

Investment Statute Modernization

Comments/Observations on the Existing Statutes

The following are comments/observations on the existing code.

General Comments/Observations

Readability: The existing code has been modified and patched many times over the years resulting in a fragmented structure that is difficult to read and follow. The statute must be easier to read and understand.

Based on Modern Portfolio Theory: Modernization of the investment code should balance the modern portfolio theory which is based on the prudent investor rule over that of the prudent man rule.

Basis for statutes: The basis for statutes and the way they are written should not be taken from audit guidelines.

Code Specific (Other Than Mutual Funds) Comments/Observations

LLC: LLC should be expanded to include other properties and asset classes other than “What the insurer owns and wants to develop”.

Limits on Subsidiaries: Subsidiaries should not be limited to 4% of the insurer’s assets. Requesting special consent annually per WAC 284-07-520 (permitted practice) should not be considered an acceptable practice.

Subsidiary Profitability: Not all subsidiaries are held for profit. Some support convenience for our policyholders, such as a brokerage agency for lines of business that we do not write.

Corporate Obligations: (investment grade) This section is very difficult to work with and understand. Also, this section only allows fixed interest, therefore any variable rate corporate securities are not specifically permitted. The depth of review should apply to medium and lower grade obligations, not investment grade.

Common Stock: This section can be interrupted to include only value stocks, that is, stocks that pay dividends. Companies that don’t pay dividends are reinvesting into themselves which will translate into insurer’s income through capital gains. This section will need revision to account for growth stocks.

Foreign Securities: Global economies are becoming more interdependent on each other and growth opportunities are becoming more evident in emerging market countries. The existing statute prohibits investing in these markets. Modern portfolio theory suggests that a moderate allocation to these markets would be appropriate. A clear definition would be helpful.

Obligations Rated by the SVO: Not all obligations are rated by the SVO. For example, filing exempt securities are not rated by the SVO. However, the Policy and Procedures manual gives the insurer a procedure to determine a rating. This section fails to recognize this. Also, the current NAIC ARO’s are refusing to provide a rating for “Escrowed to Maturity” and “Pre-refunded” municipal bonds unless the issuer pays the ARO a fee. The rating agencies are holding these Treasury-like securities hostage which could force insurers to file these securities with the SVO, which will come out of the policyholder’s surplus.

Specific Upcoming Mutual Fund Legislation

Benefits and Purposes for the Use of Mutual Funds

Liquidity: By using NAIC qualified money market funds, we can earn a competitive rate while having access to funds on a same day basis.

Diversification: By using mutual funds, we can diversify our holdings without the need to commit excessive capital to any one asset class. We can invest small amounts.

Outsource Manager Expertise: By using mutual funds, we can access fund management expertise in areas where we do not want to hire that expertise internally. For example, high yield or international equities.

What We Would Like to See

Code Section: Mutual funds, Exchange Traded Funds (ETF) and money market funds, collectively, should be written under their own section for clarity. Alternatively, mutual funds could be identified within their respective categories; money market funds in cash, bond fund in bonds and equity funds in equities.

Inclusion: Mutual fund legislation should include all aspects of mutual funds including ETF and money market funds.

Limits: Limits on mutual funds, ETF and money markets should be eliminated or set significantly higher than the current 4% rule. Passive (index) funds could have a higher limit or no limit.

Level of Review: Mutual funds, ETF and money markets should be reviewed on the general characteristics of the fund itself and not the underlying assets of the funds (i.e. no look-through provision). From our understanding, this is similar to what other states have adopted in their statutes.

Unique Consideration to Guard Against

Look-Through: The proprietary nature of mutual funds makes any look-through a challenge and impossible to determine holdings at the time of purchase or to attain current holdings at any review period.

Issuer Based Limits: The current provision under RCW 48.13.030 (4% rule) works for corporate and municipal issuers, but is not a workable limitation for a mutual fund family.

Diversification by Nature: A mutual fund by nature provides diversification. An S&P 500 fund removes non-systematic risk leaving only the market risk itself. Limiting such funds or similar funds seems counterproductive.

Summary

The current investment statutes are antiquated and force the reader to jump from section-to-section making it difficult to understand. The structure of the statutes increase the likelihood of conflicting law. It is our belief that RCW 48.13 should be replaced in its entirety with new code. After our initial review of the “Defined Standards Version” and the “Defined Limits Version”, it is our opinion that the Defined Standards Version should be the foundation upon which

Washington's insurance investment statutes are based. It is our belief that some adjustments to limits and clarification of terms would be required. It is also our belief that clear direction on the statute's foundation should be determined early so that focus on that code and any adjustments to that code can be handled efficiently.