



OFFICE OF  
INSURANCE COMMISSIONER

June 24, 2010

Investment Modernization Interested Parties:

Thank you for your response to our latest proposed draft of the investment modernization bill sent on June 2, 2010. We continue to consider your comments within OIC and will wait until after our dialogue on June 28 for any update to the draft. This proposed modernization bill is a major directional change for both OIC and members of the industry. The following quote from the annotations to the defined standards model act is congruent with OIC thinking about the draft:

Whatever authorized classes of investments or generally applicable limitations that a state chooses to adopt, the degree of financial strength exhibited by an insurer should have a direct bearing on its degree of investment freedom. Three points should be made to explain the value of these types of restrictions in the context of a defined standards investment law:

1. The ability to absorb investment risk varies inversely to the level of existing underwriting risk. The existence of restrictions of the type proposed for assets equal to liabilities plus a minimum surplus requirement will force a gradual transition to conservatism on the part of an insurer as its surplus position deteriorates. At the very least, this will check the worst excesses that can result from the well-known tendency of money-losing insurers to seek high-risk investment solutions to underwriting problems. It must be kept in mind that, while the risks of underwriting and investment closely relate to one another, the solutions to problems that can and do arise in either sphere of activity are mutually exclusive. Underwriting problems require underwriting solutions. Investment problems require investment solutions.
2. These limits exist for the regulator's guidance. Limits should not be set at the level one would willingly accord to the most skilled and most financially capable investor, but rather at the level at which the commissioner should be prompted to make an inquiry. There is a point at which responsible industry participants and the general public should want the commissioner's staff to make an inquiry about the activities of potentially irresponsible industry participants.
3. The proposed limits do not bar insurers with capital in excess of the minimum asset requirement from investing their discretionary capital as they please, subject to their own written investment policy.

The following comments are presented as a combined response to the specific comments we received since June 2.

June 24, 2010

Page Two

Generally, articles of incorporation confer upon a board of directors the duties and ultimate responsibility for managing the affairs of the corporation. Those directors generally are authorized to delegate duties and responsibilities to management, subject to the board's ultimate oversight and responsibility. As I see it, management has no authority except by delegation from the board.

In the proposed modernization bill, we have tried to be very intentional in our use of the terms board and insurer to recognize the board's ultimate authority and its ability to delegate. Sections 5 and 6 follow that intentionality and only require board action to approve an investment policy developed by the insurer (however that development has been delegated internally) following the guidelines set out in those sections. Even current law (RCW 48.13.340), which will be retained, recognizes the board's right to delegate authority regarding investment transactions. I see Sections 5 and 6 as merely clarification of existing law by adding specific guidelines to be considered in the investment process.

Section 7 limits investment in partnerships, joint ventures, and limited liability companies to the "basket clause" limits of Sec. 7(12) with prior approval of the commissioner. While many mutual funds formed as LLP or LLCs are traded on established exchanges and provide investment liquidity and a readily determinable market value per share, many investments in LLPs and LLCs are not. This lack of price transparency and liquidity remains a concern with regard to insurer reporting and liquidity of investments. Partnerships and joint ventures often present extended liabilities for insurers that are not necessarily reflected or accounted for in the investment price. Prior approval allows an opportunity to review the liability issue.

Section 7 also classifies Canadian investment as foreign investment. Even though we border Canada and it is our largest trading partner, when insurers run into trouble there are sovereign jurisdiction and treaty issues that can complicate the marshalling of insurer assets for the protection of United States' policy holders. Recovery on troubled foreign investments may present unique problems. We would appreciate further analysis on how liquidation and recovery of Canadian investments is substantially similar to liquidation and recovery of U.S. investments.

Section 8, Annotation 6, # 3 of the defined standards model law is not contemplated as statutory language but as explanation of the value of restriction in the context of defined standards model law. We see nothing in the draft modernization bill which prevents investments beyond those identified in Sections 7 and 8, as long as the investment is not prohibited and the insurer meets MAR. We see no need for the suggested addition to Sec. 8.

Section 8(1)(c) limits domestic equity investments by including an insurer's subsidiary investments against the aggregate equity limit. We recognize that an insurer's investment portfolio and subsidiaries can serve different purposes. Our experience indicates that subsidiary investments tend to be longer term investments and, therefore, less liquid. As written, this section does not prohibit investment in subsidiaries, it merely requires more liquid investments in the calculation of MAR.

Section 8(1)(c)(ii) limits an insurer's subsidiary investments. The proposed limitations were drafted with an understanding of general industry averages. Limiting an insurer's investment in its subsidiaries to the lesser of 10% of its admitted assets or 50% of its surplus will lessen investment risk by decreasing concentrations of subsidiary investment. As written, this

June 24, 2010

Page Three

proposed bill would allow the commissioner to consider special circumstances to allow larger investments.

Section 8(1)(c) allows a non-life insurer to hold up to 25% of its admitted assets in domestic equities authorized by Section 7(4). Section 8(1)(f) allows a non-life filer to hold up to an additional 20% of admitted assets in foreign debt and equities authorized by Section 7(7). These two subsections allow for the possible aggregate investment of up to 45% of its admitted assets, if the insurer does not have any subsidiary investments under Section 8(1)(c). In determining whether or not a mutual fund investment is properly classified as an investment under Section 7(4) or Section 7(7), we will first verify the mutual fund is registered with the SEC and then look to the underlying investments of the mutual fund.

Section 8(1)(a)(v) limits the aggregate amount of investment in medium and lower grade obligations that pay cash income less than the equivalent yield for a Treasury issue with a comparable average life to 1% of its admitted assets. Insurers are not required to invest in these riskier investments. This bill limits what investments can be counted toward MAR. If on any financial statement date, the total investment exceeded the limit, the excess would not be counted toward MAR.

Section 8(2) limits insurer investment in SVO listed mutual funds to no more than 5% of its admitted assets. We believe this model law language preserves the diversification across investment types and investment funds necessary to minimize investment risk.

Section 8(2) decreases the amount allowed to be invested in the securities of a single issuer and its affiliates from 4% of admitted assets to 3% of admitted for life insurers. We believe the diversification provided by this model law language is essential in minimizing investment risk, particularly for smaller insurers.

Section 8(3), by its express terms, applies to the admitted portion of assets for all subsidiaries authorized by Section 7(4)(g).

Section 18 gives the OIC broad rule making authority to establish minimum financial security benchmarks and by order to exempt specific insurers from specific rule. This is model law language that has only been modified to identify the fact that any rule-making must be done under the constraints of the Administrative Procedures Act (APA). The APA process provides insurers ample time and opportunity to be actively involved in the rule adoption process and provides for a reasonable structured implementation of the rule.

A telephone inquiry asked if under Section 8(2), FNMA, FHLMC, and FHLB were government subsidiaries. Our position is that those entities are not government subsidiaries and are subject to the 3% or 5% limitations of Section 8(2).

Sincerely,



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