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August 30, 2006

The Honorable Howard D. Mills, III
Chair, Hybrid RBC (E) Working Group
c/o New York State Department of Insurance
25 Beaver Street
New York, New York 10004

Re: 2006 Hybrid Scenarios

Dear Superintendent Mills:

The Bond Market Association (the "Association")¹ appreciates the opportunity to comment on the definitions of hybrid securities (the "Definitions") set forth in the document entitled "Definitions of Hybrid Securities" and the proposals regarding the treatment of such hybrid securities (the "Scenarios" and together with the Definitions, the "Proposals") set forth in the documents entitled "2006 Hybrid Scenario Comparative Chart" and the "8/24 New 2006 Hybrid Securities."

We understand that the Proposals are intended to be short-term solutions applicable only for 2006.² As such, our support of any Proposal is premised on its application for such short-term period.³ In addition, the Association believes that, to the

¹ The Association is a trade association that represents approximately 200 securities firms, banks and asset managers that underwrite, trade and invest in fixed-income securities in the United States and in international markets. Fixed income securities include U.S. government and federal agency securities, municipal bonds, corporate bonds, mortgage-backed and asset-backed securities, money market instruments and funding instruments such as repurchase agreements. The Association is expected to merge with the Securities Industry Association in November 2006. More information about the Association and its members and activities is available on its website www.bondmarkets.com, and information regarding the Securities Industry Association is available on its website at www.sia.com.

² As mentioned in the Association's comment letter dated August 23, 2006, we respectfully request that the NAIC prepare a briefing paper for the review of regulators and the public regarding the risk associated with hybrid securities and evaluating the adequacy of notching by national recognized statistical rating organizations ("NRSROs") as soon as is reasonable practicable, but in any event, no later than October 2, 2006.

³ Treatment of hybrid securities beyond 2006 should be determined by the incremental material risks, if any, that are posed by such securities after significant and more

extent a definition of hybrid securities is referenced in the Scenarios, Definition 3 is an appropriate definition to use for all the Scenarios. Definition 3 focuses on mandatory deferral, a novel feature that has been identified as potentially justifying treatment different than the treatment for other securities, at least prior to a more thorough review of risks by the National Association of Insurance Commissioners (the "NAIC"). We also believe that, if the NAIC concludes that notching is appropriate, any such notching should be precise in relation to the risks and therefore notched by using NRSRO ratings notching increments.

Scenario 1 and Scenario 1A

The Association continues to strongly support Scenario 1 for the reasons previously articulated in our comment letter dated August 16, 2006 and in the letter dated August 14, 2006 from the American Council of Life Insurers. We believe that adoption of such Scenario will bring the most clarity to the markets as it will result in a continuation of recognized and established NAIC procedures and precedents.⁴ In addition, we note that a majority of the Valuation of Securities Task Force voted on June 11, 2006 to follow the proposal articulated by Scenario 1.⁵

We believe that the implementation of Scenario 1 is the only Scenario that would significantly decrease the confusion surrounding the treatment of hybrid securities post-March 15, 2006.⁶ We believe that the market continues to be perplexed by the post-March 15, 2006 classifications made by the Securities Valuations Office ("SVO"), since many securities previously classified have been reclassified. Furthermore, we believe that market participants are unsure about the reliance that should be placed on the SVO's Advance Ratings Service ("ARS").

We understand that since March 15, 2006, more than 45 securities have been

thorough review of any such risks has been completed. Prior to such review, we do not believe that the Proposals should be considered as long-term solutions. In particular, we note that certain of the Proposals represent compromises and introduce a number of issues separate from a risk analysis that would need to be resolved prior to discussion of the feasibility as long-term solutions.

⁴ We continue to note, as stated in prior letters, that additional improvements should be made regarding the dissemination of information.

⁵ We believe the vote on June 13, 2006 by the Financial Condition (E) Committee to change the decision of the Valuation of Securities Task Force unnecessarily altered a well-established process that, with modifications to promote increased transparency, could have lead to the restoration of clarity and order in the marketplace.

⁶ On March 15, 2006, the SVO reclassified the Floating Rate Enhanced Capital Advantaged Preferred Securities issued by Lehman Brothers.

reclassified in a manner inconsistent with previous classifications.⁷ For example, on March 31, 1999, pursuant to a request made through its ARS, the SVO completed a detailed review of the 8.151% Non-Cumulative Dated Silent Partnership Certificates issued by Dresdner Funding Trust I (the “Dresdner Security”) and concluded that such security would be classified as preferred equity. The SVO sent a letter to the insurance company that had filed the ARS request advising it of this decision. Later that same year, the NAIC’s database reported the Dresdner Security as debt. However, on August 25, 2006, the SVO reclassified the Dresdner Security as common equity without explanation. We note that SVO management has publicly stated that there has been no change in the NAIC’s rules or policies in respect of any securities, including the Dresdner Security. Thus, without further explanation, the market cannot determine why something previously classified as either preferred equity or debt should receive common equity treatment, or why a security previously classified in one manner should receive a different classification subject only to the passage of time. In addition, we believe that the market may be wary about using ARS, which was recommended as a solution to the confusion by the SVO in the July 13, 2006 meeting and in certain written comments, or relying upon past classifications. As shown by the example of the Dresdner Security and the numerous securities reclassified since March 15, 2006, ARS determinations and prior classifications may be changed in a manner inconsistent with previous classifications without articulated justifications. We believe a return to status quo prior to March 15, 2006, or the situation proposed by Scenario 1, has the potential to restore order to the market as SVO determinations will follow a well-understood pattern, and risk-based capital requirements will be more predictable.

Notwithstanding the foregoing, in response to a request by the NAIC to provide alternatives to the Scenarios previously presented by them, the Association set forth Scenario 1A (and accompanying “Definition 3”). While we continue to strongly advocate adoption of Scenario 1, as discussed in our comment letter dated August 23, 2006, prior to a more complete review of risks that hybrid securities may pose, we believe that Scenario 1A in combination with Definition 3 creates a clean, easily understood and enforceable rule for the short-term. Reducing ambiguity is crucial to investors in determining trading and investment strategies and issuers in raising capital through innovative instruments. In addition, the Association believes that Scenario 1A addresses the only potential element of incremental material risk that has been identified that is not present in traditional perpetual preferred securities (which securities are explicitly excluded from the definition of hybrid securities, and therefore from the review of the Hybrid RBC (E) Working Group, submitted by the New York State Insurance Department).

⁷ We understand that American Council of Life Insurers intends to send a separate letter detailing such securities. To the extent that a list of such reclassified securities is not provided, the Association would be pleased to provide such list.

The Association has previously provided the NAIC with a list of hybrid securities as defined by Definition 3. The Association would be pleased to provide an updated list of such securities as necessary, and continues to welcome further discussions with the NAIC to the extent that the NAIC believes additional risks may exist.

Scenario 2C

We believe that Scenario 2C should be modified in order to capture any risks hybrid securities pose to investors. We suggest that securities relying solely on a capital replacement covenant to obtain Basket D treatment by Moody's Investors Service ("Moody's") be excluded from this Scenario. Such a covenant does not introduce any additional risk to insurance companies or other investors, as it merely imposes a restriction on the source of funds used to redeem hybrid securities. Inclusion of securities with these covenants would mandate a higher reserve factor when there is no increased risk to investors. This would not further the NAIC's goal of reflecting actual risks in the risk-based capital measure.

The capital replacement covenant is a voluntary covenant entered into by certain issuers. It requires the issuer to redeem hybrid securities only with the proceeds of other securities that have equal or greater equity content (for purposes of Moody's equity credit) than the hybrid securities. Such a covenant does not affect the rights of investors in hybrid securities. In the event of a full redemption, all existing holders of hybrid securities would be redeemed pursuant to the redemption provisions of the governing document. Thus, such investors would no longer be holders of the securities, and therefore, would not be harmed by the method in which the issuer raised funds for the redemption. In the event of a partial redemption, the holders of hybrid securities that are redeemed would be replaced by holders of securities with equal or greater equity content than the redeemed hybrid securities. Therefore, the capital replacement covenant does not result in any adverse change in the financial condition of the issuer upon redemption, full or partial, of the hybrid securities.

However, we note that Scenario 2C is inappropriate as a long-term solution. Moody's determines Basket treatment by analyzing the payment flexibility that the terms and conditions of the securities give to issuers, rather than the likelihood that an issuer will actually utilize such flexibility. For purposes of determining the Basket treatment, Moody's does not consider whether such features pose a risk to investors, as illustrated by the capital replacement covenant. In addition, the Basket treatment is affected by certain terms that the NAIC does not consider as incremental risks for certain debt. This Scenario also gives undue weight to determinations made by one NRSRO. Without another benchmark for accuracy, it creates an opportunity for arbitrariness. It may also impose a virtual requirement for issuers to submit such securities to Moody's for ratings. Thus, it may disadvantage other NRSROs without any justification, and preferences

Moody's in a manner never previously adopted by the NAIC. It may have the effect of reducing issuers' freedom of choice to obtain the best service provider.

Definition 1

The Association believes that Definition 1 is overly broad and perhaps inappropriately causes securities that present no identified additional risk to insurance companies and other investors to potentially be treated as securities with significant risk. The Association believes that the securities to be treated as risky instruments should be those with features associated with increased risk.

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Once again, we thank you for the opportunity to comment and we look forward to working with the NAIC, the SVO and other market participants on determining a solution appropriate for the regulators and for the marketplace. If you have any questions or suggestions, please contact me at mkuan@bondmarkets.com or 646.637.9220.

Sincerely,

A handwritten signature in black ink, appearing to read "Mary Kuan", with a stylized, cursive script.

Mary C.M. Kuan
Vice President and
Assistant General Counsel

cc: Mr. Dan Swanson, RBC Manager
Mr. Todd Sells, Senior Financial Regulatory Services Manager