

Approved: \_\_\_\_\_

Date

3-30-01

## MINUTES OF THE SENATE COMMITTEE ON FINANCIAL INSTITUTIONS AND INSURANCE.

The meeting was called to order by Chairperson Sandy Praeger at 9:30 a.m. on March 22, 2001 in Room 234-N of the Capitol.

All members were present except:

Committee staff present: Dr. Bill Wolff, Kansas Legislative Research Department  
Ken Wilke, Office of the Revisor of Statutes  
JoAnn Bunten, Committee Secretary

Conferees appearing before the committee:

Rebecca Wempe, Assistant General Counsel, Security Benefit Life Insurance  
Don Gaskill, Director of Financial Surveillance Division, KID

Others attending: See attached list.

### Hearing on HB 2473 - Life insurance companies; replication transactions

Rebecca Wempe, Assistant General Counsel, Security Benefit Life Insurance, testified before the Committee in place of Tom Swank of SBG in support of **HB 2473**. The bill would allow Kansas domiciled insurers additional flexibility in managing their investment portfolios. Ms. Wempe noted that 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. The bill with amendments by the Kansas Insurance Department would provide a third method of obtaining that same exposure - - replication. Ms. Wempe explained to the Committee that replication is another way of obtaining exposure to an already permissible investment class as outlined in her written testimony. (Attachment 1)

Don Gaskill, Director of Financial Surveillance Division, KID, offered his support for the bill. He noted that the Kansas Insurance Department met with Security Benefit Life, Topeka, concerning **HB 2473**, and both agreed that passage of the bill would provide a flexible and efficient method of obtaining exposures to permitted asset classes and allow domestic life insurance companies to be competitive with other insurers domiciled in other states. (Attachment 2)

Written testimony in support of the bill was received from Bill Sneed, representing American Investors Life Insurance Company. (Attachment 3)

There were no opponents to the bill.

Senator Brungardt made a motion the Committee recommend **HB 2473** favorable for passage, seconded by Senator Barnett. The motion carried.

### Discussion and Action on HB 2146 and HB 2247

The Chair briefed the Committee on the background of **HB 2247** which removes the sunset provision from the Business-Health Partnership Act. The bill had not been acted upon by the House Insurance Committee, and it was suggested to amend provisions of the bill into **HB 2146**, which was recently amended into another bill, and that a substitute bill be created.

Senator Feleciano made a motion to amend the provisions of **HB 2247** into **HB 2146** and create a substitute bill, and that the Committee recommend **Senate Substitute for HB 2146** favorable for passage, seconded by Senator Teichman. The motion carried.

CONTINUATION SHEET

**Discussion and Action on HB 2480 - Adoption of model regulation concerning privacy of financial and health information of consumers**

The Chair briefed the Committee on the history and provisions contained in **HB 2480** which is called the privacy bill. A balloon of the bill was discussed that contained an amendment offered by the Kansas Association of Health Plans and approved by the Kansas Insurance Department at a previous Committee meeting. Since the time the bill was passed by the House, the compliance date for the federal HIPAA privacy regulations had been delayed from February 26, 2003 to April 14, 2003. The amendment offered would replace the effective date of the NAIC Model to February 1, 2003, since February 26 is no longer a relevant date and would replace the second reference to February 26, 2003 to April 14, 2003 to be consistent with the HIPAA regulations.

Senator Feleciano made a motion to adopt the amendments changing the implementation dates, and that the Committee recommend **HB 2480 as amended** favorable for passage, seconded by Senator Teichman. The motion carried.

The Chair also noted that because of the delayed implementation, a summer interim this year would allow concerns addressed by the property-casualty insurance companies to be studied, and recommendations if needed for changes could be made for the next legislative session.

**Adjournment**

The meeting was adjourned at 10:30 a.m.



# Memo

**Date:** March 22, 2001

**To:** Members of the Financial Institutions and Insurance Committee

**From:** Thomas A. Swank  
Senior Vice President and Chief Investment Officer  
Security Benefit Life Insurance Company

**Subj:** House Bill 2473 - Replication

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Madame Chair, 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

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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.

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

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- 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.



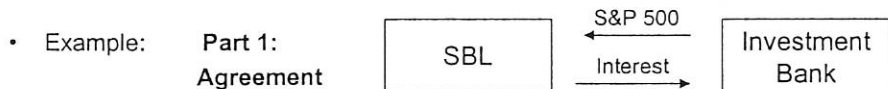
## WHERE WE WANT TO GO

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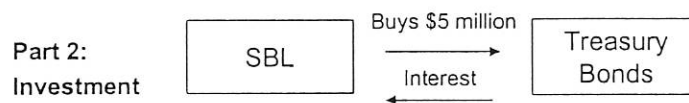
- Add a third alternative to the mix: Replication
- Replication is another way to obtain exposure to an already permissible asset class.
- Replication Defined: the combination of a financial instrument or an agreement - where cash does not change hands - that produces the characteristics of a permissible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

## WHERE WE WANT TO GO

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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

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- 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





**Kathleen Sebelius**  
Commissioner of Insurance  
**Kansas Insurance Department**

TO: Senate Committee on Financial Institutions & Insurance  
FROM: Don Gaskill, Director of Financial Surveillance Division  
RE: HB 2473 – Replication Transactions  
DATE: March 22, 2001

Mdm. Chairwoman 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

in such investments. We support the bill as it passed the House 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.



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WHITE  
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SHALTON

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## Memorandum

**TO:** The Honorable Sandy Praeger, Chair  
Senate Financial Institutions and Insurance Committee

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

**RE:** H.B. 2473

**DATE:** March 22, 2001

Madam Chair, 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,

A handwritten signature in black ink that reads 'William W. Sneed'.

William W. Sneed

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One AmVestors Place  
555 Kansas Avenue, Suite 301  
Topeka, KS 66603  
Senate Financial Inst. & Insurance  
Date: 3-22-01  
Attachment No. 3