proposed to assist the administrators to achieve their aim of certainty and finality. PwC wrote to 1,707 LBIE account holders, who it was thought may have claims against LBIE for return of assets, asking them to set out full details of their claims. PwC also published a notice on the administration website inviting clients and counterparties, who had not received a letter but who nonetheless think they might have a claim, to set that claim out. By May 2009, PwC had received 1,214 trust property claims. The effect of the cut-off date would be to deprive clients (beneficial owners) of their proprietary rights without their agreement if they had not submitted a claim.

This scheme was novel because a normal scheme of arrangement compromises the rights of creditors, however the proposed scheme sought to compromise the proprietary rights of the beneficial owners (clients) of the assets. None-theless, the administrators said that the scheme did fall within Part 26 of the CA 2006 because if the trust clients were to suffer a short-fall they would have a pecuniary claim for damages against LBIE, as required by normal scheme of arrangement under Part 26 of the CA 2006.

Court's First Instance Decision

It was held by Mr Justice Blackburne that the court did not have jurisdiction to sanction the proposed scheme of arrangement which sought to vary (or deprive) some client's proprietary rights, which were independent of any rights these clients had against LBIE as creditors. The judge held that there was no dispute in respect of pecuniary claims which a creditor may have against the company for damages or equitable compensation for breach of trust, they are to that extent creditors. However, this did not affect the court's jurisdiction to sanction a scheme in so far as it compromised or removed rights over trust property.

The difficulties faced by the administrators were recognised by Blackburne J who stated that the certainty provided by the scheme and the early return of assets was admirable. However, the court could not get away from the fact that a scheme of arrangement under Part 26 of the CA 2006 is a way for the company to settle its own assets amongst its creditors. Trust property held by the company is not the company's property (assets) and therefore cannot be settled by a scheme of arrangement. Further, the scheme of arrangement could not deprive trust clients of property that was rightfully theirs just because they did not submit their claims before the cut-off date set out in the scheme of arrangement.

Court of Appeal Decision

During the appeal, the administrators asserted that the judge at first instance had focussed too much on the variation of existing property rights under the scheme and had failed to adhere to the statutory test which simply required an arrange-ment between a company and its creditors. There is no requirement that such an arrangement is only made with creditors in that capacity. In addition, the administrators argued that all that is required is for a person to qualify as a creditor and then the scheme is engaged and extends to all the rights of that creditor against the company and not merely to those which gave rise to the claim in debt.

The Court of Appeal dismissed the appeal and upheld the decision of Blackburne J. Notwithstanding the wide interpretation given to terms within Part 26 CA 2006, a person with the beneficial interest in property held by an company cannot be considered a creditor, rather they are the owner of specific property in possession of the company. Whilst a breach of trust by the company would give rise to a claim in a creditor capacity, the trustee/beneficiary relationship does not of itself entitle the beneficiary to a pecuniary claim.

As regards the administrators' secondary argument - that a scheme can be validly approved for beneficiaries of trust property where they are also a creditor – this was also rejected. In the absence of clear authority, the court considered that if a person's claim did not render them a creditor then the subject matter of that claim would not be covered by the arrangement. The fact that an individual may be a creditor for a different purpose would be unaffected.

Whilst both the first instance and court of appeal were sympathetic to the purpose for which the scheme was being proposed – and considered that the scheme may represent a reasonable proposal – they did not consider it fell within the terms of the legislation and thus they did not have jurisdiction. Whilst a scheme of arrangement is a flexible tool in the corporate restructuring tool box, the courts have shown that they will not allow it to be used in inappropriate circumstances to the detriment of individuals' rights. A scheme is just one solution available to an administrator. It is not an automatic fix and, as the appeal court noted, the administrators LBIE may be better served by making an application pursuant to the Trustees Act or the court's inherent jurisdiction to resolve the beneficiaries' rights.

Elizabeth Wheal

Charlotte Lilley

Elizabeth Wheal (elizabeth.wheal@rpc.co.uk) is a Senior Associate and Charlotte Lilley (charlotte.lilley@rpc.co.uk) is a trainee solicitor in the Insurance Restructuring and Insolvency Team at London law firm Reynolds Porter Chamberlain LLP.

The Board at Work

By Patrick H. Cantilo, Cantilo & Bennett L.L.P.

With winter storms impeding trips to the beach and the curling competition all but over in the Olympics, members of IAIR's Board of Directors turned their spare time to the betterment of humanity by addressing important aspects of the Association's future.

IAIR Broadens Its Scope!

For some time IAIR's Members and Directors have been debating whether the Association should broaden its scope to encompass, in addition to receiverships, alternative mechanisms for dealing with troubled insurers. After extensive deliberations, on February 26, 2010, the Board of Directors took a significant step in that direction by adopting a new Mission Statement as follows:

To assemble individuals interested in the affairs of insurers which are financially stressed or troubled or are in need of restructuring or in receivership;

To establish ethical and professional standards in the conduct of the affairs of such insurers;

To provide to its members professional education relevant to such pursuits; and

To recognize, through accreditation, the attainment by its members of expertise and proficiency in such pursuits.

You can see our new Mission Statement on the website and on newly prepared materials.

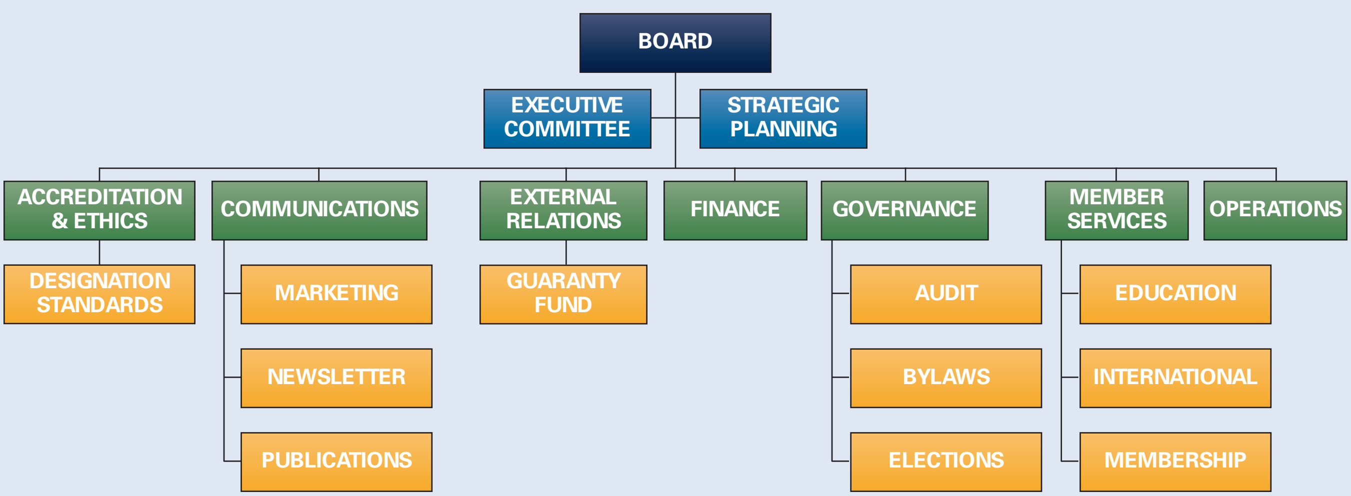
Revision Of Bylaws

The Board voted to present for approval at a meeting of the Membership to take place Friday, March 26 a revised set of Bylaws that include a number of "housekeeping" changes and some more substantive amendments as follows:

- Replaced the reference to Objectives with the new Mission Statement
- Simplified the process for admitting new members
- Made the Immediate Past President a member of the Board of Directors
- Authorized a President to be reelected once (for a total tenure of two years) and to be a director for the second term even if otherwise "termed out"
- Broadly revised the committee structure as described below

New Committee Structure

The Board voted to revise the Association's committee structure to one in which seven functioning and two advisory committees report to the Board with a variety of subcommittees reporting to the functioning committees. Graphically, the new structure is depicted in the chart below. More details are contained in the revised Bylaws which will soon be sent or made available to all the Members.



Difficulties of SSAP No. 43R to an Insurance Receiver

By Mark F. Bennett and David G. Greenberg, Cantilo & Bennett, L.L.P.

Prior to the adoption of Statements of Statutory Accounting Principles ("SSAP") No. 43R—Loan-backed and Structured Securities – Revised, the valuation of loan-backed and structured securities was governed by SSAP No. 43—*Loan-backed and Structured Securities*, SSAP No. 98—*Treatment of Cash Flows When Quantifying Changes in Valuations and Impairments*, and SSAP No. 99—*Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*. On September 14, 2009, SSAP Nos. 98 and 99 were replaced with SSAP No. 43R. SSAP No. 43R provided updated guidance on recording other-than-temporary impairments ("OTTI") on loan-backed and structured securities. SSAP No. 43R became effective for September 30, 2009, financial reporting. Under SSAP No. 43R, loan-backed securities are defined as pass-through certificates (*e.g.*, asset-backed or mortgage-backed securities), collateralized mortgage obligations, and other securitized loans where the payment of principal and interest is proportional to principal and interest received from the underlying securities. Structured securities (e.*g*., collateralized debt obligations ("CDOs")), on the other hand, are defined as loan-backed securities which have been divided into two or more classes for which payment of principal and interest is paid sequentially, rather than being allocated and paid in proportion to principal and interest received from the underlying investment securities.

For simplicity in this article, loan-backed and structured securities will both be referred to as loan-backed securities.

The recently adopted SSAP No. 43R may require insurers to recognize a loss on loan-backed securities even if such insurers have the intent and ability to hold such securities to maturity. Under SSAP No. 43R, a loan-backed security is valued at amortized cost, unless the security is rated by the National Association of Insurance Commissioners ("NAIC") Securities Valuation Office as NAIC 3 through 6 (non-life companies) or NAIC 6 (life companies), and in this event, the security is valued at the lower of amortized cost or fair (market) value. In addition to the valuation requirements above, for any security whose fair value is less than its amortized cost, the insurer must determine whether the impairment (decline) is "other than temporary." If the impairment is considered to be an OTTI (in other words, the insurer does not expect to collect the entire amortized cost of the security), then the insurer must recognize a loss on that security. If the OTTI is caused as a result of the insurer's intent to sell (or lack of ability to hold) the security before it recovers the loss in value, then the insurer must write the security down to fair value and recognize a loss for the amount of the write-down.

The difficulty in applying SSAP No. 43R comes when trying to apply the OTTI requirements to those securities that the insurer has the intent and ability to hold, but which have impaired fair values. Unless it is very clear that the insurer will receive all cash flows as structured, the insurer will likely be required to perform cash-flow modeling for the security to determine whether the impairment is credit related (in other words, whether the insurer will receive all contracted cash flows). If the results of the cash-flow modeling (present value of the expected cash flows) are lower than the amortized cost of the security, then the insurer will need to value the security at the amount of the discounted cash flows and recognize a loss for the amount of the write-down.

The required SSAP No. 43R analysis may require a write-down of the investment securities that were held at higher values under the previous guideline of SSAP No. 98. Conversely, if a loan-backed security had been treated as an OTTI investment under the previous guideline of SSAP No. 98, SSAP No. 43R may provide for a "write-up" in value of the investment, which is certainly unique under statutory accounting principles. SSAP No. 43R is unusual in that the previous accounting rules provided that once a company took an OTTI write-down, it could not typically "write-up" the value of the securities unless it sold the same. The complexities of SSAP No. 43R are apparent and become more complex as determining the impairment status of certain securities may require extensive analysis.

As will be discussed more thoroughly in this article, the requirement to determine the future cash flows and market values is not a simple task. Specifically, the requirement to determine future discounted cash flows and market values for structured security products, such as CDOs, is a complex endeavor which many insurance entities are not equipped to develop. Even some Wall Street firms will have difficulty in analyzing the underlying securities that may comprise certain loan-backed securities. The use of outside Wall Street firms to analyze loan-backed securities, on behalf of an insurance receiver, may be an expensive process. The process will involve a discounted cash flow analysis of projected future cash flows for all loan-backed securities where there is uncertainty as to cash flows, and it will also require a market value analysis for NAIC 6 (life companies) and NAIC 3 through 6 (non-life companies) rated investment securities, both of which must be performed for each statutorily mandated financial reporting period. The process of accurately depicting the value of loan-backed securities is also vital for other reasons, such as a sale of the company and representations of financial condition, audits, and determining the availability of funds for policy payments or other financial transactions.

The complexity of determining market values for loan-backed securities is compounded by the current state of the capital markets. When determining the market value for a typical common or preferred stock, it entails a simple process of receiving a quote from one of many standard services. The process of determining market values for loan-backed securities may pose other challenges. In late 2007, the loan-backed market became illiquid and severely distressed. The market for these once high and mighty securities became almost nonexistent. The lack of a "normal" market was the impetus for the cash-flow modeling changes to SSAP No. 43R. The liquidity and market for some of the loan-backed securities have since come back, albeit to an extent. However, this market is not as liquid or robust as it once was, leading to valuation and inefficient investment trading problems, while severe illiquidity and depressed prices persist for some securities. To be sure, there is a lack of a true market for some loan-backed securities that may be considered distressed or under price pressure, meaning that difficulties arise in pricing these securities and price quotes may reflect unrealistic market values. For example, there may be significant discrepancies in offer and bid prices. In addition, sales that do occur may be in response to liquidity concerns, "fire sales," or other distressed scenarios which artificially depress values and create further material valuation differences. Furthermore, the actual price of trades may not be disclosed, and those that are disclosed may not reflect the right value to assign to those securities. In order to combat this problem of taking past offers or sales as true market values, an insurance receiver (or an ongoing company) may need to do additional analysis to find the proper market price.

The market for these once high and mighty securities became almost nonexistent.

Specifically, for distressed loan-backed securities, mid-market pricing tends to provide more reliable pricing information for current market values of distressed and illiquid securities. This process collects data from several sources including actual recent trading activity, market bids and offers, and general market intelligence from broker dealers and trading desks. The data is analyzed where trades based on forced sales or liquidations are not considered so that prices are not skewed downward unfairly. The other trades must be carefully analyzed to determine the cash flow and required rates of return assumptions that market participants may have used in determining their offer prices. Once all pricing information is gathered and accurate data is compiled, the mid-point between the bid and offer levels is used. This mid-market pricing process tends to be more representative of the current market value for each security and should provide a more realistic price for some of these illiquid securities. The insurance receiver must make sure that good and "auditable" records are prepared, as valuations may be reviewed during an audit. In general, the insurance receiver will also want "auditable" records of determined values for support of any future policy payments, reinsurance, or other transactions that may involve estimates of assets available, assets to be transferred in a financial transaction, or as support for any rehabilitation plan.

Difficulties Of SSAP No. 43R To An Insurance Receiver (Continued)

To determine the expected future cash flows of these loan-backed securities, some of the original underwriters provide discounted cash flow information to investors. However, their approach may be flawed. Many of these underwriters have advisory divisions which either owned or advised customers on purchasing these assets or have other close relationships with an underwriter that tend to encourage more optimistic cash flow scenarios. Many of these underwriters may no longer be doing any real or in depth analysis of their own to support the cash flow estimates for these securities or may have significant differences in perspectives on the future performance of the assets. In a recent experience, we noted that the underwriter's values (based on their cash flow assumptions and expected losses for structured securities) for certain loan-backed securities were up to 50% higher than the value determined by the receivership team of expert consultants that evaluated updated information on discounted cash flows for each structured security. The potential conflict of interest may encourage underwriters to present a much better scenario than what a conservative and realistic analysis may have shown. The original underwriter may be the only source available for discounted cash flows, unless the insurance company has internal resources available to develop the cash flow analysis, which is unlikely in most instances. For expediency, many insurance companies may simply rely on the rosier cash flow assumptions of the original underwriter rather than obtaining or performing any other cash flow analysis; thus, the insurance receiver should be wary as to whether such analysis is flawed.

Even where companies have the internal resources to develop the cash flow analysis, difficulties arise simply as a result of the complexity of these securities. For example, most CDOs consist of large pools of bonds, loans and other assets. In a typical asset-backed CDO, the portfolio may consist of more than 100 individual securities. To determine the proper discounted cash flow analysis, each security must be analyzed and various assumptions must be implemented in the model including length of the security (some securities can have 30-year maturities), uncertainty in future interest rates, assumed default rates for underlying collateral, and prepayment assumptions in an uncertain economy. The sheer number of companies or securities that make up the underlying collateral pools for some of the investment securities also complicates the analysis. This is a time-consuming process where a lot of the data can be difficult to acquire, and the end result is far from an exact science. Even companies that have extensive financial resources to perform this analysis may find the required process to be cumbersome, and they may not want to dedicate internal resources to this valuation process. Data can also be sparse for some underlying securities that are either privately or foreignly held, making a cash flow or market value analysis exceedingly difficult.

Most internal investment departments at insurance companies are not equipped with a team of experienced analysts that have the capabilities or resources to perform such research. Bear in mind that many insurance companies, even before receivership, did not have an extensive team of investment analysts, choosing instead to rely on the ratings of nationally recognized rating agencies before making investment purchases. Many insurance companies have since determined that heavy reliance on rating agencies may have been particularly harmful to their investment portfolios.

Another type of structured security product that can pose additional problems to an insurer is a synthetic CDO. Synthetic CDOs are CDOs in which the underlying credit exposures are taken on by using a credit default swap rather than by having a vehicle invest in actual cash securities. Certain synthetic CDOs are essentially "light switch" investments in that if the insurer's tranche or risk class is affected before the maturity date (i.e., by too many defaults in the underlying assets), the insurer will lose the entire value of its investment, meaning that the "light switch" turns off. Alternatively, if the insurer's tranche or risk class is not affected before the maturity date, the insurer will obtain a complete payoff on its investment. In these types of investments, the insurer must take an educated guess on whether the investment will be paid in full or become worthless prior to the maturity date. The insurer must also assess counterparty risk for the swap counterparty for potential signs of default. To an insurance receiver, these educated guesses and assessments can be difficult, and the stakes are high to make the right decision. For synthetic CDOs, the insurance receiver must make an educated guess about whether greater value will ultimately be recognized for the estate (albeit by selling the synthetic CDO for what may be a distressed price), or will the synthetic CDO have few enough defaults of underlying assets where the investment will pay off at maturity. Can you spell the words "crystal ball"? Insurance receivers may find themselves tempted to sell synthetic CDOs when distressed offers to purchase are being made. There continues to be a plethora of negative news about investment securities that would affect the value of the synthetic CDO, so the retention of these investments is not for the faint of heart. A question arises—should the insurance receiver "play for an all or nothing bet" that the synthetic CDO will pay off many years down the road, or should the insurance receiver sell now, take significant investment losses, and remove the investment risk? While the tendency may be to sell such a security to remove the market risk, the receiver must weigh not only the loss taken on the sale of the investment, but also the likelihood that a security purchased with the proceeds from the sale will likely not produce investment returns equal to the investment that was sold. Such investment returns may be critical in matching the liabilities of the insurer.

The difficulty in properly valuing these types of assets will directly impact an insurer's ability to provide accurate information for tax returns and other publicly filed documents. Any change in the valuation of an asset (e.g., write-down) will have a direct impact on reported surplus, which can immediately impact options for rehabilitation efforts. Additionally, surplus write-downs can continue to strain the financial health of the insurer.

Further issues for these types of securities will involve their tax treatment. Loan-backed securities have very unique attributes which can also play a vital role in tax liabilities. Specifically, the Internal Revenue Code provides that a taxpayer who has realized losses on securities can deduct those realized losses as capital losses, but only up to the amount of capital gains. However, the Internal Revenue Code provides that any ordinary loss, in contrast to a capital loss, can be entirely deducted from the taxpayer's income which effectively lowers the taxpayer's taxable income. Therefore, a decision to sell any security at a loss should be assessed against investment gains. Incurring investment losses in excess of investment gains might result in the loss of very valuable tax benefits.

An insurance receiver should analyze whether loan-backed securities are debt obligations rather than investment securities for tax purposes. The difference in this tax categorization may allow an insurer, which may have realized losses on loan-backed securities, to deduct those losses from income as ordinary losses rather than capital losses, providing the receivership estate with significant tax benefits. However, it is important to remember that the tax and statutory rules for write-downs of securities as losses are different. Just because a security is written down for statutory purposes, it does not necessarily mean that the security is written down for tax purposes. Therefore, a receiver should be cautioned when believing that by simply writing down a security for statutory purposes they will also experience potential benefits under the tax code. However, if conditions exist to meet both requirements, the receiver may find benefit in being more aggressive with write-downs if there is a corresponding and more immediate tax benefit (i.e., security losses being treated as ordinary versus capital).

In summary, SSAP No. 43R provides some benefits to an insurance receiver, as the ability to write up securities in certain circumstances is a new feature that may enhance asset values. Further, the process of performing the SSAP No. 43R valuation will present a number of issues that require careful attention. SSAP No. 43R may assist in rehabilitation efforts as the financial markets continue to improve, but acquiring and analyzing the necessary cash flow data may be daunting. Moreover, the discounted cash flow values may be materially greater than the values realized from the forced or quick sale of the loan-backed securities. In the end, the valuation of loan-backed securities under SSAP No. 43R may present difficult decisions and challenges for insurance receivers.

Another type of structured security product that can pose additional problems to an insurer is a synthetic CDO.

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View from Washington

By Charlie Richardson, Baker & Daniels

We talked last time about the progress after Congress' August recess on the Obama Administration's proposal for financial services regulatory reform, health care/insurance reform, and the ugly duckling of insurance, namely antitrust exemption repeal.

The political world has now turned upside down, with the special election in January in Massachusetts of a Republican to replace the late Senator Edward Kennedy, the demise for most practical purposes of the health care reform movement, and the resurgence of the GOP and weakening of Democrats. Suddenly, the power and momentum of a Democratic controlled White House and Congress was sputtering a mere one year since the Obama Inaugural festivities.

So let's take stock with a fresh eye. Where are we now, and what is likely to happen before Washington shuts down this fall for the mid-term elections?

Financial Services Regulatory Reform

With health care/insurance reform on its last leg and energy/cap and trade also in the dumpster, Congress and the Administration need a win – and regulatory reform could be it.

The House's version of reform, H.R. 4173 (http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/hr4173eh.pdf) championed by Financial Services Committee Chairman Barney Frank, passed on December 11 by a vote of 223-202. The bill includes a new Federal Insurance Office within Treasury. With the heavy lift behind it, the House is likely to have hearings this year on the federalization of some lines of insurance (reinsurance? bond monolines?) and the regulation of insurance holding companies.

The Senate is on a slower track, but may speed up now that Senate Banking Chairman Chris Dodd has announced his retirement. That may give Dodd more political running room to cut deals to get to his legacy – building a signature financial services legislative success. As this article was being written in February, we were still waiting for Chairman Dodd and Ranking Minority Member Richard Shelby to roll out their "consensus" reform package. Senator Dodd released his own proposed bill on November 10, but it went nowhere and was panned by both Republicans and Democrats. Since then, virtually all work on financial services reform in the Senate has been behind closed doors.

Antitrust Exemption Repeal

Congress loves to knock the insurance industry, and one way to do that is by threatening to repeal the industry's antitrust exemption.

There have been free-standing repeal bills (H.R. 1583 and 3596) and provisions tucked in the House healthcare/insurance reform bill passed in December (H.R. 3962). With the industry united in opposition, chances are slim that Congress would pass a repeal this year. But they're greater than zero, and no one should assume that it cannot happen. There have also been renewed efforts to give the FTC authority to investigate practices within the insurance industry and then report (an antitrust/FTC bill is currently being crafted by chief sponsor Tom Perriello (D-VA) and House leadership). That is even more of a long shot.

Where From Here?

So here are my predictions:

1. The Senate Banking Committee marks up and passes some kind of regulatory reform bill sometime this spring.
2. A House-Senate Conference Committee does its thing and finishes in June or July.
3. The Congress passes a few incremental health insurance reform elements and calls it a day until after the 2010 mid-term elections.
4. Look for hearings in the House on some kind of federal regulation for parts of the insurance industry – as I said above, the reinsurers and bond carriers are the most likely targets.
5. And look for more fallout and hearings on the AIG rescue. Voter outrage over "Wall Street" bailout and the crushing level of federal debt will continue so long as the unemployment rate hovers around 10%. Like it or not, AIG carries the tag line in every story, "world's largest insurance company" – meaning that state regulation will remain under the microscope as the public and the press look for scapegoats.
6. Treasury Secretary Timothy Geithner is probably not a viable candidate for President.

Charlie Richardson is a Partner at the law firm Baker & Daniels in Washington, D.C. where he chairs the insurance and financial services practice group. Charlie assists insurance companies and others with all types of corporate, federal legislative, regulatory, public policy and compliance matters. He practices in the area of insurance company rehabilitations and liquidations.

Reducing Reliance on Rating Agencies in Insurance Regulation

By Matti Peltonen, New York State Insurance Department

The Securities Valuation Office ("SVO") of the National Association of Insurance Commissioners ("NAIC") is the centralized operation for credit and investment analysis for U.S. insurance regulators.

The SVO assesses the credit quality for those fixed income securities which do not carry Nationally Recognized Statistical Rating Organization ("NRSRO") ratings. whereas, for the rated securities, regulation has relied on ratings, translated into the six NAIC designations, which are used for regulatory purposes to assess credit quality as well as determine the level of capital required to be held against investments, or Risk-Based Capital ("RBC") charge.

Rating/NAIC Designation Equilalents - an Example	
S&P Rating	**NAIC Designation**
AAA to A-	NAIC1
BBB+ to BBB-	NAIC2
BB+ to BB-	NAIC3
B+ to B-	NAIC4
CCC+ to CCC-	NAIC25
CC, C, D	NAIC6

During the current financial crisis, the accuracy of ratings was questioned when many insurance companies' structured security portfolios suffered massive downgrades. For many hybrid securities, the rating downgrades were logical. Given the stress in the financial sector and the subordination of hybrids, the severity of downgrades and the price deterioration far exceeded those of similarly rated senior corporate securities. The collapse of some complex structured securities initially rated AAA, such as Constant Proportion Debt Obligations ("CPDOs"), showed the ratings had ceased to measure risk accurately where the NRSROs had ventured to measuring risks other than credit, such as leverage or other structural risks.

For Residential Mortgage-Backed Securities ("RMBS"), the rating agencies were questioned because the ratings seemed, at first, to lag the deteriorating housing market. But once the NRSROs started the wholescale downgrades, they then seemed to get ahead of the actual RMBS risks, in particular for many senior RMBS tranches. The Financial Guaranty Insurers ("FGIs") ran into trouble largely because of the downgrades of the originally highly rated residential securities which they guaranteed. As those securities were downgraded, the FGIs struggled to maintain their ratings. However, no amount of capital seemed sufficient to maintain a rating as the NRSROs kept changing their capital requirements for FGIs to maintain their ratings. Also, some life insurance companies, having built their portfolios relying on the stability of structured security ratings, now faced downgrades due to deterioration of their investment portfolios.

In January 2009, resulting from discussions at the New York State Insurance Department ("NYSID") about the shortcomings of the NRSRO ratings during the financial crisis, it became clear that the continued use of NRSRO ratings by the NAIC should be evaluated. Implementing any changes, however, to how ratings were used by the NAIC was going to be a major undertaking, as the ratings were so deeply embedded in the current regulatory framework.

Conflict of interest was one of the perceived problems in the model used by all the major rating agencies. For NRSROs using that model, the issuer pays for the rating and the lead manager often structures complex securities in cooperation with the rating agency to ensure the desired rating is achieved. The structured security ratings did not maintain the stability of similar corporate or municipal ratings. The conflict of interest is largely avoided in the buyside model where the investors pay for the rating. But even if the NAIC added the first buyside rating agency, Realpoint, to the list of NRSROs it uses, a wholesale shift to such agencies was not practical.

For the NAIC, a bigger immediate concern than the conflict of interest was the accuracy of ratings, necessary for accurate assessment of risks, especially during a period of massive downgrades of RMBS.

In February 2009, at the initiative of the New York and Illinois Insurance Departments, the NAIC formed the Rating Agency Working Group ("RAWG"), which was charged with assessing whether the continued use of ratings in insurance regulation was appropriate. The RAWG issued a detailed questionnaire to those NRSROs used by the NAIC and, after analyzing the responses, followed up with a hearing in September where S&P, Moody's, Fitch, and DBRS were provided an opportunity to respond to regulators' and market participants' questions and concerns. The focus of the hearing was on structured securities whose ratings had been most volatile. One of the clear outcomes from the hearing was that the rating agencies themselves recommended a reduction in the reliance on ratings in financial regulation. This was one of the recommendations of the RAWG published in its draft report (the report is likely to be finalized in spring 2010).

Another NAIC committee, the Valuation of Securities Task Force ("VOS"), which works on investment-related issues and has oversight of the SVO, started working on an alternative to NRSRO ratings where appropriate. RMBS seemed like the obvious asset class to start with, as many of those securities had experienced material downgrades – even if most downgrades were justified, following the deterioration of the U.S. housing market. The problem with RMBS ratings was, however, that the NRSROs, once caught up with the lag in downgrading them, often seemed to tend to go overboard, resulting in steep downgrades, many thousands of securities at a time, as well as the fact that different NRSROs took their downgrade action at different times. As a result, the discrepancies between different NRSRO ratings were often exceptionally wide. At any given time, many securities continued to be highly rated by some NRSROs, while having been downgraded by other agencies. The NAIC's method to 'translate' ratings into NAIC designations is to use the second lowest rating. For stable corporate ratings, this method works adequately; but for unstable and widely differing ratings, the method became arbitrary – and it was clear a better alternative was needed.

In May 2009, the American Council for Life Insurers submitted a proposal to upgrade the NAIC designations for RMBS, subject to some criteria such as structural seniority and loan vintage. The proposal was rejected by the NAIC, because a blanket capital relief was not deemed appropriate for RMBS. A preferred method was to subject every security to a rigorous analysis. A continued use of NRSRO ratings, as used by the NAIC, was deemed to no longer serve as a consistent accurate basis for the analysis. It was determined early on that a preferable approach for the NAIC was to abandon NRSRO ratings - even as a starting point for the risk analysis - and to use an altogether different analysis for RMBS. The ACLI proposal did, however, kickstart the NAIC process, and the new method was developed in cooperation with the insurance industry during the summer and fall 0f 2009. The NAIC's aim in that process was not to lower the required capital, but to develop a method to determine RBC charge more accurately for RMBS on a consistent, comparable basis.

When using NRSRO ratings, the NAIC has no control over the frequency or timing of rating reviews and the resulting NRSRO rating comparison is not always appropriate, as it does not only depend on the credit quality, but also the timing; the difference may simply be due to some of the ratings being stale. Also, the NRSROs have started incorporating their own recovery ratings into their analysis, indicating the likelihood of loss given default. In theory, the credit rating and recovery rating could be combined to calculate the expected loss number. In practice, a lot more work would have to be done before the results between different NRSROs are comparable. Also, not every agency calculates the recovery ratings on a consistent basis, nor do they use them for all RMBS; some use them only for the RMBS with the weakest credit ratings.

P&C and Health	RBC	Midpoint
1	0.3%	0.65%
2	1.0%	1.50%
3	2.0%	3.25%
4	4.5%	7.25%
5	10.0%	20.00%
6	30.0%	
Life	**RBC**	**Midpoint**
1	0.4%	0.85%
2	1.3%	2.95%
3	4.6%	7.30%
4	10.0%	16.50%
5	23.0%	26.50%
6	30.0%	

The method decided on by the VOS was to determine the credit risk by modeling the net present value of the expected loss in each RMBS, and use the result to match the RBC charge required for each of the six NAIC designations. The RBC charge also represents the expected loss on a portfolio of similarly rated securities over time. For RMBS, the expected loss determined by modeling was then to be used as a proxy to determine the NAIC designation by matching the loss with the equal loss representing RBC at the six designation levels. In determining at which point the NAIC designation changes, the NAIC used the midpoint between the designation levels, representing both the RBC charge and the expected loss. For example, a RMBS security owned by a Life company, with 5% expected loss, would get a NAIC3 designation, about equal to S&P rating BB.

Reducing Reliance on Rating Agencies... (Continued)

A modeling firm was to be selected to do the modeling, using the data at the mortgage loan level for each RMBS. The advantage of this approach was a very granular analysis, where the latest available data on such factors as residential foreclosures and delinquencies for each underlying loan could be used consistently for every security, providing a comparable snapshot at a point in time for all modeled RMBS. Also, the model used five different scenarios, which were probability weighted when determining the net present value of the expected loss. This enabled a differentiation of securities which have a similar risk profile at the base scenario, but where cashflows deteriorate under the stress scenarios.

The main fundamental difference between NRSRO ratings and the method used by the NAIC was the use of price (each insurance company's carrying value) for the RMBS as a factor in assessing credit quality, and the use of the results in determining the NAIC Designation and the resultant RBC charge. The reason for this approach is simply that a security held at par, for example, represents a higher level of risk if the same security is held at 50 – it's clear the maximum potential loss for the second company is only half the amount of the first one. This was relevant in the current market environment as many companies own their securities, either having purchased them at a discount or having deemed them impaired and written them down. The different carrying values represent different levels of risk. Instead of simply determining one "rating" (NAIC Designation) for each security as done by the NRSROs, with the NAIC method, each security can have any NAIC designation, determined by the carrying value. For example, for an RMBS with an expected loss of 20% of principal, a company holding it at par will be likely to lose 20% of its investment, and deserves a low rating and a high RBC charge (for example, NAIC 6, which is the designation representing the lowest credit quality). Another company, which carries the same security at 50, is highly likely to get its investment back and then some (an 'extra' 30%), and at level, the credit quality is much stronger and the designation may be NAIC 1, the highest, and the RBC charge is very low. At a price, every security can be AAA (unless the expected cashflows are zero). An advantage of this approach is also that if a company takes an impairment charge for a security and thereby reduces the remaining risk exposure, it is no longer penalized by the high RBC charge – which is different compared with using NRSRO ratings, where each security 'only' has one rating, and a company's reduction in its risk exposure (impairment) makes no difference. NRSRO ratings do not provide for a similar granularity or recognition of different levels of risk that companies have through different carrying values.

Instead of determining one NAIC designation for each RMBS, what was calculated with the NAIC approach was the price ranges for each of the six NAIC designations for each RMBS, leaving it for each insurance company holder to determine which designation corresponds with its carrying value for its RMBS portfolio. The published breakpoints determine at what price the NAIC designation changes, determined by the carrying value for a security.

Price Break Points for NAIC Designations for a Security

123456AB7	NAIC-1	NAIC-2	NAIC-3	NAIC-4	NAIC-5
PC	70.35	70.95	72.21	75.28	87.1
Life	70.49	71.99	75.32	83.49	94.7

After the proposal was adopted by the NAIC's Executive and Plenary committees, the NAIC invited analytical firms to compete for the project by issuing a Request for Proposal in November. The NAIC, assisted by the consulting firm Oliver Wyman, selected PIMCO Advisors from a group of over 20 applicants. PIMCO Advisors started its analytical work in December, using the available RMBS CUSIPs at that time (those held by the insurance industry), and ran the final batch at the end of January, a total of over 21,000 different CUSIPs. The SVO administered the process, vetted the results for accuracy, and worked with the industry to ensure the results were distributed to all insurance company RMBS holders.

In order to implement the new method, changes needed to be made in statutory accounting, in software which companies use in filing their financial statements, and in software used by the NAIC in assisting State Insurance Departments in examinations. The whole change, from start to implementation, was probably done on a very fast schedule, considering the magnitude of the change.

The feedback from the industry has been positive. For example, it seems the resulting designations correlate with market values better than the correlation to NRSRO ratings. The resulting overall RBC charge is likely to be lower than it would have been had the NAIC continued to use NRSRO ratings, but as the companies' annual statement filings will not be available until March

Reducing Reliance on Rating Agencies... (Continued)

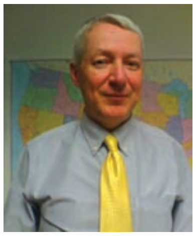
2010, the exact number will not be available until then. The main reason for the lower charge is the fact that the carrying value at a discount results in a better designation and a lower RBC charge, and many securities have been impaired or purchased at a discount over the past two years.

A simplified approach was used for the securities that could not be modeled. For rated securities (which could not be modeled), the rating determined the NAIC designation as before, but the result was then adjusted for the carrying value, in order for the results to be comparable with the modeled RMBS. The few securities which could not be modeled and are not rated, were assigned a weak designation (NAIC 5 for performing securities, and NAIC 6 for securities not paying scheduled payments) by default.

The remaining charges for VOS are to implement the extension of the RMBS solution until the NAIC adopts a long-term solution, and to decide on an approach and method to be used as that long-term solution, not only for RMBS, but also for other types of structured securities.

In determining the long-term approach, factors to be considered include how well the NRSRO ratings appear to continue to work for different types of structured securities. For structured security classes where insurers do not have a material exposure, the use of ratings may continue, but are likely to be adjusted for the carrying value to more accurately represent each insurer's risk. Also, modifications may be made to the current system where the second lowest rating is selected. For asset classes where exposures are material, an alternative will be considered. Such asset classes are Commercial Mortgage-Backed Securities ("CMBS") (about 6,500 unique CUSIPs), and Collateralized debt obligations ("CDOs") (about 1,500 CUSIPs). Different approaches need to be considered, as neither of those can use the same exact approach used for RMBS, which contain a large number of homogeneous loans, which makes a relatively straightforward modeling approach more applicable.

The change implemented by the NAIC on RMBS securities, i.e., to create an alternative to the use of NRSRO ratings, is the first concrete step taken by any financial regulators to reduce reliance on rating agencies.



Matti Peltonen joined New York State Insurance Department's Capital Markets Bureau in 2000. The Bureau supervises the capital markets & risk management activities of New York licensed insurers. He works on the development of financial analysis of investments, derivative use, structured securities, new initiatives to enhance the financial solvency oversight, increased use of risk-based analysis in examinations, and the Department's policy on derivatives and insurance securitization

The Perfect Receiver

By Patrick H. Cantilo, Cantilo & Bennett, L.L.P.

Sitting around the fireplace in our little house on the prairie recently, my grandson finished playing with his *Glenn Beck and Rachel Maddow Ultimate Fighting Set* and turned to me with that eternal question we all ponder periodically: "When do we eat, Grandpa?" As we sat in the kitchen while I made us our traditional sliced squirrel and diced lizard pizza, our conversation inevitably turned to what makes a good receiver. With great patience, Elyosus turned to me and said gently: "Grandpa, I'll tell you again, but maybe you should write it down this time."

As I turned from the oven and grabbed my chalk and tablet he commenced his explanation. "Many receivers overlook a fundamental principle. You have limited resources and will not be able to do everything you want. Start your receivership with a reasonable set of primary goals that you must attain if at all possible and a list of secondary goals that you will pursue only if your resources permit it." I asked him to slow down while I labored with my block letters to get this down. He went on. "Try hard to develop and manage your receivership plan so that you maximize your chances to do everything on your first list but don't inadvertently block a path to the goals on your second list." He took a swig of his Guinness, ate a bite of pizza, and continued. "Periodically, check your progress on both lists and revise the goals and the plan in response to past events and changing circumstances."

"Brilliant!" I said, looking at his eight year old countenance with admiration. "Unfortunately, I didn't get it all down. Could you repeat the last part?" "What part Grandpa?" he asked patiently. "Everything after 'I'll tell you again." I replied sheepishly.

This is the first in a new series of practical tips.

The Next Shoe to Drop? (An Investigation of Potential Problem Assets)

By Alex C. Hart, Investment Specialist, Maryland Insurance Administration

> *"Blessed is he who expects nothing, for he shall never be disappointed."*
> *– Alexander Pope*

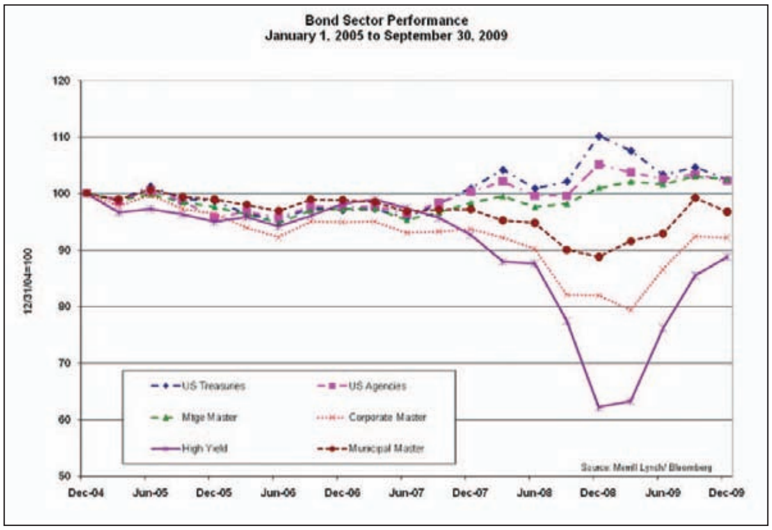
Mr. Pope could have well been an investor in 2008 and 2009, looking at the financial crisis and depressed asset values, wondering when it will end and what more he might have to endure before it does. His decimated portfolio left him with no expectation of forthcoming recovery, because several false starts were only disappointments when they were dashed by another big bank failure, the next corporate bankruptcy, or just more bad news on the economic front.

Capital Markets Review

To say that 2008 was a tough year in the capital markets is quite an understatement. The financial crisis that began in mid-2007 with the bankruptcy of Lehman Brothers, the failure of Washington Mutual, the near-failure of Wachovia, and a host of other infamous meltdowns continued on a steepening downward path for the entire year. Most asset classes showed negative price returns, with equities (as measured by the S&P 500) among the worst performing (down nearly 39% for the year). Bonds in general had a terrible year, with credit quality as the great differentiator (the lower the credit quality, the worse the performance); only US Treasury Notes/Bonds, US Agency Notes/Bonds, and US Agency Mortgage-Backed Securities (MBS) showed positive price returns for 2008 thanks to a flight to quality as corporate bonds, privately-issued asset-backed securities (ABS), and even municipal bonds all dropped[1]. Among the worst performers were commercial mortgage-backed securities (CMBS), with AAA-rated bonds dropping 22% and BBB-rated bonds falling a distressing 76%. The once-popular hybrid securities also took it on the chin pretty hard, losing about 20% of their value. The first quarter of 2009 brought only more of the same. Moreover, given the price performance noted above, yield spreads on non-Government debt over Treasury yields rose dramatically, particularly for corporate bonds and high-yield (junk) bonds.

Some signs of life emerged in the second quarter of 2009 as some market participants spoke of seeing signs of light at the end of the economic tunnel and confidence grew that the light was not from an onrushing train. Again, credit quality appeared to be a strong determinant of performance, but this time, lower credit quality generally equaled stronger price recovery while US Treasuries faltered a bit. Spreads contracted some, but remained relatively high. Among recovering securities, CMBS showed the least gains.

Chart 1: Bond Sector Price Performance



Insurer Investment Portfolio Construction

With an idea of market performance in hand, it can be put into the context of what it meant to insurers. To more fully understand how insurers were impacted by asset values, one must first understand how the main segments of the industry (Life, Property & Casualty, and Health) were postured with respect to portfolio construction at the end of 2007. With respect to asset allocation, Life insurers were generally more heavily exposed to bonds, while P&C companies had greater equities exposure, and Health insurers had the most liquid portfolios (see Table 1)[2]. Drilling down into bond portfolios yields even greater differences. Life insurers had much higher exposure to corporate bonds, while P&C insurers were more heavily invested in municipal bonds, and health insurers took a higher quality route with US Government and US Agency MBS bonds (see Table 2). Life insurers also had the lowest average credit quality, with P&C and Health insurers more heavily weighted in bonds rated "A" or better (NAIC 1) (see table 3). Additionally, because of their longer-tailed business, Life insurers exhibited a longer weighted average maturity and duration of their bond portfolios[3]. In this comparison, it becomes clear that portfolio construction is a reflection of insured liabilities. Life insurers typically lean toward fixed income investments with higher yields and longer maturities, reflecting the longer tail of their liabilities and a need for a fairly stable cash flow stream. P&C insurers rely less on cash flow to meet policyholder obligations, and instead opt for more exposure to capital appreciation to address catastrophe events. Health insurers have high volume cash flows and thus must maintain higher degrees of liquidity and conservatism.

Table 1: 2007 Asset Allocation

% Cash & Inv Assets	Life%	P&C%	Health%
Bonds	71.8%	66.4%	52.2%
Preferred Stock	2.2%	1.5%	0.6%
Common Stock	4.5%	17.3%	21.2%
Mortgage Loans	10.4%	0.4%	0.0%
Real Estate	0.7%	0.8%	3.3%
Policy Loans	3.8%	0.0%	0.0%
Cash & ST Inv	2.6%	7.5%	19.2%
Other Inv Assets	3.4%	5.5%	2.7%

Source: 2007 NAIC Statistical Compilation of Annual Statement Data

Table 2: 2007 Bond Sector Allocation

% Total Bonds	Life%	P&C%	Health%
US Government	5.6%	12.2%	23.4%
Foreign Govt	1.9%	1.7%	0.3%
Municipals	1.8%	42.3%	19.6%
Corporates	65.1%	23.3%	27.1%
MBS	24.4%	19.1%	29.6%
Affiliates	1.1%	0.9%	0.0%

Source: 2007 NAIC Statistical Compilation of Annual Statement Data

Table 3: 2007 Credit Quality

% Total Bonds	Life%	P&C%	Health%
NAIC 1	69.2%	92.4%	92.7%
NAIC 2	25.1%	5.6%	5.2%
Inv Grade	94.3%	98.0%	97.9%
NAIC 3	3.4%	1.0%	1.2%
NAIC 4	1.8%	0.7%	0.8%
NAIC 5	0.6%	0.3%	0.1%
NAIC 6	0.1%	0.1%	0.0%

Source: 2007 NAIC Statistical Compilation of Annual Statement Data

Statutory accounting considerations also impact the perceived and actual health of portfolios. Most bonds (NAIC 1-5 for Life, NAIC 1-2 for P&C and Health) and some preferred stocks (NAIC 1-3 for Life, NAIC 1-2 for P&C and Health) are carried at amortized cost (unless other than temporarily impaired), meaning that unrealized losses on such securities are not reflected in surplus[4]. While only rarely has this historically been an issue, 2008 and 2009 were such rare occurrences. At the end of 2007, on average, bond portfolios for all insurers had aggregate fair values that were in excess of their book values. By the end of 2008, though, this had changed and on average, bond portfolios for all insurers had aggregate fair values that were below their book values (see Table 4)[5]. Life insurers took the biggest hit, which reflected their higher exposure to corporate bonds, lower average credit quality, and longer weighted average maturities. It must be remembered that most of this unrealized loss was not reflected in surplus due to amortized cost accounting.

Table 4: Bonds – FMV/BACV

	Life	P&C	Health
2007	100.5%	101.1%	100.9%
2008	90.6%	94.3%	99.5%

Source: 2007 NAIC Statistical Compilation of Annual Statement Data and SVO Research

Investment Risks and Regulation

The next obvious question was what risk these unrealized and unrecognized losses posed to surplus. Again, Life insurers had the biggest risk to their surplus, P&C insurers showed moderate risk, and Health insurers had very little risk. In fact, on the surface the risk to Life insurers' surplus looked exaggerated compared to the decline in fair values of their bonds (see Table 5). The reason for this disparity lies in the basic financial management concept of financial leverage, measured by (Total Assets/Total Equity). Financial leverage is also a component of return on equity (ROE) in du Pont analysis (a higher degree of financial leverage contributes to higher ROE). At year-end 2007, Life insurers' financial leverage ratio was 9.7x, P&C insurers stood at 2.8x, and Health insurers were at a very low 1.9x; the reciprocals of these factors (Equity/Assets) are perhaps more demonstrative: Life – 10.3%, P&C – 35.4%, and Health – 52.9%[6]. Simply put, Life insurers had relatively less surplus to put at risk.

The Next Shoe to Drop? (Continued)

Table 5: Unrealized Gain (Loss) on Bonds/Capital & Surplus

	Life	P&C	Health
2007	+3.6%	+1.8%	+0.7%
2008	(61.4)%	(8.6)%	(0.4)%

Source: 2007 NAIC Statistical Compilation of Annual Statement Data and SVO Research

The risk to surplus from unrealized and unrecognized losses leads to the question of how much of the unrealized loss might become a realized loss either from impairment or sale of a distressed asset. To make this determination, the following question needs to be answered in general: Are current asset prices an anomaly or a reflection of repricing of risk? The strong recovery in prices of lower-rated securities and corporate bonds in the second quarter of 2009 appeared to suggest that the lows reached in the first quarter of 2009 may well have represented an anomaly. Into the third quarter of 2009, prices generally held steady or continued to recover, albeit at a much slower pace than what was exhibited in the second quarter. There is still enough uncertainty about the direction of the US economy, the timing and magnitude of its recovery, and further defaults that it is too early to decisively conclude that there has not been at least some repricing of risk. Beyond general market conditions, security-specific questions must also be answered to determine if losses will ultimately become realized.

- Is the security "dollar-good" (will the investor receive all of the expected cash flows from the security, including pay-off at maturity)?
- Does the investor have sufficient liquidity to allow continued holding of distressed securities (those with price declines of 20% or greater from book value)?

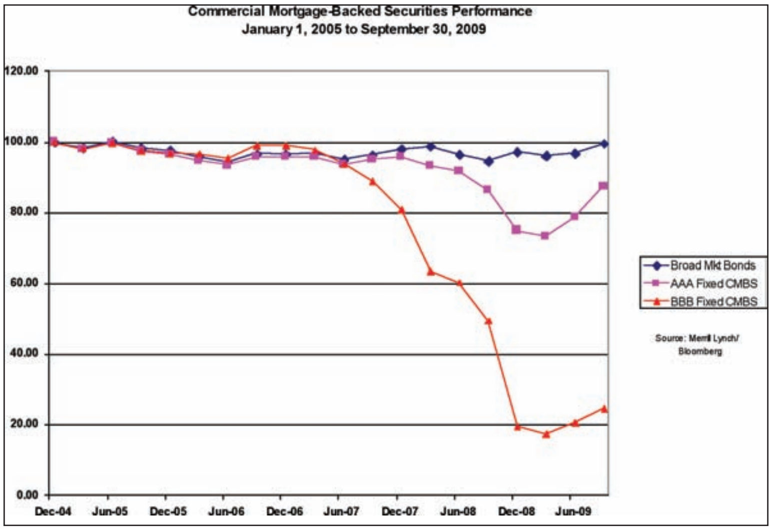
Statutory accounting guidance on other than temporary impairment (found in INT 06-07[7]) does not establish any brightline tests for determining impairment, but rather suggests a "rule of thumb" test of a price decline of 20% or more from book value sustained for six-to-twelve months or more as the starting point for impairment analysis. With this "rule of thumb" being met, it is then management's responsibility to answer the two questions above to determine if impairment is necessary. To the extent these questions can be answered affirmatively, realized losses are less likely. In this light, time may be the biggest factor in determining the realization of losses. As noted above, it remains to be seen if current market prices reflect a repricing of risk and if values will fully recover. The uncertainty of the timing of economic recovery may not allow for the correct conclusions about the "dollar good" nature of a particular security or an investor's ability to continue to hold a particular distressed asset.

The best regulatory response to the issue of (currently) unrealized losses and their potential to become realized is to be fully aware of each company's position, determine whether the amount of surplus at risk is material, understand if there could be liquidity issues that could force sales of distressed assets, and monitor the situation very closely. Critical measurements are the ratio of unrealized losses-to-surplus and the book value of distressed securities-to-cash and invested assets. These factors should be measured in consideration of the insurer's liability portfolio, and what in that portfolio could cause a need for liquidity (e.g., significant early surrenders of annuity contracts or guaranteed investment contracts, natural catastrophes, consistently poor underwriting results, ratings downgrades, material asset/liability mismatching).

In the foregoing analysis, it has been demonstrated that a wide variety of asset types suffered significant price declines over the past two years. In the case of some broad sector declines, the drop in prices may have been the result of repricing risks (either temporarily or permanently), while in other cases, there may be more sector specific reasons to be concerned about the "dollar good" nature of investments. It has been noted that among fixed income investments, CMBS experienced some of the sharpest price declines and some of the least recovery (see Chart 2). This bears further investigation, because it points to potential sector-specific risks that could suggest that interruptions to expected cash flows are more likely, making impairments, defaults, and realized losses more of an issue. Moreover, when looking at the invested asset portfolios of insurers, not only are there investments in CMBS, but also direct mortgage loans on commercial properties, mezzanine loans, and equity real estate investments (that are easily identifiable; there may be other investments that cannot be identified on an industry aggregate basis, such as debt and equity in Real Estate Investment Trusts).

The Next Shoe to Drop? (Continued)

Chart 2: CMBS Price Performance



Why, then, is commercial real estate so potentially problematic? "Commercial real estate overall tends to be a lagging indicator and performance for most property types began sliding several quarters after other sectors of the economy had turned sharply downward," according to Moody's Investor Services (Moody's)[9]. Moreover, Moody's noted that "while there are some indications that the broader US economy has started to stabilize, conditions in the commercial real estate sector are likely to continue deteriorating for several more quarters before beginning a gradual recovery in 2011[10]." This clearly suggests that perhaps the worst is yet to come with respect to the performance of commercial real estate loans. In fact, data from CB Richard Ellis showed that national average vacancy rates for both "downtown" and "metropolitan area" commercial properties had been on a steady rise since the third quarter of 2007, but had yet to reach historic highs by the third quarter of 2009 (see Chart 3)[11]. There were significant differences in vacancy rates by property type and by region of the US, but all exhibited the same rising trend[12]. The National Association of Realtors' (NAR) August 2009 forecast for vacancy rates through 2010 painted a reasonably gloomy picture (see Table 8), and its outlook for rent growth at the same time had become even more negative than six months earlier (see Table 9)[13]. Despite what looked like a possible return of some degree of confidence to the credit markets in the second quarter of 2009, the NAR's August 2009 survey of commercial Realtors® showed that an even greater number of respondents cited financing as the greatest challenge facing the commercial real estate market (compared to April 2009)[14].

To understand where the main segments of the insurance industry have exposure of this nature, an examination of industry aggregate data revealed that Life insurers had about 13% of their admitted assets invested in the combination of commercial mortgage loans, CMBS, mezzanine real estate loans, and equity in commercial real estate, while P&C insurers had a little over 2% of their admitted assets allocated to these investments, and Health insurers slightly more than 1% (see Table 6)[8]. Recalling the discussion of financial leverage above, it should come as little surprise to note that these investments represented a much greater portion of Life insurers' surplus (111%), and a more modest percentage of P&C insurers' surplus (7%), and only 3% of Health insurers' surplus (see Table 7).

Table 6: 2007 Commercial Real Estate Exposures

% Admitted Assets	Life	P&C	Health
CMBS	4.1%	2.0%	1.3%
Commercial Mtges	8.3%	0.3%	0.0%
Mezzanine Loans	0.1%	0.0%	0.0%
Income Real Estate	0.5%	0.1%	0.1%
Total CRE	13.0%	2.4%	1.4%

Source: 2007 NAIC Statistical Compilation of Annual Statement Data

Table 7: 2007 Commercial Real Estate Exposures Relative to Surplus

% Surplus	Life*	P&C	Health
CMBS	35.1%	5.7%	2.4%
Commercial Mtges	70.5%	0.7%	0.0%
Mezzanine Loans	1.2%	0.1%	0.0%
Income Real Estate	4.0%	0.2%	0.3%
Total CRE	110.8%	6.7%	2.7%

Source: 2007 NAIC Statistical Compilation of Annual Statement Data
* Life includes Capital and Surplus and AVR

The Next Shoe to Drop? (Continued)

Chart 3: US Commercial Property Vacancy Rates

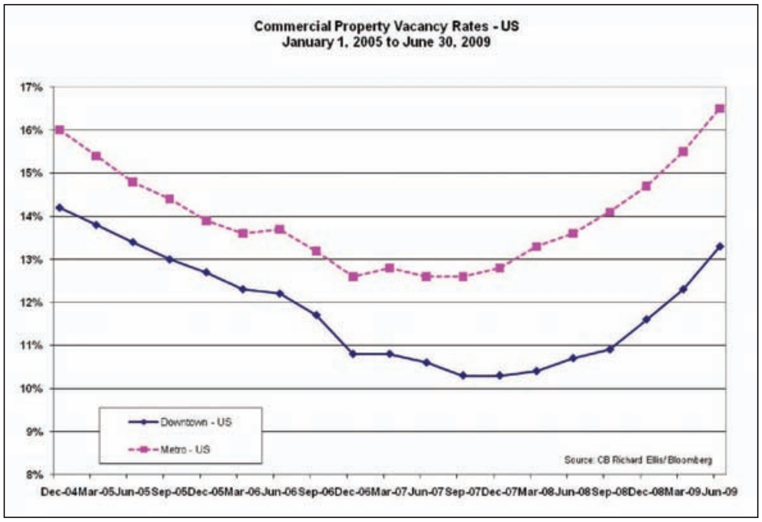


Table 8: Commercial Property Vacancy Rate Forecast

Vacancy Rates	2008	2009E	2010E
Office	13.4%	16.0%	18.9%
Industrial	10.4%	13.3%	15.1%
Retail	9.7%	11.9%	13.0%
Multi-Family	5.7%	7.3%	6.9%

Source: National Association of Realtors Press Release, August 19, 2009

Table 9: Commercial Property Rent Growth Forecast

Rent Growth	2008	2009E	2010E
Office	-0.4%	-14.1%	-10.0%
Industrial	-0.8%	-11.4%	-11.7%
Retail	-2.0%	-6.1%	-4.9%
Multi-Family	2.9%	-1.5%	0.8%

Source: National Association of Realtors Press Release, August 19, 2009

In the first three quarters of 2009, no CMBS have been issued in the US. Not only have the negative dynamics of the commercial real estate market influenced this dried-up market, but NRSRO activity has also played a strong role. Both Moody's and Standard and Poor's Corp. (S&P) have announced reviews of their modeling and ratings methodologies for CMBS, and they certainly have not been looking to make them more forgiving. In February 2009, Moody's announced that it had re-evaluated its CMBS modeling assumptions, and as a result, had downgraded many investment grade CMBS by four or five notches, and many speculative grade CMBS by five to six notches[15]. Additionally, Moody's noted that its loss expectations for 2006-2008-vinatge CMBS were then 5%. In June, S&P likewise announced that it was reviewing its CMBS assumptions, which could result in downgrades of some $235 billion of currently AAA-rated CMBS; results were due in three-to-six months[16]. S&P's action followed the downgrade of 697 CMBS issues over 2008, most of which were speculative grade. Much of the revision to CMBS modeling assumptions has certainly been driven by a sharp rise in the delinquency rates of loans in CMBS pools. Moody's noted that in July 2009, the delinquency rate on such loans had risen to just over 3%, a massive increase from the cyclical low point of 0.2% in mid-2007[17]. Moreover, in its CMBS Quarterly Insight, S&P reported that the delinquency rate reached 5.15% by the end of 2009 and is expected to reach 7% later this year. Multi-family housing properties are expected to exhibit the highest delinquency rates, followed by retail, industrial, and office properties (in descending order). It should be noted that delinquency rates on direct commercial mortgage loans made by insurers are not expected to reach these levels, as those loans tended to be higher-quality, fixed rate loans on properties with generally longer lease terms[18].

Regulators need to have a comprehensive understanding of insurers' exposures to commercial real estate. In particular, attention should be given to the quality of direct mortgage loans, including loan underwriting standards, lender due diligence adequacy, individual property characteristics, lease terms, and loan performance. CMBS exposure should be evaluated for adequacy of cash flow testing, propriety of impairments, and NRSRO status. Equity real estate investments should be analyzed based on property characteristics (including lease terms) and performance. Indirect exposures to commercial real estate (REIT investments, investments in banks and financial services concerns that made commercial real estate loans) should be identified and quantified.

Conclusions

The past two years have been the first in many in which the greater concern in the insurance industry was the left side of the balance sheet. Significant differences in portfolio construction among different types of insurers that mirror differences in their liability cash flow needs became very obvious. Life insurers, because of their concentration in fixed income investments, bore the brunt of the insurance industry's difficulties in the financial crisis. After an awful 2008 in the capital markets, the second and third quarters of 2009 gave some signs of improvement that suggested that the worst in the broad credit markets may have passed. Significant unrealized losses on fixed income investments narrowed somewhat into the third quarter of 2009, but the timing and magnitude of recovery in the US economy remained uncertain, and do not yet allow observers to reach the conclusion that those unrealized losses are unlikely to become realized. The P&C and Health insurance industries have probably come out relatively unscarred, although they have faced some surplus deterioration from unrealized losses on equities that will hopefully be somewhat temporary; recovery in equity markets should restore surplus to them. There are, however, signs that the worst in the commercial real estate market is yet to come. Be wary of insurers' exposure to commercial real estate through:

- Direct mortgage loans
- CMBS investments
- Equity Real Estate investments
- Debt and equity investments in Real Estate Investment Trusts
- Debt and equity investments in banks and other financial service concerns that made commercial real estate loans

On the whole, commercial real estate exposure is another potentially big problem for the life insurance industry. P&C and Health insurers may have material issues on a company-specific basis, but on average, should not experience as much pain as Life insurers may. Regulators and insurers should be wary of the next shoe to drop, which could be just as painful as the subprime mortgage debacle of 2008. Let's hope that Mr. Pope is not again disappointed.

This article was originally published in the Society of Financial Examiners (SOFE) publication the Examiner, Vol. 34, No. 4, Winter 2009. It is a good example of the depth of analysis that departments of insurance (DOIs) and the NAIC employ in looking at what factors may cause financial stress on insurers that may lead to the actions to avoid liquidations of insurers. Alex Hart has been the MD DOI Investment Specialist since 2002 and has been involved in several stressed or troubled company situations.

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1 Source: Bloomberg data and Bank of America Merrill Lynch. Indices used to represent market segments include S&P 500, and Merrill Lynch US Broad Market, US Treasury Master, Unsubordinated US Agency Master, Unsubordinated US Treasury/Agency Master, Mortgage Master, Mortgages – All FHLMC & FNMA 30-Yr., US Corporate Master, US Corporates AAA Rated, US Corporates BBB Rated, High Yield Master II, Municipal Master, Preferred Stock – Hybrid Securities, ABS – Credit Cards Fixed Rate, ABS – Credit Card Fixed Rate AA-BBB Rated, ABS – Home Equity Loans Fixed Rate, ABS – Auto Loans Fixed Rate, ABS – Auto Loans Fixed Rate AA-BBB Rated, CMBS Fixed Rate AAA Rated, CMBS Fixed Rate BBB Rated Indices.

2 Source: NAIC 2007 Statistical Compilation of Annual Statement Data

3 Ibid.

4 NAIC Accounting Practices and Procedures Manual, Statement of Statutory Accounting Principles Numbers 26 and 32

5 Source: NAIC 2007 Statistical Compilation of Annual Statement Data and SVO Research

6 Source: NAIC 2007 Statistical Compilation of Annual Statement Data

7 NAIC Accounting Practices and Procedures Manual, Interpretation 06-07

8 Source: NAIC 2007 Statistical Compilation of Annual Statement Data

9 "US CMBS: An Update," Moody's Investor Services, June 11, 2009

10 Ibid.

11 Source: Bloomberg data and CB Richard Ellis Vacancy Rate - Downtown, Vacancy Rate - Metropolitan Indices

12 Source: Bloomberg data and CB Richard Ellis Industrial Vacancy Rates, Commercial Suburban Vacancy Rates, Office Downtown Vacancy Rates Indices

13 "Commercial Real Estate Outlook," National Association of Realtors, August 2009

14 "Commercial Real Estate Survey," National Association of Realtors, August 2009

15 "US CMBS: An Update," Moody's Investor Services, June 11, 2009

16 Standard & Poor's Corp. Press Release, June 26, 2009

17 "US CMBS: Moody's CMBS Delinquency Tracker," Moody's Investor Services, August 2009

18 "Comparing Bank, US CMBS, and Life Insurance Company Commercial Real Estate Expected Loss and Delinquency Rates," Moody's Investor Services, May 15, 2009

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SAVE the DATES

April 21 - 23 2010	2010 Insolvency Workshop The Eden Roc Resort A Renaissance Beach Resort and Spa Miami Beach, FL
August 14 - 17 2010	IAIR Summer 2010 Meetings Sheraton Seattle & Washington State Convention & Trade Center Seattle, WA
October 18 - 21 2010	IAIR Fall 2010 Meetings Gaylord Palms Hotel Orlando, FL