

Approved February 4, 1992

Date

MINUTES OF THE SENATE COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURANCE

The meeting was called to order by SENATOR RICHARD L. BOND at  
Chairperson

9:10 a.m./~~p.m.~~ on Tuesday, January 28, 1992 in room 529-S of the Capitol.

~~All~~ members ~~were~~ present ~~except~~

Senators Bond, Francisco, Kerr, McClure, Moran, Parrish, Salisbury, Strick, Ward and Yost.

Committee staff present:

Fred Carman, Revisor  
Bill Wolff, Research  
June Kossover, Secretary

Conferees appearing before the committee:

Richard Brock, Insurance Department

The meeting was called to order by Chairman Bond at 9:10 a.m.

A motion was made by Senator Strick and seconded by Senator Yost to approve the minutes of the meeting of January 22, 1992, as submitted. The motion carried.

Chairman Bond announced that at today's meeting, the committee will hear Senate Bills 511, 517 and 520. Senate Bills 519, 518 and 509 will be heard on Wednesday, January 29, 1992. SB 510 will be heard at a later date.

Hearing on SB 511, An act concerning investments of insurance companies; mortgage related securities:

Dick Brock, Kansas Insurance Department, appeared before the committee in support of SB 511. (Attachment No. 1.) He advised the committee that SB 511 is a sequel to HB 2441, which was enacted by the 1991 Legislative Session. SB 511 represents the results of a review of investment opportunities to determine if they met the standards of investment quality and concentration limitations which generally apply to permissible investments of domestic insurers. This bill does not expand on what companies can do under federal law. In response to a question by Chairman Bond, Mr. Brock explained that the language originated with the Insurance Department, but duplicates federal law describing investments of insurance companies.

There being no other conferees, Chairman Bond declared the hearing closed on SB 511. A motion was made by Senator Strick to move SB 511 favorably. The motion was seconded by Senator McClure. The motion carried. Senator Strick agreed to carry SB 511.

SB 517 An act concerning advance of money to certain insurance companies; interest thereon:

Dick Brock, Kansas Insurance Department, appeared before the committee to testify in support of SB 517. (Attachment number 2.) This bill relates to what are commonly called "surplus notes." These notes can be repaid only from the surplus of a company and only with the approval of the Commissioner of Insurance. This bill would raise the maximum interest rate on surplus notes from a fixed rate to a variable rate: 1 1/2 percentage points less than the rate produced by the K.S.A. 16-207 formula, published by the Secretary of State each month. Neither interest or principal can be paid except out of surplus funds and with the approval of the Insurance Commissioner. Section two (2) extends the same authority to mutual fire and tornado companies. In response to a question by Chairman Bond, Mr. Brock explained that the only security for a surplus note would be the belief that the company would grow and that the loan would be repaid. The loan cannot be counted as a liability by the company; nor can the lender treat the note as an asset.

CONTINUATION SHEET

MINUTES OF THE SENATE COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURANCE,  
room 529-S, Statehouse, at 9:10 a.m./~~p.m.~~ on Tuesday, January 28, 1992, 19    

Senator Ward asked what type company would make such a loan. Mr. Brock responded that it might be another insurance company interested in expanding in Kansas or an affiliate investing to increase the company's surplus.

Fred Carman, of the Revisor's Office, questioned the wording "...any other person." Mr. Brock explained that the language was intended to avoid limiting to persons connected to the company.

Senator Parrish questioned the wording in the clarifying amendment proposed by the Insurance Department, specifically, "...no interest thereon shall be paid." Mr. Brock stated that the change was inserted to give the Insurance Commissioner specific authority.

Senator Ward questioned how this would be indicated on the company's records. Mr. Brock responded that it would show up in Surplus Funds.

There being no other conferees and no further questions, Chairman Bond declared the hearing on SB 517 to be closed. A motion was made by Senator Parrish and seconded by Senator Kerr to adopt the amendment to SB 517. The motion carried.

Senator Parrish made a motion to move SB 517 favorably. Senator Kerr seconded the motion and the motion carried. Senator Nancy Parrish agreed to carry SB 517.

SB 520 An act relating to investments of insurance companies organized under the laws of this state; limitations:

Mr. Richard Brock, Kansas Insurance Department, appeared before the committee in support of SB 520. (Attachment no. 3) SB 520 places certain limits on the amount domestic insurers may invest in medium and lower grade bonds, state or municipal bonds, and foreign obligations. This bill is from the NAIC model, which is based on a New York regulation.

Mr. Carman explained the technical corrections that need to be made to the bill.

Senator Moran asked whether this bill would require divesting any bonds and Mr. Brock responded that no investments made legally would have to be divested.

Since there were no further questions and no other conferees, Chairman Bond declared the hearing on SB 520 closed.

A motion was made by Senator Salisbury to move the bill favorably as amended. The motion was seconded by Senator Moran; the motion carried. SB 520 will be carried by Senator Moran.

The committee adjourned at 10:50 a.m.



Testimony by  
Dick Brock, Kansas Insurance Department  
Before the Senate Financial Institutions and Insurance Committee  
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

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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 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.

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.

## 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

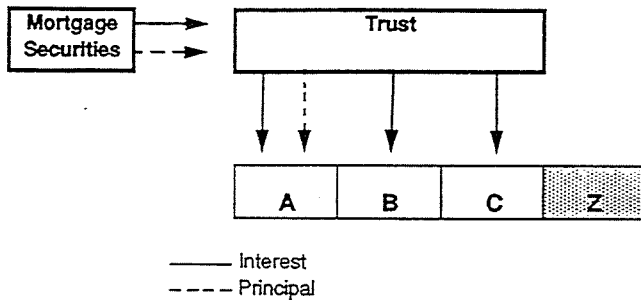
The collateral (described in the next section) is placed into a protective trust structure when the CMO is originated. The key function of the trust from the investors viewpoint is to maintain the credit quality of the CMO by protecting the integrity of the collateral underlying the bonds. The trust 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.

1-4

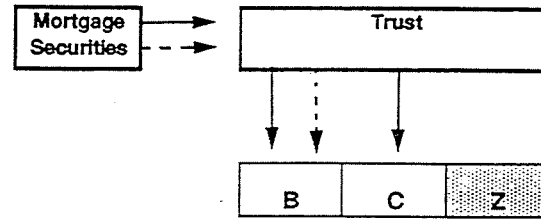
Chart 1

## 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. GNMA's 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 GNMA's. 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.

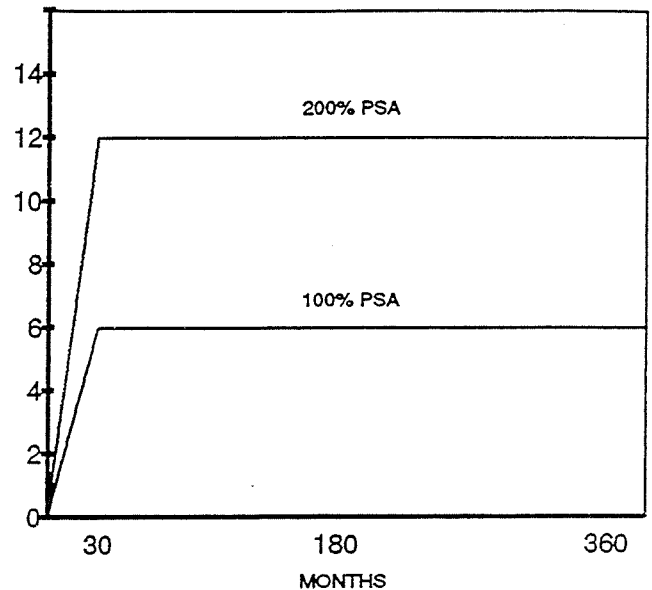
**Measuring maturity**

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

Chart 2  
PSA prepayment model  
Percent annual prepayment rate



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.

**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**

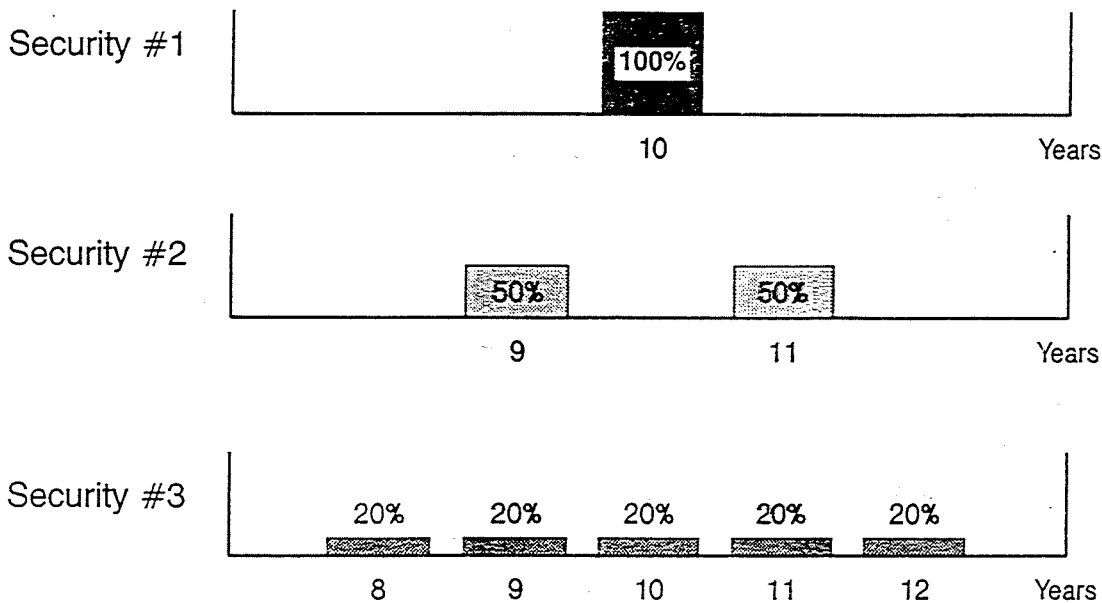
This is the projected date by which time all principal has been returned to the holder. This estimate is also important since it provides holders with an idea of when they'll have all their money back. As can be seen in Chart 3, security 3 has the latest projected final principal repayment date (12 years),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

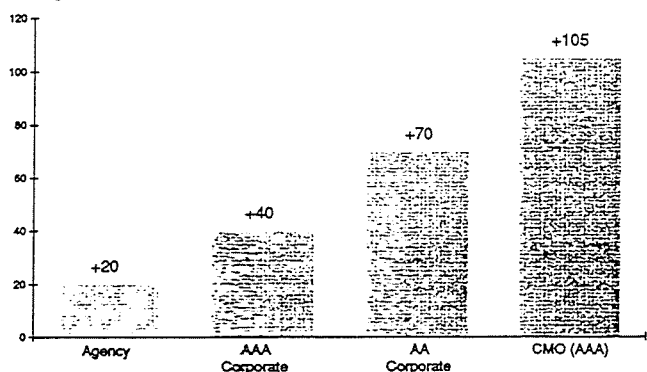
The creation of the CMO has broadened the mortgage market to include many investors who formerly could not participate. These securities provide value by offering a unique combination of investment benefits. Consider the principal benefits of investing in CMOs.

**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 elimi-

nated. 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 declining rates tend 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.

Testimony by  
Dick Brock, Kansas Insurance Department  
Before the Senate Financial Institutions and Insurance Committee  
Senate Bill No. 517

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.

# SENATE BILL No. 517

By Committee on Financial Institutions and Insurance

1-22

8 AN ACT concerning insurance; advance of money to certain insur-  
9 ance companies; interest thereon; amending K.S.A. 40-1209 and  
10 repealing the existing section.

11 *Be it enacted by the Legislature of the State of Kansas:*

12 Section 1. K.S.A. 40-1209 is hereby amended to read as follows:  
13 40-1209. Any director, officer or member of any such company, or  
14 any other person, may advance to such company any sum or sums  
15 of money necessary for the purposes of its business or to enable it  
16 to comply with any of the requirements of the laws of this state,  
17 and such moneys and such interest thereon as may have been agreed  
18 upon, not exceeding ~~five percentum per annum~~, shall an amount  
19 equal to 1 1/2 percentage points below the maximum rate of interest  
20 prescribed by subsection (b) of K.S.A. 16-207 and amendments  
21 thereto for real estate transactions. The rate of interest to be applied  
22 to any specific certificate of indebtedness shall be calculated using  
23 the most immediate prior month's usury rate published by the sec-  
24 retary of state in the Kansas register, ~~shall, with the approval of~~  
25 ~~the commissioner,~~ be payable only out of the surplus remaining after  
26 providing for all reserves and other liabilities, and shall not otherwise  
27 be a liability or claim against the company or any of its assets. No  
28 commission or promotion expenses shall be paid in connection with  
29 the advance of any such money to the company, and the amount of  
30 such advance shall be reported in each annual statement: *Provided,*  
31 *however,* ~~That~~ Such certificates of indebtedness shall not be issued  
32 nor retired without the approval of the commissioner of insurance  
33 who must be satisfied that all requirements of the law have been  
34 met.  
35

36 New Sec. 2. Any mutual fire and tornado insurance company  
37 organized under the laws of this state pursuant to K.S.A. 40-1001  
38 *et seq.* and amendments thereto may accept advances of money and  
39 issue certificates of indebtedness thereon subject to the terms and  
40 conditions prescribed by K.S.A. 40-1209 and amendments thereto.

41 Sec. 3. K.S.A. 40-1209 is hereby repealed.

42 Sec. 4. This act shall take effect and be in force from and after  
43 its publication in the Kansas register.

. The sum or sums of money advanced pursuant to this authorization and any interest thereon shall

Delete

and no interest thereon shall be paid

2-3

Testimony by  
Dick Brock, Kansas Insurance Department  
Before the Senate Financial Institutions and Insurance Committee  
Senate Bill No. 520

As Commissioner Todd noted when he requested this committee to consider the introduction of this proposal, Senate Bill No. 520 would introduce 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 difference between the medium and lower grade categories is particularly significant because of a question raised when Senate Bill 520 was being considered for introduction. Specifically, the bill limits investment in medium and lower grade bonds to an amount equal to 20% of its admitted assets and the question was raised as to how this limitation was derived. Kansas served on the NAIC task force which developed this recommendation and, as I mentioned at the time, I believed the task force used this number because New York chaired the task force and New York had already adopted a regulation which uses this percentage limitation. However, in reviewing our files on the subject, I find there was much more involved. While the New York regulation was used as a starting point, it was adopted prior to a re-rating of all corporate bonds in 1990 by the NAIC which resulted in a number of bonds falling into the medium or lower grade categories even though they had previously enjoyed a higher rating. Therefore, an argument was made that, in order to maintain the same relative level of investments as existed prior to the re-rating, the limit on medium grade bonds should be 35%. This argument was buttressed somewhat by the fact that Illinois enacted legislation in

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1990 which set the cap at 35% for all bonds rated 3 or below. However, a more persuasive argument arose from the fact that medium grade obligations "... represent traditional, high-quality credits and are not the marginal, overly leveraged securities that the public and the popular press label junk" according to the executive director of the NAIC's Securities Valuation Office. The file also reveals information attributed to First Boston Corporation that between 1986 and 1990, medium grade bonds provided net returns of 13.8% annually including a return of 7.5% in 1990. Despite these and other arguments, the task force retained and the NAIC adopted the overall limitation of 20%.

However, as you will note, the bill includes a sublimit of 10% of admitted assets on lower grade bonds. So in reality, the limit is 10% on the so-called "junk" 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 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. However, in this category of investments or with respect to state or municipal bonds, foreign obligations and so forth, there is no limit on the extent of the investments. Senate Bill No. 520 will fill this void.