HOUSE INSURANCE COMMITTEE
Testimony on Senate Bill 166

March 13, 2013

By: Chris Swickard, Vice President and Associate General Counsel
Security Benefit Life Insurance Company

Mr. Chairman and members of the Committee:

Thank you for the opportunity to appear here today. My name is Chris Swickard and I am Vice President and Associate General Counsel for Security Benefit Life Insurance Company ("Security Benefit"). I am here to testify in favor of Senate Bill No. 166.

Today's proposal relates to the modernization and uniformity of a statute dealing with insurance companies and operates only in the unlikely circumstance when an insurer becomes impaired or insolvent.

The language proposed in this bill is model language used in many other states, is recognized in the industry and is consistent with federal bankruptcy laws. Adding this model language in Kansas will assure those that we do business with around the country that Kansas law is consistent with federal law and the laws of other states – essentially, it assures them that transactions entered into with Kansas insurers will be handled like transactions entered into with their other business partners. Currently that is not the case and it puts Kansas insurers at a competitive disadvantage. This is a very technical bill and I will give you a high level overview of the issue, the problem and our proposed solution.

Introduction

Life insurers' products—products such as life insurance, annuities, long-term care insurance and disability income insurance—provide individuals, families and businesses with financial protection that may last decades. Because of the long-term nature of these products, life insurers must be able to withstand credit and market risks of substantial duration. Life insurers may use financial tools such as derivatives, which are simply financial instruments whose values are derived from one or more underlying assets, securities or indices, to prudently manage risk and maintain their financial stability in a constantly changing global economy. This helps assure that regardless of economic conditions, insurers will be able to honor their obligations to policyholders. Eliminating unnecessary and costly barriers to the use of these instruments is thus in everyone's interest.

How Netting Agreements Work Outside of Insolvency

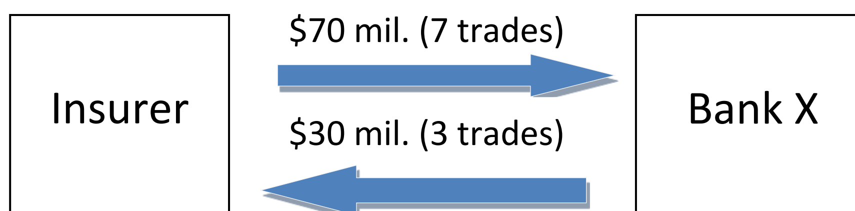
In order to manage risks through the use of derivatives, many insurers enter into qualified financial contracts - or “QFCs” with counterparties, which are usually banks or other financial institutions. While these agreements can take many forms, a basic QFC involves a series of transactions or trades. During the life of the QFC, each party may owe payments to the other. In the ordinary course of things, when the QFC is settled or terminated, the obligations are “netted” against each other (what you owe the other party is subtracted from what they owe you and the difference, or net balance, is paid to that party). For example, assume that an insurance company and a bank enter into a QFC and under that QFC, enter into 10 different trades. Assume further that the bank owes the insurer $30 million arising from three of the 10 trades, while the insurer owes the bank $70 million arising from seven of the 10 trades. Upon termination of the QFC, the obligations are netted, resulting in a net $40 million obligation from the insurance company to the bank.

The Issue

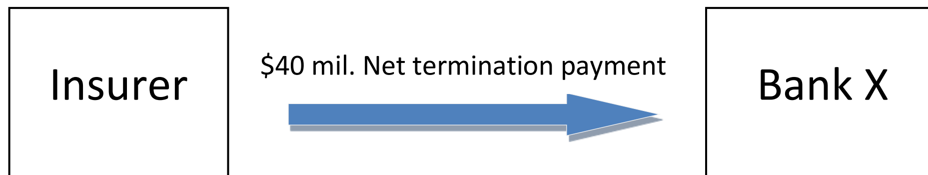
Kansas-based insurance companies face a disadvantage in obtaining trading partners because its state receivership laws do not make provision for termination and netting of QFCs in the rare instance an insurer is placed into rehabilitation or liquidation. By contrast, under federal law and the laws of many other states, termination and netting of QFCs is permitted. If an insurer is placed into receivership in a state such as Kansas whose receivership law does not specifically allow for termination and netting, the trading partner would be obligated to pay the full amount it owes the insurer but may not be able to collect the full amount owed to it by the insurer. An example will help illustrate the point.

Insurer and Bank X enter into a Qualified Financial Contract under which they engage in 10 different trades. Over time, the market value of each trade goes up and down.

Insurer becomes insolvent and goes into receivership, and Bank X would like to terminate the 10 trades. On the termination date, there are 7 trades that each have a $10 million positive market value to Bank X, for a combined positive value of $70 million, and there are 3 trades that each have a $10 million positive market value to Insurer, for a combined positive value of $30 million. As a result, the 10 trades in the aggregate have a “net” market value to Bank X of $40 million, and a termination payment of $40 million would be owed by Insurer to Bank X ($70-$30=$40).



If Bank X is permitted to terminate the QFC and netting is permitted, the value of the 10 trades are netted against one another and payment of $40 million would be owed by Insurer to Bank X. It is the purpose of this legislation to allow this netting of obligations to occur and reduce the risk of unpaid obligations in an insolvency proceeding.



If Bank X was not permitted by insurance insolvency laws to terminate the trades and net the payment obligations, the receiver for Insurer might terminate only the trades with a positive market value for Insurer and collect termination payments from Bank X on those trades and allow the other trades to stay in place. In that case, Bank X would have to pay Insurer $30 million, but may have to wait years to recover the $70 million owed to it by Insurer – if it could recover at all.

The lack of a right to terminate or a right to enforce netting would make any prudent bank wary of entering into trades with such an insurer. This is the very issue Kansas insurance companies face today because the insolvency laws applicable to Kansas-based insurers do not provide for termination and netting of payment obligations under QFCs. However, when banks enter into trades with insurers domiciled in states that do permit termination and netting of QFCs, they don't have this issue.

This unequal treatment of QFCs deters banks and others from entering into such contracts with Kansas insurance companies like Security Benefit or if they are willing to enter into such contracts, they will charge higher fees. The result is that prudent risk management is becoming more difficult and more expensive for Kansas-based insurers.

The Solution

New Section 1 of the SB 166 addresses this issue by incorporating the model language which allows the termination and netting of QFCs when an insurer is placed into receivership. Section 2 of the bill amends K.S. A. 40-3607 and adds new definitions which are needed to implement New Section 1 of the bill. I would be happy to go into the technical details of the bill if you wish but it operates as I have previously described and has been endorsed by the Kansas Insurance Department. The bill is substantially similar to legislation adopted in 19 other states, including the neighboring states of Missouri and Nebraska, as well as Iowa, Massachusetts, Minnesota, New Jersey and New York,

where some of the largest insurers in United States are domiciled. In addition, the bill is substantially the same as the Federal Bankruptcy Code and the Federal Deposit Insurance Act which both allow termination and netting of QFCs in the manner proposed by Senate Bill 166.

Take Aways

1. Kansas statutes limit the amount and type of derivative transactions insurance companies can engage in and this does not alter that in any way. The Kansas Insurance Department routinely examines Kansas insurance companies, including their use of derivatives. This bill only has effect in the unlikely event of an insolvency of a Kansas insurance company.
2. Kansas insurers are currently operating at a competitive disadvantage because our insolvency laws do not provide for termination and netting rights under QFCs.
3. The treatment of QFCs in Kansas makes it difficult to find trading partners that are needed in order to prudently manage the risks associated with providing insurance to consumers -- or if trading partners can be found, the cost is higher because of the higher risk posed by doing business with an insurance company domiciled in Kansas.
4. SB 166 addresses these problems and allows Kansas-based insurers to (a) attract quality trading partners necessary to manage business risks, (b) remain competitive with insurers from other states, and (c) facilitates offering competitive and needed products to Kansas consumers.

We do have one amendment that we would like to request which was an oversight and error in our drafting of the bill and we have discussed this with the Revisor's office. On page 3, line 8 we request that the language "contract, or made" be changed to "contract that is made."   We have discussed this bill and the amendment with the Kansas Insurance Department and it is our understanding that they agree with and are in support of this amendment and the bill in general. We also understand that the American Council of Life Insurers is in support of this bill. We are not aware of any opposition to the bill. Thank you for the opportunity to appear here today and I respectfully request the passage of this bill with the amendment as describe above on page 3 of the bill. I would be happy elaborate on the technical provisions of the bill and answer any questions at this time.