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Status and Impact of the New NAIC Investment Law

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Moderator: JOSEPH H. TAN
Panelists: LARRY M. GORSKI
MARY J. MCGINN†

Summary: The NAIC has proposed/adopted two versions of the new NAIC model investment law—the "pigeonhole" model law and the "prudent person" model law. Panelists discuss these two versions of the investment model laws, the provisions of these laws, the changes from the existing laws of the various states, and the potential financial and investment strategy impact on insurance companies.

Mr. Joseph H. Tan: About six years ago, the NAIC decided to form the NAIC Investment Law working group to come up with a new model law to help regulate insurance company investment. Even though there were clear agreements at that time between regulators and the industry, there needed to be some overhaul of the investment law that was on the books because it was outdated. There was a significant difference as to which approach to take. Should the approach of the new law focus more on the rules relating to diversification and limits on the various types of investments, the so-called "pigeonhole" approach? Or should the law leave more of the investment decisions to company's management creativity and hold management accountable for their decision making, the so-called prudent-person version? The disagreement was further aggravated by the fact that the project started out as part of the NAIC solvency agenda requirement and the fact that existing investment laws of various states differ on these two approaches.

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†Ms. McGinn, not a member of the sponsoring organizations, is Vice President, Assistant Secretary and Assistant General Counsel at Allstate Insurance Company in Northbrook, IL

Given these circumstances, one could imagine that it would be quite difficult to reach a consensus by the various states on which approach to take, not to mention the constant lobbying from the insurance industry and special interest groups.

Well, here we are. The NAIC adopted the pigeonhole version in September 1996, and the prudent person version had just been adopted for exposure in Chicago two weeks ago by the NAIC EX-4 task force. To avoid any negative connotations about the two terms pigeon-hole and prudent person, or what they may imply on the other version, the NAIC in its wisdom came up with two new terms to describe them. “Defined limits” would be used to describe the "pigeonhole" version, and “defined standards” would be used to describe the "prudent person" version. These two latter terms are now the official terms that are used.

The laws are quite extensive. The defined-limits version (i.e., the pigeonhole version) contains about 60 pages of single-spaced, typewritten material. The definition section alone is 16 pages long with 88 defined terms. The definition section, though, is actually quite helpful. For instance, while reading it, you will learn that when your company's investment officer talks about collar, he or she is not talking about blue collar or white collar, but that it is an agreement to receive payment as the buyer of an option and also as the seller to receive other types of payments on a different option. The next time your actuarial friend talks about the dollar roll transactions, you'll know that he or she is not talking about rolling over U.S. dollars to Canadian dollars, but that it is two simultaneous transactions in which the insurer sells some asset-backed securities at an earlier date with an obligation to buy back some other asset-backed securities at a later date.

The defined standards, or the "prudent person," version is shorter. It's about 16 pages, but who knows how long or complicated it will be when it is finally adopted by the NAIC.

Fortunately for us, we have two of the most qualified persons to talk about this subject: one from the regulatory side and one from the industry side. Both have been instrumental in the development of these two versions of the NAIC investment law. Larry Gorski is a Fellow of the Society of Actuaries (FSA), a Member of the American Academy of Actuaries (MAAA), and the life actuary of the Illinois Department of Insurance. He's responsible for developing and implementing laws and regulations dealing with statutory valuations, investment strategies and derivative instruments. He is also a member of the Academy Equity-Indexed Product Task Force. He's a member of the Academy Task Force on State Variations in Standard Valuation Law. He's also currently the chairperson of the NAIC Invested Asset Working Group and the Chair of the NAIC Life Risk-Based Capital

Working Group. He's also a member of the NAIC Life and Health Actuarial Task Force.

Mary McGinn is vice president, assistant secretary, and assistant general counsel of the investment law division of Allstate Insurance Company. Prior to joining Allstate, she was an attorney with the Department of Justice. Mary is a member of the American Bar Association (ABA) and the Association of Life Insurance Counsel (ALIC). She's also a member and past president of the American College of Investment Counsel. Relating to the NAIC investment law, she served as the chair of the interested parties and formerly for the advisory committee and technical resource group of the NAIC model investment law working group.

Larry will talk about the defined limits, and Mary will talk about the defined standards. After both talk about the two versions of the investment law, Larry will then talk about other NAIC projects affecting investment strategies and what's going on in the Risk-Based Capital Working Group and the Invested Asset Working Group.

Mr. Larry M. Gorski: As Joe pointed out, the work of the NAIC, with respect to the development of the pigeonhole model, started back in 1991. It took about five or six years to complete the work. It sounds like a long time, and it was a long time, but there were many reasons for that. One basic reason is that states already have a law on the books related to investments. Trying to develop a model law that agrees with the laws on the books of various states is difficult especially if coupled with all the different investment related things that happened in that time period.

Back in 1991, people were still talking about problems with junk bonds. Commercial mortgage loans were in the press. Collateralized mortgage obligations (CMOs) were emerging as the investment vehicle of choice in many insurance companies. New asset-backed securities were being developed. We often hear stories about problems with derivative instruments. Hedged funds had some major problems in the mid 1990s, and then there was Orange County and the leveraging issue. It seemed as if every time the Working Group had a meeting scheduled, a new problem was being reported and all focus was on how the model investment law would deal or react to that situation.

It's really a miracle that a law was adopted by the NAIC. Prior to a session a few weeks ago, someone asked me whether I thought the law would be adopted by any state. I think it will be adopted by several states. In Illinois, the law is on the governor's desk right now. He's ready to sign the bill. Other states are looking to the law to deal with specific issues.

One issue, in particular, is the hedging of equity-indexed annuities. Most state's investment laws deal with derivative instruments in a very simple fashion. They may only deal with exchange-traded-derivatives. They may only deal with the hedging of assets, and they're not really equipped to deal with some of the new instruments needed to hedge the exposure with equity-indexed annuities. This law does a good job, and I'll get into that in some detail.

I think Joe described the general terms of the physical size and dimensions of the law. I have the Illinois version here which is 90 pages long. It's 22 pages of definitions, ten pages of general material that's applicable to life and property and casualty companies, with 28 pages devoted to life companies and 30 pages devoted to property and casualty companies. I won't talk about the property and casualty aspect of it at all today. It's generally the same as the life component except for one major difference.

In the property and casualty component, there's this idea of a reserve requirement. Basically what is required is that a property and casualty company holds high-quality assets to support a significant percentage of the company's liability, sort of a liquidity-type requirement that's not applicable to life companies, but it is a component of the property and casualty law.

I'll focus primarily on the general aspect of both types of companies and those features specifically devoted to life companies. First is a very broad outline. The model investment law is very similar in style and structure to the investment laws, the pigeonhole versions of the investment laws that states now have on the books. The law is very similar in structure. It has the diversifications by asset class, with inside limits of some subclass factors within a class. There's a diversification requirement by issuer as appropriate. The board is given specific responsibilities under the law. Even though it's a pigeonhole law, some requirements are comparable to the kinds of things you would see in a prudent-person-type law. Basically, the board has to adopt and oversee an investment plan. Not only does it have to adopt an investment plan, but as part of that process it has to determine that the company has the expertise both in terms of people and technology to implement that plan.

So if a company is considering issuing equity-indexed annuities, then it is subject to this type of investment law. The company's board will have to determine that it has the people and the machinery to effectively hedge the exposures under that contract. The board also has responsibility for a periodic review of the investment plan, both in terms of compliance with the plan and where the plan needs updating.

One of the other features of the law is that the commissioner has some discretionary authority under the law to take action under certain circumstances. The law sets out the so-called legal investments that an insured can invest in, but the commissioner can, in certain cases, determine that while an investment is legal, it's not appropriate for the insured. So the commissioner can, in fact, require a company to stop an investment practice, start disinvesting in a certain area, or not admit some legal, but inappropriate, investment.

The law does formally recognize derivative instruments for hedging and income generation purposes, but not for replication. I'll talk about more of those ideas when we get to the derivative section. There's a basket provision like most pigeonhole versions of investment law. That's a broad outline.

I'd like to spend several minutes in talking about some of the specific provisions of the law that people generally consider to be liberalization relative to current state laws. I think when you read articles or talk to industry about this law, the feeling you get is that the law is very tight and constraining. In fact, if you take this law and stack it up against state laws that are now on the books, you'll see that there's quite a bit of liberalization relative to what is on the books now. Things that insurers can't do now, they can do under this investment law.

First, let's talk about equity interest which is basically common stock. One of the features of this law is that it tries to move away from a single concept. It takes more of an operational approach, and that will become clear as I go through some of these examples. When we talk about equity interest, we're not only talking about common stock, but we're including common and preferred stock, mutual fund investments other than money market or Class-1 bond funds, limited partnership, member interest, limited liability company, etc. We're talking about a broad class of investments that are basically equity-oriented.

To get to this operational idea, one of the things that this law does is redefine certain investment terms differently than what you might see by just looking at the name. Let's say a company owns a convertible debt instrument. If that convertible debt instrument is named a convertible equity, or is convertible to equity at the option of the issuer, that instrument is considered equity interest, even though you may see convertible debt as a title for that investment. For the purposes of the law and meeting the limit, it has broadened to the concept of equity interest.

The liberalization comes in the form of the limits. I would say that for most states now their investment law limits equity or common stock investment to a percentage of capital and surplus. I can't recall what the limit is in Illinois, but it's probably 50–75% of capital and surplus. When companies capitalize that at 70% or 80% of

assets, it creates is a substantial increase in authority to invest in common stock. However, there's an inside limit of 5% on those investments that are not listed on a qualified exchange.

The impact of that is that it does place a limit on limited partnership investment. Limited partnerships are not listed on exchange. To do that, there is a 5% inside limit on that. Overall, I think we view this as a liberalization. The question is, what is limiting companies to invest more of their assets in common stock equity interest? It's really risk-based capital. When I get to the end of my presentation, I'll talk about some of the work that's going on there.

Another major asset class with revisions relative to current law in the states is in the mortgage loan area. Many state laws have specific limits for residential mortgages, commercial mortgages, income-producing real estate, etc. This law puts a combined limit of 45% on all those assets, and it goes on to say that you can actually invest an additional 30% in residential mortgages that meet certain criteria; the basic criteria is a low loan-to-value ratio.

There are inside limits on construction loans, income-producing real estate. When you think of income-producing real estate, you think of real estate that's producing income today. The law actually defines income-producing real estate as real estate that is either developed or is planned to be completed or developed; there's an inside limit on that. Again, this is an area where I think there is some liberalization compared with current standards.

Now this next area is definitely an area where there is liberalization. That's in terms of foreign investments. Throughout the whole process of developing the pigeonhole models and investment law, we continually heard about the need and value of making foreign investments from both a yield-enhancement standpoint and from a risk-reduction standpoint due to the lack of correlation between foreign investments and U.S. investments.

So we did increase the limits on foreign investments, an aggregate limit of 20% and an inside limit based on the credit quality of the foreign jurisdiction. Basically, if it's a AAA-rated foreign jurisdiction, you can have up to 10% of your assets in that foreign jurisdiction. If you're over a high quality, it's 3%.

The one unique feature of the law is that it separates foreign investment risk and foreign currency risk. So you could have a foreign investment that's denominated in U.S. dollars. A foreign investment is tested against the foreign investment limits. There is no foreign currency exposure. Conversely, you could have a U.S. investment that's denominated in a foreign currency, and that would be tested

against the foreign currency limits. There's a 10% limit on foreign currency exposure and comparable limits on jurisdictional level. Canada is not considered a foreign jurisdiction. It has a separate limit of 40%.

So we are able to set the limits in Canada. Also, to the extent that the foreign currency exposure is effectively hedged to a swap transaction, that form of currency exposure is not counted against the limits. If you purchase foreign investments that are denominated in a foreign currency but hedge away that foreign currency risk, that's not counted against the limit. In addition, to the extent that you have operations in a foreign country, one can hold substantial amounts of investments in that foreign country and it will not count toward the limit.

Of all the areas, the area of derivative instruments is where we see the biggest change relative to current standards. First, it does limit the use of derivative instruments to hedging and income-generation purposes. Hedging is defined as meaning risk deduction as opposed to risk management. One can use these instruments to hedge both assets or liabilities, so you can use them legally to hedge the risk associated with equity-indexed products. You could also use them for anticipatory hedge purposes.

For example, if you're a guaranteed investment contract (GIC) writer and you have commitments to accept money in the future at some guaranteed rate, you could use futures contracts to lock in an interest rate or an anticipatory hedge. There are limits on the use of derivatives, but they are based on classes of derivatives and how they're used. For example, if you purchase options, caps or floors, there's an asset limit on all those purchases based on the statement value equal to 7.5% of admitted assets. There are comparable limits for options, caps, and floors, and for forwards and futures.

If you know anything about accounting of derivatives, swaps, and floors, don't have a statement value per se. They are off-balance-sheet items. So the limit of 6.5% is based on the call of these. The potential exposure is related to notional amount and the length of that contract. There's a defined way of calculating the basis for expressing that limit.

These are all hedging purposes. For income-generation purposes, there are basically two requirements. If you sell a call option, a put option, a cap or a floor, while permitted, they have to be covered in the sense that you own the asset that you're selling the option on. Also there are limits.

This last item may very well be one of the most important ideas when you think of these as derivatives for hedging equity-indexed annuities. That is, the law

recognizes both exchange-traded and over-the-counter instruments. There was a very good discussion earlier about the different ways of hedging the exposures on equity-indexed products, the use of exchange-traded instruments, and using dynamic hedging versus using options, long-date options, purchased over the counter. The law definitely allows one to go the over-the-counter route.

Investment pools is another issue that was hotly discussed throughout the deliberation. Basically an insurer would want to use the investment pool idea for either cash management or cost-efficiency purposes. Let's say you're an insurer of part of a larger group and you'd like for the group to purchase investments and somehow share in those investments such as, the mutual-fund-type contracts. The version of the law that was passed by the NAIC and Illinois recognizes both long term-and-short term pools. Short-term pools would be for cash management purposes. Long-term pools would be to achieve cost efficiencies in implementing your investment strategies.

There are aggregate limits on both pools and an inside limit on long-term pools. To implement the pool idea, the pool manager is subject to specific requirements that are spelled out in the law. There's a couple pages of them, but I really don't want to get into that. Similarly, the pool agreement has to comply with some requirements. The participants in the pool are also limited.

The big concern over this idea of investment pools was, if you opened up an investment pool to any and all participants within your business companies and those outside, in the event of an insolvency of one of those pool participants, what would it do to the other companies access to those investments? Would a bankruptcy or an insolvency somehow tie up all those assets? That's the reason why there are all these different rules on pool manager, pool agreement, and the type of participant. A pool is an idea that will make another type of investment strategy doable.

I've gone through the area that I think most people would consider to be liberalization of current laws and some ways in which those liberalizations can be used. Some ideas in the law are considered to be either innovative or tougher standards. Many people criticize the law due to its length or its complexity. If the truth to be told, the law is as long and complex as it is because that's the way the industry wanted it to be.

What happened is that as we were defining these different pigeonholes and assigning assets to the different pigeonholes, everyone had the idea that, this particular asset type didn't belong in this class or that class. "It belongs over here."

So all these different, complex definitions and exceptions to the rule were built into the law as a result of industry input.

One of the most complex areas of the law is the idea of rated credit instruments and special rated credit instruments. These ideas evolved out of recognition of some of the problems that we were seeing with mortgage-backed securities— in particular, the interest-only (IO) types of securities and varieties of that. In those cases the credit rating of that instrument is very high, usually AAA or securities valuation office (SVO) 1, but there is a substantial amount of risk to the investor in the event that interest rates move down.

Prepayment of the underlying collateral causes the investor to lose principal even though it's not a credit event. This was occurring quite frequently in the time frame that we were working on this. I was asked to develop some type of limit on those types of investments. The first thing I realized is that you couldn't put a limit on interest only securities because then a variation would be developed that would extend it out just beyond the definition. I gave up totally on the idea of trying to do it via definition.

I came up with the idea of a rated credit instrument that would evolve into a special rated credit instrument. I tried to isolate those bondlike instruments that have the potential for loss of value in the event that there's a risk exposure to something other than credit risk, IOs and things of that sort. So the definition of rated credit instruments is supposed to replace the concept of obligation for purposes of the law.

The first criterion for a rated credit instrument is that the securities be rated or required to be rated by the SVO, and not all debits are rated for a special rule for short-term obligations. Then it went on to say very soon thereafter that mandatorily convertible and nonprincipal-protected equity-linked notes are not rated credit instruments. So the nontypical equity-linked note is treated as equity and not as a debt instrument. We have this definition of rated credit instruments, and then we try to carve out of that class the kinds of instruments we were concerned about, those instruments in which there was a significant exposure to something other than credit risk. That's this idea of special rated credit instruments.

The defining rule is this. If a rate of return based on purchase cost and maturity value can become negative through reasons other than credit risk associated with the issuer, then the rated credit instrument is a special rated credit instrument. But the way of trying to look at the whole universe of instruments that people generally consider to be debt is to carve something out of it using an operational definition and apply a special limit to that. So this kind of definition will capture instruments such as IOs. It also will capture catastrophe bonds, which I'll get to a little bit later.

So it's a way of trying to put an inside limit on instruments that are not currently limited.

There are numerous exceptions to the rule, and those exceptions, in effect, would bring those instruments back within the general rated credit instrument section. That is probably the most complex area of the whole law.

I already talked about foreign investments. There was another wrinkle with the foreign investments that I think people would consider to be more conservative, and that's the definition of foreign investment. One of the issues that popped up during our discussion was transactions in which foreign investments were sold to a U.S. trust. The U.S. trust, in turn, would sell certificates to investors and, because of the nature of the investment laws that existed until then, those investments would be U.S. investments because there is a U.S. investor. I think most people would look at the transaction and say, you have foreign exposure there, so they should be considered foreign investments.

The way the law deals with that is this idea that is a look-through principle applied if the issuing entity is a shell business entity or a primary creditor or a guarantor and not domiciled in a domestic jurisdiction. So it's a way of trying to get at some transactions that, after you think about them are truly foreign investments.

I promised I would say a few words on replication transactions. The insurance industry has spent a significant amount of time arguing that, it wants increased authority to use those instruments for hedging and income-generation purposes. But it wanted to be able to use derivative instruments to replicate other instruments. The basic idea is that if you hold a cash market instrument, such as a high-grade corporate bond, and you enter into a swap transaction that swaps out the coupons in the high-grade corporate in turn, you receive a total rate of return of a junk bond portfolio. You're replicating a junk bond.

The industry wanted that authority on the basis that it thought that they could replicate cash market instruments more effectively and more efficiently. It makes a lot of sense. The problem that regulators had is because of the way statutory accounting and risk-based capital rules now exist, those instruments would be treated separately, and the derivative instruments wouldn't be viewed in the proper light. So the risk-based capital charge for that combined replicated transaction would simply be the risk-based capital for the cash market bond, which is high grade quality with low risk-based capital (perhaps 0.3%).

The counterparty exposure associated with the swap transaction would not be the full flavor of the junk bond exposure. So we decided to sit back and wait. We

wanted to see a comprehensive treatment of these replication transactions from an accounting standpoint, a reporting standpoint, a risk-based capital standpoint, and an asset adequacy or actuarial opinion standpoint across the board. If you're going to be replicating some other instrument, let's treat that replicated unit consistently with the cash market instrument that it's replicating.

The idea evolved to a point where we are considering not only replication transactions, but also synthetic transactions from the sense of manufacturing instruments that you can't buy in the cash market. This replication idea is currently prohibited in the model investment law; both in the pigeonhole and prudent person versions. But that prohibition will be looked at as soon as the NAIC completes its work in developing a comprehensive framework. If there's enough time, I'll get to that in the second part of my presentation.

The last item of strengthening that exists in the law is the antileveraging provision. If you recall, when I ran through my list of issues that surfaced during the discussion, one of those issues was Orange County. People attribute the Orange County problem to many different things, but from my standpoint, that's simple leveraging, entering into reversed repurchase transactions and using that to continue leveraging themselves up with respect to interest rate risks.

The model investment law deals with that by requiring that when you are determining compliance with the percentage limitations, you have to subtract out of your admitted assets any liabilities that may have been generated because of securities-lending transactions, the reversed repurchase transactions, etc. So it is a way of trying to de-leverage the balance sheet for one to apply the percentage limitations in the appropriate fashion.

Ms. Mary McGinn: That's spoken as a true industry person. In the interest of full disclosure, I am in Illinois, and the Allstate companies are basically Illinois companies. He is also my favorite regulator.

I have one other comment that goes back to complexity. I think the phrase I coined and somebody else started using was downward spiral of complexity. I don't deny that a downward spiral of complexity is what we got into. I think it's only fair to say that two groups helped that spiral get going. One side would come up with a provision. For example, Larry would come up with a provision and we'd look at it and we'd say, that's fine except it doesn't really stop what is important for us to do. So we would draft something to address that. The regulators would say, oh, that's fine for all you good companies, you know what you're doing, but we have this problem. The downward spiral kept going. I think we share 50%.

Basically, the prudent person model law takes a is the philosophical approach. Do you do pigeonhole, or you do prudent person? It was there from the very beginning. The real question was, how much does the law impose the qualitative and quantitative limits? To what extent is that inside the four corners of the law? To what extent do you take that and impose it on the board?

There's no question that everyone agrees the board has to act prudently; the real question is, what are the limits of the board? They're imposed in the law itself. We spent a lot of time debating this from the start of the project. The pigeonhole position prevailed and, therefore, work started going on in the pigeonhole version. What happened, though, was as each point came up, the prudent person proponent became very concerned. We would hear, "That won't fit in my state, there's a problem here." That was definitely true among the regulators as well as the industry.

So finally, about two-and-a-half years ago, the solution that the NAIC came up with was to have two alternative models. That was at a point when it was already decided that this was no longer going to be an accreditation standard. When this first started, the model investment law was an accreditation standard. It no longer is, and that took some of the pressure off. But I think it also improved when we got going on these two alternatives.

We do now have a pigeonhole version. One version of the prudent person model went up for adoption by the NAIC and was not adopted. The reason that the first version was not adopted was because of concern on the part of some regulators that there really were not enough protections there. Too few specific requirements were imposed. There wasn't enough discretion for the commissioner to come in and do something to stop companies. Simply there would be too many threats to solvency.

As a result of that, after the defeat of the first version of the prudent person law, the leadership of the NAIC sent it back. The valuation security group, which Larry has been very active working with, came up with a revised version. That revised version and revised draft was released by the NAIC last week for comment. Clearly, for those people who have an interest in this, I'm sure people back at your companies have copies of it. That will give you the details of it. But that's out for comment now until, I believe, the beginning of September 1997. It really increased the degree of at least quantitative limits that are imposed in here.

One concern of some people is whether we have actually moved closer to simply having two versions of the prudent person. You might look at it as sort of a continuum. On one end, is a very detailed, strict prudent person law. On another hand is a one-sentence law that says—you're right. One hand is a very strict pigeon

hole; every single thing is detailed. On the other hand is a one sentence law that says, invest prudently.

The pigeon hole version that we have has moved in a way. As Larry has gone through a lot of things, it's really expanded the size. Some people call it the "eagle-hole" law now. It's a bigger hole, with many more opportunities for the board to move. The same thing happened. The first draft of the prudent person law was defeated. Some people might argue that these two are getting so close together, it's beginning to look like we do have two approaches. So there is that concern that perhaps really all we have is simply another prudent person law.

A point that Larry didn't touch on too much is the difference in board authority. In many states right now boards have to approve or ratify every specific investment transaction. It is like the equivalent of having your board approve the type of individual.

Let's talk about the rate of credit instruments, that are decided and improved over some of us who have laws with many different categories. You're still going to find limits. We talked about long and complex, which it clearly is, and we've heard enough about how long it is. We have special rated credit instruments. But one point that's a little bit of a concern to the industry is the concept of legal for life. If you have an investment and it needs to be worked out, and the mortgage goes under or something, whether that remains as an admitted asset, or whether it needs to requalify under the new law. This is what I call a full-service insurance department.

There is a concern that you might have a worked-out bond or mortgage and it doesn't need to continue or need to meet the new requirements. Does it continue to comply because when you bought it, it was legal? So this is a continuing concern.

As Larry said, the useful replication of derivatives will be taken care of. The definition of hedging is one that continues to cause some problems. You can only consider it hedging if you're using derivatives to reduce rather than manage risk. I think some people believe that insurers are in the business of managing risk; in a given transaction, it may not necessarily reduce risk in the overall scope of things. It may be that you are managing the risk.

They sort of tie together because I think we all know that most any hedge we do is a replication. You might say you're hedging it, but you're also replicating an asset at the same time. So what the law has said is that as long as you are actually hedging with your replication, then it's permitted. A lot of our concern is about when we

get to do replication. Will that ability go away if the definition is managing versus reducing risk? Other than that, there's a limitation on general partnership interest.

Larry has talked about the pool, the net assets, the excessive administrative detail. A similar concern is about detail in a variety of areas. Again, there are the specific limits by category of investments. I think the categories are fairly broad so you may have a problem if there's not commissioner discretion here to expand those categories to the extent needed. Then specific insurers may need additional authority.

The prudent person law, is an alternative approach. We've already mentioned that there's as much difference of opinion or perhaps more, among the regulators, as to what this role should be and what it should look like. To what extent do you need objective standards? To what extent do you need the board to have the authority?

Some people would say that the prudent person draft that was up here is so confined that their state, which may be a prudent person state, never adopted because it moved too far from over here to there. The other approach is in the middle, and so we should be able to have something adopted before long.

Next, I'd like to give you a very brief overview of what a prudent person looks like. There are a couple of major points and then we'll go into a little more detail, but this is really what the prudent person does. First there's the requirement that the board adopt a written plan providing for the prudent investment. We'll get into some of the criteria that they're supposed to look at, both for the prudent person law and also the items that need to be addressed in the plan. That's one concept.

The second concept is with respect to what investments are regulated. In effect, they took insurer's assets and divided them into two pools. One side would show an amount of assets. These are your liabilities, plus some margin of safety. But let's just take the concept. You have liabilities and a margin of safety. Assets equal to that amount are your minimum asset requirements. So that's one category. Anything you have on the top of that are discretionary assets or excess assets or whatever you might like to call them. There is a clear difference in how the law treats those two categories.

The investments that are over in the minimum asset requirements are the ones that have to meet the law's diversification requirements. These types of investment requirements are somewhat more limited. To a great extent the qualitative assets of that are the same; again, it is the pigeonhole version.

Then the third, and very important concept, in this law, is broad commissioner discretion. Commissioner discretion is to increase the size of this first pool where we find the minimum asset requirements. So the commissioners can increase how many assets must be covered and how broad that push-up in effect needs to be. The commissioner also has discretion to permit additional assets to count over—there are more assets you can put into this. So perhaps you can change the size of the pie and make it bigger, or more assets can be made to go in, so there's a bigger pie to divide up.

The commissioner also has a great degree of authority to go in and get information and reports and to hire experts to come in and look. There's a recognition that when you have new specific criteria and you have more broad requirements, obviously, you need expertise on both sides. You need accessed information. The concern I've heard from a number of insurance departments is with the ability of insurance departments to have adequately trained examiners who really go in with a degree of expertise. They need to access the information to see how an insurer is developing its plan, how it is applying the prudent person criteria, and how it is addressing all these requirements.

The final point and what sort of holds this all together is that this law is then tied into the rehabilitation/liquidation law. When an insurer does not meet the minimum asset requirements, and you don't have the right kind of assets to cover this requirement, that leads to being deemed in a hazardous financial condition, which, therefore, leads into the rehabilitation liquidation law, and everything that flows from that. So that is sort of the overview of how it works.

In addition, there's a basket clause for 10% of admitted assets. You can have 10% of your admitted assets in any type of investment, and that still counts in here. In addition, the commissioner has discretion to adjust any of these limits that are in here to a total of up to 10% of liabilities. So there is quite a bit of commissioner discretion in here. I think that gives us an overview of how the minimum assets requirements work. You recall that the minimum financial security benchmark is the cushion. What size cushion do you need? The agreement that was reached was that the cushion for the minimum financial security benchmark is the greater of the minimum capital surplus for that type of company under your state laws and your authorized control level risked-based capital, which I think in almost every instance is what the number will be.

Unless the commissioner does something, the cushion of safety is going to be your authorized control level risk-based capital. Now the commissioner can establish a higher cushion or a higher level; it's not a lower one, because there's no discretion to decrease the cushion. There is to increase it, which can be done by order for an

individual insurer. There are a number of factors to consider in the listings of the law that ought to be considered in doing this for individual insurers. In addition, the commissioner can issue a regulation raising to a multiple of authorized control level risk-based capital for certain classes of insurers, depending on the perceived risk to the types of business that they run.

This concept of commissioner discretion is very important because it helps to address one of the concerns with draft one that had been a problem all along with some regulators. They were very concerned that the requirements would not apply to enough insurers assets. So this is to clarify that you still must cover this cushion of safety. Because we've already set up an authorized control level risk-based capital, that is what the cushion of safety will be at a minimum.

The concept of this commissioner discretion means stronger insurers, better caps, better balance sheets, looking at expertise in different types of areas of investments or underwriting or whatever. You look at the company as a whole. There may be instances where there should be more discretion. Alternatively, you look at certain companies or certain types of business, and it is thought that you need a larger cushion to protect the interests of the policyholders.

So that's sort of the overall concept. Lets go back to the board policy. There really is no difference between the two versions. The pigeonhole version says you must have an investment policy adopted by the board, and it also says that you have to manage your assets in a prudent manner. Investment law is complex.

The primary controls are in the prudent person version. In that case, there's a great degree of emphasis placed on this plan. It must be adopted and reviewed and related at the same level as in the pigeonhole. In fact, the pigeonhole is a little tighter because a quarterly review is required. So to that extent, the constraints on review and oversight are somewhat tighter.

There are written guidelines that the policy itself has to have policy procedures and controls to ensure. So there is not only a need for a policy, but also to say how I will check and make sure that it's being done. It has to have types of permitted investments, and those are based on a variety of listed items. There are: investment experience, expertise, the capital structure and the capital strengths, and the risks and rewards of the various assets that you're looking at. You require a periodic evaluation of the portfolio.

It clearly must be tied into your insurance products. How do these investments tie into insurance products and liabilities? Emphasis is on professional standards and professional expertise, and then there are certain prudent evaluation criteria that

need to be addressed. So for an investment plan, you must look at everything that I think most people would think that you ought to look at when doing an investment or an investment plan. You look at the liability side. You look at the capital. You look at your expertise, and that's how you come up with the plan.

The last item was you need to be prudent. Many laws, talks about being prudent. ERISA is an example. ERISA is clearly one of the classy prudent investment standards. For pension plans, the prudent person law is your standard. That's all it says. *Prudent* is used in the pigeonhole version in just one line: "Invest prudently." Because this is all you have to hang your hat on, there was a real concern to really go down and lay out all the factors of what we think are necessary to evaluate being prudent.

Again, I think the things that you look at to be prudent include economic conditions, possible effects of inflation or deflation, tax, diversification, and quality and liquidity of investments in affiliates. Clearly, investments in affiliates are an issue that has caused a lot of concern to regulators, especially the liquidity of affiliated investments. So that's one of the issues they specifically highlighted. There are exposures to a whole list of risks, including liquidity, credit and default, interest rate, quality, payment and extension.

You look at the asset capital and surplus, premium writing to in-force insurance, and the catchall that is mentioned several times: appropriate characteristics. In case we forgot anything from this laundry list on which months were spent, we want to make sure that we list it. You look at the liability, and the relationship of asset/liability cash flows. That does not require cash-flow testing.

There was a lot of discussion as to what actuarial opinion is being required. It was made clear that is not a requirement in this law. So they're talking in terms of cash flows. Then there is the adequacy of capital surplus. So this really was an intent from a laundry list standpoint to come up with what it is that people ought to be doing. So that's really, I think, what the law itself says from the standpoint of being prudent.

As Larry mentioned, if we look at it in some way it is different, and in other ways it is similar to the other law. Another way of looking at it might be what you really have in both laws. That is an idea of acting prudently and making investments that match your liabilities and are appropriate for your capital structure. You have board responsibility. You also have the concept that there are two groups of assets. You have a basket over here and specific details and specific quantitative and qualitative limitations apply.

Under the pigeonhole version, the group of covered assets is much bigger. Under the prudent person law, you have this pigeonhole, this group of assets that are subject to a restriction. To a great extent, very few of these restrictions in the law rather than imposed by the board. For instance, the restrictions in the prudent person law are simply qualitative, large asset class qualitative, and limited requirements. However, if you go to the pigeonhole law, you have very detailed qualitative and quantitative restrictions. So the difference lies in who imposes those restrictions.

In the pigeonhole version, the law imposes those restrictions, and the board starts with those restrictions and looks at how to do the plan. In the prudent person version, the board really looks at it and the board is responsible for coming up with especially qualitative restrictions. I think that's probably one of the main differences. One interesting thing in the pigeonhole version are the seven pages of annotations. Obviously, a lot of time has been spent on this. When we see the end product, sometimes we don't understand why someone got to where they were, or what they were trying to do. The annotations are useful in showing the intent of the drafters to pull out things to be considered. They should be very useful going forward. That's something I would recommend that people should really look at. Perhaps start by reading that, and then go back and take a look at what the rules are.

Larry touched on definitions. Two other interesting things are insurance options and futures, which probably are more on the property and casualty side. This pigeonhole law says those are not investments, and these can be regulated elsewhere. The prudent person law says they are investments.

The whole law applies to life and property and casualty insurers, although some of the limits are different. The laws are similar. As I said you have the board adoption of the plan, the assets are very similar, and so are the limits. To that extent, there's not nearly the degree of difference. The one difference on the quantitative restriction is that under the prudent person version, you have commissioner discretion to change them. Under the pigeonhole version you don't.

I think it is useful though to point out that everything isn't better in the prudent person law. There are some things that are more restrictive in the pigeonhole version. Foreign insurers in a state are required to substantially comply with the model even if it's not adopted in your domestic state. As you may be aware, some states now require substantial compliance, such as New York. This would impose it as part of that issue that is not in the pigeonhole. Per-issue limits include investments and an issuer and an affiliate, which can get to be somewhat problematic in tracking. There may be some issues there that are not in the other one.

The commissioner can require a look through the pool investment vehicles including mutual funds to underlying assets. It may present some difficulty if the commissioner actually asks you to do it. If you have foreign currency liabilities, you must make investments in such currencies to meet your liabilities. So it's not the pigeonhole that gives you permission to make those. It's mandatory that you make them; again, there's some commissioner discretion there to cover.

Regarding possible impacts, it's unlikely that it will actually be adopted in states except Illinois. Illinois has adopted it. It's on the governor's desk right now. In some states, such as Illinois, it will be more liberal than what we have. The categories are broad, so there's probably not much of a negative impact, although I would suggest, especially for rated credit instruments and replications, some issues may be raised more than what Larry may think. I would say that it does give great increased opportunity for creative investment people to come up with new ideas and new concepts. It's good for the streets. It can make lots of money structuring to fit within the pigeonhole.

The final thing is the possible codification impact. Right now a big issue in codification is a requirement in the current draft that you would look to the model investment law, which will be interesting, for the definition of admitted assets. That's causing a lot of controversy. I hope that will be addressed and taken care of but that's something to watch for.

Mr. Gorski: There is a secret that Mary will never tell you about. Some states are primarily prudent person states. I won't name names, but some of them are well known. Not only do they have an investment law, which is prudent person in design, but they also have a whole series of laws and regulations that deal with investments that are not part and parcel of the investment law. So those states that were clamoring for a prudent person law, may be substantially stricter or tougher than those states that take a pigeonhole approach.

That was one of the difficulties in trying to develop a prudent person approach. Many regulators were concerned that we develop a prudent person approach that was adopted by the NAIC. All of a sudden it has become a standard that states would adopt without realizing they really are prudent person states that have another framework of regulating investments.

The other issue is when Mary talked about the development of an investment plan. The pigeonholes are some constraint on the part of the investment decision making, in terms of coming to decision making relative to investment strategies. At the NAIC meeting, about a year and a half or so ago, a study was presented by a person from the academic community that evaluated the pigeonhole version of the law

relative to a pure prudent person law based on efficient frontiers. The study was done from the standpoint of property and casualty companies, but I think that part of the analysis was probably applicable to both sides of the fence. Basically, the conclusion was that the pigeonhole version did not place a substantial constraint on companies that were using modern portfolio theory and a prudent person approach to investments.
In fact, when the same people from the academic community did the analysis, they actually plotted the position of the property and casualty industry relative to the efficient frontier. Let's just say it was not in a good position. So there were many opportunities available to insurers within the current law and the pigeonhole law that were going unused.

A couple times in my earlier presentation I alluded to other projects at the NAIC that have an impact on insurer investment strategy. Those projects are under two specific working groups: risk-based capital and invested asset. At the risk-based capital side, three major projects are ongoing. The last one actually was very close to adoption. That's probably not of much consequence to people here, but it may be to some people. It's a modification to the preferred stock factors, basically of lowering the factor for high-quality preferred stock. The interesting thing is it also applies to capital notes, so that may be of some interest to people.

A little bit further down the road is modifications for factors and methodology related to common stock. That's the real stumbling block for insurers that want to invest in common stock. The factors are 30%. It's an anticipated complete overhaul of that aspect of the formula.

The project that I'm most interested in, and clearly it has the possibility of both increasing and decreasing risk-based capital, is to improve the qualification of the interest rate risk, or C–3 risk component of a formula. Currently, part of the formula is very crude, and a lot of work needs to be done to improve that. The upshot is that for those companies that are very well managed from an interest rate risk standpoint, risk-based capital will go down. For those that are not well managed, it may go up.

At the invested asset working group, the major project area is the recognition of replication transactions; again, you take a cash market instrument and a derivative instrument and replicate performance of another class of instruments. This project is probably a year from completion. We just received a report from interested persons at the last meeting. There were a few areas where I thought some more work needed to be done.

We plan to have an interim meeting sometime in July 1997 to move the process along. After the work of the invested asset working group is completed, parts of it will be farmed out to risk-based capital, some of which are blanks, etc. So there will be a farming out of the various components to the group to actually implement those ideas.

Is anyone here familiar with the term catastrophe bonds? Basically, they are a way of transferring catastrophic risk exposure from the insurance company to investors. *The Wall Street Journal* and other financial publications, are getting some notoriety now. It's a way for, a reinsurance company to sell off its exposures at the catastrophic level to investors who are willing to take that risk. In effect, it's replacing a reinsurance company with investors. The question is, is that risk exposure to the investor a credit risk or some other type of risk? If you remember the definition of special rated credit instruments, you know this type of instrument would be classified as a special rated credit instrument because we think the exposure to the investor is not credit related to the issuer; rather, it is related to the catastrophic event. So I think all these projects will have some impact on insurers' investment strategies.

From The Floor: But at the breakfast, Bob Wilcox presented a discussion of the valuation law possibilities. One of the objectives may be to equate statutory and generally accepted accounting principles (GAAP) liability valuation. On the GAAP asset, they've gone to market value. This is a statutory asset model that we're looking at here. So if a new liability valuation standard equates back to our GAAP, and the GAAP assets are on a market value basis, are these laws adaptable to a market value adjustment? What impact would that have on either of them?

Mr. Gorski: Well, I've attended some of the meetings of Bob Wilcox's task force, so I am familiar with the discussions. I think both laws would have to be modified because of the reference to imitations on admitted assets at statutory value. I think changes would be needed to both laws. However, I think it's premature to even be thinking about that because I believe the work of Bob Wilcox's task force is really in its infancy. It has a long way to go.

The task force was given the charge by the Life and Health Actuarial Task Force to look at the valuation laws with a blank sheet of paper. In its approach to dealing with that charge, the task force really has a blank sheet of paper, and they're looking at everything and anything. As things progress, it might narrow the focus somewhat and deal more closely with valuation of liabilities as opposed to bringing in assets. However, it may not. Whatever it does, if it's a comprehensive change, changes will need to be made investment laws, risk-based capital, perhaps there will be an

elimination of the asset value reserve (AVR), and other things, too. So that project may have significant implications up and down the regulatory framework.

Mr. Tan: One potential implication the task force might need to think about is, if indeed we do go from statutory to pure GAAP, what's the effect of that on tax reserves?

Mr. Gorski: There's another aspect. I don't have an answer to your question, but obviously that's an issue that the members are also thinking about. The charge to the Academy, which resulted in the formation of the Bob Wilcox's task force, came from the Life and Health Actuarial Task Force.

However, by thinking of such comprehensive changes to the balance sheet and marking everything to market, it doesn't make much sense to have a life industry on one basis and a casualty industry on another basis. So you really have to bring everyone into this issue, and I think there may be some problems in trying to bring the property and casualty people into this. As the project unfolds, I suspect there will be quite a reigning of the ideas.

Mr. Joe P. Francis: I like the defining rule of the special rated credit instruments. I thought that was interesting.

Mr. Gorski: It was my idea.

Mr. Francis: I have a question, though, about the principal only (PO) bond. Actually, I can think of another potentially troublesome sort of bond that I don't think would meet the defining rule of special rated credit instruments. I wonder what kind of thought has been given to that and how that would fit into the pigeonhole law.

Mr. Gorski: I guess you would have to describe the bond before I could give you an answer.

Mr. Francis: A PO bond from a CMO tranche would be one example. A different example that I can think of would be a bond sold by a film company in which the return on the bond is tied to how the film actually does. However, it might have a zero coupon or a 1% coupon. There isn't really a risk of not getting the principal back, but the market value could plunge. That would still contain some risk.

Mr. Gorski: The basic principle we've been working under is that if it's principal-protected, then it would be treated as a bond. If you remember, I specifically excluded the nonprincipal-protected equity-linked note in the definition of rated

credit instruments. The flip side is that if it is principal-protected, whether it be an equity-linked note, or an event-linked note or what have you, we are currently treating those as bonds and as rated credit instruments. It would not be considered a special rated instrument, but simply a rated credit instrument.

The issue probably will get more discussion by the Invested Asset Working Group, or the Valuation of Securities (VOS) Task Force, because they're the groups that apply credit ratings to those instruments. The current view is that one looks at the ability of the issuer to pay interest and principal if it's a floating rate or something such as that. The extent to which those things can change over time are not really built into the rules at the same level as some of the other ideas. But my view is that those would be rated credit instruments.

I guess the one other point I want to bring out is that I think some of the issues you're talking about probably point out the need to have not only a model investment law that deals with credit issues primarily, but something such as asset adequacy analysis, which deals with the variability of cash flows. It seems as if the kind of instruments you're talking about have the potential for variability other than credit reasons, and that should be dealt with by perhaps asset adequacy analysis and eventually risk-based capital.

Ms. McGinn: I think the other thing is that Larry gave a very simple version of it. So you probably want to take a look at the exact initial public offerings (IPOs) package. So if you look at all possible cash flows based on purchase price and a negative return, the specific language does pick up POs.

Mr. Tan: If an insurer has certain assets that are outside the limits, particularly the defined-limits version, can the valuation actuary take those assets into account when doing asset adequacy analysis knowing that those are real asset cash flows? Perhaps there are assets that are outside the limits, or there are certain derivative transactions.

Mr. Gorski: My answer is he or she probably can. Actually, that issue has been discussed by the Life and Health Actuarial Task Force several times. Basically, the idea is you allocate assets in value to reserves and do your cash-flow testing. If it happens that an asset of the company is not admitted and has no statutory value, I think it still could work its way into the asset adequacy analysis testing. So I think the answer is yes.

Mr. Tan: But what value do you use to equate assets to liability?

Mr. Gorski: You put zero value to the asset, but then you would have to estimate the cash flows and the timing of the cash flows resulting from that asset. So even though something is not admitted, it may not be admitted for a variety of reasons except meaning—excess of limitations or what have you. There are still cash flows emanating from that asset. I think they can be brought into the testing.