

MINUTES OF THE HOUSE COMMITTEE ON INSURANCE.

The meeting was called to order by Chairperson Rep. Robert Tomlinson at 3:30 p.m. on March 1, 2001 in Room 527-S of the Capitol.

All members were present except: Representative John Edmonds
Representative Nancy Kirk
Representative Carlos Mayans
Representative Ralph Ostmeyer

Committee staff present: Bill Wolff, Legislative Research
Ken Wilke, Legislative Revisor
Mary Best, Committee Secretary

Conferees appearing before the committee: Mr. Tom Swank, Security Benefit Group
Mr. Dan Gaskill, Kansas Insurance Department

Others attending: See Attached Guest List

Today's meeting was a hearing on **HB 2473** - Life Insurance companies; relating to replication transactions. Mr. Tom Swank, Security Benefit Life Insurance Company, offered Proponent Testimony to the committee. A copy of the testimony is (Attachment #1) attached hereto and incorporated into the Minutes by reference. Mr. Swank explained that the bill allows Kansas domiciled insurers additional flexibility in managing their investment portfolios. He explained that Insurance Companies have two ways to gain exposure to an access to index, and covered these ways with the committee. He explained the direction the companies wanted to go and the main points. Mr. Swank's handout included material from Merrill Lynch and Hehman Brothers on insurance strategies. Mr. Swank stood for questions. Questions were asked by Chairman Tomlinson, Representatives Huy, Sharp, Phelps. Rebecca Wempe, assisted Mr. Swank in answering the questions.

Mr. Don Gaskill, Kansas Insurance Department, was the next conferee to give Proponent Testimony to the committee. A copy of the testimony is (Attachment #2) attached hereto and incorporated into the Minutes by reference. Mr. Gaskill confirmed the testimony given by Mr. Swank. Mr. Gaskill spoke of an amendment which only Rebecca Wempe had a copy. Ms. Wempe shared the amendment with the committee and explained it carried a new section on definitions, Section A (14) inserting new definition of financial instrument transaction. Section E - paragraph 3 now 4 and explained this new section. As there were no copies, and there appeared to be a language problem, further testimony ceased on this subject.

Written testimony only was submitted by Mr. Bill Sneed on behalf of AmVestors supporting the bill. A copy of the bill is (Attachment #3) attached hereto and incorporated into the Minutes by reference.

With no further testimony or discussion the meeting was adjourned. The time was 4:00. p.m.

The next meeting will be March 6th.

Memo

Date: March 1, 2001
To: Members of the House Insurance Committee
From: Thomas A. Swank
Senior Vice President and Chief Investment Officer
Security Benefit Life Insurance Company
Subj: House Bill 2473 - Replication

Mr. Chairman, members of the Committee, my name is Tom Swank and I am pleased to appear before you today on behalf of Security Benefit Life Insurance Company ("Security Benefit").

Security Benefit is a Kansas life insurance company located in Topeka, Kansas with approximately \$10 billion in assets under management. Security Benefit offers fixed and variable annuities, money management services, retirement plans and, through its subsidiary broker/dealer, Security Distributors, Inc., a family of mutual funds. The Security Benefit Group of Companies employs approximately 625 individuals in Kansas.

The financial markets are constantly changing. The purpose of House Bill 2473 is to allow Kansas domiciled insurers additional flexibility in managing their investment portfolios. Currently, insurance companies have two basic methods of obtaining exposure to an asset class. First, the insurance company can purchase individual securities. Or, second, it can purchase a mutual fund. As an example, if Security Benefit wanted to invest \$5 million in equities representing the Standard & Poor's 500 (S&P 500), it could: a) take the \$5 million and purchase the 500 individual stocks; or, b) purchase an S&P 500 indexed mutual fund.

House Bill 2473, with amendments proposed by the Kansas Insurance Department, would provide a third method of obtaining that same exposure—Replication. Simply put, Replication is another way of obtaining exposure to an already permissible investment class. The methodology involves the combination of a financial instrument or agreement where no cash is exchanged with investment grade bonds to reproduce the characteristics of the approved investment. As an example, an insurer owns \$5 million of one-year Treasury securities and enters into a one-year swap to receive the total return of the S&P 500 in exchange for an interest payment equal to the Treasury securities. This transaction (Treasury bonds plus the swap) replicates a \$5 million exposure to the S&P 500. Swaps are entered into with approved counterparties such as Merrill Lynch, J.P. Morgan and Morgan Stanley.

There are five primary characteristics of Replication. First, the method can only be utilized on approved asset classes. The strategy provides an insurance company an alternative method of obtaining exposure to permissible investments. Second, Replication provides flexibility. At various times, cash investments cannot be sold due to illiquid market conditions. Utilizing Replication and varying the maturity of the financial instruments (swaps/futures/options), an insurance company has more flexibility in its asset allocation as maturing instruments do not have to be renewed. Consequently, the exposure to the asset class can be reduced at the maturity of the financial instrument creating improved overall portfolio liquidity. Using the \$5 million example above, Security Benefit might invest in four separate swaps on the S&P 500 with maturities of 3 months, 6 months, 9 months, and one-year in the amount of \$1.25 million each. If at the end of three months it does not like the outlook for the equity market, it lets the swap mature, thus reducing its equity exposure to \$3.75 million. Security Benefit now has an additional \$1.25 million invested in highly liquid investment grade bonds.

*House Committee on Insurance
March 1, 2001
Attachment #1*

Third, financial instruments like futures, swaps, and options are the most cost efficient and effective method of obtaining exposure to an asset class. Fourth, the Replication investment strategy has been approved by the National Association of Insurance Commissioners (NAIC), and has been adopted in other states. Approval of this legislation will allow Security Benefit to be competitive in the marketplace where it competes with insurers from those states. Fifth, Replication is not a speculative investment strategy. NAIC approval is only for permitted investments, and the Securities Valuation Office (SVO) must rate a Replicated transaction. The recommended amendments by the Insurance Department, which we support, will clarify that these investments must be entered into in accordance with SVO requirements.

In summary, Replication provides insurance companies a flexible, responsive and efficient method of obtaining exposures to permitted asset classes. Security Benefit requests adoption of this strategy to allow Kansas domestic insurers to be competitive with insurers domiciled in other states. Thank you for the opportunity to appear in support of House Bill 2473.

Replication

Thomas A. Swank
Senior Vice President
Chief Investment Officer



WHERE WE ARE TODAY

- Insurance company investors have two basic ways to gain exposure to an asset class or index:
 - Purchase the individual securities; or
 - Purchase a fund representing the index.
- Example:
 - If SBL wants \$5 million of exposure to equities represented by the S & P 500, it can:
 - Take the \$5 million and buy all 500 stocks in the index; or
 - Purchase an indexed mutual fund.

WHERE WE WANT TO GO

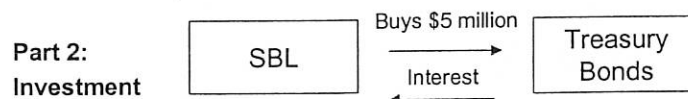
- Add a third alternative to the mix: Replication
- Replication is another way to obtain exposure to an already permissible asset class.
- Replication Defined: the combination of a financial instrument or an agreement - where cash does not change hands - that produces the characteristics of a permissible investment when combined with investment grade bonds.

WHERE WE WANT TO GO

- Example:

Part 1: Agreement	SBL	$\xleftarrow{\text{S\&P 500}}$ $\xrightarrow{\text{Interest}}$	Investment Bank
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 - SBL enters into a one-year agreement with an investment bank to receive the total return on the S&P 500 on a \$5 million notional exposure. For example, if the S&P 500 goes up to 10%, SBL receives \$500 thousand. If the S&P 500 declines 10%, SBL pays \$500 thousand.
 - To enter into the agreement, SBL agrees to pay the investment bank a rate of interest on the \$5 million exposure.



- SBL purchases \$5 million of one-year Treasury of Investment Grade Bonds.

Net Effect: SBL receives the total return on the S&P 500

MAIN POINTS

- Only on Permitted Investments
- Economics are no different than owning the cash instrument
- Provides improved flexibility and liquidity
- Improves efficiency
- Approved in other states
- Not speculative

6 October 2000

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Fixed Income

Insurance Update

*Derivatives Use To Be Encouraged Through Replication
New York State Enacts A New Law*

Insurance |

Background

Insurance regulators, after years of study, have developed a structure that will expand the range of uses of derivative instruments by insurance companies. Derivatives have unsettled regulators of insurance companies for a number of years, first because they do not fit naturally into a regulatory structure for investment limits and reserving. Just as importantly, periodic financial crises involving derivatives, even tangentially, have troubled regulators who have cited these events as justification for limiting the use of these instruments.

Until very recently derivatives use in many US jurisdictions has been limited to hedging, and "income generation." These applications are not as generous as they may seem. In practice, the work insurers must perform to justify their hedges as "effective" can be burdensome, and "income generation" is effectively limited to selling covered calls. It should not come as a surprise, then, that insurers have not been leading users of derivatives in their general accounts.

Since the early 1990s insurance companies and regulators have struggled to develop methods for regulators to deal effectively with derivatives use by insurers. The result is a structure that is unique to the insurance industry: replication.

Replication Defined – In the Insurance World

- * Simply stated, in this context a "replication" is the combination of at least one cash asset with at least one derivative instrument to produce synthetically an asset that would otherwise be permitted for investment by an insurer. For example, a U.S. Treasury could be combined with a default swap (selling credit protection) on a BBB corporation. For an insurer this would result in an assumption of default risk on the BBB credit as well as the counterparty risk of the swap seller. The newly created synthetic BBB bond would be treated as a single asset for Risk-Based Capital computation and determination of compliance with investment limits.
- * Today the CUSIP Service Bureau is prepared to accept applications from insurers for identification numbers for replicated assets as single entities. The Securities Valuation Office of the National Association of Insurance Commissioners is also prepared to rate replicated assets as if they were actual securities.¹

To secure an NAIC rating insurers must file each replication as a "Replication (Synthetic Asset) Transaction"² for ratings with the NAIC / SVO. Specifications are in place to permit the replicated asset to be shown as a single entity on the Annual Statement (Schedule DB - Part F)³ although the replication components will be listed separately in the appropriate sections of the Statement as well (Sections D and DB).

Specifications of methods for adjusting the Risk-Based Capital formula to reflect increases in risk from using replications are also in place now.⁴ At present a replication resulting in the creation of a synthetic security with a higher RBC requirement will result in a higher RBC factor being applied. There is presently no RBC benefit to using replication techniques to improve credit quality, although replication authority will enable these transactions.

Why Use Synthetic Assets?

Insurance companies will use replications when they are better than cash assets. Clearly when liquidity, spreads, execution, structure or payment dates are better than for similar cash assets, investors will favor replications. More subtlety, unique assets will also be developed to take advantage of this new investment authority. For example, Merrill Lynch has developed numerous sources of credit risk transfer that can be packaged to offer investors credits that are simply not available in the cash markets at any price. These can offer enhanced diversification into industries and access to otherwise unobtainable names. With the new replication authority we expect continued innovations that will provide increased investment alternatives for insurers.

A very broad range of attractive investment products can be created through the use of replications. Some examples are fixed rate bonds (including corporates, variable rates, emerging markets, dollar denominated and callables), convertible bonds, floating rates (stripped convertible), changes in portfolio total-rates-of-return, portfolios of common stock, index amortizing and mortgage loans. Even this extensive list is not exhaustive. Essentially replication permits the synthetic creation of any type of security that is permitted in its standalone form.

What Companies Can Use Replication?

Replications are permitted by state investment laws and insurance department regulations in a number of

² Insurers may file the NAIC / SVO's "Replication (Synthetic Asset) Transaction Form" to obtain a rating and then must pay applicable fees. Currently these are \$2100 initially and \$100 annually thereafter.

³ See Schedule DB Part F Sections 1 and 2 and instructions

⁴ See RSAT Change Form

jurisdictions.⁵ Very recently New York State updated its regulations to expand the permitted uses of derivatives to include replications,⁶ and the State of Connecticut adopted an enabling bulletin⁷ permitting replications earlier this year. A number of states, notably Illinois, are developing standards to permit these transactions for companies domiciled there.

Although the NAIC has completed its work on replications, some companies may be subject to additional regulatory requirements. As an example, as of January 1, 2000, the State of New York began requiring licensed insurers to obtain Department of Insurance approval of Derivatives Use Plans prior to entering into any derivatives transactions. Finally the pace of approvals of these plans seems to be accelerating, but many companies are still operating under interim authority with their plans pending approval. Now that New York State has updated its insurance law we believe the Department will respond favorably to companies seeking amendments to approved plans to add replication authority.

All New York domestic insurers will need to do to begin entering into replications transactions is to amend their New York State Derivatives Use Plans to add replications. Insurers in other states will need to verify that they have the necessary regulatory authority in their states of domicile and, if licensed in New York State, their Derivatives Use Plans provide for these transactions.

Other Issues

Replication, as discussed here, is solely a US insurance regulatory concept. While replication facilitates the use of derivatives and expands economic opportunity, Statutory Accounting now runs counter to developing accounting and reporting templates in GAAP. In fact, considering FAS 133, it appears that GAAP accounting and reporting standards are moving in the opposite direction, not just denying recognition of replications or synthetic assets as discreet entities, but disaggregating assets long thought of as single entities. Still, this does not preclude the effective use of replication transactions for economic benefit by insurance companies. Fortunately Merrill Lynch has done a considerable amount of work with insurer clients designed to assist them in managing the transition to FAS 133 while taking advantage of the new replication authority.

Implications for the Market

We expect increased derivatives activity from insurers, particularly in credit products. As these spreads tend to be

⁵ Legal counsel should be consulted for state-by-state determinations.

⁶ New York S6779

⁷ Connecticut Insurance Department Bulletin FS-14c-00 "Use of Derivative Instruments"

supply driven we do not anticipate an immediate tightening even with the expected start-up insurer involvement. Longer term, however, it is likely that sufficient demand will develop to tighten spreads and make these less attractive investments than they are today.

Summary

The new replication authority for insurance companies enables insurance regulators to regulate and assess appropriate risk charges for derivative instruments where this was not previously possible. In exchange, insurers have new access to a broad range of derivative instruments that they may use in their investment accounts. Access to these products will enable insurers to maintain a competitive position with other providers of financial services while improving spreads and diversifying risk. We support future enhancement of replication standards to reward and encourage risk-reduction, and we are encouraged that insurers are now able to access derivative instruments in a disciplined way to improve investment performance.

For More Information

All documents cited in this update are available upon request by email. We have also assembled a comprehensive packet of information on replications, including extensive background information. CD-ROMs containing this information are also available.

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1-8

LEHMAN BROTHERS

Insurance Strategies

Developments and Opportunities in the Credit Derivatives Market

October 4, 2000

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INTRODUCTION

With the credit expertise that insurance companies possess, structured credit products have emerged as an intriguing income enhancing alternative to traditional investments. They also provide efficient ways to alter and diversify risk exposures. These products include credit-linked notes, default swaps, default baskets, total return swaps, and index swaps, among others.

Until recently, regulatory constraints and uncertainty had kept many insurers on the sidelines of the credit derivative market. However, with the recent NAIC adoption of a model regulation covering replicating (synthetic asset) transactions, or RSATs, insurers will have considerably more flexibility to participate in this market.¹

To illustrate the implications of these developments, we provide a general overview of the credit derivatives market, describe the regulatory and accounting framework for credit derivative transactions, and present some replication transaction examples.

¹ The RSAT model regulation was adopted by the NAIC in March 2000.

THE CREDIT DERIVATIVE MARKET

A credit derivative is an agreement between two parties to transfer credit or index exposure for a specified period of time. Credit derivatives allow investors to manage credit exposures, diversify risks, or increase asset yield. According to the British Bankers' Association, the market has grown dramatically, to \$1 trillion in notional amount this year from roughly \$350 billion in 1998. Continued growth is expected as regulatory guidance develops and as investors become more familiar with the products. Industry participants expect outstanding notional to reach \$2.5 trillion in 2002.

Credit derivatives come in a variety of types. One common instrument is a default swap, in which one party pays a premium to a second party in exchange for protection against the default of a specific credit. Index and total return swaps are agreements in which one party receives the return of a specific issue, index, or basket of securities in exchange for an implied financing rate, which is typically quoted as LIBOR plus or minus a spread. These instruments can also be two sided, where the parties in the contract each exchange one risk exposure for another. These transactions are flexible and can be customized to meet an investor's particular needs.

Rationale for Using Credit Derivatives

Credit derivatives can be used to achieve a variety of objectives for insurance companies. These include:

- 1) Increasing income by leveraging credit expertise without ballooning the balance sheet,
- 2) Hedging credit risk,
- 3) Reallocating credit exposure without triggering capital gains or losses,
- 4) Acquiring credit exposure for terms unavailable in the cash market,
- 5) Diversifying exposures by entering into a total return swap on an index or basket, and
- 6) Arbitraging and relative value trading.

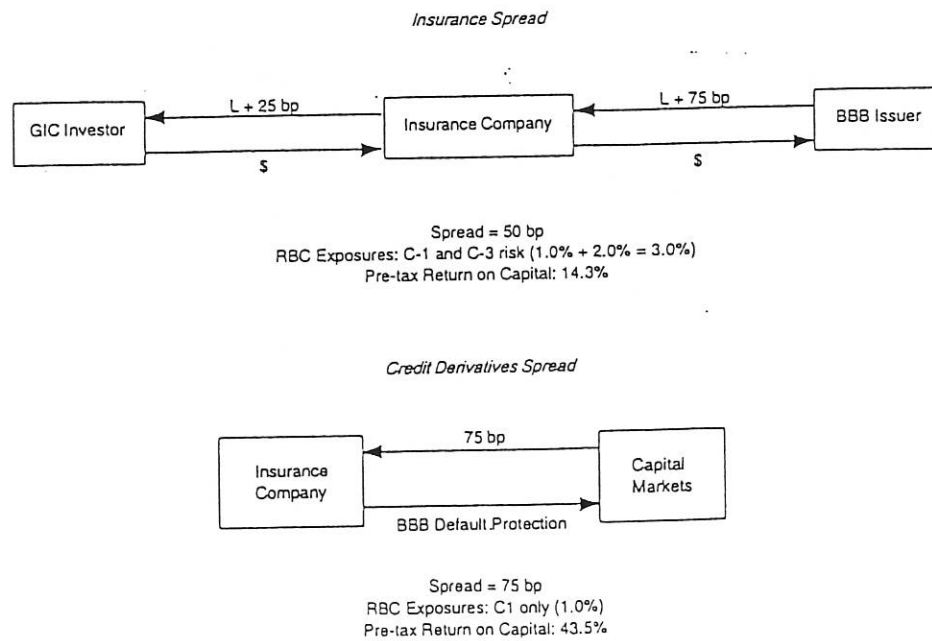
Selling protection can provide companies with a capital efficient method of increasing spread income. For many insurers, a higher spread can be earned by selling protection through a credit derivative than can be earned through insurance-related financing such as funding agreements or GICs. This results from the LIBOR-flat financing assumption that is generally used when pricing default swaps. Consider the example in Figure 1, in which an insurer sells GICs at LIBOR + 25 bp and invests the proceeds in a BBB rated credit at LIBOR + 75 bp. This strategy yields a 50 bp spread for the insurer. In the credit derivative market, the company may be able to sell protection on the same BBB credit for 75 bp (according to the LIBOR-flat financing assumption). The insurer is subject to the same credit risk, but earns an additional 25 bp under the credit derivative strategy in this example.²

² In practice, the additional spread earned using the credit derivative strategy will vary depending on a number of factors, including the insurer's cost of funds and supply and demand in the credit derivatives market. Return on capital in the example is calculated assuming the insurer holds 200% RBC and income earned on surplus held is 6.0%. (For example, the GIC ROC = $(50 \text{ bp} / (200\% \times 3.0\%)) + 6.0\% = 14.3\%$).

The credit derivative strategy is also attractive from a risk-based capital (RBC) perspective, as the insurer is not charged with a liability (i.e., C-2 or C-3) RBC requirement. Furthermore, the higher spread is earned without ballooning the insurer's balance sheet. The derivative value must be reported on the GAAP balance sheet, but this amount is zero at inception and typically will be small relative to the referenced cash instrument throughout the life of the transaction.

Credit derivatives can be used in a variety of other ways to benefit insurance companies. For example, an insurer wishing to reduce exposure to a bond in a gain position could purchase protection on the credit instead of selling the bond and triggering a capital gain. This allows the insurer to retain the above market book yield of the issue but reduces or eliminates its exposure to the credit. It also can be useful for insurers facing loss constraints. Buying protection through a default swap effectively allows the insurer to amortize the loss over time, instead of recognizing the loss immediately, as would be done if the security were sold. In addition, credit derivatives enable portfolio managers to remove their exposure to undesirable credits (e.g., bonds with unrealized losses, eroding credits, etc.) when illiquidity in the cash markets makes selling a specific issue difficult.

Figure 1. Strategies for Increasing Spread Income: GICs vs. Credit Derivatives



Furthermore, credit derivatives can be used to increase or reduce exposure to an index or basket of securities without having to purchase or sell the underlying assets. Index swaps are particularly beneficial for companies that seek a diversified exposure to a particular sector (e.g., emerging markets), but do not possess in-house expertise within that sector or a portfolio allocation large enough to gain diversified exposure in the cash markets.

For more information on credit derivative strategies, please refer to the following Lehman Research papers: *Credit Derivatives* (May 1998), *Introduction to Asset Swaps* (December 1999), *Introduction to Default Swaps* (January 2000), and "Primer on Default Baskets" (*Structured Credit Quarterly*, February 2000).

RSATS: REPLICATION (SYNTHETIC ASSET) TRANSACTIONS

What Is an RSAT?

As defined by the NAIC, an RSAT is a derivative transaction entered into in conjunction with a cash instrument to reproduce the investment characteristics of an otherwise permissible investment. For example, an insurer that owns a \$10 million five-year Treasury bond and enters into a \$10 million notional five-year A rated default swap going long credit risk (i.e., selling protection) is replicating a \$10 million five-year A rated bond.

The components of the RSAT do not have to be combined in a trust to qualify as an RSAT; the association of the cash instrument with the derivative is solely for regulatory reporting purposes. RSATs must be filed with the NAIC's Securities Valuation Office (SVO). The RSAT regulation also states that transactions with the designated purpose of hedging or income generation will be treated as such, and not be considered RSATs for regulatory purposes.³

Since the model regulation was passed by the NAIC, several states have indicated that the regulation will be implemented in the near future, while others have not yet offered guidance regarding implementation. We expect Illinois to implement the regulation near year-end 2000. New York has already adopted it, with the expectation that it will become law 90 days after it receives the governor's approval. Due to process hurdles that must be overcome, we expect adoption to be slower in states that have explicitly prohibited replication, as opposed to those states where the insurance laws are silent on the issue. California, for example, currently prohibits replication and, thus, is unlikely to adopt the model regulation soon. Insurers licensed in New York should include credit derivatives in the Derivatives Use Plan filing.

³ According to Statutory Accounting Principle (SAP) 31, *Derivative Instruments*, income generation transactions are derivatives written or sold to generate additional income or return to the company (i.e., covered option writing); hedging transactions are those that reduce the risk of assets or liabilities the company has or expects to acquire in the future. SAP 31, which is part of the Statutory Codification process, governs the statutory accounting treatment for these transactions and will be effective January 1, 2001.

Types of RSATs

The NAIC defined two types of replicating transactions: Safe Harbor-Defined RSATs and other RSATs. Safe Harbor RSATs can be presumed to be Approved RSATs and, therefore, have less rigorous SVO filing requirements than other replication transactions. Safe Harbor transactions fall into one of the following nine categories:

- 1) Bond (or bonds) with an interest rate swap,
- 2) Bond with a credit default risk swap,
- 3) Bond with a total return swap,
- 4) Bond with a foreign currency swap,
- 5) Bond with an equity option (long an option),
- 6) Convertible bond combined with the sale of an equity option,
- 7) Bond with an index amortizing interest rate swap,
- 8) Bond with an interest rate swap and swaption agreement (allowing the insurer to cancel the swap), and
- 9) Bond with an interest rate swap and interest rate cap/floor.

For the second and third transaction types, according to discussions held at various NAIC meetings, the cash instrument used need not be risk free, nor must the derivative provide protection on the cash instrument to qualify as an approved transaction. Therefore, a BBB rated default swap (going long credit risk) associated with an A rated cash component should be awarded safe harbor treatment as an RSAT.

Other RSATs are structures that do not fit into one of the above categories. These may still be approved RSATs, but only after the insurer has demonstrated to the SVO that the combined cash flows will achieve the economic performance of the synthetic asset sought to be created. The conditions that must be satisfied for an RSAT to be considered effective are listed in Exhibit A.

RISK-BASED CAPITAL CONSIDERATIONS

RBC requirements for RSATs are based on the rating(s) of the exposure the investor acquires through the transaction (the RSAT itself does not get rated by any rating agency or the SVO).⁴ Figure 2 shows the RBC charges for various credit exposures, and Figure 3 describes the RBC charges that result from various replication transactions.

A two-step process is used to calculate RBC requirements for each RSAT. The RBC charge is first calculated for the synthetic exposure (if any) that the insurer

⁴ For default and total return swaps, there is a very small additional RBC requirement based on RBC rules for swaps; this amount equals $[0.5\% \times \text{"Notional"} \times (\text{Years to Maturity})^{0.5}] \times \text{counterparty RBC factor}$.

Figure 2. NAIC RBC Charges

NAIC Designation (Rating)	RBC Charge (%)
1 (A- or better)	0.3
2 (BBB)	1.0
3 (BB)	4.0
4 (B)	9.0
5 (C- to CCC+)	20.0
6 (below C-)	30.0

Figure 3. RBC Charges for Sample Replicating Transactions

Derivative Transaction	RSAT Exposure Gained	RSAT RBC Factor (%)	Cash Instrument RBC Factor (%)	RBC Credit (%)	Total RBC Charge (%)*
Purchase A protection, hold the underlying credit	None	0.0	0.3	0.0	0.3
Exchange BBB risk currently held for BB risk	BB risk	4.0	1.0	1.0	4.0
Exchange BBB risk currently held for A risk	A risk	0.3	1.0	0.3	1.0
Sell B protection, hold A bond	B risk	9.0	0.3	none (no elimination of risk)	9.3

* Assumes the notional of the derivative equals the par amount of the cash instrument. Total RBC charge = RSAT RBC + cash instrument RBC - RBC credit.

obtains through the derivative transaction. The insurer then determines if RBC relief is provided on the cash instrument component of the RSAT and calculates this amount of RBC credit. Relief is provided on the cash instrument if the derivative transaction either 1) is a swap of prospectively determined interest rates, or 2) eliminates the asset risk associated with the cash instrument. If provided, the RBC credit is equal to the product of the following:

- 1) the minimum of the cash instrument RBC factor and the replicated asset's RBC factor, and
- 2) the statement value of the cash instrument.

The total RBC charge is the sum of the RSAT RBC and the cash instrument RBC, less the RBC credit (if any). Please refer to Exhibit B for further discussion of these rules and other examples of RBC calculations for RSATs.

GAAP ACCOUNTING TREATMENT FOR RSATS

GAAP accounting for all derivative transactions is covered by SFAS 133, *Accounting for Derivative Instruments and Hedging Transactions*. Because the RSAT is a regulatory designation only (i.e., it is not recognized for GAAP purposes), the derivative and cash component are accounted for as separate items.

Shorting Exposure

In general, transactions in which insurers buy protection for assets they hold should qualify for hedge accounting treatment. In this case, there should be little or no mark-to-market volatility in the insurer's income statement.

Going Long Exposure

In most cases, insurers selling credit protection or going long total return (without an offsetting exposure that could qualify for hedge accounting) will be required to report the derivative at fair value on the balance sheet with unrealized gains and losses reported quarterly in income. While SFAS 133 requires disclosure of all derivatives on the balance sheet, the statement does not give clear guidance to the location of the gains and losses on the income statement; it does not specify if the gains and losses must be part of investment income or other gains and losses. When appropriate, we believe that GAAP accounting should permit the interest (yield) component of the derivative to be reported as investment income and the mark-to-market return component to be reported as a non-operating gain or loss. Alternatively, the entire return could be reported as investment income.⁵ Figure 4 summarizes GAAP accounting treatment for RSAT components.

⁵ To receive either accounting treatment, the reporting entity must demonstrate for GAAP that this treatment is consistent with the entity's derivative use policy and will be applied consistently across similar transactions.

Figure 4. Summary of GAAP Accounting for RSATs

Transaction Component	If Hedge Accounting Applies	Other Cases
Balance sheet amount of derivative and cash instrument	Fair value for both components	Report derivative at fair value
Income statement impact	Derivative and hedged item impacts offset each other	Derivative fair value changes are reported in income
Interest (yield) component of swap	Offset with hedged item	Increases investment income
Marked-to-market component of swap	Offset with hedged item	Non-operating gain or loss*

* See footnote 5.

STATUTORY ACCOUNTING

Statement Value of RSAT

Statutory rules require that accounting for RSATs be based on the asset that the RSAT is replicating. For example, if the replicated asset is a bond, the RSAT is valued at amortized cost. Figure 5 summarizes the NAIC's valuation guidance for RSATs.

Income and Gains/Losses

Interest-related cash flows from the derivative component are deemed investment income for statutory accounting purposes. Total return cash flows must be segregated into an interest portion, which is deemed investment income, and a market value portion, which is recognized as a deferred asset or liability until contract termination. Realized gains and losses are recognized in income typically through the IMR after the sale or termination of the derivative contract.

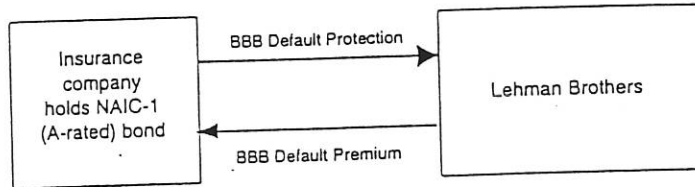
Figure 5. Statutory RSAT Valuation

If the Replicated Asset Is Valued at	And the Cash Instrument Is Valued at	Then the Derivative Is Valued at
Amortized cost	Amortized cost	Amortized cost*
Market	Market	Market
Amortized cost	Market	Market
Market	Amortized cost	Market

* The derivative may also be valued at market when both the replicated asset and the cash instrument are valued at amortized cost.

RSAT STRATEGIES INVOLVING DEFAULT AND TOTAL RETURN SWAPS

Example 1: Selling Protection—Bond with a Credit Default Swap



Purpose: Leveraging credit expertise to increase investment income on the insurers' assets.

Transaction: The insurer holds \$10 million of a five-year A rated corporate bond and enters into a default swap in which it sells protection to Lehman Brothers on a five-year BBB rated corporate bond, for which Lehman Brothers pays a default premium. The notional amount in the derivative is \$10 million.

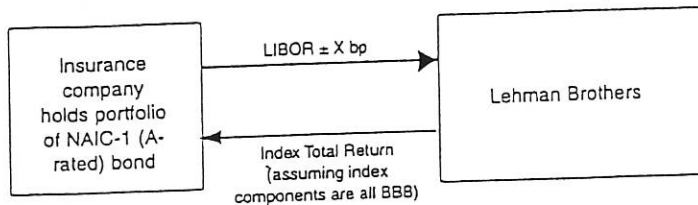
RBC Impact: The insurer incurs a capital charge of \$0.13 million: 0.3% for the NAIC-1 cash instrument held and 1.0% for the NAIC-2 credit exposure acquired through the swap.⁶

GAAP Impact: It may be appropriate to book the default premium as investment income, while the change in market value of the derivative is reported as a non-operating gain or loss. Accounting for the bond is not affected by the existence of the derivative.

Statutory Impact: Since the replicated asset has bond characteristics, the RSAT would be held at amortized cost. The default swap premium would be reported as investment income.

⁶ Footnote 4 applies to all the examples given.

Example 2: Going Long Total Return—Bond with an Index Swap



Purpose: An index swap allows the insurer to access illiquid exposures or can be used to increase or decrease exposure to a particular bond or other market index. It can be very cost effective, as transaction costs on the swap could be significantly lower than the costs associated with buying a bogey for the index in the cash market.

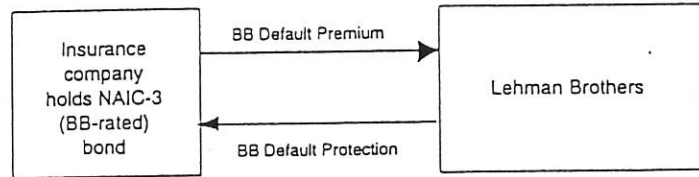
Transaction: The insurer holds \$100 million in a portfolio of A rated bonds, all with three or more years to maturity. The insurer agrees to swap LIBOR plus (or minus) a spread for the total return of a basket of BBB rated securities over a three-year period. The notional amount in the derivative is \$100 million.

RBC Impact: The insurer incurs a capital charge of \$1.3 MM; 0.3% for the NAIC-1 bond portfolio held and an additional 1.0% for the NAIC-2 credit exposure in the swap.

GAAP Impact: The insurer's payments reduce investment income as incurred. The index return received may be split between investment income and non-operating gains and losses. Alternatively, the entire total return may be reported as investment income.

Statutory Impact: The RSAT would be held at market value. Interest income would be reported in investment income, and any change in fair value of the derivative would be a deferred asset or liability.

Example 3: Buying Protection—Bond with a Credit Default Swap



Purpose: Effectively, the insurer can decrease credit exposure without actually selling the underlying issue and incurring capital gains or losses. This may be a more timely and cost-effective method of eliminating exposure to a credit than an outright sale, though an outright sale is more efficient from a RBC perspective. Alternatively, the insurer could protect itself from high-yield spread widening or outright default over a shorter-term period, such as one year.

Transaction: The insurer holds \$10 million of a five-year BB rated bond and buys five-year credit protection through a default swap on this specific issue from Lehman Brothers.

RBC Impact: The insurer incurs a capital charge of \$0.4 million (4% of par) for the NAIC-3 bond held. No RBC relief is provided on the BB bond.

GAAP Impact: The derivative would likely qualify as a hedge under SFAS 133, resulting in little or no income statement volatility.

Statutory Impact: Under statutory accounting, the derivative could be designated as a hedge of the underlying bond or as a replication transaction. In either case, the derivative (or RSAT) would be valued at amortized cost on the balance sheet.⁷

⁷ SAP 31 (also described in Footnote 3) states that derivatives used in hedging transactions should be accounted for in a manner consistent with the item hedged. Since the hedged item is a bond valued at amortized cost, the derivative is accounted for in the same manner. If designated as a replication transaction, the RSAT would have bond characteristics and, therefore, would also be reported at amortized cost.

EXHIBIT A: CONDITIONS FOR AN EFFECTIVE RSAT

Conditions for an RSAT to be deemed effective are as follows:

- 1) The transaction is determined to be an Approved RSAT;
- 2) The replicated (synthetic) asset is an otherwise permissible investment (as defined by the insurer's state of domicile);
- 3) At the RSAT's inception, the combined market value of the cash instrument and derivative components must not be materially different than the market value ascribed to the RSAT (the initial statement value of the RSAT);
- 4) The insurer's maximum potential loss in the RSAT does not exceed the gross investment in the cash and derivative components;
- 5) The derivative's term does not exceed the cash instrument's term to maturity;
- 6) The cash instrument is a fixed income asset; and
- 7) At no time is there exposure to a derivative transaction without a corresponding cash component.

EXHIBIT B: RBC CALCULATION EXAMPLES

Purchasing Protection

Consider the case in which an insurer buys protection for a BBB bond it holds. The derivative does not increase the insurer's exposure to a new credit and, therefore, has no RBC charge. The RBC credit is then zero, as the RBC factor used in the credit calculation cannot exceed the RSAT RBC factor of zero. Thus, despite purchasing protection, the total RBC charge incurred is the same before and after the derivative contract is acquired.

Basket and Index Swaps

For basket and index RSATs, the RBC requirements are based on the actual components of the basket or index referenced in the derivative. Two examples are as follows:

Example 1: Three-name basket (A, BBB, BB; weighted 30%, 40%, 30%).
RBC Requirement = 1.69% = (30.0% x 0.3%) + (40.0% x 1.0%) + (30.0% x 4.0%).

Example 2: Five-name first-to-default basket, all A rated credits.
RBC requirement should be 0.3%, since each component of the basket is NAIC-1.

According to the NAIC, RBC requirements for basket or index exposures are based on the actual components of the index or basket at the time of calculation. One interpretation of this rule is that the RBC factor for a first-to-default swap on NAIC-1 issues should therefore be 0.3%. An argument can be made that a higher RBC factor should be used since the credit risk in a first-to-default swap is greater than the average risk of the underlying credits.



Kathleen Sebelius
Commissioner of Insurance
Kansas Insurance Department

TO: House Committee on Insurance
FROM: Don Gaskill, Director of Financial Surveillance Division
RE: HB 2473 – Replication Transactions
DATE: March 1, 2001

Mr. Chairman and members of the committee:


Thank you for the opportunity to discuss HB 2473 with you. This bill would amend an investment statute that presently permits domestic life insurance companies to use financial instruments to engage in hedging transactions and certain income generation transactions. The bill would permit domestic life insurance companies to engage in “replication transactions”, which is currently not permitted. The bill also provides for the conditions upon which a domestic life insurance company may enter into “replication transactions” and sets forth some investment limitations regarding such investments.

◁ A replication transaction combines a cash instrument (usually bonds) with a financial instrument (usually swaps and options) to reproduce the investment characteristics of a permissible investment (i.e., S&P index). The replicated security is submitted to the National Association of Insurance Commissioner’s (NAIC) for a rating from the Security Valuation Office (SVO).

The Kansas Insurance Department met with Security Benefit Life concerning this bill. We appreciate their willingness to work with us regarding the life insurance companies engaging

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March 1, 2001
Attachment #2

in such investments. We support the bill as amended because we believe that this change will not compromise the solvency of Kansas insurance companies. HB 2473, as amended, will provide a flexible and efficient method of obtaining exposures to permitted asset classes, and allows domestic life insurance companies to be competitive with other insurers domiciled in other states.



Memorandum

TO: The Honorable Bob Tomlinson, Chairman
House Insurance Committee

FROM: William W. Sneed, Legislative Counsel
American Investors Life Insurance Company

RE: H.B. 2473

DATE: March 1, 2001

Mr. Chairman, Members of the Committee: My name is Bill Sneed and I represent American Investors Life Insurance Company. American Investors is a Kansas domestic life insurance company that solely sells annuity products throughout the United States. After reviewing H.B. 2473 and the amendments to be proposed by the supporters of the bill, please accept this memorandum as our support of this bill.

K.S.A. 40-2b25 is legislation that my client initiated as it relates to financial transactions in today's marketplace. We believe the additional language proposed by the proponents of the bill makes good sense and would be for the benefit of Kansas consumers.

Thus, on behalf of my client, we respectfully request that the Committee support H.B. 2473.

Respectfully submitted,

William W. Sneed

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Attachment # 3*

3-1