



Paul Graham

Vice President, Insurance Regulation & Chief Actuary
(202) 624-2164 t (202) 572-4766 f
paulgraham@acli.com

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Mr. Lou Felice, *NAIC Hybrid RBC Working Group*
c/o New York Department of Insurance
25 Beaver Street
New York, NY 10004

Dear Mr. Felice:

As requested during the July 19, 2007 Hybrid Risk-Based Capital (E) Working Group (HRBCWG) call, the ACLI¹ is sharing its views on the reporting of debt equity hybrid securities.

We want to emphasize that our analysis has focused exclusively on possible “geographic” locations of these assets on statutory financial statements. We understand that separately the HRBCWG has asked the Invested Asset Working Group of the American Academy of Actuaries for an assessment of the risk characteristics of these assets. While our analysis fully contemplates the possibility that debt-equity hybrids, as a defined class, may ultimately be assigned a unique risk factor or factors, our sole focus has been on reporting and not on any risks of these assets. In other words, what follows is a comparison of how these assets can be reported, not the separate issue of what their investments risk may be.

The following are the three alternatives that we believe exist within today’s reporting structure. We would propose that Alternative 1 – reporting hybrids in Schedule D-Part 1 is the most appropriate treatment given the current reporting structure. Detailed below are the three choices currently available for the reporting of hybrid securities (listed in the ACLI’s preferred order), including the pros and cons of each:

1. Schedule D-Part 1

Additional Data Needed/Changes Required to Blank

- Add an indicator to Column 5 to denote all hybrid securities.

Pro

- Most hybrids are debt-like in their accounting and trading characteristics so this schedule would provide a good fit for these securities.
- The accounting guidance in SSAP No. 26 is appropriate for hybrids, requiring no changes to any accounting guidance.

¹ The ACLI is the principal trade association of life insurers, representing 373 member companies operating in the United States, of which 364 are legal reserve life insurance companies, and 9 are fraternal benefit societies. These 373 member companies account for 93 percent of total assets, 91 percent of the life insurance premiums, and 95 percent of annuity considerations in the United States.

- The addition of an indicator would enable regulators to aggregate the hybrid population and conduct any analysis that they deem necessary.
- The hybrid disclosure contained within Note 21F could be eliminated.
- Catastrophe Bonds are currently reported on Schedule D-1 and notated in Column 5.
- The use of an indicator to identify these securities would be more preferable than creating investment product type classifications and totals. Providing separate totals each time Wall Street comes out with a new product will add more complexity and size to an already enormous schedule.
- Most investment accounting systems can more easily accommodate hybrid securities when set-up as bonds; thus the inconsistent reporting resulting from, and the manual intervention required to comply with the short-term solution adopted in 2006 would be eliminated.
- The data reported will more likely match the trade ticket, broker confirm and/or custodial bank records thus eliminating any audit/examination exceptions.

Con

- This reporting method differs from the short-term solution adopted in 2006 which classifies such securities as preferred stock.

2. Schedule BA

Additional Data Needed/Changes Required to Blank

- Add an indicator (or category with subtotal) to identify and total all hybrid securities.

Pro

- This is consistent with the historical use of Schedule BA for securities that do not seem to fit neatly into the other schedules.
- The hybrid disclosure contained within Note 21F could be eliminated.

Con

- Schedule BA does not quite fit debt-like securities as seamlessly as Schedule D. Various SSAPs would need to be updated to note that hybrid securities should be reported on Schedule BA.
- For P&C companies, Schedule BA imposes a flat 20% factor for all assets so it does not allow for a reasonable RBC factor.

3. Schedule D-Part 2-Section 1

Additional Data Needed/Changed Required to Blank

- The schedule would need to be expanded to incorporate securities with non-stock features.

Pro

- This reporting method is consistent with the short-term solution adopted in 2006 to classify such securities as preferred stock.

Con

- Most investment accounting systems cannot easily accommodate hybrid securities when set-up as preferreds; thus the inconsistent reporting resulting from, and the manual intervention required to comply with the short-term solution adopted in 2006 would be perpetuated. Specifically, problems have been encountered with respect to amortization/accretion, method of interest accrual, quantity and pricing unit, among other technical issues.
 - Many hybrid securities convert to floating rate instruments after the initial call date. System constraints may not permit a company to report a floating-rate security as preferred stock.
 - As a result of system limitations, companies were forced to manually identify, track and notch hybrid securities. Naturally, the methods employed by companies varied and the resulting data reported on Schedule D sometimes differed.
 - Columns 5, 6, 7 and 9 (Number of Shares, Par Value Per Share, Rate Per Share, Rate Per Share Used to Obtain Fair Value) may have been expressed as a percentage of par or price-per-share, depending upon whether the company used a bond or preferred set-up in it's accounting system (and whether it chose to manually manipulate the data).

	Number of Shares	Par Value Per Share	Rate Per Share	Rate Per Share Used to Obtain Fair Value
BOND	7,000,000.00	1.00	1.00	0.972
PREFERRED	7,000.00	1,000.00	1,000	972.00

- The NAIC designations assigned to preferred stock do not easily fit hybrids. A market indicator is required for all common and preferred stock yet most hybrids do not trade on an exchange such as NYSE, AMEX or NASDAQ.
- The guidance contained within SSAP No. 32 would need to be expanded to include:
 - A section for bond accounting as hybrids are accounted for and traded as debt securities. Similar to the changes made for Exchange Traded Funds in 2006, any accounting changes needed in the SSAPs for hybrids would be expected to be a non-substantive change. A new SSAP would not be expected.
 - IMR guidance would need to be added as IMR applies to hybrids. SSAP No.32 currently anticipates only AVR changes that relate to stock.
- State investment limitations would have to be reconsidered if hybrid securities were to permanently remain in the preferred category.

We appreciate the opportunity to comment on this issue, and look forward to continued dialog. Do not hesitate to contact me if you have any questions.

Sincerely,

A handwritten signature in black ink that reads "Paul S. Graham III" followed by a stylized monogram or flourish.

Paul S. Graham III
Vice President, Insurance Regulation and
Chief Actuary

cc: Dan Daveline, NAIC
Nancy Bennett, AAA