NAIC National Association of Insurance Commissioners & The CENTER for INSURANCE POLICY and RESEARCH

Capital Markets Special Report

The NAIC's Capital Markets Bureau monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of US insurance companies. A list of archived Capital Markets Bureau Special Reports is available via the index

U.S. Insurance Industry's Exposure to Short-term (Schedule DA) Assets

Short-term investments, such as those reported by insurers on Schedule DA, repay as cash within a year of acquisition. Cash equivalents are a subset of short-term assets that mature or repay as cash within 90 days of acquisition. Schedule DA does not include investments deemed to be cash equivalents, which are instead reported on a part of Schedule E. This special report discusses the U.S. insurance industry's exposure to Schedule DA assets, including a more detailed review of its exposure to certain money market funds (the largest category) within this Schedule.

As of year-end 2012, insurers held $137.2 billion of book/adjusted carrying value (BACV) in short-term investments. The largest component of their short-term holdings, representing almost half of Schedule DA assets, was certain money market funds. Insurers also held lesser amounts of other short-term assets, including bonds, affiliated investments and even mortgage loans. After money market funds, U.S. Treasury, agency and government-sponsored entity (GSE) debt was the second-largest exposure, at about 19% of the total. The table below provides a historical breakdown of assets reported in Schedule DA.

U.S. Insurance Industry Exposure to Schedule DA

($bil BACV) Description	2004	2006	2008	2010	2011	2012	% of 2012
Certain Money Market Funds	$37.0	$45.5	$89.4	$61.7	$64.3	$63.7	46.5
U.S. Treasury, Agency, & GSE Bonds	41.4	41.0	35.9	29.0	34.9	26.3	19.2
Industrial & Misc. Bonds	27.9	26.9	32.3	37.4	22.3	24.7	18.0
All Other Government Bonds	5.7	5.5	9.2	3.5	2.9	15.0	10.9
Parent, Subsidiary, & Affiliated Investments	3.2	2.4	4.0	3.3	4.6	4.3	3.1
Structured Bonds (all types)	0.8	0.4	0.4	0.2	0.2	0.1	0.1
Mortgages	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other	1.9	5.0	8.1	2.8	2.7	2.8	2.1
Total	**$117.9**	**$126.8**	**$179.4**	**$138.0**	**$132.0**	**$137.2**	**100.0**

The shorter maturities of Schedule DA assets are, by their nature, less sensitive to interest rates and less vulnerable to market fluctuations. As such, increasing allocations to Schedule DA assets in general reduces an insurer's liquidity risk. However, the trade-off for such safety is a lower average investment return. The table below shows that insurers increased their allocation to Schedule DA assets from 2.8% in 2007 to 3.8% in 2008, perhaps in response to uncertain market conditions and an increased demand for liquidity resulting from the financial crisis. The increased allocations to cash, cash equivalents and Schedule DA assets were partly responsible for the general trend toward lower investment returns in subsequent years.

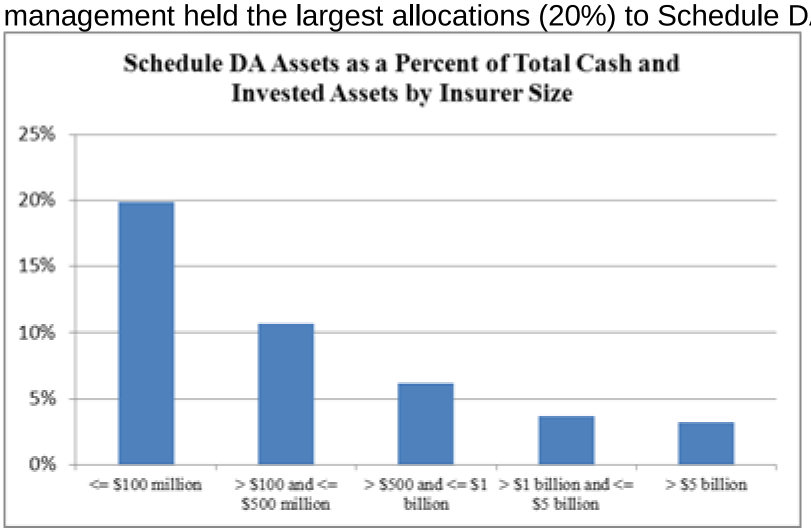
($bil BACV) All Industries	2004	2006	2008	2010	2011	2012
Schedule DA Assets	$117.9	$126.8	$179.4	$138.0	$132.0	$137.2
Schedule DA as % of Total Cash and Invested Assets	2.9%	2.8%	3.8%	2.7%	2.5%	2.6%
Cash and Cash Equivalents as % of Total Cash and Invested Assets	1.7%	1.8%	2.1%	1.5%	1.4%	1.7%
Gains from Cash, Cash Equivalents, & Short Term Investments	$2.7	$9.8	$6.3	$0.7	$0.5	$0.6
Return on Cash, Cash Equivalents, & Short Term Investments	2.9%	5.1%	2.6%	0.3%	0.3%	0.3%
Return on Total Cash and Invested Assets	10.7%	5.8%	5.4%	5.1%	5.0%	4.8%

The table below shows the historical percentage of Schedule DA assets across the five insurer types. The health industry has consistently been the largest holder of Schedule DA assets as a percentage of cash and invested assets over the years.

Schedule DA Assets as Percent of Total Cash and Invested Assets						
	2004	2006	2008	2010	2011	2012
Life	1.4%	1.5%	2.8%	1.9%	1.8%	2.0%
Property & Casualty	5.5%	4.9%	5.4%	3.8%	3.4%	3.1%
Health	11.1%	10.9%	15.1%	11.7%	11.9%	10.7%
Fraternal	4.0%	2.5%	2.2%	1.0%	1.2%	1.4%
Title	4.1%	4.4%	5.2%	1.7%	1.0%	1.6%

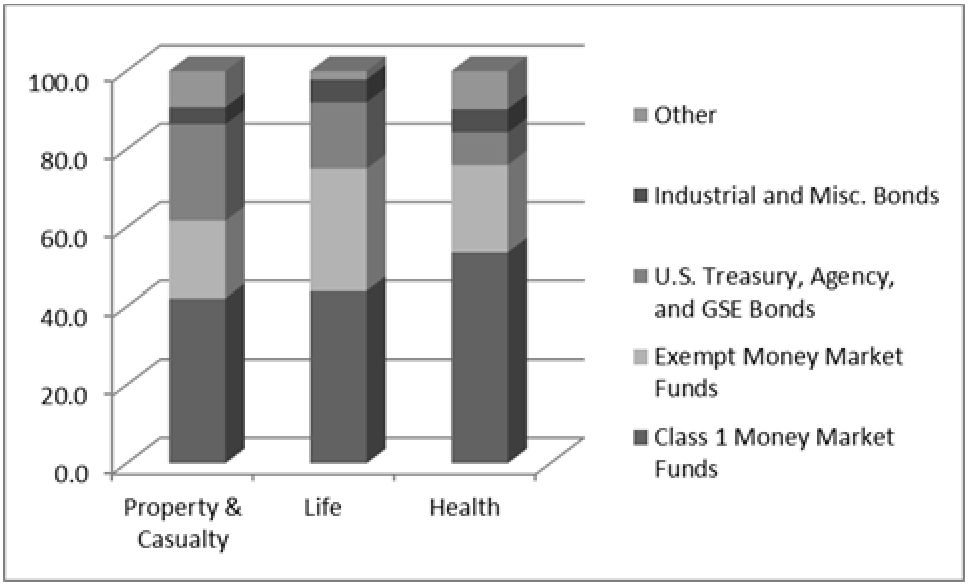
<u>Relationship between Schedule DA Holdings and Insurer Size</u>

Smaller insurers (that is, those with less than $100 million in cash and invested assets) invested a greater percentage of their total cash and invested assets in Schedule DA assets than larger insurers. This suggests smaller insurers tend to be more conservative with respect to asset-liability matching. As the chart below shows, insurers with less than $100 million of assets under management held the largest allocations (20%) to Schedule DA assets as of year-end 2012.



The chart below breaks down the Schedule DA investments of property/casualty, life and health insurers with less than $100 million of total cash and invested assets as of year-end 2012. As the chart shows, Schedule DA investments for "small" insurers consisted of mainly Class 1 money market funds. Exempt money market funds were also a large component.

Breakdown of Schedule DA Assets as of Year-End 2012
Insurers with Less Than $100 million of Total Cash and Invested Assets



Money Market Fund Classifications

A money market fund is an open-ended mutual fund that invests in low-risk, short-term debt securities. Regulated under Rule 2a-7 of the Investment Company Act of 1940, money market funds are important sources of liquidity for all types of investors as they can withdraw money at any time without penalty. In addition they earn a slightly higher yield than cash in bank deposits. Typical investments found within a money market fund include (but are not limited to) U.S. Treasury bills, commercial paper, repurchase and reverse repurchase agreements, banker's acceptances and short-term certificates of deposit. Certain money market funds have consistently been among the largest holdings of insurers within Schedule DA since 2005 and represented 47% of the industry's Schedule DA assets at year-end 2012.

Pursuant to the *Purposes and Procedures Manual of the NAIC Securities Valuation Office (SVO)*, the NAIC classifies money market funds reported on Schedule DA into two types: U.S. Direct Obligations/Full Faith and Credit Exempt List (Exempt); and Class 1 List (Class 1). Exempt funds are limited to money market funds that invest exclusively in the direct obligations (or backed by the full faith and credit) of the U.S. government (or collateralized repurchase agreements comprised of those securities) and maintain a money market fund rating of AAAm by Standard & Poor's (S&P) or Aaa-mf by Moody's Investors Service (Moody's) or an equivalent money market fund rating from another nationally recognized statistical rating organization (NRSRO). As such, they are not subject to risk-based capital (RBC) requirements. Class 1 funds have a minimum money market fund rating of Am by S&P or A-mf by Moody's (or an equivalent or higher quality rating from another NRSRO) and invest at least 97% of total assets in a combination of U.S. government securities, securities with the highest short-term credit quality rating, securities of money market funds that are registered investment companies, and collateralized repurchase agreements comprised of such obligations. In addition, both fund types must have a maximum redemption period of no more than seven days and a stable net asset value per share of $1 at all times. Funds that meet these stringent requirements are less volatile. For statutory accounting purposes, they are treated as debt because the quality of the underlying collateral within these funds is considered to be equivalent to U.S. government debt. The table below shows the historical split between exempt and Class 1 money market funds, along with a clear preference by insurers for Class 1 funds (which, coincidentally, offer higher returns). Nevertheless, the table also shows that, at times, insurers have increased their allocations to the better quality but lower-yielding exempt funds. Still (at least during the time periods shown) insurers' allocation to Class 1 money market funds has generally exceeded exposure to exempt funds.

($bil BACV)	2004	2006	2008	2010	2011	2012
Money Market Funds - Exempt	$6.8	$7.7	$26.4	$12.5	$20.3	$19.5
Money Market Funds - Class 1	$30.3	$37.9	$63.0	$49.2	$44.0	$44.2

Comparing insurer holdings of money market funds to the broader market, U.S. insurance industry exposure totaled $63.7 billion at year-end 2012, representing 5.4% of the $1.2 trillion money market fund total (as reported by the Federal Reserve Statistical Release dated June 6, 2013).

In addition to being divided into exempt and Class 1 funds, money market funds can be further reviewed by the type of fund provider. The most common money market fund providers within the U.S. insurance industry are asset managers, the largest of which (as of year-end 2012) are identified in the table below. Note that the three largest asset managers totaled roughly 25% of the industry's Schedule DA exposure to money market funds.

($bil) Asset Manager	$BACV	% of Schedule DA MMF* Exposure
Dreyfus	$6.3	9.8
BlackRock	4.9	7.7
Federated Investors	4.4	6.9
Fidelity	4.3	6.8
State Street	3.9	6.1
AIM Advisors	3.6	5.6
Northern Trust	2.4	3.7
Morgan Stanley	2.3	3.7
Others	11.9	18.7
Total	**$44.0**	**69.1**

*MMF = money market fund.

In addition to asset managers, bank holding companies also offer money market funds, and they accounted for the remaining 31% of money market fund providers within the U.S. insurance industry (as shown in the table below). Note that, in the table below, the top three banks accounted for 27% of the industry's Schedule DA money market fund exposure as of year-end 2012.

($bil) Bank Name	$BACV	% of Schedule DA MMF Exposure
JP Morgan Chase	$8.2	12.9
Wells Fargo Bank	5.4	8.4
Goldman Sachs	3.8	5.9
Bank of America	0.7	1.0
PNC Bank	0.5	0.7
UBS	0.2	0.4
Others	1.0	1.6
Total	**$19.7**	**30.9**

Money Market Funds: Historical Background

Money market funds were first offered in the U.S. in 1971 by The Reserve Fund, an asset manager based in Media, PA. The Reserve Fund sought to attract investors seeking yields greater than a passbook savings account but with equivalent "safety."

Money market funds report their net asset values (NAVs) at $1 per share. Unlike other types of mutual funds where investment returns result in a fluctuating fund share price, money market fund investment returns increase the number of shares investors hold. If a money market fund's NAV falls below $1 (known as "breaking the buck"), it means that the fund's assets are not sufficient to cover the shareholder claims; that is, investors have lost money. Only three money market funds in history have "broken the buck." One of those funds — the Reserve Primary Fund — was affiliated with The Reserve Fund.

Money Market Funds that "Broke the Buck"

Fund Name	Date	NAV at Liquidation
First Multifund for Daily Income (FMDI)	1978	$0.94
Community Bankers US Government Fund	1994	$0.96
Reserve Primary Fund (member of The Reserve Fund family of funds)	9/16/2008	tbd*

*To be determined upon full liquidation.

Impact of the Financial Crisis on Money Market Funds

As of Dec. 31, 2007, insurers held more than $700 million of Reserve Primary Fund exposure, the majority (or 80%) of which were life insurers. Total insurer exposure was roughly 1% of the fund's $65 billion in total assets. On Sept. 16, 2008, the day after Lehman Brothers Holdings Inc. filed Chapter 11 bankruptcy, Reserve Primary Fund broke the buck after its shares fell to $0.97 following the write-down of its exposure to $785 million of Lehman Brothers commercial paper. Investors in general became concerned about money market funds. Many sought to redeem their holdings, forcing many more money market funds to liquidate assets or impose limits on redemptions. Money market funds generally hold investments that mature within weeks or months, but are required to be able to redeem shares within days. This maturity mismatch caused the funds to be vulnerable to redemption notices in excess of the cash and equivalents immediately available.

In response to the greater-than-usual volume of redemptions, in September 2008 the U.S. Department of the Treasury announced a temporary and optional program whereby the Exchange Stabilization Fund (which promotes exchange rate stability) would make available up to $50 billion to insure the holdings of any publicly offered eligible money market mutual fund. The program guaranteed that the NAV of a covered fund's shares would not fall below $1 or “break the buck,” and was similar to the federal program that insures U.S. bank deposits via the Federal Deposit Insurance Corporation. However, one month later, the federal Emergency Economic Stability Act of 2008 effectively barred the U.S. Treasury from using the Exchange Stabilization Fund “for the establishment of any future guaranty programs for the U.S. money market mutual fund industry.”

In March 2010, the U.S. Securities and Exchange Commission (SEC) imposed assorted new rules specifically for money market funds designed to reduce risk-taking behavior. They included six key provisions: improved liquidity (e.g. 30% of money market funds’ holdings must be liquid within one week; higher credit quality (maximum of 3% invested in second tier securities); shorter portfolio maturities (e.g. maximum weighted average maturity of a fund’s portfolio restricted to 60 days); periodic stress tests to evaluate a fund’s ability to withstand shocks; enhanced disclosure (monthly reporting of holdings); and authorization of a fund’s board of directors to suspend redemptions if a fund breaks the buck. The usefulness of these reforms was soon tested by various capital market stresses that occurred in 2011, including crises related to the Eurozone countries. Despite the difficult capital markets conditions, money market funds emerged generally unaffected operationally, according to analysis provided by the Investment Company Institute. And, money market funds continue to play an important role in insurer short-term investments.

Since then, in December 2012, staff from the SEC’s Division of Risk, Strategy and Financial Innovation published a study that included a detailed analysis of possible causes of investor redemptions in money market funds during the recent financial crisis, characteristics of money market funds before and after the 2010 reforms, and how future reforms might affect investor demand for money market funds. The study showed that government money market funds generally are not susceptible to heavy redemptions or runs due to the nature of the underlying assets. In turn, in June 2013 the SEC proposed a couple of alternative reforms which would include additional fund diversification and disclosure measures; however, these recent proposals were still pending as of mid-November 2013.

Conclusion

Schedule DA contains a variety of short-term investments that are reported as such by the U.S. insurance industry. While certain money market funds are the largest exposure within Schedule DA assets, U.S. Treasury and U.S. government-related bonds are the second-largest, and mortgages account for a much smaller proportion. The amount insurers invest in Schedule DA assets may, in part, reflect their market sentiment; that is, it increases when they deem the safety and liquidity of short-term investments as an appropriate strategy, and it decreases when insurers feel more confident about assuming investment risks. Or, Schedule DA assets may simply represent a place to “park” funds until more attractive opportunities become available. They are low-risk assets and represent an important source of liquidity for all insurers.

The Capital Markets Bureau will continue to monitor developments within this asset class and report as deemed appropriate.

November 15, 2013								
Major Insurer Share Prices			**Change %**			**Prior**		
		Close	**Week**	**QTD**	**YTD**	**Week**	**Quarter**	**Year**
Life	Aflac	$67.48	2.6	5.9	27.6	$65.75	$63.72	$52.89
	Ameriprise	105.47	2.3	13.6	68.9	103.12	92.84	62.45
	Genworth	14.54	1.5	12.7	94.1	14.33	12.91	7.49
	Lincoln	50.00	2.5	16.1	94.0	48.76	43.08	25.77
	MetLife	52.01	3.7	9.1	58.8	50.14	47.66	32.76
	Principal	49.19	1.5	13.4	73.3	48.44	43.39	28.38
	Protective	47.84	2.6	9.3	68.0	46.64	43.76	28.47
	Prudential	88.62	2.0	13.1	66.9	86.90	78.39	53.09
	UNUM	33.31	0.5	8.4	60.7	33.16	30.72	20.73
PC	ACE	$98.70	0.4	6.4	24.2	$98.28	$92.78	$79.50
	Axis Capital	49.19	1.4	11.0	42.7	48.50	44.30	34.46
	Allstate	54.70	1.1	4.5	36.6	54.12	52.33	40.05
	Arch Capital	58.54	0.1	6.5	33.6	58.47	54.96	43.82
	Cincinnati	51.08	1.0	7.2	31.1	50.57	47.63	38.95
	Chubb	94.82	0.5	6.8	26.4	94.32	88.80	75.01
	Everest Re	157.83	0.9	6.8	43.9	156.42	147.73	109.67
	Progressive	27.40	3.1	0.3	30.4	26.58	27.33	21.01
	Travelers	88.67	1.0	4.7	24.0	87.80	84.66	71.53
	WR Berkley	43.75	1.1	2.8	16.4	43.29	42.54	37.59
	XL	31.39	0.4	0.8	25.9	31.25	31.14	24.94
Other	AON	$81.58	1.2	12.1	47.2	$80.60	$72.76	$55.41
	AIG	49.30	1.6	(0.4)	39.7	48.54	49.48	35.28
	Assurant	61.35	2.5	11.1	77.9	59.84	55.23	34.48
	Fidelity National	27.88	2.7	6.5	18.2	27.14	26.18	23.58
	Hartford	35.44	3.3	12.5	58.3	34.30	31.52	22.39
	Marsh	47.27	2.4	8.7	37.8	46.14	43.51	34.30
Health	Aetna	$65.08	2.7	(2.0)	41.0	$63.35	$66.40	$46.17
	Cigna	83.64	3.7	5.6	57.0	80.68	79.22	53.29
	Humana	98.27	3.2	1.8	43.6	95.19	96.52	68.43
	United	71.87	1.9	(1.6)	32.8	70.50	73.01	54.12
	WellPoint	90.10	3.2	3.3	48.4	87.28	87.24	60.73
Monoline	Assured	$23.59	10.1	20.7	67.1	$21.43	$19.54	$14.12
	MBIA	12.92	13.7	21.2	63.1	11.36	10.66	7.92
	MGIC	7.98	2.0	10.8	195.6	7.82	7.20	2.70
	Radian	13.21	1.6	(5.5)	114.8	13.00	13.98	6.15
	XL Capital	31.39	0.4	0.8	25.9	31.25	31.14	24.94

November 15, 2013 Major Market Variables	Close	Change % Week	QTD	YTD	Prior Week	Quarter	Year
Dow Jones Ind	15,961.70	1.3	5.9	21.8	15,761.78	15,072.58	13,099.80
S&P 500	1,798.18	1.6	6.4	26.4	1,770.61	1,689.92	1,422.10
S&P Financial	284.25	1.3	5.2	28.5	280.51	270.26	221.17
S&P Insurance	281.69	1.8	6.6	41.1	276.80	264.30	199.67
US Dollar $		Change %			Prior		
/ Euro	$1.35	1.0	(0.4)	2.2	$1.34	$1.36	$1.32
/ Crude Oil bbl	93.84	(0.8)	(9.4)	2.4	94.60	103.60	91.62
/ Gold oz	1,287.40	0.2	(1.7)	(23.1)	1,284.60	1,309.80	1,673.70
Treasury Ylds %	%	Change bp			%	%	%
1 Year	0.13	0.02	0.03	(0.02)	0.11	0.10	0.14
10 Year	2.71	(0.05)	0.06	0.95	2.75	2.65	1.76
30 Year	3.80	(0.06)	0.08	0.85	3.85	3.72	2.95
Corp Credit Spreads -bp		Change %			Prior		
CDX.IG	21.27	0.0	(15.0)	(62.7)	21.27	25.04	57.04

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