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Corporate Governance of Investments: Avoiding the Next Class-Action Suit?

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Summary: The mutual fund industry has long been subject to SEC scrutiny that requires managers to invest according to written investment policy. As insurance companies pursue the management of institutional and retail funds, how do they ensure that neither their customers nor their boards are unpleasantly surprised by unexpected investment holdings or practices? This session outlines what steps insurers are taking to ensure that all parties are comfortable with investment managers' activities and focuses on:

- *Investment policy development: What are the characteristics of good investment policy?*
- *Investment policy compliance: How to validate that managers are investing according to policy.*
- *How to validate that managers comply with other regulatory issues.*

Mr. William P. Chirolas: Our panel consists of Susan Ende, Paul L'Italien, and Michael Roch. So you don't get the wrong idea, the "Avoiding the Next Class-Action Suit" concept was simply a way to get you into the room. We will not be talking about legalities here. We are talking instead about how to do management, and how the regulatory authorities handle our management of investments.

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Obviously, there have been suits against insurance companies with regard to their investment policies, but most have not gone very far. There is much more to the participating dividend and demutualization equity share calculations than just investment earnings and investment allocation. The question of how the other lines relate to the original participating line (especially the start-up costs, a loan from the participating business, and the interest rate, whether there is or has been an equity interest in the new line) is equally if not more important.

In summary, this is not a course on how to sue an insurance company. It is basically a guide on how to handle the entire investment process.

We are going to start this morning with Paul, who will give us guidance on the investment and regulatory world. He will be followed by Susan, who will explain the New York State law and filing requirements. We will finish with Mike, who is a portfolio manager for Metropolitan Life; he will tell us exactly how he does his job.

Mr. Paul J. L'Italien: I'm a senior investment policy officer at John Hancock. As you all know, insurance company boards of directors have fiduciary responsibility for all company assets, which include general account and separate account assets. Today I am going to talk about separate account assets.

Corporate governance is the process by which boards prudently fulfill this responsibility. Two key aspects of fulfilling the responsibility are ensuring that assets are prudently managed and making sure that everyone knows exactly how they are being managed. That is why we include an investment policy as part of each separate account contract. It clearly states to our customers, the investment manager, and our board of directors how funds will be managed, and it allows everyone to review it for prudence.

In creating an investment policy, there is strong interdepartmental involvement. My own department, investment policy and research, as well as the law department, the investment manager, the product areas, the customer, and the compliance area are all involved. Why do we care about corporate governance? We care because we want to make sure there are no unpleasant surprises for our customers, the regulators, or our board.

I'll be discussing how we perform corporate governance at John Hancock. I will focus on investment policy development and compliance. Within investment policy development there are three steps: manager selection, risk assessment, and the development of an investment policy document. Once an investment policy has been established, we need to assure ourselves that the manager is complying with its provisions. This requires compliance checks with each of its quantifiable aspects. We also want to monitor the manager's performance in order to assure ourselves of the manager's continued investment expertise.

Sometimes insurers are asked by a customer to allow an outside manager to manage separate account assets. In selecting a manager who is new to the organization, you have to perform due diligence, define the manager's permitted investment activities, and create a management agreement that spells out the terms of the relationship. In performing due diligence on a new manager, you make sure that the manager has an appropriate level of investment expertise and has proper operational controls in place. To determine investment expertise, you should review the manager's historical performance in the asset class and style under consideration. Several publicly available databases exist that provide this information and allow you to compare the manager with all other managers using that same style. It is also important to identify the key people in the firm, their experience, and the stability of the firm. If a firm's track record is largely dependent upon a single individual, you need to consider the implications of that individual leaving the firm.

As part of the due diligence, you should also request a copy of the firm's ADV, which is the SEC's registration form. It will tell you if the firm has violated any SEC regulations over the past ten years. Civil litigation doesn't appear on the ADV. It might also be prudent to do a background check on the key people. A final step in the due diligence process is to gather information regarding prior customer satisfaction. You may want to determine how many customers have left the manager over the past several years and the reasons for those departures.

Once we are comfortable with the manager, we specifically define what asset classes they can invest in, such as equities or fixed-income securities, domestic or foreign securities, and public or private securities. We will also detail any investment practices, such as securities lending, borrowing, and purchasing securities on a forward basis. Next we make sure that the manager has the proper authority to invest in the asset classes and to engage in the investment practices submitted by the investment policy. We assure ourselves that state law permits the investment activity and that the investment subcommittee of our board and the committee of finance has delegated proper authority to the manager.

A final step in the manager selection process is the creation of a management agreement detailing the contractual relationship between the manager and the insurer. As part of the agreement, we include the investment policy for each separate account under management. We also specify the various investment authorities delegated to the manager. If the manager doesn't have the authority to engage in certain transactions allowed by an investment policy, derivatives for example, he or she would either need to seek prior approval from the committee of finance for each transaction, or ask another arm of the company who has the proper authority to engage in that investment activity. The management agreement also prohibits the manager from entering into certain transactions unless they are specifically mentioned in the investment policy. I will talk more about this later. Finally, the agreement also specifies the manager's fees and under what circumstances the manager can be replaced.

As part of the process of developing the investment policy, we assess the risks involved in both the assets and liabilities, and we make sure the investment policy is prudent and clearly communicated to the customer. We assess the level of investment guarantees backed by the funds when we consider the appropriateness of an investment policy. Such guarantees may limit the fund's investment style or its asset classes. The investment policy is then created with prudent limits that address any of these concerns, as well as the customer's risk tolerance. It also fully discloses to the customer all aspects of the investment strategy so as to preclude any later surprises.

Finally, I will speak about the investment policy document. It is intended to create a shared understanding among the customer, investment manager, and our committee of finance. The goal is to create a document that explicitly defines the scope of the manager's investment authority, with a large enough scope so as not to limit the investment style. We interpret our investment policies to be enabling rather than limiting. A manager can only acquire investments that are specifically described in the investment document, rather than being free to acquire anything not prohibited by the document.

Our investment policies cover several significant areas. Each of these areas becomes a section of the policy, and, wherever possible, quantitative limits are used. The investment and performance objectives section describes the policy's asset classes, investment style, benchmark, and overall risk of the fund. The asset class section broadly lists what asset classes the fund will invest in, such as fixed income or equity. Investment style could be described as active or passive, diversified or concentrated. There is the portfolio's benchmark, which might be public (such as the S&P 500) or customized, such as a series in Treasury strips with various spreads over each. The benchmark should bear a reasonable relationship to the assets in which the manager invests and to the overall risks of the portfolio. Finally, we believe that any details appearing later on in the policy should not introduce risks beyond what are apparent in this investment and performance objectives section.

The next section lists investment types. As an example, an investment policy that calls for corporate bonds should not acquire emerging market debt, denominated in a foreign currency, unless the policy stated that it could acquire the debt of foreign issuers and that some of its securities may be denominated in foreign currencies. Asset classes that don't appear in the benchmark should also be identified for special attention. For example, a separate account, whose benchmark is the S&P 500, would need to explicitly state any type of investment other than common stock. Finally, an investment policy should be broad enough to allow the manager to invest in all securities comprising the benchmark.

The next section in our investment policies is one on diversification and concentration. This section states the minimum number of securities that a fund will hold. It also lists the maximum concentration in a single issuer, industry, and sector. For example, the policy might state that the fund will have a maximum exposure of 5% to any one issuer, but 15% to any industry, or 30% to any one sector. If a fund doesn't have any diversification limits, this section will explicitly state that it doesn't. For some funds, the minimum allocation to a targeted asset class might be included. An example would be the policy of a large cap value fund, requiring at least 80% of its assets be comprised of large cap value stocks.

Credit quality limits are usually included in the policies of fixed-income funds. For example, a fixed-income policy might state that at least 80% of its assets will be investment grade, and the remaining 20% will be rated at least single B. For international funds, we might limit the funds to country weightings relative to the country weightings of its benchmark.

The duration constraints section applies only to fixed-income funds. Fixed-income policies could either state a duration target or explicitly state that there isn't one. The target might be absolute, such as a constant five-year duration, or it could be relative to the duration of the fund's benchmark. Some funds have a customized duration target based upon the fund's anticipated payout schedule. Since no portfolio can maintain its duration exactly at its target duration, you need to establish a corridor around the target duration. The corridor is the target duration, plus or minus either a fraction of the year or a percentage of the target duration. Finally, you have to identify which duration methodology you're using, such as modified or effective duration.

Another section that only applies to fixed-income funds is quality. Our investment policies frequently limit the minimum quality for an individual security, and the minimum average quality for the whole portfolio. Once you refer to fixed-income quality, you need to define it. We list which rating agencies we use to measure quality. For unrated securities, it's the manager who determines the quality. For split-rated securities that have different ratings from different agencies, we state whether we use the average quality, least quality, or highest quality rating.

The next section describes nonstandard investment classes that must be identified in a policy if they are to be used. The clearest examples of nonstandard investment classes are any derivatives, and we require a separate section for each derivative type used. We state whether the derivatives can be bought or sold, whether they're for hedging purposes and for options, and whether or not they're covered options. Restricted securities, such as private placements and 144(A)s, also need to be clearly identified. We also identify mortgage-backed securities (MBS) and other types of asset-backed securities (ABS) separately because of their potential option risk. If MBS or ABS are used, we also require identification as to whether they'll be pass-throughs or structured securities, and, if structured, whether they'll be the safer or the riskier tranches.

We also clearly identify foreign securities, and define them as securities either issued in a foreign currency or by a foreign issuer. We do this to identify foreign currency and foreign country risks. Last, we consider catastrophe bonds, initial public offerings (IPOs), and commodities to have unique risks, so they require identification in a policy as an investment class.

Similar to nonstandard investment classes, we also call attention to what we consider to be nonstandard investment practices. Many of these nonstandard investment practices that we require to be specifically mentioned could potentially expose an account to leverage, which means exposing it to a market risk greater than its amount of committed funds. We preclude all leverage from an account unless we consider it to be both prudent and fully explained to the customer. One example of leverage would be borrowing funds short-term and investing them long-term. Reverse repurchase agreements are similar to borrowing and would create analogous investment risks.

When securities are purchased on a forward basis, payment doesn't occur until months later at delivery, which could cause an account to be leveraged. To prevent such leverage with forwards, we require them to be collateralized with short-term holdings. Other types of investment practices that we specifically identify are securities lending and short sales.

The last section of the investment policy refers to the maintenance and guidelines, or compliance. This section states that once policy violations occur, there must be a prudent course of corrective action. An account can fall out of compliance either as a result of changes in securities prices or downgrades. We state that in these instances, the investment manager must take action, but only in a prudent manner. This action should include the investment considerations of timing and price, but with the end result of compliance.

We have now covered what I call investment policy development, the manager selection, the assessment of risk, and the drafting of the investment policy document. The next step in corporate governance is to ensure that managers are complying with their investment policies. The first step in checking compliance is getting the data and making sure it's complete. If it's incomplete, you will not be able to determine whether or not the portfolio is in compliance with this policy. A second issue with data is accuracy, especially for securities prices and quality rating. This can be especially difficult for private placements. Timeliness is also important since data quickly loses value after the close of a period. Another consideration is when no single source contains complete portfolio information. If you are using multiple sources to get complete data, make sure that all of the data are as of the same point in time. Finally, the data must be independent of the investment manager. Otherwise, the data's integrity could be questioned.

Once you have the data, you need to check the compliance with every quantifiable limit in the investment policy. If you find that you can't test many of the policy provisions, then it's possible that the policy language is overly arbitrary and subject to differences of opinion. This is just what you want to avoid in a clear investment policy. However, there may be some qualitative provisions for which it's very difficult to test. Determining whether a derivative is used solely for hedging purposes may be one example. Ideally, compliance checking would occur before a position is entered into. This is called front-end compliance. With front-end compliance, it is very difficult for investment managers to accidentally throw a portfolio out of compliance through an inadvertent trade. Front-end testing is expensive though because it requires every trading system to be connected with sufficient portfolio data to run all necessary tests before entering into a position.

The other compliance alternative is to test using data on existing holdings. This is called back-end testing. With back-end compliance, you need to decide the frequency of testing. Ideally it would occur daily. At a minimum, it should be performed quarterly. Testing sometimes reveals compliance issues. Here we make a distinction between trades that throw a portfolio out of compliance and market moves that cause it to go out of compliance. In the former case, inappropriate trades should be reversed as soon as possible, and any loss should be absorbed by the manager. In the latter case, prudent timing is advisable.

The final step to compliance monitoring is reviewing the manager's performance in order to monitor continued investment expertise. While the absolute performance is of interest, performance relative to the benchmark and relative to other managers may be of greater value because it shows how the manager compares with the market and with his or her peers. In looking at this performance, you generally look at the year-to-date performance and the performance for the prior one-year periods, three-year periods, and five-year periods, as well as performance since the inception of the fund.

This is how we do corporate governance at John Hancock through investment policy development and compliance.

Mr. Chirolas: Our next speaker will be Susan Ende. Paul explained how a company deals with investment-related issues. Now we are going to see how the regulators do the same.

Ms. Susan M. Ende: I'm going to shift focus a little and talk about the general account. My remarks are going to touch on two key areas. First, I'm going to give everybody an overview of New York Regulation 33, which is the specific New York law that regulates and monitors fairness and equity with regard to investment income allocation. For those of you who don't do business in New York, you are not required to comply with this regulation, but it is an excellent regulation if you're looking to set up some kind of corporate governance policy for your company. Second, I'm going to talk about Metropolitan Life's compliance structure, and how we have set up our process in order to ensure compliance with Regulation 33.

As I've just mentioned, Regulation 33 focuses on general account allocations. This is the primary law that monitors fairness and equity with regard to allocations of expenses and investment income. It specifically provides the instructions as to how you ensure and demonstrate to the state regulators fairness and equity with regard to your investment income allocation. Its focus is on the participating policyholder and ensuring an equitable distribution among those classes of individuals.

I'm being careful to talk about investment income allocation and not asset allocation. That's a very important point to understand. Under New York law, you cannot specifically allocate assets (at least not general account assets) to classes of policyholders. You can segment those assets and assign them for purposes of income allocation, but, by law, all general account assets back all general account liabilities. With segmentation, we assign assets to various blocks of business solely for the purpose of allocating investment income.

Regulation 33 provides three specific ways or methods for allocating investment income to your major annual statement lines of business. For those of you who don't work in producing the annual statement, let me take a moment to define them. We have industrial life, ordinary life and annuities together; credit life, group life, group annuities, and group accident and health; and other accident and health. The three specific methods outlined for allocating investment income apply primarily to those major statement lines of business.

The first acceptable method is to allocate your income in proportion to your total mean policy reserves. The second method is to allocate income in proportion to your total mean funds. The third method is the investment year method (IYM). Under New York Regulation 33, segmentation is considered to be an IYM methodology. The first two methods are called portfolio methods, and they are not that common in big companies today. I have to emphasize that these are the only three methods for allocating investment income that are approved by and acceptable to the New York Insurance Department. Any deviations from these methods must be filed with and receive approval from the superintendent before they can be implemented.

Since most companies are not using the portfolio methods, at least at the major statement level, I am going to focus my remarks on compliance with regards to the IYM of allocation. Looking at it a little more closely, the IYM specifies quite clearly how it is supposed to be implemented. First, if you are going to use the IYM (and remember, segmentation is considered to be part of IYM), it must be used for allocation to all major annual statement lines of business. You cannot have some lines of business using a portfolio type method and other lines using IYM. It's all or nothing.

It should also be used for allocation to what the New York Regulation refers to as secondary annual statement lines of business. For our purposes, that's the split of the ordinary lines between life insurance, ordinary annuities, and ordinary supplementary contracts. Finally, Regulation 33 specifies that within statement lines—when you're getting down to your product groupings or your specific segments within your statement lines—you should use a method that is fair and equitable and to the extent it would be feasible, you should use IYM. At this level, many companies switch to a portfolio method, and that's acceptable with Regulation 33.

Regulation 33 has two specific requirements with regard to the IYM. First, in the initial year that you switch to the IYM or develop a plan of segmentation, you must file the complete plan with the New York Department and receive approval of that plan before implementation. In subsequent years, you must file any revisions to that plan of investment income allocation by November 1. The revisions require approval of the superintendent before they can be implemented. It is basically a very tight form of governance for companies doing business in New York State.

Let's talk about the initial filing. In 1981 John Thompson, who was then a supervising actuary at the New York Insurance Department, listed 13 items that the New York Insurance Department required to be in an initial filing or plan of segmentation. Seventeen years later, these items are still required to be in your initial plan. When you change your plan of allocation, you have to address changes to these 13 items. Let's review these very briefly.

First, you have to provide a statement of reason for introducing segmentation and the basic objectives of the program. You must then provide a precise definition of your business segments and a complete listing of how you intend to segment the general account portfolio. You must provide a description of how the system will operate to avoid unfair discrimination in the allocation of assets or the assignment of assets among segments. This is a critical part of the filing, particularly when you have some segments that are nonparticipating and other segments that are participating. You basically need to specify your guidelines as to how you are going to assign those assets fairly and equitably.

The other items that must be a part of an initial filing include:
- A description of changes in your company organization contemplated in connection with segmentation.
- A statement of how cash flow will be measured for each segment, including a discussion of the treatment of negative cash flow.
- The rules for the sharing of investments among business classes.
- A complete description of how assets already on your books will be handled. It's important to note that the New York Insurance Department does not allow retrospective segmentation. Once you switch, you can only segment going forward. You must come up with a specific plan for dealing with the assets you already own.
- A description of how the investment strategies are expected to be developed *and* a clear statement that all assets support all liabilities. In other words, segmentation does not imply segregation.
- A discussion with the insurance department of how segmentation might be expected to impact the company's financial results.
- Specific allocation rules as to how income will be allocated among segments, across annual statement lines of business, and among products within annual statement lines of business.
- Verification for the insurance department that segmentation will apply to all businesses within your general account.
- A description of the changes that will be needed in the company's accounting systems.

This detailed plan of investment income allocation goes on file with the New York Insurance Department once they approve it. If you subsequently change your plan of allocation, you have to refile and get additional approvals.

Once the initial filing is completed and you're set up to go under the IYM or segmentation, your focus shifts towards compliance. There are two components of compliance. First is external compliance, or the actual dealings with the New York Insurance Department. This takes two forms. One, as I've already mentioned, is the annual filing. The second is the quinquennial examinations where the New York Insurance Department sends in its auditors to make sure you're adhering to its rules and regulations.

In order to be able to deal with the insurance department with a high level of confidence, we at MetLife have established an internal compliance process. We monitor our plan of investment income allocation, which essentially builds support for whatever filings must be done. For a company the size of MetLife, an internal compliance process is particularly important. It's important in a decentralized environment to ensure that, on a day-to-day basis, active portfolio management remains in compliance with our plan of investment income allocation and Regulation 33. It is also important and critical in a decentralized environment to have an auditable internal compliance process so that external filings can be supported. Our internal auditing department has monitored our compliance system and given it a seal of approval.

The internal monitoring process developed at MetLife has four specific features. The first one I'll call the segment list. The senior vice president in charge of MetLife's portfolio management division is required at all times to maintain an up-to-date list of all segments. In addition to identifying the segments, the list should include which annual statement line the segment resides in, and the allocation methodology across the statement line or within the statement line. There is also a specific record as to whether we are using the portfolio method or the IYM within the statement line.

It is helpful to have a list of products that are associated with each segment including, most critically, whether the products are participating or nonparticipating. The focus of Regulation 33 is primarily the participating policyholders. It's important here to note that if you refine your segments or open up new ones, it's considered by the New York Insurance Department to be a modification of your plan of investment income allocation, which requires that you notify them.

The next feature of our internal monitoring process includes the establishment of a portfolio management group for each segment. This group consists of senior management from the line operation, the investment department, and the chief actuary. This group sets the investment guidelines for each segment. In addition, we have a portfolio manager who watches over the segment on a daily basis and directs purchases and sales of securities. The manager also meets with other portfolio managers to review asset assignments for the segment. My associate, Mike Roch, is going to cover these aspects of our internal compliance process in greater detail later.

The fourth component of our internal compliance process is the governance of the investment income allocation committee (IAC). The IAC is an interdepartmental committee consisting of senior management from investments, corporate actuarial, the lines of business, the tax department, and the law department. It is chaired by the chief actuary. This governing body has two specific roles. First, it provides for an annual certification that the allocation of investment income and the assignment of the assets to the segments is fair and equitable. Committee members review reports that detail asset assignments focusing on asset sector, yield, and duration. They review the asset assignments in terms of the investment plan established at the beginning of each year, noting any key deviations from the plan, and documenting any reason the portfolio managers deviated from those plans. The certification stipulates that assets are assigned according to investment guidelines and that no one segment receives an inappropriate share of high yield or other attractive assets. Particular attention is focused on the participating business, and there is a thorough review of the allocation between the participating and nonparticipating segments. This is a pretty strong governance document.

The second purpose of the IAC is to review and approve any changes in allocation procedures. Before we even go to the New York Insurance Department to file specific changes, we have to have internal approval from our governing body, the IAC. The IAC meets on a quarterly basis, if needed, to review any anticipated changes in our plan of investment income allocation.

MetLife has a fairly complex internal monitoring process, which we, at the company, believe positions us well for external compliance. Regulation 33 stipulates that each insurer must maintain records that show the system actually used for the allocation of investment income, the actual basis of allocation, and the actual monetary distribution of investment income to annual statement lines of business. Working with the IAC, the auditing department makes sure that this documentation is kept and maintained. One can typically expect this kind of documentation to be reviewed during the state's quinquennial examinations. The state does not typically look at this in the annual filing.

The annual filing with the New York Insurance Department is critical. If any modifications are made to your plan of investment income allocation, you must file by November 1 of the year you want them to be effective with the New York Insurance Department. That filing must include a list of all changes to the plan of investment income allocation. In addition, you must also provide a demonstration that such changes are fair and equitable, particularly if you're asking for any exceptions to the three methodologies incorporated in Regulation 33. Changes must be approved before implementation. If you implement changes prior to receiving New York Insurance Department approval, your organization may be fined—something we want to avoid.

The annual filing at MetLife is coordinated within the actuarial department. The actuary responsible for preparing the filing, which is currently me, uses the minutes of the IAC meeting, the monthly portfolio manager's report, and other relevant reports to determine whether or not a filing is required. Remember, it is not necessary to do a filing every year. It is only required if you intend to make changes to your plan of investment income allocation.

If it's determined that no filing is required, it's important to keep records and documentation of your due diligence in reaching that conclusion. If it's determined that a filing is required, it is my job to figure out exactly what needs to be included in that filing. I can't overemphasize here that judgment is key and so is materiality. The way this works at MetLife is that I work very closely with our lawyers in preparing this filing. We have a thorough legal review of the filing before it goes to the New York Insurance Department. When we prepare our filings, we try to make distinctions between what we consider to be significant changes to our plan, those which I and the lawyer agree immediately would require approval before implementation, and those we consider to be refinements to our current plan, such as the addition of segments. Although the Department likes to be notified, you do not have to obtain their specific approval before implementing a new segment. We try to tailor the filings depending on whether we are seeking approval of a major change, or whether we're just notifying the Department of minor activities and modifications that we've made during the year.

If we're asking for approval to a change in our plan of investment income allocation, we have to demonstrate fairness and equity. We usually provide the New York Insurance Department with a comparison of both the book and market values of the assets in the segment before and after the proposed change and the difference in investment allocation that will result because of the change. Again, the focus here is on participating policyholders. While you technically need approval for changes in investment income allocation for a segment that is exclusively nonparticipating, the Department will not usually require as rigorous documentation for this.

In order to obtain approval by the New York Insurance Department, we usually have to go through a give-and-take process. It is very rare that you'll send a filing in and get a letter back saying "Approved." They usually require several iterations of additional information. Many times we have to meet with them in person to discuss the filing and business reasons for the filing. Overall, I have found that if you do your homework up-front and are well organized, the department is very reasonable with approving your changes. This is why we feel our internal compliance process is so important. It usually facilitates our dealings with the New York Insurance Department.

In conclusion, we at MetLife have a very sophisticated internal monitoring process. We have found that the overall process works very well. Most importantly, it facilitates our dealings with the New York Insurance Department.

Mr. Michael Roch: I am a portfolio manager for MetLife's general account. I am here to speak about active portfolio management at MetLife through the asset/liability management (ALM) process. When I say ALM, I mean how our investment policies are developed, and how corporate governance plays an important role in that development.

ALM at MetLife is a four-phase process. The phases are defining the liabilities, defining investment strategies, integrating with corporate planning, and implementing the plan. Before I discuss each phase in more detail, I will briefly explain what each one is.

The first phase is defining liabilities. If you think about what MetLife (or any insurance company) does, you realize that we design and sell products. When we sell a particular product, we are borrowing money from our customers. What we promise to do with that money makes up the liability. How we ensure that we can pay it back to the customer (for example, in monthly installments, as an annuity, in a lump sum 30 years into the future, and so on) is the investment strategy.

Integrating with corporate planning is really a corporate governance issue. It involves the fulfillment of our corporate requirements while at the same time meeting the promises to and the requirements of our customers. In the final phase, the plan gets implemented.

I will now go through each phase in more detail. The first phase is defining the liability. The first thing we need to do is create a financial profile. The profile describes the product and market in financial terms. It provides the information needed to identify the key liability characteristics necessary for proper management. In defining the liabilities, we consider its projected cash flows at relevant interest rates. Naturally, we must also consider any constraints associated with the product. These constraints can vary from product to product, and include such things as minimum spread requirements, minimum returns to the customer and to ourselves, risk-based capital, and surplus constraints.

The liability profiles get run through a model that helps determine certain key characteristics needed for the ALM process. One of the most important measures we use is duration. In simple terms, duration measures price sensitivity to changes in interest rates. The longer the duration of the product, the greater its sensitivity to interest rate changes, and vice versa. Whenever possible, we try to match the duration of the assets to the duration of the liability. This prevents surplus from being affected solely because of changes in the interest rate environment.

The second phase in ALM is defining the investment strategy. This is what I do on a daily basis, and it's a complex and involved process. Our investment department determines the long-term target portfolio. We use the phrase long-term target portfolio to define the asset mix that will best meet the liability requirements over the long term. Information developed in defining the liability is integral to establishing the long-term target portfolio; you cannot define the asset mix in a vacuum.

The duration of the assets must match the duration of the liabilities. They should also provide and maintain the spreads necessary to support the liabilities and profit margins of the company. Matching cash flows is also important, especially in the short run.

Once the inputs are set, the investment department runs its models, which help determine the asset mix that will make up the target portfolio. It should be kept in mind that the model does not produce a single answer. Different asset combinations will work. The model produces alternatives that need to be evaluated by both the portfolio managers and the lines of business.

Once the optimum asset mix has been chosen, a portfolio manager can begin the process of moving existing portfolios towards the long-term target. Given our portfolio's current position and size, it can take a year or longer before the final target is reached.

Once the portfolio manager and the lines of business agree on the target portfolio, the next step is to integrate the results into the overall corporate plan. In order to do this, approval is required at several levels. The first approval needs to come from the individual general account portfolio management (GAPM) boards. These GAPM boards are responsible for overseeing the investment strategies for each portfolio. Their members are senior management from both the investment department and the lines of business. The GAPM boards make sure that the proposed portfolio is appropriate for the given liability.

The next step is to have the company's corporate board approve all individual strategies. This is done on an annual basis. The board is mindful of the company's overall risk tolerance. It must then decide if the individual product investment strategies are too risky, not risky enough, or meet the company's overall risk criteria. Once the board approves the investment strategy and ALM plan, it then gets integrated into the company's overall business plan.

The fourth and final phase of the process is implementing the plan. A plan is developed to get the asset mix to the long-term target portfolio. Actual results need to be compared to expected results. This encompasses all ALM functions, including asset and liability duration, cash flows, default levels, lapses, and various constraints. Based on these results, the ALM strategy is adjusted if necessary. These reviews are done on almost a daily basis.

What I'd like to do now is focus once again on the investment strategy piece. Among other things, the investment strategy involves assessing asset risk. There are five basic asset risks that need to be considered:

- Interest rate risk, meaning the change in market value of an asset or liability as interest rates move;
- Credit risk, or the exposure to changes in the ability of borrowers to repay their debt;
- Option risk, or the exposure because of changes in the values of securities with embedded options, such as MBS and collateralized mortgage obligations (CMOs);
- Liquidity risk, which is the ability to sell assets quickly and at reasonable prices;
- Equity risk, which is exposure to changes in the value of common stock and equity real estate.

Once the investment plan has been developed, the first stage of our corporate governance is to present it to our GAPM board. The boards are made up of senior people from the marketing, financial, actuarial, and investment departments, along with the lines of business. There are GAPM boards for every portfolio at MetLife. Currently, our general account is comprised of 26 portfolios. The boards normally meet four times a year, and on an emergency basis when necessary. Recently, emergency meetings were held based upon the turmoil in the emerging markets area.

Our GAPM boards normally meet to discuss investment strategies and target portfolios, and allowable variances from those target portfolios. They discuss compliance with GAPM board constraints and monitor this periodically. The GAPM boards also create a benchmark against which asset total rate of return performance is measured. This helps determine whether or not the portfolio manager is doing an adequate job. Finally, they discuss compliance to overall company investment guidelines.

I'd like to use an example of a real portfolio to explain how each portfolio is managed through our guidelines, and how corporate governance plays a part. The portfolio objective is to meet or exceed the returns of a custom total rate of return index, subject to a number of constraints. As a portfolio manager, we must comply with each constraint.

One constraint is asset quality. For example, the fixed-income portfolio should have an average credit rating of A+ or better, while public and private corporates should have an average credit quality of at least A-. Noninvestment grade assets are not allowed to exceed 10% of the total corporate portfolio.

Duration constraints are also given. The target duration for the portfolio's fixed-income assets is set so that it matches that of the liability. The portfolio must be managed in such a way that the actual duration will vary by no more than plus or minus 0.1 years from the duration target. For issuer concentration, no more than 1% of the fixed-income assets should be invested in a single corporate issuer or CMO.

There are additional constraints in the area of asset distribution. The target portfolio gives allowable ranges to broad asset categories such as Treasuries, corporates, MBS, agricultural mortgages, equities, and real estate. The ranges generally vary from 5% to 30% of the total portfolio. The final constraint is on derivatives. Derivatives can only be used for legitimate hedging purposes. The amount of the portfolio being hedged at any one time is not allowed to exceed 15% of the portfolio's total assets.

My final topic will be asset allocation guidelines and procedures, and how we make sure that our allocation process is in compliance with our investment plan and our liability requirements. The first thing we do is have a determination of needs, and that's done on a daily basis by the portfolio manager. The portfolio manager prepares a daily needs sheet based on anticipated cash flows, the target portfolio mix, and current market conditions. This then gets distributed to the asset originators who actually purchase the assets.

To ensure we are able to maintain fairness among all of the company's portfolios, we have a portfolio allocation group. This group is a set of professionals not associated with the portfolio management groups or asset originators, but they are familiar with our rules of fairness. Their job is to distribute and allocate assets to each of the portfolios, and to make sure there's compliance with company policies and objectives.

The allocation group has also set up numerous fairness tests that oversee the entire process. The policies were created to ensure that each portfolio receives an equitable proportion of all asset allocations, taking into consideration the different average life and other requirements of each portfolio. This group is essentially the link between portfolio managers and the asset originators.

The control mechanisms over this process are provided by the portfolio managers, who review all pending asset purchases and the intended allocations. The portfolio manager has the opportunity to decline any allocation, but only for liability reasons. Portfolio managers cannot decline them solely for spread or other market factors. In other words, they cannot cherry pick based on the attractiveness of the asset.

At MetLife, we have set up special allocations for certain investment types that are not very common in the marketplace. These asset types include high-yield bonds, syndicated bank loans, and putable corporates. For these scarce assets, allocation percentages are set ahead of time, essentially on an annual basis. These allocations are managed similar to a mutual fund approach. While the allocations are based on needs, they are not adjusted during the year.

In conclusion, we have three levels of compliance and development of investment policies. The first one is done by active portfolio management and the ALM process. The second level is done by our GAPM and other boards. The third is our annual corporate review, during which all the individual plans are rolled up to make sure they comply with overall company directives. As Susan pointed out, we're audited annually, and that provides us some assurance that the process is equitable and fair and complies with all regulations.

Mr. Joseph J. Buff: I realize that you didn't really intend to comment on possible class-action lawsuits or on governance to protect against them. However, I was wondering if you would mind commenting on, for example, potential lawsuits arising because shareholders believe your investment performance is underperforming significantly that of the market, or policyholders who feel they're not getting their fair share in a demutualization or whatever. What kind of issues can arise, and is there any difference in how you protect against the different kinds of potential class-action lawsuits?

Ms. Ende: At least for a demutualization or a change in corporate structure, New York State has a whole process for handling that. Most of what we were talking about today would not apply. Since we haven't gone through the experience yet, I can't really comment on it. From time to time, you hear about policyholders questioning your fairness in an attempt to maybe sue you over that issue. At MetLife, we have found that because we have this internal compliance process, and mainly because of New York Regulation 33, most of that type of activity gets dismissed very early on.

Mr. L'Italien: I also can't really speak to demutualization issues. At Hancock, our big concern is the next wave of potential class-action lawsuits, whatever that might be. The first wave was unfair sales practices. The next one might be policyholders claiming they did not know what the investment manager was doing with their money. As I stated during my presentation, our intent at Hancock is to make sure these policies are absolutely clear and that customers and our board know exactly what we're doing. Remember, that the board ultimately has the fiduciary responsibility for all investments. We also check to make sure that we actually do what we tell people we are doing.

Mr. Luke N. Girard: Could the panelists talk a little bit more about how they manage liquidity, and how they do that in relation to what's required with respect to the liabilities?

Mr. Roch: I think liquidity is an important issue. We always make sure that a certain percentage of our portfolio's assets are in liquid assets in case we ever need to access cash. We have very large requirements of both Treasury holdings and cash holdings in order to accomplish this.

We also manage it very carefully. We actually have a liquidity department or cash management department, that is entirely dedicated to managing cash for the company.

Ms. Ende: From a regulatory standpoint, when we switched to segmentation, we filed our liquidity portfolios with the New York Insurance Department. Liquidity is pooled across all of our segments, and we were very specific in letting the Department know that's how we intended to manage liquidity. That's just something you should keep in mind.

Mr. L'Italien: In separate accounts, liquidity is going to be account-specific. Most of the separate accounts we have are nonpooled accounts with customized policies, so it's a question of how much liquidity the customer wants. Many of them are total pass-through accounts, where it's liquid by the nature of the assets. For those that are private placement accounts, the customer always has the right to take their assets if they want, but they have to take them at market.

Mr. Stephen R. Thomas: I have a question related to the Harris Trust case. I saw a lot of things up there on participating versus nonparticipating segments. Have you taken the additional step of taking your participating business and splitting it up by ERISA versus non-ERISA funds? Second, I know you have a framework in place for compliance with state regulators. Do you also have a separate, specific framework in place to handle the ERISA-type clients?

Mr. Chirolas: For those of you who are not familiar with the Harris Trust case, it is an ERISA case whereby general account assets were deemed to be fiduciary assets, making for complications in terms of all kinds of filings.

Mr. L'Italien: The Harris Trust case does affect John Hancock. At the risk of sounding like a broken record, the one thing we try to do at Hancock is to make absolutely clear to everyone exactly what it is we are planning to do. Keep in mind that Harris is a general account issue, and what I spoke about earlier relates to our separate accounts. We are still studying the situation relative to our general account. I'm not really in a position to talk about it yet at this forum.

Ms. Ende: With regard to the first question about portfolios, I'm not sure. That's just the way the segments are defined at MetLife. Some of them are completely ERISA, and some of them are non-ERISA. I don't think we focus on actually splitting portfolios that way. We come up with segments based on business needs, and how best to serve our broad customer base.

As Mike pointed out, we usually have portfolios for institutional business. These tend to be the ones, at least on the group annuity side, that are regulated by ERISA. We also have portfolios for individual business. With regards to ERISA compliance, the compliance process that I outlined does not deal specifically with that. The ERISA compliance is handled by the legal and contract people within each line of business. Obviously, I've been consulted at various times with regards to investment income allocation and ERISA issues, but that's governed by another independent body of people.

Mr. L'Italien: Similarly, at the Hancock, all of the ERISA business is in just one or two segments and everyone involved with those segments is extremely aware of ERISA and sensitive to ERISA issues.