INVESTMENTS OF INSURERS MODEL ACT
(Defined Standards Version)

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Statement of Principles

The development of regulation of the investments of insurers requires an analysis of the complexities, uncertainties, and competitive forces and frequent changes in the investment markets and in the insurance business, the diversity among insurers, and the need for a balance among risk, reward and liquidity of an insurer's investments. It also requires an analysis of how to safeguard the financial condition of domestic insurers and at the same time to permit domestic insurers to be competitive with insurers domiciled in other states and with other financial industries that operate under different regulatory regimes.

Each state is urged to determine through independent study which methods are best suited to its needs, and whether its existing regulatory structure may be improved by using provisions from either or both of the model laws recommended by the National Association of Insurance Commissioners (NAIC) or from existing regulatory structures in other states or industries. Two alternative model laws are recommended by the NAIC. These are:

A. Investments of Insurers Model Act (Defined Limits Version);

B. Investments of Insurers Model Act (Defined Standards Version).

These model laws are not considered by the NAIC to exhaust regulatory methods to address the regulation of investments of insurers. Nor are these model laws recommended by the NAIC to be used as standards for the examination of insurers unless substantially similar provisions are found in the statutes and regulations of the state of domicile of the insurer.

Drafting Note: States considering provisions in this model should also read the statement of principles and annotations prepared by the drafters to supplement and explain significant concepts in investment statutes.

Section 1. Purpose and Scope

A. The purpose of this Act is to protect and to further the interests of insureds, creditors and the general public by providing, with minimum interference with management initiative and judgment, prudent standards for the development and administration of insurer investment programs.

B. This Act and the regulations adopted to interpret and implement it apply to domestic insurers and U. S. branches of alien insurers entered through this state, except for insurers organized pursuant to [cite statutes applicable to exempted insurers].

Drafting Note: This Act does not define the types of insurers subject to its provisions, leaving this to other sections of the code since state laws treat insurers writing various lines of insurance differently. For example, if an entity is authorized to operate as a health maintenance organization, the state may provide different investment authority commensurate to operating as a health maintenance organization.

C. Separate accounts established in accordance with [cite statutes allowing the creation and maintenance of separate accounts] shall be evaluated separately pursuant to that section.

Section 2. Definitions

For purposes of this Act:

A. "Derivative instrument" means an item appropriately reported in schedule DB (derivative instruments) or schedule DC (insurance futures and insurance futures options) of an insurer's statutory financial statement (or successor schedules), pursuant to applicable annual statement instructions or statutory accounting guidelines.

B. "Derivative transaction" means a transaction involving the use of one or more derivative instruments.

C. "Income generation" means a derivative transaction involving the writing of covered options, caps or floors that is intended to generate income or enhance return.

D. "Lower grade investment" means a rated credit instrument or debt-like preferred stock rated 4, 5 or 6 by the Securities Valuation Office of the National Association of Insurance Commissioners (NAIC) or any successor office.

E. "Medium grade investment" means a rated credit instrument or debt-like preferred stock rated 3 by the Securities Valuation Office of the NAIC or any successor office.

F. "Minimum asset requirement" is the sum of an insurer's liabilities and its minimum financial security benchmark.

G. "Minimum financial security benchmark" is the amount an insurer is required to have under Section 3.

H. "Replication" means a derivative transaction involving one or more derivative instruments being used to modify the cash flow characteristics of one or more investments held by an insurer in a manner so that the aggregate cash flows of the derivative instruments and investments reproduce the cash flows of another investment having a higher risk-based capital charge than the risk-based capital charge of the original investments or investments.

I. "SVO listed mutual fund" means a money market mutual fund or short-term bond fund that is registered with the United States Securities and Exchange Commission under the Investment Company Act of 1940, and that has been determined by the NAIC's Securities Valuation Office to be eligible for special reserve and reporting treatment (other than as common stock).

Section 3. Minimum Financial Security Benchmark

A. Minimum Financial Security Benchmark.

(1) Unless otherwise established in accordance with Paragraphs (2) and (3) of this subsection, the amount of the minimum financial security benchmark for an insurer shall be the greater of:

(a) The authorized control level risk-based capital applicable to the insurer as set forth by [insert reference to the risk-based capital law] less the asset valuation reserve and voluntary investment reserves as defined under [insert reference to the risk-based capital law]; or

(b) The minimum capital or minimum surplus required by statute or regulation for maintenance of an insurer's certificate of authority.

(2) The commissioner may, in accordance with the factors in Subsection B(2) of this section, establish by order a minimum financial security benchmark to apply to a specific insurer provided it is not less than the amount determined by Paragraph (1) of this subsection.

(3) Except as provided in [cite applicable state laws consistent with drafting note following Section 1B], the commissioner may establish by regulation a minimum financial security benchmark that is a multiple of authorized control level risk-based capital to apply to any class of insurers provided the amount established by the regulation is not less than the amount determined in Paragraph (1) of this subsection.

B. The commissioner shall determine the amount of surplus that shall constitute an insurer's minimum financial security benchmark, as an amount that will provide reasonable security against contingencies affecting the insurer's financial position that are not fully covered by reserves or by reinsurance.

Drafting Note: Insert the title of the chief insurance regulatory officer whenever the term "commissioner" appears.

(1) Types of contingencies. The commissioner shall consider the risks of:

(a) Increases in the frequency or severity of losses beyond the levels contemplated by the rates charged;

(b) Increases in expenses beyond those contemplated by the rates charged;

(c) Decreases in the value of or the return on invested assets below those planned on;

(d) Changes in economic conditions that would make liquidity more important than contemplated and would force untimely sale of assets or prevent timely investments;

(e) Currency devaluation to which the insurer may be subject; and

(f) Any other contingencies the commissioner can identify that may affect the insurer's operations.

(2) Controlling factors. In making the determination under this subsection, the commissioner shall take into account the following factors:

(a) The most reliable information available as to the magnitude of the various risks under Paragraph (1) of this subsection;

(b) The extent to which the risks in Paragraph (1) of this subsection are independent of each other or are related, and whether any dependency is direct or inverse;

(c) The insurer's recent history of profits or losses;

(d) The extent to which the insurer has provided protection against the contingencies in other ways than the establishment of surplus; including redundancy of premiums, adjustability of contracts under their terms, investment valuation reserves whether voluntary or mandatory, appropriate reinsurance, the use of conservative actuarial assumptions to provide a margin of security, reserve adjustments in recognition of previous rate inadequacies, contingency or catastrophe reserves, diversification of assets and underwriting risks;

(e) Independent judgments of the soundness of the insurer's operations, as evidenced by the ratings of reliable professional financial reporting services; and

(f) Any other relevant factors.

Section 4. Authorized Investments

A. Subject to the provisions of this Act, an insurer may loan or invest its funds, and may buy, sell, hold title to, possess, occupy, pledge, convey, manage, protect, insure and deal with its investments, property and other assets to the same extent as any other person or corporation under the laws of this state and of the United States.

B. With respect to all of the insurer's investments, the board of directors of an insurer shall exercise the judgment and care, under the circumstances then prevailing, that persons of reasonable prudence, discretion and intelligence exercise in the management of a like enterprise, not in regard to speculating but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital. Investments shall be of sufficient value, liquidity and diversity to assure the insurer's ability to meet its outstanding obligations based on reasonable assumptions as to new business production for current lines of business. As part of its exercise of judgment and care, the board of directors shall take into account the prudence evaluation criteria of Section 5 of this Act.

C. The insurer shall establish and implement internal controls and procedures to assure compliance with investment policies and procedures to assure that:

(1) The insurer's investment staff and any consultants used are reputable and capable;

(2) A periodic evaluation and monitoring process occurs for assessing the effectiveness of investment policy and strategies;

(3) Management's performance is assessed in meeting the stated objectives within the investment policy; and

(4) Appropriate analyses are undertaken of the degree to which asset cash flows are adequate to meet liability cash flows under different economic environments. These analyses shall be conducted at least annually and make specific reference to economic conditions.

Section 5. Prudence Evaluation Criteria

The following factors shall be evaluated by the insurer and considered along with its business in determining whether an investment portfolio or investment policy is prudent; the commissioner shall consider the following factors prior to making a determination that an insurer's investment portfolio or investment policy is not prudent:

A. General economic conditions;

B. The possible effect of inflation or deflation;

C. The expected tax consequences of investment decisions or strategies;

D. The fairness and reasonableness of the terms of an investment considering its probable risk and reward characteristics and relationship to the investment portfolio as a whole;

E. The extent of the diversification of the insurer's investments among:

(1) Individual investments;

(2) Classes of investments;

(3) Industry concentrations;

(4) Dates of maturity; and

(5) Geographic areas;

F. The quality and liquidity of investments in affiliates;

G. The investment exposure to the following risks, quantified in a manner consistent with the insurer's acceptable risk level identified in Section 6H:

(1) Liquidity;

(2) Credit and default;

(3) Systemic (market);

(4) Interest rate;

(5) Call, prepayment and extension;

(6) Currency; and

(7) Foreign sovereign;

H. The amount of the insurer's assets, capital and surplus, premium writings, insurance in force, and other appropriate characteristics;

I. The amount and adequacy of the insurer's reported liabilities;

J. The relationship of the expected cash flows of the insurer's assets and liabilities, and the risk of adverse changes in the insurer's assets and liabilities;

K. The adequacy of the insurer's capital and surplus to secure the risks and liabilities of the insurer; and

L. Any other factors relevant to whether an investment is prudent.

Section 6. Insurer Investment Policy

In acquiring, investing, exchanging, holding, selling and managing investments, an insurer shall establish and follow a written investment policy that shall be reviewed and approved by the insurer's board of directors at least annually. The content and format of an insurer's investment policy are at the insurer's discretion, but shall include written guidelines appropriate to the insurer's business as to the following:

A. The general investment policy of the insurer containing policies, procedures and controls covering all aspects of the investing function;

B. Quantified goals and objectives regarding the composition of classes of investments, including maximum internal limits;

C. Periodic evaluation of the investment portfolio as to its risk and reward characteristics. This subsection shall not preclude an insurer from the use of "modern portfolio theory" to manage its investments;

Drafting Note: States may wish to consider whether it is necessary to include a definition of "modern portfolio theory" as used in Section 6C.

D. Professional standards for the individuals making day-to-day investment decisions to assure that investments are managed in an ethical and capable manner;

E. The types of investments to be made and those to be avoided, based on their risk and reward characteristics and the insurer's level of experience with the investments;

F. The relationship of classes of investments to the insurer's insurance products and liabilities;

G. The manner in which the insurer intends to implement Section 5; and

H. The level of risk (based on quantitative measures) appropriate for the insurer given the level of capitalization and expertise available to the insurer.

Section 7. Authorized Classes of Investments

The following classes of investments may be counted for the purposes specified in Section 11, whether they are made directly or as a participant in a partnership, joint venture or limited liability company:

A. Cash in the direct possession of the insurer or on deposit with a financial institution regulated by any federal or state agency of the United States;

B. Bonds, debt-like preferred stock and other evidences of indebtedness of governmental units in the United States or Canada, or the instrumentalities of the governmental units, or private business entities domiciled in the United States or Canada, including asset-backed securities and SVO listed mutual funds;

C. Loans secured by mortgages, trust deeds, or other security interests in real property located in the United States or Canada or secured by insurance against default issued by a government insurance corporation of the United States or Canada or by an insurer authorized to do business in this state;

D. Common stock or equity-like preferred stock or equity interests in any United States or Canadian business entity, or shares of mutual funds registered with the Securities and Exchange Commission of the United States under the Investment Company Act of 1940, other than SVO listed mutual funds;

E. Real property necessary for the convenient transaction of the insurer's business;

F. Real property, together with the fixtures, furniture, furnishings and equipment pertaining thereto in the United States or Canada, which produces or after suitable improvement can reasonably be expected to produce substantial income;

G. Loans, securities, or other investments of the types described in Subsections A to F of this section in countries other than the United States and Canada;

H. Bonds or other evidences of indebtedness of international development organizations of which the United States is a member;

I. Loans upon the security of the insurer's own policies in amounts that are adequately secured by the policies and that in no case exceed the surrender values of the policies;

J. Tangible personal property under contract of sale or lease under which contractual payments may reasonably be expected to return the principal of and provide earnings on the investment within its anticipated useful life;

K. Other investments the commissioner authorizes by regulation; and

L. Investments not otherwise permitted by this section, and not specifically prohibited by statute, to the extent of not more than five percent (5%) of the first $500,000,000 of the insurer's admitted assets plus ten percent (10%) of the insurer's admitted assets exceeding $500,000,000.

Drafting Note: This Act is silent with respect to an insurer's participation in partnerships as a general partner. States may consider limitations on an insurer's authority to act as a general partner due to the legal complexities attendant on this role. The language in Subsection D of this section in no way authorizes the insurer to act as a general partner.

Section 8. Limitations Generally Applicable

A. Class Limitations. For the purposes of Section 11, the following limitations on classes of investments apply:

(1) Investments authorized by Section 7B, and investments authorized by Section 7G that are of the types described in Section 7B;

(a) The aggregate amount of medium and lower grade investments, twenty percent (20%) of its admitted assets;

(b) The aggregate amount of lower grade investments, ten percent (10%) of its admitted assets;

(c) The aggregate amount of investments rated 5 or 6 by the SVO, five percent (5%) of its admitted assets;

(d) The aggregate amount of investments rated 6 by the SVO, one percent (1%) of its admitted assets; or

(e) The aggregate amount of medium and lower grade investments that receive as cash income less than the equivalent yield for Treasury issues with a comparative average life, one percent (1%) of its admitted assets.

(2) Investments authorized by Section 7C, forty-five percent (45%) of admitted assets in the case of life insurers and twenty-five percent (25%) of admitted assets in the case of non-life insurers;

(3) Investments authorized by Section 7D, other than subsidiaries of the types authorized under [cite applicable provisions of holding company law] twenty percent (20%) of admitted assets in the case of life insurers and twenty-five percent (25%) of admitted assets in the case of non-life insurers;

(4) Investments authorized by Section 7E, ten percent (10%) of admitted assets;

(5) Investments authorized by Section 7F, twenty percent (20%) of admitted assets in the case of life insurers, and ten percent (10%) of admitted assets in the case of non-life insurers;

(6) Investments authorized by Section 7G, twenty percent (20%) of admitted assets;

(7) Investments authorized by Section 7H, two percent (2%) of admitted assets; and

(8) Investments authorized by Section 7J, two percent (2%) of admitted assets.

B. Individual limitations. For purposes of determining compliance with Section 11, securities of a single issuer and its affiliates, other than the government of the United States and subsidiaries authorized under [cite applicable provisions of holding company law], shall not exceed three percent (3%) of admitted assets in the case of life insurers, and five percent (5%) in the case of non-life insurers. Investments in the voting securities of a depository institution, or any company that controls a depository institution, shall not exceed five percent (5%) of the insurer's admitted assets.

C. Investment subsidiaries. For purpose of determining compliance with the limitations of this section, the admitted portion of assets of subsidiaries under [cite applicable provisions of holding company law] shall be deemed to be owned directly by the insurer and any other investors in proportion to the market value or if there is no market, the reasonable value, of their interest in the subsidiaries.

D. Effect of quantity limitations. To the extent that investments exceed the limitations specified in Subsections A and B, the excess may be assigned to the investment class authorized in Section 7L, until that limit is exhausted.

E. Special rule for mutual funds, pooled investment vehicles and other investment companies. If the commissioner considers it desirable in order to get a proper evaluation of the investment portfolio of an insurer, the commissioner may require that investments in mutual funds, pooled investment vehicles or other investment companies be treated for purposes of this Act as if the investor owned directly its proportional share of the assets owned by the mutual fund, pooled investment vehicle or investment company.

F. Unless otherwise specified, an investment limitation computed on the basis of an insurer's admitted assets or capital and surplus shall relate to the amount required to be shown on the statutory balance sheet of the insurer most recently required to be filed with the commissioner.

Drafting Note: States may consider additional language intended to prevent the "grossing-up" of admitted assets and consequent evasion of this Act's investment limitations by requiring that the amount of admitted assets be reduced by the amount of the liability recorded on an insurer's statutory balance sheet for; the return of acceptable collateral received in a reverse repurchase transaction or a securities lending transaction, cash received in a dollar roll transaction, and other amounts reported as borrowed money in the most recently filed financial statement.

Drafting Note: Some states encourage domestic investment as a matter of public policy through premium tax or other incentives. States with such a public policy might consider expanded individual issuer limitations for state general obligations, if a preference for public-sector investment is desired.

Section 9. Protection Against Currency Fluctuations

An insurer doing business that requires it to make payment in different currencies shall have investments in securities in each of these currencies in an amount that independently of all other investments meets the requirements of this Act as applied separately to the insurer's obligations in each currency. The commissioner may by order exempt an insurer, or by regulation a class of insurers, from this requirement if the obligations in other currencies are small enough that no significant problem for financial solidity would be created by substantial fluctuations in relative currency values.

Section 10. Prohibited Investments

A. (1) An insurer shall not invest in investments that are prohibited for an insurer by statutes or regulations of this state.

(2) The use of a derivative instrument for replication, or for any purposes other than hedging or income generation, is prohibited.

B. A reasonable time, not in excess of 5 years, shall be allowed for disposal of a prohibited investment in hardship cases if the investment is demonstrated by the insurer to have been legal when made, or the result of a mistake made in good faith, or if the commissioner deems that the sale of the asset would be contrary to the interests of insureds, creditors, or the general public.

Drafting Note: Derivative instruments shall not be used for replication, or for any purposes other than hedging or income generation, until such time as the National Association of Insurance Commissioners adopts methods of disclosure, reserving for risk-based capital and asset valuation reserve, and assessing risks associated with these investments. At that time, the prohibition against the use of derivative instruments for replication shall sunset.

Drafting Note: This Act does not address an insurer's investments in or loans to officers or directors or their immediate families. States should consider the need for specific guidance for these types of investments and loans if they are not addressed in another part of the insurance code.

Section 11. Effect of Investment Restrictions

A. Invested assets may be counted toward satisfaction of the minimum asset requirement only so far as they are invested in compliance with this Act and applicable regulations promulgated and orders issued by the commissioner pursuant to this Act. Assets other than invested assets may be counted toward satisfaction of the minimum asset requirement at admitted annual statement value.

B. An investment held as an admitted asset by an insurer on the effective date of this Act which qualified under [insert reference to state′s prior code provisions on insurer investments] shall remain qualified as an admitted asset under this Act.

C. Assets acquired in the bona fide enforcement of creditors' rights or in bona fide workouts or settlements of disputed claims may be counted for the purposes of Subsection A for five (5) years after acquisition if real property and three (3) years if not real property, even if they could not otherwise be counted under this Act. The commissioner may allow reasonable extensions of these periods if replacement of the assets within the periods would not be possible without substantial loss.

D. If an insurer does not own, or is unable to apply toward compliance with this Act, an amount of assets equal to its minimum asset requirement, the commissioner may deem it to be financially hazardous under [insert reference to statute providing the lawful grounds for liquidation and rehabilitation].

Section 12. Reports and Replies

A. The commissioner may require any of the following from a person subject to regulation under this Act:

(1) Statements, reports, answers to questionnaires and other information, and evidence thereof, in whatever reasonable form the commissioner designates, and at such reasonable intervals as the commissioner chooses.

(2) Full explanation of the programming of any data storage or communication system in use.

(3) That information from any books, records, electronic data processing systems, computers or any other information storage system be made available to the commissioner at a reasonable time and in a reasonable manner.

B. The commissioner may prescribe forms for the reports under Subsection A and specify who shall execute or certify the reports. The forms for the reports required under Subsection A shall be consistent, so far as practicable, with those prescribed by other jurisdictions.

C. The commissioner may prescribe reasonable minimum standards and techniques of accounting and data handling to ensure that timely and reliable information will exist and will be available to the commissioner.

D. Any officer, manager or general agent of an insurer subject to this Act, any person controlling or having a contract under which the person has a right to control the insurer, whether exclusively or otherwise, or a person with executive authority over or in charge of any segment of the insurer's affairs, shall reply promptly in writing or in other reasonably designated form, to a written inquiry from the commissioner requesting a reply.

E. The commissioner may require that any communication made to the commissioner under this section be verified.

F. A communication to the commissioner, or to an expert or consultant retained by the commissioner, required by the provisions of this Act shall not subject the person making it to an action for damages for the communication in the absence of actual malice.

G. Notwithstanding the provisions of Subsection F, the commissioner may bring suit against any person providing information required under this Act that is not truthful and accurate.

Drafting Note: If a state's insurance code and regulations contain provisions substantially similar to this section, the state may consider deleting this section or replacing this section with language contained in other portions of its code.

Section 13. Retention of Experts

The commissioner may retain at the insurer's expense attorneys, actuaries, accountants and other experts not otherwise a part of the commissioner's staff as may be reasonably necessary to assist in reviewing the insurer's investments. Persons so retained shall be under the direction and control of the commissioner and shall act in a purely advisory capacity.

Section 14. Commissioner's Orders

A. If the commissioner determines that an insurer's investment practices do not meet the provisions of this Act, the commissioner may, after notification to the insurer of the commissioner's findings, order the insurer to make changes necessary to comply with the provisions of this Act.

B. If the commissioner determines that by reason of the financial condition, current investment practice, or current investment plan of an insurer, the interests of insureds, creditors or the general public are or may be endangered, the commissioner may impose reasonable additional restrictions upon the admissibility or valuation of investments or may impose restrictions on the investment practices of an insurer, including prohibition or divestment.

C. The commissioner may count toward satisfaction of the minimum asset requirement any assets in which an insurer is required to invest under the laws of a country other than the United States as a condition for doing business in that country if the commissioner finds that counting them does not endanger the interests of insureds, creditors or the general public.

D. If the commissioner is satisfied by evidence of the solidity of an insurer and the competence of management and its investment advisors, the commissioner, after a hearing, may by order adjust the class limitations in Section 8, for that insurer, to the extent that the commissioner is satisfied that the interests of insureds, creditors and the public of this state are sufficiently protected in other ways. Adjustments granted with respect to Section 8, in aggregate, are limited to an amount equal to ten percent (10%) of the insurer's liabilities.

Section 15. Administrative Hearings

A. An insurer aggrieved by an order or any other act or failure to act of the commissioner regarding compliance with this Act or regulations promulgated under this Act may request a hearing by following the procedures of [insert citation to statutes on requesting hearings before the commissioner].

B. The commissioner shall hold hearings under this section privately unless the insurer requests a public hearing, in which case the hearing shall be public.

Drafting Note: This section is written to permit insurers to request or participate in hearings whether the cause of aggrievement is direct or indirect. This section contemplates that a state's hearing officer or other authorized public official may apply administrative law to make appropriate determinations of a complainant's standing. If a state's administrative statutes or regulations with respect to hearings bar any standing to parties other than those directly aggrieved by an act or omission of the commissioner, then the word "directly" should be inserted in Section 15A after "insurer" and before "aggrieved."

Drafting Note: If a state does not confine hearing requests and participation to only those parties that are directly aggrieved by an act or omission of the commissioner, then consideration must be given to the procedures that will be employed to publicize the subject of pending hearings and adjudge the standing of each party at interest that is not directly, but only indirectly, aggrieved. To allow participation of indirectly aggrieved parties in closed proceedings without adequate publication and screening procedures is likely to bias proceedings in that only parties in favor with those directly at interest would have an opportunity to seek standing and redress. This model law is silent with respect to specific publication and screening requirements.

Section 16. Confidentiality of Information

The investment policy, or information related to the investment policy provided to the commissioner for review under this Act shall be considered confidential and shall not be a public record or subject to subpoena, except as [insert citations to statutes on filing financial statements with the commissioner, statutes on examinations, and statutes on rehabilitation and liquidation] may permit disclosure.

Section 17. Conflict of Laws and Other Standards

A. This Act shall prevail over any other statute except [cite state holding company law] purporting to authorize an insurer to make a particular investment if the other statute was enacted before [fill in effective date], and shall prevail over any statute enacted thereafter unless the latter negates the application of this section or of particular provisions in this Act by specifically designating them by number.

B. An insurer shall value its assets in accordance with the valuation standards of the NAIC to the extent those standards are consistent with the statutes of this state or regulations or orders of the commissioner.

Drafting Note: If a state's insurance code and regulations contain provisions substantially similar to this section, the state may consider deleting this section or replacing this section with language contained in other portions of its code.

Section 18. Regulations

A. The commissioner may, in accordance with [insert citation to administrative procedures act or other statutes concerning promulgation of regulations], promulgate regulations interpreting and implementing the provisions of this Act.

B. The commissioner may, in accordance with [insert citation to administrative procedures, act, or other statutes concerning promulgation of regulations], promulgate special investment restrictions as follows:

(1) The commissioner may by regulation prescribe for defined classes of insurers special procedural requirements including special reports, prior approval or subsequent disapproval of investments.

(2) The commissioner may by regulation prescribe substantive restrictions on investments of defined classes of insurers, including:

(a) Specification of classes of assets that may not be counted toward satisfaction of the minimum asset requirement even though they may be counted for unrestricted insurers;

(b) Specification of maximum amounts of assets that may be invested in a single investment, or an issue, a class or a group of classes of investments, expressed as percentages of total assets, capital, surplus, legal reserves or other variables;

(c) Prescription of qualitative tests for investments and conditions under which investments may be made, including requirements of specified ratings from investment advisory services, listing on specified stock exchanges, collateral, marketability, currency matching and the financial and legal status of the issuer and its earnings capacity.

C. If the commissioner is satisfied by evidence of the solidity of an insurer and the competence of management and its investment advisors, the commissioner, after a hearing, may by order grant an exemption to that insurer from any restriction under Subsection B of this section to the extent that the commissioner is satisfied that the interests of insureds, creditors and the general public of this state are protected in other ways.

Section 19. Effective Date

This Act shall be effective [insert date].

Chronological Summary of Action (all references are to the Proceedings of the NAIC).

1997 Proc. 3rd Quarter 25-26, 268, 274-286 (adopted).
2001 Proc. 1st Quarter 372-373 (amendments adopted later are printed here).
2001 Proc. 2nd Quarter 11, 14, 319, 339 (amended).

ANNOTATIONS

INVESTMENTS OF INSURERS MODEL ACT
(Defined Standards Version)

Section 3

Annotation 1: This Act references certain capital standards, provides a framework in which these standards relate to the investment laws, and establishes consequences for failure to meet capital standards. To the extent an insurer's investment program is imprudent, the insurer is unsound.

The minimum financial security benchmark and the minimum asset requirement together form the cornerstone for this Act's approach. This approach represents an effort to solve the basic dilemma in regulating insurer investments: (1) that the investment staffs of most insurers are better equipped than the insurance department or the legislature to make decisions about the appropriate investment programs for themselves, and (2) that this is not true of all insurers. Managements of insurers are not equally wise, skilled or responsible. While many will agree that the expertise of an individual insurer with respect to setting its investment policy usually equals or exceeds that of regulators and legislators, many will also agree that allowing complete discretion on the part of an insurer would be an unsound means of protecting the public interest.

Setting a reasonable minimum financial security benchmark, and thus, a minimum asset requirement, for which a more stringent investment regulatory framework is used, allows a high level of company discretion for investments above the minimum asset requirement while still providing adequate regulatory protections for policyholders and claimants from adverse insurer financial results.

This section sets a minimum asset requirement under which invested assets counted toward satisfaction of the requirement must be invested according to the limitations and restrictions of this Act. Assets in excess of the minimum asset requirement would not be subject to these limitations and restrictions, except in qualified circumstances, and may be invested in accordance with the insurer's own written investment policy.

The key to this regulatory approach to investments, then, is the setting of the minimum financial security benchmark. States should consider the nature of the business, (e.g., property and casualty, life, health, financial guaranty, etc.) in looking at the factors for setting the minimum financial security benchmark. The various levels contained in the NAIC's risk-based capital models may be an appropriate standard for states to consider in setting the minimum financial security benchmark. In addition, from an enforcement and solvency regulation standpoint, it is important that the minimum financial security benchmark, and thus, the minimum asset requirement, be tied to the state's liquidation and rehabilitation laws. This means that an insurer failing to meet the minimum asset requirement would be considered in hazardous or potentially hazardous financial condition, allowing the commissioner to take appropriate regulatory action.

It is essential to describe three concepts for capital requirement in order to convey an understanding of this Act's approach.

1. The "minimum capital" (for stock corporations) and "minimum surplus" (for mutuals) are intended to provide solidity at the time a new corporation is launched, and for a reasonable time into the future, during the formative period. The amount needed depends on what the new insurer intends to do, and is fixed on the basis of the information given to the commissioner at the time of incorporation. This concept is included in this Act as Section 3A (1)(b).

   After formation, the financial needs of a company will change as it develops and expands its operations. A minimum capital or surplus fixed permanently at the time of incorporation is too static to satisfy developing needs. If the minimum capital or surplus were to accommodate all possible or imaginable developments, it would be so large that it would prevent all new incorporations.

2. The "minimum financial security benchmark" is designed to measure the minimum capital requirements of a going concern; it expands as the financial needs of the corporation expand, but it may also contract with them. It is the amount of surplus necessary to provide reasonable security against contingencies affecting the insurer's financial position that are not fully covered by reserves or by reinsurance. It is the lowest permissible figure, below which the insurer's operation could have to be considered so hazardous as to permit, but not require, delinquency proceedings. This concept is included as Section 3A (1)(a).
   The authorized control level risk-based capital may be seen by some states as being too small a margin of safety.

Some states may consider it advisable for an insurer at that point to have already initiated changes to its investment practices, or even to have been placed in liquidation or rehabilitation. Section 3A (3) offers a means to establish a higher standard for specific classes of insurers. Section 3A (2) permits the commissioner to establish a higher standard for a specific insurer by issuance of an order.

3. The "proper surplus" for a particular company's operation is a level for the determination of an insurer's board of directors, in consultation with management. Their viewpoint on the subject is constrained by the minimums imposed by other concepts of capital requirement. Desirable ratings from the principal rating agencies, for example, can be expected to require surplus in excess of the minimum financial security benchmark. "Proper surplus" does not require statutory definition.

Section 4

Annotation 2: This section is not intended to require strict matching of asset and liability cash flows nor to suggest that the insurer's investment staff or its investment consultants cannot undertake the required analysis of cash flows.

Annotation 3: For some insurers, such as farm mutuals, county mutuals, fraternals, etc., recognition of each of the factors might be confined to a written acknowledgment that one or two investment classes are the only classes appropriate for that company under a multitude of conditions. For a multistate or multinational company, a periodically revised, sophisticated appraisal of the economy and its effect on the company's operations, products and investments would be appropriate. The necessary degree of technical sophistication will legitimately vary based upon the type and size of the insurer.

Section 6

Annotation 4: The insurer's board of directors has the central responsibility for formulating and assuring implementation of the investment policy. The purpose of this section is to encourage the board of directors to define long-range objectives appropriate to the insurer, set a written investment policy consistent with these objectives, and make sure that management is following the plan. A good written investment policy promotes a clear understanding of objectives by both management and board, thereby preventing rash actions during inevitable periods of volatility. Most importantly, an investment policy can help an insurer to avoid running afoul of the law, or to jeopardize its policyholders' interests through poor investment choices. Regulatory review can assure that the investment plan document exists, and appears competent in its preparation.

Despite these potentially salutary effects, review of the investment plan is ill suited as the primary basis for regulatory enforcement. Indeed, this Act has no automatic filing requirement for an insurer's investment policy; rather, the commissioner may request it under Section 12 or may require automatic filing by a regulation promulgated under Section 18. As written, this Act does not contemplate formal approval of an insurer's investment policy by the commissioner.

The reason for this approach is that a plan, by its very nature, is strictly prospective. Regulatory enforcement must also consider actions and their results. An assessment of the prospective advisability of any insurer's written investment plan is subject to highly technical and academic argumentation. When an insurer's investment policy results in adverse financial trends, decisive action is needed, not ponderous symposia of investment theory before a court of law.

Section 7

Annotation 5: States could adopt an entirely different plan of investment categories based on an independently commissioned study, retain their existing investment categories, or seek guidance from the defined limits version of this Act. A state's history and indigenous industries may serve as useful considerations. For example, if oil exploration and refining have long been an important part of a given state's economy, and persons possessing the requisite knowledge and interest are thus more commonly found among residents of that state than throughout the nation at large, a special category for that investment may be worthy of consideration. Alternatively, a state may decide that its dependence on a particular industry is so substantial that it may wish to encourage its financial institutions to diversify, and accordingly, establish no preferential category.

Section 8

Annotation 6: States could adopt limitations based on an independently commissioned study, retain their existing limitations, or seek guidance from the defined limits version of this Act. 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.

Section 9

Annotation 7: This section recognizes that the ability to absorb investment risk varies inversely to the level of underwriting risk, and that this principle will generally apply to international operations as well as domestic operations.

If an insurer perceives that acceptable underwriting risks may be located in foreign nations with extremely unstable currencies and without suitable investment opportunities, the commissioner may waive requirements to hold the foreign-denominated securities that would otherwise be required through an order issued pursuant to Section 14B.

If alien requirements call for a larger investment in foreign-denominated assets than would otherwise count in satisfaction of the minimum asset requirement, Section 14C would authorize the commissioner to count these assets if doing so does not endanger the interests of insureds, creditors or the general public.

These exceptional circumstances do not undermine the principle that if an insurer has contracted to make payment in a given currency, it should have assets in that currency available to honor its obligations. Hedging will not normally be adequate in the case of significant, ongoing business commitments to a given alien insurance market.

Section 10

Annotation 8: Section 10B is a mechanism for the disposal of prohibited investments. It is not enough for a law merely to declare that certain investment practices or instruments are illegal. There must be a specific mechanism to effect a disposition or other resolution of the problem. Section 10B is one way, but not the only way, to respond to this necessity. For certain types of illegal investments or practices, a state might not want to include the hardship qualifications contemplated in this Act.

Section 11

Annotation 9: The crucial enforcement mechanism of this Act is that assets, which are not in compliance with this Act, do not count toward the minimum asset requirement. If an insurer does not meet the minimum asset requirement, then under Section 11D, the insurer may be deemed to be in financially hazardous condition, and the commissioner may commence delinquency proceedings against the insurer. The statutes enumerating the grounds for liquidation and rehabilitation should be modified to cross-reference to Section 11D if this Act is adopted by a state.

Section 12

Annotation 10: This Act does not specify sanctions that apply to concealment or falsification of records, or refusal to provide reports and replies (other than on the basis of one's rights under the constitution of the United States or of the constitution of this state). As the effectiveness of a discretion-based system depends upon the ability of the commissioner to acquire timely and accurate information, states should consider the need for appropriate sanctions applicable to violations of this section. For example, some state insurance codes provide, as an ultimate penalty, that concealment or falsification of records is one of the grounds for liquidation or rehabilitation.

Annotation 11: From time to time, persons, in following the law, will be called upon to make a report or reply that, answered with integrity, will place them in conflict with an insurer's board or management. It must be acknowledged that the limited immunity granted by this Act to persons making legally required communications or cooperating with an investigation would not fully protect persons from all possible forms of reprisal. This Act does not deal comprehensively with the question of legal immunities, or redress available to persons injured by unjustifiable reprisal. It is hoped that a broader consideration of these matters is to be found elsewhere within a state's laws. This Act concerns itself with providing a minimum level of protection from unjustifiable reprisals through the legal system. At a minimum, a person acting without malice should not be placed in legal jeopardy for complying with state law or cooperating with an investigation by governmental authorities.

Section 13

Annotation 12: The professional expertise and financial resources necessary to handle the review and investigation of most investment matters should be available through customary funding sources already in place. However, it is desirable that one option be to directly charge insurers to fund the cost of expert assistance on complex or highly technical investment questions that may arise in consequence of an insurer's investment plans or practices. It is difficult to anticipate the full extent of such special needs in the budget process. In addition, state governments often severely limit contingency funds in a conscientious effort to prevent waste. The funding mechanism for examinations is not necessarily sufficient, because it is not always feasible or desirable to call an examination when the matter at hand is limited in scope. Care should be taken to keep direct charges or other assessments made pursuant to this Act from being abused as blank checks, or as a form of ongoing taxation without explicit legislative approval.

Section 14

Annotation 13: Flexibility of response is critical to conscientious regulation of the insurance industry. Insurers vary by management quality, product mix, size, territory and reserving practices, to name only a few differences. A single set of standards cannot adequately encompass the investment requirements of every niche insurer in the industry, an industry filled with niche insurers. Regulations that do not consider this fragmentation of the industry will unduly restrict management initiative and judgment in certain lines of business, thereby raising the price and reducing the availability of insurance in certain lines.

Effective and ethical use of discretionary powers is essential to retain public confidence. The responsible regulator, much like the responsible insurance company executive, must keep the interests of insureds, creditors and the general public ever in mind. Even the most carefully designed investment laws will not protect the people of a state in which the regulators cannot or will not enforce the law.

The discretion provided to the commissioner in this Act is essential to permit regulation of an insurer's investments because of their complexities and uncertainties and because of competitive forces and changes in the insurance business and in the investment markets. This Act is not intended to be the sole source of the commissioner's regulatory authority, but is to be used in conjunction with and in harmony with the other regulatory tools available to the commissioner.

Section 16

Annotation 14: Transparency in financial and regulatory actions allows market and social forces to encourage both responsible insurance management and responsible insurance regulation. In addition, the hallmark of our free capital market is that few, if any, opportunities to establish a proprietary long-term competitive advantage can be found and preserved on an enduring basis. Accordingly, if a state has a strong open records law, care should be taken not to allow an overly broad construction of confidentiality beyond correspondence and communications of material that is clearly unique and proprietary. The investment policy of an insurer should be extended privileged status. However, mere reference, even detailed reference, to the subject of investment should not automatically result in classified status for the communication.

Section 17

Annotation 15: Well-designed laws are based upon careful consideration of the history of the jurisdiction to which they are intended to apply, and on an understanding of the legal climate in that jurisdiction. A state should not adopt this Act unless it has been adapted to meet the specific situation of the history, insurance industry, general economy, and legal precedents of the state. If a state's adoption of the regulatory approach suggested by this Act represents a significant departure from precedent, various conflicts of law are only to be expected despite the most diligent efforts to avoid them. This section suggests one way, but not the only way, of minimizing the impact of these situations.

