Approved March 24, 1992
Date

MINUTES OF THE House COMMITTEE ON Insurance.

The meeting was called to order by Representative Turnquist at
Chairperson

3:30 ~~a.m.~~/p.m. on Thursday, March 19, 1992 in room 531 N of the Capitol.

All members were present except:

Representative Sebelius, Excused
Representative Ensminger, Excused

Committee staff present:

Mr. Fred Carman, Revisor
Mr. Chris Courtwright, Research
Mr. Mark Hunter, Intern
Mrs. Nikki Feuerborn, Secretary

Conferees appearing before the committee:

Mr. Dick Brock, Insurance Department
Mr. William Sneed, American Investors Life Insurance

Hearing on SB 511 - Investments of certain insurance companies in mortgage related securities

Mr. Dick Brock of the Insurance Department appeared as a proponent of the bill. This bill is a result of a review of investment opportunities for insurance companies to determine if they meet the standards of investment quality and concentration limitations which generally apply to permissible investments of domestic insurers. The major component is the use of the term "mortgage related securities" to identify the types of investments to which the bill applies. The second major component is the requirement that any mortgage related securities issued by a private entity as opposed to the Federal Home Loan Mortgage Corporation or Federal National Mortgage Association must be rated "1" or "2" by the Securities Valuation Office of the National Association of Insurance Commissioners or comparably rated by Standard and Poor's or Moody's. The third major component of the bill is the limitation included in both subsections (1) and (b) of Sections 1 and 2 which provides that no insurer can invest an amount greater than 2% of its admitted assets in any one issue or pool. (See Attachment 1).

Representative Welshimer moved to amend **SB 511** per the balloon presented by the Insurance Department. Representative Gilbert seconded the motion. Motion carried.

Representative Welshimer moved to report **SB 511** a favorable for passage as amended. Representative Cozine seconded the motion. Motion carried.

Hearing on SB 520 - Insurance company investments in junk bonds, limitations

Mr. Dick Brock on the Insurance Department appeared as a proponent of the bill. This bill introduces limitations on the amount domestic insurers may invest in medium and lower grade obligations. Bonds assigned a 4, 5, or 6 investments grade by the NAIC are often called "junk bonds." The bill limits investment in medium and lower grade bonds to an amount equal to 20% of an insurer's admitted assets. The bill includes a sublimit of 10% of admitted assets on lower grade bonds. This 10% limit is further reduced by providing that no more than 3% of an insurer's admitted assets can be in obligations rated 5 or 6 and more than 1% in bonds that are rated 6 by the NAIC. An amendment submitted by the Insurance Department makes it clear that the limits imposed by the bill are the only limits that apply to medium and lower grade securities. (See Attachment 2).

Representative Neufeld moved to adopt the balloon amendment as presented by the Insurance Department. Representative Weiland seconded the motion. Motion carried.

Representative Helgerson moved to report **SB 520** favorable for passage as amended. Representative Cozine seconded the motion. Motion carried.

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

CONTINUATION SHEET

MINUTES OF THE House COMMITTEE ON Insurance,

room 531 N, Statehouse, at 3:30 xxx/p.m. on Thursday, March 19, 1992, 19 92

Hearing on SB 517 - Advances of money to insurance companies , interest thereon

Mr. Dick Brock of the Insurance Department appeared as a proponent of the bill. Surplus notes are notes evidencing a loan to a mutual property and/or casualty insurer which can be repaid only from the surplus of the company and only with the approval of the Commissioner of Insurance. Because of this limitation on repayment, the statute provides that such loans shall not be a liability so this is a way a mutual insurance company can increase its surplus and add to or maintain its growth other than through its capacity to produce net earnings. The current statute has not been amended since 1939 so the 5% interest currently allowed has been the same for more than 50 years. For this reason the bill proposes to replace the current 5% interest rate with a variable rate of 1 1/2 percentage points less than the rate published by the Secretary of State. The new section 2 makes the same surplus note provisions applicable to mutual fire and tornado companies. The amendments are corrective changes made to reflect the original intent of the Insurance Department. (See Attachment 3).

Representative Sprague moved to pass **SB 517** to the consent calendar. Representative Neufeld seconded the motion. Motion carried.

Hearing on SB 519 - Purchase of insurance benefits

Mr. Dick Brock of the Insurance Department appeared as a proponent of the bill. This bill addresses the practice of a person or organization paying a lump sum to a life insurance policy holder in an amount equal to some percentage of the expected benefits under a life insurance policy in exchange for that person or organization being named as the beneficiary under the policy. This bill would make another interested party aware of the transactions and provide the policy holder a three day "cooling off" period during which they could cancel the sale. The bill was amended to require persons transacting this business to be licensed by the Commissioner of Insurance; file details of the contracts, discount rates and other operative documents with the Commissioner; give policy owners who enter into such arrangements 15 days to rescind the contract; and provide certain information to the policy owner including notice of the 15 day right of decision. (See Attachment 4).

Hearing on SB 491 - Life insurance, declination of coverage

Mr. Chris Courtwright gave a staff review of the bill. This bill would require that the insurance company notify the applicant of the refusal of a policy and return the premium. The bill also indicates than an independent agent is an employee of the insurance company and not of the applicant or insured.

Written testimony was presented by Senator Bogina. (See Attachment 5).

Mr. Bill Sneed, American Investors Life Insurance Company, appeared as a proponent of the bill. The amended Senate bill specifically itemizes what should be encompassed for a conditional receipt that is commonly issued when a life insurance product is sold. (See Attachment 6).

Representative Turnquist reported on a meeting which occurred between Representatives Weiland and Neufeld, and representatives of the Board of Regents, State Architect's Office and the Insurance Department regarding self-insurance or state-owned buildings or an insurance market mechanism for coverage. It is their recommendation that legislation be introduced to allow the state to purchase insurance for state-owned buildings. The overall loss history is good so the premium would be lower than was anticipated.

Representative Helgerson moved we approach the Appropriations Committee and ask for funds for an insurance market mechanism to insure state-owned buildings. Representative Welshimer seconded the motion. Motion carried.

CONTINUATION SHEET

MINUTES OF THE House COMMITTEE ON Insurance,

room 531-N Statehouse, at 3:30 ~~xxx~~/p.m. on March 19, 1992

Representative Helgerson said some money may be available from federal funding. Federal reimbursements is available for certain programs such as rent for buildings housing human resources, hospitals, etc.

The meeting adjourned at 5:00 p.m.

GUEST LIST

COMMITTEE: House Insurance DATE: March 19, 1992

NAME (PLEASE PRINT)	ADDRESS	COMPANY/ORGANIZATION
David Hanson	Topeka	Ks LIFE Assoc
Lori Callahan	Topeka	KaMMCO
Keith Hawkins	Mission KS	PYRAMID LIFE INS CO
BRAD SMOOT	Topeka	BCBS
Michelle Liester	Topeka	KGC
Dick Brock	"	Ins Dept

Testimony by

Dick Brock, Kansas Insurance Department

Before the House Committee on Insurance

Senate Bill No. 511

During the 1991 legislative session, the Kansas legislature took advantage of a unique opportunity to nullify a federal preemption of state insurance investment laws. You did so by enacting House Bill No. 2441 which permitted Kansas domestic insurance companies to continue to invest in mortgage related securities of the same kind and to the same extent as permitted by the Secondary Mortgage Market Enhancement Act of 1984 but under the cloak of state law. As this 1991 legislation was being considered, we knew these investment opportunities needed to be reviewed to determine if they met the standards of investment quality and concentration limitations which generally apply to permissible investments of domestic insurers.

Senate Bill No. 511 represents the results of that review. Sections 1 and 2 are identical except section 1 applies to property and casualty insurance companies domiciled in Kansas and section 2 applies to domestic life insurers. Other than that distinction, the sections are the same and each has only 3 major components. The first and major component is the use of the term "mortgage related securities" to identify the types of investments to which the bill applies and we have included a definition of this term. I am not going to pretend that I know what particular investments this definition encompasses although I have attached to my testimony a copy of an article that is, I think, somewhat enlightening. In developing the legislative proposal that is now Senate Bill 511, I simply copied or paraphrased the portions of the federal statutes which described the securities the Secondary Mortgage Enhancement Act of 1984 permitted to be purchased regardless of state law -- these federal statutes were also referenced in 1991 House Bill No. 2441 -- and used these descriptions as the definition of "mortgage related securities". As a result, Senate Bill No. 511 is not intended to

House Insurance
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Attachment 1

limit the types of securities in which domestic insurers were permitted to invest by the federal law. This proposal and the definition of "mortgage related securities" has been reviewed by the investment managers of at least 6 Kansas domestic insurers and they have raised no concerns or objections either subsequent to our meeting on the subject or as the bill proceeded through the Senate so I believe the definition does what it was intended to do.

The second major component is the requirement that any mortgage related securities issued by a private entity as opposed to the Federal Home Loan Mortgage Corporation or Federal National Mortgage Association must be rated "1" or "2" by the Securities Valuation Office of the National Association of Insurance Commissioners or comparably rated by Standard and Poor's or Moody's. This requirement was also included in the federal law so it isn't a more onerous restriction than previously applied. From the Insurance Department's perspective, this is, however, an important requirement and being sure such a requirement would always apply is one of the reasons we sought to retain state control over insurance company investments by nullifying the federal preemption.

The third major component of Senate Bill 511 is the limitation included in both subsections (a) and (b) of Sections 1 and 2 which provides that no insurer can invest an amount greater than 2% of its admitted assets in any one issue or pool. This limitation was not present under the federal law but it does add a measure of safety by assuring that the concentration of assets in any one security is not too great. This is an area where some Kansas insurers have encountered a problem with the bill and I have therefore attached to my testimony a proposed amendment which will, we believe, accommodate a legitimate concern. Following passage of the bill by the Senate, we were made aware of the fact that these types of securities are traded in large blocks of $250,000 increments --

$250,000, $500,000, $750,000 etc. and the yield is greater as the size of the block increases. As a result, some of the smaller domestic insurers would effectively be precluded from investing in or be extremely limited in their ability to invest in such securities because 2% of their admitted assets would not allow sufficient latitude. At the $500,000 level, a company would have to have at least $25 million in assets to exercise this investment option and a number of Kansas domestic insurers are below that level. Yet, we are talking about securities issued or guaranteed by the federal government which presumably yield a good return. Consequently, the amendment suggests that the bill be amended to provide an additional and different means of stating the maximum allowable investment. Specifically, the proposed amendment would add a dollar amount of admitted assets to accommodate the problem just described.

Finally, although it is not in Senate Bill 511, the Commissioner has authority under another statute (K.S.A. 1991 Supp. 40-222b), and specifically a regulation issued pursuant to such statute, to order a company to "... limit or withdraw from certain investments or discontinue certain investment practices ..." with respect to any insurer that has been deemed to be in a hazardous financial condition. This is a significant consideration and authority which can be used since mortgage related securities now fall within the purview of Kansas insurance investment statutes.

As a result of all these considerations, we believe Senate Bill 511 is an appropriate and necessary follow-up to 1991 House Bill No. 2441 and respectfully request your favorable consideration of both the proposed amendment and the bill.

PaineWebber

Viewpoint

The ABCs of CMOs

Few investment vehicles introduced over the past half century have generated as much excitement, or confusion as the Collateralized Mortgage Obligation (CMO). While the CMO structure is more complex than either corporate bonds or simple mortgage pass-throughs, it offers unique benefits that cannot be found in these other types of securities. What the collateralized mortgage obligation does is "restructure" or "repackage" the cash flows from an underlying mortgage security, and creates from them a series of sequentially maturing bonds. In plain English, the CMO takes the principal payments from FNMA, FHLMC or GNMA pass-throughs and creates various classes of bonds with different maturity structures (known as tranches). CMOs add value by enabling investors to participate in the mortgage markets across the entire range of the maturity spectrum (short, intermediate and long term). The sole objective of this report is to provide a more detailed description of how CMOs work, as well as their principal benefits and risks to investors.

Why bother with CMOs?

Although CMOs are more complicated than more traditional fixed income securities, there are powerful incentives for participating:

- Strong credit quality
- An attractive yield premium over Treasury securities
- A wide range of maturity structures to choose from
- Unique structures that better match the investors risk profile
- Greater payment frequency
- Virtually no exposure to "event" risk

Yet the holder can't lose sight of the risks they present:

- Risks from changes in prepayment rates
- Liquidity limitations
- Interest rate risk
- Potential for fluctuation in yield "spreads"

The basic structure

Chart 1, on page 2, provides an illustration of the basic structure of a CMO. The entire process begins when specific collateral (GNMA, FNMA and FHLMC pass-throughs, or whole loans) is placed in a protective trust structure. The trust then issues a series of different bond classes with various maturities and coupon rates. The simplest set of bonds emerging from the trust, known as the "plain vanilla" sequential pay, is shown in Chart 1. In a sequential-pay structure the tranches (i.e. bond classes) are retired in a specified order. Diagram A demonstrates how this process works. All principal repayments and prepayments generated from the mortgage securities held as collateral in the trust will be paid to *only one tranche at a time* ; in our example it begins with tranche A. Once all the principal has been returned to the holders of tranche A, then tranche B becomes the current tranche. Tranche B is then entitled to all principal repayments and prepayments generated from the underlying collateral. The process continues until all of the tranches have been retired in this *sequential* fashion. In the meantime, interest payments will be made to each tranche based upon the stated coupon rate and the principal balance remaining (with the exception of the z-tranche, which is discussed later).

The trust

The collateral (described in the next section) is placed into a protective trust structure when the CMO is originated. The key function of the trust from the investors viewpoint is to maintain the credit quality of the CMO by protecting the integrity of the collateral underlying the bonds. The trust assures that there is no co-mingling of assets between the issuer of the CMO, and the CMO itself. The collateral is held exclusively for the benefit of the tranche holders, and cannot be used to satisfy any other claims against the issuer. The trust is structured in such a way that even under a worst case scenario (prepayment rates on the collateral dropped to zero) there are always enough assets to pay off the liabilities. This structure has sometimes been termed "bulletproof", and is one of the reasons that in most cases, CMOs are able to attain a AAA rating.

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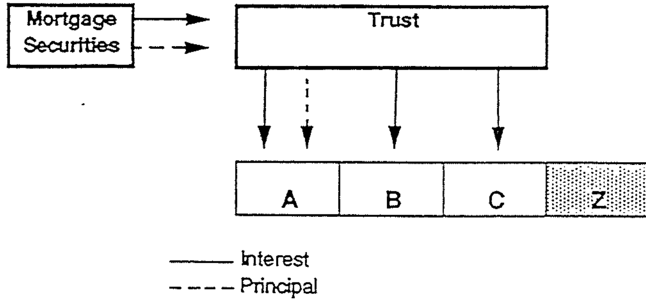
Michael Ryan, CFA (212) 713-4671

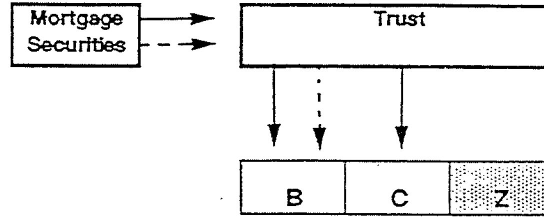
Chart 1

CMO cash flow diagram

A. Initial cash flow diagram



B. Cash flow diagram after first tranche is retired



Types of collateral

The most important element in determining the credit quality and performance features of a CMO is the underlying collateral. For the most part CMOs have been backed by pools of agency pass-through securities such as FHLMC, FNMA and GNMA. However, there are some issues that have been collateralized directly with individual whole loans. The principal characteristics of these different forms of collateral are defined below.

Federal Home Loan Mortgage Corporation (FHLMC)

FHLMC participation certificates represent an undivided interest in a pool of conventional, non-assumable 30-year fixed-rate mortgages. The participation certificate "passes through" to the holder a monthly cash flow which includes interest, scheduled principal repayments and any unscheduled return of principal (prepayments). FHLMC PCs are guaranteed only by the Federal Home Loan Mortgage Corporation, not directly by the U.S. Government. Although not a direct government obligation it is considered highly unlikely that the government would permit a default on a FHLMC sponsored security.

Federal National Mortgage Association (FNMA)

FNMA mortgage-backed securities are formed by pooling fixed-rate conventional mortgages, and to a limited extent, FHA and VA mortgages. Interest and principal repayments are passed through to the holder on a monthly basis. Like FHLMC PCs, FNMA mortgage backed securities are not directly backed by the U.S. Government, but rather, are solely the obligations of the FNMA. It is also considered unlikely that the Government would permit a default by FNMA.

Government National Mortgage Association (GNMA)

The GNMA pass-through represents a pooling of Federal Housing Authority (FHA) and Veterans Administration (VA) mortgages on 1–4 family residences. Unlike conventional mortgages, FHA and VA mortgages are assumable in the event of the sale of the underlying property. The full and timely payment of principal and interest is guaranteed by GNMA, which is backed by the full faith and credit of the U.S. Government. GNMAs are the only agency pass-through to provide this direct and explicit government guarantee.

Whole Loans

A small number of CMOs have also been collateralized by whole loans (the individual mortgages themselves). This type of collateral carries no agency or government guarantee, and is therefore dependent upon the credit quality of the mortgage holder. Whole loan backed CMOs are required to obtain private mortgage insurance from a AAA rated insurance company in order to protect the holder against the potential risk from defaults.

Hybrids

Some CMOs are also backed by a combination of different types of collateral. For example, a specific CMO deal may be backed by both GNMA and FNMA mortgage securities, or perhaps a combination of whole loans and GNMAs. Evaluating different types of collateral held in combination is similar to simply evaluating the collateral independently.

Return of principal

Like all mortgage securities, CMOs will provide the holder with periodic repayments of principal which include both scheduled repayments and unscheduled prepayments. Chart 1 illustrated the sequential-pay CMO structure, in which principal payments are made to only one tranche at a time until each class has been retired. Although the bonds are retired in a specified sequential order, this does not mean to

imply that the repayment period is somehow "fixed". Over the life of the CMO, there are likely to be fluctuations in both the timing and size of the principal repayments as prepayment rates change. There are many reasons why people might pre-pay a mortgage including: divorce, death, default, job transfer or simply a trade up to a larger home. However, the most important factor affecting the level of prepayment is a change in interest rates. As interest rates fall, homeowners find it advantageous to refinance their homes at the lower rates. On the other hand, as interest rates rise the incentive to refinance diminishes, and prepayments tend to slow down. Since prepayment activity is such an important element in the evaluation of mortgage securities, a standard for comparison needed to be established. That standard is known as the PSA model.

PSA Model

The PSA (Public Securities Association) prepayment model is no more than a benchmark established for comparing mortgage prepayment rates. The model assumes that prepayment rates start at a 0.2% annualized rate for the first month after the mortgage is originated. Pre-payments continue to rise at a 0.2% annualized rate for the first 30 months and then level off at 6%. It makes sense that prepayments would be low in the first months after the mortgage is initiated since the homeowner is likely to be reluctant to immediately refinance. A mortgage security with prepayment rates in line with the PSA model are said to be prepaying "at 100% PSA". If a mortgage were prepaying at twice the level of the model, it is said to be "at a 200% PSA speed". Chart 2 provides an illustration of the actual PSA model.

Measuring maturity

The maturity of any bond is an important element in determining its value and applicability to a given investor. Unfortunately, measuring the maturity of a CMO is not as simple as measuring the maturity of a traditional "bullet" maturity bond. Since prepayment rates are likely to fluctuate, we can only estimate the maturity of CMOs. The principal methods used for measuring the maturity of CMO tranches are detailed below.

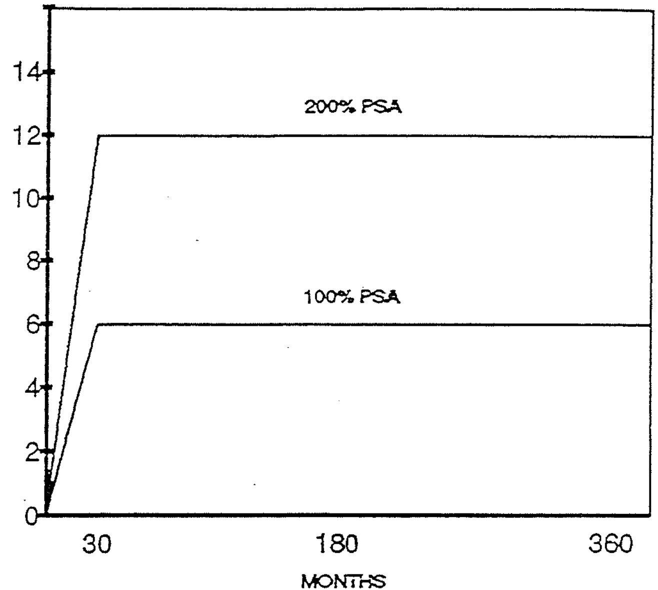
Average life

Average life is recognized as the standard measure for comparing the maturity of CMOs to other types of fixed income securities. Technically, average life is the weighted average time to receipt of all principal payments, based upon a certain prepayment speed assumption. It can be viewed simply as an estimated "average maturity" for the CMO tranche. Chart 3 provides an illustration which might be helpful in gaining a better understanding of the concept of average life. Note that the three securities in Chart 3 have vastly different maturity structures. Security 1 is typically referred to as a "bullet" maturity, which means that all principal is returned in a single payment. Securities 2 and 3 however, return principal over an extended period rather than on a single maturity date. Securities 2 and 3 differ because the principal returns for security 3 are distributed over a longer horizon than security 2 (5 years versus 2 years). All three securities have in common an average maturity or *average life* of 10 years. Average life is therefore the only acceptable method for accurately comparing two securities with vastly different maturity structures.

Chart 2

PSA prepayment model

Percent annual prepayment rate



Projected first principal repayment

Based upon the estimated prepayment speed, each CMO tranche will have a projected first principal return date. This is the date when principal is first projected to be returned to the tranche holder. This measure is important because it provides an estimate of when the partial returns of principal are likely to begin. Chart 3, on page 4, shows that the projected first principal repayment date for each security is different. Security 3 has the earliest projected first principal payment (8 years) while Security 1 has the latest (10 years).

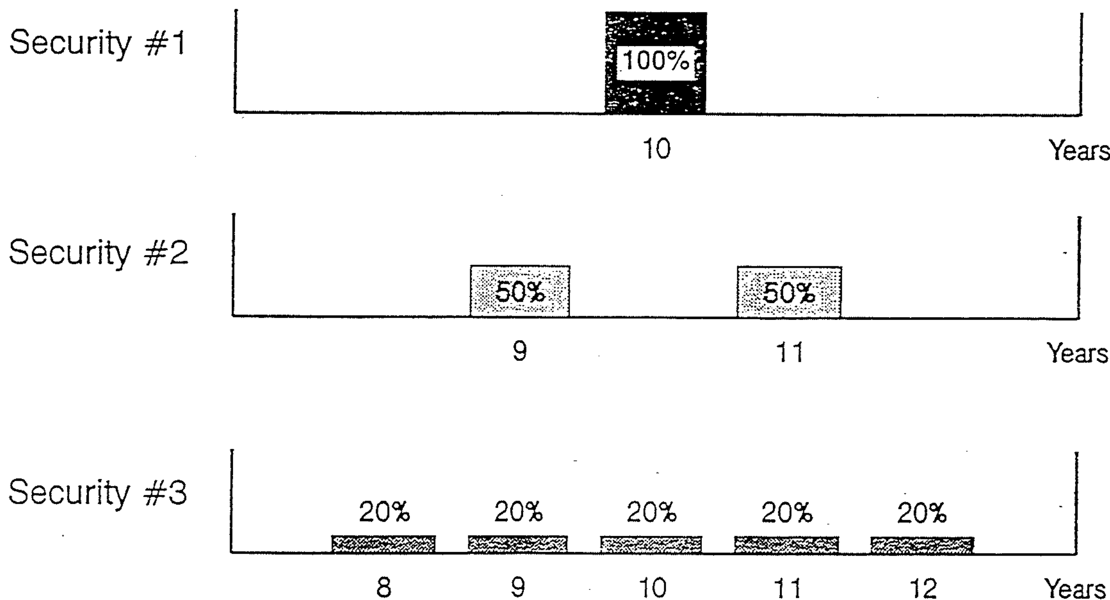
Projected final principal repayment

This is the projected date by which time all principal has been returned to the holder. This estimate is also important since it provides holders with an idea of when they'll have all their money back. As can be seen in Chart 3, security 3 has the latest projected final principal repayment date (12 years), while security 1 has the earliest (10 years).

Repayment window

The period between the first and final returns of principal is popularly referred to as the repayment window. The "window" is important because it provides the holder with an

Chart 3
Maturity structure comparisons



estimate of the potential dispersion of the principal repayments. A tight window is typically seen by most investors as more desirable. Therefore, those securities with wider repayment windows will generally offer higher yield premiums than identical securities with a tight window. Consideration must also be given to how sensitive the window is to any changes in prepayment rates.

Stated final maturity

The concept of the stated final maturity date is largely misunderstood by investors. This measure reflects the date when the final principal payment would be made *assuming there were no prepayments on the underlying collateral* (0% PSA speed). This is not a realistic assumption, since at least *some* mortgage holders are likely to prepay prior to the final maturity date. Stated final maturity is therefore not used as a maturity measure, but rather as an identification method for administrative and regulatory purposes.

The factor

Like any other mortgage security CMOs have a "factor" which represents the percentage of the original principal balance remaining. For example, a factor of .75 would mean that 75% of the original principal balance were remaining. If the investor had purchased $100,000 worth of a CMO tranche, he would have only $75,000 of the principal balance remaining. For non-current CMO tranches (those which are not yet receiving principal repayments) the factor remains 1.0. The factor will only change when principal is being returned to that tranche.

Types of issuers

There are two different types of organizations that originate CMOs: Government agencies and private financial institutions. *While there are substantial differences between the credit quality of a government agency and a private issuer, there is virtually no difference between the quality ratings of the CMOs each issues* . This is because the ratings are almost entirely dependent upon the quality of the underlying collateral, rather than quality of the actual issuer. The market will make little distinction between a CMO tranche backed by FNMA mortgage-backed securities which is issued directly by FNMA, versus one issued by a private institution. There are however certain institutional investors who may distinguish between the different issuers in order to comply with certain regulatory and capital requirements, or satisfy specific investment constraints.

Other structures

Up until this point our discussion of CMOs has been limited to the sequential pay "plain vanilla" tranche. There are however, a wide variety of CMO tranche structures that have been engineered to satisfy different clients needs. The following is a brief description of the characteristics of the different tranche structures, as well as an assessment of their principal benefits and risks.

Planned Amortization Class (PAC)

The PAC bond was developed to provide the holder with greater protection against prepayment risk. PAC bonds are designed to provide the holder with a predetermined schedule of principal returns as long as prepayments remain within a certain PSA range (commonly referred to as the *PAC band*). In other words, PAC bonds will behave in much

the same way as a sinking fund bond. As long as the prepayments remain within these PSA speed levels, the holder will not be subject to either contraction risk (a shortening of the average maturity) or extension risk (a lengthening of the average maturity). Consider for example a PAC bond which is initially priced with an assumed PSA speed of 150% and has a PAC band ranging from 75% PSA to 300% PSA. Even if the prepayments on the PAC bond had risen as high as the 250% level, or fallen as low as 90%, *the maturity schedule would not have changed*. Of course, should this band be breached, then the maturity schedule of the PAC bond would be likely to change. While PACs provide greater protection against prepayment risk than plain vanilla CMOs, they also offer the holder a lower yield premium over comparable Treasury bonds.

Targeted Amortization Class (TAC)

Like the PAC, TAC bonds were developed to provide the holder with greater protection from prepayment risk than the plain vanilla bond. TACs however, offer only "one-sided" protection. They protect the holder from exposure to contraction risk, but not from extension risk. TAC holders are exposed to the same levels of extension risk as plain vanilla bond holders. To put it quite simply, a TAC resembles a combination of half a PAC and half a plain vanilla bond. It provides the contraction risk of a PAC, and the extension risk similar to a plain vanilla tranche. Of course, like PAC bonds, the contraction risk protection is limited. If prepayments rise above a certain level, the TAC will also suffer maturity contraction. TACs will typically trade at higher yields than the more protective PAC bonds, but lower yields than plain vanilla.

Support class

The prepayment risk exposure which has been reduced for PAC and TAC holders, must be transferred to some other tranche in the CMO. Support classes (also known as companion classes), *absorb* this prepayment risk from PACs and TACs, and therefore have greater potential cash flow volatility. The maturity schedule of support class bonds are more sensitive to changes in prepayment rates than plain vanilla bonds. Support class holders are typically compensated for this increased prepayment risk with a higher yield premium.

Z-tranche

Deferred interest bonds (more popularly known as Z-bonds) behave like a combination of a zero coupon bond and a regular CMO tranche. During the first phase of the life of the z-tranche (accrual phase) the bond will provide no cash flow, and will instead compound at a set rate (like a zero coupon bond). The value of the z-tranche will continue to build through the accrual phase (as reflected by the increase in the factor). Once all other tranches have been retired, then principal and interest payments will flow to the z-tranche holder. The z-tranche typically has the longest average life of any tranche within the CMO deal. However, the investor must be aware that neither the accrual phase nor the payment phase follow any guaranteed maturity schedule. Changes in the prepayment rate will impact the maturity structure during both the accrual and payment phases of the z-tranche.

Real Estate Mortgage Investment Conduit (REMIC)

The REMIC was created in 1987 to provide both the issuers and investors greater flexibility under the The Tax Reform Act of 1986. REMICs are actually not a specific type of CMO tranche, but rather a special form of CMO deal structure. Since 1987 virtually all CMOs deals have been issued in the REMIC format. The terms REMIC and CMO are often used interchangeably, although technically they are not identical. While all REMICs are CMOs, not all CMOs are REMICs. The distinction is an important one for non-resident aliens. All REMICs are exempt from U.S. withholding tax, while non-REMIC CMOs may or may not be, depending upon when the deal was issued and how it was structured.

CMOs provide many attractive benefits

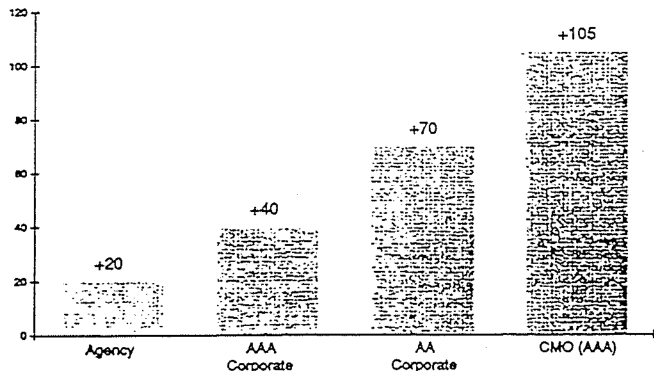
The creation of the CMO has broadened the mortgage market to include many investors who formerly could not participate. These securities provide value by offering a unique combination of investment benefits. Consider the principal benefits of investing in CMOs.

Credit quality: CMOs are among the safest of all fixed income securities in terms of their exposure to default risk. The high quality of the collateral (GNMA, FNMA and FHLMC), coupled with the protective trust structure enables these securities to attain the very highest investment grade rating (AAA).

Chart 4

Yield premium versus Treasuries (10 year average life)

Basis points



High yield: CMOs offer investors a substantial yield premium over comparable Treasury, Agency and Corporate bonds. Chart 4 provides an illustration of the yield advantage offered by CMOs in the 10 year maturity range. While Agency and AAA rated corporates provide between 20 and

40 basis points over the Treasury, CMOs offer more than an additional 100 basis points in yield. Even when compared to a weaker (AA) corporate bond, the CMO still offers about 35 basis points higher yield.

Maturity structure: CMOs provide different classes of bonds, with a wide range of maturity structures. This enables investors to participate in the mortgage market over the entire spectrum of the yield curve (short, intermediate and long term). Investors who had been precluded from participating in the mortgage market, have found CMO structures which satisfy their horizon needs.

Unique structures: The unique tranche structure enables the investor to control the level of prepayment risk exposure. PAC and TAC bonds provide the investor with valuable protection from prepayment risk. On the other hand, an investor with greater horizon flexibility may determine the higher yields offered by support tranches are worth the increased cash flow volatility. CMOs offer mortgage market participants the ability to control their own exposure to prepayment risk.

Payment frequency: Most CMO tranches provide the holder with monthly interest payments. Corporate, Treasury and Agency bonds on the other hand typically offer only semi-annual payments of interest. Income oriented buyers generally prefer the greater frequency of cash flows.

Event risk: CMOs are free from the default risk which has plagued the corporate bond market over the past decade. These securities are immune to the effects from LBOs, takeovers, corporate restructurings or credit downgrades.

Investors must also consider the risks

There are unique risk factors that make CMOs unsuitable for certain types of investors. The investor must keep in mind that these are still mortgage securities and bear many of the same risks of other mortgage issues.

Prepayment risk: Changes in the prepayment speeds of the underlying mortgage collateral will have a direct impact upon the maturity structure of the CMO tranches. An increase in prepayment speeds will lead to an acceleration in principal returns and a *contraction* in the average maturity, or average life. A drop in prepayments on the other hand will lead to a slow down in principal returns and an *extension* in the average life. Although certain CMO structures can limit prepayment risk exposure, it can never be completely eliminated. Of course, the vulnerability of an investor to either contraction or extension risk is dependent upon their investment horizon flexibility, as well as any reinvestment opportunities which might exist.

Liquidity risk: CMOs are created by "carving up" larger pools of mortgages. As these mortgages are sliced into smaller and smaller pieces to satisfy the needs of specific investor groups, liquidity suffers. The continued expansion of the CMO market should however, lead to enhanced liquidity in most tranche structures. Generally speaking, superior liquidity can be found in PACs and plain vanilla tranches. Agency deals tend to trade at slightly tighter spreads than private label issues, and larger tranches will tend to have better liquidity.

Interest rate risk: Like any other fixed income security, CMOs are exposed to interest rate risk. As interest rates rise, the value of the securities is likely to drop. Longer term tranches, z-bonds and support classes tend to have the greatest interest rate risk exposure.

Spread risk: The yield spreads between Treasury and mortgage securities fluctuate on a daily basis. If yield spreads on a CMO widen versus Treasuries, an investor seeking to liquidate a position could suffer a capital loss, even if the Treasury market is virtually unchanged.

Not a trading vehicle: Because of their exposure to prepayment risk, CMOs in general, are not an effective method for leveraging movements in interest rates. As interest rates fall, the average life of most CMOs will tend to contract since decling rates trend to prompt prepayments, thus limiting the upside return potential.

Complexity yes, but with a purpose

The payoff for coping with the more complex structure of CMOs is a unique opportunity for investors to capture high yield, yet still maintain strong credit quality. Because of their complexity relative to simple government, agency and corporate bonds, investors must familiarize themselves with the basics of CMOs.

Prices of companies mentioned as of 10/14/91:

Federal Home loan Mortgage* FRE $98
Federal National Mortgage Association* FNM $63

*PaineWebber Incorporated and/or Rotan Mosle Inc., an affiliated corporation of PaineWebber Incorporated, has acted in an investment banking capacity for this company.

As Amended by Senate Committee

Session of 1992

SENATE BILL No. 511

By Committee on Financial Institutions and Insurance

1-22

9 AN ACT concerning insurance; investments of insurance companies
10 ~~other than life~~; mortgage related securities; amending K.S.A.
11 1991 Supp. 40-2,138 and repealing the existing section; also re-
12 pealing K.S.A. 1991 Supp. 40-2,139.
13
14 *Be it enacted by the Legislature of the State of Kansas:*
15 New Section 1. Any insurance company other than life hereto-
16 fore or hereafter organized under any law of this state may invest
17 with the direction or approval of a majority of its board of directors
18 or authorized committee thereof, any of its funds, or any part thereof
19 in:
20 (a) Mortgage related securities issued or guaranteed by the fed-
21 eral home loan mortgage corporation and federal national mortgage
22 association but the amount invested in any one such issue shall not
23 exceed two percent of the admitted assets of the company as shown
24 by its last annual report or a more recent quarterly financial state-
25 ment filed with the commissioner of insurance;
26 (b) mortgage related securities issued by or in the name of any
27 private entity which are designated "1" or "2" by the national as-
28 sociation of insurance commissioners in their most recently published
29 valuations of securities manual or supplement thereto or are rated
30 investment grade by standard and poor's (at least BBB-) or moody's
31 (at least Baa3) at the time of acquisition. The investment in any one
32 such issue shall not exceed two percent of the admitted assets of
33 the company as shown by its last annual report or a more recent
34 quarterly financial statement filed with the commissioner of
35 insurance.
36 (c) For purposes of this section "mortgage related securities" shall
37 mean a security that either:
38 (1) Represents ownership of one or more promissory notes or
39 certificates of interest or participation in such notes (including any
40 rights designed to assure servicing of, or the receipt or timeliness
41 of receipt by the holders of such notes, certificates, or participations
42 of amounts payable under, such notes, certificates, or participations),
43 which notes:

the greater of $750,000 or

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1 (A) Are directly secured by a first lien on a single parcel of real
2 estate, including stock allocated to a dwelling unit in a residential
3 cooperative housing corporation, upon which is located a dwelling
4 or mixed residential and commercial structure, or on a residential
5 manufactured home as defined in U.S.C. §5402(6) of title 42, whether
6 such manufactured home is considered real or personal property
7 under the laws of the state in which it is to be located; and
8 (B) were originated by a savings and loan association, savings
9 bank, commercial bank, credit union, insurance company, or similar
10 institution which is supervised and examined by a federal or state
11 authority, or by a mortgagee approved by the secretary of housing
12 and urban development pursuant to U.S.C. §§1709 and 1715b of
13 title 12, or, where such notes involve a lien on the manufactured
14 home, by any such institution or by any financial institution approved
15 for insurance by the secretary of housing and urban development
16 pursuant to U.S.C. §1703 of title 12; or
17 (2) is secured by one or more promissory notes or certificates of
18 interest or participations in such notes (with or without recourse to
19 the issuer thereof) and, by its terms, provides for payments of prin-
20 cipal in relation to payments, or reasonable projections of payments,
21 on notes meeting the requirements of subparagraphs (1)(A) and (B)
22 or certificates of interest or participations in promissory notes meet-
23 ing such requirements.
24 For the purposes of this paragraph, the term "promissory note",
25 when used in connection with a manufactured home, shall also in-
26 clude a loan, advance, or credit sale as evidenced by a retail in-
27 stallment sales contract or other instrument; or
28 (3) involve offers or sales of one or more promissory notes directly
29 secured by a first lien on a single parcel of real estate upon which
30 is located a dwelling or other residential or commercial structure,
31 and participation interests in such notes:
32 (A) Where such securities are originated by a savings and loan
33 association, savings bank, commercial bank, or similar banking in-
34 stitution which is supervised and examined by a federal or state
35 authority, and are offered and sold subject to the following conditions:
36 (i) The minimum aggregate sales price per purchaser shall not
37 be less than $250,000;
38 (ii) the purchaser shall pay cash either at the time of the sale or
39 within 60 days thereof; and
40 (iii) each purchaser shall buy for such purchaser's own account
41 only; or
42 (B) where such securities are originated by a mortgagee approved
43 by the secretary of housing and urban development pursuant to

U.S.C. §§1709 and 1715b of title 12 and are offered or sold subject to the three conditions specified in subparagraph (3)(A) to any institution described in such subparagraph or to any insurance company subject to the supervision of the insurance commissioner, or any agency or officer performing like function, of any state or territory of the United States or the District of Columbia, or the federal home loan mortgage corporation, the federal national mortgage association, or the government national mortgage association.

Transactions between any of the entities described in subparagraph (3)(A) or (3)(B) involving nonassignable contracts to buy or sell the foregoing securities which are to be completed within two years, where the seller of the foregoing securities pursuant to any such contract is one of the parties described in subparagraph (3)(A) or (3)(B) who may originate such securities and the purchaser of such securities pursuant to any such contract is any institution described in subparagraph (3)(A) or any insurance company described in subparagraph (3)(B), the federal home loan mortgage corporation, federal national mortgage association, or the government national mortgage association and where the foregoing securities are subject to the three conditions for sale set forth in subparagraphs (3)(A)(i) through (iii).

New Sec. 2. Any life insurance company heretofore or hereafter organized under any law of this state may invest with the direction or approval of a majority of its board of directors or authorized committee thereof, any of its funds, or any part thereof in:

(a) Mortgage related securities issued or guaranteed by the federal home loan mortgage corporation and federal national mortgage association but the amount invested in any one such issue shall not exceed two percent of the admitted assets of the company as shown by its last annual report or a more recent quarterly financial statement filed with the commissioner of insurance;

the greater of $750,000 or

(b) mortgage related securities issued by or in the name of any private entity which are designated "1" or "2" by the national association of insurance commissioners in their most recently published valuations of securities manual or supplement thereto or are rated investment grade by standard and poor's (at least BBB-) or moody's (at least Baa3) at the time of acquisition. The investment in any one such issue shall not exceed two percent of the admitted assets of the company as shown by its last annual report or a more recent quarterly financial statement filed with the commissioner of insurance;

(c) for purposes of this section "mortgage related securities" shall mean a security that either:

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1 (1) Represents ownership of one or more promissory notes or
2 certificates of interest or participation in such notes (including any
3 rights designed to assure servicing of, or the receipt or timeliness
4 of receipt by the holders of such notes, certificates, or participations
5 of amounts payable under, such notes, certificates, or participations),
6 which notes:
7 (A) Are directly secured by a first lien on a single parcel of real
8 estate, including stock allocated to a dwelling unit in a residential
9 cooperative housing corporation, upon which is located a dwelling
10 or mixed residential and commercial structure, or on a residential
11 manufactured home as defined in U.S.C. §5402(6) of title 42, whether
12 such manufactured home is considered real or personal property
13 under the laws of the state in which it is to be located; and
14 (B) were originated by a savings and loan association, savings
15 bank, commercial bank, credit union, insurance company, or similar
16 institution which is supervised and examined by a federal or state
17 authority, or by a mortgagee approved by the secretary of housing
18 and urban development pursuant to U.S.C. §§1709 and 1715b of
19 title 12, or, where such notes involve a lien on the manufactured
20 home, by any such institution or by any financial institution approved
21 for insurance by the secretary of housing and urban development
22 pursuant to U.S.C. §1703 of title 12; or
23 (2) is secured by one or more promissory notes or certificates of
24 interest or participations in such notes (with or without recourse to
25 the issuer thereof) and, by its terms, provides for payments of prin-
26 cipal in relation to payments, or reasonable projections of payments,
27 on notes meeting the requirements of subparagraphs (1)(A) and (B)
28 or certificates of interest or participations in promissory notes meet-
29 ing such requirements.
30 For the purposes of this paragraph, the term "promissory note",
31 when used in connection with a manufactured home, shall also in-
32 clude a loan, advance, or credit sale as evidenced by a retail in-
33 stallment sales contract or other instrument; or
34 (3) involve offers or sales of one or more promissory notes directly
35 secured by a first lien on a single parcel of real estate upon which
36 is located a dwelling or other residential or commercial structure,
37 and participation interests in such notes:
38 (A) Where such securities are originated by a savings and loan
39 association, savings bank, commercial bank, or similar banking in-
40 stitution which is supervised and examined by a federal or state
41 authority, and are offered and sold subject to the following conditions:
42 (i) The minimum aggregate sales price per purchaser shall not
43 be less than $250,000;

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(ii) the purchaser shall pay cash either at the time of the sale or within 60 days thereof; and

(iii) each purchaser shall buy for such purchaser's own account only; or

(B) where such securities are originated by a mortgagee approved by the secretary of housing and urban development pursuant to U.S.C. §§1709 and 1715b of title 12 and are offered or sold subject to the three conditions specified in subparagraph (3)(A) to any institution described in such subparagraph or to any insurance company subject to the supervision of the insurance commissioner, or any agency or officer performing like function, of any state or territory of the United States or the District of Columbia, or the federal home loan mortgage corporation, the federal national mortgage association, or the government national mortgage association.

Transactions between any of the entities described in subparagraph (3)(A) or (3)(B) involving nonassignable contracts to buy or sell the foregoing securities which are to be completed within two years, where the seller of the foregoing securities pursuant to any such contract is one of the parties described in subparagraph (3)(A) or (3)(B) who may originate such securities and the purchaser of such securities pursuant to any such contract is any institution described in subparagraph (3)(A) or any insurance company described in subparagraph (3)(B), the federal home loan mortgage corporation, federal national mortgage association, or the government national mortgage association and where the foregoing securities are subject to the three conditions for sale set forth in subparagraphs (3)(A)(i) through (iii).

Sec. 3. K.S.A. 1991 Supp. 40-2,138 is hereby amended to read as follows: 40-2,138. Notwithstanding the provisions of section 106 of the secondary mortgage market enhancement act of 1984, P.L. 98-440 (15 U.S.C. 77r-1), the provisions of articles 2a and 2b of chapter 40 of the Kansas Statutes Annotated relating to the qualifications, limitations and kinds of investments that insurance companies domiciled in Kansas may purchase and hold shall apply ~~except as provided in K.S.A. 1991 Supp. 40-2,139~~.

Sec. 4. K.S.A. 1991 Supp. 40-2,138 and 40-2,139 are hereby repealed.

Sec. 5. This act shall take effect and be in force from and after its publication in the statute book.

Testimony by

Dick Brock, Kansas Insurance Department

Before the House Committee on Insurance

Senate Bill No. 520

Senate Bill No. 520 introduces limitations on the amount domestic insurers may invest in medium and lower grade obligations. Under the bill, those assigned an investment grade of 3 by the Securities Valuation Office of the National Association of Insurance Commissioners (NAIC) are designated as "medium grade obligations" and those assigned a 4, 5 or 6 investment grade by the NAIC are defined as "lower grade obligations". Although I know of no official definition or designation, it is bonds in this latter category that are often called "junk bonds".

The bill limits investment in medium and lower grade bonds to an amount equal to 20% of an insurer's admitted assets. However, the bill includes a sublimit of 10% of admitted assets on lower grade bonds. So in reality, the limit is either 20% on medium grade securities or 10% on medium grade bonds and 10% on lower grade or the so-called "junk" bonds. This latter 10% limit is further reduced by providing that no more than 3% of an insurer's admitted assets can be in obligations rated 5 or 6 and no more than 1% in bonds that are rated 6 by the NAIC.

Currently, a domestic insurer may invest in corporate bonds rated "1" or "2" by the NAIC or in any other corporate obligations which meet certain earnings tests at the time of the investment. In this category of investments or with respect to state or municipal bonds, foreign obligations and so forth, there currently is no limit on the extent of the investments. Senate Bill No. 520 will fill this void; however, subsequent to its enactment by the Senate, we became uncomfortable about the relationship of these limitations to the provisions in the investment code that permit a domestic insurer to invest up to 10% of its admitted assets in securities that may or may not be specifically permitted or described and regardless of any limitations or conditions that would

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otherwise apply. This provision is appropriately called the "leeway" or "basket" clause. In the case of medium and lower grade securities, much of the value of Senate Bill No. 520 would be lost if the limits prescribed therein could be circumvented through the leeway clause. Therefore, attached to my testimony is a proposed amendment which we believe makes it clear that the limits imposed by Senate Bill 520 are the only limits that apply to medium and lower grade securities.

Session of 1992

SENATE BILL No. 520

By Committee on Financial Institutions and Insurance

1-22

9 AN ACT relating to insurance; investments of insurance companies
10 organized under the laws of this state; limitations.
11
12 *Be it enacted by the Legislature of the State of Kansas:*
13 Section 1. As used in ~~sections 1 and~~ *section* 2 of this act:
14 (a) "Medium grade obligations" means obligations which are des-
15 ignated "3" by the national association of insurance commissioners
16 in its most recently published valuations of securities manual.
17 (b) "Lower grade obligations" means obligations which are des-
18 ignated "4", "5" or "6" by the national association of insurance com-
19 missioners in its most recently published valuations of securities
20 manual.
21 (c) "Admitted assets" means the amount shown on the insurer's
22 last annual report as filed with the state commissioner of insurance.
23 (d) "Aggregate amount" of medium grade and lower grade ob-
24 ligations means the aggregate statutory statement value thereof.
25 (e) "Institution" means a corporation, a joint-stock company, an
26 association, a trust, a business partnership, a business joint venture
27 or similar entity.
28 (f) "Insurance company" or "insurer" means an insurance com-
29 pany other than life organized under the laws of this state.
30 Sec. 2. (a) No insurance company shall acquire, directly or in-
31 directly, any medium grade or lower grade obligation of any insti-
32 tution if, after giving effect to any such acquisition, the aggregate
33 amount of all medium grade and lower grade obligations then held
34 by such insurer would exceed 20% of its admitted assets. Within
35 this limitation no more than 10% of its admitted assets shall consist
36 of lower grade obligations; no more than three percent of its admitted
37 assets shall consist of obligations designated "5" or "6" in the val-
38 uations of securities manual; and, no more than one percent of its
39 admitted assets shall consist of obligations designated "6" in the
40 valuations of securities manual. Attaining or exceeding the limit of
41 any one category shall not preclude an insurer from acquiring ob-
42 ligations in other categories subject to the specific and multi-category
43 limits.

(b) No insurer organized under the laws of this state may invest more than one percent of its admitted assets in medium grade obligations issued, guaranteed or insured by any one institution nor may it invest more than one-half of one percent of its admitted assets in lower grade obligations issued, guaranteed or insured by any one institution. In no event, shall such insurer invest more than one percent of its admitted assets in any medium or lower grade obligations issued, guaranteed or insured by any one institution.

(c) Nothing contained in this act shall prohibit an insurer from acquiring any obligations which it has committed to acquire if the insurer would have been permitted to acquire that obligation pursuant to this act on the date on which such insurer committed to purchase that obligation.

(d) Notwithstanding the limitations of subsection (b) an insurer may acquire an obligation of an institution in which the insurer already has one or more obligations, if the obligation is acquired in order to protect an investment previously made in the obligations of the institution, except all such acquired obligations shall not exceed one-half of one percent of the insurer's admitted assets.

(e) Nothing contained in this act shall prohibit an insurer to which this act applies from acquiring an obligation as a result of a restructuring of a medium or lower grade obligation already held or require such insurer to sell or otherwise dispose of any obligation legally acquired prior to the effective date of this act.

(f) Nothing contained in this act shall permit or be construed as permitting an insurer to exceed, alter or otherwise circumvent any of the limitations or restrictions applicable to the investments authorized by K.S.A. 40-2a01 *et seq.* and amendments thereto.

(g) Notwithstanding the provisions of K.S.A. 40-2a16, the total investment in medium and lower grade securities shall not exceed the limitations set forth in subsection (a) of this section.

~~(g)~~ (h) The board of directors of any insurance company organized under the laws of this state which acquires or invests, directly or indirectly, more than two percent of its admitted assets in medium grade and lower grade obligations, shall adopt a written plan for the making of such investments. The plan, in addition to guidelines with respect to the quality of the issues invested in, shall contain diversification standards acceptable to the commissioner which may include, but not be limited to, standards for issuer, industry, duration, liquidity and geographic location.

Sec. 3. As used in section 4 of this act:

(a) "Medium grade obligations" means obligations which are designated "3" by the national association of insurance commissioners in its most recently published valuations of securities manual.

(b) "Lower grade obligations" means obligations which are designated "4", "5" or "6" by the national association of insurance

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1 *commissioners in its most recently published valuations of securities*
2 *manual.*
3 *(c) "Admitted assets" means the amount shown on the insurer's*
4 *last annual report as filed with the state commissioner of insurance.*
5 *(d) "Aggregate amount" of medium grade and lower grade ob-*
6 *ligations means the aggregate statutory statement value thereof.*
7 *(e) "Institution" means a corporation, a joint-stock company, an*
8 *association, a trust, a business partnership, a business joint venture*
9 *or similar entity.*
10 (f) "Insurance company" or "insurer" means any life insurance
11 company organized under the laws of this state.
12 Sec. 4. (a) No insurance company shall acquire, directly or in-
13 directly, any medium grade or lower grade obligation of any insti-
14 tution if, after giving effect to any such acquisition, the aggregate
15 amount of all medium grade and lower grade obligations then held
16 by such insurer would exceed 20% of its admitted assets. Within
17 this limitation no more than 10% of its admitted assets shall consist
18 of lower grade obligations; no more than three percent of its admitted
19 assets shall consist of obligations designated "5" or "6" in the val-
20 uations of securities manual; and, no more than one percent of its
21 admitted assets shall consist of obligations designated "6" in the
22 valuations of securities manual. Attaining or exceeding the limit of
23 any one category shall not preclude an insurer from acquiring ob-
24 ligations in other categories subject to the specific and multi-category
25 limits.
26 (b) No insurer organized under the laws of this state may invest
27 more than one percent of its admitted assets in medium grade ob-
28 ligations issued, guaranteed or insured by any one institution nor
29 may it invest more than one-half of one percent of its admitted assets
30 in lower grade obligations issued, guaranteed or insured by any one
31 institution. In no event, shall such insurer invest more than one
32 percent of its admitted assets in any medium or lower grade obli-
33 gations issued, guaranteed or insured by any one institution.
34 (c) Nothing contained in this act shall prohibit an insurer from
35 acquiring any obligations which it has committed to acquire if the
36 insurer would have been permitted to acquire that obligation pur-
37 suant to this act on the date on which such insurer committed to
38 purchase that obligation.
39 (d) Notwithstanding the limitations of subsection (b), an insurer
40 may acquire an obligation of an institution in which the insurer
41 already has one or more obligations, if the obligation is acquired in
42 order to protect an investment previously made in the obligations
43 of the institution, except that all such acquired obligations shall not

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1 exceed one-half of one percent of the insurer's admitted assets.
2 (e) Nothing contained in this act shall prohibit an insurer to which
3 this act applies from acquiring an obligation as a result of a restruc-
4 turing of a medium or lower grade obligation already held or require
5 such insurer to sell or otherwise dispose of any obligation legally
6 acquired prior to the effective date of this act.
7 (f) Nothing contained in this act shall permit or be construed as
8 permitting an insurer to exceed, alter or otherwise circumvent any
9 of the limitations or restrictions applicable to the investments au-
10 thorized by K.S.A. 40-2b01 *et seq.* and amendments thereto.
11 ~~(g)~~ The board of directors of any insurance company organized
12 under the laws of this state which acquires or invests, directly or
13 indirectly, more than two percent of its admitted assets in medium
14 grade and lower grade obligations, shall adopt a written plan for the
15 making of such investments. The plan, in addition to guidelines with
16 respect to the quality of the issues invested in, shall contain diver-
17 sification standards acceptable to the commissioner which may in-
18 clude, but not be limited to, standards for issuer, industry, duration,
19 liquidity and geographic location.
20 Sec. 5. This act shall take effect and be in force from and after
21 its publication in the statute book.

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(g) Notwithstanding the provisions of K.S.A. 40-2b13, the total investment in medium and lower grade securities shall not exceed the limitations set forth in subsection (a) of this section.

(h)

Testimony by

Dick Brock, Kansas Insurance Department

Before the House Committee on Insurance

Senate Bill No. 517 as Amended by Senate Committee

Senate Bill No. 517 relates to what are commonly called "surplus notes". These are notes evidencing a loan to a mutual property and/or casualty insurer which can be repaid only from the surplus of the company and only with the approval of the Commissioner of Insurance. Because of this limitation on repayment, the statute provides that such loans shall not be a liability so this is a way a mutual insurance company can increase its surplus and add to or maintain its growth other than through its capacity to produce net earnings. Therefore, it is a particularly valuable vehicle when a mutual insurer incurs very significant and unanticipated losses through a sudden deterioration in investment values or, as is more frequently the case and certainly occurred in 1991 in Kansas, multiple catastrophic storms produce huge underwriting losses. When such losses create a substantial loss in surplus the ability of the mutual insurer to continue to serve its members is severely impaired because the surplus must be sufficient to support the exposure represented by the amount of premium it writes. Thus, an insurer may have what sounds like a huge surplus e.g. 60-100 million -- even more -- yet, in relation to the risk it has assumed under its insurance contracts the surplus may be inadequate or at least inadequate to support future growth. It is in these kinds of circumstances that the ability to borrow from an affiliate, another insurer or some other source without creating a liability is a useful and reasonable means of addressing the problem.

The current statute, K.S.A. 40-1209, has not been amended since 1939 so the 5% interest currently allowed has been the same for more than 50 years and it could be even longer than that. This doesn't mean the provision hasn't been used because it has but given the limitations on repayment of surplus notes it is only reasonable that the allowable interest rate be somewhat more consistent with current conditions. For

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this reason, Senate Bill No. 517 proposes to replace the current 5% interest rate with a variable rate. In developing the proposal, we reviewed other Kansas laws which provide for variable interest rates and the provisions in K.S.A. 16-207 relating to real estate seemed to produce a reasonable basis. Using this base also has the advantage of a readily available rate because the Secretary of State is required to publish the interest rate produced by the K.S.A. 16-207 formula each month. The rate for January appears in the January 9 issue of the Kansas Register and the rate is 9.60% -- for December 1991, it was 10.19%. Senate Bill 517 provides for some modification of this rate because even though we believe the anticipated interest on a surplus note should be sufficiently adequate to attract the financing, we don't believe it should be so attractive that an active market for surplus notes develops. Therefore, Senate Bill 517 provides that the rate shall be 1 1/2 percentage points less than the rate published by the Secretary of State. Consequently, a surplus note issued in February 1992 would be issued at a maximum rate of 8.1% -- a surplus note issued in January 1992 would be issued at a maximum rate of 8.69%.

New Section 2 of Senate Bill 517 simply makes the same surplus note provisions applicable to mutual fire and tornado companies. These are what we used to know as "county mutuals". We only have one such mutual left in Kansas but this authority might be useful to it at some point. Therefore, while the subject was open to legislative consideration, we included this authority in our proposal.

The Senate Committee amendments were corrective changes made at the request of the Department to reflect our original intent.

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Testimony by

Dick Brock, Kansas Insurance Department

Before the House Committee on Insurance

Senate Bill No. 519

Senate Bill 519 addresses a new and growing practice of a person, or organization paying a lump sum to a life insurance policyholder in an amount equal to some percentage of the expected benefits under a life insurance policy in exchange for that person or organization being named as the beneficiary under the policy.

Currently, this can be done by anyone from anywhere without any standards, disclosure or any other restrictions on the transaction. The practice first became visible in New Mexico 2 or 3 years ago, has since spread to California and, because the Insurance Department has received a specific inquiry from a firm engaged in this activity, is obviously an expanding business.

We have received no complaints from policyholders and beneficiaries and we don't want to infer that by proposing Senate Bill No. 519 we believe the activity is inherently bad. In fact, it can be advantageous in some situations as evidenced by the 1990 legislative action which permits life insurance companies to include accelerated benefit provisions in their Kansas policies. Given the relatively recent development of this activity, I suspect the vast majority, perhaps even all, the organizations currently engaged in this business are doing so with the utmost of good faith and fairness. Nevertheless, when a particular activity is directed solely toward elderly and terminally ill people, the chances for abuse are high and become higher as more and more entrepreneurs become aware of it.

We will be the first to admit that we don't know exactly what should be done. California has enacted legislation requiring the persons and firms involved in this business to register and file a description of their operations with the Insurance Department. From that information, the California department plans to develop what they hope will be practical

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and effective consumer safeguards. The National Association of Insurance Commissioners has a working group addressing the subject but no recommendations have yet been developed or adopted. Nevertheless, we don't believe we should wait until some Kansas citizen is deprived of what may be one of their most significant assets before we at least address the potential problem.

As originally introduced Senate Bill No. 519 was a minimal measure that would not have unduly interfered with completion of a legitimate transaction but would hopefully (1) make another interested party aware of the transactions and (2) provide the policyholder a 3 day "cooling off" period during which they could cancel the sale.

As is obvious by the amendments, the Senate Committee on Financial Institutions and Insurance did not believe the original bill went far enough. Frankly, we didn't either but, because we knew so little about these arrangements, we were simply seeking some means of providing at least some measure of protection to Kansas citizens until more information was available. The Senate Committee believed we should be more aggressive in terms of acquiring additional information while at the same time imposing significant consumer protection measures. Accordingly, the bill was amended to require persons transacting this business to be licensed by the Commissioner of Insurance; file details of the contracts, discount rates and other operative documents with the Commissioner; give policyowners who enter into such arrangements 15 days to rescind the contract; and provide certain information to the policyowner including notice of the 15 day right of recision. These amendments parallel requirements enacted in California.

The Department strongly supports the bill as amended and respectfully requests your favorable consideration.

STATE OF KANSAS

TOPEKA

SENATE CHAMBER
STATE CAPITOL
TOPEKA, KANSAS 66612
(913) 296-7362

AUGUST BOGINA, JR., P.E.
SENATOR, TENTH DISTRICT
JOHNSON COUNTY
5747 RICHARDS CIRCLE
SHAWNEE, KS 66216

COMMITTEE ASSIGNMENTS
CHAIRMAN: WAYS AND MEANS
VICE CHAIR: GOVERNMENTAL ORGANIZATION
MEMBER: FINANCE COUNCIL
LEGISLATIVE POST AUDIT

March 23, 1992

Discussion SB 491

Mr. Chairman and Members of the Committee, the subject matter of SB 491 as amended is intended to correct a problem that probably does not arise very often, but when it does, the results could be disastrous. In order to explain the problem, I will relate an actual experience.

In March of 1989, a company paid the premium and four partners completed application forms for life insurance on each of the partners. Subsequently, the insurance company requested a physical examination of one of the applicants. After the examination, neither the company who owned the policies or the partners heard anything from either the Agent or the Company. It was assumed the policies were in force. Shortly before the partner who was requested to have the physical examination passed away on November 9, 1989, the Agent attempted to deliver a check from the insurance company for the amount of the premium for that one policy. He stated that the policy had been denied approximately 8 months before his appearance. The check was void because of age and not accepted (printed on the check "Void after 6 months"). Neither the owner of the policy, the company, or the insured, the partner, were informed of the denial prior to that time.

The Insurance Company claimed that they informed the Agent about the denial, therefore they had no responsibility in the matter. Further the Insurance Company contended that the Independent Agent was the responsibility of the policy owner and not the Insurance company. This unknown development caused the fulfillment of the partnership "Buy-Sell" agreement considerable compliance problems. In case it is of interest, the deceased was Charles Fyock of the Company Bogina, Fyock, Hawley & Urkevich.

The bill would require that the Insurance Company notify the applicant of the refusal of a policy and return the premium. You will note the great difference between the proposed notification and that which occurred in 1989 when the agent notified the applicant and insured eight months after an alleged denial. I believe proper notification is essential.

The bill also indicates that an Independent Agent is an employee of the Insurance Company and not of the applicant or insured.

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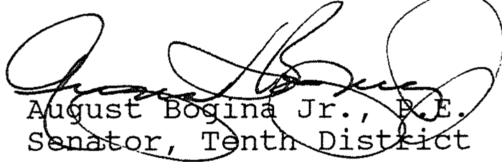
This amended bill may seem simplistic and common sense, but I assure you, these issues are currently interpreted by at least one Insurance Company and Independent Agent in a manner as described herein.

Thank you for consideration of these bills. Although not an expert in insurance matters, I am available to answer questions.

Respectfully submitted,



August Bogina Jr., P.E.
Senator, Tenth District

MEMORANDUM

TO: Representative Larry Turnquist
Chairman, House Insurance Committee

FROM: William W. Sneed
American Investors Life Insurance Company

DATE: March 19, 1992

RE: Senate Bill 491

Mr. Chairman, Members of the Committee: My name is Bill Sneed and I represent American Investors Life Insurance Company. In that capacity, I am here as a proponent of S.B. 491.

On behalf of my client, I have worked with various members of the insurance industry, the Kansas Insurance Department, members of the Senate Committee and, of course, the bill's sponsor. S.B. 491 was amended by the Senate, and the result thereafter still provides the safeguards that the bill's sponsor was attempting to address.

These amendments place specificity on the general topic that is encompassed in S.B. 491. In an attempt to make certain that all parties, the insurer and the insured, know their exact responsibilities, the Senate expanded S.B. 491 to specifically itemize what should be encompassed for a conditional receipt that is commonly issued when a life insurance product is sold. Inasmuch as it benefits both parties to issue these temporary policies during the underwriting process, we believe it is equally important to itemize the specific issues so that hopefully there will be no confusion on behalf of either party when this transaction occurs.

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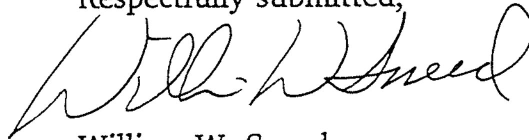
It was not our intent to water down S.B. 491, but to add specificity to it. Thus, I will be happy to discuss the specific items, but generally speaking, they are items that are commonly utilized during temporary insurance while underwriting occurs. Further, we have tied this bill into current law, K.S.A. 40-2,111, which is commonly referred to as the "adverse underwriting statute." By utilizing the current law, we have effectually established the procedure companies will have to utilize during the underwriting process, and at the same time guaranteed the insured the protection that he or she may believe has been currently purchased.

I appreciate the opportunity to present this to the Committee and respectfully request that S.B. 491 be favorably passed as amended. If you have any questions in the interim, please feel free to contact me.

Respectfully submitted,



William W. Sneed