



## Preparing for the NAIC's New Treatment of Municipal Debt

September 2010

*Why would the majority of the NAIC's Rating Agency Working Group's work be focused on a part of the fixed income market that came out of the recent 'credit crunch' relatively unscathed?*

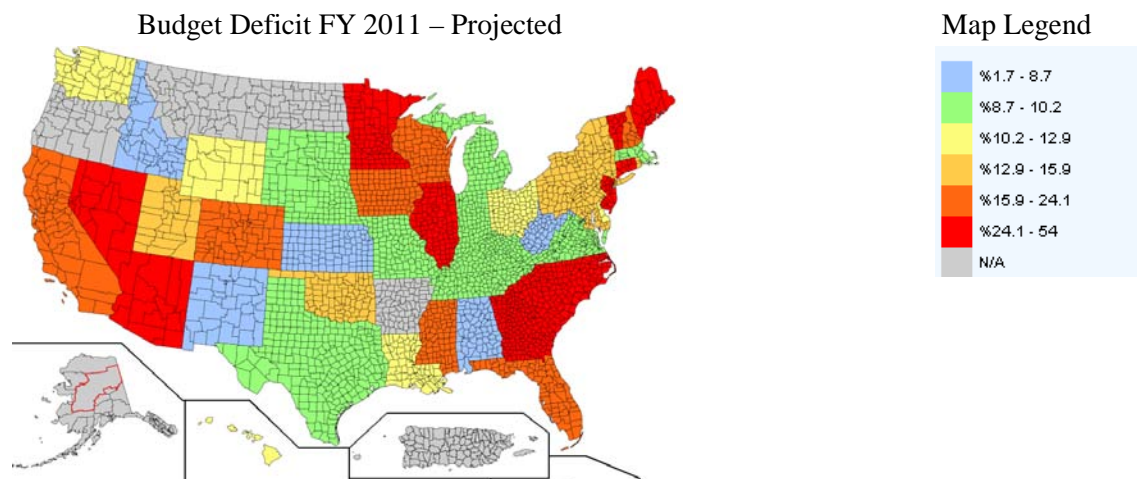
The NAIC's Financial Condition Committee specified the primary responsibility for its Rating Agency Working Group for 2010<sup>i</sup>:

*whether states', municipalities' and other public entities' creditworthiness should take into account the unprecedented financial burdens many public sector issuers face from aging populations, public pension liabilities, infrastructure needs, and revenue instability.*<sup>ii</sup>

The Valuation of Securities Task Force was also tasked with looking into whether the relationship between ratings and NAIC designations should be altered.

Undoubtedly, the NAIC is concerned about the potential impact to the insurance industry of *any* error in measuring municipal debt risk. More specifically, the concerns focus on the fundamentals of municipal credit and the ability of insurers and regulators to comprehensively evaluate municipal borrowers. Indeed, the NAIC has gone so far as to hint at creating their own agency.

The NAIC is not alone in their concerns. A number of high profile insurance industry investors have already begun to reposition their portfolios. Tom Wilson, the CEO of Allstate, commented that "government borrowing is way out of control" as Allstate has cut municipal bond holdings by approximately 15% since the middle of 2009<sup>iii</sup>. Warren Buffet is predicting a "terrible problem" for bonds in the coming years and has cut Berkshire's portfolio by a similar percentage.<sup>iv</sup> Indeed, state budget deficits have ballooned, with nine states projecting deficits greater than 24% of their budget in FY 2011.



To date, performance in the municipal bond market has been relatively good. However, pressure on regulators to be proactive is growing especially as headline risk continues to grow. This brings us to the main concern that insurers and those who manage insurer's portfolios should be considering:

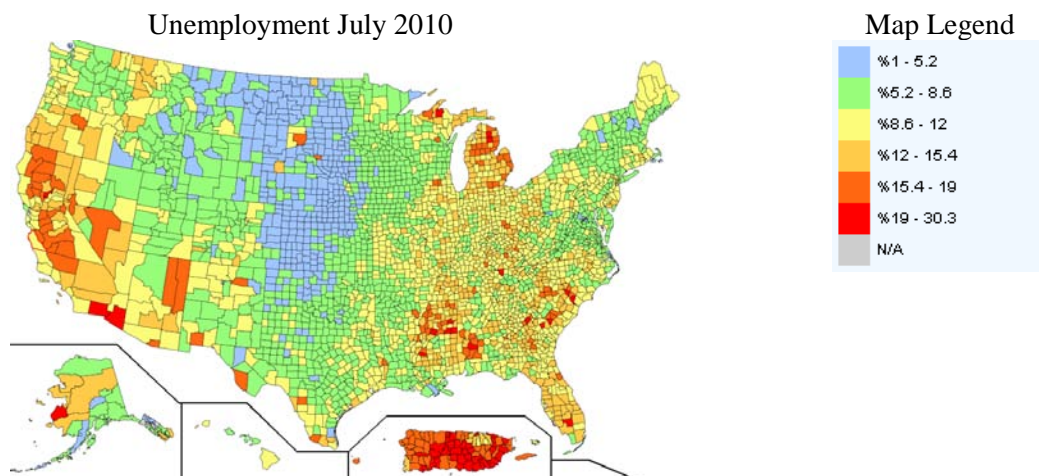
With the demise of monoline insurance and the credibility of the rating agencies called into question, is the NAIC laying the groundwork to potentially alter how municipal bonds are classified and valued?

It certainly appears so with the NAIC noting:

*An alternative valuation method may need to be developed, as the NAIC methodology of matrix pricing using comparable bonds may have limitations... unprecedented burdens resulting from the "baby boomer" generation, may necessitate alternative views and assessments of municipal creditworthiness.<sup>v</sup>*

Importantly, the majority of municipal debt is currently considered relatively low risk, allowing insurers to obtain better capital treatment on these assets as they are generally classified as NAIC 1 or NAIC 2. However, high ratings may simply compound the problem for insurers. For example, for a life insurer, the move from NAIC 1 to 2 more than triples the capital reserve requirement, whereas a move from NAIC 5 to NAIC 6 causes an increase of less than a third. While the credit risk may or may not be greater on lower-rated securities, the regulatory risk is certainly greatest for those assets with the best classifications.

Should the NAIC move forward with such a change and base classifications on municipal fundamentals such as pensions and demographics, most companies – even those with relatively bullish views on municipal credit -- will be incented to sell out of bonds backed by communities with less attractive characteristics.



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<sup>i</sup> [http://www.naic.org/committees\\_e\\_rating\\_agency.htm](http://www.naic.org/committees_e_rating_agency.htm) Accessed 9/3/2010

<sup>ii</sup> Ibid

<sup>iii</sup> <http://www.bloomberg.com/news/2010-07-07/allstate-ceo-says-government-borrowing-out-of-control-munis-may-suffer.html>

Accessed 9/3/2010

<sup>iv</sup> <http://www.businessweek.com/news/2010-06-02/buffett-expects-terrible-problem-for-municipal-debt-update1-.html> Accessed 9/3/2010

<sup>v</sup> Ibid