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NAIC MODEL INVESTMENT LAW

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Panelists will discuss the history and evolution of the law, its current status, provisions and highlights, and the impact of the proposed law on actuarial practice and life insurance companies.

MR. JOSEPH D. KOLTISKO: A very distinguished panel will discuss the history, the impact, and some of the details of the proposed Model Investment Law (MIL). Arthur Fliegelman is from Salomon Brothers; Ron Cacciola is a senior investment officer from the Home Insurance Company, and Stephen Kruft is an attorney specializing in derivatives and other investment products at Chase Manhattan Bank. Formerly, he served as an attorney with New York Life.

To set the stage, I'd like you to recall why we have investment laws and laws in general. Even though it's a very expensive, difficult, and perhaps painful proposition to follow governmental standards in operating our companies, one has to compare that with the alternative—which is to have our companies operate in an environment of anarchy and perhaps unprofessional behavior. The MIL arose out of the particular circumstances that the life and property casualty (PC) companies faced when this process began four or five years ago. I'd like you to bear in mind the need to serve the public interest as we proceed to describe and criticize various features of the law.

First of all, Arthur Fliegelman from Salomon Brothers will give us an update on the various stakeholders and their points of view on the MIL, its likely impact, and the chances for implementation. Mr. Fliegelman is a vice president of the bond portfolio analysis group of Salomon Brothers fixed-income research department. He specializes in assisting insurance company clients in the design, evaluation, and implementation of fixed-income portfolios. He's had extensive experience in working with both life and PC companies in regard to investment and other financial issues. Mr. Fliegelman is a technical advisor to the NAIC MIL working group, which is drafting the MIL. Before joining Salomon Brothers in 1984, Mr. Fliegelman was affiliated with CIGNA Corporation and Hane Associates. He is a chartered financial analyst (CFA) and a member of the New York Society of Security Analysts.

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MR. ARTHUR FLIEGELMAN: I'm going to try and give a summary of what the MIL is about and what the concerns of the various parties are. If anything, I'd like to leave you with a sense of why this thing has taken four years to get where we are and why we're still not finished.

During 1991, the failures of Executive Life, First Capital Life, and finally Mutual Benefit Life brought into clear focus the severe solvency problems facing the existing regulatory system. The system faced intense scrutiny from the media, policyholders, and most importantly, Congress. The insurance regulatory powers—the state insurance departments of the NAIC—not surprisingly desired to keep the role of insurance regulators to themselves. As a response, the NAIC developed and adopted the financial regulations standards program, popularly referred to as accreditation, in an effort to affirm and improve the quality of state regulation.

The need for a minimum investment regulation standard as part of the accreditation process was obvious. Few observers believed that the existing patchwork of inconsistent state investment laws served to adequately protect policyholders from insurer insolvencies. The NAIC began the development of the MIL in the summer of 1991 to fill this need for a minimum investment regulation standard. At that time, the NAIC created the MIL working group and charged it with the responsibility of developing an investment law. The working group's initial target completion date of December 1991 has obviously been repeatedly revised.

Today an insurer's investment operations are controlled primarily by the investment laws of its domiciliary state. However, due to the size and scope of recent investment-related insurer insolvencies, states have begun to reconsider their decision to exempt certain insurers from the application of domestic investment laws. They could instead apply their regulatory authority on an extraterritorial basis as does New York.

The working group and its multitude of industry technical advisors have labored mightily for almost four years in an effort to develop this MIL. The industry advisors and the working group have met in innumerable meetings and have prepared countless drafts during this time. What then are the issues that make the development of the MIL so difficult? Why have the regulatory and industry participants had such a difficult time coming to a resolution on this matter? There are a variety of reasons why this is the case. I will review some of the reasons in an attempt to better understand the dynamics driving, or more precisely, hindering, this process.

INDUSTRY DIVISIONS

In certain cases, various segments of the insurance industry have disparate views regarding what constitutes an appropriate MIL. A wide variety of fault lines in the industry separate it into two or even additional camps on specific issues. These fault lines include large companies versus small companies, well-capitalized companies versus poorly capitalized companies, companies following traditional investment policies versus those following new-age investment policies, and stock companies versus mutual companies. Indeed, some of the industry-only meetings have been almost as contentious as those held between regulators and industry representatives. In addition, the NAIC's administrative decision to first eliminate advisory committees and then the formal technical resource groups only further exacerbated this problem by making it even more difficult for the industry to develop compromise positions both internally and with regulators.

DIVISIONS AMONG REGULATORS

Disparate views also exist among regulators regarding what constitutes an appropriate MIL. The more concerned departments believe that the law should directly address the problems causing recent failures so that additional such failures will not reoccur. These regulators believe that specific quantitative diversification limits and qualitative restrictions are necessary to compel insurers to follow prudent investment policies. At the other end of the spectrum, some departments believe that discretion is necessary for both companies and regulators in order for an investment law to appropriately function. The dispute between those advocating a flexible investment law, the so-called prudent person proponents, versus those advocating an investment law mandating strict diversification limits, the so-called pigeonhole approach, is an important issue dividing some regulators.

CONTINUED COMPARISON TO CURRENT INVESTMENT LAWS

Each state already has an investment law. In many cases, the regulators and industry representatives involved in drafting the MIL were instrumental in drafting these state laws. Consequently, the MIL development processes were replete with individuals experienced in the process of developing an investment law. Many of these participants believed that their state's approach was the proper one and inevitable conflicts resulted from these inconsistent state laws.

THE TOWER OF BABEL REVISITED

The individuals involved in drafting the investment law come from a variety of professional backgrounds, with attorneys predominating among industry representatives. In contrast, few regulators have a legal background. Some of the issues have been bitterly disputed. The differences seem to lie mostly in semantics. A clear example of this problem was the continued arguments regarding the use of fiduciary and the directors' accountability standard. Regulators believed that insurance company directors had a fiduciary responsibility to policyholders, a view that even most participants believed conceptually correct, but industry attorneys were highly concerned about potential legal ramifications that might occur if the actual word was used explicitly in the MIL. These linguistic differences compounded the already difficult development process.

UNREALISTIC EXPECTATIONS

Most current state investment laws were developed years ago in a significantly different economic and investment environment than currently exists. As a result, companies and their investment professionals are frustrated by the current investment limitations under which they must operate. For example, companies may be subject to archaic restrictions relating to certain of their investments. These companies hope that the MIL will release them from these restrictions, but in many cases these companies have unrealistic expectations regarding the degree of relief that might result from the near-term investment law revisions.

NEGATIVES GET MORE ATTENTION THAN POSITIVES

Closely related to the problem of unrealistic expectations is the inevitable fact that negative changes get more attention than positive ones. The investment law will cause insurers new problems, but it also offers opportunities for companies in areas such as asset-backed securities, foreign investments (non-U.S. or Canadian), and derivatives. For example, the current investment law draft contains a 20%-of-assets foreign investment limitation compared with the 6% limit currently in effect for New York-domiciled life insurers. Unfortunately, the investment law problems get far more attention than the opportunities. In reading media reports, one might conclude that the adoption of the investment law in its current state would be a catastrophic occurrence for the insurance industry.

I believe that the investment law would instead benefit most insurance companies by giving them a consistent, comprehensive, and understandable investment legal framework under which they could operate. The industry would benefit from the investment law's completion and adoption in a number of ways. First is the resulting increased industry credibility with policyholders and rating agencies. The insurance industry, particularly life insurers, continues to lose credibility with policyholders and rating agencies. This has been particularly the case with large institutional buyers of investment-oriented products for employee defined-contribution plans. Plan sponsors remain apprehensive regarding their assumption of a fiduciary responsibility for the offering of general-account-based products to their employees. This is especially true after the sponsoring employer is involved with the failure of an insurer offering such products, and the employer is left with the resulting administrative trauma. The adoption of the investment law will not in and of itself eliminate this problem, but it would have a positive overall effect on the industry's perception. The countrywide adoption of the investment law would be a positive step in assisting the industry in redeeming its credibility with the insurance-purchasing public.

MAINTENANCE

I believe that the investment law's ongoing maintenance, once it is adopted, is the most important issue that has remained unaddressed to date. The working group and its industry advisors have focused their efforts primarily on developing the investment law. However, over the long term, the process by which these investment requirements will be maintained or neglected will become more important in the initial details. This lack of timely maintenance is a serious problem in many state investment laws today. A significant improvement in this area might be the MIL's most important legacy.

CONCLUSION

The NAIC and the industry participants are now in the fifth year of their continuing efforts to develop the investment law. The target completion date is now year-end 1995. After numerous postponements, I remain skeptical about whether this target date can be achieved. In addition, the recent public comments of influential NAIC members regarding the likelihood of the investment law becoming an accreditation standard might make one question the NAIC's current commitment to this effort. Nonetheless, the completion and adoption of the investment law will benefit the development process, the participants, the regulators, the industry and more importantly, insurers' policyholders. Any investment law modifications will have both beneficial and detrimental effects on specific companies, but I continue to believe that on balance the industry can benefit from this change. I hope this time will come soon.

MR. KOLTISKO: Stephen Kruft is a vice president at the Chase Manhattan Bank, specializing in the legal aspects of derivatives transactions with insurance companies. He was also responsible for coordinating Chase's comments on the MIL. Prior to joining Chase in 1989, Mr. Kruft was assistant general counsel of New York Life Insurance Company. He's a fellow of the American College of Investment Counsel, a graduate of the University of California, and has law degrees from the University of Virginia and New York University.

MR. STEPHEN KRUFT: My involvement with the MIL consisted of reviewing it from the standpoint of Chase and the bank's position in commenting on the aspects of it that seemed undesirable to us. Now why would a bank have any interest in the MIL for insurance companies? I guess the initial motivation for this was honestly a selfish one in that we want to do business with the insurance companies and the insurance industry. Chase has extensive business with the insurance industry. We want insurance companies to be able to make their own decisions when doing business with us without undue restrictions, and many of the provisions in the MIL had implications in that regard. After looking at the code from that point of view, the review became sort of a larger process as we realized there were other areas in it that offered opportunities for comment and improvement. I'll tell you the conclusions that we came to and I'll go over some of the concerns we had with the MIL. I'll spend time going over a real life situation illustrating where the code creates both opportunities and problems for banks dealing with insurance companies.

To me, the MIL seemed desirable in two particular ways. It first provided uniformity for insurance companies. They would be on an equal footing. You wouldn't have to look at insurance investment laws of all these states and territories every time there was a product at issue. Second, it provided very important clarity in some areas that are unclear presently. I'll talk about a particular example of this and mention how the investment law helps everybody.

In my own business of derivatives, one of the biggest headaches we have is the problem of the authority of insurance companies to enter into them. This is a very gray area and in some states insurance companies tell us they don't know if they have authority. A whole host of problems has come together to make this a difficult area for us. The first is that with all the difficulties that banks have had in the derivatives business, numerous items from our regulators have come telling us about risk management: Banking Circular 277 from the Comptroller of the Currency, "Risk Management and Financial Derivatives;" one from the Federal Reserve; and an examination handbook from the Comptroller of the Currency on risk management of derivatives. They all say that you have to make sure that the parties you deal with have authority to enter into these products before you deal with them.

It makes sense because you all know the story of those London, England municipalities. After (obviously) becoming very much out of the money to their derivatives' dealers they said, "By the way, none of this is authorized and all these transactions are void." And they won! They weren't going to do this at a time, obviously, when all these dealers owed them, but they succeeded in court, and all these transactions were declared void and all those dealers lost a large sum of money. So we have to make sure of the authority of whom we're dealing with.

This is a very questionable area in the typical state investment codes. Right now there are very serious questions in the State of New York. Other codes say nothing; in some places regulators have put forth informal guidance, but that's usually about the best we have. So there's tremendous scrutiny upon us. Insurance company customers say they want you to do business with them anyway and bear all the legal risk of what's going to happen if these transactions are void. The MIL, on the other hand, addresses this topic very specifically and says that derivatives, swaps, and such products for certain purposes are authorized. That clarity is very important. We don't think the section, as it is presently worded, is very good. It is too restrictive, but at least it says these products are permitted, and it gives us something to go on when we deal with counterparties.

Now in going through the MIL, we also found a few areas in which we think there are great opportunities for improvement. The first is that in going through the code we think that the code is generally too restrictive on insurance companies and the investments they can enter into. I know from having been at New York Life and dealing with other insurance companies that they're sophisticated financial institutions. They know how to manage risk and can easily learn how to manage new risks. As the chairperson of New York Life once said, insurance companies are in a risky business already, that's what they do, so managing risk is something they can do. Following that theme, they should be allowed to make their own investment decisions as long as they can manage the attended risks, but the code still continues to largely use the pigeonhole approach to risk management.

It contains enforced diversification and black and white rules where more flexibility would be appropriate. If you compare, for example, what our banking regulators have done, and again going to the derivatives business, there's very extensive guidance but it's all directed at managing risks—what risks you have to manage, how you should manage them, how examiners should look at your management of those risks—you might say it's the prudent person approach. As to two examples of this restrictiveness that we think might be reviewed, the code restricts the purposes of derivatives transactions largely to hedging only, except in the case of selling covered call options. It eliminates the prudent use of derivatives to generate income, and it's difficult for us to fathom why. For example, if an insurance company can enter into a very complex oil and gas partnership that involves all sorts of risks and all sorts of considerations, why can't it do the same thing with a very simple commodity swap that has no risk except to rise and fall with the price of oil and the credit of the dealer that sold it to them? An insurance company can take a position on interest rates by doing a floating rate loan; why can't it do the same with the simplest of all types of interest rate swaps. So more flexibility may be advisable in areas such as that; that's just one of many. In the same area, the code completely restricts the use of derivatives to certain counterparties which have certain ratings and so on. This restricts, in our view, an insurer's access to the markets. Although Chase is a perfectly eligible counterparty, for example, under these rules why shouldn't insurers be able to choose the counterparties they deal with and manage the risks in the same way that we do?

The second area where we think the investment code could stand some improvement and some discussion is that in many areas its provisions are just contrary to market practice. This was the focus of many of our comments to the NAIC, which we sent most recently in October 1994; that set of comments was 15 pages long. Just as a minor example of this, provisions in the MIL on lending of securities speak in terms of collateralization of securities lending transactions, but they don't permit another standard in this practice, which is use of letters of credit as credit enhancements and basically collateralization of securities lending. So there are many areas where standard practices that banks are familiar with are not allowed by the MIL, probably because of oversight. And finally, the selfish side here is that the code does restrict insurance companies from buying products of banks in areas where we don't think it should. Examples are some letters of credit that I just mentioned, the fact that derivatives can only be used for hedging, and the restriction on derivatives' counterparties. We think that some technical input is very important to the MIL so that it does not restrict activities that are perfectly prudent in common market practice.

A final area of general concern to us is that the NAIC seems to have ignored the views of the insurance industry as well as banks. I don't blame it for ignoring banks, probably because banks aren't viewed as the friendliest parties, but when parties do comment on items that are simply wrong, they ought to be looked into and they ought to be fixed. This attitude problem has been mentioned in many memos that have come out from law firms and other sources. We think that if all these comments are true, the NAIC needs to get with the program, talk to people, figure out these problems, and fix them before the investment law is finalized.

We think the NAIC needs to be more responsive to the needs of the industry and needs to also educate itself about some of these activities and products it is trying to regulate. I'm sure people in both the insurance industry and the banking industry would be glad to help in that process.

MR. KOLTISKO: Ron Cacciola is a senior vice president at the Home Insurance Company. Mr. Cacciola is responsible for portfolio strategy and management of the company's $3 billion fixed-income investments. He's also responsible for asset/liability risk analysis. He served on the MIL technical resource group, which provided assistance to the NAIC MIL working group. Prior to joining the Home Insurance Company in 1989, Mr. Cacciola managed fixed-income research and financial strategy departments at Security Pacific and Merrill Lynch. Mr. Cacciola graduated from Wesleyan University with a B.A. in economics and English, and received an MBA from Columbia University where he was a Bronfman Foundation fellow. As you're probably aware, the Home Insurance Company and Zurich Insurance will be completing a transaction very shortly, which will be a recapitalization of the Home Insurance Company. When that transaction is consummated, Mr. Cacciola will join an organization called Centre Chase Investment Advisors. It will be a specialist investment management group focused on the insurance industry.

MR. RONALD CACCIOLA: I intend to discuss three topics associated with the MIL: the broad, philosophical issues that have contributed to a frequently acrimonious debate between insurers and regulators on investment restrictions; the criteria by which investment managers might regard a uniform investment law as being manageable or even successful; and the likely practical consequences of implementation of the current MIL draft. My views on this subject largely developed through my experiences as an active member of the technical resource group to the MIL working group in 1993–94. During this period, the technical resource group researched investment-related topics, attempted to present broad industry opinion on these matters, as well as prepare drafts of the law that attempted to represent some degree of industry consensus within the constraints placed upon us by the working group.

Within the government and loan-backed securities subcommittees, of which I was cochairperson, we wrestled with issues such as ways to reconcile nonuniform state implementation of the Secondary Mortgage Market Enhancement Act legislation with a standardized MIL, segregation of structurally risky collateralized mortgage obligations (CMOs) from lower-risk mortgage-backed investments, and the appropriate treatment of credit and concentration risks. As cochairperson of the investment portfolio standards subcommittee, I helped to organize a review of recent regulatory initiatives apart from the domestic insurance industry and helped to prepare a set of recommendations regarding standards for insurer investment plans as well as board and regulatory oversight of these plans.

Although I've not yet heard state insurance regulators referred to as "jackbooted thugs," the MIL has engendered a great deal of angry rhetoric from the insurance industry. There exists a general and strongly held sentiment in the industry that the regulators contributing to the MIL fundamentally misunderstand the investment management process, let alone the investments themselves and the proper roles of the agents in that process. There are certainly grounds for serious criticism, but the extreme negative views probably are unfounded. The need for more uniform insurance investment laws is the unfortunate consequence of the snail-paced get-unfettered evolution of 50 state laws and sets of regulations.

From the regulator's perspective, the status quo suffers from nonuniform and archaic investment laws to the detriment of solvency oversight and protection, particularly with respect to multistate writers and multistate subsidiary groups. From the insurer's perspective, the current system can be needlessly complicated with respect to compliance and harbors great uncertainties in many state jurisdictions regarding the treatment of modern classes of investments. The tug of war being contested in each category of investments and investment practices is over whether to make the new model more uniformly stringent or uniformly flexible. A great deal of energy has been expended by the industry in opposition to the regulators' preference for a pigeonhole approach, that is, a law containing detailed and explicit numerical limitations and diversification requirements, over the prudent person approach, as for example embodied in the regulation of private employee benefit plans.

The industry's articulation of its preference for a prudent person law has glossed over some real concerns arising from the insurance context in which regular reporting and examination by regulatory bodies is required. What's most important to the industry is that the effect of implementing a prudent person investment law is quite different depending upon whether there exists one regulatory body interpreting the prudent standard or whether there are 50 interpreters all with differing levels of resources and expertise. Without clear guideposts, it is difficult to see insurance investment laws becoming either more uniform or effectively communicated in a system of state regulation.

As an example of how standards of investment prudence can diverge as the number and makeup of interpretive bodies increase, to this day, state pension funds in Indiana, West Virginia, and South Carolina are prohibited from investing in common stocks. As has been well demonstrated, arbitrary investment restrictions in one asset class arising from a local regulatory body's edict can lead to speculative excesses in other less-restricted classes as compensation. A related criticism of the MIL regularly voiced by the industry is because it is so detailed in its enumeration of limitations, it cannot possibly adapt in a timely fashion to evolving investment structures and practices.

Although a legitimate issue, this point seems to be greatly exaggerated. In the first place, the majority of state laws and the current nonuniform system investment legislation are already out of date as opposed to having the risk of falling behind. Many of these laws follow the problematic format of enumerating eligible investments within a category; for example, all the government agencies in excruciating detail. Second, the MIL working group has had some success in defining broad categories of investments; for example, rated credit instruments as opposed to a list of specific types of fixed-income investments that are inherently flexible and adaptive to change. As long as the NAIC keeps in place investment review mechanisms, the regulatory process seems likely to keep pace with evolving investment structures as well as or better than it has in the past.

A fourth criticism of the MIL process may be that its current implementation is not highly consistent with regulatory initiatives undertaken globally as well as domestically outside insurance. Recent regulatory activity apart from the U.S. insurance industry has focused on the components of a sound risk management process and the role of senior management in that process. Two valid questions are invoked by this observation: Does the current draft encourage modern quantitatively driven risk management practices? And does the rigid uniform structure of investment limits imposed by domestic insurers by the model law create competitive disadvantages with respect to investment returns and the cost of capital versus other financial institutions worldwide?

The final large-scale issue relates to the potential overall costs of implementation of the MIL. In addition to the possible adverse effects I just mentioned, industry commentators have referred to the cost associated with standardization of investment limits across companies with very different liability structures, enforced diversification costs, and the derivatives' restrictions that are currently contemplated. A cost/benefit analysis of legislative change of this magnitude does seem warranted.

From an operational perspective, insurance investment managers have a more focused set of concerns about the MIL. The attributes under which investment professionals would judge the model law to be manageable or even successful include the following points:

1. A particular insurer's investment objective may center around outperforming the total return of its standard or customized benchmark, maximizing after-tax income subject to certain duration and credit constraints or some other policy constraints. Investment managers wish to see that such value-enhancing objectives of the insurer receive their proper weighting and remain achievable vis-à-vis the risk-reduction constraints desired by the regulators.
2. A uniform investment law must permit insurers to retain the flexibility to tailor investment strategies to specific liability structures. Although as evidenced by regulation outside the MIL, the regulators clearly desire constraints on interest rate mismatches. They generally have not followed the strategy within the MIL of varying quantitative investment limitations by differing liability structure. For

example, no distinction is made between appropriate investment limits for PC writer of inflation-sensitive long-duration liabilities versus a short-duration writer. The industry generally fears that limits attached to riskier inflation-hedging assets will be crafted for the average insurer and will be oblivious to the liability structures of those at the extremes.

3. Investment managers will regard unambiguous definitions and limitation descriptions as an attribute of a successful investment law. For a model law intent on implementing strict quantitative tests, too many unclear classification rules remain in the current exposure draft.
4. To promote intelligent decision making, the limits embedded in the model law should be consistent with the market's evaluation of relative risk. Some industry commentators have complained that the treatment of certain categories of investments, for example, high-quality foreign bonds and exchange-traded stocks, more reflects past tradition and prejudices than a thorough analysis of risk.
5. A fifth criteria for judging a model law relates to the degree to which it impairs the creation of efficient investment portfolios and operations. For example, a company desiring a small exposure to equities may view the controlled purchase of stock index features as the cheapest means of gaining exposure, which tracks the overall market. A model law that would in all cases prohibit such investments as part of a global ban on derivative replication would not promote efficiency.
6. The adaptability of the model law to changes in investment markets and security structures is an important issue to the investment manager. As discussed previously, investment managers will want to see in place a law that leaves room for new investments that are broadly similar to existing categories as well as mechanisms for rapid adoption of amendments to the model law as the investment landscape changes.
7. A practical consideration for the investment manager is that the investment constraints embedded in the model law should be tied to concepts and data to which the manager has access. The investment manager has the greatest stability, of course, to comply with limits based on the cost or market value of investments. Limits based on financial reporting outside the investment manager's direct control must be retrospective rather than concurrent or prospective to be workable.
8. The investment professional would like to see the adoption of a MIL that logically interacts with other insurance regulation affecting investments. If other insurance regulatory requirements or calculations, such as risk-based capital (RBC), explicitly enter into the language of the MIL, it would be beneficial to see the same investment behaviors encouraged and discouraged across all regulation.
9. Finally, the investment manager would like the model law to contain limited instances of forced, uneconomic asset sales. For the most part, the MIL exposure draft permits the grandfathering of existing investment portfolios; however, there has been debate over the treatment of investments resulting from postadoption workouts and refinancings of all kinds.

Definitive conclusions about the effect of the MIL will need to await the preparation of a final exposure draft. Even at that point, the probabilities of a uniform adoption process across the 50 state legislatures may not be clear; nevertheless, some initial observations with respect to the current exposure draft follow. Generally speaking, most limitations of the MIL appear to be roughly equivalent or slightly more liberal than those currently contained in most state laws. This observation is particularly true with respect to the laws of some of the larger states. This is not a surprising outcome as working group representatives of the more influential state departments have argued for adoption of substantial components of their current state legislation while being receptive to some points of modernization and liberalization. On average, the insurance industry has gained some flexibility versus the status quo in important investment areas including foreign investing, particularly dollar-denominated foreign bonds and derivatives.

However, the MIL differs from the approach followed in a few states. An adoption of this model may force some insurers domiciled in these states to modify certain investment policies. In certain states such as New Hampshire, fewer explicit diversification tests are applied. Wisconsin has implemented what is essentially a prudent person law with greater discretion granted to insurers with stronger capitalization. Surveys of current asset allocation practices as well as surveys of senior insurance investment officers' views on optimal or projected policies do not foreshadow the MIL imposing catastrophic new constraints or causing asset sell-offs for the average company. Of course, there is certain to be a small number of companies whose basic portfolio allocations and policies will be severely affected, and a larger number of companies will face new constraints on less significant portfolio activities.

There are five areas that I would like to discuss briefly where the MIL in its current exposure draft might cause some hardship for the industry. First, the use of derivatives for the purpose of replication as opposed to hedging or income generation had been excluded in the exposure draft. The Goldman Sachs insurer chief investment officer (CIO) survey published in April 1995 noted that nearly 37% of life and health respondents were using derivatives to replicate other securities, either occasionally or frequently, and 13% of PC insurers were using derivatives for such a purpose occasionally. One can be sympathetic to the difficulties in carving out legal language for conservative uses of derivatives and replication, but it is difficult to see the current blanket prohibition as being beneficial to portfolio optimization or efficiency.

The definition of rated credit instruments, the basic fixed-income investment category, contains some technical problems relating to restrictions on investments with possible negative rates of return as currently set forth in the exposure draft. As drafted, it is even unclear that mortgage pass-throughs or currently callable corporates purchased at premium prices could qualify technically as eligible investments. The regulators are aware of this technical problem and will attempt to clean this up in their next exposure draft; however, it remains unclear what treatment will be afforded to riskier mortgage derivatives, such as interest-only structures and structured notes with principal at risk. At this point, no investment authority appears to be intended for such instruments.

A third area of concern relates to possible micromanagement of unsecuritized mortgage and real estate investments. A number of large companies are concerned about quantitative limitations placed on the subcomponents in this category, which attempt to enforce diversification. They are also concerned about the underwriting and mortgage structure requirements contained in this section of the draft. PC insurers are troubled by the newly conceived reserve requirement provision contained in the exposure draft. Their concerns relate to the effect of an extra set of binding constraints in addition to the asset category pigeonholes. The implications of these for long-tail writers and the serious compliance problems caused by requiring the monitoring of high-quality asset coverage of reserves on a more frequent basis than the reserves are reported.

Finally, a number of difficult interpretive issues required for compliance testing have been left unresolved. Within an investment law structure to rely upon additional limits for many subcategories of a traditional investment class, the boundaries between these subcategories need to be drawn finely and clearly. Rules for classifying investments of certain hybrid structures, complicated credit guarantor status or multilayered subsidiary and parent places of jurisdiction remain unresolved in many cases. Industry suggestions for clarifying the definition of "foreign" have to date not been accepted.

In conclusion, the MIL as currently conceived is probably not quite as crippling as the strongest industry critics would have us believe, nor as coherent and complete as the regulators attest.

FROM THE FLOOR: This is a question concerning replication. If one buys a fixed-rate asset and does a swap, is that swap a hedge or is that a replication transaction? How would that be treated under the MIL?

MR. KRUFT: I guess my own liberal view in that particular case would be that it would be a hedge, but I don't know. I guess this is one of the concerns of dividing everything between hedging and income generation.

MR. CACCIOLA: The problem is in the way the law refers to the purpose for which the investment was purchased. I think that's stretching what's been done in prior regulation, at least in terms of an investment restriction law, and I think there will be many challenges.

MR. FLIEGELMAN: I agree with Ron. Many definitions aren't clear; they probably will never be clear or won't be for a long time or won't until there's some sort of legal action relating to them. The understanding of the people involved in the process is that, while it's very hard to say what's hedging, there are probably few transactions out there that somebody wouldn't argue is a hedge. Replication occurs when you're basically changing the fundamental underlying nature of the asset. Fixed-to-floating is not what they had in mind as replication. What they had in mind was people doing transactions when you're taking a fixed-income instrument and you're basically turning it into an equity performance or a total return on a high-yield index or something such as that, a fairly fundamental change in the nature of the asset.

FROM THE FLOOR: If it's changing the nature of the liability, then it would be a hedge.

MR. CACCIOLA: I think so.

MR. FLIEGELMAN: You can argue that. Basically if the insurance department doesn't agree, you discuss it. Also, there is a great deal of discussion about whether the investment law ought to allow replication. My understanding is that none of the investment laws in any state today specifically authorizes replication, whatever that means.

FROM THE FLOOR: Though they may be silent, they may just permit the underlying derivatives to be purchased to some limit.

MR. FLIEGELMAN: Given that no state law anywhere, to the best of my knowledge, explicitly states that you can do replication transactions, I think it's unrealistic to expect a MIL to say that it's OK. But what if one day they realize that replication's OK. How will you control it? Basically the whole system is built on this little checklist-type system. It goes in different pieces in the annual statement schedule; you total up the numbers, and you see some things fit in. How you develop a system to control a company's transactions and risk profile if you're going to allow them to do that? I'm not saying you shouldn't allow them to do that, but that brings up a whole different set of questions. Quite honestly, I don't think I've seen anybody on either side of the table try to address that other than to say you must trust management. But I think it's also clear in some cases that managements aren't very trustworthy.

FROM THE FLOOR: Accountants or actuaries could certify compliance as they already do for asset adequacy analysis.

MR. FLIEGELMAN: Well, property casualty companies are not required to do that; not all life companies are required to do that. How do you control equities in something such as that? Does any actuary here want to take the responsibility for doing it?

MR. KOLTISKO: I think one issue is professional liability for the actuary's opinion. Most actuaries shy away from the risk of professional liability for certifying that their companies will be solvent, in light of asset/liability management.

FROM THE FLOOR: Are separate accounts excluded from the MIL?

MR. FLIEGELMAN: As long as they're not guaranteed. Nonguaranteed separate accounts would not be covered by the law. Are you talking about a book value guaranteed separate account?

MR. CACCIOLA: Isn't the intent to leave that up to each state?

MR. FLIEGELMAN. It remains to be seen whether anybody's going to adopt it so this may all be a big to-do about nothing. But in the end, each state will be able to make its own decision on what it adopts and how it modifies it and, for that matter, as Ron pointed out, how it interprets what it has adopted, even if the language is identical. I'm not going to say no state will adopt it. I do know that Steven Foster, chairperson of the Accreditation Committee, former president of the NAIC, and the chairperson of the parent Valuation of Securities task force, during a conference call that Salomon Brothers sponsored several weeks ago, said he would not expect to have Virginia adopt it. So at this point, it's not clear that anybody would adopt it. I wouldn't say that I expect no one to adopt it, but no states have said that they're ready, willing, and able to adopt it. Of course, it's not done. Right now it's going to be a benchmark.

FROM THE FLOOR: When do you see it being done?

MR. FLIEGELMAN: They said December 1991; this is 1995. The current target's December 1995. Do I think they'll be ready then? Well, they missed every target to date, and as a betting man, I'd probably bet against their date. They're getting closer; presumably there will be something. I don't think anybody wants to do this for the rest of his or her life.

MR. CACCIOLA: Then there's a multiyear lag before state legislatures adopt it .

MR. KOLTISKO: Has the National Conference of Insurance Legislators (NCOIL) come out in opposition to it?

MR. FLIEGELMAN: Well, I don't think NCOIL has commented on this in particular. There's obviously disagreements between NCOIL and the NAIC; that's no secret. In the end, the individual state insurance departments and the individual legislatures will decide. NCOIL has no decision-making ability. I didn't even realize that 17 states are not even members of NCOIL; only 33 states are members.

FROM THE FLOOR: This is probably more a philosophical question about the NAIC thinking one way instead of another way. It seems that just about any asset class, whether or not you're using derivatives, can have negative returns. Companies lose on bonds and things like that all the time; it seems to me that the purpose of restricting replication, where you're actually going to change the characteristics of what you bought, can't be to prevent losing money because you can lose money anyway. So why isn't the NAIC focusing on what it probably should be trying to limit, which is speculation? Speculation could be more easily defined as something that is going to be speculated if there exists a nonzero probability of actually losing everything.

MR. CACCIOLA: Can I answer that in two parts? First, I'll speak to trying to eliminate the possibility of negative rates of return. They specifically want to eliminate the possibility of a negative rate of return from purchase through maturity (not early sale) for reasons other than credit risk. They want to eliminate basically the possibility that you buy a security at a huge premium, such as an interest-only mortgage-backed security, and you hold it through its life and you earn a negative return. They view that as not being a bond investment, and it's not clear where they want to make some room for it. In terms of the replication issue, I think it comes down to the fact that they are concerned that perhaps it would be reasonable, given some equivalence to the company's limits, to buy underlying equities, and to buy Standard & Poor's (S&P) 500 futures. I think they're scared that there's this undercurrent of desire for replication that involves a 30-derivative layer trade that could never be reported in this blanks format that they rely upon for examinations; then the risks will be undisclosed. I think that's what's going on.

MR. FLIEGELMAN: We all have to put on our hats, whether we're pseudoregulators or guarantee funds, and ask, how do you control the process? I'm not saying it's uncontrollable, but the fact of the matter is that if you're an investment officer of the insurance company, you can probably lose a certain amount of money in the cash market but you probably couldn't lose all of it. An investment officer who runs amuck in the derivatives market could probably manage to quickly wipe out an institution.

I'm not saying that because you shouldn't allow them, but it brings in a whole different set of issues. I see there's a panel here on Barings. I mean it wouldn't have been possible to lose as much money as Barings did in a cash market. Barings lost in the derivatives market, and nobody seemed to know. That is the kind of nightmare that a regulator sees. If that thing should ever happen in the insurance industry, the guaranty funds, namely the rest of the companies that remain in the industry, have to pay the tab. Are there ways to give people more authority and still try to put some good tests or checks or balances into the process? The answer is yes. Is anybody publicly advocating them yet at this point? No, not really. It does mean in the end somebody will probably have to assume a certain amount of liability for it, and I don't see people raising their hands and volunteering to do that. Who wants to take the liability and say that they've basically reviewed it, and everything's OK? Would you take their word for it? Ultimately someone has to be responsible, but no one's stepping up to the plate.

MR. WILLIAM J. SCHREINER: Mr. Kruft, how would you see a regulator regulating; that is, how can you step in before a crash occurs to stop companies from doing things you believe they should not be doing?

MR. KRUFT: That's a good question. I can only speak to the way it has been done in our industry. There have been fairly broad guidelines on how to manage those risks and fairly narrow and strict examination guidance and frequent examination by sophisticated examiners to see just what positions are. Talking about filling in the blanks, I don't know if there's any way you can express all the risks that might exist in blanks. We're under constant visitation from our regulators, who are very sophisticated financially, but on the other hand are, I think, friendlier and more understanding of our activities than many insurance regulators I've had the pleasure of meeting.

MR. SCHREINER: How would you react to a suggestion that bank regulation has not been effective?

MR. KRUFT: It has been effective at least as it has developed. There were many problems in banks, but then the regulatory schemes I've been talking about have been developed in the last few years mainly in response to those problems. In the sense of regulation of savings and loans and so on, where there wasn't the same examination or the same regulatory activity, I'd say it has not been effective. But today I think we're under constant visits from our regulators and there is constant examination of our risk management systems. I suspect it's much more effective than it was a couple years ago, but I'd react and say, yes, it wasn't probably as effective as it could be.

MR. FLIEGELMAN: However one wants to describe the insurance examination process, I don't think I've ever heard the term *frequent examinations by sophisticated examiners* being used to describe the insurance examination process. I don't know if anyone would disagree with me.

MR. CACCIOLA: One additional concern I have about a prudent person approach is that I think, especially if you've gone through this draft of the MIL, you'll see that companies have a requirement of rebutting a claim of imprudence in essence. There's basically in some ways a slightly different approach that has been followed. Rather than the department having to prove a problem deficiency, it's up to the company to positively refute that claim. When the burden of proof falls on the company to refute a claim, investments could easily become a wedge issue. A company gets into a fight with the local insurance department over a liability, a policy issue, inclusion or marketing issue, or whatever, and then investments become the wedge issue to basically torture the company until it gives up. I think that's a real risk, given how a prudent person approach might be actually implemented across all these 50 state departments.

MR. PETER L. SMITH, JR.: Mr. Cacciola referred to international competition from non-life insurance products and investments. Last summer the U.K. passed an investment law. There's been an explosion of life insurance products and investment strategies in the U.K. and in Europe. Is the NAIC committee looking at what other countries are doing, taking a look at the competitiveness issue? Within North America, for instance, Canada has followed the U.K. model. I can see Canada, as well as Mexico, developing a similar model within the North American Free Trade Agreement (NAFTA) framework.

MR. CACCIOLA: I think you're right to say that regulators have been ostrichlike in ignoring what's going on overseas. It's funny you mentioned Canada. I think that's the only country, other than the U.S. that they think has legitimacy. Canadian investments versus all other foreign investments have this exalted status in this law. I think that it has been easier in some of these other countries, including Canada, that have more federal systems of regulation to implement a prudent person approach because one body interprets these standards. I think that these regulators tend to be somewhat xenophobic and don't take what's going on overseas very seriously. That has repercussions in that they don't even like insurers to invest in investments of foreign countries let alone follow the regulatory models.

MR. SMITH: There certainly is an issue in providing value to policyholders by offering investment opportunities under a different regulatory framework.

MR. FLIEGELMAN: I think that the regulators probably are most concerned about three issues: solvency, solvency, and solvency. After they've addressed those three issues, then they'll worry about other issues.

In terms of overseas competition, quite honestly, even from my perspective, I'm not sure that's very realistic. Is there competition to the insurance industry? Absolutely. Whether I see selling overseas insurance products, here is another thing. I think you see a tremendous amount of competition about alternative investment products being sold to the same marketplace in a different regulatory framework, but the insurance industry, as an industry, is just as able to market those products also. It just hasn't done so very effectively. For example, the industry referred to the example of mutual funds as being competition. Well, there's no restriction, and for that matter probably the vast majority of the major life insurance companies also sell mutual funds. The point of fact is they've generally been very unsuccessful at it. The problem hasn't been regulatory problems, the problem has been, I presume, in the marketplace. They just haven't been able to sell their product. Fidelity, Vanguard, and other competitors have been able to sell the product, but they haven't. I think the view that the regulators have is that when a person's buying an insurance product, he or she is buying what they view as a very safe, conservative product, and that's what they're going to try to deliver. Is it going to be an optimally performing product? No.

FROM THE FLOOR: My perspective is that if we have a choice of which subsidiary to sell from, we could use a favorable domiciled subsidiary to offer investment-linked products that are attractive. Given the internationalization of our business, the regulators will have to think more globally in the future.

MR. FLIEGELMAN: You're saying that in other words, you're selling the products of an American company overseas, and you could use various domiciliary countries to do that. There's no question, that brings up a whole Pandora's box of questions about how to control the behavior of U.S. companies in foreign countries that work in a completely different framework, that have different products, different regulatory requirements, different accounting treatments, and even different assets.

I don't know if regulators will ever be able to deal with that issue. They're trying to deal with it in a very rudimentary fashion. It's not a major problem today, quite honestly. Only a handful of U.S. companies sell products in extensive amounts overseas. The companies are well known, and so I think they're going to try and cobble some kind of work around, but is it going to be a real solution? I don't know, but like I said, only a handful of companies even care about that issue.

FROM THE FLOOR: To the extent that definitions aren't tightened up, is there reason to hope they will be?

MR. KRUFT: I'm skeptical they can get tightened up because some of the same issues have been talked about for three years. In terms of the definition issues, I think the debate has been somewhat circular. The same points that were being raised by the industry two, three years ago keep coming up and end up being discussed but then not dealt with. I'm skeptical that, in effect, maybe that's what this law will end up being in a sense. It will be a prudent person law because so many of these definitions will be left loose and they'll be open to interpretation by examiners.

MR. FLIEGELMAN: I'm not an attorney, but keep in mind that the NAIC has no real legal standing. So even if the NAIC reaches some kind of decision somewhere along the line, other than having the actual verbiage incorporated into the actual document, it's adopted by the individual state. I'm not sure that what the NAIC says matters. The courts are going to decide it and each court in each state is going to make up its law. I presume each has its own precedents already in some of these words, which is what the concern about the word *fiduciary* was.

MR. KRUFT: Mr. Fliegelman is correct. In the past, all sorts of model laws were passed in some states and not in others. The model laws and the commentary on them, though, do have some impact and are oftentimes cited as what the state law should mean, but they're not binding. The courts will decide. But I guess if you have a model act that has passed in some form, that model law and interpretations of it will have some influence but not be binding on the courts of the state that adopt it. But there's a lot of experience with those. I guess the most common are things such as limited partnership laws that are adopted as model codes and that exist in most states. The uniform commercial codes started out that way—that's probably the best known one—but some are not passed in very many places and people often look to the commentaries and the original version for guidance.

MR. FLIEGELMAN: Would you describe the supporting verbiage as being more helpful than not?

MR. KRUFT: Yes, I would describe it as being more helpful than not because anything you can grasp that shows the intended meaning is useful.

MR. KOLTISKO: There are a couple of related model laws. The model Holding Company Act addressed the issue of parents and affiliates, and the Guaranty Fund Act would address how the regulators would treat, for example, derivative transactions in an insolvency. How do those two acts interrelate with the MIL currently, and what progress have you seen there in relating the three of those programs?

MR. CACCIOLA: Just in terms of the model Holding Company Act, the original sort of charter of this working group was to tackle all the subsidiary and affiliated investment issues. They realized how unachieveable that goal was and backed off and tried to eliminate all references to subsidiaries and affiliates and handed it back to the model Holding Company Act group. But in essence, through the debate many very good questions were raised that didn't have consensus answers about what is reasonable. For example, should there be any restriction on how much of a company's assets should be invested in other insurance company subsidiaries? There's a very different set of opinions across regulators, across the industry, and I think these subsidiary and affiliate questions will be revisited for decades because they were so complex and unresolved during the period when this group tried to tackle them. I'm sure Arthur has much more on that.

MR. FLIEGELMAN: Yes. They basically, at least for the time being, punted the investments of subsidiaries and affiliates to a separate working group that just got reconstituted recently. There's no question that's a very important issue. Ever since the days of Baldwin United, it's been clear that you can't deal with solvency issues by ignoring them. For that matter, another more recent example is the failure of Monarch. Clearly, any number of companies have failed because of imprudent investments related to subsidiaries and affiliates. In many cases, I understand for the P&C industry, it's probably the leading cause of investment-related failures. It's not buying a bond that doesn't mature or bad asset/liability management; it's basically putting money in the subsidiary and affiliate and never seeing it again. It's a very difficult issue. In terms of the failure of insurance companies, what happens with the derivative transaction then is, I guess, a big open question. I don't know how many cases we've had of companies failing with significant open transactions. There has been a lot of litigation regarding Mutual Benefit Life and its open positions. There has been some work done on the NAIC level to try to get that squared away. Why did Investors Equity fail with large derivative positions? Actually very few insurance companies with large derivative positions have failed. I can certainly tell you from the point of view of an institution such as Salomon Brothers, and I assume Chase and our brethren are no different. That's something we look at very long and very hard. It's not my responsibility, but I'm sure that gives some people at Salomon Brothers premature gray hair when trying to deal with those issues.

MR. KRUFT: This is a very serious problem for the derivatives business. The worry is that if a company becomes insolvent, what is the receiver or state going to be able to do? For example, the typical swap agreement provided in all these positions is netted. The real danger is so-called cherry picking in which it's theorized that a receiver could reject all the undesirable positions and maintain all the desirable ones. Basically every kind of company except an insurance company is now under an insolvency regime in the U.S., and in many of the developed countries, that provides netting under a derivatives agreement. So you may be able to get out of it, but you will not be able to cherry pick these positions.

This has not been adopted so far in the Rehabilitation and Liquidation of Insurers Model Act even though comments have been made by the derivatives trade organization International Swap Dealers Association (ISDA) and other sources. So is this a greater risk that people take when dealing with insurance companies and derivatives? They don't know what the receiver is going to do. Where this came up most recently was in the Confederation Life insolvency in Canada. In Canada, there are several different insolvency regimes a company can pick, depending upon its status, and they happen to choose the one in which there is some question as to whether netting of derivatives positions is enforceable or not. People were very worried as to how that would work out. As it happened, things were just settled and closed out, but there could have been real problems.

FROM THE FLOOR: Does the MIL require netting (offsetting gains and losses on separate derivatives contracts with the same counterparty, so that in an insolvency only the aggregate amount is owed)?

MR. KRUFT: The NAIC model act in its present form does not have any provisions of that sort. It's unclear as to what would happen to derivatives positions. I know suggestions have been made both ways, but nothing has come out that would respond to it. The state laws that exist now typically have no specific provisions so no one knows what would happen. Downgrade collateral provisions are allowed. My recollection is that the act does have some provision for security and enforcement of collateral, so in many cases derivatives are being collateralized. The general view is that you certainly could have a provision that would allow termination of derivatives contracts at some time prior to insolvency or upon insolvency. So when people enter into derivatives with insurers under these questionable laws, most people will provide that there's an automatic termination immediately upon receivership. Anything that terminates a contract prior to insolvency, such as a downgrade, would be allowed, but most people don't like those because the effect of a provision allowing you to terminate based upon a ratings downgrade is to allow the party that has that right to play the market against the other party. Basically, even if you don't have any real credit concerns, you wait until you're in the money as much as possible and then terminate.

FROM THE FLOOR: Wouldn't that affect you anyway if the contract was marked to market?

MR. KRUFT: Well, it is marked to market, but you could wait until a position where you had the most value owing to you and terminate, to actually realize the loss. But the movement now is toward collateralizing those positions on a marked-to-market basis, and people generally think that this secured position would be enforced but again, it is unclear under many insolvency laws.

FROM THE FLOOR: Is that considered avoidable preference?

MR. KRUFT: It could be, but most of those preferences have periods so that if collateral was delivered within a particular time prior to insolvency, then it might well be a preference under some statutes. But I think most of those have fairly short time periods so you wouldn't end up losing everything. Just the fact that you're collateralized is generally not considered preferential but, yes. If the preference period were 60 days and a large amount of collateral was delivered within that period, at least under old bankruptcy laws, which are basically what prevailed for insurance companies, you could be required to give up the collateral. That's a concern but that's only within the period.

FROM THE FLOOR: Do you have any comments on the most recent working group meeting? What issues are outstanding?

MR. FLIEGELMAN: They still have quite a ways to go, but many issues are still left. I would say that in the life insurance side of the industry, probably the biggest single issue remaining, other than the basket provisions, which will probably be the absolutely last provision dealt with, are those relating to commercial mortgages and real estate. That's still a very large concern within the insurance industry. That specific area will be most likely have some significant impact. Most of the other limitations far out on the outer edges of what companies do in general they're not going to have a tremendous effect. Commercial mortgages and real estate are still very much of an issue. There's a short meeting in June and in July. I suspect we're going to be meeting for quite a while. I have no idea when this will get done and I do not know what's going to happen with the document when it's completed. We could be here next year talking about it again, still waiting for it to get completed.