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August 23, 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: 8/18 New 2006 Hybrid Scenarios

Dear Superintendent Mills:

The Bond Market Association (the "Association")¹ appreciates the opportunity to submit a proposal (the "Proposal") regarding the definition of hybrid securities and the treatment of such securities. We note that the Proposal is intended to be an interim solution applicable only for 2006, and we do not submit such Proposal as a long-term solution.

We believe that, given the significant impact of any decision on the market, any potential risks to investors should be clearly evaluated and quantified in advance of implementation of a long-term policy. We do not believe that such extensive review has yet occurred. We note that the New York State Insurance Department ("NYSID") recently sent a memorandum to the Hybrid RBC (E) Working Group (the "Working

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.

Group”) questioning items that may impact the risk to investors.² This memorandum was addressed in great detail in the recent letter submitted by the American Council of Life Insurers. However, as the memorandum has not been adopted by the Working Group, it is unclear whether it represents the view of the Working Group. In addition, to date, neither the memorandum nor the comments from the American Council of Life Insurers have been meaningfully addressed.

Given the accelerated time frame for an interim solution, prior to more fulsome review of risks, we address the potential that recent innovative features incorporated into hybrid securities may present new incremental additional risks to investors. We note that the National Association of Insurance Commissioners (the “NAIC”) has reviewed securities with debt and equity characteristics, such as traditional perpetual preferred securities, for many years, and has classified such securities as either preferred equity or debt without additional notching by the NAIC. Thus, the Proposal focuses on features different from those incorporated in perpetual preferred securities that regulators may feel justify a different treatment and that may pose incremental additional risk. For purposes of the Proposal, we define new incremental additional risks to investors to be risks to investors due to structural developments in securities around and after February 2005, when Moody’s Investors Service began assigning higher degrees of equity credit to securities with certain structures.

The Association believes that the only incremental additional risk not present in traditional perpetual preferred securities is mandatory deferral, a relatively recent feature of certain securities.³ Mandatory deferral refers to a provision which prohibits an issuer from making dividend or interest payments to investors in the event that certain pre-determined financial parameters are met. Mandatory deferrals do not affect the security holders’ claim, or priority of claims, on payments (including principal) due from the issuer in the event of a bankruptcy or similar action. The Proposal explicitly excludes deferrals due to laws and regulatory activity (including minimum regulatory capital ratios) as such deferrals are not new provisions and no discernable increase in new risk element has been associated with such deferrals. Additionally, regulatory deferrals are associated with certain types of issuers, regulated entities, rather than the types of securities such entities issue. We also note that regulatory deferral is a feature found in many securities which the Securities Valuation Office (the “SVO”) has classified as debt, such as surplus notes issued by insurance companies and subordinated term debt issued by banks and their holding companies.

² The memorandum refers to the “Definition of Hybrid Securities Risk Not Addressed By A Credit Rating” sent by the NYSID to the Working Group on August 4, 2006.

³ Research reports that pre-date March 15, 2006, the first NAIC ruling on a security with a mandatory deferral (as discussed in the Proposal), have also stated that the mandatory deferral feature is new and unique to United States securities.

We acknowledge that for the purpose of preparing interim guidance, the NAIC has not completed its analysis of the risks of certain features, including the mandatory deferral feature. We also note that nationally recognized statistical rating organizations (“NRSROs”) consider deferrals when determining their ratings, and reduce their ratings by one notch to reflect the potential impact of deferrals. We generally support the process by which NRSROs rate securities. However, notwithstanding the foregoing, given the NAIC’s goal of reaching a short-term solution imminently, we propose that, for this interim period only, insurers be required to adjust the NRSROs’ ratings for Hybrid Securities (as defined in the Proposal) down by one NRSRO ratings notch for insurance regulatory purposes.⁴

We recognize that under the Proposal, NAIC designations for certain securities may not be affected as some issuers are very highly rated; for instance, all securities rated AAA to A will have the same risk-based capital factor, and consequently, the NAIC designation will not be altered for those securities. We believe that such a policy is appropriate for high fundamental credit levels as mandatory deferral triggers are generally set at a threshold appropriate for non-investment grade issuers (while, to date, issuers of securities with mandatory deferral features are investment grade) and at a low probability of being breached.⁵

We note that insurance regulators have frequently stated that in situations of uncertainty, they generally prefer to act conservatively. We acknowledge that some may object to the Proposal as it does not automatically result in higher factors for all hybrid securities. We also recognize that any solution implemented prior to the completion of adequate research and analysis may not be perfect, and we understand the preference to err on the side of conservatism. However, we also note that a decision on the side of conservatism (i.e., automatically requiring notching of all hybrid securities) can distort investment behavior and can result in harm to those whom the policy is designed to protect. For instance, if regulators assign risk based capital charges to hybrid securities that are excessive relative to the fundamental risk of hybrid securities, insurance companies may invest in other securities with similar risk based capital charges and higher yields but with higher fundamental risk. Thus, regulatory policies intended to be conservative may actually result in the investment portfolios of insurance companies

⁴ The Association respectfully requests that the NAIC prepare a briefing paper for the review of regulators and the public regarding the risk associated with mandatory deferral and evaluating the adequacy of NRSRO notching for mandatory deferral as soon as is reasonably practicable and in any event, no later than October 2, 2006.

⁵ We believe that investors would resist mandatory deferral provisions in non-investment grade issuers. Thus, to date, mandatory deferral provisions exist only for investment grade issuers, and we believe that is unlikely to change.

having more risk than if the risk based capital charges had been aligned more appropriately.

The Proposal

The Association defines “Hybrid Securities” as securities with characteristics of debt and of equity that possess each of the following characteristics:

- (1) the evaluation of such securities is accorded some degree of equity treatment by one or more of the nationally recognized statistical rating organizations and/or the securities are recognized as regulatory capital by the issuer's regulatory authority;

and

- (2) the operative documents of the securities require a deferral of interest and/or of dividend payments based upon the satisfaction of one or more pre-determined triggers derived from financial statements. Such trigger will typically be a failure to satisfy a earnings-, cash flow- and/or capitalization based financial ratio test over a specified period of time. Such triggers do not include deferrals due to laws or regulatory requirements (including minimum regulatory capital ratios) or activities.

In addition, the Association proposes that insurers continue to classify and designate Hybrid Securities (as defined in the Proposal) on a filing exempt basis as preferred stock or debt, as specified in the debt/equity guidelines of the Purposes and Procedures Manual (the “Manual”) which governs the actions of the SVO. For this interim period only, insurers will be required to make a downward adjustment to the NRSROs’ ratings for such Hybrid Securities by one NRSRO ratings notch for insurance regulatory purposes.

The Association also respectfully requests that the NAIC post a list of the CUSIP numbers of Hybrid Securities as defined by the Proposal in an easily accessible location on its website. In order to facilitate the compilation of CUSIP numbers, the Association would be pleased to provide the NAIC with research reports (or a list) of Hybrid Securities, or securities with the mandatory deferral feature subject to such interim Proposal. In addition, we understand that such information can also be easily obtained from the NRSROs.

Benefits of the Proposal

The Proposal addresses a new feature which may have created uncertainty

regarding risk among regulators. On an interim basis, it permits the imposition of a higher risk factor. In addition, as implementation of such Proposal follows the standard filing exempt process, there is no need for new procedures. Unlike scenarios previously submitted, which may increase demands on the SVO, this Proposal will require few NAIC resources as the requirements are easily verifiable. The Proposal also provides much needed clarity to the marketplace as to how securities would be treated. Thus, there would be significant improvement in the ability of insurance companies to determine their investment and trading strategies and in the ability of industry to structure transactions.

* * * *

To the extent that the NAIC concludes that hybrid securities have significant risks other than or in addition to mandatory deferral, the Association welcomes a dialogue with the NAIC on such features. We would be happy to modify the Proposal accordingly to the extent that other actual risks can be demonstrated.

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 concerning the Proposal, 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