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NAIC MODEL INVESTMENT ACT UPDATE

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This session will review the current state of developments on the most recent draft of the new NAIC Model Investment Law.

MR. JOSEPH H. TAN: Since 1991, work has been underway in the NAIC to develop a model law to address investment issues. This work was begun as a part of the NAIC solvency agenda to institute common standards among the majority of the states that do already have investment laws, and to provide a model for those that do not. As many of you know, the technical resource group supporting the NAIC model working group submitted a draft in June 1993. The working group in turn responded with its own discussion draft in time for hearings at the fall 1993 NAIC meeting in Boston. I don't need to remind those of you who attended that meeting in Boston that the most tactful thing I can say is that responses to this draft had one thing in common: it was met with very solid opposition. Since fall 1993, the working group and the technical resource group supporting it have both met a number of times and worked hard to produce a draft that met the regulatory goals without being overly complicated or seeming to micromanage investments.

Larry Gorski and Chris Anderson are here to discuss the progress that has been made, outline possible ranges of what might be included in the draft once it is all ready for enactment, and guess about when all this might take place. The Illinois Insurance Department has played a leading role in this process, and we're fortunate to have Larry here who has significant involvement in this. Chris Anderson has been active in the technical resource group supporting the model law as well as other technical resource groups' activities in the past few years.

Larry Gorski is a recent Fellow of the Society of Actuaries, a member of the American Academy of Actuaries, and has been employed by the state of Illinois since 1973. He's very active in the NAIC. He's chairperson of the life risk-based capital (RBC) working group, chairperson of the invested asset working group, a member of the NAIC life and health actuarial task force, and a member of the NAIC asset valuation reserve (AVR) interest maintenance reserve (IMR) working group. As most of you might know, he's a frequent speaker at many professional meetings. Chris Anderson is a director and insurance specialist in the fixed-income research group of Merrill Lynch. He's a recent chartered financial analyst (CFA), and his NAIC activities include supporting the model investment law and being a member of the invested asset working group as part of the technical resource group, and also being a technical resource group member in the AVR-IMR agenda. My name is Joe Tan, the director of the National Actuarial Network, Inc., and our recorder is Pat Gallagher, an independent consulting actuary.

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I'm sure we all look forward to hearing what Larry has to tell us about the recent developments and what we might expect to see. Following Larry's comments, Chris will discuss reactions to the law from the investment perspectives.

MR. LARRY M. GORSKI: I think your comments concerning the results of the Boston meeting really were a watershed in the sense that, after the regulatory conversion model investment law was exposed, we heard a tremendous amount of negative comments relative to it. We tried, to some degree, to address those comments between September and December 1993 at our meeting in Hawaii, and the Hawaiian meeting really showed the foolishness of the path we were going down in terms of making a more complex model. I guess the thing that's somewhat surprising to most people, myself included, even though we have two completely different tracks—an industry-type model with a prudent man as the basis, and a regulatory approach based on pigeonholes—our goals are basically the same, and that's where I'd like to start with this presentation.

Our goals are basically the same: We want a model investment law to promote solvency. It needs to recognize the competitive environment. It needs to be easy to administer, and we need to put more emphasis on board responsibility. I'd like to spend a few minutes on that. When the first version of the model investment law came out from the industry, the cornerstone or capstone of the version was board responsibility. The board would be responsible for adopting written guidelines, making sure that those guidelines are complied with, and in fact, to some degree, take charge of the investment activities of the insurance company.

At our first few meetings the regulators really didn't put much stock in terms of that type of requirement. They gravitate towards the pigeonhole approach. As the process has evolved though, we're looking more and more as that being a very important element of a model investment law. Basically, we would expect the board to approve written guidelines relative to investment practices of the company. Those guidelines deal very explicitly with diversification, interest rate risk, credit risk, liquidity concerns, foreign investments, and other investment practices, let's say the use of reverse repurchase agreements, dollar-rolled transactions, etc. We're looking for those written guidelines to be the expression of the board as to the level of investment risk an insurance company is willing to take. That obviously requires a board that understands investments and is able to quantify the level of the risk that it is willing to take in the form of some type of written guidelines. As the regulators put more emphasis on this last point, I suspect industry action is to put less emphasis on it because we're really asking for this to be a critical feature of any model investment law.

I think Joe discussed the history and status. Right now we're in step three of significant rewrites. Basically after we left the Hawaii meeting, we decided it was time to retrench from our pigeonhole within a pigeonhole within a pigeonhole within a pigeonhole approach and to get to more broad-based asset classifications and maybe limits at that level but not any inside limits, and that's basically the direction we're moving into. I'll get more specific as I run through the presentation, but generally we're trying to look at limits on a broad class: fixed-income securities or equity interest, preferred stock, mortgage loan, real estate and derivative instruments, and a few other lesser classes, but I'll have more to say about that as we move through.

The change in direction of our group really hinged on making decisions relative to these key decision points. As had been indicated, the model investment law was really one part of an overall arsenal of regulatory tools dealing with solvency. The model investment law is the last piece to be developed, and that's unfortunate because all the other tools have been developed. RBC, extension of the AVR to all classes, implementation of cash-flow testing, in effect, have confused regulators and nonregulators as to what the proper role of the model investment law should be. In some sense, people argue, maybe we don't need a model investment law anymore because we have all these other tools in place. However, the other tools don't really deal with concerns that regulators have about liquidity, diversification, and board responsibility. So as we ran through the points made at the September and December 1993 meetings, we had to reevaluate our views on these key decision points.

Another key decision point that's controversial from many different perspectives is, how much discretionary authority should commissioners have? Should commissioners have the ability to approve or recognize innovative investments in an unlimited fashion? Should they be allowed to do that only in a limited framework? If they do, what should they consider when exercising that authority? Conversely, the concept of once legal always legal doesn't really make sense any more. Take for example a situation where a company invested in a new investment vehicle, a new investment subclass, and as time rolls on, everyone realizes in order to be successful in that particular investment class, you need a tremendous amount of expertise both in terms of personnel and tools and a company doesn't have that. Should the commissioner or the regulators have the authority to look to that company and say that, over this time period, you need to divest yourself from that investment class? Even though it's legal and there's no legal prohibition against that investment, the company just doesn't have the skill to handle that type of risk, and that's a very important issue. It's becoming more important as investment vehicles become more complex, and one needs more tools and ability to handle those types of investments.

Now, we'll get to a brief outline of the model investment law and some of the key issues. I've talked about the investment policy approved by the board. That will become a very important aspect of the model investment law. At every meeting that we've had since December 1993, there's been discussion about this item. One particular problem that is not really amenable to any tools we have in place is, how do you deal with companies that are active managers of their portfolio or use derivative instruments for replication transactions? In that case, companies are able to modify the risk return profile of the company very quickly. So simply looking at a snapshot at a point in time and being comfortable that the snapshot is an accurate portrayal of the company's risk return profile over time really doesn't get the job done. You need something like an investment policy approved by the board and periodic compliance with that policy. As I pointed out, the investment classes are going to be broadened in terms of scope. We'll no longer have what's called corporate obligations or bond classification. We're going to have something known as rated credit instruments, and when I get to that, I'll point out the reason why we're going that route. And we'll have the standard classes of investments with, what I would say, probably broad limits in that area. But the broader these limits become, the more important the commissioner's discretionary authority becomes. It will be a trade-off at that point.

We'll still have credit quality limits very similar to what everyone's familiar with and comfortable with now in terms of quality limits by asset class including the junk bond limits. Segregated investment classes will be by significant risk, and that gets to that rated credit instrument issue. Right now when you talk to someone in the investment community, a regulator or an insurance person, you talk about fixed-income securities, you really don't have any idea as to whether that instrument you're talking about is really characterized by a credit risk or some other risk, and right now I'm referring to let's say interest only (IO) or principal only (PO) where you have a lot of prepayment or extension risk. Is the primary risk associated with this particular fixed-income security credit, or is it something else? What we're trying to do in our process is to develop operative definitions, not necessarily legal definitions for asset classes, but operative definitions that focus in on, let's say, the traditional risk associated with a particular investment class, and I'll illustrate that as we go along.

Probably the most controversial item of the whole process is derivatives. Right now the model investment law will recognize derivatives for hedging purposes, and there's a definition of hedging. It will recognize derivatives for one form of income generation, that being the sale covered calls, however, the whole issue of replication transactions has been deferred to the work of the invested asset working group. One interesting portion of the discussion about hedging is that basically the industry focuses its definition on risk management, and the regulators focus on risk reduction. That becomes important when you talk about the concept of, let's say, duration management through the use of futures contracts. The industry would say that we're trying to manage the duration of your fixed-income securities by using futures contracts to peg a certain duration, fine tuned around that based on changes in interest rates. We would argue that is not recognized within the model investment law, it's not risk reduction as we defined it. So that's an area where we have gone around and around, and that's the split between risk reduction and risk management. The issues surrounding the replication of cash market instruments by the combination of cash market instruments and derivatives focus on questions concerning proper reporting, proper accounting, RBC implications, and cash-flow-testing implications. If you're replicating a common stock portfolio by using Treasuries and Standard & Poor's (S&P) 500 futures contracts, it should be reported as common stock, not as Treasuries. You should have AVR-RBC implications related to common stock holdings. For cash-flow-testing purposes, they should be viewed as equities and not fixed-income securities. So the work of the invested asset working group is trying to first identify all the possible issues related to replication, and then to develop suitable regulatory solutions to those issues.

The model investment law will separately recognize foreign investment risk versus foreign currency risk. There will be a limit on foreign investments. There will be a separate limit for foreign currency. The model investment law is looking at foreign investments from two perspectives: foreign investments as an investment class and foreign currency risk. One of the things that we are pursuing is that foreign currency risk is a risk that's not picked up by the AVR or RBC. So there is some talk of trying to quantify foreign currency risk separately and have factors in AVR and RBC to deal with that. Basically we're looking at three different tiers, a three-tiered basket, where the first tier would deal with spillages. Let's say there's a 50% limit on fixed-income securities and a company inadvertently held 51%, that 1% would go into the spillage basket. Then there would be a second basket that would be available to all

companies that would be usable for experimentation, purchasing new investment vehicles, and so on. That would probably be capped at maybe 15-20% of capital and surplus. And then a third limit may be capped at 40% of capital and surplus would be subject to commissioner approval. If company A would want to get into a new investment vehicle, it would have to come to the department, request approval, and demonstrate that the company understands the risk, the board understands the risk, the company is able to quantify the risk, and its surplus is such that it can handle the risk associated with that particular investment class, and that would be a discretionary-type basket.

A controversial item that has been resolved is the regulation of parent and subsidiaries and affiliated assets, and for the longest time, that was included in the model investment law. It has been taken out, and it's going to be dealt with strictly through the Model Holding Company Act. The one wrinkle is that the model investment law would explicitly prohibit public securities association (PSA) investments and classifying in any of the particular pigeonholes designed by the model investment law. It would strictly be legitimized and limited by the Model Holding Company Act. And as I said before, the once legal always legal concept may no longer be acceptable because of the changing investment environment.

Now I'll get a little bit more specific about the rated credit instruments. Coming away from the Hawaii meeting, we didn't know what to do with many of the exotic tranches of collateralized mortgage obligation (CMOs) and possibly of asset-backed securities that exist with respect to fixed-income securities. We tried the pigeonhole within the pigeonhole within the pigeonhole approach, and we all decided that it was kind of foolish to go that route. So we decided to purify the various investment classes, and we came up with this idea of rated credit instruments. And the basic idea is that we will recognize many types of financial instruments within that particular investment class and will recognize bonds, notes, debentures, credit tenant loans, and so on. Basically what it says is that, if there exists a situation where the investor, the insurance company, can experience a negative rate of return over the life of the contract, over the life of the investment, due to reasons other than credit risk, the investment doesn't belong, it's not a rated credit instrument, it's something else. So if you invest in an IO and you plop down $10 million for a future cash-flow stream, and that cash-flow stream could disappear because of prepayment risk under certain scenarios and your rate of return will be less than zero, it's not a rated credit instrument, it belongs somewhere else. If you buy an equity-linked note in which the combination of coupon payments and principal payments could be such that you could suffer a negative rate of return, it's not a rated credit instrument, it belongs somewhere else. Where that somewhere else is is still somewhat open to debate, but it's not going to be a rated credit instrument, it's not going to be recognized as a fixed-income security. We did the same thing in the preferred stocks section. I've been becoming more familiar with variations of these types of instruments. I've come across preferred stock that has a mandatory convertible or exchangeable provision. So it's not at the option of the holder, but it's required after N years, this preferred stock be exchanged one for one or converted one for one to common stock. Well, in that case, the preferred stock behaves like common stock, and that's what it should be viewed as. So even though you may have a legal definition, a term on top saying this is preferred stock, it's not preferred stock, it's common stock, let's not fool ourselves, and that's where it belongs. The idea is to develop classes of instruments

that reflect the more traditional view of the risk associated with them, and to get away from legal definitions and move towards operative definitions. And then, this is simply the language dealing with the PSAs, investments in parent and subsidiary and affiliated investments will not be permitted via the model investment law, but recognized and limited through the Model Holding Company Act.

And last, when is all this going to be completed? Heaven only knows, I guess. We expect three more regulatory meetings: (1) a session for rewriting—basically there's about four or five sections of the model investment law that need some rewrites from our standpoint; (2) a session to put everything together; and (3) a session to make sure there are no loose ends. So we're looking for a draft being ready by September 1994, let's say, opening up for industry comment, and if all goes well, a year from now we should have a finished product. So that's my prognostication as to where we're going with this. I think a lot hinges on cooperation with respect to the board responsibility issue. That is going to be a very important issue from a regulatory standpoint, and I suspect from an industry standpoint, also.

MR. CHRISTOPHER T. ANDERSON: I think we all understand the role, as it's evolving, of the technical resource group. Resource groups supporting various efforts are here to help support regulators as they embark on solving problems for the industry and regulating the industry. But that's not why I'm here. One of the things that I'll be doing is raising as many problems as we solve, and part of the objective of that is to both show you the complexity of trying to satisfy the regulatory goals that are being addressed, and to just give you a better sense of what's happening and how it's happening, and just a broader perspective of what's going on. We'll do that in one way through some specific examples just to show you that this is a complex task. Before the end of the session, we'll give you a sense of where and how you can get further information, and following Larry's timetable that he just outlined, how you can participate in that effort and stay involved and aware.

Thinking back a couple of years to not the very beginning in 1991 but a little after that, I could see a timetable of probably a year for completion. And I guess I still see a timetable of about a year for completion. So it's a little like a constant maturity Treasury, and one of these days we'll take that next step forward and we'll get to 364 days. With a new leadership though, both on the industry side, with Mary McGinn from Allstate taking over responsibility on the health and life side for the technical resource group, and with Carol Ostichuck of the State of Florida taking over the chair of the working group, I have a lot of confidence in those two people. They're interested and involved and dedicated to this process, so I think the kind of thing that Larry was talking about is reasonable in terms of a time frame going forward, and we'll be more specific about that in a bit.

Part of the balance and part of the tension that existed in the law itself in previous drafts, the things that Joe told you about, were on one hand strict, specific limits, and on the other hand more of a prudent person approach. And just to go through a specific example of how that really works and what the impact is, let's consider the topic that Larry raised, and that is the risk of loss of principal in an investment due to factors other than interest rates. One way you can approach that is to draw strict limits and draft really strict rules. Now some of the issues that arise when you do that may inadvertently capture something that's a perfectly reasonable instrument. A

30-year Treasury bond may have a five-year call period. Does that really subject it to risk of loss of principal if you pay a premium? You may need to manage around other laws. The secondary Mortgage Market Enhancement Act is a federal statute that applies in some states, and doesn't apply in others. There's a matter of opinion as to what extent that would or would not cover some of these instruments. Third, you may not have enough flexibility for new products, developing new products as they go through. I think the working group, in a real breakthrough in a recent discussion period coming up with a new product basket, has made tremendous progress in addressing that. The question is whether it will work and whether it will be implemented. If it does work, I think we should all support that very enthusiastically and provide it adequate limits.

Other things can change in the future. If you look at CMO investment ten years ago when New York drafted its investment law, a small limit would have been perfectly appropriate, but now with substantial percentages of assets in some of these so-called new products, that would clearly be insufficient. Also when you start drawing lines in the sand, you invite participation in the pastime of tax minimization. There's nothing wrong with that from a tax point of view or from a regulatory point of view, but I doubt if regulators really are interested in setting the fertile minds of Wall Street to work at devising new products solely to circumvent reasonable regulation, so that's certainly one other drawback of drawing specific strict lines in the sand. And it's also possible that, if you have a speed limit of 55 miles an hour and it's posted in the wrong place, you can permit someone legally to do something that's irresponsible.

A prudent person approach, on the other hand, may not give what the industry needs for investment. It may not provide the adequate authority for investment. Regulators object to it, in some instances, because it can provoke confrontation, real toe to toe. My view of what a prudent person does is not your view, and there are some departments that really like to be able to say, you are over the limit, you are over the line. At the end of the day, though, a prudent person, which certainly a number of people in the industry favor, may create the kind of burden of proof that they may not want because it may be very difficult to substantiate what you're looking for. The bottom line of what we'll see in the draft, probably in July 1994, will be some combination of these two different approaches. It's something that not everyone will love because it will combine both the better and the less desirable features of both of these elements.

Another key issue that Larry talked about is derivative products, and he mentioned that derivatives were defined in a very specific and narrow way, and I think that's essential for this process. As we've just said, though, making those definitions and making those distinctions can be very difficult. Let me just talk through an example. Let me take an asset, tranche it, create an A class and B class for you, and just describe it for a second and then we think about what they are. The class A in this theoretical investment is credited to Ron Luskin from Wells Fargo Nikko who published this in a recent piece on derivatives in Association for Investment Management and Research (AIMR). He put together a very nice 150-page piece on derivatives [Luskin, Donald., "If Derivatives Are So Great, Why Don't More People Use Them?", ICFA Continuing Education: Derivatives Strategies for Managed Portfolio Risk, December 15, 1993, page 10]. Let's say the class A tranche has first claim on earnings, and effectively he's short a put on the enterprise value so you take one as

opposed to the other. The class B tranche on the other hand has unlimited upside. You realize if the enterprise does better, you'll do better, there's no limit. The limited downside includes you can lose your investment value; you have a junior claim on earnings; the A class holder gets first claim; there's no responsibility for managing the enterprise; you can walk away from the enterprise; if the enterprise fails, there's no claim, and there's no personal liability. So what is this derivative product that gives you upside and no downside, a claim on earnings? It's called equity, just common stock. So, depending on how you want to define a derivative product, you can define almost anything as a derivative.

Let's take another example, which Luskin cites, and that is the difference between a $50 bill and a $50 gold piece. Which is which? The $50 bill derives its value from the common expectation of the productive value, productive capabilities of goods and services of people in the U.S. That's a little bit esoteric. The $50 gold coin is convertible into currency, it's convertible into goods and services, and you can even fill your teeth with it. So my sympathy is with regulators as they try to make these definitions. The conclusion of Luskin's article is that, in effect, the bill is a derivative product, and the gold coin is a good example of something that really does have an exotic option associated with it. A derivative product is something which we're not familiar with and something we're not used to dealing with even though the equity of the common stock is something few of us would call a derivative product.

Larry made the point well, the NAIC now through the model investment area is looking at dealing with this issue in one of three different ways: calling something a hedge, calling something replication, which is something that Larry's dealing with in invested asset, and calling something speculation. Investing in these products requires both risk assessment and risk management, and one of the questions is, how do you enforce this within the context of the law? How specific can you get? By definition, of course, hedging is limiting risk, and you know what it costs you to put the hedge on and you are limiting risk. What other risks are you undertaking when you put a hedge in place? Do you have basis risk; do you have other elements of risk? I mean this is just another example of what regulators have confronted and must confront going forward as they put both the technical elements and also the spirit of prudent person on a piece of paper that we'll all have to live with.

Larry also mentioned that, of course, this all needs to fit into a context. It can be argued that when the model law was undertaken, when the mandate was put forward for a model law, there were a lot of other things that were not in place. AVR was not in place; RBC for life and health was not in place. So the question is whether there's a need, given all the regulatory tools that exist, for a document like this. I think Larry made the point well, and I think others would echo it, that despite the progress we've made in other areas, there is a need, if only for one reason, and that is that there should be investment practices that will be imprudent regardless of when they're entered into, and just because they don't happen to appear on a quarterly statement or an annual statement doesn't mean that they should be sanctioned or approved. So I think we do have a need for this kind of regulatory tool.

So how is it all going to work? I mean we all know that regulators have been working very hard on this process, yet there's a certain tension within the NAIC coming from state regulators, and there's always a pressure from the federal

government. I think at this point it's receded, but at some point there's pressure to shore up any shortcomings that the state regulatory process may exhibit. I think the pressure is probably appropriate and will keep us on track, but we all have to understand that enactment of a model investment law may be somewhat slow. State legislatures have been swamped with model acts. New York state is not accredited at this time, and there's been increasing resistance from state legislators first to get more involved in the NAIC process, and second, to have just more of a say in what's going on. So it's also true that state legislatures generally feel that they want to address something like a model investment law, do it now, and be done with it for five or ten years. Yet there are other elements that are not quite resolved yet, and a good example is the replication issue. I don't think there will be an opportunity to come back in six weeks or six months or two years and say, gee, you know we'd like to get something else in here. So the time frame I think is still a little bit open, and we also should probably indicate that the NAIC leadership at least in December 1993 publicly indicated that no decision has been made at this time as to whether the model investment law will be made a criterion for accreditation. Now it's hard for me to believe that it won't be. I think this is central to so much of what insurers do, but still I think that reflects the pressure that's been received to slow down the process.

So, I promised you at the very beginning we'd talk about what you can get, what you can see. You can go back in history and you could see an analysis of the September 1993 draft, and I think that's a good example of what you'll be able to see when the new discussion and exposure drafts come. A lot of work was put into this. The things you should look for first are in tabular form in the new draft, the July 1994 or summer draft. I would assume that the key provisions will be assembled in tabular form so you can see key provisions from a table. In the last go around, it was 13 pages long, a very useful tool. I would look for that; I would get it. I'm sure it will be put together by the working group. So that's a first tool, a table summarizing the provisions. Of course, you want to get the law itself. I'm sure that will be available through trade associations, even the NAIC. Joe Severling is a staff person in Kansas City. Joe is very receptive to getting things out to people, so I wouldn't hesitate at all to contact him, and we'll talk about that in a second. So look at the chart. The comment letters and summaries run about 3/4 of an inch thick; they were very valuable. They can give your company insight as to what the industry reaction is overall. They were tabulated for the September 1993 draft in such a way that you could see what the key issues were; you could see which company commented on each issue. For each company, you could see which issues they commented on so you got a good picture of what was going on and what the reaction was. That takes a little more work to dig into, but specifically if your company cares about an issue, you can find out who else is concerned. We understand that there will be hearings conducted probably in the fall, probably half a day or possibly longer. So in anticipation for that, comment letters will come either before or after that, and you'll be able to get a handle on what's going on. So trade associations and others will certainly evaluate the coming drafts.

For the June 1994 discussion draft or July 1994 discussion draft, I would just strongly encourage you to look over the key provisions. Maybe you look back on September 1993 tables so you can see what you want to focus on and what's changed, but look at that, circulate it. It's been an issue, I think, as to when

investment people have had a chance to really look at this and read it and reflect on it and consider it and come to their views. There's always a tendency to wait until the last minute to do this, and it really is important for all of us to do what we can to encourage the investment people to really think about the nitty-gritty and what this does, for example, to their securities lending practices or what it does to the things that a company needs to do to remain competitive. So I just would strongly urge you to do whatever you can to get involved and then react. Once you've seen it, once you've thought about it, send your company reaction to the NAIC and the staff that will assemble this, probably through the Florida department. Obviously the trade associations appreciate your comments. And last, of course, to the technical resource group, copies of anything to either Mary McGinn, Allstate, Northbrook, IL, on the life and health side, or Ross Davidson from USAA, San Antonio, TX, would be greatly appreciated.

In summary, we're a lot closer then we were before. I really think we are making progress. It's not a lead pipe cinch, it's not certain that there will be agreement at the end of the day that a law is required. My feeling though is that it's very likely that we'll see something. We'll see a hybrid, we'll see a balance, and it will be a combination of a lot of the thoughts and work that have been incorporated into the draft so far, and I'm optimistic that it's going to be reasonable. I think the steps I've seen from the working group from their recent round of meetings have been creative and responsive. I think they took a situation that was not moving forward very quickly, and I think there's a breath of fresh air. I'm optimistic that we'll see something that is workable, and I think overall it's going to be constructive.

MR. SCOTT D. HOUGHTON: My question has to do with a specific in the first draft of the model law. There were some specific restrictions on commercial mortgages requiring loan-to-value ratios of 75% for a fully amortizing mortgage, and 60% for a mortgage with a balloon payment. I just wondered if either of the panelists could comment on what the status of those might be in the final version of the law.

MR. GORSKI: The issue of the loan-to-value ratios has been explored subsequent to the Hawaii meeting, and there was significant progress from the standpoint of the industry needs in that particular area. I really don't want to discuss the particulars yet because there's still one open discussion related to bullet loans as to what the loan-to-value ratio should be in that case, and I don't want to force anyone's hand by making a comment now, but the best I can say is that regulators are cognizant of the competitive environment in this particular area and the limits that had been previously set would have prohibited insurers from operating in that market, so I think progress has been made there.

MR. HOUGHTON: So would the provisions most likely stay or be watered down or changed?

MR. GORSKI: They would be modified to make them work acceptably to current industry practice, as opposed to instituting a practice that would knock you guys out of the market.

MS. DONNA R. JARVIS: With the recent controversy over derivative products, I've read that Congress is currently considering passing some sort of legislation in this

area, and I was wondering if you have any more information on this subject, and how might any proposed legislation and the model investment law affect each other?

MR. GORSKI: I have been involved in that process to a substantial degree. I actually had the opportunity to meet with some of the staff people for Representative Jim Leach (R-IA) who drafted the Leach Report and the original proposed legislation. I guess the first thing I think that everyone needs to be aware about goes back to some comments that both Chris and I made. In Leach's proposed legislation, while it dealt with derivative instruments, the universe of derivative instruments envisioned in that legislation went far beyond simply options, futures, floors, etc. It actually extended all the way to CMOs, mortgage-backed securities. So the impact of that legislation was potentially more far-reaching than people had actually recognized. I had, like I said, a couple-hour meeting with staff people, and I impressed upon them the extent of activity that insurance regulators are involved with respect to derivatives, and I think they understood what we were doing. The one area where they focused in on after our conversation, what the current general accounting office (GAO) report focuses on, is the dealer activity of unregulated affiliated entities to insurance companies. So Congress seems to be getting away from regulating insurers as end users of derivative instruments, and dealing more with the dealing activity of certain unregulated affiliate companies to insurance companies. I guess I suspect that that's the direction any future legislation may go in the near future. So the regulation, insurer uses of derivatives, however that's defined, will stay with state insurance departments and state law. This other activity may very well be regulated by the SEC.

MR. ANDERSON: Just to add one piece. Obviously, not everything belongs in the model investment law, and not everything needs to be restricted in the law. And since the law is an industry restriction, I think it needs to be seen in context. Larry just made the point that mortgage-related securities, at least in this industry, have been dealt with in different ways than as derivative products. That's probably part of a separate session, but Larry deserves a lot of credit and the invested asset working group deserves a lot of credit for having pursued rigorously what I view as a four-point agenda for really making CMOs visible and obvious to regulators so they can be regulated appropriately. And for that reason, I think it's appropriate that they be dealt with in an investment law for this industry in a special fashion. So I guess the bottom line is I don't think everything belongs in the law if there isn't a specific problem. If it's being dealt with elsewhere, so be it.

MS. JARVIS: I do have another question. Mr. Anderson, you had talked about the effect on securities lending programs, and I was wondering, are there any specific laws that you can tell us about or regulations, rules, or guidelines in the model investment law affecting that?

MR. ANDERSON: I raised that as an issue because I think it's not exactly a nuance point; it certainly isn't a nuance at all, but it's not one of the top six or eight bullet points that we've seen so far. The working group members have discussed some of the elements that they've worked on with some of us, but that's a good example of something that could be extremely important and that we need to focus on. And the bottom-line answer is, we don't know yet the direction that will be taken by the group, but that's the kind of thing that we need to focus on. To answer your specific question as to what the attention has been, certainly there was a reaction to

that in the previous draft and Larry would have an update of what's been done by the working group since. But that's a good example of the kind of thing that we need to look at, it's very important.

MR. GORSKI: I indicated that there were three more meetings of the model investment working group. That is one topic that really has been deferred until sort of the tail end. The open issues, the issues that have not yet been given a rewrite status are the securities lending transactions, short-term and long-term investment pools and, from the property & casualty (P&C) side, the investment law reserve requirement. Those seem to be the issues that have been put off to the tail end. Securities lending is something that is on the agenda for our next meeting though.

MR. TAN: I have a follow-up to that derivative question. There's a practical question related to the area of valuation actuary. If the insurance company invests heavily in derivatives and has in place a complicated hedging process, can the valuation actuary assume that, whenever the scenario's testing result shows negative, that the hedging process would take care of the problem and thereby still conclude that cash-flow-testing results are appropriate? What does the investment law say on this topic and also on the related area of the valuation actuary?

MR. GORSKI: Well, I guess there's probably another step that you did indicate. You sort of implied that we have a company that's a heavy user of derivative instruments for hedging purposes. Currently the annual statement, its statutory statement, may not even indicate that. Many of the derivatives are over-the-counter instruments, so there's no real reporting in the annual statement. However, starting with 1994, Schedule DB, which is the series of schedules dealing with derivatives, is going to be tremendously enlarged and enhanced to deal with both exchange-traded and over-the-counter instruments, and there's going to be a series of reporting going on relative to those instruments. As a regulatory actuary, when I'm reviewing an actuarial memorandum, I look to Schedule DB to see if a company is a user of exchange-traded instruments, I go to the footnotes to see if there's any discussion of the use of interest rate swaps. Sometimes I even go to Report to Stockholders to see if there's any mention of any derivative instrument utilization. I expect if a company is using these instruments in a hedging practice relative to assets supporting some of its liabilities being tested that those instruments need to be captured in the asset adequacy analysis, in the cash-flow modeling.

When I first started reviewing memorandums three years ago, the typical response I would get from an actuary is that there's no need to model the company's derivatives because it uses them for hedging purposes, and if the company doesn't incorporate them in its modeling, it is obviously being conservative. Well, that argument really didn't buy much time with me. The next go around, I saw much better treatment of derivative instruments, but I only look at 35 or 40 memorandums a year, so obviously I have not touched the full range of industry uses of derivatives. I expect Schedule DB for 1994 is going to open my eyes, but the answer to your question is, I do expect a valuation actuary doing an analysis for a company that is a user of derivatives to fully incorporate those instruments and the performance of those instruments in the cash-flow modeling. To me it's ridiculous not to because many of these instruments, while they may perform one way in one environment, could blow up in another environment. There may be some hidden bombshells in those instruments, so the actuary needs to think about that and incorporate it in the modeling.