

RECORD, Volume 27, No. 3*

New Orleans Annual Meeting

October 21-24, 2001

Session 29PD

Floating Rate Funding Agreements

Track: Investment

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Panelists: VICTOR MODUGNO
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Summary: Floating rate funding agreements, which have put options or short maturities, became an important product for many insurers in the 1990s. They are usually issued to short-term funds such as money market, securities lending, and buffer funds. The default by General American Life Insurance on \$6 billion in funding agreements in 1999 led to a retrenchment in this market. Buyers became concerned about credit risk, and sellers came under increased rating agency and regulator scrutiny.

MR. VICTOR MODUGNO: I'm a consulting actuary who specializes in these products. In addition to moderating this session, I'm going to be giving the insurer's viewpoint—the actuarial aspects, financial reporting, and so forth. Prior to starting my own firm in 2000, I was with Transamerica since 1990, where I was vice president of institutional products and where I introduced this product in the early '90s.

Our next speaker will be David D. Sylvester, executive vice-president, Wells Capital Management. As head of liquidity investment, David is responsible for the management of over \$60 billion in money-market fund and short-duration, separate-account assets. He has over 26 years of investment experience and has

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† Mr. John Ricketts, not a member of the sponsoring organizations, is vice president at Chambers, Dunhill, Reuben & Company in Columbus, OH.

‡ Mr. David D. Sylvester, not a member of the sponsoring organizations, is executive vice president at Wells Capital Management in Minneapolis, MN.

Note: The Chart(s) referred to in the text can be found at the end of the manuscript.

been with Wells Capital Management and its predecessor organization since 1979. Prior to joining the firm, Mr. Sylvester was fixed-income portfolio manager at National Bank of Detroit, now Bank One. David will give the buyer's point of view.

Our final speaker will be John W. Ricketts, vice-president, Chambers, Dunhill, Reuben & Company (CDR). John will talk about marketing these products. John joined CDR in 1992. His primary responsibility is coverage of money market and short-term, fixed-income markets.

I'm going to start with an overview. This product is called a funding agreement in those states that have funding agreement legislation. A funding agreement is a series of payments that are not contingent upon either mortality or morbidity. The product we're going to be discussing today has these characteristics. First of all, they typically pay a short-term rate such as the London Interbank Offered Rate (LIBOR). Other rates would include Commercial Paper (CP) and Fed Funds. These contracts have short maturities or puts. About the longest they go, in terms of maturity or put, is 13 months, because that's the maximum that a money-market fund can buy. They may have a rolling maturity. There are contracts that have maturities that constantly roll forward one month. They have 13-month maturity. At the end of 12 months, the maturity date rolls out one month. They're bought by money market funds or other short-term investment funds (STIF). The most common other types of funds that purchase them are security lending funds, but sometimes they're purchased by a buffer fund of a GIC. We're not including the funding agreement note issuance programs (FANIPs) that you're seeing a lot of companies doing, like the Euro note programs. These have long-bullet-type maturities, although they do have floating rates. Those particular contracts were covered in the annual meeting last year in session 55PD, "GIC in a Box," and it's on the SOA Web site at www.soa.org.

The General American failure, which happened in August of 1999, has greatly reduced this business, especially the seven-day put business. General American had \$6.8 billion in funding agreements and \$5 billion in the seven-day market, which was 60 percent of that market. This is seven calendar days. What happened to them was their contracts got put. It was in the middle of the summer over a weekend. They had very little time to react, and that was part of their problem. Once Moody's downgraded them to A3, A3 maps into Prime 2—and money market funds can't hold Prime 2 paper, regardless of what rate General American is paying.

The financial reporting on this product is really quite simple. The GAAP, tax, and stat reserves are the account balance. The interest rate is usually pretty low, because they're short rates. So normally there would not be any deficiency reserve. But even in very unusual circumstances, because of the interest-rate reset, the duration of the guarantee at the end of the year is going to be minimal. Even under those circumstances, which would be rare, there would be no deficiency reserves. The GAAP operating, tax, and stat income is simply the interest spread. Now, depending on the state, the reserves are either going to show up in line 25

(miscellaneous) or in exhibit 10. In some states these are GICs, so they would be in exhibit 10. In California and North Carolina, where they're not insurance products, they would show up as a miscellaneous liability. Index Separate Account has a totally different reporting. The statutory is marked to market. I'm going to talk about that a little bit later in more detail.

Rating agency and regulatory issues:

- In reaction to the General American failure, New York issued Circular Letter #33 (NY CL 33) in 2000 that requires extensive reporting on these contracts.
- Moody's Limits.

I'm certainly not a spokesman for the rating agencies. I would suggest you look up a session in the San Diego meeting on liquidity management—also on soa.org or Moody's own Web site, moodys.com. They have a paper on this. For experienced companies, a maximum of 20 to 30 percent of the liability should be funding agreements, and only 20 percent of that should be this real short.

- S&P. S&P has formal liquidity tests. You can look this up in the Atlanta meeting in 1999. There was a session on liquidity where S&P discussed their liquidity requirements. Or you can go on S&P's Web site, standardandpoors.com, where there is a complete write-up of their liquidity tests. S&P has an immediate test and a two-year test, and you get the worst result of those two. You have a special mark to market on the assets. Junk bonds, for example, are valued at zero in the immediate scenario, and 100 percent of the funding agreements are put. So you end up with a ratio of assets to liabilities. AAA would be 2.6. This is only one function of the rating. Obviously there's capital and other factors. So this doesn't determine your overall rating, but it is a separate item.
- SEC. The rate is not guaranteed for one year, so some attorneys say that it doesn't qualify under safe harbor as a fixed annuity. If you have to go to the private placement exemption, you have to have a qualified institutional purchaser and disclosure. If commissions are paid, you have to distribute through a broker dealer.

Issues regarding investment and liquidity:

- There are a number of ways to manage this business. One is a matched book—for example, corporate floaters. So, if you buy a four-year, A-rated floater, you're going to get a significant spread. I don't know where that is today. It could be 30 or 50 basis points over LIBOR. It's one way to get spread, if you're crediting LIBOR in the contracts and earning over that. What you're taking here is credit duration risk. You're issuing a short contract, and you're taking the credit risk of the issuer for five years. Adjustable Rate Mortgages (ARMs)/collateralized mortgage obligations (CMOs) is another strategy. There you're taking basis and prepayment risk. With the ARMs, you

- have caps. You also have resets at six months or a year. CMOs might have premiums that you would lose in the event they prepay faster than expected.
- Another strategy is to mismatch—to simply buy longer-dated assets, particularly in a positive-yield-curve environment. This was referred to as the carry trade, and this was popular in the early '90s. It actually could be done today also. You probably shouldn't be presenting this as a strategy, though, because the rating agencies and the regulators wouldn't like this much. But it could be part of an overall asset/liability modeling (ALM) strategy to offset other mismatches in your book, and then it makes sense. If you need to lengthen or shorten your liabilities, this may be a way to do that—by issuing some of these.
 - Exotic or high risk-based capital (RBC) assets, junk bonds, bank loans, index arbitrage partnerships. Those work better in the index-separate account simply because of the capital requirements.
 - Liquidity risk. I think the best way is to limit the amount of real short maturities you have to highly liquid assets, such as agencies that you can repo very easily or otherwise have them backed up by bank liquidity lines. That would be the way to manage that risk.

We're talking now about index separate account. In the Chicago meeting last year, we had an entire session just on the index separate account. That's been published on www.soa.org. If you really want to learn about this, I'd go back and read the transcript of that session. Under an index separate account, LIBOR is an interest rate series as defined in the model reg. So, it would qualify as an index separate account. The investment must mirror the index. So, you have to have investments that replicate LIBOR—cash-type investments. Then you can get the NAIC 1 RBC. You have to file a plan of operation, and, depending on the strategy, you may have to set up additional asset maintenance requirement (AMR). So you might have to add additional reserves to the NAIC 1 RBC, depending on what the investment strategy is. Here on the financial side, if the value of the liability exceeds the market value of the assets less the AMR, you have to set up deficiency reserves. However, the GAAP and tax income can simply be the performance fee that you're taking out of the separate account.

Finally, I'm going to talk about other collateralized structures that could come into use. There are basically two types of collateral that you can use with these contracts. The first is what I would call the weak collateral. Under this particular collateral, the policyholder is given a perfected first security interest in certain general account assets that are placed in custodial account, and the insurer retains ownership. So there's no change in ownership. The second type is strong collateral that has to be done on a tri-party repo basis. You're transferring the assets to a custodian that would be a bank under a repo-type of arrangement. There you retain the right to trade those securities, but you have to substitute securities based upon whatever the credit or collateral requirements are. Let's say it's government agencies. You'd have to substitute a government agency, if you take one out and sell it.

MR. DAVID D. SYLVESTER: I'm from Wells Capital Management. The purpose of my participation on this panel is to give issuers and potential issuers of funding agreements a little bit of a perspective of these investments or arrangements from the user's or investor's standpoint.

Wells Capital Management is a wholly owned subsidiary of Wells Fargo Bank, which is the leading banking subsidiary of Wells Fargo & Company. Wells Fargo & Company is the largest financial service company west of the Mississippi. We were founded in 1852. We are the original express company that was founded to haul in eggs and take out gold from the gold miners in California after the '49 Rush. Today our business is a bit of an extension of that. We are a registered investment advisor. We are registered with the Securities and Exchange Commission (SEC), and we provide investment advice to institutional clients on a for-fee basis. The fee is generally a percentage of the assets that we have under management.

We have over 200 people at Wells Capital, we average about 15 years of industry experience, and, as of June 30, we have about \$90 billion under management. A good portion of that—two thirds—is invested in short-term securities and short-duration securities. We would define "short term" as maturing in two years or less. We are the sub-advisor to the Wells Fargo money market funds, which is a \$50 billion-plus complex of money market mutual funds and a large place where we would use funding agreements as an investment. We have a number of different types of portfolios that we invest for in my group—the short-duration group.

What kinds of pools of money do we have? It's not Wells Fargo's own money. This is all client money. We have 20 different money market funds and over \$54 billion in assets that are largely retail and middle-market businesses, who are customers of Wells Fargo and invest their liquid cash in our money market funds. It's middle-America retail money that finds its way into our money market funds.

Wells Fargo also manages 14 different securities lending pools. These are arrangements whereby we will lend client securities out to different broker dealers. In exchange, we receive collateral, often in the form of cash, and that cash is then invested. It's an ALM business, and the idea is for us to invest that cash at a higher rate than we pay out on those loans.

We also have over 600 separately managed accounts for corporations, public entities, insurance companies, foundations, employee benefit plans—the whole gamut of institutional business. But by and large, when we're looking at funding agreements, we're looking at our money market funds and securities lending pools.

I thought it might be helpful to take a look at these portfolios—these money market funds and securities lending pools—and see what the portfolios look like and where the funding agreements fit into the whole investment process. Our money market funds are managed under a rule from the SEC called Rule 2(a)7, which is a rule that allows us to value all of the investments in the portfolio after amortized cost

and to maintain the share value of a money market fund at a constant one dollar. This is what enables you, as a shareholder of a money market fund, to put a dollar in a money market fund and have a strong expectation that you're going to get a dollar out when you go to redeem your shares.

As long as we follow the guidelines of Rule 2(a)7, we can value these shares at a dollar. The guidelines are oriented toward making sure that we have a high-quality portfolio and ensuring that we have short maturities on our securities. The maximum final maturity of a security that's generally allowed under Rule 2(a)7 is 397 days, which is the SEC's perception of a year. We also have to maintain the average maturity of a fund at 90 days or less. So, if we follow those three things and the other 2,380-or-whatever specific little requirements of Rule 2(a)7, we can use the words "money fund" in our name, and we can take your money in and give you a dollar back for every dollar we take.

Chart 1 is a little bit about the portfolio composition of what I would call a typical prime money market fund; one that would invest in commercial instruments, not restricted to municipal securities or government securities.

- The bar chart on the left-hand side shows how the different securities are broken down into portfolio by their average maturity. You can see that over 40 percent of the portfolio matures within one month—1 to 29 days. At the time I drew this, we had about 40 percent of the portfolio that was maturing. A good third of that comes due every day. The reason for that is that the short-term orientation of this fund has to do with our two main objectives, which are to maintain a constant one-dollar, net-asset value and to have sufficient liquidity to meet shareholder redemption needs. So, a good 40 percent of the portfolio matures within a month.
- You can see that as the maturities go out longer, we have a smaller amount invested in each one of these maturity blocks. When we get to the period where we're looking at investments—six months to a year, we only have eight percent of the portfolio invested there. The portfolio has to be structured this way to meet those liquidity needs and, at the same time, to keep our average maturity within that 90-day framework that's required by the SEC. A portfolio with this type of structure would have an average maturity of about 50-to-55 days and is in this position for some other reasons that have to do with managing the interest-rate sensitivity of the portfolio and our expectation of the future direction of interest rates.
- On the right-hand side, I have a pie chart that shows the breakdown of the portfolio by the different types of investments. Over half of the portfolio—one of our money market funds—is invested in commercial paper. That's basically in a prime fund—our main investment. That's what gives us the flexibility to target maturities to the specific dates we need and basically construct a portfolio with a maturity structure that we desire.

- Floating rate notes (FRNs) make up the second-largest portion of the portfolio, and these would largely be corporate notes. They would also be government agencies, where we would have a final maturity of up to a year but then some periodic reset of the interest rate off of some standard money market index. The indexes that we use are typically fed funds and then one-month and also three-month LIBOR, and that's about 15 percent or so of the portfolio. About 10 percent of the portfolio is invested in bank deposits. These are very short-time deposits with banks—sometimes one-day, two-day, three-day. They're also large-denomination certificates of deposit that are purchased from banks around the world as an alternative to some of the other asset classes.
- Then we start to get into some of the things that we use, but we use them to a lesser degree. Repurchase agreements are used to provide some liquidity where we will lend funds to a broker dealer on a collateralized arrangement. Asset-backed securities provide some boost in yield and some credit quality. Funding agreements are about four percent of our portfolio. That looks like a pretty small percentage, but on an industry basis, we're actually one of the larger participants in the funding agreement market.

So, this is what a typical money market fund under our management looks like. We're not especially different from the industry. I think the message here is that money market funds have a high need for liquidity. They're very short portfolios. Funding agreements in a money market fund are a niche product—a niche investment for us.

Chart 2 shows a typical securities lending pool that would be under our management, and it differs a little bit from a money market fund. It's much shorter, for one thing. This would be a portfolio that might have an average maturity of 10 to 15 days. That's because the securities lending business is basically an ALM business, and the liabilities on this side of the business are very short. A lot of them are just open, daily loans. So they have a lot of one-day liabilities and one-day investments. Although the portfolio composition is a little different in terms of commercial paper and floating rate notes and so on,, funding agreements are, at this point, pretty much a niche investment for us.

So, if they're a niche investment, why do we buy funding agreements? What do they offer to us? We don't buy them just so we can come to the conference. They've got some other investment advantages that we perceive. They're either real or they're perceived, and since we believe them, I'm not sure which is which. But we feel the advantages of funding agreements are:

1. They give us some industry diversification. Money market investments are largely concentrated in a prime fund in the banking industry and in the finance industry—consumer finance, auto finance, and so on.

2. They give us the ability to diversify into an industry that we, as an advisor, are comfortable with. Life insurance is an industry that we're familiar with. We like the industry. We think it has good prospects, and we like some of the companies in it. They give us the ability to diversify our industry exposure.
3. They also give us the ability to diversify the issuers. We're limited under the rule to five percent to be invested with any one issuer, and we're limited under our own internal policies to a much smaller percentage than we place with any one issuer of investment obligations. This offers us the opportunity to add more issuers to our approved list and get a little bit better diversification.
4. As I mentioned before, the prime objective of a money market fund is to maintain a one-dollar, stable, net-asset value. Funding agreements, by their nature, are valued by us at their book value. So, the book value accounting valuation function actually helps us, because we can get investments that pay rates of interest that are tied to longer-term indices. At the same time, they're valued from a marked-to-market standpoint every day at their book value, and this helps us maintain our one-dollar, stable, net-asset value.
5. Additional yield is also an advantage that we like to see. It's an advantage that we require in order to make this investment, and I think the yields on certain fund agreements can be attractive from an investor's standpoint.
6. We think that the companies with whom we do business offer us the opportunity to upgrade our credit quality a bit. We have a pretty select list of life insurance companies with whom we will write business like this, and we think it gives us a better credit quality.
7. Depending on how the contract is structured, it also might offer us more liquidity.

If there were only advantages, we'd have approximately 90 percent of our portfolio in funding agreements, but we don't. We only have three or four. So there must be some barriers that prevent us from increasing our exposure to this sector. The disadvantages of funding agreements are significant.

1. The first and biggest hurdle is the liquidity issue. Money market funds are limited under SEC Rule 2(a)7 to a maximum of having 10 percent of their portfolio invested in illiquid investments. By practice, money market funds will invest a significantly smaller percentage of their portfolio in illiquid investments. There's no strict SEC definition, but illiquid investments are generally believed to be those that we can contract for payment. In other words, they are those that we can sell or put within a seven-day period at a price that approximates their amortized cost. So, 30-year Treasury bonds are liquid, but they're liquid in that they can be sold. They're not liquid from the

standpoint that the price may or may not approximate its amortized cost. Securities that can be put back at par within that seven-day period are liquid. We get par. We have our amortized cost, and we have the seven-day hurdle. Investments that can be put back on a 30-day basis don't meet this hurdle. So, I think it's the conflict between the insurance company's need to limit the amount of short-put contracts that they write and the money market investor's need for liquid investments that is the biggest limit on the amount of business that we can write in this sector.

2. Another disadvantage is the complexity of the contracts. I think that every insurance company with which we have done a funding agreement does not at all perceive that its contract is complex. I believe that the people on the other end of that piece of business know every word in that contract. They know every paragraph. They know exactly where it sits. They know the meaning of it and the ramifications. But every contract that comes to us is new. One of the big hurdles to this business becoming a little bit more mainstream is that there is no standardized contract. I look at some of the very complex pieces of business that are done in money markets, repurchase agreements, swap agreements, and lending. They are all done under standardized contracts and standardized agreements. Having a standardized, uniform contract really adds to the fluidity and acceptance of the business. The funding agreement business, however, has no uniform contract, so it certainly takes us a considerable period of time to become as familiar with a contract as the insurance company. As the investor, we should be as familiar with that contract as the other side of the transaction.
3. Another barrier is that funding agreements can present certain operational risks. Most of the investments in our portfolios will follow set clearing and payment mechanisms. They will clear through DTC or the Federal Reserve. Our interest payments come in that form. The information on them is available on some standard industry databases. These things are not present in a funding agreement. As a result, whenever something is non-standardized, it presents a higher element for risk. There's a higher risk in that the interest payment is going to be wired into our custodian bank, and, because it doesn't come in the standard DTC format as that of 90 percent of our investments, it's not going to find its way into the account on the exact day. It's going to create a payment delay. So there are some operational risks there.
4. There are also some language barriers between the investment community and the insurance industry. I think that we are used to dealing in certain terms, such as principal amount, par amount, and interest payment. We're used to having interest calculated in a certain way. We're used to having interest rates reset in a certain manner. If I look at the floating-rate note portfolio that I have or the investments that I have that are tied to LIBOR, they will all reset the same way. They will all reset on a rate of two New York

or London business days before the effective date. The effective date will be a fixed day of the month or quarter. In the event it's not a business day, it will follow what is called a modified next-business-day convention. Funding agreements don't operate like that, however. There's not that level of standardization. We therefore spend a great amount of time looking at the interest-payment reset provisions and the payment provisions to ensure that rates are reset on days when we're going to be open for business, that payments are going to be made when we're able to invest them, and that payments are not scheduled to be made on weekends and holidays without a compensation of interest for that delay—those sorts of things. We just don't always speak the same language, so there's a fair amount of time that's spent on our side trying to take the contract and take the language that's acceptable from an insurance company's and their counsel's standpoint and translating that into provisions that will fit the standards and the standard processes of the investments that we make.

It also might be helpful if I talked through the process of buying. What's our process when we buy a funding agreement? It's not like buying or selling a Treasury bill. It takes a little bit more time.

1. It starts with an initial inquiry—possibly on the part of an insurance company. Maybe somebody's interested in writing some of this business, and either directly or through a broker, they find us. Or it's an inquiry that's made on our part. Maybe we would be interested in looking at funding agreements at this point, and we're wondering who, out in the market, might be issuing. We might occasionally make those inquiries directly, but usually we will make those inquiries through a broker. The reason we do that is it's much more efficient for us, from a buyer's standpoint, to have the broker go out and make those inquiries with all of the insurance companies, than it is for us to sit and make a series of phone calls. When the two parties initially find each other, there's a general discussion of terms. What's the tenor of the contract, the final tenor? What are the thoughts in terms of size, index that'll be used, reset-type provisions, and, certainly, the spread? Interest rate is a big part of that general discussion, too. It gets to be a general discussion involving the thought, "I'd be interested in doing this amount at that spread, and the insurance company would be interested in doing this kind of a put, and I'd be interested in this." Again, we get into a general discussion.
2. When we hone in on that, we start to get into a much more specific discussion of the terms. Then we really nail down what each party wants to get out of this business arrangement.
3. Once that's done, it's up to the insurance company to draft a contract and submit a draft to us.

Then go through a contract review process. They're reviewed by the portfolio managers. They're reviewed by our analysts. They're reviewed by our legal department. Each party has a little bit different part of the contract that they might be looking at, slightly different things that they might be trying to get out of that review process, but we will go through an editing process, and we will invariably have some suggestions on things that we would like to see modified. That usually will lead to some sort of a negotiation period and discussion over those terms and the reasons for them, and the two parties will then, either directly or through a broker, come to some understanding of what the contract will look like.

1. Then we'll start to talk about the operational details, such as how and when payments are to be made. We will schedule a settlement date and a payment date.
2. Then the contracts will be completed and sent to us for signature. We'll sign them—usually at the last minute, and we'll fax a signed page back.
3. Lastly, payment will be made.

Now, the entire lapsed time for this process is usually, in my experience, two-to-four weeks, from the time of an initial inquiry until the time we finally settle up with money. I think that the important thing to note here is that the maximum maturity of an investment, from an SEC regulatory standpoint, is measured from what's called the trade date to the final maturity. In this process, there is not a trade date, per se, in the same way there is when we sell Treasury bills or buy federal agency discount notes. But there's a date that we've got to call a trade date, and that's usually the date when we begin to have a specific discussion of those terms. So it's important to remember that that needs to be no more than 397 days from that date to the final maturity of the contract.

Here's the multibillion dollar question: What would make us buy more? I guess there are several things.

1. One might be if there were more issuers. Certain issuers in life insurance companies who would meet our credit quality standards do not participate in this market or do not have availability for us.
2. Another is more yield. There are certain arrangements that we've passed on because we just didn't feel that they offered enough of a yield advantage for our shareholders.
3. A variety of terms would be another reason. I know this session is "Floating Rate Funding Agreements," but we have entered into some shorter-term, fixed-rate arrangements with an insurance company where there were shorter, three-or-four-month-type contracts at a fixed rate. We found those attractive. So, a variety of terms can be attractive to us.
4. Another would be more liquidity. Right now the big barrier is liquidity. The reluctance on the part of the industry to write seven-day puts in the wake of the General American collapse is understandable on our part. Yet at the same

time, the lack of liquidity is really what gets to the heart of our inability to expand this at this point beyond that niche sector.

MR. JOHN RICKETTS: I work with Chambers, Dunhill, Reuben & Company. We're a Beverly Hills boutique in the capital markets. We're headquartered in L.A. and have been active since 1986 in a number of investment contract transactions. Typically, I'm functioning as an advocate for the insurance industry to the money markets, and that's a fairly straightforward argument to make. You have a series of very strong credit—well-capitalized companies in the financial sector that you're not seeing. So you're getting into our sector diversification from very strong credits. By working with funding agreements, you're being appropriately paid to do the work necessary to add these names to your approved list. So that's the advocate for the industry.

Part of the yield curve plays for insurance companies that are issuing funding agreements. So my presentation is going to focus initially on a larger description of the money or cash markets, and then, using a fairly standard competitive strategy approach, I will describe how funding agreements function in that market.

The first point that I want to emphasize is that funding agreements, when they are sold to a 2(a)7-regulated money market fund, become part of our country's money supply. They are then included in the definition of M2. I like to hit on that because I don't typically sense that we're aware that we are functioning in a market in which one person is making a decision that has an immediate and direct impact on the size of that market or on the behavior of that market. As part of M2, Alan Greenspan gets to make decisions that have an effect on this product line.

Because they're utilized in securities lending, securities lending is \$3 trillion-plus in assets, and those lending operations provide critical liquidity to the capital markets in general—Euro bonds and international equities, as well as just the smooth functioning of the equity markets. So you're participating in two, very essential sectors of the U.S. capital market, and the funding agreements are unique in that aspect. To give some scope to that market, as of mid-year this year there was \$25 billion in insurance company funding agreements outstanding in money market and security-lending programs. Just to compare that, those are contracts that have been in force since the late 1980s, when some of these notes were first issued to short-term investors.

Since 1998, the insurance industry has been participating in global and Euro medium-term note programs, which are asset-backed programs put together on a private placement basis by Wall Street dealers that hold funding agreements. There's almost \$50 billion outstanding there. That's been a dramatic growth for funding agreements. What we're observing is that the use of funding agreements in money markets, largely the result of General American's unfortunate situation, has become a relatively mature market. The opportunities that are there focus on understanding how that market operates and in developing minor adaptations that

scratch where it itches. As an example, take Dave's comment on three- and four-month contracts and how those might function in a money market fund. This market doesn't shrink. So you are selling product into a market that experiences consistent growth. The supply of cash available for investments such as this does not contract.

There were two quarters in the early '80s where there was minor contraction. But on a year-over-year basis, there's always more money that needs to be invested, and there may not always be assets available to invest in. As M2, the taxable money market funds are about \$1.4 trillion. So it's a significant part of the total. About 20 percent of the money supply flows into money market funds that are capable of investing in funding agreements. Those money market funds can further be segmented into retail and institutional. We'll touch on that, because those funds behave differently and have different risk profiles.

I've borrowed heavily from Michael Porter's competitive strategy model here, and I'd like to suggest a paradigm for putting all the different forces that act on a funding agreement into a conceptual framework. I'll start with the bargaining power of money market portfolio managers. This is a market where you're an effective borrower, and they are lenders to you. They know they're lenders, and so they have a high degree of bargaining power when they approach you to discuss purchasing a funding agreement. They're also accustomed to seeing a high degree of transparency among the other people that come to them and ask for loans. So on a corporate-credited issuing commercial paper, there is a high degree of understanding in regard to where that money fits on their balance sheet. When you compare that to the difficulty of finding funding agreements outstanding on a statutory report, it begins to be clear that we do need to pay you a little extra just to understand the industry. That's one example of the buyer's perspective, as they're approached for funding agreements. Generally they have a high degree of transparency, and they appreciate that. That allows an issuer to differentiate itself when it's working with money market funds.

As you evaluate alternative products, there's a list of just traditional money market products that are available for investment in these funds. It's our observation that probably the most direct competitor would be the floating-rate note programs. As an issuer of a funding agreement, you're really only being compared against other insurance companies. You're looking at existing companies with strong credit ratings that have fairly focused product lines. You probably see them in the GIC stable value market.

To match some of the pressure for negotiation among the money market portfolio managers, we've observed that there are opportunities to match that closely with decisions that are made in the investment department. It's been our observation, working across a range of issuers, that those companies most capable of acting quickly—and capturing advantages—have a high level of coordination with their investment departments, as they're issuing funding agreements. They may even be

managed directly out of the treasurer's office. At a very high level, you're coordinating specific portfolio decisions with the decision to issue a funding agreement.

Finally, potential competitors. Realistically there's a growth in 144(a) or private-placement paper that's coming into the money markets. There are some privately placed asset-backed programs that offer funding agreement-type spreads to money market managers, and those would be forces that'll have an impact on the demand and the pricing that's required for funding agreement books of business.

I mentioned earlier segmentation among the money market funds. Let me just explain the differences between money market funds and securities lending. Money market funds are divided into retail versus institutional. Typically a 2(a)7 money market fund manager is going to have a higher sensitivity to the liquidity of the assets that they're buying. Clearly, they're expecting to see yield relative to other similar credits in the money markets, and they are more sensitive to put length or the existence of having a put of some sort in the contract. They will be more discriminating on credit. In other words, if we're working with an issuer that is a AA, A, split-rated credit, we have an easier time finding a credit analyst that will work an approval for a securities lending program—where you're working with a securities lending desk that has its own credit list—than we would a 2(a)7 fund. So that's a consideration for a potential issuer. Finally, they are more predominantly LIBOR buyers. They prefer a one-month or three-month LIBOR coupon on the contract. If you look at a further breakdown on money market funds, they generally fall into three categories.

1. Government only, which are going to be T-bills and lots of repurchase agreements.
2. Taxable money funds, which are going to include commercial paper, corporate notes, and funding agreements.
3. Tax-free muni assets.

We are only interested in the taxable, and we break those down between retail and institutional because those funds behave differently. A retail money market fund is likely to have stickier money, i.e., the fund balances in that fund run consistent month-to-month, week-to-week. They stay consistent over quarter end. An institutional money fund is probably held by a corporate chief financial officer (CFO), may be held by a securities lending program, and is subject to what's considered hot money. Institutional money funds are used opportunistically by a number of investors because they are a lagging asset class.

Securities lending is interesting in that the program managers have control over both their funding cost and the reinvestment rate that they're able to get. In other words they have to pay something to get a block of Treasuries out on loan, and they have some control over what that is, or they're able to negotiate a term loan

on 200 million of general collateral Treasuries to a dealer for 90 days at a specified rate, and they can pay a slightly higher rate in the lending alternative to them, then they get more out on loan. That generates more revenue for them as a lending program. It helps them with their clients. That's a positive. That's within their control. Then they're also evaluating reinvestment rate. And so on any given investment decision somewhere at the same time they're considering, okay, this may help me get x out on loan. So it can have an impact on them beyond just what's the yield on the asset. That leads to matched book opportunities. If I can find a fed funds-paying asset that I know will offer me a consistent spread for the next 90 days—a consistent spread to fed funds, I can pass on a slightly stronger yield to get the assets out on loan. That's an opportunity. Because so much of that book and so many of their liabilities are priced to fed funds, they are generally more interested in fed funds floaters, which leads to the need for a basis swap or a willingness to take on fed funds basis risk when issuing a funding agreement.

Just a quick example. In the weeks following September 11, it was possible for a corporate CFO to issue commercial paper (CP) at something close to two percent. The fed was pumping incredible liquidity into the markets. Overnight funds were trading at zero or one quarter of one percent, and you could issue CP cheap—something close to two percent. You could turn that around, throw that into an institutional money fund, and pick up a substantial premium to that. You were probably picking up 250-275 for that week, and there were several billion dollars that traded that way.

So, if your funding agreement is held by an institutional money fund, you are subject to that type of thought process from their ultimate customers. What that means is that the cash balances are not as stable. Your position in that portfolio may come up for review if they have a significant liquidity draw. It's just a different risk profile.

Retail funds—funds sponsored by bank—are sticky because there's typically a number of other relationships in play there that mean that cash is really cash. It's cash that's held in reserve. There is a temporary decision with a sophisticated player in the markets. To give just a further breakdown, in this case it's one trillion in each one of those categories. So total assets in retail money funds is one trillion. Total assets in institutional money funds is \$1.04 trillion. Of that two trillion, 1.4 is taxable money funds. And I'm going to give you a further breakdown. There are about 15 very large fund complexes, and that group of 15 portfolio managers controls a third of that market—almost 500 billion. So you have a very concentrated market.

Some more detail on securities lending. There is \$3.7 trillion available to go out on loan. I'll describe how the securities lending market functions—how that comes about. Custodial banks have been the dominant players in this market. It's pension funds. It's been insurance company assets—large state programs, and the lion's share of that \$3.7 trillion is just government securities—Treasuries. No, that's the

most that's out on loan. The bulk of that is equities—\$1.6 trillion, but only about 7% of that gets out on loan. So, you're looking at almost half of that being equities that never get loaned out. There's about \$261 billion in Treasuries, and typically 70% to 80% of that is out on loan. So what that means, if you're providing an asset for the cash reinvestment in securities lending, is that it's the supply-and-demand for general collateral in the government securities market that is the easiest factor to track in terms of trying to decide what's going on in the securities lending market.

Securities lenders—custodial banks—are holding these assets. They're holding them there to deliver just temporarily in case a broker dealer has a fail or needs to borrow a large chunk of government securities to act as collateral in another repurchase transaction. That's the function that they provide. They're liquidity for individual security instruments to help protect the primary dealers from fails and help them finance their books. The biggest driver of the cash that gets generated in these programs is the government securities part of their business.

You've got about \$500 billion in cash, and it is generally invested as a spread to Fed funds. The Robert Morris Associates (RMA) quarterly survey, just on a quarterly basis, provides some operating figures on the performance of this industry. RMA is kind of a collection of bank lending officers, and they've provided services to the custodial banks as they've operated these lending programs. They need a spread of typically seven-to-25 basis points in order for them to find this business feasible. They have a very short average maturity—11 to 20 days—before they have the next reset on an asset in their program. What is interesting is that their programs probably have a barbell that you would not see in a money market fund. A money market fund is going to have a short—overnight to one week—and then, as it goes out to about 180 days, it's a correspondingly smaller part of their overall portfolio. Securities lenders can actually go out beyond 12-13 months. So they will hold two-year final maturities, and you will see about 20% of their portfolio. In some cases, that's held out beyond a year. So you have a third or better that's carried overnight and then a portion that's carried out beyond two years. They're using that longer-term portion to generate the extra yield that they need to put securities out on a term loan.

I'm not going to go into a lot of the detail on the asset classes. These are fairly mundane. Repo obviously offers liquidity, which is very easy to do overnight. It's broker/dealer credit risk, which may or may not be attractive. I'm just going to try and give some yield comparisons relative to a funding agreement. Repo right now is trading at a 248 for overnight, and that's what's got to be paid to get financing done by the broker dealers. Commercial paper, highly liquid, offers corporate credit risk. GE today is trading at a 228. If you have an appetite for Ford credit risk, you could pick up a 280, but that's not a comparable credit. That's not going to get bought by most money funds. Finally, asset-backed commercial paper programs would be bank asset-backed programs—financing receivables. They typically trade somewhere around a 240—all very strong credits and all AAA-rated.

Today, we think pricing is an expectation of a quarter-point rate cut, and therefore, you're looking at 30-day yields that are clearly below what's happening if you invest overnight. LIBOR on a 90-day basis is trading at a 235. A solid AA insurance company offering a 90-day put in today's market would be offering something like 10 to 15 basis points over three-month LIBOR. That would deliver a 245 to a portfolio manager, so they're comparing that 245 to, let's say, a 240, and then making a value decision on the effort involved to work through contract and credit issues.

The biggest lesson I've learned in six years is that there's no long term in the money markets. There's no long-term view. In two weeks, all of these value comparisons change dramatically. It's probably desirable to think opportunistically when issuing the money market funds.

Factors for competitors. Existing companies are all strong credits, split rated or better, a good business mix between personal and pension business, and have limited health-insurance exposure, limited property and casualty exposure at the issuing company level, and five billion minimum in general account assets. These are just general credit screen requirements that we observe as we're working with different portfolio managers.

What are the investment decisions that we see people making as they're issuing a funding agreement? Do I operate a fixed-rate or floating-rate portfolio to back these assets? If I'm operating fixed, do I use basis swaps to generate the LIBOR, or is a fed fund spread necessary? Do we do those swaps on a portfolio-wide basis or a transaction-specific basis? If we know we're issuing fed funds plus 20 to this securities lender on \$200 million for the next year, do I want a swap that matches those terms exactly, and then I'll consider that swap in the funding agreement as my liability? Or do I have a portfolio that I'm broadly managing on a floating rate basis, and I may be using swaps as a part of that? That's a decision that gets made.

Monitoring credit spreads across the yield curve. Right now we're in an environment where the yield curve is much steeper than it has been. We're also seeing credit spreads blown out dramatically. That offers two terrific opportunities for an insurance company that has a funding agreement program outstanding. They can very quickly raise in the short market at their investment grade credit at a much lower funding cost and then make an appropriate credit and duration yield pickup.

I'm just going to mention flexibility and adaptability. For programs operating, flexibility to me is the ability to work with contract terms and settlement difficulties and many of the things that Dave mentioned. To me, adaptability is that capacity to find those opportunities when credit spreads increase—just being in touch with what's happening on the long- to short-term part of the market and being able to respond.

As a final note, funding agreements operate in a really unique environment. You're triply regulated in one effect. You have to deal with state-insurance commissioners and with all the requirements of meeting liquidity tests for them, as well as an increased scrutiny from the rating agencies. Your customers are regulated either by the SEC or the Office of the Comptroller Currency (OCC), if they're a bank short term investment fund (STIF) or if the cash in the securities lending program is categorized as a STIF. So they have some thorny questions to answer about what they're buying, and because many of these are banks or parts of banks, they fall under the scrutiny or get attention from the Fed as well. Of course, because it's part of the money supply, there are decisions being made from time-to-time that have an impact on the short part of the curve, which directly affects the attractiveness of funding agreements.

There were really two, primary points that I wanted to achieve with this presentation. One is that you can have a great deal of confidence that the money markets are a reliable funding source. They're not going away. They're not contracting. They have the ability to remain a reliable funding source, even after the credit crisis of General American. They continue to find this product attractive. The second point is that the buyers do have a high degree of power. They do have a lot of alternatives. They do have options. And they have an interest in achieving credit transparency or knowing more about your business than they have in the past.

MR. MODUGNO: We have time for questions. If you do have a question, please step up to the microphone, and state your name and affiliation.

MR. PAUL J. DONAHUE: I have a question for Mr. Sylvester about what "approximates" means in the liquidity context. If you had an instrument that you could put at book in 12 months and at 98% of book in seven days, would that qualify as liquid?

MR. SYLVESTER: Unfortunately, there is no percentage definition that's attached to approximates. That is the way the precedent is written. We think that the term "approximates" has to be taken in its context, and so in the context of a money market fund, where overall the value of the assets absolutely has to remain within a band of 99½%-to-100½% of the value of the shares outstanding, and since the band of tolerance is typically 99¾%-to-100¼%, we would, for our purposes, say 99¾ to par and a quarter approximates.

MR. DONAHUE: I don't understand the money market restrictions, but it sounds like those are portfolio-level obligations as you described them. It seems it might have more flexibility for some subset of instruments in the portfolio.

MR. SYLVESTER: No, the rule actually says that you have to contract for the disposal of an investment at a price that approximates the market value at which

it's held. The market value at which it's held in a money market fund is its amortized cost. So it's talking about that specific investment.

MR. DONAHUE: I understand, but you were looking for guidance to the rule, which I thought—you're saying that for the fund as a whole the asset tolerance is a percent, and then it's a business rule that makes it a quarter of a percent. But I would think that if you were working for—and that's what I meant by the portfolio level restriction—and then someone decided, since you said there's not exact guidance about what approximates means, that that's a good place to look. But that's transferring, as it seems to me, a portfolio-level restriction to an individual instrument, whereas the basic principles of diversification and others—you might conceivably decide that there was more latitude for some. In other words, if on 90% of your assets you could always get exactly market, then for 10% you might be able to let yourself take as little as 99% or 98%.

MR. SYLVESTER: That would seem reasonable to me from a portfolio management standpoint, and I wouldn't disagree with you that that would be a reasonable portfolio management decision. However, the SEC would not accept that as a reasonable and prudent management decision in a money market fund specifically and would look for each and every asset in a money market fund to meet those same tolerances of low volatility. So, you would not be considered in compliance with Rule 2(a)7 if you had some assets that were at 90, 98, and some that were at 102, and they all averaged out to par.

MR. DONAHUE: But, again, I was speaking specifically about an instrument that was put-able below par.

MR. SYLVESTER: Well, the question is could an individual asset be put at some level below par? And the problem with that then becomes that, under some other portion of the rule, if we cannot put that back at par, then it's not considered a put under the rule. So, even though I can sell a security at 99¾, if I have a put feature that entitles me to put a security back at 99¾ of its face value, that would not be considered a put under Rule 2(a)7.

MR. SYLVESTER: Quite frankly, the number is par. I understand that this is bothering people, and it's confusing you. You're saying you should be able to have one instrument that appreciates in price and one that depreciates in price. But the reality is that's not the way money market regulation works.

MR. DONAHUE: Commercial paper might sell below cost

MR. SYLVESTER: The question is whether selling a piece of commercial paper at a price below its amortized cost and putting an instrument back to an insurer at something below its amortized cost is the same thing. Is that it?

MR. DONAHUE: Yes

MR. SYLVESTER: The difference is that we're trying to define two different things. One is the ability to sell, and the other is the ability to put. In order to put, I have to put back at par.

FROM THE FLOOR: Would they would both fit into the illiquid basket?

MR. SYLVESTER: They would both fit into the liquid basket if we had the ability to sell a security at approximately the amortized cost or if we had the ability to put a security back. In order to have a put we have to put back at par. That's part of the definition of put. If we have a put at something other than par, it's not a put.

MR. SYLVESTER: I don't think that we would reasonably deem that there was a sufficient number of buyers for us to call it a liquid investment. The question was what if the insurance company offered us the ability to sell the funding agreement?

MR. MODUGNO: What's the impact when an issuer issues to one of these conduits or other dealer programs—or funding agreement note programs that are focused on the short-term market, and they have outstanding funding agreements?

MR. RICKETTS: We've seen that happen in a couple of situations, and it's brought two items to light. One is that the insurance industry's ability to participate in the note programs is generally perceived as positive for the industry and positive for the issuer, because it's additional liquidity—additional funding for them. So it does not raise any concerns among the credit analyst when somebody's holding a funding agreement. Secondarily, if it's offered to a fund that is holding a funding agreement, they're generally happy to either continue holding their funding agreement and purchase notes out of the funding agreement note program, or they may not have been comfortable with funding agreements as an asset class, and so you're finding new portfolios that are interested in taking credit risk to the insurance industry and are able to do it in the new format. So there is not a direct competition between outstanding funding agreements directly from the issuer and their same name showing up in a note program.

MR. MODUGNO: Has there been any impact on these products from the September 11 disruptions?

MR. RICKETTS: Let me address this generally. There was a very quick overview of the insurance industry after September 11. Credit analysts were interested primarily in reinsurance exposure. If a company had—coming into the same balance sheet—large reinsurance risk, they wanted to know about it. Every one of the life issuers that participates in this market was given a clean read on that item. There was concern about the equity allocation in a company's general account because the equity markets were going through a lot of volatility, and people didn't want to find surprises showing up with insurance companies on that note, if there was a sudden loss in value on that. Finally, there was some attention paid to an issuer's willingness to meet contractual claims. Companies that had received a lot of

attention based on other high-dollar-payout events—there were just questions asked about their willingness to step up if there were large claim issues related to New York. And interest—the only area where that got any attention was some of the New York portfolio managers were just not willing to take a wait-and-see on what happens with some of those credits. So, the only sensitivity to the insurance industry has been reinsurance related and the past history on an issuer's posture towards paying claims. If there were news bulletins that addressed invoking war clause, that was probably viewed as a negative by some of the credit analysts.

MR. MODUGNO: If there are no other questions, that concludes the meeting. Thank you.

Chart 1

For Whom Do We Invest?
Typical Money Fund Composition (8/31/01)

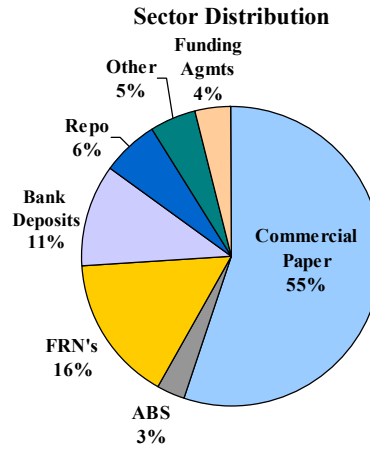
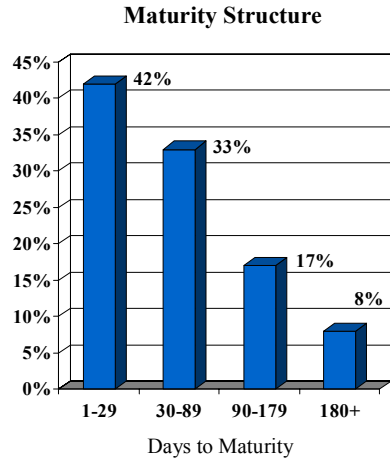


Chart 2

For Whom Do We Invest?
Typical Sec Lending Pool Composition (8/31/01)

